Assessing President Bush's Fiscal Policies

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The economy has struggled during the nearly four years of the Bush Administration. Household real incomes and net worth have fallen, there are fewer jobs, and households remain under substantial financial stress.

To ascribe this performance entirely to the President's economic policies would be incorrect, however. The economy has suffered a string of misfortunes from the bursting of the Y2K stock market bubble and corporate accounting scandals to 9/11 and the war on terrorism. Indeed, the economy's travails would have been substantially greater if not for the aggressive easing in monetary policy, and the fiscal stimulus provided by the President's tax cuts and surging government spending. The President cannot be faulted for his willingness to use all of the economic resources at his disposal to lift the heretofore flagging economy.

The President can be faulted, however, for how he has used those resources. The economic bang for the buck of the President's policies has been modest at best, and the result is a record federal budget deficit that is still growing. Even more worrisome is the prospect of continuing large budget deficits long into the future, which will weigh on the growth in jobs and living standards.

The Administration's response to this concern has wavered between largely dismissing the economic implications of large budget deficits to arguing that its policies will result in such a strongly expanding economy that the nation's budgetary problem will solve themselves. Neither is likely. More likely, the nation will eventually struggle with the Hobson's choice of future tax increases and/or painful cuts to government programs.

The purpose of this article is to assess the economic efficacy of fiscal policy during the Bush Presidency. The contribution of fiscal policy decisions to the economy's performance so far during his first term is quantified. How the economy would have performed under an alternative set of fiscal policies, designed specifically to stimulate the economy, is also considered. The economy's future performance is also assessed under the assumption that current policy, in which the President's tax cuts eventually expire, is unchanged, and under the assumption that the President's current policy proposals, in which his tax cuts are made permanent, are quickly adopted if he is re-elected. The article begins with an assessment of the economy's performance so far during the President's term.

Taking Stock. The economy has struggled during the Bush Presidency. Real GDP has expanded, but only slowly, growing at a 2.5% per annum rate. This is one of the weakest performances during any Presidential term since World War II. Indeed, this is the slowest top-line growth aside from that experienced during the second Eisenhower term in the late 1950s and Bush senior's term in the early 1990s (see Table 1).

The growth in real GDP has not been sufficient to forestall substantial job losses. There are some 1.1 million fewer payroll jobs today than when President Bush took office. No other President since World War II has suffered out-right job declines during their term. Those befallen by unemployment continue to have a difficult time finding new jobs. The average duration of unemployment remains at close to five months, which save for a brief period in the depths of the severe early 1980s recessions when unemployment soared to over 10%, is the longest unemployed workers have had to look for work before finding a new job since the Great Depression. An extraordinarily high still more than one-fifth of unemployed workers have been without a job for 27 weeks or more when workers' standard unemployment insurance benefits expire.

The unemployment rate has remained low during the President's term, averaging only 5.5%. This is near the average unemployment rate experienced throughout the past World War II period. This belies the health of the job market in recent years, however, due to an unprecedented decline in labor force participation. Since peaking in early 2001, the participation rate has declined by well over a percentage point. While a number of factors have driven participation lower, a key factor is potential workers' reticence to even look for a job given their belief that there are few viable job opportunities. If the participation rate had simply held steady since its peak, then the unemployment rate would have averaged over 6.5% during President Bush's term.

The struggling job market has been a millstone on household finances. Average real household income has remained largely unchanged and real median household income has fallen during President Bush's term. Weighing on incomes has been weak labor compensation growth. Total labor compensation as a share of national income is currently as low as it has been since the mid-1960s and wages and salaries as a share of income has never been lower.

Households are also less wealthy, as rising housing values have not been able

Table 1: The Economy's Performance During Presidential Terms Since World War II

	Real GDP Growth	Consumer Price Inflation	Employment Growth	Average Unemployment Rate	Real Median Household Income Growth	Real Household Net Worth Growth
Bush Presidency '01Q1 - '04Q1	**2.5**	**2.1**	**-0.2**	**5.5**	**-0.3**	**-0.6**
Clinton II '97Q1 - '00Q4	3.9	2.4	2.3	4.4	1.7	5.7
Clinton I '93Q1 - '96Q4	3.3	2.8	2.5	6.0	1.2	3.5
Bush I '89Q1 - '92Q4	2.1	4.2	0.6	6.3	-0.7	0.7
Reagan II '85Q1 - '88Q4	3.8	3.4	2.7	6.5	1.7	4.3
Reagan I '81Q1 - '84Q4	3.2	5.3	1.4	8.6	0.4	1.2
Carter '77Q1 - '80Q4	3.2	10.1	3.1	6.5	0.9	1.9
Nixon II - Ford '73Q1 - '76Q4	2.2	8.2	1.7	6.7	-1.2	-2.4
Nixon I '69Q1 - '72Q4	3.3	4.6	2.1	4.8	1.8	0.9
Johnson II '65Q1 - '68Q4	5.0	3.2	3.9	3.9	3.9	3.4
Kennedy - Johnson I '61Q1 - '64Q4	5.2	1.2	2.3	5.8	3.3	3.1
Eisenhower II '57Q1 - '60Q4	2.0	2.0	0.5	5.5	na	na
Eisenhower I 53Q1 - '56Q4	2.8	0.8	1.5	4.3	na	na
Previous Fifty Years	3.5	4.0	2.2	5.7	1.3	2.2
Average of Cycles from Recession Trough	3.0	3.6	1.3	6.5	1.0	1.1

Sources: BLS, BEA, Federal Reserve Board, Economy.com

to offset the impact of still lower stock values and rapidly rising household debt loads. Real household net worth is lower today than at the start of the President's term. It has risen in every other Presidential term.

A weak job market and incomes combined with a weaker balance sheet have resulted in a substantial increase in household credit problems. Personal bankruptcy filings, mortgage foreclosure rates, auto repossession rates, and delinquency rates on manufactured housing loans and credit cards are all at or just off record highs.

The economy has performed well with respect to inflation so far during the Bush Presidency, with consumer price inflation averaging just over 2% per annum. This is the lowest rate of inflation since the Kennedy Presidency and compares very favorably with the over 10% inflation that raged during the Carter term. Homeownership has also steadily increased during the Bush Presidency, a trend that began during Clinton's first term, with the sharp decline in mortgage interest rates.

It is important to note that President Bush's term extends through the end of this year and with the currently improving economy the previously cited economic statistics will likely also improve. Current job growth if sustained in coming months, for example, may be sufficient to return employment back to where it was at the start of the Bush Presidency. Incomes are also rising and credit problems are past their worst. Despite the improving economic statistics, it is likely that the economy's performance during President Bush's term will end up being as poor as during any other Presidential term since World War II.

It is also important to consider that measuring the economy's performance during Presidential terms depends in part on the stage of the business cycle when the term begins. President Bush had the misfortune to begin his term just prior to the March 2001 start date of the last recession. A recession that his Presidency had nothing to do with. President Clinton, in contrast, began his first term nearly two years after the end of the early 1990s recession. Conclusions regarding the economy's recent performance do not change, however, when comparing it to its performance during the same stage of past business cycles. The average of per annum real GDP growth in past cycles since World War II, for example, has been 3%.

There is an argument to be made that the economy has suffered through a series of massive shocks during the Bush Administration, severely exacerbating the economy's problems and making comparisons to previous historically periods difficult. These shocks include the collapse in stock prices which began in earnest in late 2000, 9/11, the invasion of Afghanistan in late 2001, the corporate accounts scandals which hit a fever pitch in the summer of 2002, the invasion of Iraq in early 2003, and a series of terror alerts and combat losses that continue until today. The economy has been subject to enormous shocks in the past, however, including free-falling stock prices, debilitating credit crunches, global financial crises, and conventional and cold wars.

Policy stimulus. While the economy has struggled with substantial shocks during the Bush Presidency, it has at the same time been the beneficiary of unprecedented combined monetary and fiscal stimulus. Nearly all of the economic growth experienced since the President took office is due to the aggressive easing in monetary policy and greater federal government largesse.

The magnitude of the monetary stimulus is evident from the sharp decline in the federal funds rate target from 6.5% in mid-2000 to a low of 1% that prevailed through this June. The real federal funds rate, as measured by the difference between the nominal rate and long-run inflation expectations as implied by Treasury inflation—protected securities, is negative and will likely remain so at least through the end of this year. Given that the real funds rate first turned negative soon after 9/11, this will ultimately be the longest stretch of a negative real funds rate on record.

The vehicle and housing markets have been the principal beneficiaries of the extraordinarily low rates. Automakers have been able to offer wildly popular zero percent financing deals given that their own borrowing costs are so low. Generational-low mortgage rates have sparked record-shattering home sales and single family homebuilding, and even more importantly ignited a mortgage borrowing binge. Homeowners have raised an astonishing more than $300 billion in additional cash secured by the equity in their homes since the monetary easing began. The cash has been used to repay other higher costs debt, to finance home improvement and other investments, and to supplement incomes and support broader consumer spending.

The magnitude of the fiscal stimulus is evident in the yawning budget deficit, which is on track to post a record $450 billion during fiscal year 2004 which ends this September. As recently as fiscal year 2000, the year before President Bush took office, the federal government was running a record surplus of just under $250 billion. This is a swing of some $700 billion in just four fiscal years.

Three rounds of tax cuts, including the 2001 Economic Growth and Tax Relief Reconciliation Act, the 2002 Job Creation and Workers Assistance Act, and the 2003 Jobs and Growth Tax Relief Reconciliation Act, have reduced individual taxpayer's collective tax bills by some $300 billion this year compared to what they otherwise would have been (see Table 2). This includes $100 billion of cuts in 2004, on top of the over $100 billion provided last year, and nearly $50 billion in each of the previous two years. Businesses have also received substantial tax benefits. Large businesses that make investments before the end of this year, for example, will benefit from accelerated depreciation schedules and small businesses from larger investment write-offs.[1]

Federal government outlays have also surged, with spending excluding interest payment on the federal debt expanding at close to a double-digit per annum pace during the Bush Presidency. Spending growth has been as strong only in the depths of the Vietnam and Korean Wars, and while current defense and homeland security spending is rising rapidly, the government is also writing much larger checks for almost everything it writes checks for.

The economic impact of the combined monetary and fiscal stimulus has been substantial. Indeed, if monetary and fiscal policy had remained unchanged

[1] Large businesses that make an investment before the end of 2004 can immediately expense one-half of that investment. Depreciation schedules revert to their less attractive rules at the start of 2005. Small businesses also receive a tax benefit; they are able to expense $100,000 of investment, up from $25,000.

Table 2: Tax Cuts Enacted During the Bush Presidency
$ bils

	2001 Economic Growth & Tax Relief Reconciliation Act	2002 Job Creation & Worker Assistance Act	2003 Jobs & Growth Tax Relief Reconciliation Act	Total	Share of 2001 GDP
2001	-51	0	0	-51	-0.5
2002	-38	-51	0	-89	-0.9
2003	-91	-43	-61	-195	-1.9
2004	-108	-29	-149	-286	-2.8

Sources: Joint Committee on Taxation, BEA, Economy.com

during the Bush Presidency, the recession that began in early 2001 and ended later in the year, would have likely instead lasted through much of 2003.[2] The economy would still be shedding jobs.

Over the entirety of the Bush Presidency, monetary and fiscal stimulus have added an estimated 2.5 percentage points to per annum real GDP growth (see Table 3). Of that, 1.5 percentage points is due to an easier monetary policy and 1 percentage point to fiscal policy. Of the contribution to growth from the fiscal stimulus, the bulk has been from surging defense spending and income tax cuts to lower and middle income households. At the peak of the stimulus in early 2002, combined policy stimulus provided a whopping 4 percentage points to real year-over-year GDP growth (see also Chart 1). Even during the first quarter of this year, nearly one-half of the close to 4% annualized real GDP growth in the quarter was due to the policy stimulus.

Bang for the Buck. The economy has benefited from the fiscal policies implemented during the Bush Presidency, but only because of their sheer magnitude.[3] The economic bang for the buck from these policies, or economic stimulus provided for a given dollar of lost tax revenue or increased spending, has been substantially lacking.[4] This is evident from the massive swing from fiscal surplus to deficit in the past four fiscal years. While this nearly $700 billion swing amounts to nearly two percentage points of per annum real GDP growth, it has generated economic gains of only just over one-half that.

Mitigating the economic efficacy of the President's fiscal policies is that a majority of the benefits going to taxpayers have gone to high income and high net worth households. More than one-half of the tax benefits under the 2001 tax cut, for example, have accrued to the no more than 3% of taxpayers earning over $200,000 in annual taxable income. These households have benefited substantially from subsequent cuts in marginal personal income tax rates, reduced dividend income and capital gains tax rates, and the phasing-out of the estate tax. These tax cuts however have a particularly low economic bang for the buck (see Table 4).

The near-term economic bang for the buck of reducing personal marginal tax rates, the most significant part of the President's fiscal policies, is only 59 cents. That is, the one-year increase in GDP is only 59 cents for every dollar of lost tax revenue. Reducing the economic potency of lower income tax rates for higher income households is the high rates of saving and other financial resources of these households. They are substantially less likely to spend any tax savings quickly than lower and middle income households. An estimated less than one-half of any tax benefit to households with incomes above the median are spent within one-year of receiving the benefit. This compares to nearly 90% for households with incomes below the median.[5]

As such, the creation of a new 10% income tax bracket and the child tax credit rebate as part of the President's tax policies has provided a significant

[2] This is based on simulations of Economy.com's macroeconomic model system. See the Appendix to this study for a description of the methodology used to derive these results. A description of the macroeconomic model system is available upon request.

[3] It is important to note that various fiscal policies implemented during the Bush Presidency have been due to substantial efforts by Congress. Congressional Democrats were instrumental in the inclusion of tax rebates in the 2001 tax bill and the federal emergency unemployment insurance program, for example.

[4] The economic bang for the buck concept was used and described by the CBO in "Economic Stimulus: Evaluating Proposed Changes in Tax Policy," January 2002. This study is available at http://www.cbo.gov/showdoc.cfm?index=3251&sequence=0

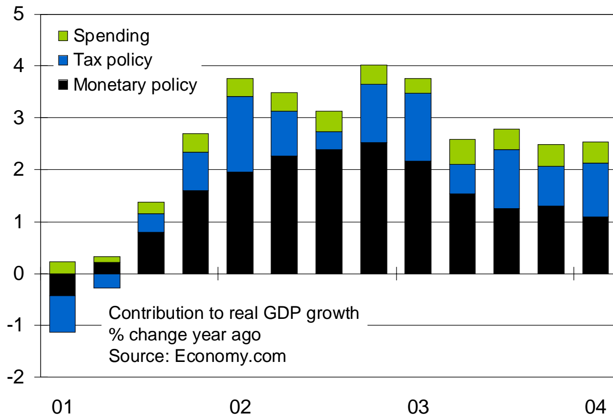
[5] The Economy.com macroeconomic model system accounts for differences in propensities to consume out of disposable income for deciles of the income distribution.

Table 3: Monetary and Fiscal Policy Contribution to Real GDP Growth

	2001	2002	2003	2004Q1
Real GDP Growth	**0.5**	**2.2**	**3.1**	**3.9**
Policy Stimulus	1.1	3.3	3.5	2.1
Monetary Policy	0.9	1.9	2.2	1.1
Federal Fiscal Policy	0.2	1.3	1.3	0.9
Tax Cuts	0.0	0.9	0.8	0.5
Lower Income Taxpayers	0.0	0.6	0.5	0.4
Higher Income Taxpayers	0.0	0.2	0.1	0.0
Business Tax Benefits	0.0	0.1	0.1	0.1
Government Spending	0.2	0.4	0.5	0.4
Defense Spending	0.1	0.3	0.4	0.4
Nondefense Spending	0.1	0.1	0.1	0.0
Other	-0.6	-1.1	-0.4	1.8

Source: Economy.com
Note: Based on simulations of Economy.com's macroeconomic model system

Chart 1: Massive Policy Stimulus



economic boost. The near-term economic bang for the buck of both is over a dollar.

The reduction in tax rates on dividend income and realized capital gains, a policy vigorously advocated by the President, also has only a small near-term economic bang for the buck. While the long-term economic benefits are potentially significant, due to the inequities in the taxation of corporate income, the impact on the economy's near-term performance is largely through higher stock values. Stock values should rise by an amount equal to the present value of the stream of future tax savings. Although this calculation depends on a number of assumptions, the boost to stock values is estimated to have been no more than 5%.[6] While this should support economic activity through positive wealth effects, these effects are small. Also diluting the near-term economic punch of eliminating dividend taxation is the resulting increase in interest rates on tax-free bonds, including Treasurys and municipal bonds, which compete for investable funds against the stocks of dividend paying companies.

Other aspects of the fiscal policies adopted during the President's term have been more economically efficacious. The provision of emergency federal unemployment insurance benefits and larger grants-in-aid to state governments have been particularly potent policies as they put cash in the hands of financially-pressed households who likely immediately spent it. These were only minor parts of the adopted policies, however. The accelerated depreciation benefits for businesses have also supported previously moribund business investment. An estimated one-fourth of the increase in investment in equipment and software since late 2001 is due to this tax benefit.[7]

Counterfactual scenario. The economic effectiveness of the fiscal policies adopted during the Bush Presidency can be further assessed by considering how the economy would have performed if alternative policy choices had been made. This is done by quantifying the economic impact of a counterfactual scenario through an historical simulation of Economy.com's macroeconomic model system.

The counterfactual scenario assumes that a package of policies designed to stimulate the economy is debated in the immediate wake of 9/11 and signed into law at the start of fiscal year 2002. The scenario includes a combination of policies designed to provide the most significant and timely boost to the economy. The total cost of the package is designed to be some $300 billion, approximately equal to the estimated cost of the President's tax cuts through fiscal year 2004.[8] The policies included were either actually adopted at some point during the President's term, although more sparingly, or were debated but never became law (see Table 5).

Emergency unemployment insurance benefits were included as part of

[6] See "Dividend Taxation," Regional Financial Review, April 2003.

[7] See "Accounting for Bonus Depreciation," Regional Financial Review, April 2004, for a detailed description of this policy and its impact on investment and the broader economy. The estimated near-term economic bang for the buck of bonus depreciation is only 24 cents, but it does rise quickly to near a dollar after the benefit expires and corporate tax bills increase.

[8] The total cost of the President's tax cuts will be ultimately substantially greater than $300 billion given that they are set to expire at the end of this decade as stipulated under current law. The tax cuts in the counterfactual scenario expire in fiscal year 2004. Defense and homeland security spending in the counterfactual scenario is set equal to actual spending. Other spending, aside from transfer payments, was increased as stipulated in the FY 2000 budget.

Table 4: Economic Efficacy of Bush Fiscal Policies

	Near-Term Economic Bang for the Buck	**Cost FY 2001 - 2004 *$ bil***	**% of Total Cost**	
Extend Emergency Federal UI Benefits	1.73	-11	2	-18
10% Personal Income Tax Bracket	1.34	-162	26	-217
State Government Aid	1.24	-20	3	-25
Child Tax Credit Rebate	1.04	-50	8	-52
Marriage Tax Penalty	0.74	-2	0	-2
Alternative Minimum Tax Adjustments	0.67	-5	1	-3
Personal Marginal Tax Rate Reductions	0.59	-196	31	-115
Business Investment Writeoff	0.24	-153	24	-37
Dividend-Capital Gain Tax Reduction	0.09	-24	4	-2
Estate Tax Reduction	0.00	-13	2	0

Source: Economy.com

Note: Economic bang for the buck equals the ratio of the one-year change in real GDP to federal government revenue loss or spending increase.

Table 5: Counterfactual Scenario Assumptions

	Cost FY 2002	Cost FY 2002 - 2004	
	$ bils	*$ bils*	*% of Total*
Payroll Tax Holiday	-148	-148	50
Business Investment Write-off	-48	-2	1
Family Tax Cut	-64	-64	22
State Government Aid	-50	-50	17
Extend Emergency Federal UI Benefits	-16	-32	11
Total	**-326**	**-296**	

Source: Economy.com

the 2002 tax bill, for example, but these benefits were limited and allowed to expire at the end of 2003. In the counterfactual scenario, the emergency UI program is substantially expanded, as no other policy considered by policymakers to stimulate the economy provides as large an economic bang for the buck. UI benefits support hard-pressed households that spend it as quickly as it is received.

The counterfactual scenario also includes accelerated depreciation benefits for businesses. These benefits are similar to those actually adopted except that they expire at the end of 2002. The current depreciation allowances are still in effect, expiring at the end of this year. Businesses have substantially greater incentive to increase investment more quickly if they only have a temporary window of opportunity to do so. Most of the economic boost provided by the President's accelerated depreciation policy, for example, was delayed until this year.

The counterfactual scenario includes a one-time family tax cut providing $300 for each adult in a family and $300 for the first two children. A family of four thus receives a tax cut of $1,200. It is generally held that a permanent cut in personal taxes will induce a larger increase in consumer spending than will a temporary tax cut. This view is based on theories of consumer spending that conclude that consumers not only consider their current income but also their expected income over a long period when making spending and saving decisions. A temporary tax cut, so the argument goes, does little to raise lifetime income and thus weighs on consumers' willingness to spend their tax saving.

This view is less compelling than it appears, however. The majority of households likely have very short-term horizons when making assessments of their income. Indeed, many households save little, and have little or no net worth. Their horizon is not much further than their next paycheck. Any tax benefit they receive will almost certainly be spent immediately. It is only households near the top of the income distribution who have horizons that effectively extend much beyond several years. The economic benefit of a permanent tax cut is also mitigated by the impact such a cut may have on long-term interest rates. Bond investors holding government debt with maturities that extend for decades are highly sensitive to policy changes that will have long-run implications for the federal fiscal situation.

The counterfactual scenario also includes a large $50 billion one-time grant to state governments scrambling to fill in the very large budget holes that were developing in early 2002. As most state governments are required by their constitutions to quickly eliminate their deficits, they were forced to be particularly aggressive in cutting payrolls, reducing funding for programs ranging from healthcare to education, and even raising taxes. All of this was a substantial drag on the economy that could have been ameliorated with more support from the federal government.

The most costly policy included in the counterfactual scenario is a payroll tax holiday. The nearly $150 billion price tag pays for a six-month holiday beginning in November 2001 when tax rates are cut in half for both workers and their employers.

Cutting payroll taxes is a particularly efficacious way of stimulating a struggling economy given that they can be quickly implemented, as they are under the control of federal policymakers, and any benefits show up immediately in paychecks and checking accounts. In 2002, annual earnings up to nearly $85,000 were subject to a 6.25% tax earmarked for Social Security and an additional 1.45% for Medicare. Employers match the taxes withheld from their employees.

A cut in payroll taxes benefits the nation's least advantaged workers, with less in the way of savings and other assets. This is particularly true since the cut is designed to begin at the end of the calendar year when higher income taxpayers have already surpassed the annual maximum contribution subject to the Social Security portion of the payroll taxes. Indeed, a number of lower income workers who don't earn enough taxable income to qualify for the family tax cut get some benefit from lower payroll taxes.

The timing is also propitious as it coincides with Christmas shopping, when consumers are most obliged to spend. This would have been particularly important to very nervous retailers during Christmas 2001. Cutting payroll taxes paid by employers also provides a bit of extra cash to struggling small business owners, many of whom were having increasing financial difficulty. Cutting payroll taxes even temporarily also lowers the cost of labor, reducing their incentive to shed workers as many businesses did in the wake of 9/11.

Any concern that cutting payroll taxes would somehow undermine the financial viability of Social Security or Medicare would be misplaced. Both programs are funded out of general revenues, of which personal income, corporate income and payroll taxes are all part. It does not matter how Social Security and Medicare are funded; all that matters is that they are.

The 2001 recession can not be avoided in the counterfactual scenario as

it is already history when the stimulus package is passed into law. The ensuing recovery in the counterfactual scenario is substantially stronger, however. Instead of actual real GDP growth of only 2.2% in 2002, which while substantially better than if no fiscal stimulus was provided at all, the economy would have expanded by a whopping 4.3% (see Table 6).[9] Growth would have slowed in 2003 and 2004 as the stimulus ended, but the expansion would have become self-sustaining long before it actually did. Substantive job growth would have resumed by year's end 2002 instead of at the start of 2004. There would have been some 2 million more jobs today if the policies in the counterfactual scenario had been implemented. The unemployment rate would have thus peaked well below 6% instead of well over 6%.

Given that all of the policy steps taken in the counterfactual scenario are temporary, this assuages worries among bond investors that they would undermine the government's long-term fiscal health. As such, long-term interest rates do not appreciably rise as even as the economy improves. This point is crucial because if long-term rates were to rise, they would offset the economic benefits of the stimulus package. Indeed, while the federal government's fiscal situation erodes substantially in fiscal year 2002 when the stimulus provided in the counterfactual scenario is at its peak, it improves quickly. By FY 2004 the deficit is less than one-half that currently expected.

Broadly speaking, if a package of fiscal policy steps were taken soon after 9/11 that were substantial, but temporary, and designed to get the most significant bang for the buck, the economy would not have avoided the 2001 recession, but the ensuing recovery would have been significantly more robust.

Large persistent deficits. The President's fiscal policies have not been very efficacious in stimulating the economy, and moreover, any near-term benefits will be eventually overwhelmed by the impact of the persistently large federal budget deficits expected to result from those policies. Even under sanguine economic assumptions, cumulative budget deficits over the next decade appear headed into the trillions of dollars.

An improving economy will ensure that coming deficits will narrow from this year's record shortfall, but they will remain large as the erosion in the budget situation in recent years has largely not been due to the heretofore weak economy. Indeed, the previously struggling economy is responsible for only an estimated one-fifth of the swing from surplus to deficit between fiscal year 2000 and this fiscal year (see Table 7). Another one-seventh is due to what are arguably unavoidable increases in defense outlays. The remainder is the result of the President's tax cuts and increased non-defense spending.

The most optimistic ten-year deficit outlook is available from the Congressional Budget Office.[10] Assuming no change in current fiscal policies, and that discretionary spending rises at the rate of overall inflation, the budget deficit is projected to vanish a decade from now. Most of the improvement in the fiscal situation occurs after FY 2010, however, when the President's tax cuts are legislated to expire. Currently lower personal income, dividend and capital gain rates revert back to the rates prior to the tax cuts. Estate taxes are also re-instituted. The cumulative ten-year deficit in the CBO outlook is just under $2 trillion, equal to approximately 1.5% of GDP (see Chart 2).

A more pessimistic, yet perhaps more realistic, fiscal outlook begins with the CBO's projection, takes its underlying economic assumptions as given, and makes several popular and reasonable changes to fiscal policy. Most significantly, the President's tax cuts are assumed to be made permanent. The President has made such a proposal the economic centerpiece of his re-election bid. This would add some $1.5 trillion to the cumulative ten-year budget deficit taking the cumulative deficit to $3.5 trillion or nearly 2.5% of GDP.

The alternative minimum tax is also assumed to be indexed to inflation to forestall what will soon be a rapidly growing number of middle-income taxpayers who are forced to begin paying this more onerous tax. If a change is not made, then the number of taxpayers falling under the AMT will rise from approximately 3 million today to 33 million a decade from now.[11] Adjusting the AMT will add an additional almost $400 billion to the ten-year cumulative deficit.

Defense spending under the CBO outlook also appears unreasonably low, particularly in light of the nation's growing overseas and homeland security obligations. Simply holding defense outlays to 4% of GDP, still very low by post World War II standards, would add another $1 trillion to the cumulative deficit. Non-defense discretionary spending expectations in the CBO outlook also appear at odds with political realities. The ten-year cumulative deficit would increase by another more than $500 billion if the real annual growth in such spending were held to just 2%.

Together, these tax and spending changes would result in an expected cumulative ten-year budget deficit of well over an astounding $5 trillion, equal to almost 4% of GDP. Fiscal prospects seem set to erode even more substantively after the ten-year budget horizon with the aging of the population and the stresses this will place on Social Security, Medicare and Medicaid.[12]

Optimism that if the President's tax cuts are made permanent that they would create powerful incentives for more investment and harder work and thus ultimately more tax revenues and an improving long-term fiscal situation is misplaced. This supply side argument is vastly overstated. There is no empirical evidence to suggest that lower top marginal tax rates, that have already been cut in half during the past quarter century, would provide anywhere near the necessary supply-side boost to the economy needed to right the fiscal situation.[13]

Deficits of the size that would ensue if the tax cuts are made permanent will have serious negative long-term economic

[9] It is assumed in both the counterfactual and the no fiscal stimulus scenarios that monetary policy is unchanged through early 2002 when the federal funds rate target is lowered to 1.75%, but is adjusted according to a modified Taylor's rule after that. In the counterfactual scenario the funds rate target rises to just over 3% at year-end 2004 instead of the 2% currently expected. In the no fiscal stimulus scenario the funds rate target is only 1% at year-

[10] The Bush Administration's Office of Management and Budget provides only a five-year budget outlook, which during the period is comparable to that provided by the CBO assuming no fiscal policy changes.

[11] This estimate is based on calculations by the Urban Institute-Brookings Institution Tax Policy Center.

[12] The first cohort of the large baby boom generation reaches the 62 retirement age in 2008.

[13] See "How the CBO Analyzed the Macroeconomic Effects of the President's Budget," CBO study, July 2003, http://www.cbo.gov/showdoc.cfm?index=4454&sequence=0

Table 6: Economic Impact of Counterfactual Scenario

	2001	2002	2003	2004
Real GDP Growth				
Actual	0.5	2.2	3.1	4.4
Counterfactual Scenario	0.8	4.3	3.3	3.1
Difference	*0.3*	*2.1*	*0.2*	*-1.3*
No Fiscal Stimulus Scenario	0.3	0.9	1.8	3.7
Difference	*-0.2*	*-1.3*	*-1.3*	*-0.7*
Real GDP (bil 2000$)				
Actual	9,867	10,083	10,398	10,857
Counterfactual Scenario	9,894	10,314	10,658	10,991
Difference	*27*	*231*	*261*	*134*
No Fiscal Stimulus Scenario	9,845	9,931	10,115	10,487
Difference	*-21*	*-152*	*-283*	*-370*
Employment (mil)				
Actual	131.84	130.34	129.94	131.31
Counterfactual Scenario	131.93	131.32	131.58	133.33
Difference	*0.09*	*0.98*	*1.64*	*2.02*
No Fiscal Stimulus Scenario	131.70	129.69	128.92	129.89
Difference	*-0.14*	*-0.65*	*-1.02*	*-1.42*
Unemployment Rate				
Actual	4.8	5.8	6.0	5.6
Counterfactual Scenario	4.8	5.6	5.7	5.3
Difference	*0.0*	*-0.1*	*-0.3*	*-0.4*
No Fiscal Stimulus Scenario	4.8	5.9	6.2	6.0
Difference	*0.0*	*0.1*	*0.2*	*0.3*
91-Day T-Bill				
Actual	3.47	1.63	1.03	1.22
Counterfactual Scenario	3.47	1.75	1.85	2.54
Difference	*0.00*	*0.12*	*0.82*	*1.32*
No Fiscal Stimulus Scenario	3.13	1.15	0.47	0.97
Difference	*-0.34*	*-0.48*	*-0.56*	*-0.25*
10-year Treasury Note				
Actual	5.02	4.61	4.01	4.62
Counterfactual Scenario	5.08	4.95	4.96	5.07
Difference	*0.06*	*0.34*	*0.95*	*0.45*
No Fiscal Stimulus Scenario	4.66	3.94	3.56	4.39
Difference	*-0.36*	*-0.67*	*-0.45*	*-0.23*
Federal Budget Surplus/Deficit (bil $)				
Actual	127	-158	-375	-452
Counterfactual Scenario	164	-323	-286	-203
Difference	*37*	*-165*	*89*	*249*
No Fiscal Stimulus Scenario	164	-138	-384	-504
Difference	*37*	*20*	*-9*	*-52*

Source: Economy.com
Notes:
1) Assumes fiscal stimulus package is passed October 2001.
2) Calendar years except surplus/deficit which is fiscal years.
3) Annual averages, except for employment and unemployment rate which are the average for the fourth quarter
4) 91-day T-Bill is on an equivalent bond basis
5) Actual is history for 2001-2003 and expected for 2004.
6) Differences are scenarios measured against actual.
7) Actual is history for 2001-2003 and current forecast for 2004

Table 7: Decomposing the Federal Budget Surplus/Deficit
$ bils, FY

	2000	2001	2002	2003	2004	Change '00 - '04	Share of Change
Unified Budget Surplus/Deficit	237	127	-158	-374	-447	-684	
Less: Business Cycle Impact	118	48	-76	-92	-29	-147	21
Equals: Cyclically Adjusted Surplus/Deficit	119	79	-82	-282	-418	-537	
Plus: Technical Factors	38	10	49	5	16	-22	3
Equals: Standardized Surplus/Deficit	81	69	-131	-287	-434	-515	
Tax Cuts	0	-71	-85	-200	-286	-286	42
2001 Tax Cut	0	-71	-37	-94	-108	-108	
2002 Tax Cut	0	0	-48	-43	-29	-29	
2003 Tax Cut	0	0	0	-63	-149	-149	
Spending Stimulus	0	-31	-135	-171	-214	-214	31
Defense	0	-10	-49	-65	-98	-98	14
Social Security	0	-9	-10	-16	-19	-19	
Medicare	0	-6	-13	-17	-19	-19	
Interest	0	17	23	29	30	30	
Other	0	-23	-86	-102	-108	-108	

Source: Economy.com
Notes:
1) Spending stimulus is measured by actual spending relative to FY 2000 budgeted spending.
2) FY 2004 is a forecast based on Treasury data through May 2004

implications. Empirical evidence strongly suggests that deficits result in higher longer-term interest rates and crowd out private more productive investment. Indeed, econometric analysis shows that persistent federal budget deficits equal to 1% of GDP add approximately 25 basis points to 10-year Treasury yields.[14] The relationship between deficits and interest rates is so strong it can be seen graphically (see Chart 3).

Deficits equal to 4% of GDP, as would be the case under the previously described pessimistic fiscal outlook, will raise long-term rates by approximately a percentage point over what they would be with a balanced budget. The negative long-term consequences on the economy would be substantial. Average annual real GDP growth over the next decade would be reduced by approximately 30 basis points, resulting in some 3 million fewer jobs a decade from now than would be the ease if the CBO's most optimistic scenario of no change in current fiscal policies came to pass (see Table 8).[15] Investment, productivity growth, and ultimately the nation's living standards would all be measurably weaker, and a more substantive fiscal crisis would eventually ensue.

14 A similar result was found by Federal Reserve Board researchers in "New Evidence on the Interest Rate Effects of Budget Deficits and Debt," Thomas Laubach, Federal Reserve Board Working Paper, May 2003, http://www.federalreserve.gov/pubs/feds/2003/200312/200312abs.html

15 These results are also based on a simulation of the Economy.com macroeconomic model system. Although a number of assumptions were made in this simulation the most important is that the Federal Reserve Board manages monetary policy according to a modified Taylor rule formula.

Chart 2: Darkening Fiscal Outlook

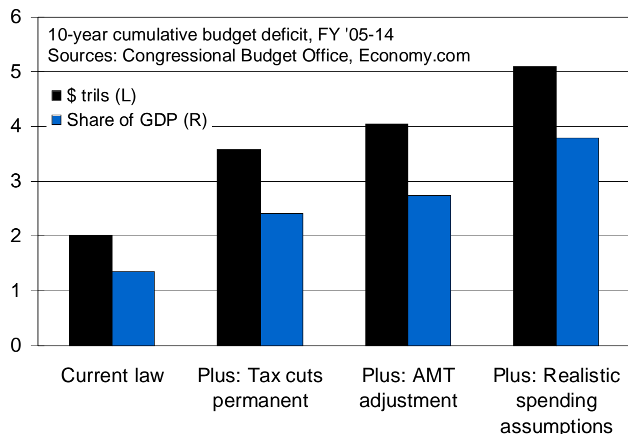


Chart 3: Deficits Do Matter

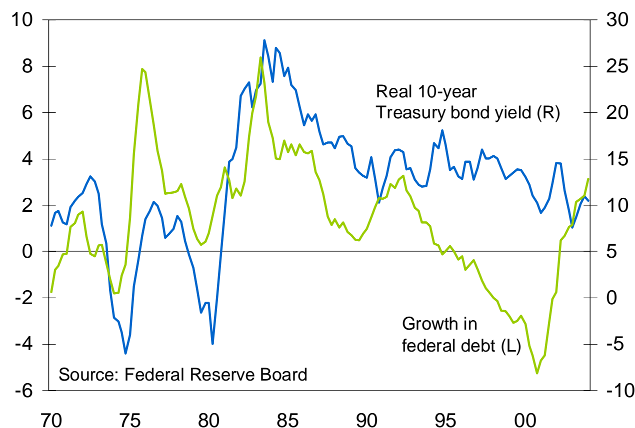


Table 8: Economic Outlook Under Different Fiscal Policies

	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	'05-'08	'05-'14
Real GDP Growth											**Avg. Annual Growth**	
CBO: No Change in Fiscal Policy	3.49	3.68	4.03	3.64	3.28	3.18	3.06	3.00	2.88	2.77	3.71	3.30
Pessimistic Fiscal Outlook	3.47	3.56	3.81	3.34	2.92	2.77	2.62	2.54	2.40	2.28	3.55	2.97
Difference	*-0.02*	*-0.12*	*-0.22*	*-0.30*	*-0.36*	*-0.41*	*-0.44*	*-0.46*	*-0.48*	*-0.49*	*-0.17*	*-0.33*
Real GDP (Billions 2000$)											**Avg. Annual Growth**	
CBO: No Change in Fiscal Policy	11,236	11,649	12,119	12,560	12,972	13,385	13,794	14,208	14,617	15,022	3.71	3.30
Pessimistic Fiscal Outlook	11,234	11,634	12,077	12,480	12,845	13,201	13,546	13,891	14,224	14,548	3.54	2.97
Difference	*-2*	*-16*	*-42*	*-80*	*-127*	*-184*	*-248*	*-317*	*-393*	*-474*	*-0.16*	*-0.33*
Employment (mil)											**Avg. Annual Growth**	
CBO: No Change in Fiscal Policy	133.69	135.93	138.00	140.15	142.30	144.43	146.60	148.80	151.02	153.23	1.64	1.56
Pessimistic Fiscal Outlook	133.68	135.83	137.74	139.64	141.48	143.24	145.00	146.75	148.49	150.20	1.55	1.35
Difference	*-0.02*	*-0.10*	*-0.26*	*-0.51*	*-0.82*	*-1.19*	*-1.61*	*-2.05*	*-2.53*	*-3.03*	*-0.09*	*-0.20*
Unemployment Rate											**Average Annual**	
CBO: No Change in Fiscal Policy	5.65	5.49	5.29	5.07	4.95	4.93	4.97	4.95	4.93	4.91	5.38	5.11
Pessimistic Fiscal Outlook	5.66	5.52	5.38	5.25	5.15	5.09	5.04	4.98	4.95	4.93	5.45	5.19
Difference	*0.01*	*0.03*	*0.09*	*0.17*	*0.20*	*0.16*	*0.08*	*0.03*	*0.02*	*0.02*	*0.07*	*0.08*
10-year Treasury Note											**Average Annual**	
CBO: No Change in Fiscal Policy	4.82	5.41	5.41	5.31	5.31	5.25	5.24	5.24	5.24	5.26	5.24	5.25
Pessmistic Fiscal Outlook	5.49	6.21	6.31	6.20	6.21	6.13	6.11	6.08	6.07	6.09	6.06	6.09
Difference	*0.67*	*0.81*	*0.90*	*0.89*	*0.91*	*0.88*	*0.87*	*0.84*	*0.84*	*0.83*	*0.82*	*0.84*
Dynamic Federal Budget Surplus/Deficit ($ bil)											**Average Annual**	
CBO: No Change in Fiscal Policy	-363	-272	-272	-281	-271	-259	-159	-16	-8	16	-297	-188
Pessmistic Fiscal Outlook	-377	-328	-371	-433	-484	-518	-574	-590	-620	-623	-377	-492
Difference	*-14*	*-56*	*-99*	*-152*	*-213*	*-259*	*-415*	*-574*	*-612*	*-639*	*-80*	*-303*

Source: Economy.com

Notes:

1) Calendar years except surplus/deficit which is fiscal years.

4) Differences are scenarios measured against CBO: No Fiscal Policy Change scenario.

Conclusions. The economy has struggled during President Bush's first term. The expansion has gained momentum during the past year, but by many measures has yet to fully rebound from the 2001 recession and weak ensuing recovery. Employment, real median household incomes, and real household net worth are lower today than at the start of the President's term.

The recession was not of the President's doing and the economy has suffered through a series of substantial shocks. Moreover, the economy would have been substantially more troubled in recent years without the benefit of the stimulus of the fiscal policies implemented during the President's term. The year-long 2001 recession would likely have continued well into 2003 without the three rounds of tax cuts and surging government spending.

The economic efficacy of the President's fiscal policies has been particularly poor, however. The cuts in marginal personal tax rates and dividend income and capital gain tax rates provide a notably small economic bang for the buck. It is not difficult to construct a package of alternative fiscal policies that would have lifted the moribund economy much more quickly and powerfully.

Moreover, the magnitude of the stimulus has resulted in a ballooning budget deficit. While this year's $450 billion deficit will be the largest ever, as a share of GDP at 4%, it will fall short of the deficits recorded in 1983 and 1992. The current fiscal outlook appears much darker than in the early 1980s and 1990s, however. Unlike those years, which were the first years of expansion following more serious recessions, this is the third year of expansion. Moreover, the current policy debate is centered on more tax cuts, not tax increases, as it was in the early 1990s. The demographic pressures posed by the aging boomers are also obviously much more intense today.

The economic import of the bleak fiscal outlook has yet to be felt. Bond investors have yet to incorporate any of this into long-term interest rates. This will soon change, however, once corporate credit needs revive and bump up against the Treasury's ever-increasing funding needs. Unprecedented foreign buying of U.S. debt will also eventually weaken. Measurably higher long-term interest rates will have a pernicious impact on the nation's long-term growth prospects.

A focused debate regarding the darkening fiscal situation and its economic implications must thus occur and be resolved. The next President may very well have the last opportunity to do this is a measured and thoughtful way. After that, the debate will be conducted in the heat of a fiscal crisis and resolved to no one's satisfaction.

Appendix. This appendix describes the methodology used to derive the estimated impact of discretionary fiscal policy changes on real GDP growth.

Begin by considering a simple expenditure model of GDP in period t, in which Y_t is equal to the sum of consumption, C_t, investment spending, I_t, and government spending, G_t. Consumption is a function of after-tax income:

$$C_t = mpc(1 - \mu_t)Y_t$$

where *mpc* is the marginal propensity to consume out of disposable income, and μ_t is the effective income tax rate. An expression for the growth in GDP can be derived by re-arranging the reduced form of this model:

$$g(Y_t) = m\,((G_{t-1}/Y_{t-1})\,g(G_t) + mpc \bullet \mu_t)$$

where $g(Y_t)$ represents the growth in Y_t and $g(G_t)$ represents the growth in G_t and

$$m = (1 - mpc(1 - \mu_t))^{-1} > 1$$

The expression for Y_t is equal the product of m, also known as the multiplier effect, and the term in parenthesis known as the initial fiscal stimulus. The term $(G_{t-1}/Y_{t-1})\,g(G_t)$ represents the direct contribution of the increase in government spending to GDP and $mpc \bullet \mu_t$ represents the direct impact of changes in the tax rate on GDP. The multiplier, m, represents the increase in after-tax incomes and thus consumption and GDP that is induced after the initial fiscal stimulus.

The part of GDP growth that is attributable to changes in the growth in government spending and effective tax rate that is above the economy potential GDP growth, Y_t^*, can be written as:

$$m\,((G_{t-1}/Y_{t-1})(g(G_t) - g(Y_t^*)) + mpc \bullet \mu_t)$$

Note that if the effective tax rate is unchanged and government spending grows at the rate of potential GDP, then this term is equal to zero. In other words, there is no fiscal stimulus.

To operationalize this expression, Economy.com's macroeconomic model system was simulated under standardized changes to a dozen different fiscal policy variables in the model system. In order to avoid including the impact of monetary policy changes in the calculations, interest rates were held constant in the simulations. All other dynamics were allowed to operate in the model system.