The economy in perspective

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DURING the 1997–98 season, the Chicago Bulls won the National Basketball Association championship after a regular-season record of 62 wins and 20 losses under coach Phil Jackson. In the next season Tim Floyd replaced Jackson, and the Bulls finished in last place with a record of 13 wins and 37 losses (during a lockout-shortened season). Does this contrast prove that Phil Jackson is a better coach than Tim Floyd? Maybe. But the retirement of superstar Michael Jordan and the trading of other key players after the 1997–98 season makes such a comparison difficult.

When Bill Clinton was president of the United States in 2000, the real gross domestic product of the U.S. economy grew 3.7 percent, the unemployment rate was 4.0 percent, and the federal budget ran a surplus of $236 billion. After George W. Bush became president, the economy tumbled into recession from March to November 2001, the unemployment rate rose to 5.8 percent by December of that year, and by

fiscal year 2002 the federal budget was $158 billion in deficit. Does this prove that Clinton followed better economic policies than Bush? Maybe. But it might also mean that a certain prominent player—call it the "new economy"—made Clinton's economic record look especially strong, but then retired and made Bush's economic record look unfairly bad.

Indeed, the president of the United States has less power over the U.S. economy than the coach of a basketball team has over wins and losses. A professional basketball coach sets strategies and schedules for a roster of 12 players. But the U.S. economy is not one large corporation with the president as its chief executive officer. In fact, the U.S. economy has five million corporations, two million partnerships, and eighteen million individually owned proprietorships. The U.S. economy is what happens when 140 million workers produce $11 trillion in annual output.

Thus, in evaluating the path of the U.S. economy during the presidency of George W. Bush, we must begin with a look at how the "new economy" of the late 1990s set the stage for the recession of 2001 and has influenced the economy since then. This context also helps to clarify the strengths and weaknesses of federal tax and spending policy from 2001 to 2004.

The unsustainable boom of the 1990s

In the second half of the 1990s, the U.S. economy moved from a moderate economic upswing that had started after the recession of 1990–91 into a turbocharged higher gear. The surge was led by remarkable advances in information and communications technology. The price of business computers and peripheral equipment of a given level of quality fell by 22 percent per year from late 1994 to late 1999. Real investment soared at an average annual rate of 13 percent per year from the end of 1994 to the end of 1999, led by spending on computers, software, and communications equipment like wireless and broadband Internet.

The potential of the new information and communications technology was epitomized by the Internet's evolution from an academic oddity into an everyday business tool. Ubiquitous Internet connections seemed to open the possibility that

industries and firms would be transformed in how they bought supplies, managed inventory, collected and processed information, coordinated their chains of production, hired and monitored workers, tracked sales, contacted customers, shipped products, and paid bills. The "new economy" became the catchphrase for this transformation, which seemed as if it might rival the level of social, business, and economic transformation caused by epochal economic innovations like the widespread use of electricity or the internal combustion engine in the first half of the twentieth century.

In the late 1990s, the U.S. economy performed almost unbelievably well. From 1996 to 2000, growth of real GDP averaged 4.1 percent per year. Unemployment sank ever lower, hitting 4.0 percent in 2000. Productivity growth in the business sector, which had averaged 1.7 percent from 1970 to 1995, rose to 2.6 percent per year from 1996 to 2000. The stock market soared; the Dow Jones Industrial Average more than doubled between 1995 and 1999.

The booming economy also brought the sweet surprise of some highly unexpected budget surpluses. Bill Clinton's proposed budget for fiscal year 1998, published in February 1997, predicted a deficit of $120 billion for 1998. But a budget surplus of $69 billion resulted for that year. The next year, Clinton's proposed budget for fiscal year 1999 predicted a balanced budget in 2000—but a burgeoning economy yielded a budget surplus of $236 billion instead. Government spending didn't stray much from the Clinton predictions, but the new economy brought in vast amounts of unexpected tax revenue. For example, Clinton's budget proposal for 1999 projected federal tax revenues of just under $1.8 trillion in 2000, but revenues were actually over $2 trillion—more than $200 billion higher than expected. In retrospect, much of this surge of revenue was linked to the rapidly rising stock market. Many people were paying large capital gains taxes on stock, having profited from shares in mutual funds or having cashed out company stock options.

The late 1990s brought real economic gains, but they also brought what Federal Reserve Chairman Alan Greenspan in 1996 called "irrational exuberance." By early 2000, the Clinton administration was clearly stating to anyone who could read

the fine print that the boom had probably run its course. Each year, the budget proposed by the president includes assumptions about how the economy will perform in the near future. The last proposed budget of the Clinton administration, released in February 2000, noted that the unemployment rate in 1999 had been 4.2 percent, but projected that unemployment would rise to 5.2 percent by 2003. Real GDP had grown 4.3 percent in 1998 and 3.9 percent in 1999, but the Clinton budget forecast in February 2000 that real GDP growth would slow to 2.5 percent by 2002. When recession struck in 2001, even those projections for GDP growth and unemployment were too optimistic.

By the later part of 2000, warning lights were flashing all over the U.S. economy. The investment boom of the late 1990s led to a "capital overhang"—a situation where firms had invested in more equipment than they needed for immediate production, and thus were ready to take a breather. The growth in business investment, which had zoomed ahead at about 15 percent in the first half of 2000, collapsed to nearly zero in the second half of 2000. With the drop in investment spending, GDP growth dropped from an annualized rate of 3.7 percent in the first half of 2000 to 0.8 percent in the second half of the year. The lowest monthly unemployment rate of the boom was April 2000's 3.8 percent, after which unemployment started rising. Broad stock market indexes peaked in the first half of 2000; for example, the Dow Jones Industrial Average hit 11,281 in January 2000, before starting a decline that would take it all the way down to 9,042 by August 2001.

Characteristics of recession and recovery

The eight-month recession from March to November 2001 was relatively short and shallow. The six other recessions since World War II averaged eleven months. GDP declined an average of 1 percent in the earlier recessions, but in the 2001 recession, output shrank only 0.5 percent.

The recovery since November 2001 has offered a bewildering mix of good news about economic growth and productivity but distressing news about job creation. Real GDP grew a solid 2.2 percent in 2002 and 3.1 percent in

2003, which is fairly close to the long-term average of 3.2 percent annual real GDP growth from 1970 to 2000. Moreover, the last few quarters of real GDP growth have been quite robust: 8.2 percent growth (projected at an annual rate) in the third quarter of 2003, 4.1 percent in the fourth quarter of 2003, and 4.4 percent in the first quarter of 2004. These numbers should be taken with a grain of salt, since recent GDP estimates are subject to revision. But the news is good nonetheless.

Economic output can be divided into two elements: the number of hours worked, and productivity per hour. Nearly all of the economic growth since the 2001 recession has been due to the second factor—that is, greater productivity per worker rather than more jobs.

During the boom of the late 1990s, productivity growth (measured by the change in output per hour in the business sector) hit 2.9 percent per year in 1998 and 1999, which was more than 1 percent per year higher than average rates in the preceding decades. These higher rates of productivity growth in the late 1990s were rightly hailed as wonderful news. Productivity is, after all, the fundamental driver of a high-income economy. When the average person produces more goods per hour, the average standard of living for society as a whole will be higher, too. Moreover, productivity growth is cumulative, so that 1 percent additional productivity each and every year will make a substantial difference to the average standard of living over a decade or a lifetime.

But although the late 1990s brought welcome news on productivity growth, the last few years have amazingly been even better. Productivity growth in 2002 was a shockingly high 4.9 percent, followed by 4.5 percent in 2003. These two years yielded the highest productivity growth in 40 years. Estimates for the first quarter of 2004 (again, subject to later revision) show productivity growth continuing at a sky-high annual rate of 4.6 percent. When productivity growth rose in the late 1990s, many analysts wondered if the increase would be long-lasting or a short-term blip. Now that a recession has come and gone, it appears that the investments in new technology in the late 1990s are indeed paying off for the economy as a whole.

The biggest economic disappointment since the recession ended late in 2001 is the lack of job growth. During the six recessions since World War II, employment rose an average of 2 percent in the first year after the end of the recession. However, in February 2004 the U.S. economy had fewer jobs than 27 months earlier, when the recession ended in November 2001. Job growth did perk up in spring 2004, with the U.S. economy gaining a total of nearly one million jobs in March, April, and May. But even after those gains, the U.S. economy had about one million fewer jobs in May 2004 than in January 2001, before the recession started, when George W. Bush took office.

However, lest we forget, the immediate aftermath of the previous recession of 1990–91 was also labeled a "jobless recovery." When that recession started in July 1990, the economy had 109.7 million jobs. The total number of jobs didn't return back to that level until January 1993—a few months too late for the re-election chances of George H. Bush against Bill Clinton.

Labor economists have offered a number of possibly complementary hypotheses as to why job growth has not matched economic growth in the last few years, although no explanation has yet found general acceptance. One theory is that job loss during recessions used to take the form of lay-offs, in which case workers could return to the same firm or at least the same industry when the recession ended. For example, building contractors might shed workers during a recession, and then hire them back during the recovery. In the last two recessions, however, job loss has often involved firms and industries for which the jobs never return. For example, the communications and the securities and commodities broker industries shed jobs during the recession of 2001, and then continued to do so after the recession ended. When workers have to shift to a different industry, hiring may be slower to resume.

A second explanation for recent slow job growth is that many of the firms that invested too heavily in the late 1990s also hired too heartily—with the result that many firms took an exceptionally long pause in their hiring at least through early 2004. Third, firms may have been reluctant to take on

new employees more recently because of a string of events that have disrupted business confidence: for example, the 2001 terrorist attacks and their aftermath, the buildup to the wars in Afghanistan and Iraq, and the uncertainties created by the scandals over corporate governance and accounting. Fourth, the last 10 to 15 years have seen a large increase in the number and availability of temporary workers, which may have led firms to believe that they can hold off on hiring until they are absolutely certain that they need more workers. It is easy for firms to add qualified workers from temp agencies at very short notice. Finally, strong productivity growth since 2002 has also meant that, at least in the short term, many employers could expand output from their existing workers and avoid hiring new ones.

But over time, productivity has not been an enemy of job growth in the United States or elsewhere. As the late 1990s showed, faster productivity growth can create new jobs at a rapid pace, too. All of the theories that seek to explain why job growth has been slow to resume since the 2001 recession implicitly assume that job growth will resume in the fairly near future. Indeed, an upswing may already have started.

Bush's fiscal policy

In January 2001, the Bush administration inherited a wobbly economy that quickly toppled into recession. There are two standard macroeconomic prescriptions to jolt an economy out of recession. First, the central bank can cut interest rates as a way of stimulating borrowing to finance business investment and large consumer purchases like homes and cars. The Federal Reserve cut interest rates 11 times in 2001, and then again in November 2002 and June 2003. The Bush administration deserves no particular credit for this Fed policy, just as it would have deserved no particular blame if the Fed had followed a different policy.

The second anti-recession prescription is to use a combination of tax cuts and increased government spending to create a higher level of demand for goods and services, and thus to stimulate the economy out of recession. The Bush administration and Congress followed this prescription vigorously—perhaps too much so. In 2000, the federal govern-

ment collected 20.9 percent of GDP in taxes, which tied the highest level in U.S. history (1944, during the peak of fighting in World War II). But for 2004, federal taxes are projected by the Congressional Budget Office (CBO) to be 15.8 percent of GDP, the lowest level since 1950. Federal spending in 2000 was 18.4 percent of GDP, which was the lowest level since 1966. In 2004, federal spending will be about 20.0 percent of GDP, which is a little lower than in the first half of the 1990s, but a little higher than the second half.

Combined, these tax cuts and spending increases created a resurgent federal budget deficit. In March 2004, the CBO projected this year's deficit to be $477 billion. This deficit is 4.2 percent of GDP, which is large, but not unprecedented. For example, the budget deficit was a larger share of GDP in 1991 and 1992, as well as every year from 1983 to 1986.

Given the 2001 recession, some combination of tax cuts and spending increases was economically reasonable and politically inevitable. But was the resulting budget deficit roughly the right size, or was it larger than it needed to be? And was the particular mix of tax cuts and spending increases well-chosen?

Budget deficits

There is no precise gauge of exactly how much the government should respond to a recession through tax cuts and spending increases. Nor is it entirely clear when a budget deficit becomes "too large." When the Federal Reserve cuts interest rates aggressively to fight recession, smaller tax cuts and spending increases are presumably needed. Given that the 2001 recession was short and shallow, and that GDP growth soon returned to close to historical averages, it's hard to argue in terms of the recovery that the tax cuts and spending increases should have been substantially larger. However, several factors suggest that lower budget deficits would be desirable.

First, the Bush administration probably didn't mean to cut tax revenues by as much as actually occurred. Just as taxes on unexpectedly large capital gains helped to drive higher-than-expected tax revenues in the late 1990s, a sharp drop-off in capital gains helped lead to lower-than-ex-

pected tax revenues by 2002. The loss of tax revenue that arose by 2003 and 2004 was greater than intended or expected when the tax cuts were passed—and the resulting budget deficits were greater than expected or intended, too. In August 2002, for example, the CBO published a report asking "Where Did the Revenues Go?" Its subject was why federal revenues had fallen so much more than the CBO had expected just a few months earlier.

Second, according to projections in the proposed Bush administration budget for 2005, interest payments on past federal borrowing will cost $275 billion per year by 2008, which will be 10 percent of all federal spending. Extensive borrowing now means high interest payments—and less flexibility for tax cuts or spending increases—in the future.

Third, when the government borrows money, it soaks up funds that would otherwise have been available for firms and individuals to borrow. It is not a coincidence, for example, that U.S. business investment soared in the late 1990s when the U.S. government ran budget surpluses, since the government was not competing with private borrowers at that time. Similarly, private investment has stayed lower in recent years with the large government deficits (of course, there were other factors as well). A sustained pattern of heavy government borrowing can discourage productivity growth by reducing private-sector investment.

Fourth, budget deficits have helped to produce the enormous U.S. trade deficit. The U.S. economy imported $490 billion more in goods and services in 2003 than it exported. From a macroeconomic perspective, a large part of the extra demand created by the tax cuts and spending increases in recent years is, in effect, buying imported products. The U.S. budget deficit is helping to stimulate the export industries of Japan, China, Mexico, Canada, and the European Union, rather than pumping up demand for U.S.-made goods and services.

A final cause for concern comes from long-term forecasts for budget deficits. All long-term forecasts should be taken with spoonfuls of skepticism, but current forecasts are especially precarious because the Bush administration has followed a legislative strategy of advocating tax cuts that are

scheduled to expire within a few years. This strategy has sometimes verged on the bizarre. For example, the federal estate tax is scheduled to disappear in 2010, and then to reappear in 2011. Only those trying to plan their own deaths—or the deaths of elderly relatives—well in advance are likely to benefit from such a provision. Such a strategy makes the long-term costs of the tax cut appear low, since the tax cut is only officially enacted for one year or a few years at most. But will taxes actually rebound back to higher levels in the future? The CBO is legally required to assume that all recent tax cuts will expire as currently legislated. On this basis, the CBO estimates that the budget deficit will gradually decline and the budget will be balanced again in 2013. However, if one assumes that tax cuts will not expire, but will instead be made permanent, and if one further assumes that the level of domestic spending per person remains constant over time, then the long-run budget deficit appears likely to worsen over time, hitting $600 billion by 2011 and heading downhill from there.

Large budget deficits were not especially worrisome in 2002 or perhaps even in 2003, when they were short-term phenomena in an economy still shaking off the effects of the recession. But a pattern of sustained large budget deficits in a growing economy creates unpleasant tradeoffs like high interest payments, lower private-sector investment, and outsized trade deficits. Also, there was a hope back in 1999 and 2000 that perhaps the federal government could run budget surpluses for a decade or more, so that the accumulated U.S. debt could be reduced before the baby boom generation hits retirement age and Social Security and Medicare expenditures rise sharply in the next decade. That hope is now a forlorn memory.

Tax cuts and fairness

Packages of tax cuts became law in 2001, 2002, and 2003. Summing up the overall effect of these laws is difficult for several reasons. One problem is that actual detailed data on which households paid how much in taxes is only available after a time lag. Such data is currently available only through 2001. Any statement you read about how the

tax cuts affected different kinds of households in 2002, 2003, 2004, or into the future are based on computer models that rely on past taxpayer patterns. Such models are worthwhile, but hardly infallible, especially when they are meant to cover a time period when overall tax revenues declined much more sharply than had been anticipated. A second difficulty is that although tax changes' effects on people earning different levels of income are the usual metric of study, the tax code also makes other differentiations. For example, income is taxed differently according to whether it is wages, dividends, or capital gains; taxes are adjusted for size of family; and tax changes can affect either individuals or corporations. Statements that summarize the impact of tax changes typically boil down all of the complexity of the tax code to a few basic and potentially misleading measures.

With these concerns duly noted, Eugene Steuerle, a tax guru at the Urban Institute, offers some well-informed speculation in his thoughtful book *Contemporary U.S. Tax Policy*, released in May 2004. Steuerle notes that there has been little change in the progressivity of the tax system (that is, the share of income paid as taxes by those at various income levels) as a whole over the last five decades. He adds: "When calculations are made for the first decade of the 21st century, my guess is that the same result is likely to apply, with exceptions at the very top and very bottom of the income distribution."

For those at the very top of the income distribution, such as those who earn more than $1 million per year, the tax cuts of 2001 and 2003 have often reduced their tax bills by tens of thousands of dollars. For this group, the big change is the reduction in the tax rates in the top two brackets from 39.6 percent to 35 percent, and from 36 percent to 33 percent. To a lesser extent, this group also benefited from lower tax rates on dividends and capital gains. However, those in the upper-middle income levels, earning well into six figures, have benefited relatively less from the Bush tax cuts. Many of them have found that although their regular tax bill has been cut, they are now subject to the alternative minimum tax, and so their savings from the tax cuts are not especially large. Finally, those in the middle and bottom of

the income distribution also benefited from Bush's tax cuts. The 2001 tax legislation reduced the lowest tax rate from 15 percent to 10 percent. It also expanded the tax credit for children and made that credit "refundable," so that even if you owed zero in taxes, the tax credit allowed you to receive a check from the government. This change offered a considerable benefit to families with children.

A large portion of the income tax cuts of recent years went to those with higher incomes, but this outcome was nearly inevitable. Major tax changes in 1986, 1990, and 1993 meant that many lower-income people now pay little or nothing in federal income taxes. In 2001, as a look at the detailed data by the CBO shows, the bottom 60 percent of households as categorized by income paid only 3.2 percent of total federal income taxes, while the top 20 percent of households paid 82 percent of federal income taxes (including the top 1 percent of households, which paid 34 percent of federal income taxes). In this situation, any reduction in federal income taxes is bound to provide more benefit to those with high incomes.

Indeed, there are only two ways for cuts in federal taxes to provide substantial benefits to those with low and middle levels of income. If a cut in income taxes is "refundable," like the child tax credit (for those with children) or the earned income tax credit (for the working poor who are below or near the poverty line), then even those who did not owe any taxes can get a refund from the government. Alternatively, cuts in federal taxes that are not income taxes—like cuts in the payroll taxes that finance Social Security and Medicare—could help those with lower incomes. However, having those with lower incomes pay less in taxes for these programs would run against the universalist ethos of those programs that everyone is taxed the same percentage of income (at least up to a certain level of income).

Over recent decades, the share of federal taxes paid by those with high incomes has generally been rising. The CBO calculated that the top one-fifth of taxpayers, ranked by income, paid 56.3 percent of total federal tax revenues in 1980 (including income, payroll, and all other federal taxes), 57.9 percent in 1990, and 66.7 percent in 2000. In 2001, the

most recent year for which detailed data are available, the share of total federal revenue paid by the top fifth of households did fall—as one would expect given the tax cuts and the declines in the stock market—but only to 65.3 percent of the total. While the tax cuts since 2001 seem to have stopped the long-term trend of having the federal tax system collecting an ever-higher share of its revenues from those with high incomes, the hard data from 2001 and CBO projections through 2004 show that those with high incomes are still paying a share of federal taxes that is high in comparison to recent decades.

Missed opportunities?

Federal government spending increased by 1.6 percent of GDP between 2000 and 2004. This increase can be accounted for almost entirely by rises in spending on defense and human resources, and a decline in the government's interest payments. U.S. defense spending increased by 1 percent of GDP from 2000 to 2004, from 3.0 percent to 4.0 percent of GDP. In the aftermath of the terrorist attacks of September 11, 2001, it seemed inevitable that a large increase in defense spending would occur. Even most of those who have expressed doubts about, say, the U.S.-led invasion of Iraq rarely argue for large cuts in defense spending in the current international climate.

U.S. spending in the broad budget category of human resources increased by 1.5 percent of GDP from 2000 to 2004. One big chunk of that increase is the unrelenting increase in Social Security and Medicare spending for the elderly. Substantial increases also occurred in other federal health-care spending, unemployment benefits, food and nutrition assistance, and education spending.

These increases in defense and human-resources spending were partly offset by a decline in the government's interest payments on its past borrowing. Interest payments declined by almost 1 percent of GDP from 2000 to 2004, since the budget surpluses from 1998 to 2001 reduced the government debt, and the very low interest rates of recent years held down the cost of financing the rest of the government debt.

The federal government will spend about $2.3 trillion in 2004, so budget battles will continue to be packed with controversy. But the changes in federal spending in the last four years have been less substantial than the changes on the tax side, and they also seem at least relatively uncontroversial compared to the tax side. Perhaps the greatest disappointment of the last four years is not the level of federal spending but the failure to reform key programs. Social Security and Medicare are not sustainable in the long term in their current configurations. Yet Social Security reform has not gotten underway and Medicare benefits have substantially increased because of the new prescription drug benefit. Supporting farmers, too, is costly, and also blocks negotiations with other agriculture-producing countries to reduce barriers to international trade. But the 2002 farm bill created additional subsidies, instead of seeking ways to restructure and phase down agricultural subsidies. Similarly, the welfare-to-work reform bill of 1996 was originally passed for five years, and has been limping along on piecemeal extensions since then. Sure, foreign policy concerns have loomed large in the last few years. But that should not stop us from rethinking important domestic policy programs.

Allocating credit

The Bush administration, with a generally friendly Congress, has clearly supported most of the tax and spending policies that were eventually enacted. However, one might validly object that it is unfair to attribute the final form of the tax and spending policies directly to George W. Bush, since some policies (for better or worse) were also shaped by Congress. One might also object that other economic policies are not considered here. But it seems unlikely that many voters will head to the polls in November contemplating the tariffs on imported steel enacted in 2002 (a very questionable policy); or the details of the Sarbanes-Oxley Act of 2002 that changed rules about accounting, financial disclosure, and governance of corporations (a positive if imperfect law); or the rules requiring cleaner emissions from diesel fuel and engines (a fine idea). Instead, the economic

issues that matter to most voters are economic growth, jobs, taxes, and the budget deficit.

The "new economy" of the late 1990s triggered a chain of consequences: faster productivity growth, an investment boom that crossed the line into "irrational exuberance" and eventually led to the 2001 recession, and shifting patterns of jobs across the economy. The Bush administration does not deserve much credit or blame for any part of this sequence: that is, the Bush administration should not be credited for the rapid productivity growth of recent years, but neither should it be blamed for an economy that was already listing toward recession in 2001 or for negligible job growth as the economy recovered. Even a U.S. president has only limited power over these kinds of powerful economic forces.

Together with the actions of the Federal Reserve in cutting interest rates, President Bush and Congress can reasonably claim some credit for keeping the 2001 recession short and shallow and for helping the U.S. economy return to a normal growth path, through a combination of tax cuts and spending increases. However, the tax cuts and corresponding budget deficits have grown larger than was expected or probably wanted. Even if short-term budget deficits were a desirable strategy as the U.S. economy rebounded out of the 2001 recession, enormous budget deficits expanding into the indefinite future would be unwelcome.

Arguably, economic policy in the last four years has in some cases been based too much on short-term political concerns, rather than a mature consideration of long-term economic interests. Examples include tax changes that appear to have low costs only because they will supposedly phase out, but in the meantime create confusion and new possibilities for creative accountants; the steel tariffs and farm price supports aimed at picking up votes in a few key "battleground" states, regardless of their negative consequences for U.S. consumers or international trade talks; and an unwillingness or inability to make fundamental reforms to Social Security and Medicare. Of course, presidents and politicians often focus on the short-run, but then must cobble together ways to address the long-run consequences.

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