

## **THE BOOM THAT WASN'T**

### **The economy has little to show for \$860 billion in tax cuts**

*by Lee Price*

Since 2001 President Bush and congressional leaders have promised that enacting each of a series of tax cuts would strengthen the economy by bringing faster growth, more jobs, and greater investment. With Congress again debating whether to extend past tax cuts and enact new ones, it's time to review how much the last four years of tax cuts have affected the U.S. economy and budget outlook. Unfortunately for most Americans, the tax cuts since 2001 have not made today's economy stronger. Over the last five fiscal years, the tax cuts have had a direct cost of \$860 billion and (with interest costs) a total effect on the deficit of \$929 billion.<sup>1</sup> By creating excessive permanent deficits, they have lowered our future standard of living.

A pivotal debate over the last four-and-a-half years has concerned whether tax cuts should emphasize stimulus or long-term restructuring of the tax code. For purposes of stimulus, tax cuts should focus on moderate-income, liquidity-constrained taxpayers, and they should expire after a limited period. But the winners of the legislative process pushed for tax cuts that do not expire and that focus on those taxpayers with high income and wealth. If their tax cuts had truly strengthened the economy, we would be observing it in the data by now.

The longer it takes to restore the revenue base and reduce the deficit, the higher the price that Americans must ultimately pay. The "rebate" checks of mid-2001 did provide stimulus that reduced the depth of the 2001 recession by putting tens of billions of dollars into the hands of liquidity-constrained households just before the terrorist attacks of September 11 shook consumers' confidence.<sup>2</sup> But the enduring tax cuts passed that year have not enhanced the economy's performance, and have in fact

caused a permanent boost in the federal budget deficit. Foreign lenders have largely financed that deficit, and they will have to be repaid by Americans in the future.

The fact that all major economic indicators are higher today than in early 2001 does not mean that the tax cuts have been beneficial. Since the Great Depression, the resilient U.S. economy has always had gains over such four-and-a-half-year periods. The appropriate question to ask is: How well has the economy performed compared to similar past periods? If the last four years of tax cuts had worked as promised, the economy should have done better than in previous cycles, when taxes were either not cut or cut much less.

By virtually every measure, the economy has performed worse in this business cycle than was typical of past ones, including that of the early 1990s, which saw major tax *increases*. The single area that has excelled in the current cycle, housing, has actually done so despite reduced tax incentives since 2001. And the tax cuts certainly didn't boost investment levels: the expiration of over \$60 billion a year in business tax cuts at the end of 2004 had virtually no observable negative effect on investment.

In fact, over the last four-and-a-half years, nearly every indicator—from job gains to economic output to spending—have fallen far short when stacked against comparable periods in past cycles.

## Comparing economic performance between business cycles

The economy was in recession from March to November 2001. The first major tax cuts were enacted in May 2001. A second round of tax cuts focused on businesses in March 2002. With jobs still shrinking in the spring of 2003, Congress passed sizeable additional tax cuts in May 2003.

To assess the economic contribution of these tax cuts, this report compares roughly the last four-and-a-half years (19 quarters) to similar stages of past business cycles. The economy had entered a recession not long before the first tax cuts were enacted. After the shallowest recession on record, economic output entered an expansionary phase in November 2001, almost four-and-a-half years ago. We now have monthly data for 58 months and quarterly data for 19 quarters since the last business cycle peak. For comparison purposes, we look at data from previous cycles that lasted as long as the current cycle. Because the recessions varied in depth, the standard procedure is to compare cyclical patterns by starting at the peak of the cycle.

This report also examines two recent episodes when taxes rose: the tax increases in the early 1990s and the expiration of business tax cuts at the end of 2004. In both cases, the economy took the increases in stride and there is no convincing evidence of economy-wide harm.

### A NOTE ABOUT THE FIGURES

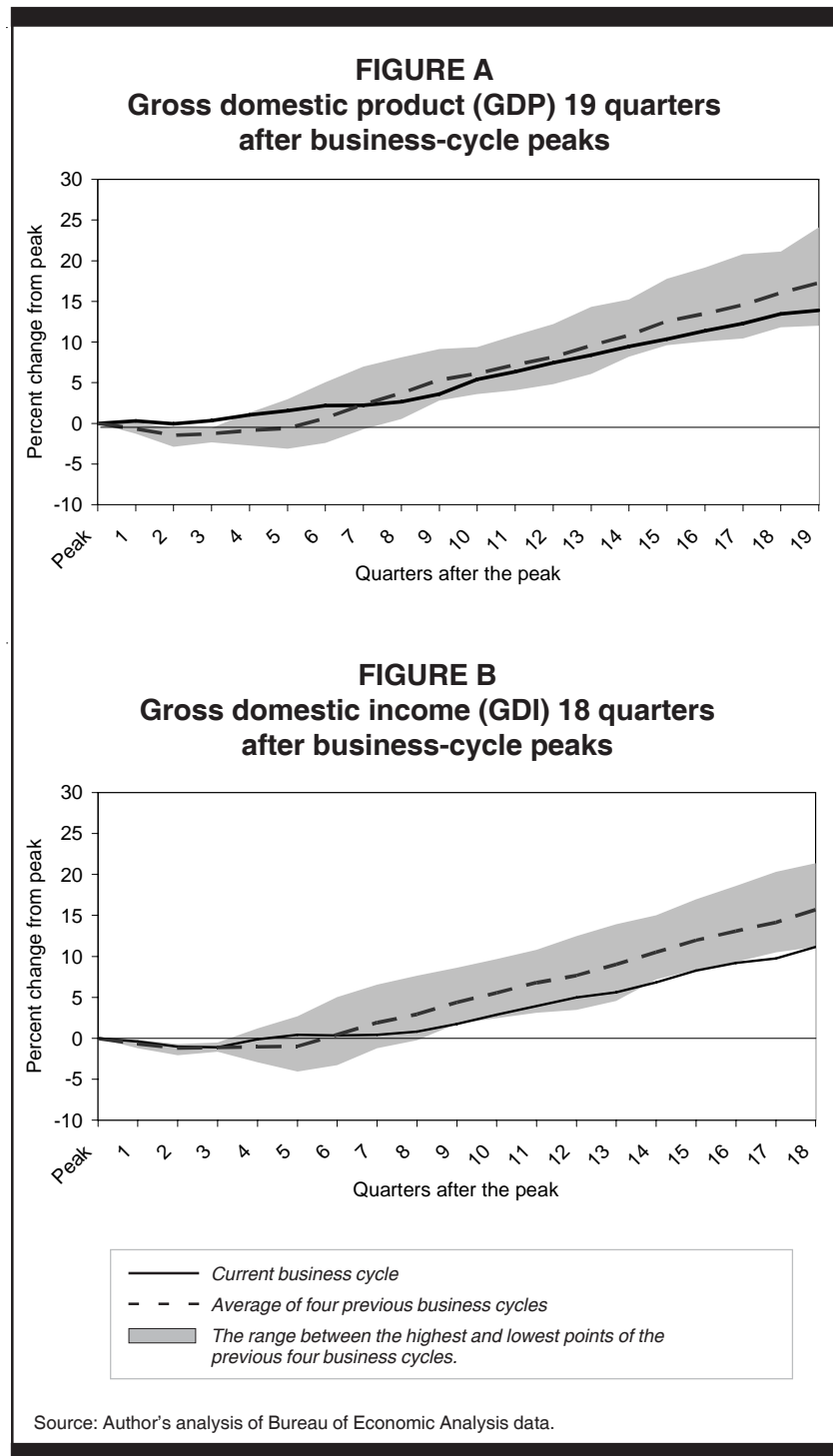
An explanation of the format used in Figures A-L is in order. These figures all compare the current business cycle (since March 2001) to comparable 19-quarter (and, in places, 58-month) periods for all previous business cycles dating back to the late 1940s (when these data first began to be collected). Except for Figures C, D, and E on labor indicators, these figures show changes in real (inflation-adjusted) dollars. The dashed line represents the average change for the four previous cycles; the gray area shows the high and low range in those four cycles. The solid line depicts the current cycle since March 2001.

## The aggregate economy

Since the start of 2001, the economy has grown markedly slower than the average of the last four cycles that lasted 19 quarters. We have two measures of the overall economy that should, in theory, have exactly the same growth rate, but often do not because of measurement difficulties. The more commonly used yardstick, the gross domestic product (GDP), increased by 13.9% over the last 19 quarters, for an average annual rate of 2.8%. That performance falls well below the average 3.4% GDP growth rate of the previous four cycles (**Figure A**). The gap is even wider for the second, equally valid measure of overall activity, gross domestic income (GDI).<sup>3</sup> By that measure, activity has expanded at only a 2.3% rate, more than a full percentage point slower than the 3.6% GDI rate of past cycles. No prior cycle has had such a low growth rate of GDI (**Figure B**).

## Employment

The prosperity of the typical American family depends on strong job growth, not only to provide job opportunities but also because a tighter labor market delivers faster pay gains. Despite several rounds of tax cuts, the labor market has seriously underperformed in the current cycle compared with previous ones. The United States has only 1.6% more jobs today than at the last business-cycle peak 58

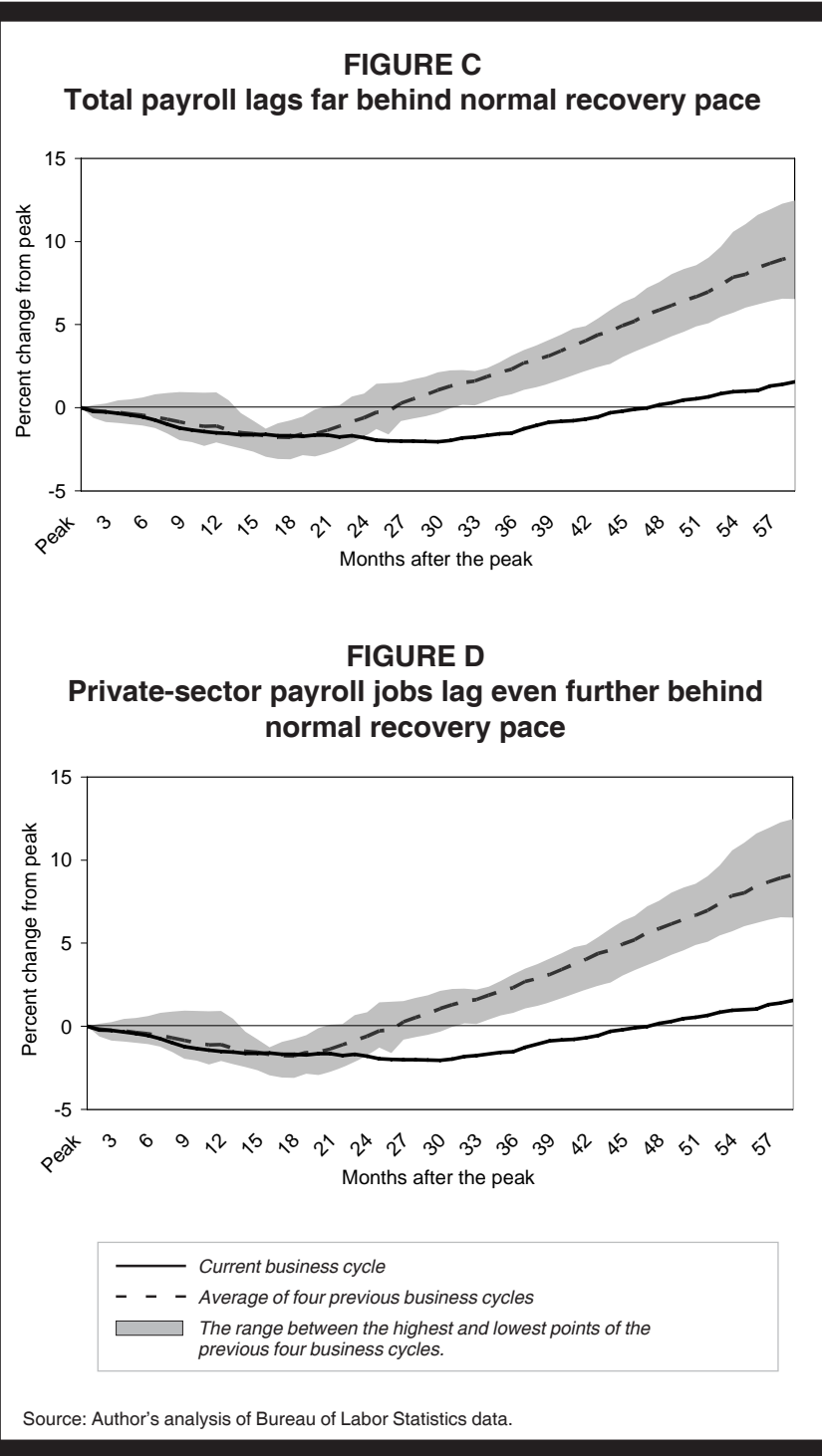


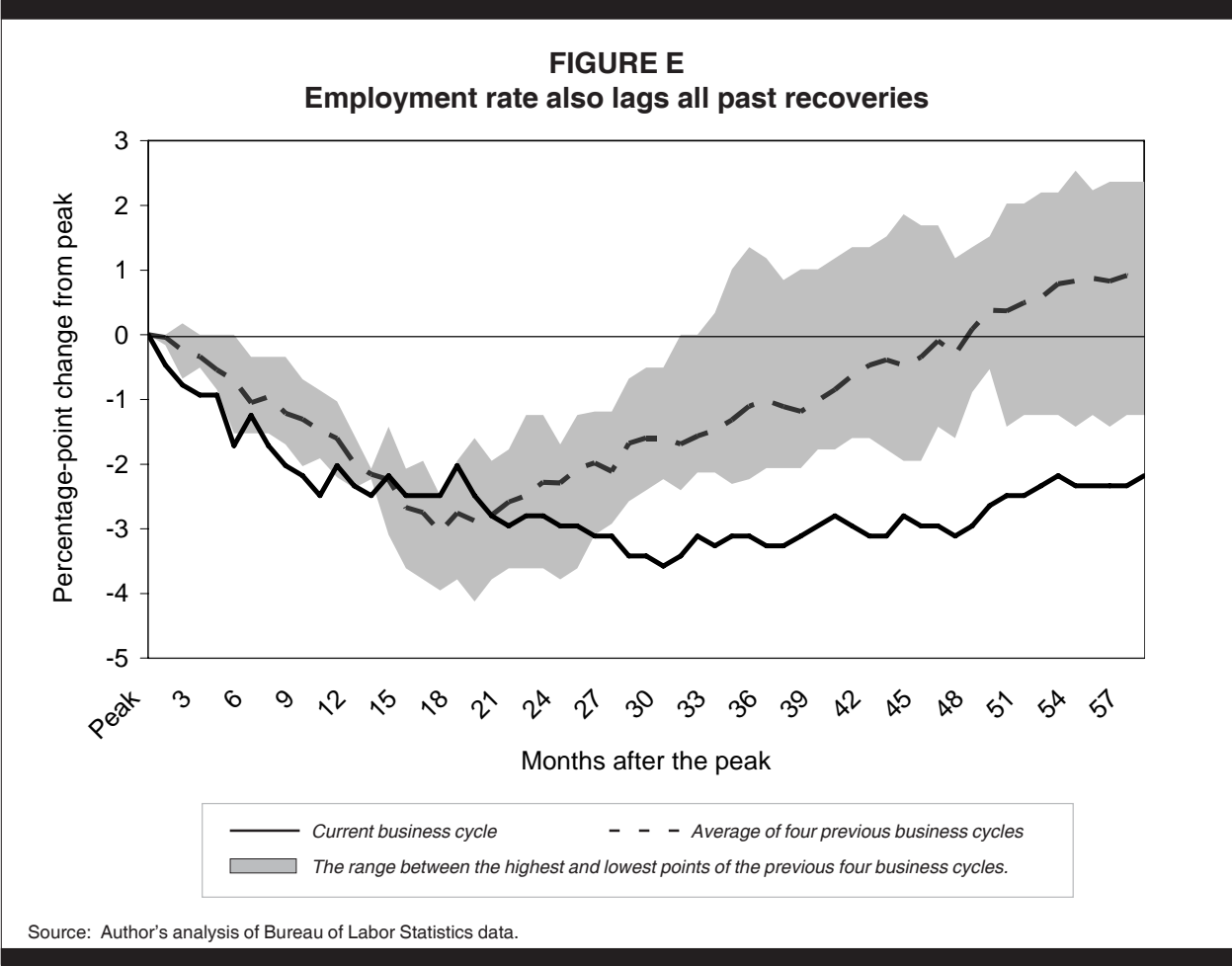
months ago in March 2001. At this stage of previous cycles, jobs had grown by an average of 9.1% and never less than 6.5% (**Figure C**).

Because tax cuts are touted as creating private-sector jobs, it is instructive to look at changes in this area of employment in isolation. Private-sector jobs are only 1.0% higher than in March 2001. The substantial rise in employment supported by increased defense spending more than accounts for this modest gain in private-sector jobs.<sup>4</sup> In comparison, private-sector jobs rose by an average 9.1% in past cycles, and the lowest previous gain was 6.9% (**Figure D**).

Keep in mind that the working-age population has been growing more than 1% per year. When researchers at the Cleveland Federal Reserve analyzed employment as a share of the working-age population, it found “the same sad story” as in the payroll figures above.<sup>5</sup> As with payroll jobs, the gains of the last two years lag those of previous cycles. The employment rate

remains 2.2 percentage points below March 2001 (**Figure E**). With a working-age population of 226.7 million, employment would be more than 4 million higher if the employment rate had recovered the level of the last peak. The unemployment rate has become a poor indicator of labor market conditions because so many people have withdrawn from the labor force.<sup>6</sup> This unprecedented decline in labor force participa-





tion itself undermines a key argument made for the tax cuts: that lower marginal rates would substantially increase incentives to enter the labor force.

In making the case for the tax cuts of 2003, the Bush Administration acknowledged that strong job growth should be expected without tax cuts. It projected that 4.1 million jobs would be created between mid-2003 and the end of 2004 without the 2003 tax cuts, and that 5.5 million jobs would be created with the tax cuts.<sup>7</sup> In fact, Congress enacted even deeper tax cuts than those on which the Bush Administration's estimates were based. Even so, only 2.6 million jobs were created over that 18-month period. Thus, by the Bush Administration's own analysis, the 2003 tax cuts failed to create more jobs than would have been expected without the tax cuts.

**Wage and salary income**

Along with anemic job growth, the current cycle stands out for the stagnation of wage and salary income. Most people's standard of living depends on their wages and salaries. The 1.2% annual growth rate of wage and salary income in this cycle falls below the pace of all four past cycles and is less than half their 2.7% average growth rate (Figure F).

## Personal income

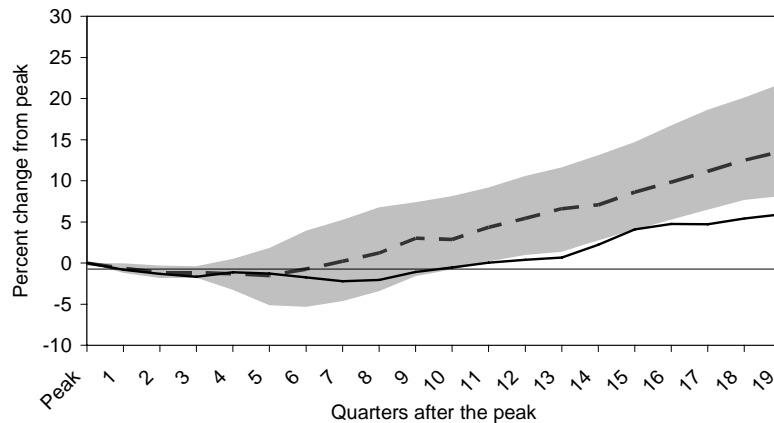
Because other forms of income have been rising faster than wages and salaries, total personal income (including fringe benefits, rent, interest, dividends, proprietor's income and transfer payments, in addition to wages and salaries) has increased at a modestly faster 1.8% pace over the last four-and-a-half years. That is almost half the average pace of 3.2% of prior cycles. Moreover, as shown in **Figure G**, personal income growth has stalled in the last year.

## Spending

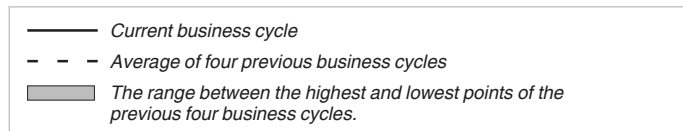
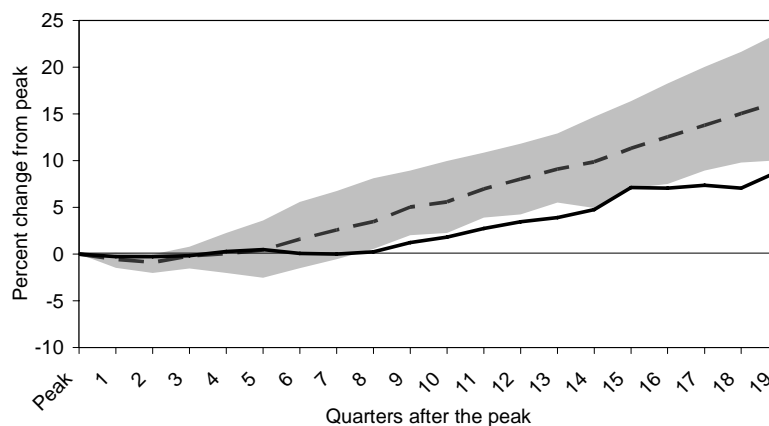
Spending has grown somewhat faster than GDP and income over the last four-and-a-half years, but it still trails the pace of earlier cycles. Total U.S. spending ("final sales to domestic purchasers" including households, businesses, and government) has grown at a 3.0% pace compared to the 2.8% pace of GDP. Spending has grown faster than output because imports have grown faster than exports (as foreign governments and investors have financed a growing trade deficit). U.S. spending gains have nonetheless lagged the 3.7% average gain of previous cycles.

The story is much the same for personal spending. Additional borrowing (and vanishing saving) has allowed households to boost their spending at a 3.1% growth rate, much faster than the 1.8% pace of their income gains. Even with the boost from borrowing, household spending has failed to keep pace with the 3.6% average of previous cycles.

**FIGURE F**  
Wage and salary income 19 quarters after business-cycle peaks



**FIGURE G**  
Personal income 19 quarters after business-cycle peaks



Source: Author's analysis of Bureau of Economic Analysis data.

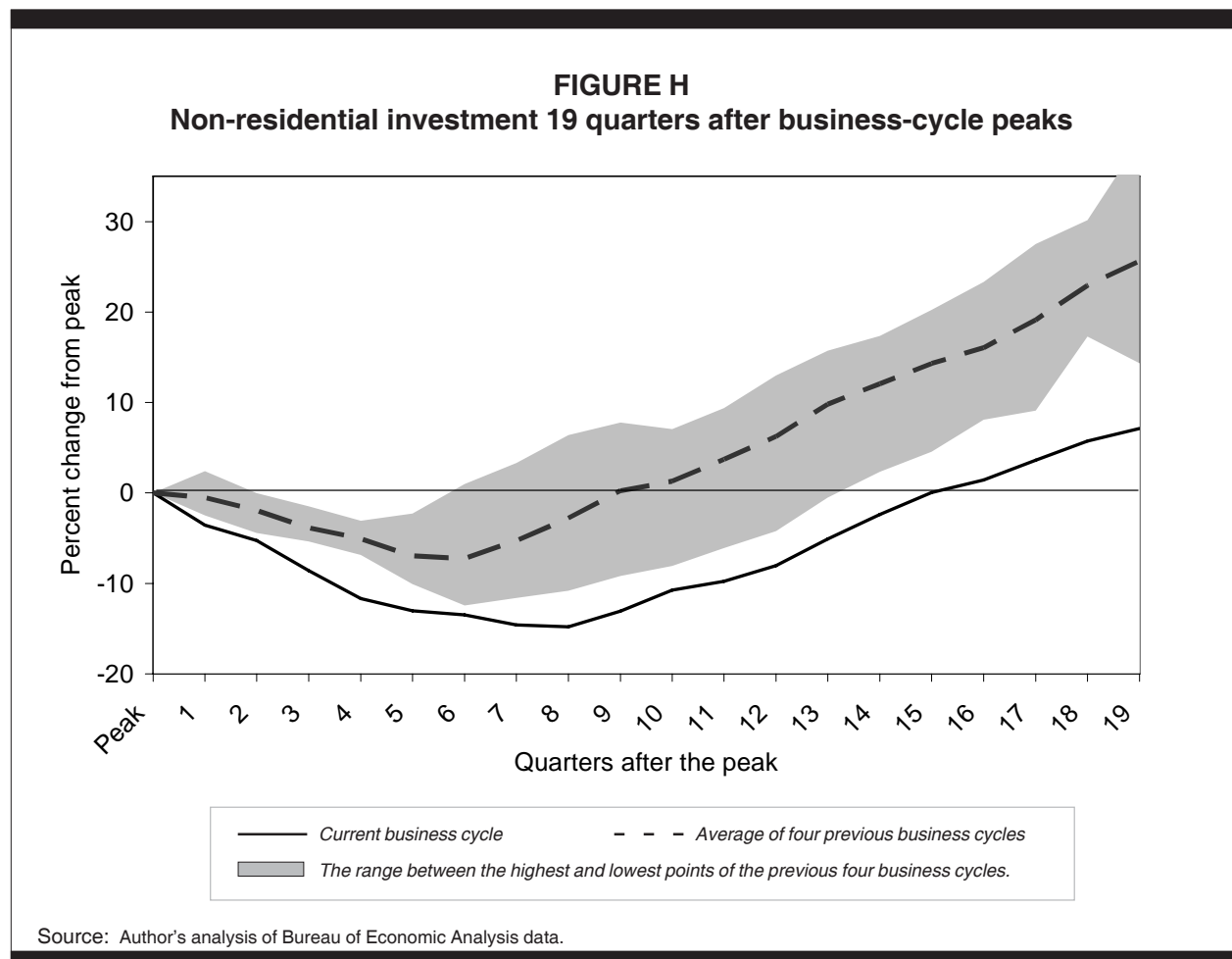
## Investment

With Congress again debating new tax cuts for business investment, a review of the effect of recent tax cuts on investment is in order. Over the last five fiscal years, the tax cuts tied to business investment have reduced revenue by an estimated \$203 billion. This large revenue loss for government brought a large windfall to businesses, but it appears to have had a negligible effect on investment.

Proponents of cuts in individual taxes—particularly lower rates for dividends, capital gains, and the highest income levels—have argued that the cuts would spur investment generally. In addition, the justification of the business tax cuts of 2002 was based on the notion that they would boost investment. Here again, the results have been disappointing.

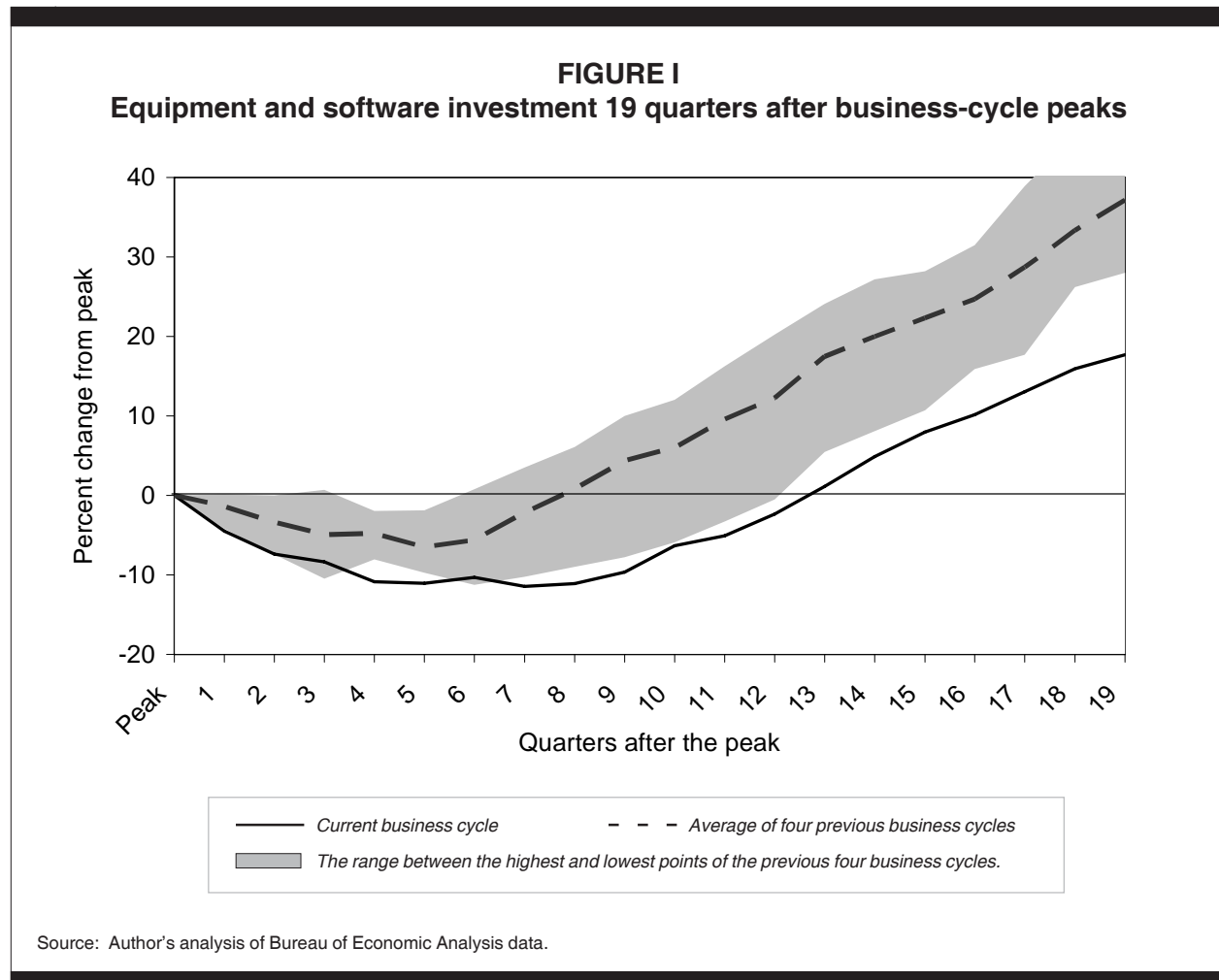
Business investment in structures, equipment, and software (so-called “non-residential investment”) was only 7.1% higher in the fourth quarter of 2005 than it had been in the first quarter of 2001. That is less than half of the 14.3% growth found in the worst of the four prior cycles, and about one-fourth of the 26.0% growth rate in the strongest prior cycle (**Figure H**).

Overall fixed investment includes business structures as well as their equipment and software. Any boost to investment from the tax breaks for individuals should have applied to structures, but the tax breaks for business tended to exclude new incentives for structures. For example, the “bonus deprecia-



tion” provision enacted in March 2002 allowed companies to immediately write off 30% of the cost of new investments expected to last less than 20 years and to put the other 70% in the standard depreciation schedule. In May 2003, Congress raised the “bonus depreciation” rate to 50% and postponed the expiration date from the original September 30, 2003 date to December 31, 2004. The bonus depreciation provision reduced revenue by an estimated \$62.5 billion in fiscal year 2004. Along with higher profits, the expiration has contributed to the estimated \$90 billion increase in corporate tax payments in fiscal year 2005.<sup>8</sup>

Three comparisons reveal the limited effect of the business-investment-related tax cuts of 2002 and 2003. First, the pattern of investment in this cycle can be compared with that of the five earlier business cycles that lasted as long as this one. Second, what happened to investment before and after the expiration of the “bonus depreciation” provision at the end of 2004 can be examined (quarter 15 in **Figure I**). Finally, we compare the current cycle with the cycle of the early 1990s, which was marked by tax increases. In all three comparisons, we trace the changes in equipment and software (E&S) investment, which is the type most affected by recent tax changes.

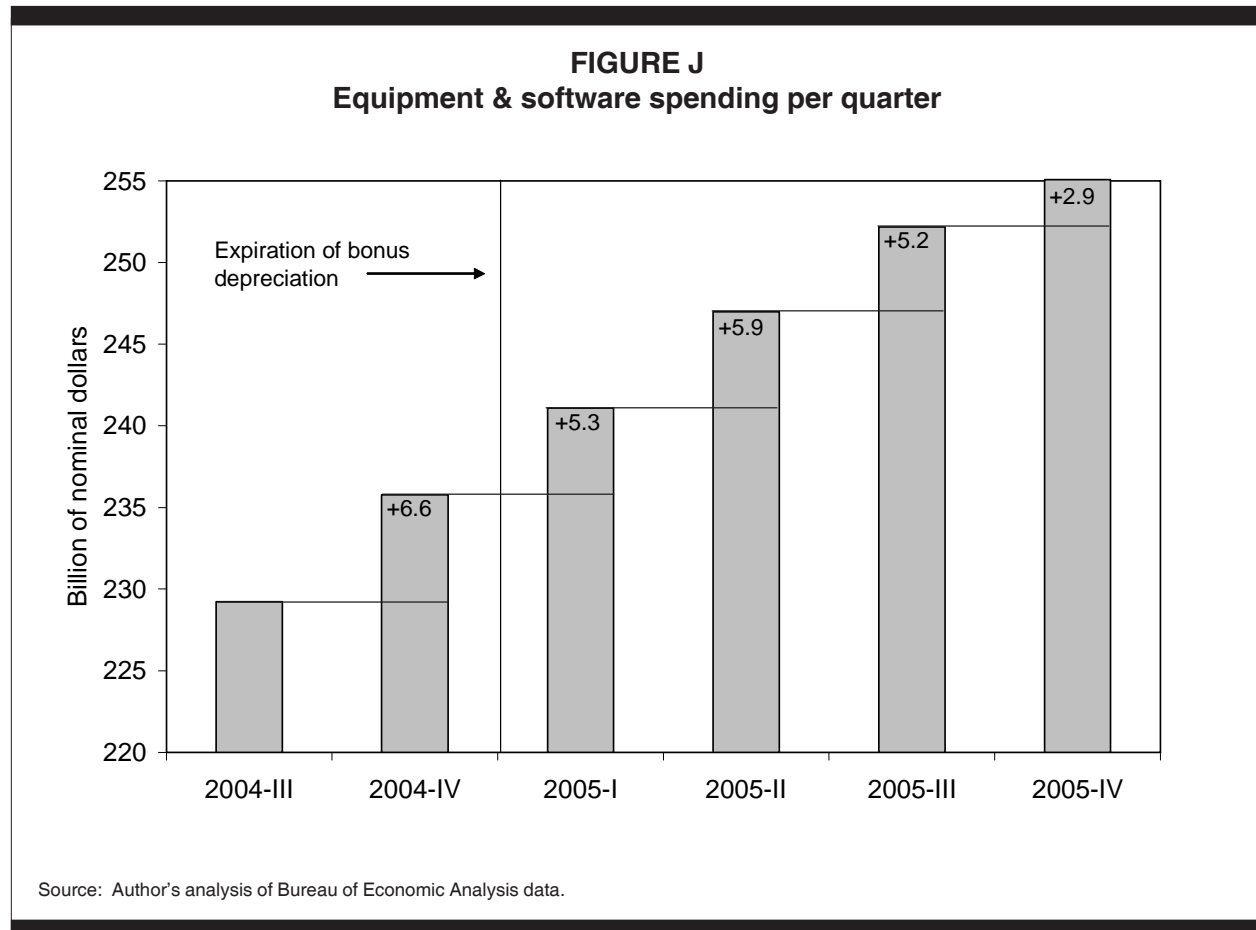




Investment always declines during a recession, and for some time thereafter, before eventually expanding for several years. To put the recent investment cycle of decline and rebound into context, we should compare it to previous business cycles. In the most recent quarter of data (fourth quarter of 2005), E&S investment stood 17.7% higher than at the peak of the last business cycle in early 2001. (See **Figure I**.) In the last four business cycles that lasted as long, that investment had grown an average of 37.1% above the prior peak.

Another way to gauge the effect of the investment-related tax cuts is to watch what happens when they expire (**Figure J**). The “bonus depreciation” provision was passed in 2002, extended in 2003, and expired on December 31, 2004. That provision alone reduced federal revenue by \$152 billion over the last four fiscal years. That tax expenditure of \$62 billion in fiscal year 2004 represented more than 7% of almost \$873 billion in equipment and software spending that fiscal year.

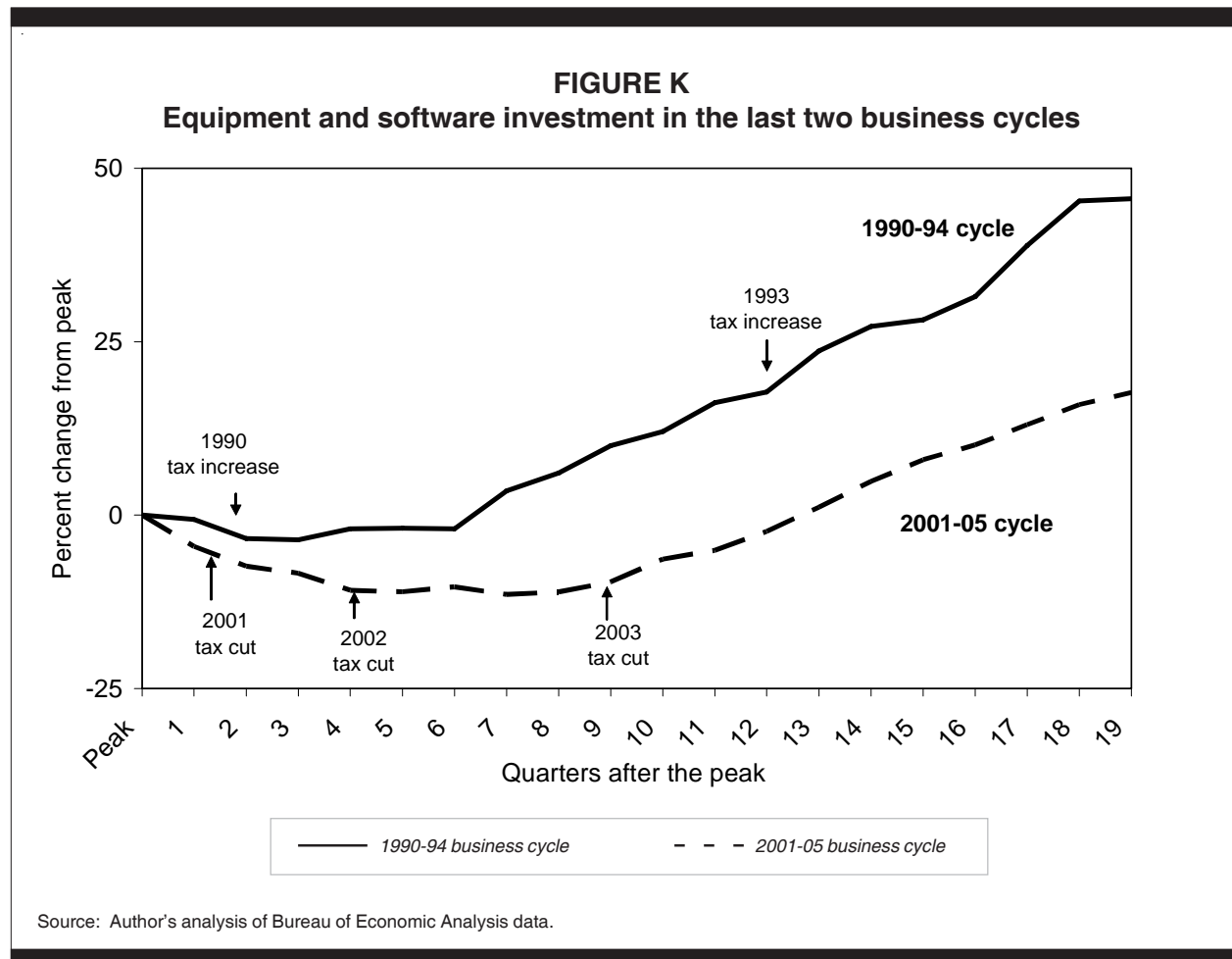
If bonus depreciation tax breaks were leveraging investment successfully, they should have caused investment to speed up at the end of 2004 and to stagnate or decline in 2005 after they expired. That simply did not occur. Nominal E&S investment grew by \$6.6 billion in the last quarter of 2004, but continued to grow by another \$5.3 billion in the first quarter of 2005, and by another \$5.9 and \$5.4 billion in the two quarters after that. These very comparable quarter-to-quarter increases indicate that “bonus depreciation” tax cuts did little to expedite or encourage E&S spending levels. More importantly,



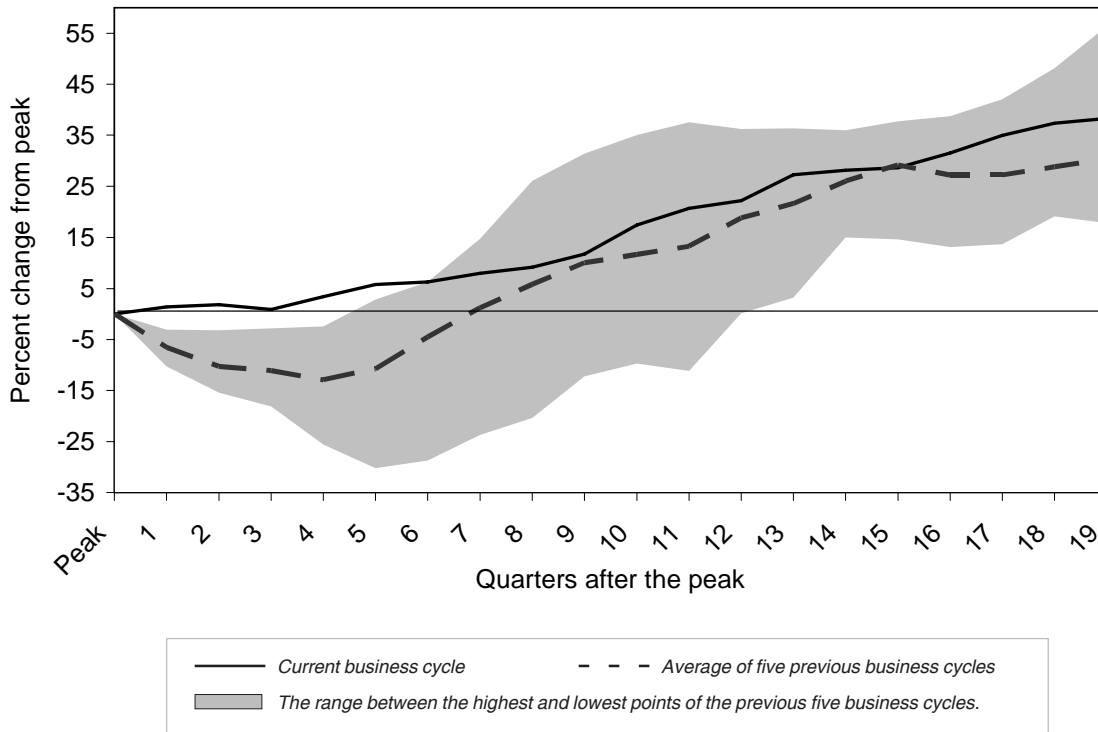
if just \$0.8 billion (one tenth of one percent of annual E&S spending) was pulled forward, then the increase in the second quarter of this year was greater than at the end of 2004 without that last minute pulling forward. Thus, the over \$60 billion in lost revenue appears to have provided an enormous windfall to businesses with negligible effect on investment or positive effect on the economy.

**Figure K** contrasts this cycle, with its tax *cuts*, to the previous cycle, with its tax *increases*. The fact that investment fared so much better in the last cycle suggests that a credible fiscal policy can contribute more to investment than large tax breaks for investment, almost all of which would have occurred anyway.

Like the cock that believes he causes the sun to rise every day because he always crows beforehand, implementing tax cuts at the normal low point in the investment cycle does not necessarily cause the subsequent increase in investment to occur. In this case, the rise in investment since early 2002 is no better than what should have been expected in the absence of investment-related tax cuts.



**FIGURE L**  
**Residential investment 19 quarters after business-cycle peaks**



Source: Author's analysis of Bureau of Economic Analysis data.

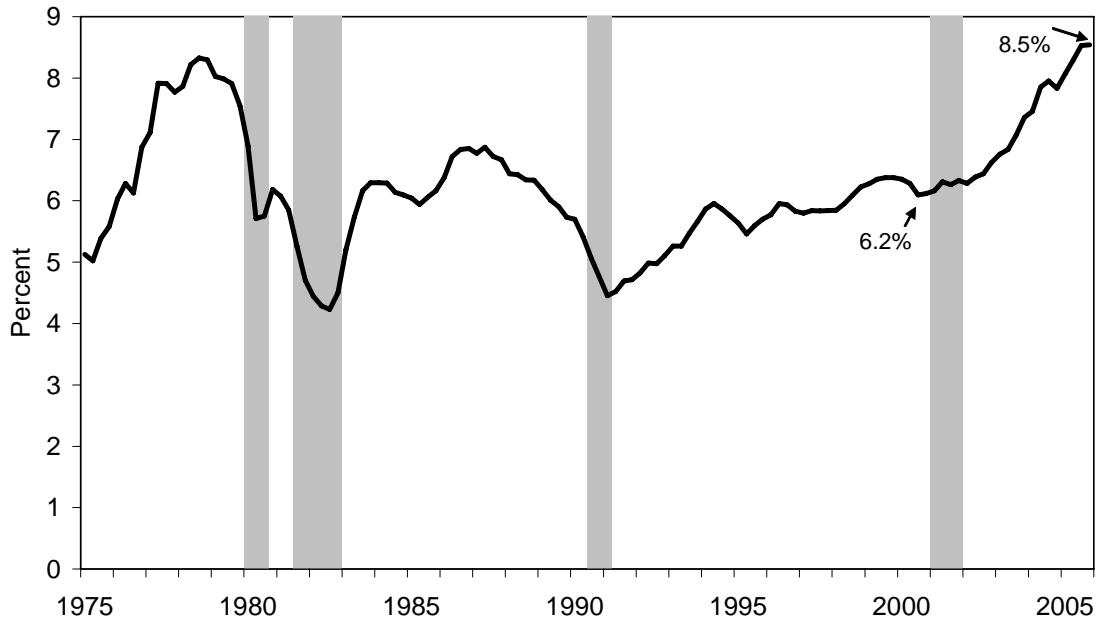
## Residential investment up despite reduced tax incentives

Only one major gauge of economic activity—construction and remodeling of homes—has done better in this cycle than the norm for past cycles. Residential investment has soared 38.3% since early 2001, substantially above the average 30.4% gain of earlier cycles. Indeed, of the previous four cycles, only that of the early 1980s surpassed the current cycle (**Figure L**).

The primary tax incentive to invest in homes comes from the deductions for interest paid on home mortgages and real estate taxes. The Joint Committee on Taxation estimates that those two deductions lowered revenue by \$92 billion in the last fiscal year.<sup>9</sup> The reductions in income tax rates since 2001 have lowered the effective value of deductions for mortgage interest and real estate taxes. For a person with a marginal tax rate of 35%, taking on a mortgage with \$10,000 in interest lowers taxes by \$3,500. Reducing that person's marginal rate to 30% lowers the subsidy for that mortgage to \$3,000.

Because cutting taxes also raises after-tax income, we must look at residential investment as a share of after-tax income. Although tax changes since 2001 have actually reduced incentives for spending on homes relative to other forms of spending, residential investment rose as a share of after-tax income, from 6.2% in the first quarter of 2001 to 8.5% in the fourth quarter of 2005 (**Figure M**).

**FIGURE M**  
**Residential investment as percent of after-tax income**



Note: Shaded areas denote recessions.

Source: Author's analysis of Bureau of Economic Analysis data.

Thus, the strength of residential investment itself shows the limited role of taxes in shaping the size and strength of the economy. Many other factors in the economy are driving the changes we observe in consumption and investment.

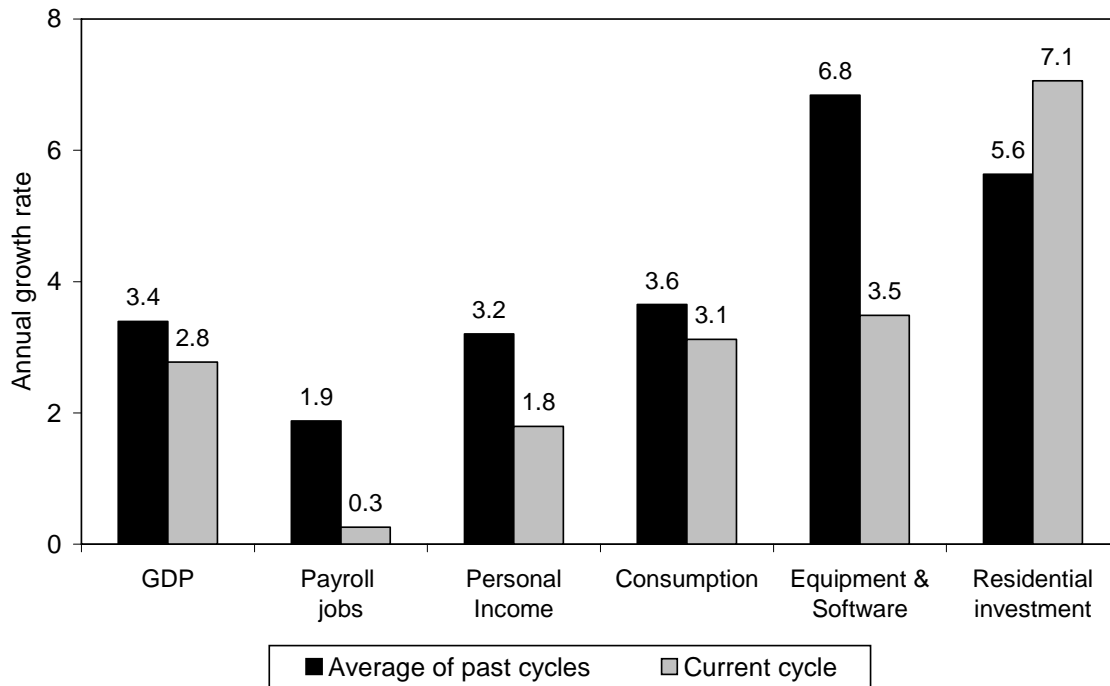
## Conclusion

A review of economic performance over the last four-and-a-half years indicates that the series of major tax cuts enacted in that time have not strengthened the economy. Almost every broad measure of economic activity—GDP, jobs, personal income, and business investment, among others—has fared worse over the last four-and-a-half years than in past cycles (**Figure N**). Proponents of the series of major tax cuts since 2001 had projected that gauges such as these would reflect improvement after enactment.

The one bright spot in the economy—residential investment—has had a reduction in tax incentives because lower income tax rates reduce the value of deductions for mortgage interest and real estate taxes.

Contrary to proponents of the very costly “bonus depreciation” provision for business investment, such investment in equipment and software was barely affected by the expiration of that provision at the end of 2004.

**FIGURE N**  
**The current cycle lags past averages by almost every measure**



Source: Author's analysis of Bureau of Economic Analysis and Bureau of Labor Statistics data.

Although the tax cuts have failed to boost economic performance, they have not failed to reduce revenues substantially. In the recently completed fiscal year 2005, the combined effect of the tax cuts passed since 2001 was \$225 billion without interest. When the interest costs from greater debt is included, the tax cuts raised the deficit by \$260 billion, a sum that would wipe out most of last year's unsustainable \$317 billion deficit. If the tax cuts are extended and reasonable assumptions about future spending are accepted, the deficit will remain near 3% of GDP (or higher) indefinitely.<sup>10</sup>

As the Congress debates whether to enact new tax cuts or to extend expiring cuts, it should carefully weigh their substantial effects on the already excessive deficit against their insubstantial effects on economic performance. We would enhance the standard of living of most Americans in the future if the tax cuts for those with high income and wealth were allowed to expire.

—Updated: March 2006

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David Ratner provided research assistance for this report.

## Endnotes

1. The Joint Committee on Taxation is the source of all the numbers in this report on the direct cost of tax legislation. Numbers that also include interest costs come from the Center on Budget and Policy Priorities.
2. Mark Zandi, "Assessing President Bush's Fiscal Policy," *The Dismal Scientist*, July 2004.
3. The Bureau of Economic Analysis makes independent estimates of both GDP and GDI, with the former compiled from production side data sources and the latter from income side data sources. In theory, the two measures should be identical in value. In practice, there is always at least a modest "statistical discrepancy." GDP receives most of the attention, but in periods such as this when the two measures persistently diverge, GDI deserves equal attention.
4. Lee Price with David Ratner, "Without defense-related spending, private sector would still be in a jobs hole," August 3, 2005, [http://www.epi.org/content.cfm/webfeatures\\_snapshots\\_20050803](http://www.epi.org/content.cfm/webfeatures_snapshots_20050803).
5. Mark Schweitzer and Guhan Venkatu, "The Employment Surveys Are Telling the Same (Sad) Story," Research Department, Federal Reserve Bank of Cleveland, May 15, 2004.
6. For an extended analysis of why the unemployment rate is not providing an accurate picture of labor market slack and an alternative measure of slack taking account of rising school attendance and employment of persons 55 and older, see Jared Bernstein and Lee Price, *An Off-Kilter Expansion: Slack Job Market Continues to Hurt Wage Growth*, EPI Briefing Paper, September 2, 2005, <http://www.epi.org/content.cfm/bp164>.
7. The Economic Policy Institute did a monthly analysis of the failure of the 2003 tax cuts to deliver the promised benefits on its jobwatch.org Web site. It also preserved Council of Economic Advisers, "Strengthening America's Economy: The President's Jobs and Growth Proposals," February 4, 2003 on its Web site after the CEA pulled it down (See [http://www.jobwatch.org/creating/bkg/cea\\_on\\_bush\\_tax\\_cuts\\_20030204\\_macro\\_effects.pdf](http://www.jobwatch.org/creating/bkg/cea_on_bush_tax_cuts_20030204_macro_effects.pdf)).
8. Congressional Budget Office, "Monthly Budget Review," October 6, 2005.
9. Joint Committee on Taxation, *Estimates of Federal Tax Expenditures for Fiscal Years 2005-2009*, January 12, 2005, p. 33.
10. Max Sawicky, "Red Ink Rising," EPI Economic Snapshot, September 21, 2005, [http://www.epi.org/content.cfm/webfeatures\\_snapshots\\_20050921](http://www.epi.org/content.cfm/webfeatures_snapshots_20050921).