The 2003 Tax Cuts and the Economy: A One-Year Assessment

by Bill Beach, Rea Hederman, Tim Kane

As the 108th Congress works its way to the end of its second session, assessments of its likely place in the history of public policy are beginning to be written. Certainly this Congress's actions on the Medicare prescription drug benefit and its support of the ongoing war on terrorism will loom large. However, the future may unfold in a way that will emphasize another of this Congress's contributions: its role in establishing the conditions for a long period of economic prosperity.

If the significant expansion of economic well-being is one of this Congress's enduring legacies, that place in history will stem primarily from the passage of the Jobs and Growth Tax Relief Reconciliation Act (JGTRRA), which President George W. Bush signed into law on May 27, 2003. That legislation is one of the greatest supply-side changes to tax law in U.S. history. And JGTRRA has delivered on its economic promise.

All across the economic spectrum, JGTRRA left its tracks. For example, the unemployment rate peaked in June 2003 at 6.3 percent, began dropping in July, and has held steady at 5.6 percent—lower than the average unemployment rate in the 1970s, 1980s, and 1990s—for all but one month of 2004. The growth of GDP accelerated sharply in the third quarter of 2003 after the tax cut was enacted. Growth has remained high, averaging 5.4 percent per year after JGGTRA, compared to a 1.8 percent annual rate over the previous three and a half years.

Why would employment and production surge so visibly? Incentives. JGTRRA accelerated the phase-in of incentives to work and invest from the President's 2001 tax cuts, while also providing major new incentives:

- **Lower tax rates on personal income** for all taxpayers. The top marginal tax rate was reduced from 39.6 percent to 35 percent, and a 10-percent bracket was introduced.
- **Lower taxes on business investment**, including a much lower tax rate, 15 percent, on dividends and on long-term capital gains. Equally important, JGTRRA allowed

businesses to more quickly deduct the expenses of their investments in machinery, computers, and software.

- **An increased child tax credit,** from $500 to $1,000 per child.
- **The end of the marriage penalty.** Married couples no longer pay higher taxes than equivalent singles, which eliminates a perverse incentive against marriage.
- **A phased-in repeal of the estate tax.**

While it will be some time before economists have enough data to make precise estimates of JGTRRA's contributions to economic activity, current data strongly imply that the legislation had much to do with the timing of economic take-off. American companies responded to the 2003 tax cuts by employing more workers and more capital equipment beginning almost the moment lower taxes became law.

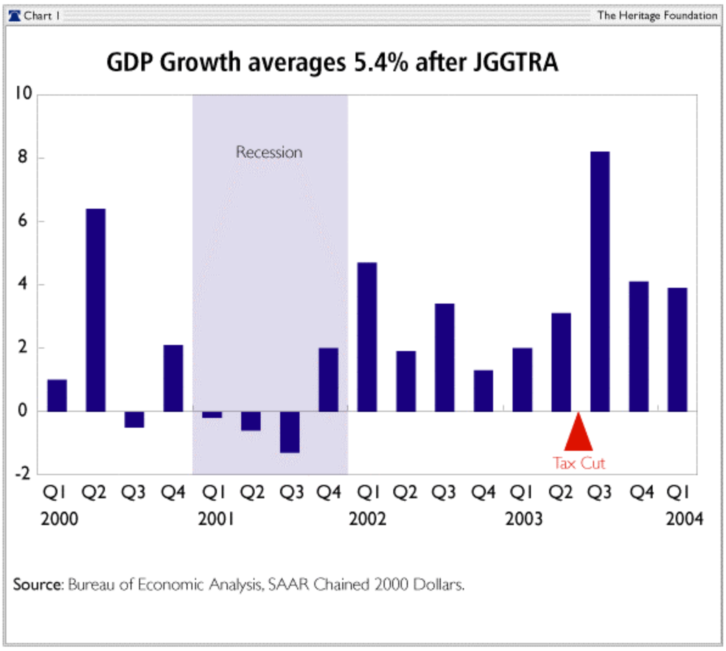
Table 1 — The Heritage Foundation

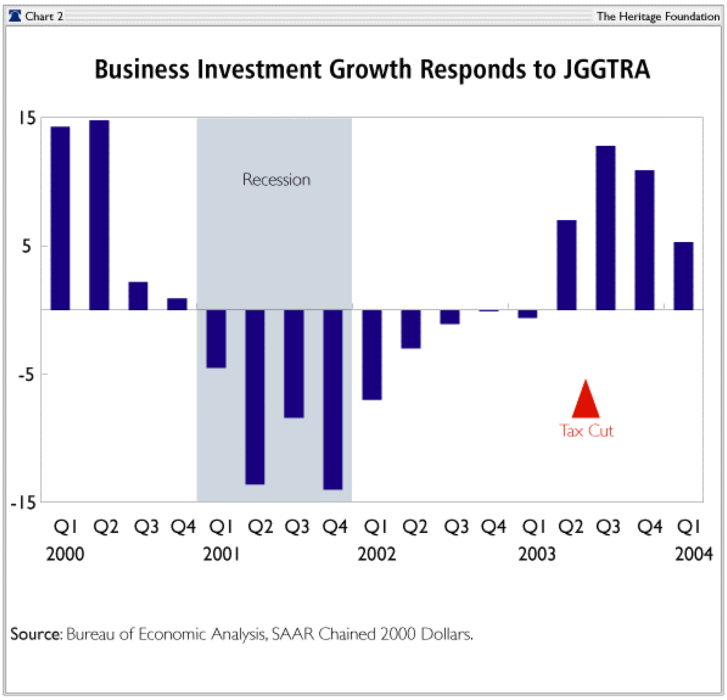
JGGTRA Impact Summary

Average Growth Over Indicated Period

Economic Indicator	Jan 2000-June 2003	July 2003-present
GDP	1.81%	5.40%
Investment	- 1.14%	13.03%
Business Investment	- 0.94%	9.67%
Dow Jones Industrial Average	- 0.43%	1.11%
Consumer Sentiment	- 0.47%	1.12%
Total Employment Growth	0.01%	0.10%
Total Employment	18,000 jobs	143,000 jobs

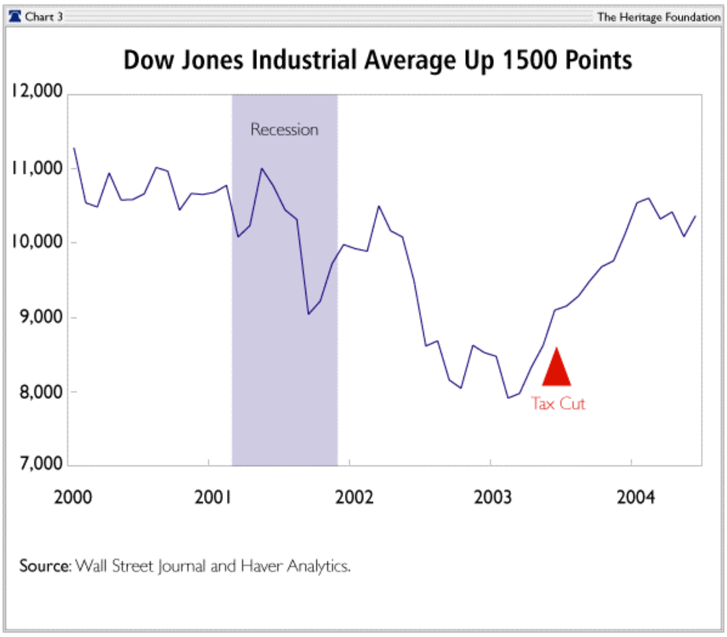
The impact of JGGTRA is summarized in Table 1. In the fourteen quarters before the 2003 tax cut, growth averaged 1.81 percent, annualized, compared to 5.4 percent during the three quarters after its passage. Total investment contracted at a rate of 1.14 percent, annualized, before the 2003 tax cut, and grew at a 13.03 percent rate after. The Dow Jones Industrial Average contracted four-tenths a percent per month before the cut, but grew 1.11 percent monthly on average after JGGTRA. Consumer sentiment grew at similar rates, getting a huge boost after JGGTRA passed. The biggest impact, though, has been on jobs, which grew at a paltry 18,000 per month for three and a half years before JGGTRA, and then surged to 143,000 per month since.

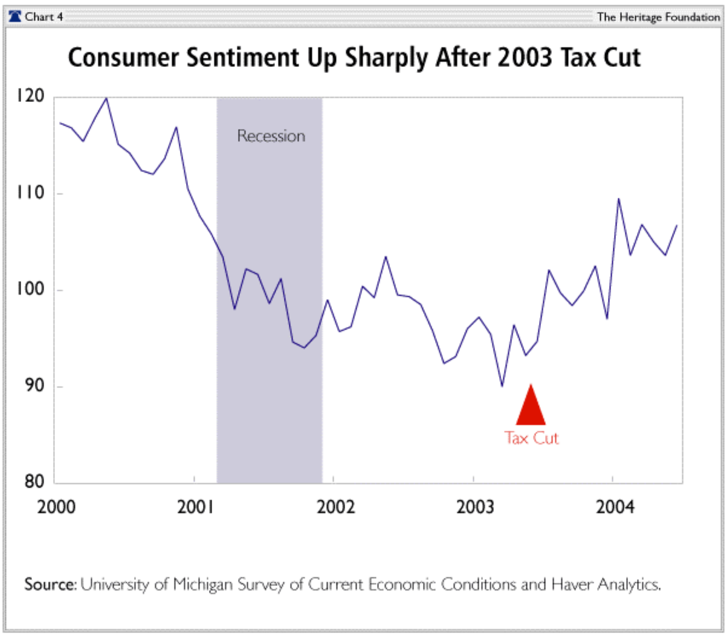


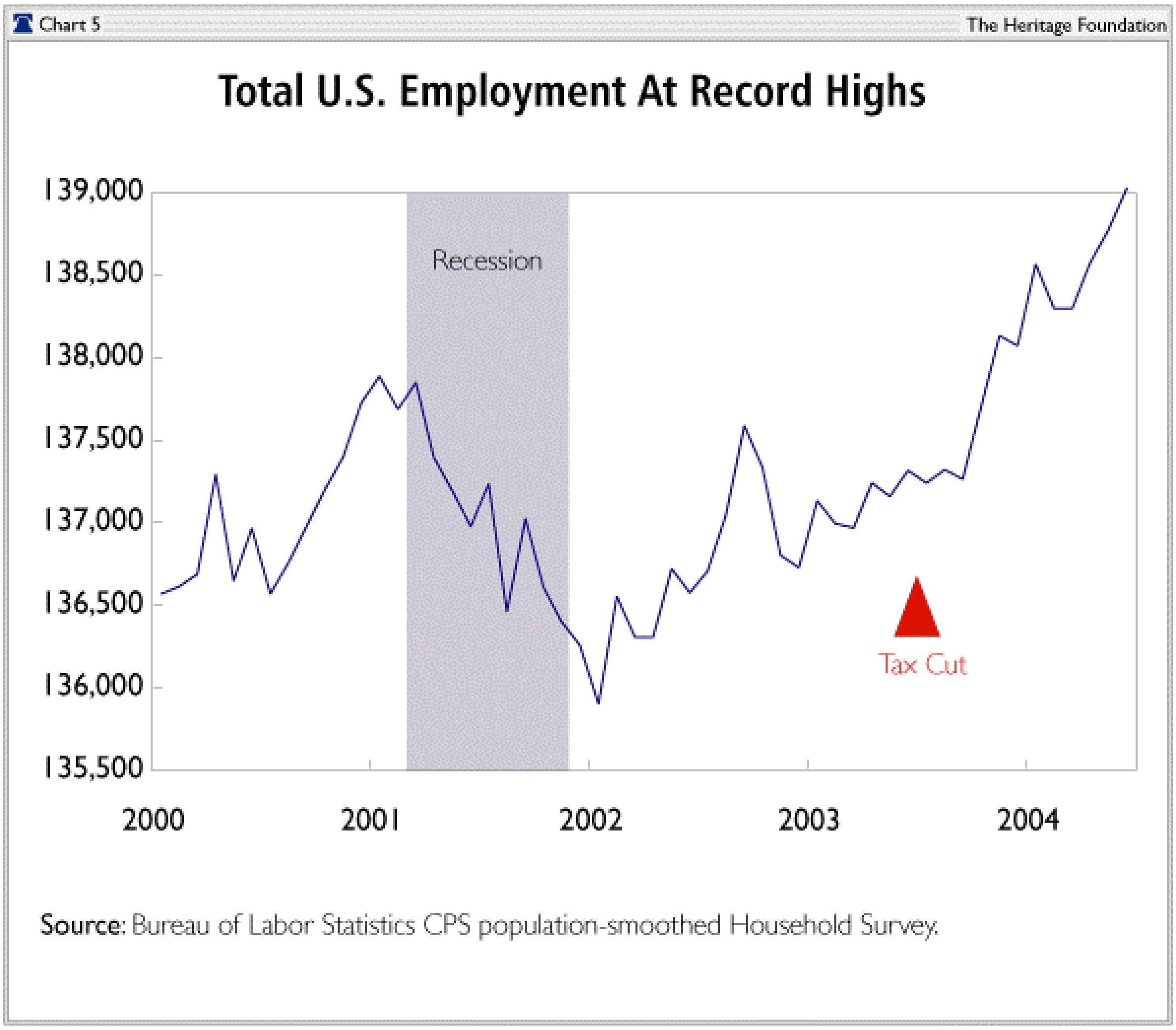


Total economic output grew by an amazing 8.2 percent, at an annualized rate, in the third quarter of 2004, as shown in Chart 1. What accelerated GDP growth in the short term was increased business investment (known as "non-residential fixed investment"), as shown in Chart 2.

Growth in business investment fell sharply in the summer of 2000, from an annualized rate of 14.8 percent in the second quarter to 2.2 percent in the third. Business investment dropped still further in the fourth quarter of that year and then declined for the next nine quarters. Non-residential fixed investment responded strongly to the reductions in taxation on capital in JGTRRA. Business investment grew 7 percent in the second quarter of 2003 and has increased in every quarter since the enactment of the bill.







Economic recovery unexpectedly floundered for more than a year in 2002, even as most forecasters anticipated a take-off. Uncertain expectations surely played a role, affirming that the non-rational elements (e.g., moods, opinions, preferences for risk) play a large role in the economy. However, a change in attitude is powerfully evident after the summer of 2003: the Dow Jones Industrial Average roared past the 10,000 mark, consumer sentiment returned to pre-recession levels, and total employment reached record highs. Charts 3-5 show how these three measures, which tell a great deal about consumer and business confidence, responded to JGTRRA.

Employment

The payroll survey is only one measure of job creation, and the last three years have revealed that it is incomplete. A job growth gap of over two million exists between payroll employment and total U.S. employment (as measured by the Labor Department's Survey of Households). Partisans tend to focus exclusively on the payroll numbers without addressing its documented inability to measure self-employment and its currently depressed double counting of turnover.

The key figure in assessing the job market, however, is the rate of employment in the overall labor force. The rate of unemployment stands at 5.6 percent today. In other words, 19 out of 20 Americans who are willing and able to work are employed, and economic theory and practice tell us this is about as low as the unemployment rate can get because of transitional and structural unemployment.

Critics say that the unemployment rate is flawed because it ignores discouraged workers, pointing not to the number of discouraged workers, which has been steady since the 1990s, but to the proportion of the population that is employed, which is below what it was at the peak of the dot-com boom. But data show that two-thirds of the decline in this measure is due to teens choosing not to enter the workforce in unprecedented numbers. Demographics, not economics, drives the ratio of employment to population. The bottom line is that the unemployment rate peaked the month before the 2003 tax cuts and is now both stable and below the average rate of the 1990s.

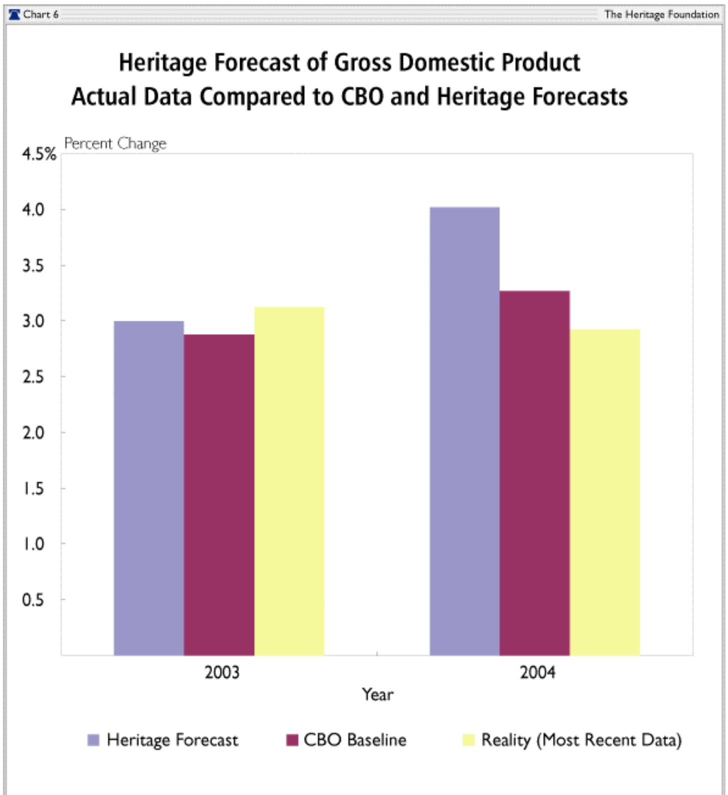
The Long-Term Economic Effects of JGTRRA

Again, current data confirm that JGTRRA made a major difference to today's economy, and additional data will no doubt further underscore the legislation's effects.

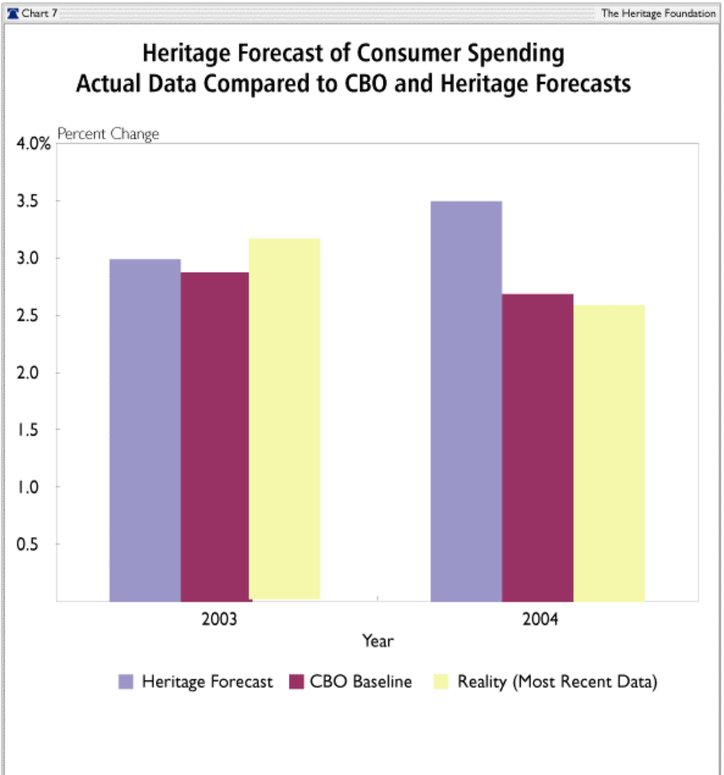
In April of 2003, the Heritage Foundation's Center for Data Analysis used one of the most respected and widely employed models of the U.S. economy to forecast the effect of the proposed version of JGTRRA on hundreds of major economic indicators.[1] CDA's forecasts of one year ago have, so far, proved mostly accurate.

GDP, non-residential fixed investment, and the S&P 500 were all stronger than the baseline models projected for 2003 and the first half of 2004, as predicted. CDA's biggest forecasting error was in employment, which did grow in the latter half of 2003, but slower than forecast.

For 2004, CDA projected almost one million more jobs over the baseline employment growth of two million. The economy has added 1.3 million payroll jobs through the first six months of 2004 and even more non-payroll jobs. The economy appears to be on pace to meet CDA's prediction of three million new jobs in total for the year.



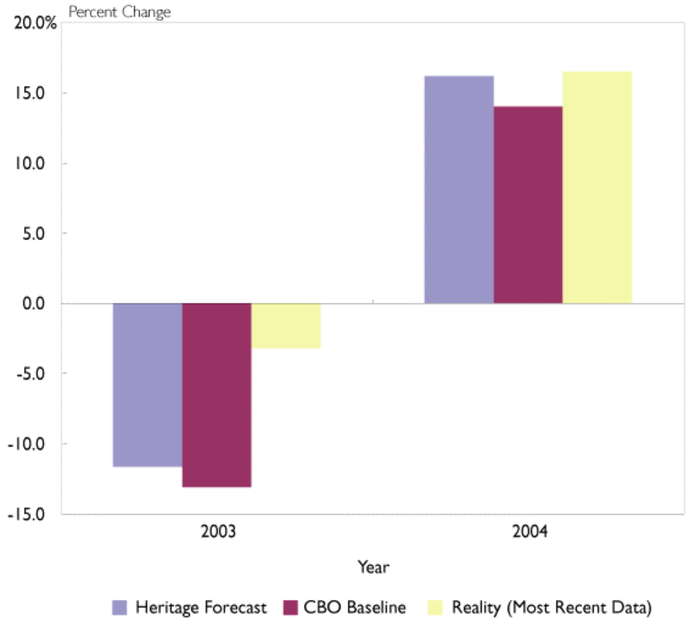
Source: Bureau of Economic Analysis, Haver Analytics, Heritage Foundation.



Source: Haver Analytics, Heritage Foundation.

Chart 8 The Heritage Foundation

Heritage Forecast of S&P 500 Index
Actual Data Compared to CBO and Heritage Forecasts



Source: Wall Street Jounal, Haver Analytics, Heritage Foundation.

Chart 9 The Heritage Foundation

Heritage Forecast of Total Employment
Actual Data Compared to CBO and Heritage Forecasts

Source: Heritage Calculations from BLS data. Heritage assumed growth in last 2 quarters would match that of first 2 quarters.

Charts 6 through 9 compare CDA's April 2003 forecast of JGGTRA's impact, the CBO's baseline forecasts, and the actual economic performance of selected indicators during 2003 and the first half of 2004.

CDA forecasts can be used to estimate the impact of the 2003 tax cut over the next five years. GDP should grow, on average, by almost $70 billion per year above baseline. Consumption expenditures should be almost 1 percent, or $69 billion, more per year that without the tax cuts. Non-residential fixed investment should grow strongly at over $50 billion a year, or over 3 percent. The S&P should continue to climb and reach 1840 by the end of 2008.

We anticipate the long-term effects of JGGTRA will be even stronger than the short-term stimulus. The supply side of the economy has new incentives to expand, to work, to save, and to invest.

Conclusion

JGGTRA was an important step forward in organizing federal taxes in a manner that optimizes growth for all Americans by establishing incentives to work and invest. Fast, steady increases in employment and investment led increases in other indicators almost immediately upon the Act’s implementation in July 2003.

The greatest benefit to supply-side policy, however, is in the long-term dynamics, and so patience will be required before we can fully assess the impact of JGGTRA.

Two principles bear repeating, however. First, economic theory and experience tell us that permanent changes in policy have a larger impact on behavior than temporary stimuli. Reducing taxes on capital has wide support, including the strong backing of Federal Reserve Chairman Alan Greenspan, as the key to accelerating long-run growth. JGGTRA was a historic achievement in this regard. But the best elements of JGGTRA must be made permanent in order to be fully effective in promoting growth. Second, JGGTRA is a far cry from fundamental tax reform. An optimal pro-growth tax system would be much simpler and treat all Americans equally, without the chaotic unfairness of countless special interest deductions and credits that plague the existing code.

Bill Beach is Director, Rea Hederman is Manager, and Tim Kane is Research Fellow, of the Center for Data Analysis at The Heritage Foundation.

---

[1]The Center for Data Analysis at The Heritage Foundation used the GII U.S. Macroeconomic Model, owned by Global Insight, Inc. to conduct this analysis. The model was developed by Nobel Prize–winning economist Lawrence Klein and several colleagues at the University of Pennsylvania's Wharton School of Business. The methodologies, assumptions, conclusions, and opinions in this report are entirely the work of Heritage Foundation analysts. They have not been endorsed by and do not necessarily reflect the views of the owners of the model.