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A MACROECONOMIC POLICY ANALYSIS OF THE FIRST PRESIDENCY OF GEORGE W. BUSH

INTERMEDIATE MACROECONOMIC THEORY

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I. Introduction: The Booming Clinton Years

When George W. Bush was inaugurated as president of the United States in 2001, the economic climate forecasted by the US Office of Management and Budget included \$5.6 trillion in cumulative surpluses over the next ten years. On the campaign trail in 2000, Mr. Bush declared his own spending plans for the expected surpluses: half allocated toward Social Security funds; one quarter toward “important projects;” and the last fourth toward tax cuts for the people (Economist 2003). Unfortunately, the president's plans were thwarted by the sudden dot-com bust in parallel with the financial uncertainty that followed the September 11 disaster. In March 2001, less than three months into Mr. Bush's first term, the economy officially entered a recession.

A complete understanding of the macroeconomic environment during George W. Bush's first presidency requires some familiarity with the macroeconomic context against which it is set. A divided Congress, particularly following the Republican sweep in of Congress in 1994, left the Clinton administration in a politically difficult position insofar as enacting significant fiscal policies. As such, real per capita federal spending grew at its lowest level since World War II. The federal tax code was altered to reflect a number of changes supported by Clinton, among them a greater degree of progressivism and an increase in the number of low-income taxpayers exempt from the income tax. These changes added significant complications to the tax code, but they more finely stratified taxpayers, promoted a perceived distributive fairness, and increased federal revenues (Bienkowski et al 2006).

[Average annual percent change, except as noted]

| Item | 1973 to 1995 | 1995 to 1999 | Accelera- tion ¹ |
|---|--------------------|--------------------|--------------------------------|
| Labor productivity | 1.43 | 2.90 | 1.47 |
| LESS: Contribution of | | | |
| Capital services | 1.06 | 1.53 | .47 |
| Labor quality | .26 | .31 | .05 |
| Computer sector total factor productivity | .16 | .39 | .23 |
| EQUALS: Total factor productivity excluding computers | -.06 | .65 | .70 |

¹ Percentage points.

Note.—Labor productivity is the average of income-and product-side measures of nonfarm business output per hour worked.

Data for 1999 estimated by Council of Economic Advisers.

Detail may not add to totals because of rounding.

Sources: Department of Commerce (Bureau of Economic Analysis) for output and computer prices; Department of Labor (Bureau of Labor Statistics) for hours and labor quality; Macroeconomic Advisers, LLC for capital services; and Council of Economic Advisers.

Accounting for Productivity Acceleration in the 1990s (USGPO 2000)

However, other than relieving a tax bias against saving, Clinton's policies were not generally consistent with those that would encourage economic growth. Yet Clinton's tax increases did not seem to dampen the economy's growth, partly because of extraordinary productivity growth of 2.90 percent versus the historical 1.43 percent during the period. His administration experienced no recessions and enjoyed an average inflation rate of 1.8 percent with a tight variance, which Bienkowski et al (2006) attributes to Clinton's noninterference in Alan Greenspan's wise handling of monetary policy during that time. The increase in tax revenues handsomely improved the net fiscal balance of the federal government from a deficit of \$297.4 billion in 1992 to a surplus of \$189.5 billion in 2000. The Economic Report of the President (USGPO 2000) succinctly summarized the economic climate at the end Clinton era in its opening words:

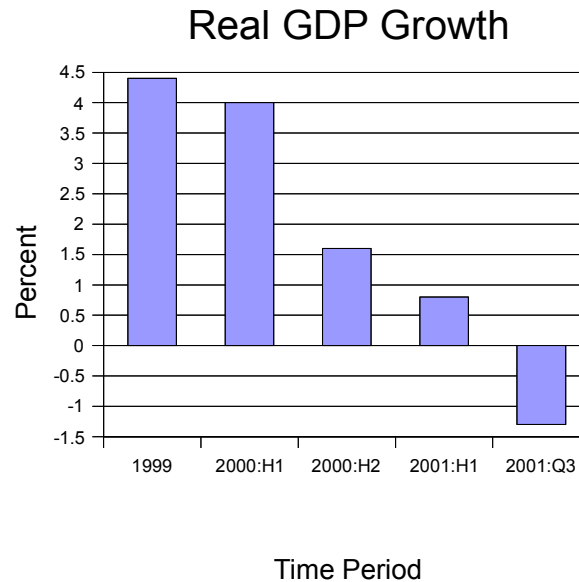
The results have been a 20- million-job increase in payroll employment since January 1993, the lowest unemployment rate since 1969, the lowest core inflation rate since 1965, the lowest poverty rate since 1979, rising productivity, significant

gains all across the income distribution, and a Federal budget in surplus for 2 years in a row after nearly three decades of deficits. The current economic expansion, already the longest peacetime expansion on record, is on the threshold of becoming the longest ever.

Mr. Bush was seemingly destined to inherit a rosy economic situation. The economy was expanding at record pace and at record length, with yearly surpluses projected to achieve \$889 billion by 2011. even given Mr. Clinton's sub-optimal taxation policies and missed opportunities for additional economic growth, there was seemingly little to worry about from a macroeconomic perspective.¹

The good times began to fade about a month after the 2000 edition of the Economic Report of the President was published. The US officially entered a recession in March 2001, riding on the heels of a worldwide collapse in equity prices (Kraay and Ventura 2005). As the year progressed, other factors like preparations for the year-2000 bug and slower business spending on technology also began to take their tolls (USGPO 2002). Mr. Bush, having officially begun his tenure as president in January 2001, was faced with the task of stimulating the economy back to growth. The chart below is reproduced from USGPO (2002) and illustrates the declining real GPD growth leading up to the recession.

¹ A discussion of Mr. Clinton's macroeconomic policies is beyond the scope of this paper. A brief summary can be found in Bienkowski et al (2006).



II. Fiscal and Monetary Policies of the Bush Administration

Mr. Bush campaign promises and fiscal policy suggestions were based on the expectation of large budget surpluses accruing throughout and beyond his presidency. With these surpluses, he envisioned a new kind of conservative politician, one he called the “compassionate conservative.” This variant of the usual conservative stance of smaller government through fewer taxes and social programs maintains the element of tax cuts while increasing spending on social programs.

On the expenditure side, Mr. Bush suggested policy actions that expanded public health care and education. Insofar as health care, Mr. Bush proposed a reform of Medicare that added a prescription drug benefit affecting 41 million elderly subscribers at a cost of \$400 billion over ten years starting 2003 (Shughart 2004). On the education front, Mr. Bush implemented the No Child Left Behind Act, whose aim was to increase graduation rates and access to post-secondary education at a cost of nearly \$13.8 billion (USOMB 2003). He also unsuccessfully pushed for what he called an “ownership society,” where pension systems like Social Security could be

privatized, giving citizens a a greater degree of personal freedom in retirement (Bienkowski et al 2006). Mr. Bush followed through with these promises even after potential surpluses were known to have disappeared (Steurlle 2004).

The September 11 attacks and the subsequent War on Terrorism also caused expenditures to surge substantially. According to OMB numbers Mr. Bush spent \$84 billion more than Bill Clinton on the Department of Defense, bringing that total to \$380 billion for FY2004 (USOMB 2003). Expenditures on the Department of Homeland Security for the same fiscal year were 64 percent higher than pre-9/11 levels, totaling \$36.2 billion. These figures do not account for funding provided to Afghanistan or used in the Iraq war and occupation, which Shughart (2004) estimates at \$48 billion by 2004.

The tax side of fiscal policy also received plenty of campaign trail attention, where a key selling point of Mr. Bush's candidacy was the passage of a large tax cut—and eventually, a series of tax cuts. The initial grounds for the tax cut were the return of excess surplus to taxpayers through a non-discretionary package, since the economy was booming at the time. However, as the economy entered a recession and motivations turned more pragmatic, tax cuts were advocated as a tool for quickly sailing past the economic doldrums and generating jobs (Weller et al 2004). Mr. Bush's administration focused on discretionary fiscal almost exclusively during its first term.

The first round of tax cuts became known as the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA). The Act cut average rates for taxpayers at every level of income, and moved 62 percent of taxpayers to lower marginal rates. It also created a marriage penalty relief and eliminated the estate tax, which were equivalent to selective rate deductions. Further, the bottom “rung” was moved from 15 percent to 10 percent, relieving the tax burden of those who were making just enough to qualify as income tax payers. In totality, the tax cut

implemented \$1.3 trillion in reductions over the ten years started in 2001 (Weller et al 2004). According to Steurle (2004), the larger percentage tax cut was granted to those at the bottom rather than the top of the rate schedule. Over 2001, however, only \$72 billion in tax cut stimulus was actually experienced (Weller et al 2004).

The Job Creation and Workers' Assistance Act of 2002 (JCWA), the second in the series of major tax cuts, was a response to the disaster of September 11, 2001. Before the attacks, surpluses were still being forecasted, as Mr. Bush claimed EGTRRA would only make use of a portion of the surpluses. These projections were shattered by the negative synergy from a terrorist attack on American soil in concordance with an already sputtering economy. The attack wracked equity markets, causing a severe fall in revenues that was accompanied by a 2.05 million job loss in 2001 and an increase in unemployment from 4.0% to 5.8% (USGPO 2002). These circumstances prompted Congress and the president to forgo short-term fiscal diligence in lieu of sustaining long-term macroeconomic goals of full employment and growth. JCWA provided an extension to temporary unemployment assistance, extended tax relief to New York City, and renewed various expiring tax breaks. In terms of revenue, its most important provision was to allow accelerated write-off of depreciation on assets, which freed up cash for businesses in the short term (Steurle 2004). In total, the package provided \$51.2 billion of relief in the subsequent fiscal year (Bienkowski et al 2006).²

Reaction to JCWA was lukewarm, with the economy improving through mid-2002, but sputtering toward the end of the year and the beginning of 2003. The administration decided it would not sit by idly and again drafted a tax cut to stimulate growth. The last major tax cut passed by the Bush administration was the Job and Growth Tax Relief and Reconciliation Act of 2003 (JGTRRA). Steurle (2006) provides an excellent summary of the features and costs of the package, tabulated below:

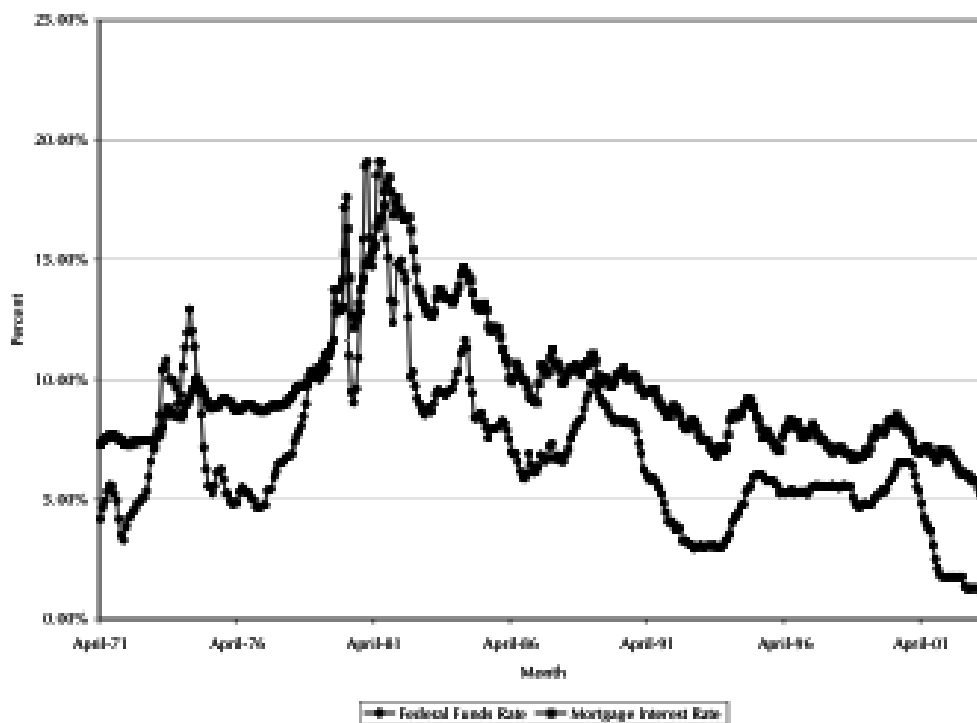
² Measured in 2003 dollars.

| PROVISIONS OF JGTRRA | | |
|---|-------------------|--|
| PROVISION | EXPIRATION | COST IN \$ BILLIONS (WHEN EXTENDED TO 2013) |
| Increased child tax credit | 2004 | \$56.9 |
| Expanded 10 percent bracket | 2004 | \$46.4 |
| Tax breaks for married couples | 2004 | \$26.5 |
| Temporary Increase in the alternate minimum tax exemption | 2004 | \$244.5 |
| More favorable depreciation rules for small business | 2005 | \$12.5 |
| Expanded (50% write-off) depreciation for corporations | 2004 | \$170.5 |
| Lower dividends and capital gains tax rates | 2008 | \$164.9 |

Many of the provisions of JGTRRA were already scheduled in EGTRRA, but they were moved to an earlier date to speed up the recovery. JGTRRA provided a total of \$60.8 billion of tax relief over 2003 and 2004 (Bienkowski et al 2006).³

From a monetary policy perspective, the Federal Reserve Board, chaired by Alan Greenspan, sought to maintain the steady and smooth growth rate experienced during the Clinton years. Before the recession, the Fed began raising interest rates to abate what it perceived to be an overheating economy. Once the recession took effect in early 2001, however, it began a series of aggressive cuts to bring federal funds rate down from the high mark of 6.5 percent. The Fed continued to cut rates well into 2003, when in June interest rates sat at 1.0% (Weller et al 2004). This was the lowest point at which the federal funds level had been in four decades (Auerbach 2003).

³ Measured in 2003 dollars.



Short-Term and Long-Term Interest Rates, 1971-2002 (Weller et al 2004)

III. Macroeconomic Theory & Policy Choices

The underlying theory motivating the various policy choices selected by Mr. Bush and his administration reflects proven macroeconomic theory and a certain taste for non-discretionary policies. The expenditure side of fiscal policy was characterized by discretionary spending focused on three areas of the economy: health care, education, and defense. One may categorize this spending as either something that was promised on the campaign trail, such as Medicare changes or education reform, or as unforeseen expenditures, like the fiscal fallout from September 11, the War on Terrorism, and military operations in Afghanistan. While expenditures by the government are known to drive aggregate demand, government expenditures were a small part of Mr. Bush's fiscal policy.

Mr. Bush's tax policy is a much more interesting subject, and his administration's monetarist-leaning preference for tax cuts as an engine of growth was made obvious from its

track record. However, the campaign trail rhetoric of the fairness returning money to taxpayers' pockets glosses over the entire incentive scheme behind taxation. The idea behind a tax cut during a recession is to counteract the downward pressure on growth by removing a disincentive for firms to work. By allowing consumers to keep a greater share of their earnings, they are not only able to consume more, but they are also able to save and invest a greater amount, increasing capital stock and the nation's potential productive capacity. Deficits incurred as a consequence of lower tax revenue would eventually be repaid as growth returns (Wellet et al 2004). The advantage behind non-discretionary, broad tax cuts such as EGTRRA and JGTRRA is in their versatility, allowing firms to adapt and optimize in the new environment rather than adapting the policy to the environment. This sort of policy is the typical Monetarist prescription for economic expansion.

The Federal Reserve Board's monetary policy is another important tool for managing the economy. Through the manipulation of interest rates, the Fed has a hand in guiding the direction of the economy. In general, one finds that investment is inversely related to interest rates. During a recession and recovery period where inflation is at acceptable tolerances, monetary policy is geared toward encouraging investment by keeping interest rates low. Low rates make borrowing attractive, allowing the various players in the market to borrow money for consumption or investment (Wellet et al 2004). Higher consumption would generate increases in demand and consequently production would rise to match the new demand, while increases in investment should expand capital stock and productive ability.

IV. Fiscal and Monetary Policy Outcomes & Future Considerations

Having established the Bush administration's economic policies and their underlying theory, it is useful to assess the policy outcomes. As described above, the two main problems that Mr. Bush sought to resolve were low and negative growth rates, later combined with a spike in

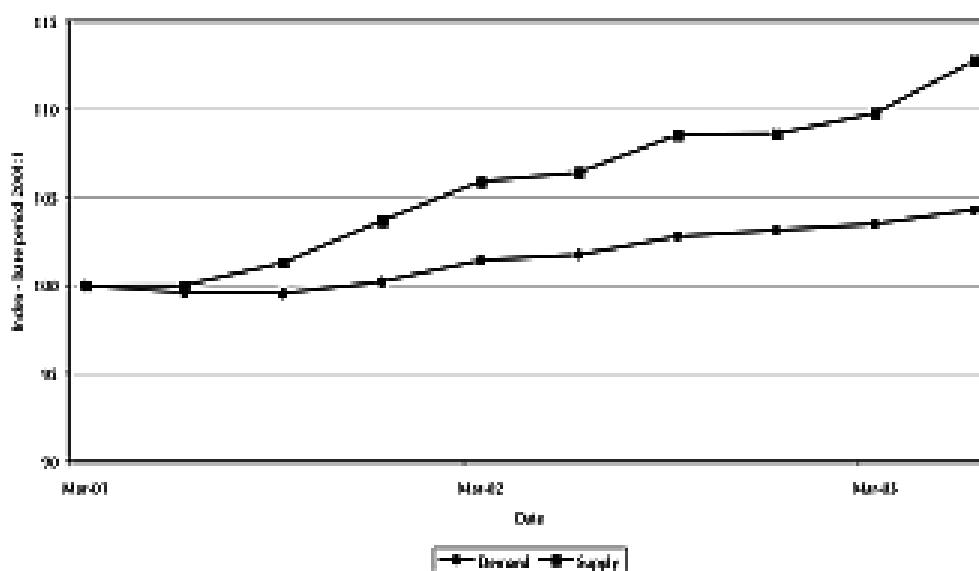
unemployment.

There is little debate regarding the topic of the optimality of tax cuts as responses to recessionary macroeconomic environments. Rather, it is the *type* of tax cut that generates discussion. Mr. Bush and his team thrice assembled and passed (relatively) non-discretionary tax relief packages that were back-loaded—that is, they provided many of their benefits over the long rather than the short term. Weller et al (2004) asserts this is an inefficient structure, as the economy demands more aid in the very short term. For example, only 28 percent of the rebate checks worth \$300 for single filers and \$600 for joint filers were spent in the initial months following EGTRRA's passage. Further, EGTRRA overlooked the economic fact that one's marginal propensity to consume one's tax cut falls as income rises. It was thus a blunder to target the top 20 percent of taxpayers with 55 percent of of the tax cut rendering the relief even less effective. Further evidence of the sub-optimality of EGTRRA is given by Auerbach (2002), which constructs simulations of macroeconomic behavior and concludes that the tax relief package hurts national saving in the long run (Weller et al 2004). Other tax cuts suffered from their own faults: JGTRRA's focus on cutting taxes related to investment income caused changes in portfolio selection rather than increased saving, while JWCA's accelerated depreciation measures were useful only in the year immediately following their effect (Steurle 2004). One prudently concludes that each of EGTRRA, JWCA, and JGTRRA would have benefited from having been short-term, discrete policy actions.

Monetary policy by the Fed during the recession followed the theoretical standard, but it was pushed close to its limits. The Fed was required to keep interest rates at lower levels for a longer period of time than had previously done. Nevertheless, the Fed did experience an fortunate chance event. The decline in interest rates triggered a decline in mortgage rates that coincided with a period of rising housing prices. This combination set off a refinancing boom

that added \$545 billion in resources to household accounts, boosting consumption and shortening the recession substantially. By mid-2003, however, households held a record 114 percent of their disposable income in debt (Weller et al 2004).

Lastly, one ought to evaluate fiscal policy with respect to the roles of investment and government spending. The role of investment is particularly important as it is connected with the seeming unresponsiveness of the economy to monetary policy (consumption aside). Real investment declined by 1.7 percent in the first year and rose by 0.5 percent in the first year and a half of the recovery. Historical averages indicate of 7.2 percent and 8.6 percent investment growth rates for the first year and first six quarters, respectively, of previous recoveries. The dominant force in bucking these historical trends was idle capacity, with 25.8 percent of industrial capacity sitting idle in the second quarter of 2003. Government spending during the recession grew, but almost entirely due to expenses associated with defense (Weller et al 2004).



Aggregate Supply and Demand Growth, 2001-2003, Indexed at 100 base (Weller et al 2003)

The economy's initial reaction to monetary and fiscal policy choices was discouraging: repeated tax cuts were encouraging only modest growth, and growth was not generating any new

jobs (hence a “jobless” recovery). However, as idle capacity was filled to meet growing aggregate demand, the economy picked steam in the latter half of 2003. Through 2004, 2.6 million jobs were added to payrolls (USGPO 2005). Even given the lack of appropriate action by the federal government, the economy eventually resumed its expansionary trajectory. The administration now looked forward to its second term in office and the new problems it would have to face: reduced revenues, deficit spending (largely due to long term tax cuts), and significant expenses associated with wars abroad.

V. Conclusion

This paper has introduced the economic conditions leading up to George W. Bush's first presidency, including the causes underlying the recession that began in March 2001. It has assessed in detail the macroeconomic policies established by the Bush administration. From the fiscal standpoint, it has analyzed the major tax cuts—EGTRRA, JWCA, and JGTRRA—and the character of federal expenditures. From a monetary standpoint, the Fed's policy for the period was discussed. The discussion of macroeconomic policies included some reflection on the political aspects affecting the administration's spending, including its underlying compassionate conservative ideology, the September 11 attacks, and the subsequent wars. After providing the theoretical bases for the described macroeconomic tools, the outcomes that resulting from policy actions were discussed, focusing on the reasons for which the economy did not react as quickly as expected. The fourth section closes with a brief description of the background conditions against which Mr. Bush's second term was set.

In general, the author has found that the Bush administration's reaction to the recession that took place between 2001 and late 2003 was correct, but poorly schemed. Some of the literature reveals that targeted short-term tax cuts, rather than non-discretionary long-term relief packages, would have provided a superior vehicle for returning an economy to a path of full

employment and sustained growth. In addition, tax policies that observe phenomena such as a decreasing marginal propensity to consume or the incentives behind the accelerated depreciation system of JWCA would have comprised even more effective instruments. Lastly, the literature also shows that increases in the lackluster government spending would likely have accelerated recovery (Weller et al 2004).

It is easy for one to appreciate the difficulty behind crafting a set of macroeconomic actions that accounts for all possible variables. While the approach suggested by Weller et al (2004) suggests Keynesian policy solutions, this is not to say that Mr. Bush should have abandoned his monetarist inclinations. If his tax cuts had been orchestrated in such a way to create short term relief—say, over the first two or three years immediately after the recession appeared on the government's radar—rather than focusing on the long term, tax policy might have provided a truly formidable tool for stimulating growth. Ultimately, even with all of his errors, George W. Bush was able to mismanage the American economy back to growth, not unlike his predecessor.

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