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COMMENTARY

# 'Every Reason to Be Proud'

By LAWRENCE B. LINDSEY
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The government has just closed the books on the 2006 fiscal year and released the figures for revenue collected. It has also been five years since the first of the Bush tax cuts began to help the economy and consumers' wallets, so it is a natural time to look back and evaluate their economic and budgetary effectiveness.

We now know that economic activity first began declining in the third quarter of 2000, although the data at the time didn't show it; and 2001 was a rough year, with growth moving back and forth around the zero mark. In August most American families received the first part of their tax cut -- a check, typically for $600. But this was overshadowed by 9/11. In the weeks following the attacks the economy began to gradually shut down. The stock exchanges and New York bond markets were closed, while air travel and transport stopped in an economy where over half a million business travelers flew every day and 25% of trade by value arrived and left by air. Uncertainty paralyzed the business community.

President Bush gave numerous speeches to rally the nation to return to normal; administration officials fanned out across the country to urge Americans to spend. The private sector did its part: Auto companies began zero percent financing and some companies made promotions based directly on the tax cuts. Far from being the disaster most forecasters (including me) had feared, the fourth quarter showed the biggest consumer-led surge since 1992. As business inventories were drawn down, production could expand again.

Mr. Bush followed up with an investment-oriented tax cut proposal in his 2002 State of the Union message. But by mid-year, with growth returning but only at a modest clip, we began working on a proposal to accelerate the multiyear tax cuts of 2001 to take full effect in 2003. We also began developing proposals to improve investor psychology through a long-overdue reduction in the double taxation of dividends. The final bill was enacted in May 2003.

The tax-cut program was not particularly novel or out-of-the-mainstream: It just combined some very sensible supply-side oriented reforms to make the tax code less burdensome with some much-needed demand-side relief. The focus of the early tax cuts was on families with children, people with high propensities to spend. A typical middle-class couple with two children got a minimum of $1,600 in relief -- equivalent to a 4% increase in their real take-home pay, or two years' worth of real pay raises in the 1990s.

Nor did Mr. Bush propose the tax cut by accident. He unveiled it in December 1999 in Des Moines, Iowa, at the height of the stock market bubble, when everyone was feeling a little giddy and some economists were arguing that we had repealed the business cycle. So it took great courage for him to say, "Yet I also believe in tax cuts for another practical reason: because they provide insurance against economic recession. . . . I hope for continued growth -- but it is not guaranteed. A president must work for the best case, and prepare for the worst." He was well-prepared; and as Alan Greenspan said, the tax cuts were "extraordinarily well timed from the point of view of the economy."

While the good positive effects of the tax cut on the economy are relatively non-controversial, their effect on the federal budget stirs a great deal of controversy. The just-released figures on tax receipts in 2006 allow us to shed some light on this debate.

First, a look back at 2002 shows that it was the collapse of the bubble and the effects of 9/11 that were mainly responsible for the decline in tax revenue and the rise of the budget deficit -- and not the tax cuts. As a baseline for comparison, consider the economic and revenue projections the departing Clinton administration prepared as background for the FY 2002 Budget. That projection was based on continued solid growth and no tax cuts, although growth had in fact already begun to decline. As a result, the Clinton FY 2002 budget projected revenues of $2.210 trillion; but only $1.853 trillion was actually collected. This provided a FY 2002 shortfall of $357 billion, the result of both the tax cuts and the drop in economic activity.

The Joint Committee on Taxation estimated that the FY 2002 revenue loss of the first Bush tax cut was $38 billion and $51 billion from the second Bush tax cut -- $89 billion in all. This leaves $268 billion of the shortfall to be attributed to the effects of the collapse of the 1990s bubble, the attacks on 9/11, and other economic drags. Swings in economic activity, not discretionary tax changes, drive the great majority of the swings in federal revenues, and were the cause of the deficits of the early part of the decade. Since then, it has been a matter of fiscal "catch-up."

The data suggest that process of "catch-up" has been far more successful than official estimates thought possible. In August 2003 the non-partisan CBO forecast tax revenue in FY 2006 at $2.276 trillion (which excluded $53 billion of tax relief passed subsequently). That forecast included the effects of the slowdown, a return to more rapid growth, and the 2003 tax cuts. But the data just released showed FY 2006 revenues of $2.407 trillion, $131 billion higher than CBO projected after the tax cuts were accelerated and $624 billion higher than the FY 2003 revenues. For perspective on that $131 billion of extra revenues, the total 2006 revenue loss from all of the president's tax cuts was only $193 billion.

There were two reasons for the revenue feedback. First, after the tax cuts were passed the economy expanded more rapidly than most projected at the time. Second, more taxes were collected from each dollar of GDP than expected. When an economy of a given size produces higher-than-expected revenue after a tax change, it must mean that the tax code has become a more efficient revenue generator. Lower tax rates, particularly on dividends and entrepreneurial income, provide incentives for people to give up some of their previous -- economically distorting but tax-efficient -- behavior.

This response is underscored by the distribution of receipts, which have shifted decidedly up the income scale. Although critics endlessly call the Bush measures tax cuts for the rich, the share of income taxes paid by the top 1%, 5% and 10% of taxpayers has moved up. These people were most affected by higher rates of the past, and have the greatest ability to reorient their economic behavior when rates are reduced.

While economists will argue about how to divide up the extra revenue between the demand-side and supply-side responses, the more interesting question is what would have happened without an aggressive fiscal policy response. In Japan, five years after its bubble burst, tax receipts were still 14% below their peak because the economy was so weak; in the U.S. they are 19% higher than in 2000. Evidence suggests that monetary policy, though helpful, was not the lone cause of the recovery. Consumption spending turned up sharply in the third quarter of 2003, coincident with reduced tax withholding in paychecks. Nearly every important macroeconomic variable, including the unemployment rate, started improving noticeably in the second half of 2003, the first time the full impact of the tax cuts hit the economy. Moreover, consumption spending turned up in advance of the housing boom, whereas in Australia, New Zealand and the U.K. the increase in home prices clearly led an acceleration in consumption growth.

Mr. Bush has every reason to be proud of his tax cuts. Granted, he shouldn't expect a chorus of bipartisan praise based on the numbers just released. But he should rest assured that economic historians will credit the tax cuts as having been a model of the successful application of economic theory to the real world.

***Mr. Lindsey, president and CEO of the Lindsey Group, was President Bush's chief economic adviser from 2001 to 2002.***