

# Southwest Economy



## The Unsinkable Texas Economy Takes on Water

After a decade of strong employment growth, the Texas economy weakened significantly in 2001. Texas' economic growth, which began decelerating in early 2000, continued to slow throughout 2001. A sharp downturn in high-technology industries led to a decline in manufacturing activity and weak growth in the service sector. Demand for Texas products dropped on the national and world markets. Mexico, an important Texas trading partner, entered recession, which sharply reduced activity along the border.

By the end of the summer the Texas economy was vulnerable to an external shock. That shock came on Sept. 11. The U.S. economic slump and subsequent energy price decline worsened the outlook for Texas' economic growth. The energy industry quickly cut back activity, and the airline and travel industries laid off thousands of workers. The Texas economy has decelerated rapidly, and it is possible that it has been dragged into recession along with the nation.

### What Has Made Texas' Economy Unsinkable?

Texas has a history of strong employment growth, which often continued even when the

*(Continued on page 2)*

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*Is Telecom Disconnected  
or Just on Hold?*



*Financial Globalization:  
Manna or Menace?*

## The Federal Budget: What a Difference a Year Makes

At the beginning of 2001, federal spending was lower and revenues were higher, relative to GDP, than in recent experience. The resulting surplus was paying down the federal debt. Projections indicated that the entire debt would eventually be retired if tax and spending laws remained unchanged.

Three major events during 2001 altered these budgetary patterns. In June, a new tax law brought sweeping income tax reductions. A recession, induced or deepened by the Sept. 11 terrorist attacks, further reduced revenue and pushed up spending. The budgetary response to the attacks also increased spending on defense, homeland security and recovery. As the policy emphasis shifted from preparing for long-term needs to meeting current challenges, the budget moved back into (or close to) deficit.

*(Continued on page 6)*

# The Federal Budget: What a Difference a Year Makes

(Continued from front page)

## Budget Policy at the Beginning of 2001

Federal budget results for the fiscal year ended Sept. 30, 2000, were striking in several respects. Federal spending came in at 18.4 percent of GDP, its lowest level since 1966. In recent years, slower medical cost inflation and defense cutbacks kept spending growth from matching the rapid pace of GDP growth. In contrast, revenues reached 20.8 percent of GDP, higher than in any year in U.S. history except 1944.

Most notably, individual income taxes were 10.3 percent of GDP, up from 7.6 percent in 1992. Strong economic growth caused incomes to rise faster than inflation, pushing taxpayers into higher tax brackets (brackets are adjusted each year for inflation but not for real growth). High stock prices helped bring in \$118 billion in capital gains taxes, almost triple the \$40 billion in 1995.<sup>1</sup>

The combination of restrained spending and high revenues yielded a \$236 billion surplus, the third consecutive surplus and the largest in history. During the three surplus years, the government paid down 10 percent of its outstanding

debt. Fiscal 2000 was the eighth consecutive year in which budget balance improved (in 1992, the budget deficit was \$290 billion). For the first time in recent history, the non-Social Security portion of the budget was in surplus, by \$84 billion.

In January 2001, the Congressional Budget Office (CBO) foresaw growing surpluses throughout the next decade if tax and spending laws remained unchanged (*Chart 1*). This projection marked a dramatic change from the January 1997 outlook of steadily growing deficits. The 2001 projection showed the entire federal debt being retired in fiscal 2009.<sup>2</sup>

## The 2001 Tax Cut

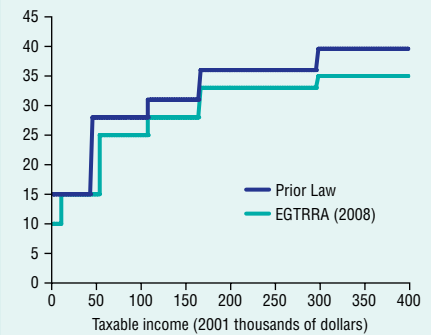
The first major budgetary event of 2001 occurred on June 7. Congress and President Bush adopted the Economic Growth and Tax Relief Reconciliation Act (EGTRRA), which provides broad-based individual income tax relief.<sup>3</sup>

EGTRRA's most striking feature is its sunset provision, under which the entire law expires at midnight on Dec. 31, 2010. Unless Congress extends EGTRRA before then, prior law springs back into

Chart 2

## EGTRRA Reduces Marginal Tax Rates

Tax rate, percent (married couples)



force in 2011. A few provisions expire even earlier, while other provisions phase in slowly, taking full effect in 2006, 2008 or 2010.

**Provisions.** The law's centerpiece is a reduction in individual income tax rates (*Chart 2*). Starting in 2001, a 10 percent bracket replaces part of the 15 percent bracket. The 15 percent bracket is lengthened (only for married couples), a change that phases in from 2005 to 2008. The 28, 31 and 36 percent brackets are each reduced by 3 percentage points, and the top bracket is lowered from 39.6 percent to 35 percent. Each of these brackets was reduced a half point in 2001 and is cut another half point for 2002–2003; an additional full point reduction is set for 2004–2005. The final reduction will take place at the beginning of 2006. All brackets return to their initial levels in 2011.

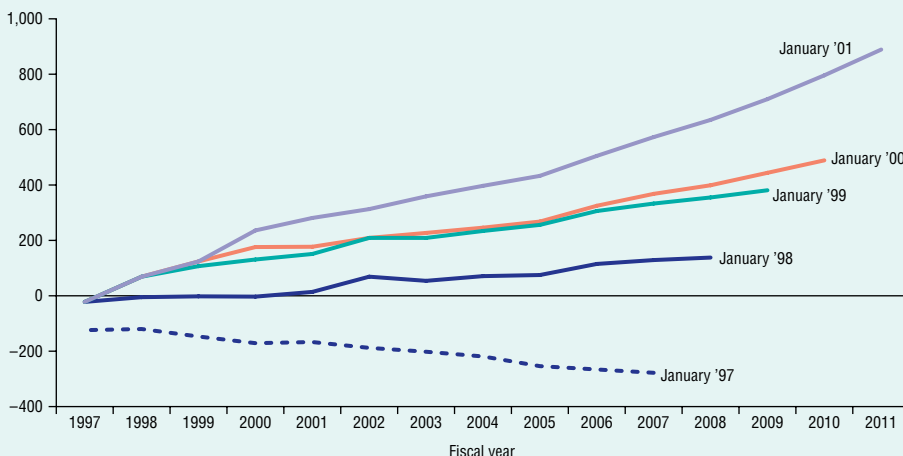
EGTRRA also repeals the estate tax. It gradually lowers the tax on a \$10 million estate from \$4.9 million for people dying in 2001 to \$2.9 million for those dying in 2009. It then eliminates the tax entirely for those dying in 2010. However, the tax is fully reinstated for people dying in 2011, after the sunset provision takes effect. From a tax-avoidance perspective, then, any day in 2010 is a good day to die.

EGTRRA has many other provisions.<sup>4</sup> It doubles the child credit from \$500 to \$1,000 by 2010 and allows some low-income workers who do not owe income tax to receive part of their credits in cash. The law also expands a variety of saving

Chart 1

## CBO Projected Mounting Surpluses in January 2001

Budget balance (billions of dollars)



SOURCE: Congressional Budget Office.

and education incentives. For married couples, EGTRRA provides a larger standard deduction, an expanded earned income tax credit and higher income phaseout ranges for some tax breaks. (Confining these provisions and the longer 15 percent bracket to married couples reduces the marriage penalties that many two-earner couples face and increases the marriage bonuses that many single-earner couples enjoy.) EGTRRA eventually repeals the personal exemption phaseout and the itemized deduction limitation, two provisions that raise effective marginal rates by 1 to 2 percentage points for high-income taxpayers.

Some things are not in EGTRRA. It does not reduce the corporate income tax or payroll and self-employment taxes. It does not change the special 20 percent tax rate for long-term capital gains. It trims, but retains, the gift tax, even when it repeals the estate tax. Unlike many recent tax laws, it does not include industry-specific or highly targeted tax breaks. It offers little relief from the individual alternative minimum tax, thereby increasing the number of people subject to that tax (see box titled “EGTRRA Doubles Reach of Alternative Minimum Tax”).

**Distribution.** Although EGTRRA provides tax savings at all income levels, the largest savings (in dollar terms) go to high-income taxpayers. Critics of EGTRRA complain that a large fraction of its tax savings goes to a small group of high-income taxpayers. Supporters contend that this group is entitled to a large share of the tax savings because they make a large share of tax payments.

Chart 3 shows the allocation, across five income groups, of the number of tax returns, tax payments before EGTRRA and tax savings from EGTRRA. Although the three lower-income groups file most of the tax returns, the higher-income groups pay much of the taxes and receive much of the tax cut. For example, those with incomes above \$200,000 file 2.7 percent of tax returns, pay 32 percent of taxes and receive 32 percent of the tax cut. (This group earns 25 percent of all income.) Those with incomes below \$20,000 file 30 percent of all tax returns, bear 1.6 percent of the tax burden and receive 2.8 percent of the tax cut. (This group earns 4.3 percent of all income.)

These estimates do not include cor-

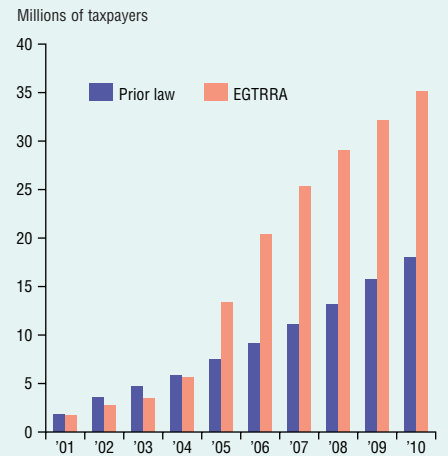
## EGTRRA Doubles Reach of Alternative Minimum Tax

The individual alternative minimum tax (AMT) has lower rates than the regular income tax but allows fewer deductions and credits. Taxpayers must pay the AMT if it is higher than their regular income tax. Congress adopted the AMT in 1978 to ensure that taxpayers, particularly those with high incomes, could not use “excessive” deductions and credits to avoid paying income tax.

In 2000, the AMT affected only 1 million taxpayers, causing them to pay about \$9 billion in additional taxes. But because the AMT (unlike the regular income tax) is not adjusted for inflation, another 16 million taxpayers, including some middle-income people, were expected to move onto it by 2010 under prior law (see chart). The tax liability was expected to reach \$45 billion. Because the AMT disallows deductions for dependents and state and local taxes, people with large families living in high-tax states are most likely to be subject to the AMT.

Because EGTRRA offers little AMT relief, taxpayers already slated to be on the AMT receive little benefit from the law. Also, for many of those who would otherwise have been on the regular income tax, EGTRRA will reduce their regular tax liability below their AMT liability and move them onto the AMT. By 2010 the AMT rolls will swell to 35 million (one-third of all taxpayers), including many middle-income families; the amount of AMT liability will soar to \$133 billion. Of course, Congress may take measures to forestall the spread of the AMT.

### Taxpayers Subject to AMT, 2001–10



SOURCE: Jerry Tempalski, “The Impact of the 2001 Tax Bill on the Individual AMT,” unpublished manuscript, U.S. Treasury Department, November 2001.

porate income taxes, estate and gift taxes, and self-employment taxes. Including the estate tax changes would assign a larger share of the EGTRRA tax savings to high-income groups.

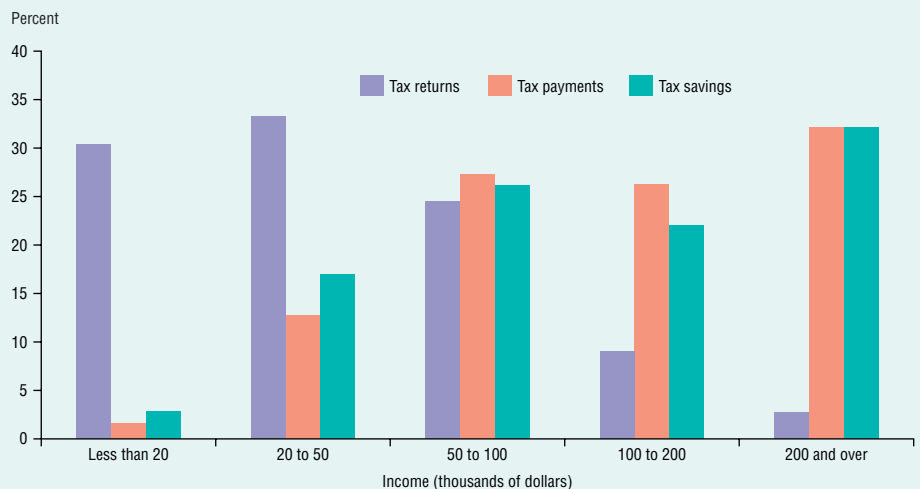
**Economic Effects.** As EGTRRA moved toward passage in the spring of 2001, an economic slowdown was evident. Sup-

porters of EGTRRA argued that it would promote economic recovery by boosting disposable income, thereby stimulating consumption. As a fiscal stimulus, EGTRRA achieved a rare distinction by taking effect before the economy recovered on its own.

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Chart 3

### Tax Savings, Like Tax Payments, Are Largest for Wealthy



SOURCE: Joint Committee on Taxation.

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distribute the 2001 savings from the 10 percent bracket (about \$38 billion) in rebate checks during July through September. Chart 4 shows the upward spike in disposable personal income in those three months. (Starting in July, tax withholding was also reduced to reflect the other 2001 rate cuts.) Congress hoped the rebates would quickly boost consumer spending. Some economists suggested, however, that consumers base their spending decisions on their long-run incomes and therefore would save a one-time income increase like the rebate.

The chart indicates that consumer spending did not immediately respond to the rebates. In July and August (as in May and June), spending remained close to a trend line fitted to its April 2000–April 2001 growth rate. Consumer spending plunged in September due to the terrorist attacks, recovered in October and then slipped again in November.

From a longer-term perspective, EGTRRA also affects economic incentives. Economists view marginal rate cuts as an appealing form of tax relief because they encourage work, entrepreneurship and private saving. The EGTRRA rate cut benefits the many small businesses that operate as proprietorships, partnerships, limited liability companies and S corporations because these firms are subject to the individual, rather than the corporate, income tax.<sup>5</sup>

High tax rates also encourage other

forms of tax avoidance, such as tax shelters, fringe benefits, home ownership and charitable giving. For good or ill, the rate cut tends to reduce these activities.

Because the effects of tax-rate changes are difficult to isolate, their size is still disputed. But the EGTRRA rate cuts are likely to have less impact than the 1964, 1981 and 1986 rate cuts because they are smaller, slower and made from lower levels. For example, the 1981 law slashed the top rate from 70 percent to 50 percent five months after its adoption, while EGTRRA reduces the top rate from 39.6 percent to 35 percent over five years. EGTRRA reverses only about half of the increase adopted in 1993, when the top rate rose from 31 percent to 39.6 percent.

**Budgetary Impact.** According to official Joint Tax Committee estimates, EGTRRA reduces revenue by a cumulative total of \$1.35 trillion (*Chart 5*). The estimates do not reflect changes in work, saving and investment but do reflect other behavioral responses. The revenue loss grows as more provisions phase in but tapers off in fiscal 2011 because EGTRRA sunsets three months after the fiscal year begins. If the law is extended, however, the revenue loss continues to grow. Interest on the lost revenues (not shown) adds another \$385 billion to the 10-year budget impact.

CBO released new budget projections in late August 2001. For fiscal 2010, CBO projected a surplus of \$507 billion, down

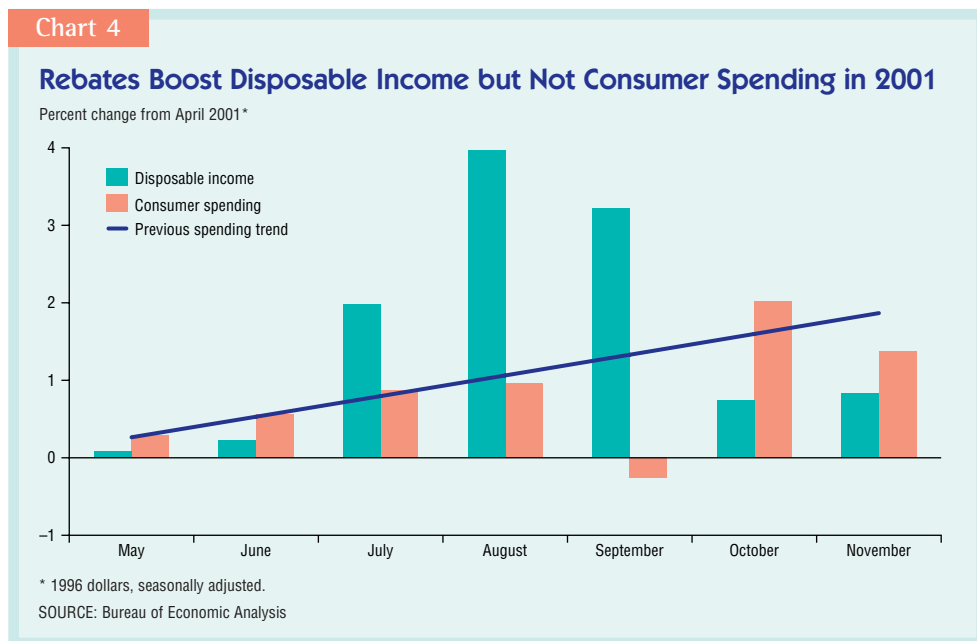
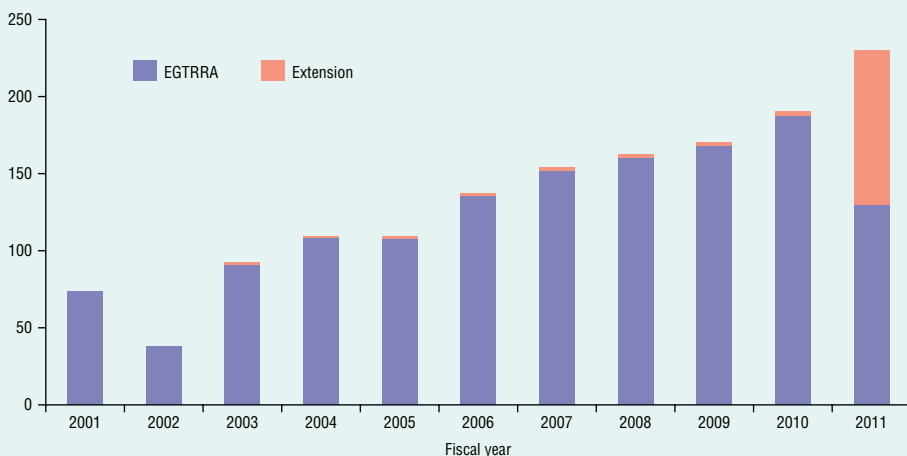


Chart 5

## EGTRRA Revenue Loss Grows Over Time

Billions of dollars



SOURCE: Joint Committee on Taxation.

from \$796 billion forecast in January 2001. Of the \$289 billion revision, \$262 billion was due to EGTRRA (\$187 billion revenue loss plus \$75 billion interest).

The new projection showed the non-Social Security portion of the budget temporarily slipping back into small deficits. For 2010, though, CBO foresaw a \$184 billion surplus outside of Social Security (down from the \$484 billion projected in January). Moreover, the government was still on track to retire its net debt in fiscal 2012 (three years later than expected in January).

Two weeks after they were issued, however, the CBO projections, like so much else, became obsolete. On Sept. 11, 19 hijackers carried out terrorist attacks that killed 3,100 people.

### Terrorist Attacks and Recession

The attacks further weakened the economy, ensuring that the slowdown would qualify as a full-fledged recession, as later confirmed by the National Bureau of Economic Research.<sup>6</sup> As in any recession, revenues have fallen and spending on social programs has risen. Along with the federal government, state governments face revenue shortfalls and extra spending for unemployment benefits and Medicaid.

Fiscal 2001 ended on Sept. 30 with a surplus of \$127 billion, \$26 billion less than CBO had projected in August. Part of this shortfall reflected extensions firms received

on tax payments and deposits after the attacks. The non-Social Security part of the budget posted a \$36 billion deficit. Revenues fell to 19.6 percent of GDP from the previous year's 20.8 percent, while spending held steady at 18.4 percent.

Of course, the attacks had budgetary implications beyond their damage to the economy. Congress quickly adopted spending measures to respond to the attacks. Laws adopted Sept. 18 and Jan. 10, 2002, provide \$40 billion of new spending—\$17 billion for national defense and foreign aid, \$10 billion for homeland security and \$13 billion for domestic recovery. A Sept. 22 law gives airlines \$5 billion in grants and authorizes \$10 billion in loan guarantees. It also offers federal compensation to victims of the attacks, at a cost of \$5 billion or more.

After the attacks, Congress began working on a stimulus package to boost consumption and investment. Congress considered temporary investment incentives, a supplemental rebate for households with little or no income tax liability (these households did not receive the first rebate), tax relief for firms with losses and those subject to the corporate alternative minimum tax, a capital gains rate cut, a suspension of payroll taxes, tax incentives for workers and firms near Ground Zero, and acceleration of part of the EGTRRA rate cut. On the spending side, Congress considered extended unemployment benefits, health insurance

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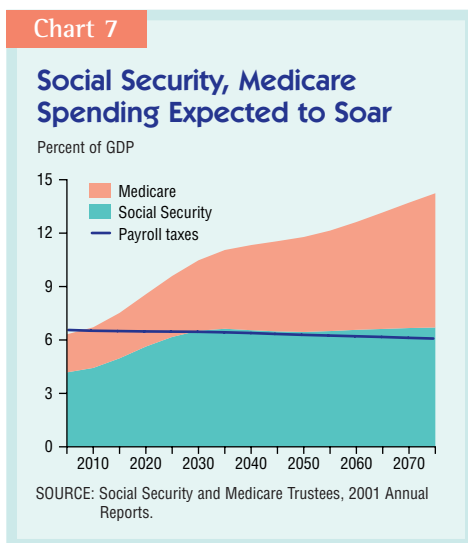
assistance for the unemployed and grants to state Medicaid programs. Most of these measures would have been temporary.

Due to congressional deadlock, however, no package was adopted in 2001. While this inaction prompted some economists to forecast a slower recovery, others argued that interest-rate cuts by the Federal Reserve were providing sufficient stimulus and that recovery would soon begin anyway. These economists noted that a stimulus package might even be counterproductive if it drove up long-term interest rates.<sup>7</sup>

Congress may consider a stimulus package again in early 2002. It also may consider partial federal reimbursement of insurance costs from future terrorist attacks, another proposal that fell by the wayside during 2001.

CBO released new budget projections in late January. CBO estimates a \$21 billion deficit for fiscal 2002, with a \$181 billion deficit in the non-Social Security portion of the budget. While this \$21 billion overall deficit is a stark contrast to the \$313 billion surplus CBO projected in January 2001, it is also much different from the \$188 billion deficit projected in 1997. Despite recent events, the budget is in stronger shape than had been expected five years ago (*Chart 6*).

CBO foresees the budget returning to surplus in fiscal 2004. For 2010, it projects a \$294 billion surplus, including a \$4 billion non-Social Security surplus. The



surplus becomes larger after EGTRRA expires, allowing the net federal debt to be retired around 2014. Of course, new tax and spending measures or economic and foreign policy developments may affect the budget outlook.

Halting or slowing debt repayment imposes a higher debt service burden in the future, which will require tax increases or spending cuts beyond those already required to address the steep expected increase in Social Security and Medicare spending (*Chart 7*). The move away from debt repayment reflects a shift from preparing for these long-term needs to meeting the current challenges facing the nation.

## Conclusion

A major tax cut, a recession and the response to the terrorist attacks transformed the federal budget outlook in 2001. Resources were shifted away from paying down debt and preparing for long-term needs and toward meeting current needs, particularly tax relief, economic recovery and the battle against terrorism.

—Alan D. Viard

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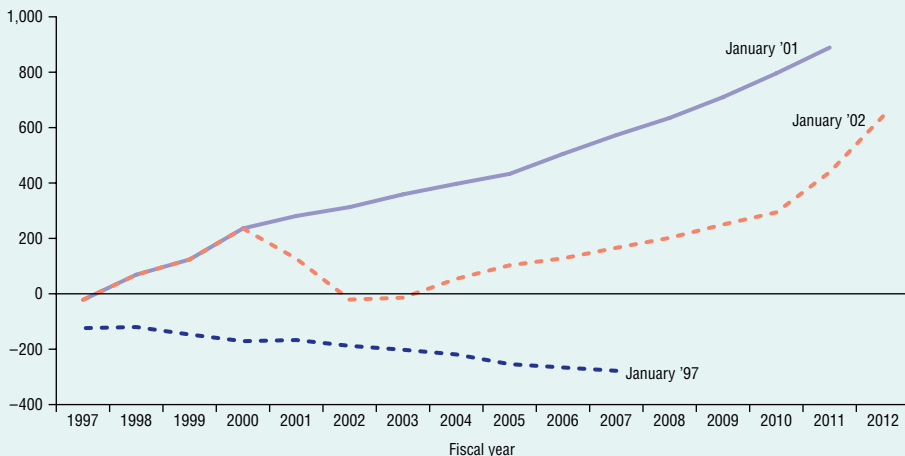
## Notes

- <sup>1</sup> A 1993 tax law also raised income tax revenue, although a 1997 tax law reduced it.
- <sup>2</sup> CBO actually projected that the government would run out of debt to retire in fiscal 2006 because holders of the remaining \$1.2 trillion would be unwilling to sell before maturity. It would then begin accumulating excess funds. By 2009, the excess funds would equal the remaining outstanding debt.
- <sup>3</sup> For a simple description of EGTRRA, see Congressional Budget Office, *The Budget and Economic Outlook: An Update*, August 2001, pp. 5–10. For a more complete description, see Joint Committee on Taxation, *Summary of Provisions Contained in the Conference Agreement for H.R. 1836, The Economic Growth and Tax Relief Reconciliation Act of 2001*, JCX-50-01, May 26, 2001.
- <sup>4</sup> The text of EGTRRA runs 113 pages in the *United States Code Congressional and Administrative News*. This is much shorter, though, than the 316-page text of the 1997 tax reduction law.
- <sup>5</sup> For new evidence that small business growth is sensitive to individual income tax rates, see Robert Carroll, Douglas Holtz-Eakin, Mark Rider and Harvey S. Rosen, "Personal Income Taxes and the Growth of Small Firms," in *Tax Policy and the Economy*, vol. 15 (Cambridge, Mass.: MIT Press, 2001), pp. 121–147.
- <sup>6</sup> The economic effects of the attacks are discussed by Evan Koenig, "Down but Not Out: The U.S. Economy after Sept. 11," Federal Reserve Bank of Dallas *Southwest Economy*, Issue 6, November/December 2001.
- <sup>7</sup> Economists' reaction is described in Steve Liesman and Jon E. Hilsenrath, "Many Economists See No Major Loss in No Stimulus Bill," *Wall Street Journal*, December 21, 2001, p. A2.

**Chart 6**

## CBO Revises Budget Forecast

Budget balance (billions of dollars)



SOURCE: Congressional Budget Office.