How Tax Proposals Could Affect Aggregate Demand, Output, and Revenue

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Dynamic Scoring of Tax Proposals

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Dynamic Scoring

TPC

- Conventional analysis includes many behavioral responses, but assumes output and overall price level remain unchanged
- Dynamic scoring incorporates effects of policy on macroeconomic variables such as GDP, capital, and labor
- Macro effects uncertain, but likely non-zero
- With consensus assumptions, dynamic effects on revenues tend to be modest

Dynamic Scoring

TPC

- Macroeconomic effects influence revenues, but also useful information for assessing desirability of tax policy changes
- Other features of tax policy more central than macro effects
  - Level of revenues
  - Distribution of tax burden
- Tax policy affects the economy at the margins

Two Approaches to Dynamic Analysis

- Keynesian
  - Effects stem from changes in demand
  - Equations relate aggregate variables
  - Output changes relative to its potential level
  - Output returns to potential after a few years
- Overlapping generations
  - Effects stem from behavior at household level
  - Households responds to incentives to work and save
  - Households forward-looking
  - Output equals potential

TPC Keynesian Model

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- Estimates effects in two stages
  1. Direct effect of policy on demand
  2. Indirect effects of initial change in demand

- Model employs a range of assumptions for both direct and indirect effects

- Effects fade over 4 years

Direct Effect on Demand

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- With more after-tax income,-consumers spend more
  - Lower-income households spend a larger share of their additional income than higher-income households do
  - Baseline assumption:
    - Lowest quintile spends 90 cents out of each additional dollar
    - Highest quintile spends just 55 cents out of each additional dollar
- Investment incentives lead firms to invest more
- Higher wealth leads consumers to spend more

Indirect Effects on Demand

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- Direct effect generates further, indirect effects that can add to or offset the direct effect
  - On the plus side, increased demand can lead to increased hiring, investment spending, or consumption spending
  - But increased demand could lead to higher interest rates, reducing investment and consumer spending

Indirect Effects on Demand

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- In normal economic times the Fed offsets expansionary tax policy by raising rates to prevent increase in inflation
- In deep recession the Fed will not change rates
- TPC’s Keynesian model assumes 2017 will be a blend of those two states, and following years will be “normal”
- In 2017 indirect effects offset 1/6 of direct effects; in later years 1/2

House GOP Tax Plan

TPC

- Cuts taxes for most households
  - With higher incomes, people spend more
  - Biggest cuts go to high-income households
    - Mutes spending increase

- Expensing provision encourages firms to boost investment spending

FIGURE 1

Effect of House GOP Tax Plan on GDP

Percent, Calendar Year

Notes: Estimated effects are zero after 2020.
Source: TPC Keynesian Model.

FIGURE 2

Dynamic Effect on Revenues, House GOP Tax Plan

$ Billions, Fiscal Year

Notes: Effects are zero after 2021.
Source: TPC Keynesian Model.

FIGURE 3

Impact on Revenues, Including Dynamic Effects, of the House GOP Tax Plan

$ Billions, Fiscal Year

Source: TPC Keynesian Model.