

## Some Background

TAXES AND THE ECONOMY

How do taxes affect the economy in the long run?

**Q. How do taxes affect the economy in the long run?**

**A. Primarily through the supply side. High marginal tax rates can discourage work, saving, investment, and innovation, while specific tax preferences can affect the allocation of economic resources. But tax cuts can also slow long-run economic growth by increasing deficits. The long-run effects of tax policies thus depend not only on their incentive effects but also their deficit effects.**

Economic activity reflects a balance between what people, businesses, and governments want to buy and what they want to sell. In the short run, demand factors loom large. In the long run, though, supply plays the primary role in determining economic potential. Our productive capacity depends on the size and skills of the workforce; the amount and quality of machines, buildings, vehicles, computers, and other physical capital that workers use; and the stock of knowledge and ideas.

### TAX INCENTIVES

By influencing incentives, taxes can affect both supply and demand factors. Reducing marginal tax rates on wages and salaries, for example, can induce people to work more. Expanding the earned income tax credit can bring more low-skilled workers into the labor force. Lower marginal tax rates on the returns to assets (such as interest, dividends, and capital gains) can encourage saving. Reducing marginal tax rates on business income can cause some companies to invest domestically rather than abroad. Tax breaks for research can encourage the creation of new ideas that spill over to help the broader economy. And so on.

Note, however, that tax reductions can also have negative supply effects. If a cut increases workers' after-tax income, some may choose to work less and take more leisure. This "income effect" pushes against the "substitution effect," in which lower tax rates at the margin increase the financial reward of working.

Tax provisions can also distort how investment capital is deployed. Our current tax system, for example, favors housing over other types of investment. That differential likely induces overinvestment in housing and reduces economic output and social welfare.

### BUDGET EFFECTS

Tax cuts can also slow long-run economic growth by increasing budget deficits. When the economy is operating near potential, government borrowing is financed by diverting some capital that would have gone into private investment or by borrowing from foreign investors. Government borrowing thus either crowds

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out private investment, reducing future productive capacity relative to what it could have been, or reduces how much of the future income from that investment goes to US residents. Either way, deficits can reduce future well-being.

The long-run effects of tax policies thus depend not only on their incentive effects but also on their budgetary effects. If Congress reduces marginal tax rates on individual incomes, for example, the long-run effects could be either positive or negative depending on whether the resulting impacts on saving and investment outweigh the potential drag from increased deficits.

#### PUTTING IT TOGETHER

That leaves open questions on how large incentive and deficit effects are, and how to model them for policy analysis. The Congressional Budget Office and the Joint Committee on Taxation each use multiple models that differ in assumptions about how forward-looking people are, how the United States connects to the global economy, how government borrowing affects private investment, and how businesses and individuals respond to tax changes. Models used in other government agencies, in think tanks, and in academia vary even more. The one area of consensus is that the most pro-growth policies are those that improve incentives to work, save, invest, and innovate without driving up long-run deficits.

The Urban-Brookings Tax Policy Center (TPC) has developed its own economic model to analyze the long-run economic effects of tax proposals. In TPC's model, simple reduced-form equations based on empirical analysis determine the impact of tax policy on labor supply, saving, and investment. TPC used this model to estimate the long-run economic and revenue effects of the Tax Cuts and Jobs Act.

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#### Further Reading

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