Q. How might the TCJA affect economic growth?

A. The Tax Cuts and Jobs Act will likely boost economic output modestly in both the short and the longer run, but not all those gains will flow to the incomes of Americans.

The Tax Cuts and Jobs Act (TCJA) reduced tax rates on both business and individual income, and enhanced incentives for investment by firms. Those features most likely will raise output in both the short run and the long run, but most analysts estimate the effects will be modest and will offset only a portion of revenue loss from the bill (table 1).

TABLE 1

TCJA Growth Effects

	Effect on Size of GDP (%)[a]			Ten-year Dynamic Revenue Feedback (%)
	2018–20	2018–27	2027	
TCJA as written				
Barro and Furman (with crowd out)	-	-	0.2	16.7[b]
Congressional Budget Office	0.6	0.7	0.6	31.0[c]
International Monetary Fund	0.8	0.6	-0.1	-
Mertens	0.3–2.4	-	-	-
Moody's	0.4	0.3	0.4	-
Penn-Wharton Budget Model (low return)	-	-	0.6	7.7
Penn-Wharton Budget Model (high return)	-	-	1.1	19.1
Tax Foundation	0.9	2.1	2.9	69.5
Tax Policy Center	0.7	0.5	0	12.8
TCJA extended				
Barro and Furman (with crowd out)	-	-	1	20.5[b]

Sources: Barro and Furman (2018); Congressional Budget Office (2018b); International Monetary Fund (2018); Mertens (2018); Zandi (2017); University of Pennsylvania (2017); Tax Foundation Staff (2017); Page et al. (2017).

(a) All figures are approximations

(b) Dynamic revenue effects do not incorporate crowd-out.

(c) Primary deficit effect.

Background

How might the TCJA affect economic growth?

Over the first year or two after enactment, the TCJA is likely to influence the economy primarily by raising demand for goods and services. Cuts to individual income taxes mean that most households will have more after-tax income, which they are likely to spend. In addition, provisions such as allowing the expensing of some capital investment are likely to increase investment spending by firms. As businesses see more of their goods being purchased, they will ramp up production, boosting economic output.

Those short-run effects are likely to be limited, however, for two main reasons. First, much of the tax cuts flow to higher-income households or to corporations, whose stock tends to be held by the wealthy. Higher-income households tend to spend less of their increases in after-tax income than lower-income households. Second, as of Fall 2018, unemployment is low and output is near its potential level. Therefore, any increase in demand will be offset by a tightening of monetary policy, as the Federal Reserve increases interest rates to avoid rising inflation.

In the longer run, the TCJA is likely to affect the economy primarily through increased incentives to work, save, and invest. Reductions in individual income tax rates mean that workers can keep more out of each additional dollar of wages and salary. That will encourage people to work more hours and draw some new entrants into the labor force. However, those reduced rates are scheduled to expire at the end of 2025; after that, there is little or no tax incentive to increase work.

Lower individual tax rates, a lower corporate tax rate, expensing of capital investment, and other reductions in business tax rates will increase the after-tax return to saving, encouraging households to save and reducing the cost of investment for firms. Those changes will lead to more investment, a larger capital stock, and higher output, by most estimates.

The increased investment must be financed by a combination of private saving, public saving (or government budget surpluses), and net lending from abroad (which could take the form of bond purchases, portfolio investment, or direct investment of physical capital). Most analysts, consistent with empirical research, estimate that private saving will rise only modestly in response to an increase in the after-tax rate of return. And the bill reduces public saving, by increasing the deficit. Therefore, much of any increase in investment from TCJA is likely to be financed by net foreign lending. That will increase the future interest and profit payments that flow to foreigners, reducing the resources available to Americans. For that reason, in examining the effects of TCJA it may be more illuminating to look at changes in gross national product (which subtracts that type of payment) rather than gross domestic product (which does not). For example, the Congressional Budget Office estimates that TCJA will boost GDP by 0.6 percent in 2027, but—taking account of increased payments to foreigners—GNP will be up by only 0.2 percent.

Background

How might the TCJA affect economic growth?

Data Source

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