TAX FOUNDATION

Economics of the Tax Cuts and Jobs Act, June 1

Not all tax cuts have the same effect on the U.S. economy. Most analyses of the Tax Cuts and Jobs Act (TCJA) have predicted that the bill will grow the U.S. economy over the next 10 years. But why is this the case? When analyzing how a tax change will affect the U.S. economy, the most important question to ask is, "What incentives does it create?" Regarding the Tax Cuts and Jobs Act, certain key parts of the law will increase the incentives of businesses to invest in the United States, which will grow the long-term size of the U.S. economy. Other parts of the law, particularly the provisions that are temporary, will have limited economic effects.

1. Tax policy can affect the size of the economy by changing incentives to work and invest.

   In the long run, the size of the economy is determined by labor, capital, and technology. As a result, the economic impact of a tax cut isn't primarily based on how much money it puts in people's pockets; it depends on what incentives it creates for work, investment, and innovation.

2. The main reason why the Tax Cuts and Jobs Act is expected to grow the economy is the corporate rate cut.

   Corporate rate cuts have a large economic effect because they make it less expensive for companies to invest in the United States. There's good evidence that companies' investment decisions are sensitive to tax policy.

3. The temporary provisions in the TCJA will have limited economic effects if they are not made permanent.

   When businesses and households make decisions, they consider long time horizons. As a result, temporary tax provisions won't change the fundamental trade-offs that taxpayers face. However, some of the temporary tax provisions, if made permanent, could have a very significant economic effect—notably, 100 percent bonus depreciation.

4. The positive economic effects of the TCJA will lower the fiscal cost of the law.

   Dynamic scoring allows lawmakers to see how the economic effects of tax changes will affect revenue. Every dynamic score of the TCJA has shown that the economic effects of the law will lower the revenue loss for the federal government. However, no dynamic score has shown that the law will pay for itself.

Further Reading:

"Preliminary Details and Analysis of the Tax Cuts and Jobs Act" – Tax Foundation staff, https://taxfoundation.org/final-tax-cuts-and-jobs-act-details-analysis/

"A Unified Theory of Some of the Misconceptions in the Tax Reform Debate" – Scott Greenberg, https://taxfoundation.org/unified-theory-misconceptions-tax-reform-debate/

Economics of the Tax Cuts and Jobs Act

Scott Greenberg
Senior Analyst
seg@taxfoundation.org

Introduction to Tax Foundation University

Outline

- What did the Tax Cuts and Jobs Act do?
- In what ways does tax policy affect the economy?
- What might the economic effect of the Tax Cuts and Jobs Act be?
- How does the size of the economy affect federal revenue?

Overview of the Tax Cuts and Jobs Act

Individual Tax Changes	Business Tax Changes	International Tax Changes
• Temporary individual rate cuts • Temporary increase in the standard deduction and child tax credit • Temporary elimination of the personal exemption • Temporary limits on deductions for state and local taxes paid and mortgage interest paid • Indexing tax provisions to chained CPI • Temporary increase in the alternative minimum tax exemption • Temporary increase in the estate tax exemption	• Corporate rate cut • Temporary 100 percent expensing • Limit on net interest deduction • Limit on net operating loss deductions • Temporary new deduction for households with pass-through business income • Slower deductions for research expenses, beginning in 2022 • Repeal of several tax preferences for specific business activities	• Exclusion of dividends received from foreign corporations ("territorial tax system") • A new minimum tax on U.S. companies with high-return foreign income and low foreign taxes ("GILTI") • A new deduction for income derived from intellectual property held in the U.S. ("FDII") • A new minimum tax on large companies with significant payments from the U.S. to foreign parties ("BEAT") • A one-time transition tax on foreign profits held offshore

Assorted Estimates of the Effects of the 2017 Tax Act on the Level of Real GDP

Percent

	First Five Years					Tenth Year	Average		
	2018	2019	2020	2021	2022	2027	2018–2022	2023–2027	2018–2027
Moody's Analytics	0.4	0.6	0.2	0.1	0.0	0.4	0.3	0.3	0.3
Macroeconomic Advisers	0.1	0.3	0.5	0.6	0.6	0.2	0.4	0.5	0.5
Tax Policy Center[a]	0.8	0.7	0.5	0.5	0.5	*	0.6	0.3	0.5
International Monetary Fund	0.3	0.9	1.2	1.2	1.0	-0.1	0.9	0.3	0.6
Joint Committee on Taxation	–	–	–	–	–	0.1 to 0.2	0.9	0.6	0.7
Congressional Budget Office	**0.3**	**0.6**	**0.8**	**0.9**	**1.0**	**0.6**	**0.7**	**0.8**	**0.7**
Goldman Sachs	0.3	0.6	0.7	0.7	0.7	0.7	0.6	0.7	0.7
Tax Foundation	0.4	0.9	1.3	1.8	2.2	2.9	1.3	2.9	2.1
Penn Wharton Budget Model	–	–	–	–	–	0.6 to 1.1	–	–	–
Barclays	0.5	–	–	–	–	–	–	–	–

Sources: Congressional Budget Office and the organizations listed above.

Real values are nominal values that have been adjusted to remove the effects of inflation.

GDP = gross domestic product; – = not available; * = between -0.05 percent and zero.

a. Values are for fiscal years.

$$Y = A \times L^{\alpha} \times K^{1-\alpha}$$

The size of the economy is determined by:

1) **Total factor productivity** (technology, institutions, etc.)

2) **Labor** (the number of hours people work)

3) **Capital** (machines, equipment, factories, etc.)

Evidence for the Effects of Business Taxes on Investment

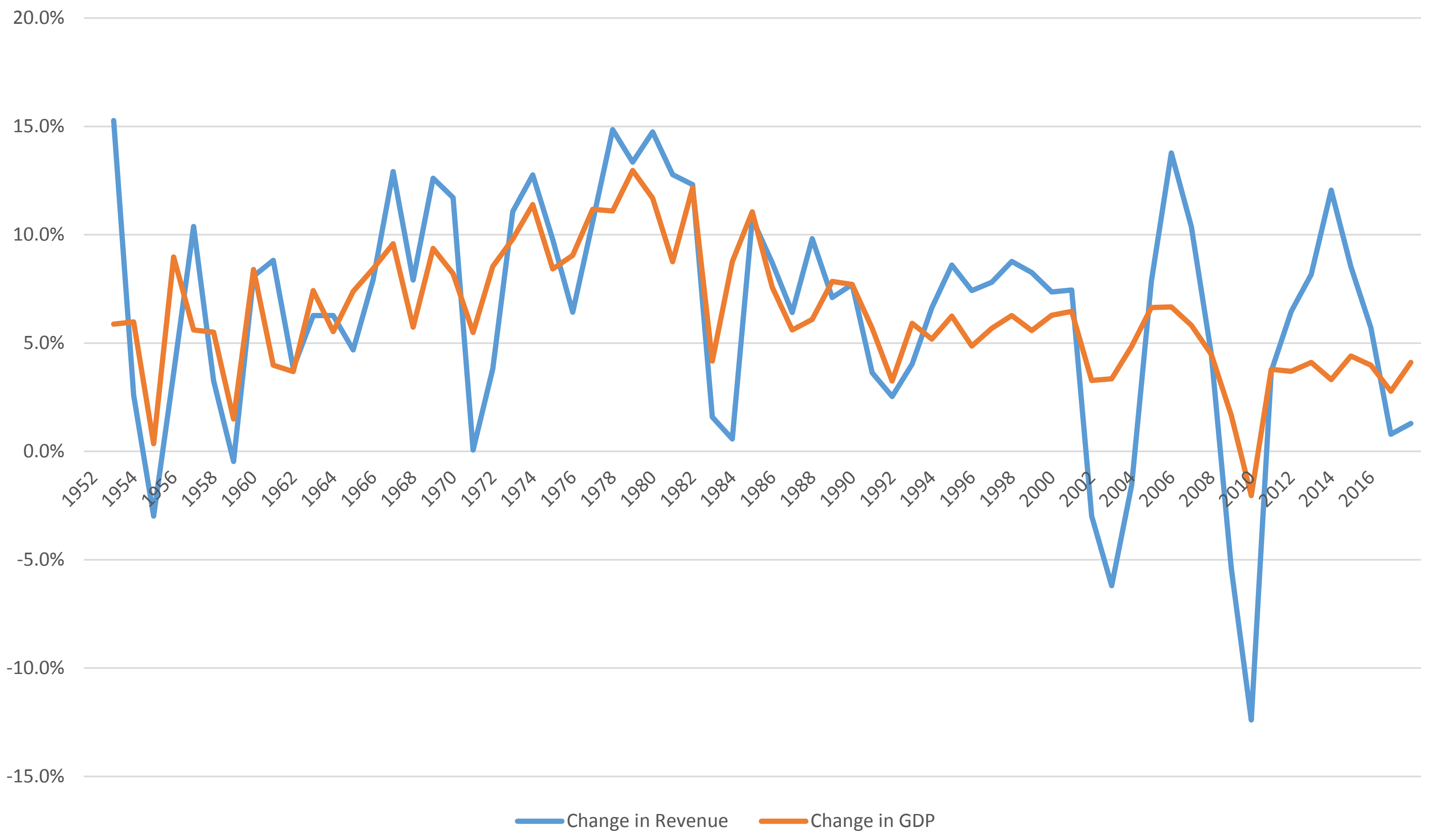
- “A one percentage point reduction in [corporate] tax rates increases investment by 4.7 percent of installed capital” (Ohrn 2018)
- “Bonus depreciation raised investment in eligible capital relative to ineligible capital by 10.4 percent between 2001 and 2004 and 16.9 percent between 2008 and 2010.” (Zwick and Mahon 2017)
- “In a cross-section of countries, our estimates of the effective corporate tax rate have a large adverse impact on aggregate investment, FDI, and entrepreneurial activity.” (Djankov et al., 2009)
- “Taken together, this evidence implies that the volume of [foreign investment], and accompanying economic activity and corporate tax bases, is highly responsive to local tax policies.” (Hines 2007)

Comparing the Annual Rate of Economic Growth Under Tax Reform to Baseline Projections

Source: Tax Foundation, Taxes and Growth Model, Nov. 2017.

Changes in Federal Revenue are Strongly Driven by Changes in the Economy

Annual Change in Federal Revenue and in U.S. Gross Domestic Product, 1952-2017



- TABLE 1 -
ESTIMATED BUDGET EFFECTS OF THE CONFERENCE AGREEMENT FOR H.R.1
Fiscal Years 2018 - 2027

[Billions of Dollars]

Provision	2018	2019	2020	2021	2022	2023	2024	2025	2026	2027	2018-22	2018-27
Conventional estimate…………	-135.7	-280.0	-258.8	-220.8	-178.3	-137.9	-120.1	-114.6	-40.6	32.9	-1074.0	-1,456.0
Additional Effects Resulting from Macroeconomic Analysis ………………	32.2	34.4	36.6	38.5	37.0	40.5	46.5	47.8	35.5	35.5	178.8	384.6
NET TOTAL ……………………………………………………………………………………	-103.5	-245.6	-222.2	-182.3	-141.3	-97.4	-73.6	-66.8	-5.1	68.4	-895.2	-1071.4

Joint Committee on Taxation

Tax Foundation Estimates of the Economic and Revenue Effects of the Tax Cuts and Jobs Act

Change in Static Revenue, 2018-2027	Change in Long-Run GDP	Change in Dynamic Revenue, 2018-2027
-$1,469 billion	+1.7 percent	-$448 billion
Source: Tax Foundation, “Preliminary Details and Analysis of the Tax Cuts and Jobs Act,” December 2017		

Questions?