THIRD WAY

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The Republican Tax Fallacy

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It's a common Republican mantra: tax cuts will unleash economic growth. Recently. President Trump's Council of Economic Advisors claimed the new Trump tax cuts will increase real GDP by over 5% in the near term and up to 3.5% by the end of the decade. [1]

The problem is: that assertion is wrong.

Tax cuts don't end up bolstering the economy anywhere close to what the CEA study asserts. A meta-analysis of economic estimates from the eight tax cuts since 1986 shows that the actual impacts pale in comparison to Republican claims. In fact, the impacts of these tax cuts are more than likely changing GDP by somewhere between -0.5% and +0.5% in the long run. [2]

Similarly, the Budget Lab at Yale finds that the new bill bumps growth slightly by 0.2 percentage points a year in the first couple of years and then becomes a growing drag on the economy. In 30 years, the economy is 3% smaller than if the bill wasn't passed. [3] Other independent analyses also show much the same results. The right-leaning Tax Foundation finds the economy only 0.8% larger in the long run from the bill and the Penn-Wharton Budget Model estimates the economy is 1.5% smaller after 30 years. [4]

Tax policy *should* change to improve the economy and distribution of income. It should also be used to finance a government that provides benefits to working families and other public policy goals. But the research just does not support the conservative argument that tax cuts are a universal boon to economic growth.

So why don't tax cuts lead to huge economic growth?

It is theoretically possible for tax policy to thread the needle and lead to growth, but there are many hurdles to clear. IF the economy is weak or in a recession, IF increases to the budget deficit magically disappear, IF corresponding spending cuts axe unproductive expenditures, and IF businesses invest tax savings into productive purposes, then tax cuts can spur long-term economic growth. But that's a LOT of ifs.

Stepping out of theory and into the real world, there are four reasons why tax cuts aren't going to grow the economy like Republicans attest:

First, tax cuts do not magically pay for themselves. Reducing taxes means less money coming into the government. If—and, remember, that's a big if—tax cuts spur economic growth, the government only collects a fraction of the funds created by that growth. Budget experts estimate that a tax cut would need to produce $5-6 of economic growth for every $1 of tax cuts to "pay for itself." This is way beyond what any reasonable person suggests would happen. [5] Consider the 2017 Tax Cuts and Jobs Act, which lowered average rates but had a limited, yet positive, impact on corporate investment. [6] Since this minimal impact did not occur alongside spending cuts or tax increases, the tax bill significantly increased projected deficits. [7] The bill didn't pay for itself.

Second, the debt that comes from tax cuts has detrimental effects. Tax cuts occurring alongside spending reductions (or other tax increases) can be deficit neutral, but tax cuts that are not paid for add to our nation's debt. And that debt reduces long-term growth. A Congressional Research Service study found that paying more interest on the debt, and how that interest crowds out other investment spending, eliminates most of the growth effects that tax cuts might have. [8] Some of the most well-renowned mainstream tax experts at Brookings and independent budget modeling groups agree. [9] Conservative arguments occasionally suggest that short-term growth effects compound over time, but so would debt payments and their effects. In short, increased deficits erase some growth effects that tax cuts might have.

Third, the type of tax cut matters—as does the type of offset. Which taxes are cut, and which policies are changed to pay for a tax cut, influences how much the economy grows. A notable academic study estimates that a 10% decrease in "distortionary" or "unproductive" taxes increases GDP growth by 0.2%. [10] Economic growth, therefore, can occur from strategically cutting taxes that disincentivize work and investment as well as contribute to wasteful spending. Temporary tax cuts, however, don't lead to as much growth. The right-leaning Tax Foundation notes that major parts of the current Republican tax bill are temporary, which should greatly reduce any of their economic effects in the long run. [11]

Fourth, tax cuts don't always get put to productive purposes. To know whether tax cuts will help growth, one must ask: what do people and businesses do with their tax savings? If tax cuts are fully financed and a business' savings are invested in workforce development, productive capital, or research, then one can probably say that the tax cut has led to some economic growth. However, IMF analysts estimated that 20% of the tax savings in the 2017 tax Cuts and Jobs Act was invested in capital and R&D. The remaining 80% was paid to shareholders through buybacks, dividends, and balance sheet adjustments. [12] One can reasonably assert that some, but definitely not all, of that 80% was productively invested (e.g., equity purchases that businesses then use for capital investments). But the specific value is difficult to estimate, and it's safe to say some of the revenue loss was wasted.

As policymakers debate tax policy, it's important to think about the impacts on the economy and economic growth. But assuming the Republican bill will supercharge the economy just isn't true.

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