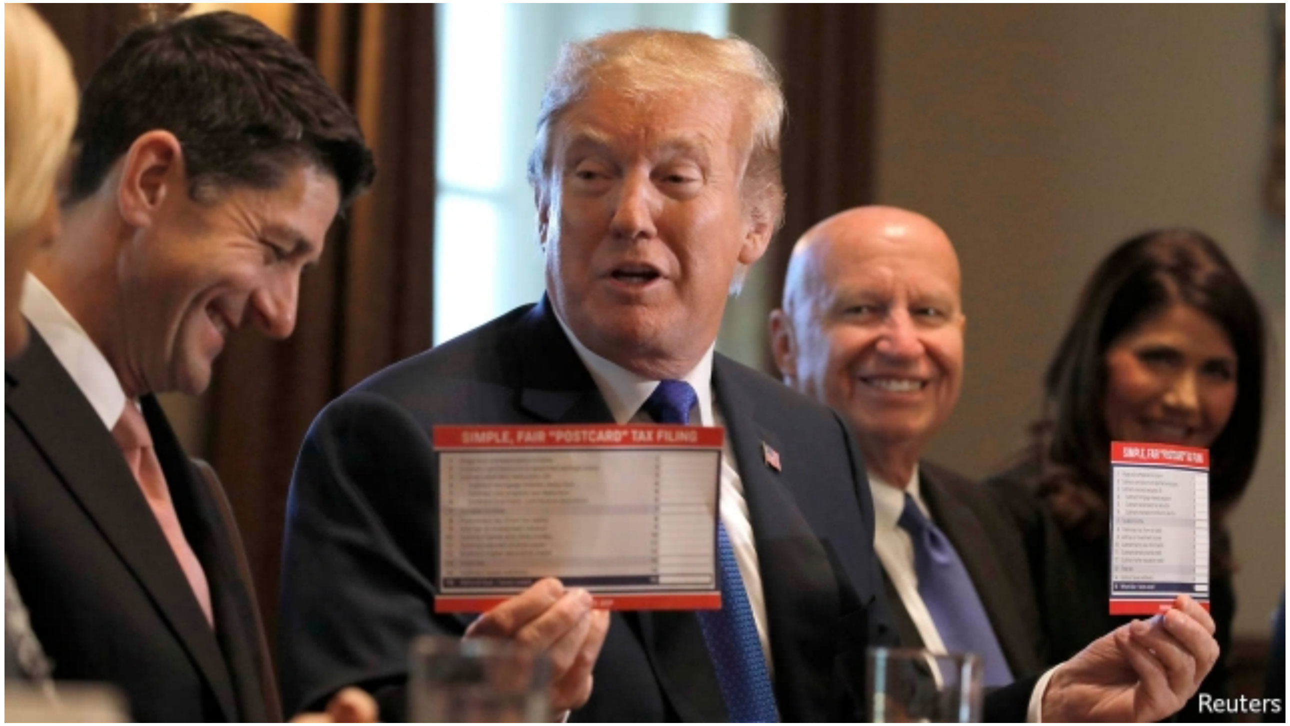
Free exchange

What is the purpose of tax reform?

There are better motivations for tax overhauls than boosting growth



Print edition | Finance and economics Nov 18th 2017

IF MAKING America great again is the aim, you could do worse than bring back the economic growth rates of the late 1990s. President Donald Trump's team reckons that the Republican tax plan making its way through Congress will do just that. "We are creating a model that creates economic growth in this country," says Gary Cohn, the director of Mr Trump's National Economic Council. Kevin Hassett, who runs the Council of Economic Advisers, reckons the bill should push growth above 4% per year.

Such heights are not beyond the realm of possibility, but if America reaches them tax reform will have little to do with it. That is not because of the specifics of the plan. Rather, it reflects an underappreciated reality: tax reform can accomplish many things, but raising long-run growth is not generally among them.

Most assessments of the Republican tax proposals, like most analyses of most tax plans, conclude their effects on growth will be small. The Penn Wharton Budget Model, a non-partisan public-policy initiative, projects that GDP in 2027 will be between 0.4% and 0.9% higher as a result of the bill.

Nonsense, say the adherents of the supply-side school of thinking. Economic growth can be broken down into changes in the supply of labour and in labour productivity. Supply-siders reckon that lower tax rates on labour income should raise its supply; lower taxes on capital income should, by increasing saving and investment, nurture innovations which will eventually boost productivity.

The actual economics, alas, are less straightforward (see table). Tax cuts that boost income from employment raise the cost of time off; this "substitution effect" implies that people should work more when tax rates drop. But there is an offsetting "income effect": as earnings rise, demand for most amenities, including leisure, also goes up.

Although theory suggests cuts to marginal tax rates should favour the substitution effect, the evidence is more ambiguous. In summarising the literature on the subject, the Congressional Research Service, the legislature's public-policy group, notes that in practice neither labour-force participation nor hours worked move much in response to tax changes. Among high-income men, the effects on labour supply are non-existent.

Not much to write home about

US tax and GDP

	Average top marginal tax rate on labour income, %	Real average annual GDP growth, %
1950-70	84.8	3.86
1971-86	51.8	2.94
1987-2010	36.4	2.85
1987-92	33.3	2.31
1993-2002	39.5	3.68
2003-07	35.0	2.79

Source: "Tax rates and economic growth", J. Gravelle and D. Marples, Congressional Research Service, 2014

Economist.com

Reported labour income does rise in response to income-tax cuts, thanks mostly to reductions in tax avoidance. That certainly matters; effort spent eluding Uncle Sam represents an economic loss. It is just not large enough to have a detectable effect on long-run growth.

The evidence is similarly ambiguous about the effects of tax cuts on income from capital. In practice, savings rates respond little, if at all, to tax changes. American savings rates have fallen over the past 40 years despite a decline in the effective rate of tax on capital income. Domestic savings are not the only source of investable funds; Republicans claim their plan will attract a growth-boosting wave of money from abroad. But such flows tend to occur slowly and incompletely: a blessing, perhaps, for the Trump administration, given the massive trade deficits that would result from a rapid, large-scale influx of capital.

Tax reform might affect firms' investment decisions. But firms' ability to deduct the cost of new investments from their tax bill mutes the incentivising effects of changes in the corporate-tax rate. And as Larry Summers of Harvard University has pointed out, cuts to corporate tax do not simply reward hungry innovators, but also increase the return on profits earned by behemoths with market power.

Given evidence that rising industrial concentration in America is undermining competition, there is good reason to worry that rate cuts will pad the wallets of oligopolists and their shareholders. (Awkwardly, CEOs convened by the *Wall Street Journal* this week to attend a discussion with Mr Cohn mostly declined to raise their hands when asked whether they would make new capital investments if the Republican tax plan were passed.)

All told, a cut in the corporate-tax rate of ten percentage points would raise long-run output by only 0.15%, according to an analysis by the Congressional Research Service. National income would rise still less, since much of the gain in GDP would flow to foreign investors.

As with income taxes, cuts in corporate-tax rates make avoidance less worthwhile; just imagine freeing up the time and talent spent cooking up clever tax-limiting strategies like the "Dutch sandwich" or the "double Irish". Yet such costs scarcely register in long-run growth figures.

A some-zero game

In other respects, however, changes to tax make a world of difference. They can affect growth a lot in the short run, especially after a recession, when there is spare capacity around waiting to be activated by increased demand. That counts for less at the moment. America has less slack than it did earlier in the recovery, and the Federal Reserve, fearing inflation, might offset the stimulative effect of tax cuts with higher interest rates.

The budget implications are much bigger. The implacable resistance to government borrowing displayed by Republicans in the immediate aftermath of the Great Recession, when bigger deficits might have done a lot of good, has crumbled. GOP leaders acknowledge that their bill will increase government debt by $1.5trn, or about 8% of current GDP, over the next ten years.

Most striking of all are the distributional consequences. According to an analysis by the Tax Policy Centre, the bill introduced in the House of Representatives will reduce the tax burden of the top 0.1% of earners by an average of $278,000 by 2027, compared with an average cut of $10 for the bottom 20% of earners.

The Republican tax plan would eliminate inefficiencies in the tax code. That should help the American economy run a little more smoothly. Yet with this reform, as any, distributional and budgetary consequences are not secondary effects to be subordinated to a broader growth dividend. They are the main event. It is long past time tax debates reflected that.

This article appeared in the Finance and economics section of the print edition under the headline "The grow-nothings"