Trump's tax reform: not very effective and at the wrong time

No. 247, 21 March 2019

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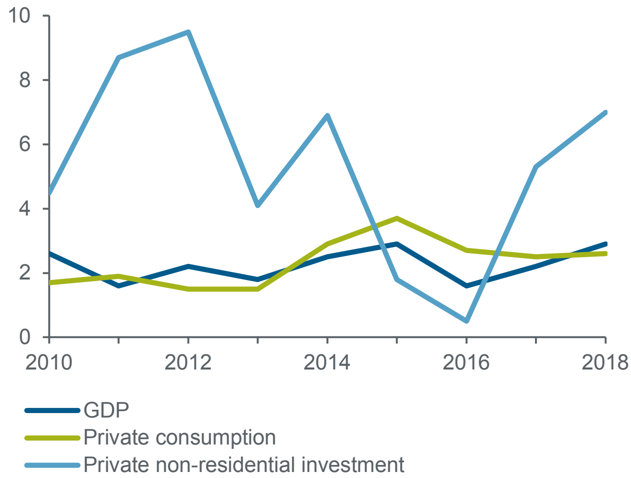
On 22 December 2017, US President Trump signed the 'Tax Cuts and Jobs Act' (TCJA), which had been passed by Congress and provided for, among other things, a reduction in corporate and income tax rates and incentives for repatriating profits earned abroad. The TCJA package has a total volume of USD 1.5 trillion through 2027. The US administration and studies conducted by several economists and institutes predicted that the reform would speed up US economic growth in 2018 by 0.3 to 1.2 percentage points. The figures for the year 2018 indicate that the reform has definitely boosted business investment above all. However, we estimate its overall effect on GDP to be relatively moderate, also because the impact of the reform on the business cycle is unlikely to extend much beyond the year 2018. One reason for its inadequate cyclical impact might be its timing: it is a procyclical measure. Another reason is that tax cuts in the US provide weaker growth impetus than spending-based fiscal stimulus measures. US corporations have so far been using a large portion of the profits repatriated from abroad to buy back their own shares. According to the relevant studies, these weak effects will also result in a disappointing structural and long-term effect on the growth potential of the US economy.

Tax reform has only moderate growth effects

A good year after the tax reform came into effect, the first conclusions can be drawn about how it may boost the economy. GDP grew 2.9% year-on-year in 2018, a rate that is above the average for the period after the financial and economic crisis. This indicates that the tax reform has definitely generated a cyclical effect. It came almost exclusively from business investment. Private sector investment without residential construction grew 7.0% year-on-year in 2018. But the momentum of business investment is relatively volatile anyway, so that such a vigorous increase is not unusual. Furthermore, the rise in investment is also part of a recovery trend after the weak year 2016, when business investment (private non-residential) nearly stagnated as a result of the sharp drop in the oil price (Figure 1). The subsequent surge in momentum began already in 2017, before the tax reform came into effect, and would also have continued at least in part in 2018 without the tax reform. Compared with investment, private consumption did not increase very much in 2018. It grew by 2.6% on 2017, roughly the same rate as in the two previous years.

Figure 1: GDP, consumption and investment

Price adjusted, per cent on previous year



Source: Bureau of Economic Analysis

How much of the cyclical momentum of 2018 is ultimately attributable to the tax reform, however, cannot be quantified with precision. In any case, estimates of a cyclical effect of more than one percentage point for 2018 were exaggerated.[1] Based on the cyclical expectations prior to the announcement of the specific tax plans, which ranged from 2.3 to 2.5% for 2018, the additional effect of the reform on GDP for 2018 – all other conditions remaining equal – would be between 0.4 and 0.6 percentage points. However, the cyclical boost provided by the tax cuts is likely to decline noticeably again over the course of the year.

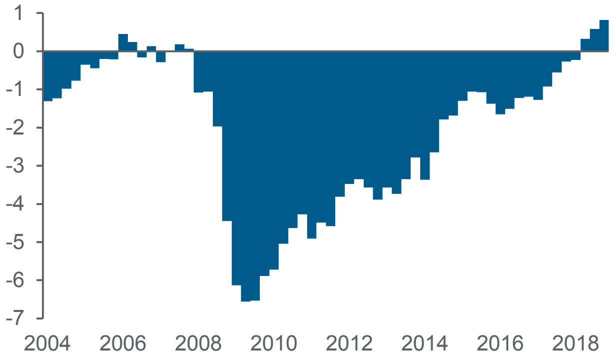
Procyclical character dampens fiscal stimulus

A possible explanation of the rather moderate effect on the business cycle is the timing of the tax cuts. 2018 was the ninth consecutive year of expansion. That means the US is currently in its second longest growth cycle since the earliest records from the 1850s. According to estimates by the Congressional Budget Office (CBO), the US economy has already been running above its potential level since the second half of 2018 (Figure 2). The high degree of capacity utilisation can now be seen very clearly in the labour market as well. In November 2018 the unemployment rate was 3.7%, the lowest in 48 years.

An analysis by the Federal Reserve of San Francisco (FRSF) has revealed that, for the first time since the Vietnam war, US fiscal policy has returned to being procyclical again as a result of the tax reform, which means that the primary public deficit is growing during a period of cyclical expansion.[2]

Figure 2: US output gap

GDP as a percentage of potential GDP

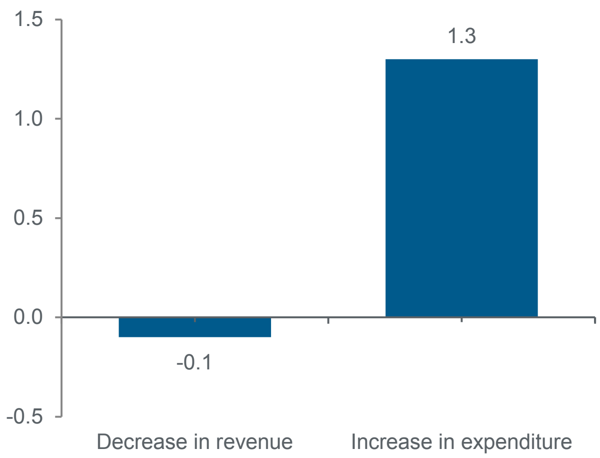


Source: Congressional Budget Office

The fiscal multiplier for tax cuts in the US is only a fraction of the one for spending-based (fiscal) stimulus measures and can be even lower or even negative during periods of full capacity utilisation, as is currently the case (Figure 3).[3] On that basis one can expect the cyclical impetus of the tax reform to be weaker than if these fiscal measures had been introduced anticyclically and/or in the form of higher government spending. Moreover, the marginal propensity to consume is 20 to 30% lower in growth periods than during recessions, which may also explain why the reform has failed to additionally stimulate private consumption.[4]

Figure 3: Multiplier effect for the US in expansionary fiscal policy and capacity overutilisation

Cumulative effect on GDP after four quarters from raising the deficit by one unit



Source: International Monetary Fund

The long-term, structural growth effects of the reform are also deemed to be relatively low. The effects resulting from the income tax cuts are only temporary anyway since the new tax rules for private households are to be gradually rolled back after 2025. Besides, around 75% of these tax cuts apply to taxable income of more than USD 200,000, and they reach only 5% of all taxpayers in the first place.[5] The corporate tax cuts, which are not temporary, should lead to lower capital costs for corporations in the long term. However, several studies predict that up to 50 % of this effect on potential growth might be neutralised by a faster rise in the interest rate level. Accordingly, the overall long-term growth impact of the tax reform on the potential GDP level is therefore very conservatively estimated at 0.02 to 0.05 percentage points per year up to 2027.[6] Seen in its entirety, the tax reform therefore presents a rather modest cyclical outcome without any significant long-term effect.

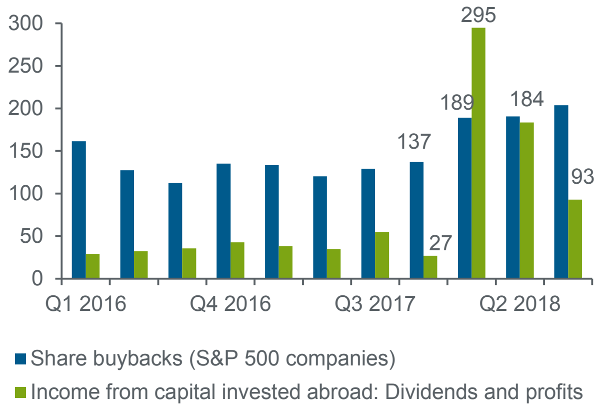
In addition to the lower effectiveness of the tax cuts, the pro-cyclical approach might also reduce the fiscal policy scope for stimulus measures in times of weaker economic performance. An IMF study predicts that the already relatively high public debt level of the US central government will rise to around 85% of economic output by the year 2023 and will be around four percentage points higher than in a scenario without a tax reform.[7] The increased debt will put more pressure on the administration to initiate fiscal consolidation. If this consolidation were to fall into a period of economic contraction, it would result in a significant intensification of the downturn because the fiscal multiplier on US GDP is higher during these periods, at -1.8, than in expansionary periods (-1.3).[8]

Capital reflows are used primarily for share buybacks

As the reform also set tax incentives for repatriating to the US profits that were earned abroad, experts expected one-time reflows of cash reserves and other assets worth some USD 1.5 trillion[9]; President Trump even mentioned the figure of USD 4 trillion.[10] This effect also appears to be significantly smaller than expected. While US companies still repatriated capital in the amount of USD 295 billion and USD 184 billion in the first and second quarter, it was a mere USD 93 billion in the third quarter (Figure 4). Besides, it is questionable how much of this additional capital was and is actually being used for investment. The strong growth in the volume of share purchases by S&P 500 enterprises (+53% in Q1 to Q3 2018 on the same period in the previous year) is a clear indication that for now enterprises are not investing the additional capital in expanding their capacities.

Figure 4: Share buybacks and repatriation of capital

In USD billion



Source: S&P Dow Jones Indices, Bureau of Economic Analysis

Conclusion: Tax reform remains below expectations

At present, the tax reform of the Trump administration hardly appears to be able to live up to its big promises. Besides its rather moderate short-term cyclical effect, what is particularly doubtful is whether the reform will have a structural effect on US economic growth beyond the short term as well. The high expectations for the effect of US companies' repatriation of foreign profits also appear to have been exaggerated. ■

[1] Mertens (2018) draws on various existing empirical estimates of the macro-economic effect of tax changes and applies them to the US tax reform of 2017. On average, the models applied arrive at a cyclical effect of 1.2 percentage points of additional growth for 2018. Cf. Mertens, K. (2018), The Near Term Growth Impact of the Tax Cuts and Jobs Act, Federal Reserve Bank of Dallas Research Department Working Paper 1803 (https://doi.org/10.24149/wp1803, last retrieved on 6 March 2019)

[2] Mahedy, T. and Wilson, D. (2018): Fiscal Policy in Good Times and Bad – FRBSF Economic Letter 2018-18. (https://www.frbsf.org/economic-research/publications/economic-letter/2018/july/procyclical-fiscal-policy-tax-cuts-jobs-act/ , last retrieved on 6 March 2019). Using historical time series on the public primary deficit and the output gap of the US (the relative difference between potential and actual economic output), the authors determined the cyclical share of the primary deficit and in this way demonstrated that US fiscal policy has been procyclical only twice in the post-war era. The first time was during the Vietnam war at the end of the 1960s and the second time is the present situation under the Trump administration.

[3] Baum, M. A., Poplawski-Ribeiro, M. M. and Weber, A. (2012): Fiscal Multipliers and the State of the Economy (No. 12-286). International Monetary Fund. This IMF study comprises previous results on fiscal multipliers from six industrial nations (Canada, US, United Kingdom, Germany, France and Japan) and adds own calculations on fiscal multipliers in which it distinguishes between stimuli through taxes and government spending and additionally calculates different multipliers for periods of expansion and contraction. Its key finding is that in all countries the fiscal multipliers for government spending are significantly higher than for tax cuts. Expenditure-based fiscal stimuli are significantly more effective when they are introduced anticyclically, while in revenue-based stimuli (taxes) the difference is smaller and more heterogeneous.

[4] Mahedy, T. and Wilson, D. (2018): Fiscal Policy in Good Times and Bad – FRBSF Economic Letter 2018-18, p. 4. (https://www.frbsf.org/economic-research/publications/economic-letter/2018/july/procyclical-fiscal-policy-tax-cuts-jobs-act/, last retrieved on 6 March 2019).

[5] Zandi, M. (2019). U.S. Macro Outlook: A Plan That Doesn't Get It Done | Moody's Analytics. (https://www.economy.com/dismal/analysis/commentary/299138/US-Macro-Outlook-A-Plan-That-Doesnt-Get-It-Done/, last retrieved on 6 March 2019).

[6] Barro, R. and Furman, J. (2018): Macroeconomic Effects of the 2017 Tax Reform. Brookings Papers on Economic Activity. and Zandi, M. (2019). U.S. Macro Outlook: A Plan That Doesn't Get It Done | Moody's Analytics. (https://www.economy.com/dismal/analysis/commentary/299138/US-Macro-Outlook-A-Plan-That-Doesnt-Get-It-Done/, last retrieved on 6 March 2019). Both analyses estimate the long-term effect of the tax reform on the potential level of US economic performance for the next 10 years. The first study estimates the effect at 0.02 or 0.04 percentage points per year depending on whether a crowding-out effect occurs as a result of increased returns on US government bonds. Mark Zandi, chief economist of Moody's Analytics, estimates the effect at 0.05 percentage points per year.

[7] Chalk, N., Keen, M. and Perry, V. (2018): The Tax Cuts and Jobs Act: An Appraisal. IMF Working Paper WP/18/185. Figure 9, p.9.

[8] Baum, M. A., Poplawski-Ribeiro, M. M. and Weber, A. (2012): Fiscal Multipliers and the State of the Economy (No. 12-286). International Monetary Fund. Table 1, p.7.

[9] Massa, A. (2018): $1.5 Trillion in Corporate Cash Is Coming to America. (https://www.bloomberg.com/news/articles/2018-08-17/game-on-with-1-5-trillion-in-corporate-cash-coming-to-the-u-s, last retrieved on 6 March 2019).

[10] Davison, L. (2018): Trump's Tax Promise of Trillions Back to U.S. Fails to Materialize. (https://www.bloomberg.com/news/articles/2018-12-06/trump-tax-promise-of-trillions-back-to-u-s-fails-to-materialize, last retrieved on 6 March 2019)