US tax reform: a short-term demand shock, with more uncertain effects in the long term

In late December 2017, both houses of the US Congress agreed to vote in a fiscal stimulus plan called the Tax Cuts and Jobs Act. This concerns both households and businesses and represents an overall cost of 1,500 billion dollars over ten years, or around 8 annual GDP points, according to figures from the Congressional Budget Office (CBO)[1]. This Focus looks at the first available *ex ante* evaluations from American or international public and private bodies.

Tax cuts are expected to benefit households above all

For households, the plan calls for a simplification of the income tax band system and a lowering of the marginal tax rate for the highest band from 39.5% to 35%. It also includes a substantial reduction in taxes and social contributions for unincorporated enterprises in the form of a flat-rate exemption of 20% of income. All in all, according to the CBO, these tax reductions should represent around 0.4 GDP points in 2018 and twice that for the following years. Over ten years, and not including the possible effects of the reform on the potential growth of the American economy, the entire household block is set to represent a combined expenditure of 7 GDP points. The scenario used in this edition of *Conjoncture in France* forecasts a reduction of 0.2 GDP points as early as H1 2018, or 35 billion dollars. Thus the forecast for growth in taxes and social contributions on households is set to be lowered from a trend rate of +1.0% per quarter, in line with payroll, towards stabilisation in H1 2018. This slowdown in taxes and social contributions is expected to contribute around 0.2 points to the acceleration of household purchasing power. In the long term, the impact on household consumption is likely to be slightly smaller as the tax reduction is mainly targeted at the better-off, who have a lower propensity to consume.

Companies should benefit from a sharp and immediate reduction in their taxes

For companies, the plan provides for a reduction in the nominal rate of corporation tax, from 35% at present to 21%, combined with a one-off initial depreciation allowance. These adjustments are likely to ramp up very rapidly to represent a tax expenditure of around 0.8 GDP points over one year from 2018-2019 before decreasing rapidly from 2020-2021. Their effect is then expected to lessen gradually, as the depreciation allowance measure disappears. All in all, over ten years, these measures are likely to present a cumulative cost of around 3 GDP points. Hufbauer and Lu (2017) believe the measures will bring about a significant reduction in the effective rate of taxes and social contributions on company profits, which should remain relatively high compared with the apparent rate of corporation tax, as there are also additional duties. The first simulations by the Peterson Institute for International Economics[2] (PIIE) produced figures that show a rapid fall in the marginal tax rate for corporate investment, especially in equipment and structures, of almost 3 points below the trend, simulated with no reform as of 2019. According to the same simulations, the average rate of corporation tax is expected to tumble rapidly to almost 5 points below trend, again simulated with no reform. All in all, the combined effect of these two measures on annual GDP growth is likely to be an average of around 0.8 points, according to the PIIE.

The effect of the stimulus is likely to be limited by certain points in the plan and by crowding out effects

These initial figures also highlight other effects of the reform, however, which could affect growth. First, some are directly related to additional measures contained in the law, especially the end of the deductibility of interest on loans for businesses and households, and an overhaul of the scope of US taxation, which will now apply to resident units and will no longer apply to agents of American nationality regardless of where they live. On the other hand, the reform does include a one-off measure of a low level of taxation on savings repatriated from abroad by resident businesses, and which until now have not been taxed. This is accompanied by a corporation tax surcharge on dividends and income from assets invested abroad and repatriated to the United States, especially income from patents and other intangible assets (Hufbauer and Lu, 2018). These additional measures are expected to lead to an increase in corporate tax income. According to figures from the CBO, this is likely to result in a three-fold reduction in the size of the tax stimulus for businesses. Thus, by 2021, the

1. https://www.cbo.gov/system/files/115th-congress-2017-2018/costestimate/53415-hr1conferenceagreement.pdf
2. https://piie.com/system/files/documents/furman20180106ppt.pdf

marginal tax rate on corporate investment looks set to exceed its pre-reform level, at almost 23.0%.Lastly, in addition to these elements are the traditional effects of budgetary policies being crowded out by interest rates when they significantly increase the scale of public debt. The first figures from the PIIE, using data from the Joint Committee on Taxation, show that financing the reform seems likely to be achieved mainly through budgetary deficit, which should therefore increase by about 2 GDP points by 2027. By combining all these elements, these figures show that the reform has a fairly limited effect on US growth, which will probably be between 0.1 and 0.2 GDP points annually. However, other institutions have produced more favourable estimates: in its January 2018 forecasts, the IMF reckons that the effect is likely to be 0.4 GDP points per year (*Table*).

The tax stimulus comes with a budgetary stimulus

The bipartisan agreement voted by Congress in early February allowed for the release of 80 billion dollars in 2018, then 85 billion dollars in 2019 for military spending, or around 15% of the defence budget. In addition, 130 billion dollars in non-defence federal spending are also planned, 20 billion of which for infrastructure, or 20% of the total budget excluding defence. This spending on infrastructure is expected to be renewed every year for 10 years, with a quarter of it earmarked for rural areas. Finally, this agreement provides for the release of 90 billion dollars to assist those regions affected by hurricanes. All in all, this new public expenditure represents almost 2 GDP points over two years. ■

Bibliography

Hufbauer G. C. and **Lu Z.** (2017), "Business tax cuts will boost US competitiveness", *Real Economic Issues Watch*, Peterson Institute for International Economics, November.

Hufbauer G. C. and **Lu Z.** (2018), "Corporate tax reform favors domestic production, not US multinationals", *Realtime Economic Issues Watch*, Peterson Institute for International Economics, January. ■

Annual average effects of measures (off fiscal stimulus) on GDP over the next ten years, as estimated by various institutes

Institution	Scope	Annual average effect on GDP by 2027
IMF	Enterprises and households	0.4 point
Joint Committee on Taxation	Enterprises and households	< 0.1 point
Peterson Institute for International Economics	Enterprises excluding crowding out effects and excluding international taxation	0.8 point
Peterson Institute for International Economics	Enterprises including crowding out effects and including international taxation	< 0.2 point

Sources: IMF (World Economic Outlook, January 2018), Joint Commitee on Taxation and PIIE (references: https://piie.com/system/files/documents/furman20180106ppt.pdf