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Intended and Unintended Effects of the Tax Cuts and Jobs Act on the U.S. Economy

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Abstract

The purpose of this paper is to dissect the Tax Cuts and Jobs Act (TCJA) passed by President Trump and the United States Congress on December 22, 2017. TCJA is a long run Classical Policy aimed at increasing the potential Gross Domestic Product (GDP) and creating a more efficient economy for the private sector and individuals. Income taxes are predominant sources of funding for the United States government as they both raise revenue for the federal government and hold the private sector accountable. TCJA – a long run growth policy – has the remarkable potential to benefit the United States economy, but at a considerable cost. Decreasing taxes decreases revenue. Government spending would need to be reduced in order to offset the deficit caused by tax reduction. The plan was carried out, however, spending cuts were not made. Expanding deficits add to the nation's debt. Therefore, the TCJA has the potential to substantially help the United States economy in the long run, but the deficits' created by the policy can cause serious repercussions. This paper aims at examining the changes in GDP, Investment, Consumer, and Government Spending before and after TCJA was passed.

1. Introduction

The Tax Cuts and Jobs Act (TCJA) was passed just after 48 days of consideration, a bill that overhauled a three-decade-old tax code on December 22, 2017 (Hungerford, 2018). The document aimed at reducing individual and corporate tax rates. The original intent of the policy was to be a Classical long-run policy aimed to stimulate growth and increase the potential GDP of the United States. For the policy to be effective, the tax cut must be combined with a reduction in government spending. The tax cuts were passed; however, Congress did not agree on decreasing government spending. As a result, the corporate tax changes are permanent and the income taxes are set to expire on December 31st, 2025. This paper will analyze the bill's objectives, projections, and reveal economic benefits & repercussions.

2. Theory and Intended Effects

In theory, the TCJA promises to bring increased prosperity to the already booming United States economy by giving individuals and corporations more disposable income. More disposable income equates to higher consumption, investment, and wages for workers while expanding the GDP.

2.1 Impact on the Gross Domestic Product

More disposable income will equate to more consumption, growing the GDP. GDP is represented as follows:

GDP = Consumer Spending (C) + Investment Spending (I) + Government Spending (G) + Exports (X) - Imports (Z)

Figure 2 shows the increases in Real GDP until 2028, figure 3 shows the Real GDP from 2016-2018. Figures 4, 5, and 6 show trends in Consumer Spending, Government Spending, and Investment Spending respectively. Most graphs depict positive results after TCJA was passed.

As the equation suggests, an increase in C & I will increase the GDP. This increase will not be respective to the increases in C & I, rather the increase in GDP will be substantially larger because of the Keynesian Spending Multiplier. The Keynesian Spending Multiplier is known for expanding wealth cyclically. If money is invested in the private sector, it will benefit the workers and their families, the firm, and the surrounding economy. The people who have been impacted positively firsthand will then spend the money elsewhere and create a ripple of prosperity for others.

According to Arnold Zellner and Jacques Kibambe Ngoie in Evaluation of the Effects of Reduced Personal and Corporate Tax Rates on the Growth Rates of the U.S. Economy (2018), “Many countries that have instituted tax reforms have experienced substantial increases in growth.” Consumers will receive additional disposable income in the form of tax cuts and be encouraged to spend. Likewise, businesses will be more prompted to invest the surplus, increasing investment spending (I). In their paper, Zellner and Ngoie state, “The private sector is allowed to manage a larger portion of its revenue, while government is forced to cut public spending on social programs with little growth enhancing effects.” When individuals have freedom over their money, they have the potential to grow it. If the government controls money, they will use the money for public purposes, eliminating the opportunity to grow money.

In figure 2, according to the Consumer Budget Office (CBO), TCJA is projected to increase the real GDP of the United States by an average of 0.7% annually. As the period comes to an end, and some of the tax cuts expire, the increased positive effect of TCJA on the real GDP starts tapering off. The most fruitful years are between 2022 and 2024, the change in Real GDP being almost 1.0%.

2.2 Firm reinvestment and wage growth

If firms have more money to work with after tax cuts, they would be more likely to hire people, reinvest, and/or increase wages for existing workers. Spending additional revenue rather than saving will further benefit the firm and the general population. Hiring more workers will provide more jobs, benefit the local economy, and the firms as they will inherit talent and gain productivity. Reinvestment will ensure the business is up-to-date with current technology and have the opportunity to expand if needed. Increasing wages for existing workers will ensure increased productivity and help firms expand. In this scenario, we can see the impact of the Keynesian Spending Multiplier even though TCJA is Classical long-run growth policy. In Figure 6, according to the U.S Bureau of Economic Analysis (BEA), TCJA has increased investment spending. In Q1 & Q3 of 2018, we see an increase in spending when compared to previous quarters. A dip in investment spending occurs in Q2 of 2018, but the spending recovers in Q3 and has a higher yield when compared to Q1 of 2018, showing a positive effect of TCJA.

3. Unintended Effects

3.1 The Federal Deficit

Theoretically, tax cuts will help citizens and businesses but have the potential to increase the deficit if spending is not controlled. The TCJA reduced the top corporate tax bracket from 35% to 21% and the top individual tax bracket from 39.6% to 37% (Smith and Howard). The individual tax changes expire on December 31, 2025, and have the potential to create major deficits in the U.S Government until then (York, 2018). Due to the tax cuts, we will see a dramatic reduction in the federal revenue which would entail borrowing money to fund our government or eliminating federally funded programs. Increased borrowing will lead to increased interest rates as there is a greater risk associated as the principal increases. To keep up with increased risk, interest rates would need to be hiked.

Figure 1 shows the annual deficit in percentage of the total GDP. After TCJA was passed, the deficit is expected to increase and account for about 5-6% of the annual GDP. As visible, there are spikes in the deficit for some years. The increases in deficits on the graph between 1981-1986 can be attributed to the recession at the time. Similarly, the Great Recession between 2007 to 2009 contributed to the increased deficits. In 2009, President Obama and Congress implemented the American Recovery and Reinvestment Act (ARRA), a Keynesian Fiscal Policy aimed at increasing spending in hopes of stimulating the economy (Amadeo, 2019). The Policy included a $787 Billion stimulus package, accounting for huge deficits between 2009-2013 (Amadeo, 2019).

In 2017, the United States was able to pass TCJA, but could not agree on reducing spending. As a result, the revenues decreased while spending was the same, leading to a huge deficit. The deficit created by TCJA is comparable to deficits created when the United States was in a recession. This may be a cause for concern as the economy is vigorous at the moment; increased deficits have the ability to threaten vitality as they increase the already enormous debt. Deficits usually occur when the Federal Government needs to borrow additional funds to stimulate the economy out of a recession or partake in a war. The government tries to reach a balanced budget when the economy is healthy, the complete opposite as to what is happening now. There are a lot of benefits associated with TCJA in the long run; but without reducing spending or raising revenue to help cover the deficit, the bill's positive impact on the economy could be hindered. Increased debt will lead to higher interest payments on our debts, eventually hurting our economy as we may need to repay the money some point in time.

3.2 Permanent vs. Temporary Tax Cuts

Permanent and temporary tax cuts cause different effects on the confidence of consumers and firms. Permanent tax cuts have outstanding effects on the economy. The Tax Cuts and Jobs Act was meant to be permanent. The philosophy behind the legislation was to improve the potential GDP and make the economy more efficient in the long run. However, some provisions of the tax cuts expire for individuals on December 31, 2025, making the individual portion of the act temporary (York, 2018). Temporary tax cuts can confuse firms and individuals which may do more harm than good. In Evaluation of the Effects of Reduced Personal and Corporate Tax Rates on the Growth Rates of the U.S. Economy, the authors studied the effects of permanent and temporary tax cuts. After their research, they said "We conducted comparative analysis between temporary and permanent tax cuts and found the obvious: well-thought permanent tax cuts produce much better economic outcomes. Economic agents are well informed about the time nature of the tax cuts and react accordingly." If tax cuts are permanent, consumers are more likely to expend the extra money, rather than hoard. This behavior may be explained by the fact that permanent tax cuts are seen as more stable than tax cuts lasting a few years. In the latter case, a consumer would be more likely to save money.

Arnold Zellner and Kibambe Ngoie state "Fierce critics of tax cut policies have often argued that tax cuts may not necessarily lead to expected results when the targeted economic agents' reaction is contrary. For example, when agents tend to save more or pay their debts with the extra revenue obtained from personal income tax rebates." When tax cuts seem to be temporary and the state of the economy is volatile, the public ends up saving the extra money for a rainy day. When money is saved instead of spending, the intention of helping Americans backfires. The government loses revenue when tax cuts are issued. When consumers save the extra money, there seems to be no way of that money being reinvested.

In 2008, President George W. Bush passed temporary tax cuts in hopes of benefiting the private sector and people of all income groups. The tax cuts were short-run Keynesian in nature, aiming to help the United States get out of the recession and back on track. Unfortunately, these tax cuts backfired as they were temporary. "Among others, the Bush tax rebate of Spring 2008 aimed at stimulating the U.S. economy has averred to be a failure because it was of temporary nature. As we know, temporary tax cuts of this kind are essentially saved especially when they go to rich people who do not really need them. At the same time, people in the middle and low-income group were so concerned about the future of the economy, losing their job or their house, that they could surely not use temporary tax cuts for direct spending. Instead, they used it for saving or debt repayments" (Zellner and Ngoie). Though these tax cuts are not Keynesian in nature, they aim to increase the potential GDP of the United States and not the country's current economic state. Individuals who have done their homework know this tax cut expires on December 31, 2025, at the moment. The fact that TCJA has an expiry date for individual earners communicates the fact that these tax cuts are not permanent even though the expiry date is more than six years away. If consumers know there is an end date, they are more likely to save their tax cuts instead of investing them. This goes against TCJA's objective and can do more harm than good.

4. Conclusion

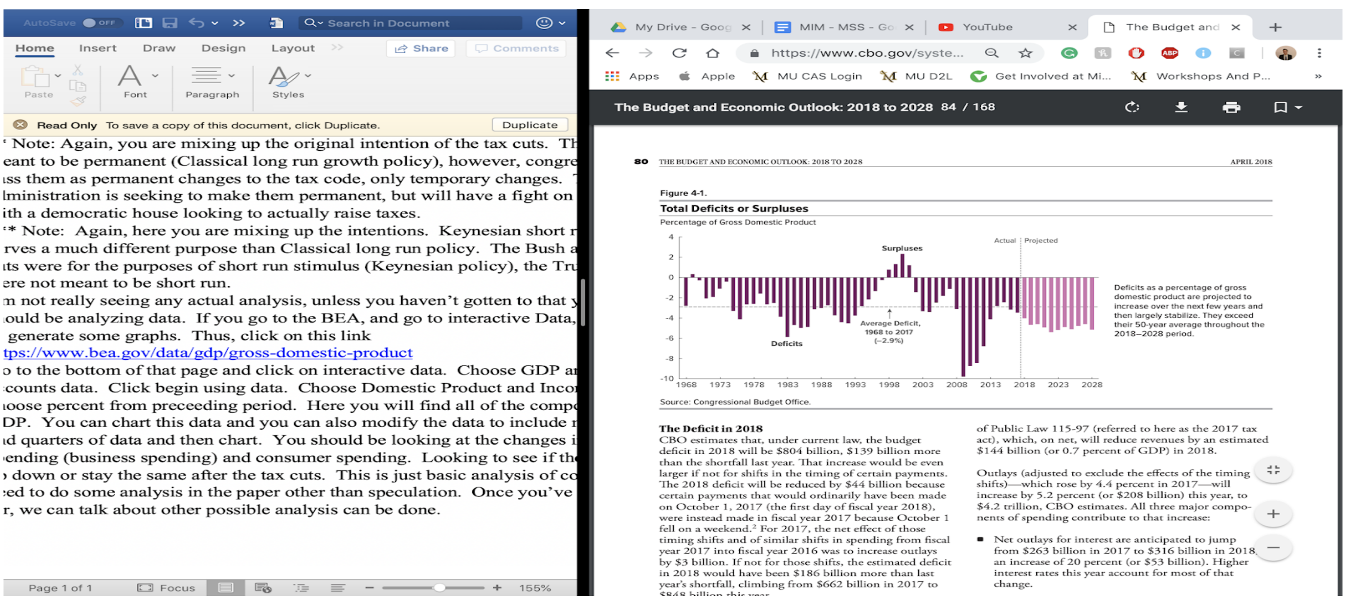
This paper discussed the Tax Cuts and Jobs Act (TCJA), its purpose, and its effect on the United States economy. Though it has been only a year since the legislation has been passed, its effects on the U.S economy are quite evident. GDP, Consumer Spending, Government Spending, and Investment Spending have increased when compared to pre-TCJA levels. The corporate and individual tax cuts are responsible for tremendous success. Firms and consumers acquired additional disposable income which was spent and invested back into the economy. This benefited the economy due to the effects of the Keynesian Spending Multiplier.

TCJA is a long run Classical Growth Policy, so the original intent of this policy was to reduce spending while giving corporations and consumers tax breaks. The original plan would have prevented the deficit from increasing and helped keep it under control. Unfortunately, Congress could not agree on reducing spending and the legislation was passed without reduced spending. This resulted in dramatic decreases in revenue while spending remained about the same. Due to a imbalanced budget, deficits are projected to grow substantially over the next several years, essentially looking like we are in the middle of a recession.

Although TCJA has benefited the United States economy in its first year, we must remember the policy has long term effects. The rising deficits and debts created by the act can drastically eliminate the positive intentions of TCJA. We must continue to observe the effects the Tax Cuts and Jobs Act has had and examine whether the impact on the United States economy is temporary, or permanent.

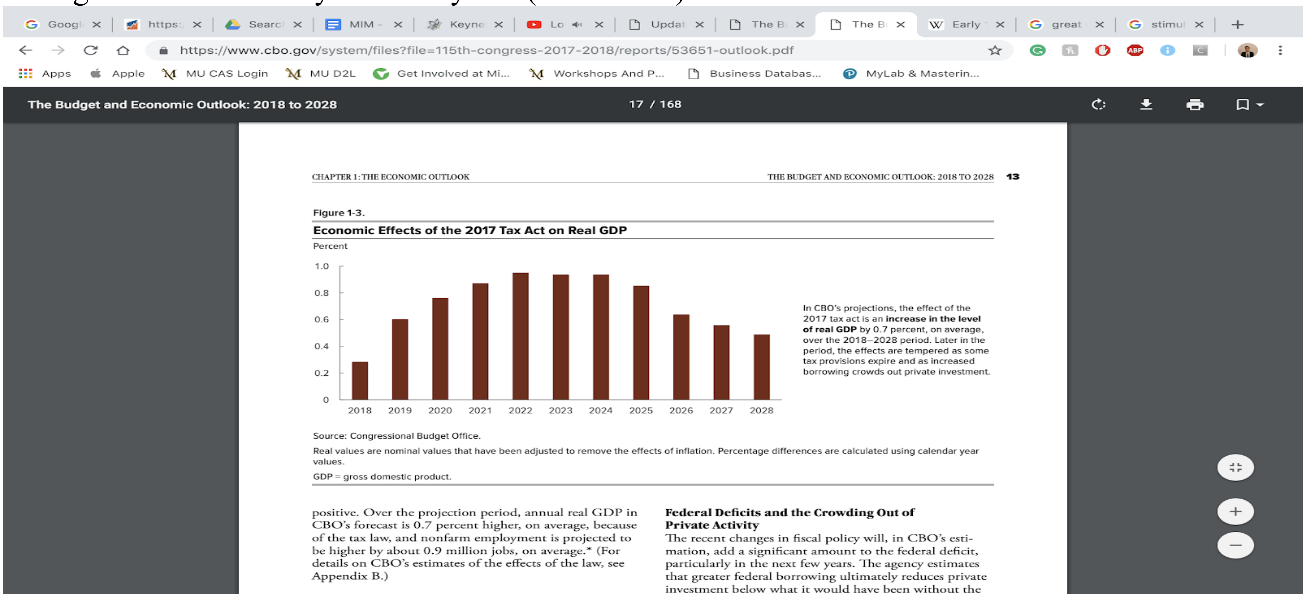
Appendix

Figure 1 shows the annual deficit in percentage of the total GDP over the years (1968-2028).



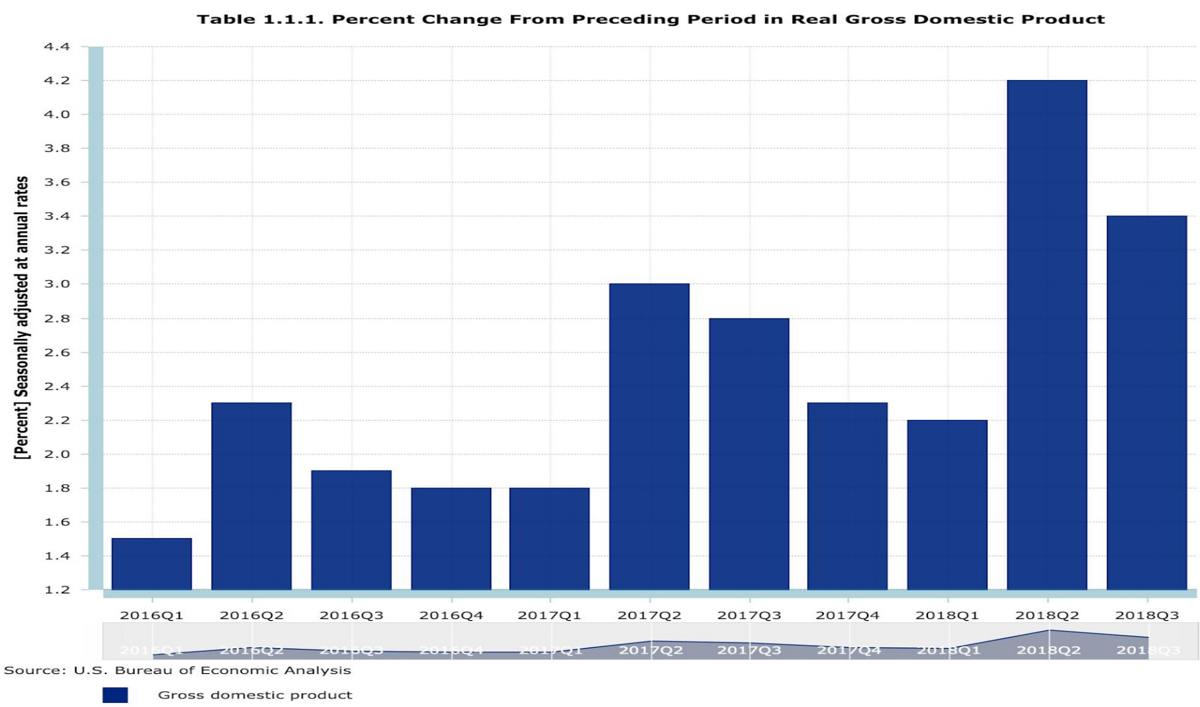
Source: Congressional Budget Office.

As figure 2 suggests, the TCJA is projected to increase the real GDP of the United States by an average of 0.7% annually over the years (2018-2028).



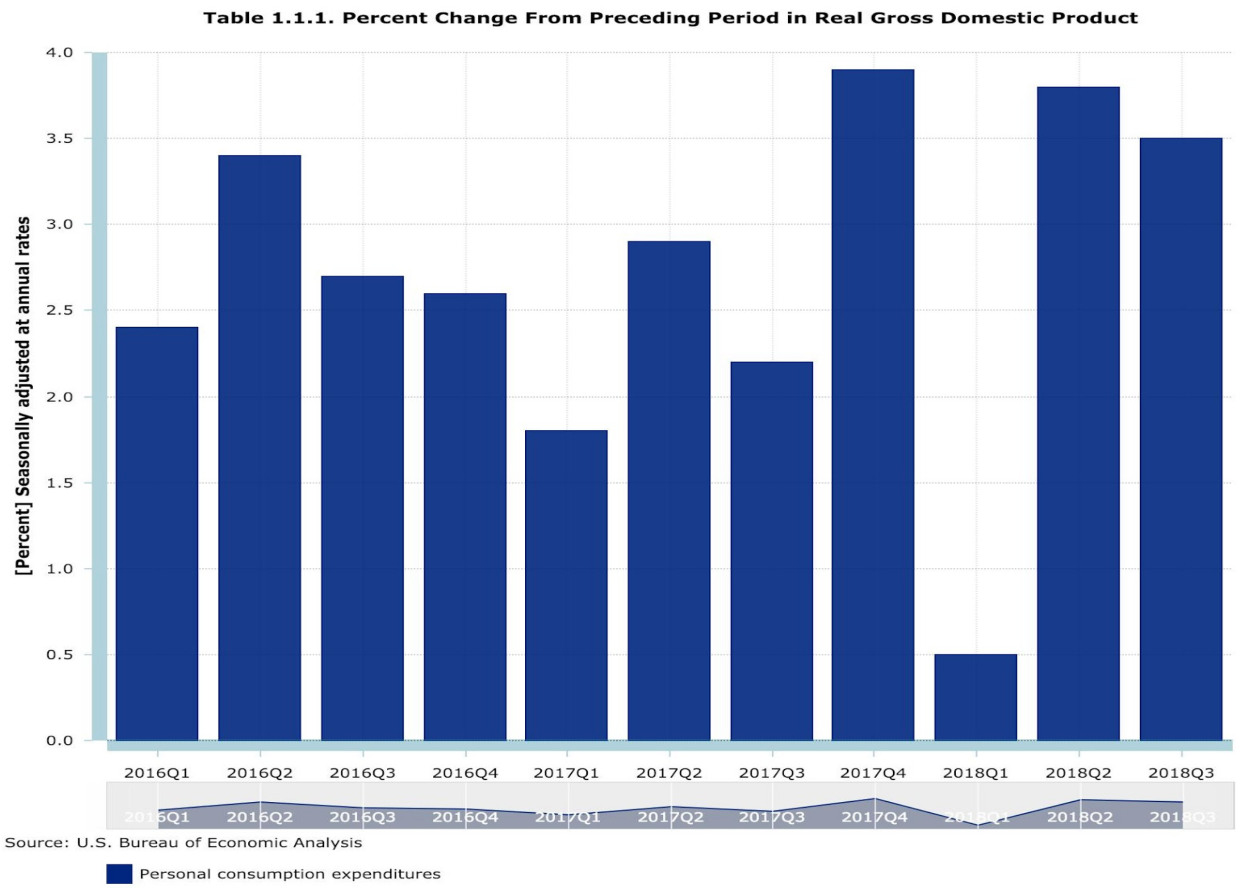
Source: Congressional Budget Office.

Figure 3 shows the percent change of Real GDP before and after the TCJA was passed



Source: U.S Bureau of Economic Analysis.

Figure 4 shows the percent change in Personal Consumption Expenditures before and after the TCJA was passed.



Source: U.S Bureau of Economic Analysis.

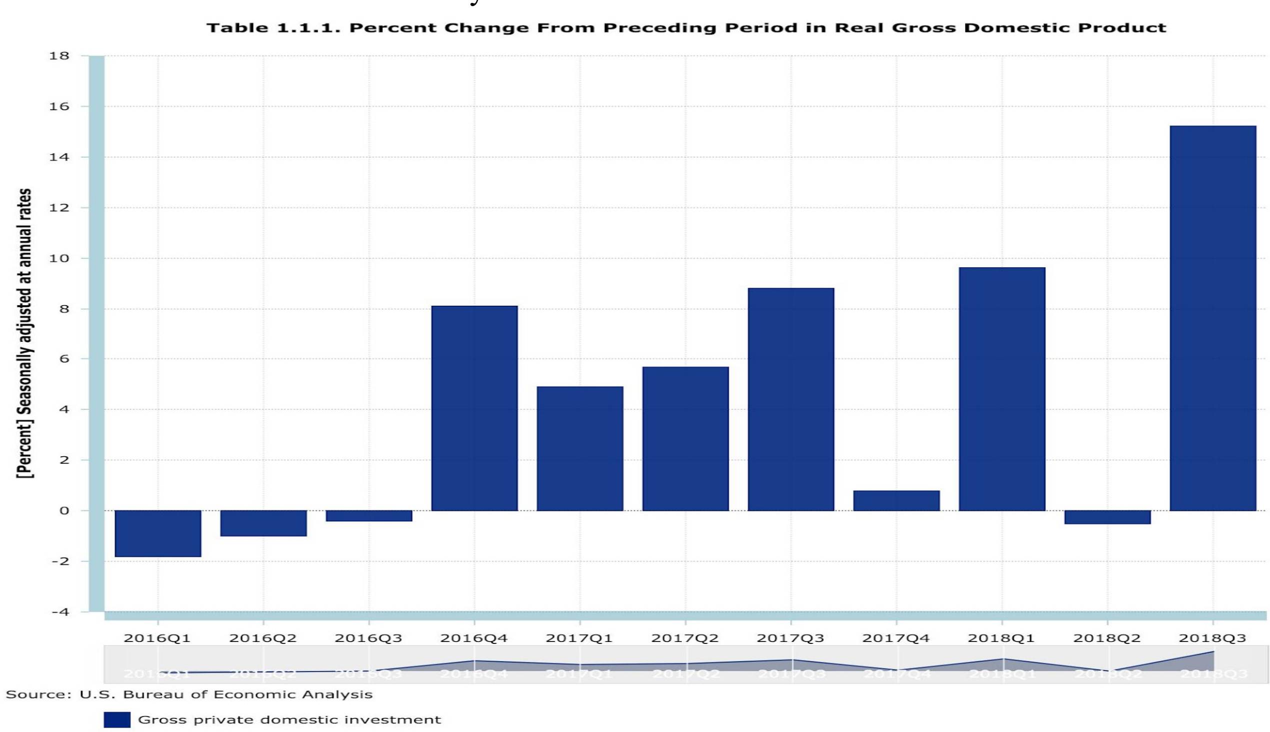
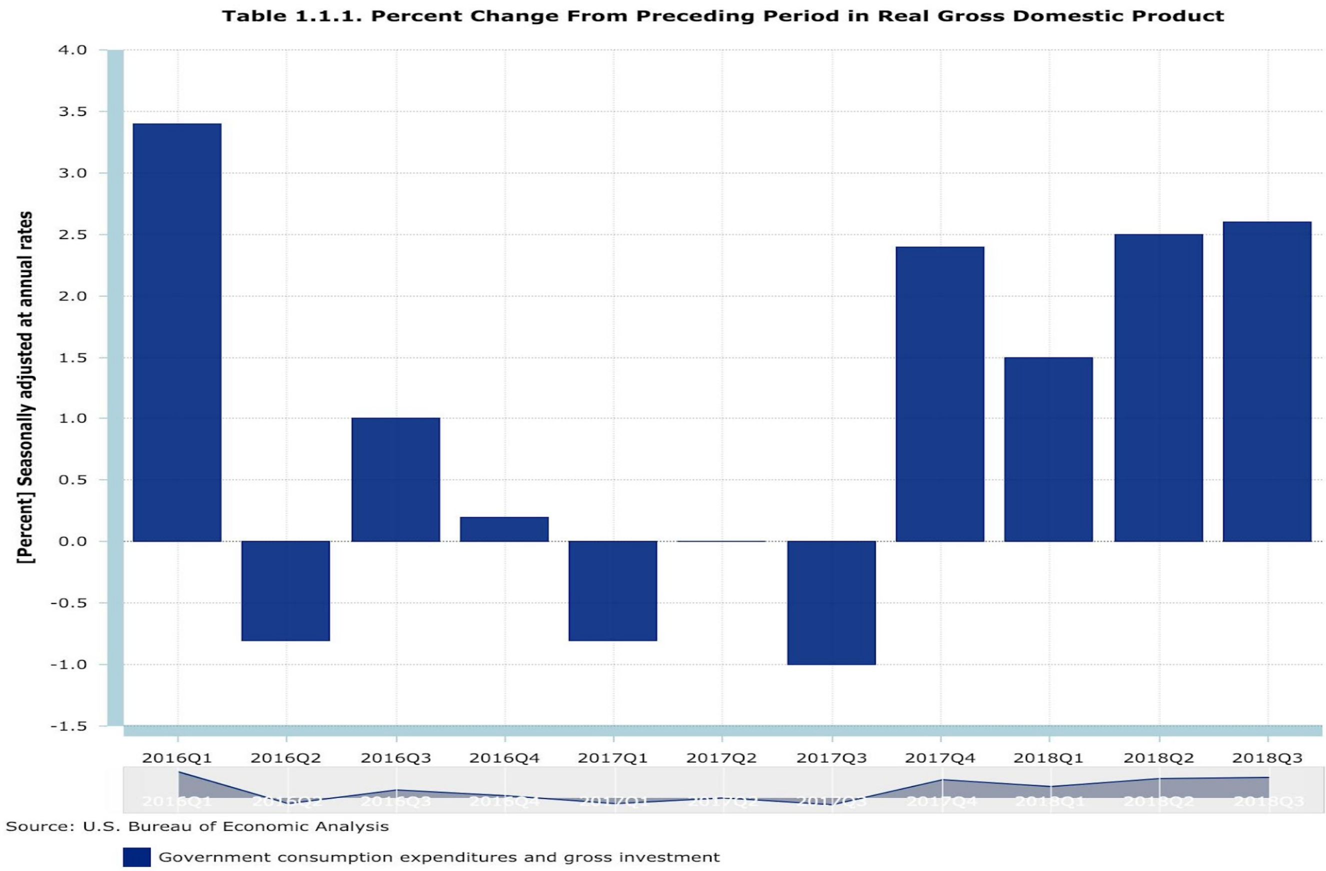
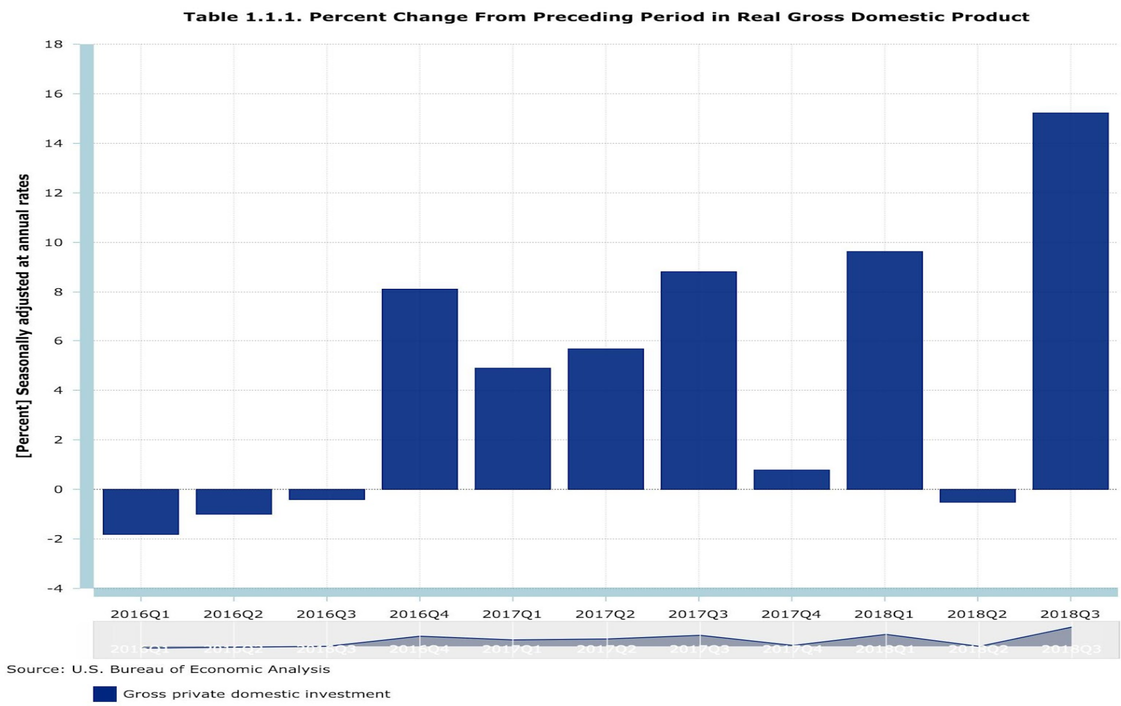


Figure 5 shows the percent change for Government Consumption Expenditures and Gross Investment before and after the TCJA was passed.



Source: U.S Bureau of Economic Analysis.

Figure 6 shows the percent change in GDP for Private Domestic Investment before and after the TCJA was passed.



Source: U.S Bureau of Economic Analysis.

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