Economists see little magic in tax cuts to promote growth

By Patricia Cohen and Nelson D. Schwartz
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If one assumption has undergirded Republican economic policy for decades — and is the foundation of the Trump administration's first budget proposal — it is that tax cuts will unleash fantastic growth.

The basic idea is that shrinking the government's share increases what people take home, encouraging workers to work more and investors to invest more. But while taxes can create incentives that can promote growth, liberal and conservative economists alike said there was no evidence that the White House budget announced on Tuesday would do so.

"The assumed effects on growth are just huge and unwarranted," said William G. Gale, a co-director of the nonpartisan Urban-Brookings Tax Policy Center and a former economic adviser to the first President George Bush.

The Trump administration promises to cut taxes, keep revenues steady and crank out average annual economic growth of 3 percent, but neither the budget nor the tax reforms previously outlined in sketchy form provide enough detail to figure out if that will happen.

While the United States cruised along with 3 percent growth — and higher — in the late 1990s and mid-2000s, growth has not reached anywhere near that level since well before the recession. The best showing in the past decade was in 2015, when the annual rate of expansion hit 2.6 percent.

In 2016, the economy expanded at an annual rate of 1.6 percent, the weakest performance in five years. Even as economies in Europe and Asia show signs of life after years of stagnation or outright recession, expectations for faster growth soon in the United States have ebbed. Both the Federal Reserve and the Congressional Budget Office have projected a pace of less than 2 percent in the long run.

Since mid-March, yields on the benchmark 10-year Treasury bond have fallen from 2.62 percent to 2.28 percent on Tuesday, a sign that traders are discounting the likelihood of a sudden pickup in growth.

An analysis of Mr. Trump's tax plan by the bipartisan, nonprofit Committee for a Responsible Federal Budget estimated that the federal debt would rise by $5.5 trillion over the first decade. Even if lower taxes encouraged people to save and invest more, the huge government deficits created by the budget would crowd out private investors and offset some of those direct effects, several economists said.

Alan D. Viard, a tax expert at the American Enterprise Institute, a conservative research organization in Washington, said he and other researchers had repeatedly found that "deficit-financed tax cuts were usually harmful to growth."

Cutting the tax on investment income, for example, delivers the most bang for the buck, Mr. Viard said, but unless the lost revenue is made up through increases in other taxes or spending cuts, the deficit will balloon and economic growth will suffer.

Previous presidents have not had a lot of success using tax cuts to spur growth. "The historical record is pretty clear that large tax cuts don't pay for themselves through economic growth," said Michael J. Graetz, a professor of tax law at Columbia University.

The 1981 tax cut that President Ronald Reagan pushed through did provide a short jolt to the economy, Mr. Graetz said, but he pointed out that the administration was compelled to raise taxes in 1982 and 1984 to keep the deficit under control.

Tax cuts championed by President George W. Bush in 2001 and 2003 performed even worse. While the cuts temporarily stimulated spending by putting more money in people’s pockets, they did not have much impact in enhancing the economy’s ability to produce goods and services.

Both President Trump and the House Republicans’ proposals reserve the biggest tax cuts for the wealthiest. Slashing rates at the top is probably the least effective way of spurring spending, however, because high-income households have the luxury of socking away a financial windfall, said Nariman Behravesh, chief economist at the research firm IHS Markit. The Trump plan, he said, “could well end up hurting a lot of poor people without boosting growth.”

“If you tilt the tax cuts toward lower-income households, they will spend more of it,” Mr. Behravesh said. “There is virtually no debate among economists about that.”

And the deep cuts in the budget to programs that benefit primarily those at the bottom of the economic ladder will, if anything, reduce their spending.

The left-leaning Economic Policy Institute estimated that the budget cuts would decrease growth by more than 1 percent by 2020.

Many economists on the left and the right agree that the current code as it applies to businesses is misguided: It puts the United States at a competitive disadvantage and encourages corporations to keep income abroad. But fixing that problem isn’t merely a matter of slashing rates.

“With the economy back to near full employment, conventional tax cuts or stimulus spending won’t have that much of an effect,” said Douglas Holtz-Eakin, a conservative economist who served in the George W. Bush administration and advised John McCain’s 2008 presidential campaign. “What is needed are policies that genuinely augment the supply side of the economy.”

What might that look like? Instead of simply cutting rates, Mr. Holtz-Eakin would opt for incentives for business to invest in new equipment or software, infrastructure investments that speed transportation and ease other frictional costs, and retraining that improves workers’ skills and increases the proportion of prime-age Americans who are employed.

Mr. Viard of the American Enterprise Institute added tax relief for child-care expenses to the list of reforms that could bolster growth.

There are lots of reasons to tinker with the tax code, many experts say, but the notion that there is a simple cause-and-effect relationship between cuts and growth is faulty. “Tax policy is clearly not some overwhelmingly powerful tool that affects growth,” Mr. Viard said. There are simply too many other things — like technology, worker productivity and aging — that can either muffle or overwhelm their impact.

In the months after Mr. Trump’s unexpected victory in November, many business leaders and investors thought that the Washington logjam might finally break and that corporate tax reform, more infrastructure spending and other growth-friendly policies would be passed by Congress and signed into law.

But with Washington and the White House now distracted by the investigation into possible ties between former Trump aides and Russia, momentum for major tax cuts or a big infrastructure bill has stalled.

On Friday, the government will announce revised figures for growth in the first quarter of 2017, but not much improvement from the initial 0.7 percent estimate last month is expected.