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Before House Democrats

"Economic and Fiscal Impact of House and Senate Tax Legislation"

December 13, 2017

Efforts to cut taxes and reform the tax code are in full swing. Both the House and Senate have passed their versions of tax legislation and have begun work to resolve the differences between them. This testimony assesses the impact of both tax proposals on the economy and the federal government's fiscal situation over the next decade. If either plan were to become law as proposed neither would materially increase long-run economic growth, but both would add significantly to the government's deficits and debt load.

Businesses win big

Both the House and Senate are proposing large tax cuts, with both plans targeting 10-year static deficits—ignoring the impact of the tax cuts on the economy and thus tax revenues—of well over $1.4 trillion, or more than 7% of current GDP. Businesses are the biggest beneficiaries under both tax plans. Of the close to $1.5 trillion price tag, over $1 trillion goes to businesses in the House plan and closer to $800 billion in the Senate plan (see Table 1).[i]

Breaking this down further, the House plan would give corporations a net tax cut of almost $500 billion over 10 years on a static basis. Smaller pass-through entities—businesses whose owners pay personal income tax on their companies' earnings—would see a tax cut of about $600 billion. The Senate plan would reduce corporate taxes by a smaller near $450 billion, as it delays the reduction in the top corporate marginal rate by a year, and gives pass-throughs a $350 billion cut.

Large multinationals would benefit substantially under both plans by a move from the current global taxation system—the corporations' worldwide earnings are taxed at the U.S. rate—to a territorial one—the corporations' U.S. earnings are taxed at the U.S. rate and there is a lower tax on overseas earnings. They will also enjoy a one-time tax holiday on the trillions in earnings they now hold overseas to avoid the current high tax rate. However, the House plan is somewhat less friendly to multinationals in that it imposes an excise tax on payments made by U.S. companies to their foreign subsidiaries.

The biggest corporate tax expense in the plans is the proposed reduction in the top marginal rate from 35% to 20%.[ii] Lowering the top tax rate on pass-through income and allowing businesses to reduce their tax bill by fully expensing their investment for at least five years are also costly. To help pay for this largess, various business-related tax loopholes are eliminated or scaled back, and the deductibility of interest payments made by businesses are partially limited.

Individual winners and losers

Tax breaks for individuals are more modest, amounting to a near $400 billion under the House plan over 10 years on a static basis and $700 billion under the Senate plan. The big winners are taxpayers in the top 5%, with current incomes well over $300,000 per year, whose after-tax income increases by more than 2% in 2018 and near 1.5% by 2027.[iii] Low-income taxpayers in the bottom 60%, with current incomes of less than $86,000, get a 1% tax cut in 2018, and essentially no tax cut by 2027. Middle-income taxpayers receive a tax cut of approximately 1.5% in 2018 and less than 0.5% by 2027.

The biggest individual tax expenses are the proposal to reduce marginal rates and significantly increase the standard deduction and child tax credit. The House would eliminate the estate tax and alternative minimum tax—a boon to wealthy households—while the Senate would be less generous by phasing out the tax cuts beginning in 2025, scaling back the AMT, and only increasing the amount of wealth exempted from the estate tax. To help pay for all this, both the House and Senate plans would repeal or scale back itemized deductions except for mortgage interest, investment interest, charitable contributions, and up to $10,000 in real property taxes.

Stronger growth?

Proponents of the tax legislation argue that it will significantly increase economic growth. The most common refrain is that the tax cuts will lift real GDP growth closer to 3% per annum from the roughly 2% that has prevailed during the current expansion. They also argue that this additional growth will generate roughly enough additional tax revenue for the plan to pay for itself. That is, there would be large so-called supply-side effects from the tax cuts. So large that on a dynamic basis—after accounting for the bigger economy—the plan will not add to the nation's deficits and debt.

They are wrong on both counts. Neither the House nor Senate plans will meaningfully improve economic growth, at least not on a sustained basis. Growth would be stronger initially since the deficit-financed tax cuts are fiscal stimulus. But given that the economy is operating at full employment, stronger inflation and higher interest rates will result. The economic benefit of the lower tax rates on business investment is washed out by the higher interest rates, and the economy ends up no bigger than it would have been without the tax cuts.

This is evident in simulations of the Moody's Analytics macro model, which is similar to models used by the Federal Reserve, Congressional Budget Office, and the Joint Committee on Taxation—the official budget scorer of tax legislation.[iv] Under the House plan, real GDP growth is 30 basis points higher in 2018, adding close to half a million jobs, and pushing unemployment below 4% (see Table 2).[v] Since this is well below the full-employment unemployment rate, which the Federal Reserve and Moody's Analytics currently estimate to be 4.5%, the Fed responds by tightening monetary policy more aggressively. Long-term interest rates also increase due to the monetary tightening and to investor expectations of larger future budget deficits.[vi] While lower corporate tax rates by themselves would incent more business investment due to the resulting lower *after-tax* cost of capital, the higher interest rates largely wash this out by increasing the cost of capital.[vii] In the end, the economic lift from the tax cuts is small, adding an estimated 3 basis points per annum to real GDP growth over the next decade.

The tax plan does not increase growth from 2% to 3%, as the proponents argue, but from 2.00% to 2.03%.

The economic impact of the Senate plan is similar; real GDP growth is less than 20 basis points stronger in 2018, but almost 30 basis points stronger in 2019, since that is when the lower corporate tax rates take effect (see Table 3). Growth under the Senate plan is a bit slower in the longer run than the House plan, as it phases out the individual tax cuts, adding only 2 basis points per annum to real GDP growth over the next decade.

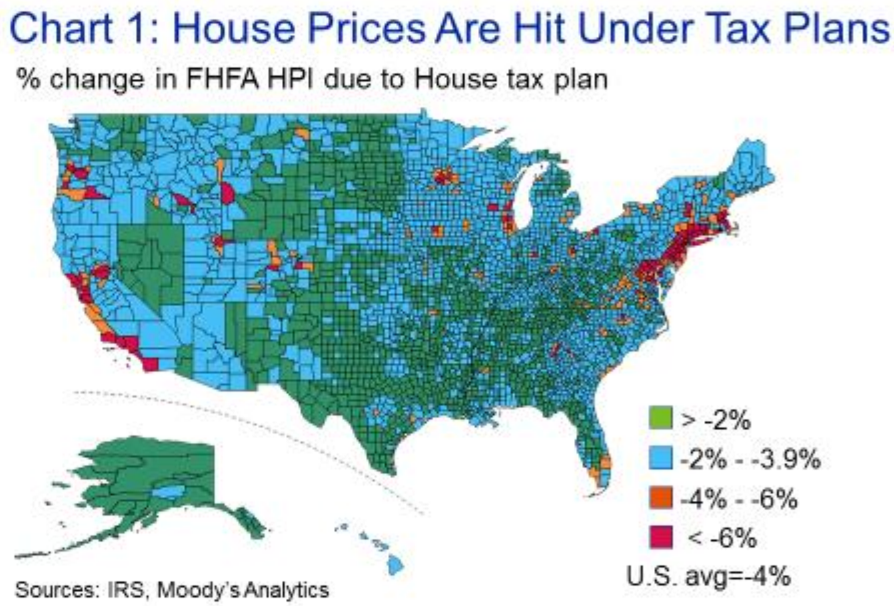
Higher stock prices, lower house prices

The House and Senate tax reform plans will lift stock prices, but reduce house prices. Stock prices receive a lift given the higher *after-tax* earnings of large publicly traded companies, although this is partially offset by the impact of the higher interest rates on the price multiple that investors are willing to put on those earnings. Accounting for these crosscurrents, and the uncertainty with regard to whether the lower tax rates will be permanent after the 10-year budget horizon, the tax plans should lift stock prices by between 10% and 15%.

Much of the increase in stock prices has already occurred as investors are increasingly discounting some probability of tax cuts soon becoming law. This probability appeared to rise sharply immediately after last year's presidential election, when stock prices increased significantly, especially for tax-sensitive companies. Investors seemed to be much less sure this summer as Republican attempts to repeal Obamacare failed. At the current time, investors are attaching a high probability to tax cuts. As such, if the House or Senate tax plans actually become law in the next few weeks, the additional bump to stock prices should be modest.

House prices suffer under both the House and Senate plans. The tax law changes significantly reduce the value of the mortgage interest deduction, or MID, and property tax deductions, which are capitalized in current house prices. In particular, both plans reduce the value of the MID by doubling the standard deduction and thus significantly reducing the number of households that itemize and thus take advantage of the MID. They also limit the deduction for property taxes up to $10,000, while the House goes further by roughly halving the amount of mortgage debt on which taxpayers can deduct interest. Also, the higher mortgage rates that result from the higher budget deficits and debt under the plans weaken housing demand.

Considering all of this, the hit to national house prices under the House plan is estimated to be near 4% at the peak of their impact in summer 2019 and closer to 3% under the Senate plan. That is, national house prices will be approximately 3% to 4% lower than they would have been if there were no tax legislation. The impact on house prices is much greater for higher-priced homes, especially in parts of the country where incomes are higher and there are thus a disproportionate number of itemizers, and where homeowners have big mortgages and property tax bills.[viii] The Northeast Corridor, South Florida, big midwestern cities, and the West Coast will suffer the biggest price declines (see Chart 1). Counties such as Essex NJ, Westchester NY, Cook IL, and Delaware PA could see house prices reduced by as much as 10% compared with what they would have been otherwise.



The impact on the broader national economy of the higher stock prices and lower house prices is largely a wash. The principal channel through which changing asset prices impact growth is on consumer spending via the wealth effect—the change in spending due to a change in wealth. Stock wealth rises somewhat more than housing wealth declines due to the tax law changes, but the housing wealth effect is currently a bit larger than the stock wealth effect.[ix]

Big dynamic deficits

The House and Senate tax plans will significantly exacerbate the nation's fiscal problems. On a static basis, the tax plans will cost taxpayers up to $1.5 trillion over the next decade. On a dynamic basis, the price tag is not much lower. While there are economic benefits on revenues from the lower marginal rates, they are not sufficient to pay for the cuts. Government borrowing thus increases, causing interest payments on the accumulating debt to rise. The added interest payments offset the economic benefits on revenues, making the static and dynamic budget deficit and debt load about the same.

Under both plans, the government's debt-to-GDP ratio rises from just over 75% today to almost 100% a decade from now, measured on either a static or a dynamic basis. By comparison, with no changes to tax policy, the debt-to-GDP ratio still would rise significantly, but only to 95%. Neither prospect is an attractive one, but a tax plan that adds significantly to the government's debt load is bad policy.

Pluses and minuses

There are aspects of the tax plans that are difficult to model and quantify: Some add to economic growth, and others detract from it, but on net these largely cancel each other out. Moving from a global to a territorial system will stop inversions by U.S.-based multinationals, ensuring more headquarters stay here. Limiting the deductibility of interest payments would also curb businesses' use of debt in financing their activities. Given the nation's experience with too much leverage, and the already-high levels of debt at nonfinancial corporations, this would be a plus.

The most significant unquantifiable drawback of the plans is that they will very likely sunset in 10 years. Under Senate rules, tax and spending legislation that passes using the reconciliation process, in which only a simple majority of votes is required, must be deficit neutral by the last year of the 10-year budget horizon. If the JCT-scored legislation shows that there will be a deficit a decade from now, then all of the provisions in that legislation expire. This is very likely the fate of the Republican tax plan. Uncertainty over how future lawmakers would deal with this tax cliff will likely crimp business investment, particularly longer-lived, riskier types of investment, as the cliff comes into view.

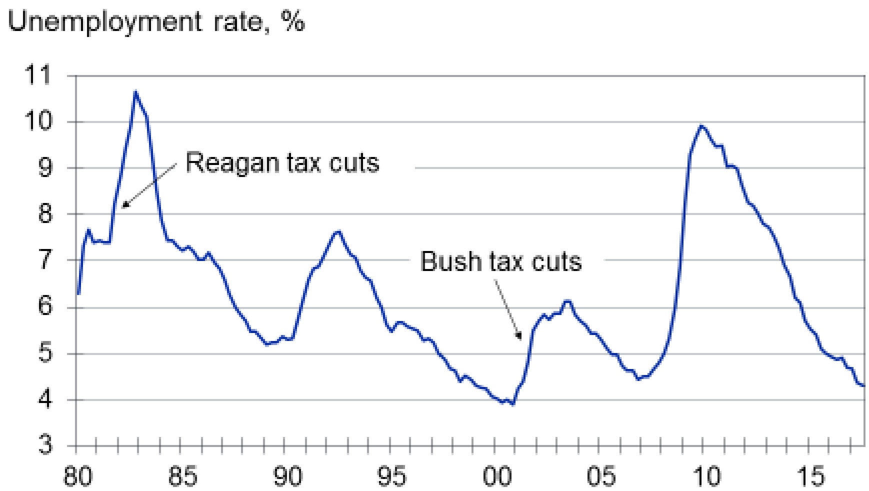
Making the tax code simpler, and thus more transparent and efficient, would be an economic plus. However, it is unclear that the tax plan accomplishes this. Scaling back the number of individual tax brackets and eliminating various loopholes will streamline the tax code. But reducing the top tax rate on pass-through income to below the top personal tax rate means higher-income individuals likely will try to pass themselves off as pass-through entities. Curtailing such gaming will complicate the code.

Bad timing

It is particularly bad timing for deficit-financed tax cuts. This is evident when considering the economic and fiscal backdrop during the last two major tax cuts—the Reagan cuts of the early 1980s and the Bush tax cuts of 2001. Those cuts were bigger than what the House and Senate currently have planned—about 12% of GDP—but they became law when the economy was struggling and the fiscal situation substantially better than today.

The early 1980s were a time of serious economic stress, with rampant double-digit unemployment. The bursting of the stock market bubble and 9/11 pushed the economy into recession in 2001. Unemployment today is near 4%, and even with no tax cuts, is widely expected to fall below 4% in coming months, consistent with the lowest unemployment rates in the nation's history (see Chart 2). Most businesses are already complaining that they cannot find qualified workers to fill their record number of open job positions. Inflation is still low, but policymakers at the Federal Reserve believe it is set to accelerate even without a push from a deficit-financed tax cut.

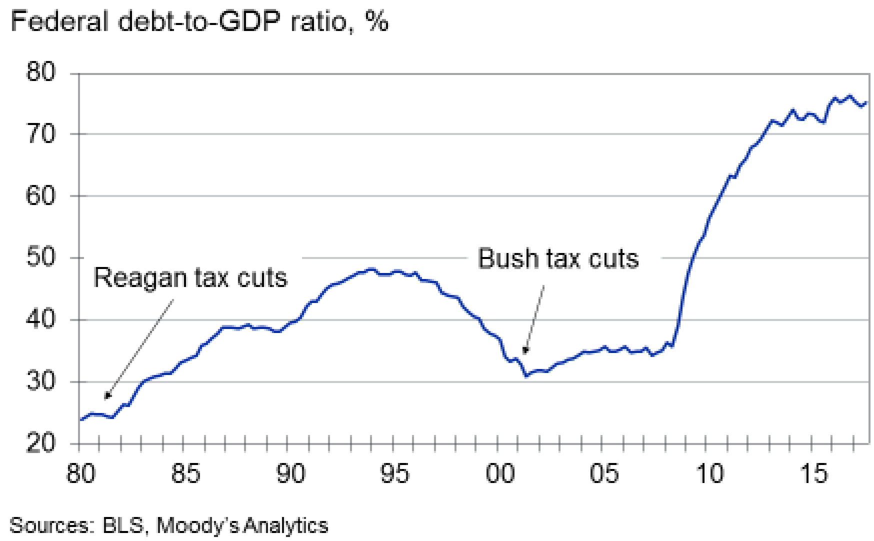
Chart 2: Unemployment Is Much Lower Today…



Sources: BLS, Moody's Analytics

The government's finances were also much better prior to the Reagan and Bush tax cuts. Tax revenues as a share of GDP were close to a record 19% of GDP, compared with 17% today (see Chart 3). Indeed, revenues have averaged almost precisely 17% over the past half century. It is thus difficult to argue that collectively we are over-taxed, at least not by any historical standard. Debt loads were also much lower prior to past tax cuts—25% of GDP under Reagan and just over 30% under Bush. This compares to over 75% today. Perhaps even more importantly, the concern back in the early 2000s was that the country would be running government surpluses and there would be a lack of Treasury securities to trade.[x] Today, the fiscal outlook is dark even without a deficit-financed tax cut.[xi]

Chart 3: …And Fiscal Situation Much Worse



Well-designed tax reform

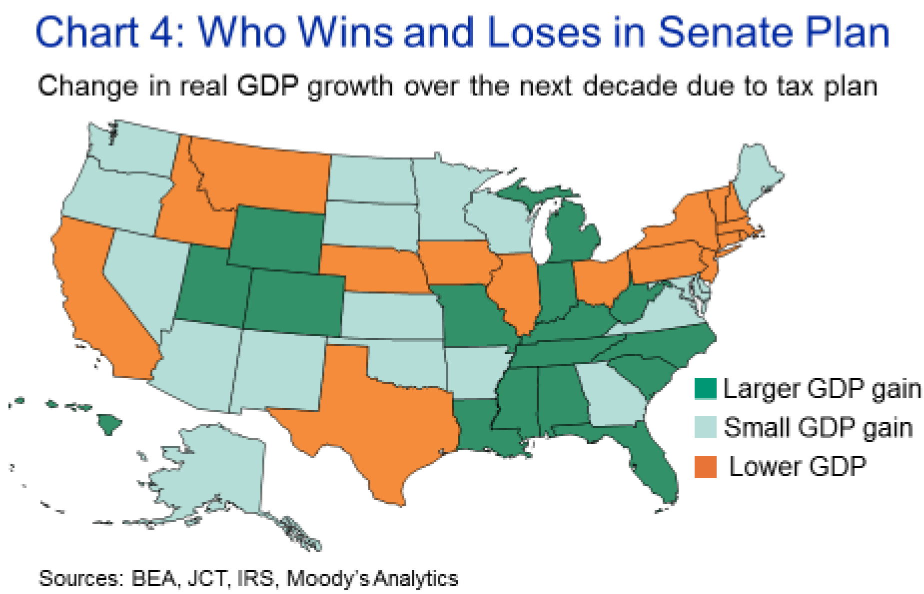
None of this is to say that policymakers should not pass a well-designed tax reform plan. Tax reform that lowers marginal rates, particularly for businesses, but is paid for and does not add to the government's deficits and debt load will result in stronger sustainable economic growth. This is the clear message in the best recent research from the JCT, Congressional Research Service, and academia (see Table 4).

Perhaps the most relevant research is the JCT 2005 study that considered a 20% cut in the federal corporate tax rate under the assumption that the cut was deficit-financed, and also assuming that it was paid for by cuts to government spending. In the long run, consistent with a 10-year budget horizon, a paid-for corporate tax rate cut lifts real GDP by almost 1%, but a deficit-financed tax cut by only 0.3%. This is very consistent with our model's results, which show that real GDP is 0.3% higher under the House plan a decade from now, and 0.4% under the Senate plan.

Even under the best designed tax plans, including those that involve more fundamental changes to the tax code such as adopting a progressive consumption tax, the lift to GDP in the long run is still relatively modest, at least compared with the expectations of those who strongly advocate for tax cuts to support long-term economic growth. According to a 2006 study by the Treasury, the progressive consumption tax lifts real GDP by 6% in the long run, or approximately 0.6% per annum. Paid-for, well-designed tax cuts are a plus for the economy, but they are not a magic elixir.

Regional economic impacts

The economic impacts of the tax plans vary across the country. Looking at the impact of the Senate plan on state economic performances, as measured by real GDP growth over the next decade, the state economies that benefit most are largely in the South, with Alabama and the Carolinas the biggest winners (see Chart 4). The industrial Midwest, including Indiana, Kentucky, Michigan and Tennessee also fare relatively well, as do the Rocky Mountain states of Colorado and Utah.



State and regional economies that do not benefit or actually suffer due to the tax cuts over the next decade are concentrated in the Northeast, particularly the New York City region. California's economy, along with sundry states in the agricultural Midwest and northern Rockies, also sees no benefits. These states combined account for about half the nation's real GDP.

Behind the differences in economic performance across states are the distributional impacts of the changes to the individual tax code, the impact of the elimination of the state and local income and sales tax deductions and scaling back of the property tax deduction, and the different impacts on house prices across the country. The Northeast also suffers from stronger net out-migration since the region is more costly to live and work in, while the South's economy benefits from those Northeasterners who move to the lower-cost South.

Conclusion

The tax cuts the Trump administration and Republican Congress appear set on rushing into law are bad policy. They *will not* meaningfully help the economy, they *will* add significantly to the nation's debt, they *will not* make the tax code simpler, they *will* be a boon to multinationals and very wealthy households, and they could not be more poorly timed.

The economic outlook depends in good measure on what happens, or does not happen, in Washington DC in the next few weeks around tax reform. If tax reform efforts fail, it will be an opportunity lost, but it will be better than passing large deficit-financed tax cuts as proposed in the House and Senate tax plans. Good tax reform is very difficult to do, and the tax reform proposals policymakers are currently considering do not get it done.

[i] The static budget scores of the House and Senate plans are available from the Joint Committee on Taxation.
[ii] A good rule of thumb is that every 1 percentage point change in the top marginal corporate tax rate reduces tax revenues by approximately $120 billion over 10 years on a static basis, and closer to $100 billion on a dynamic basis.
[iii] These are the distributional impacts of the House plan as estimated by the Tax Policy Center. The Joint Committee on Taxation has also estimated the distributional impacts for both the House and Senate plans.
[iv] A white paper describing the Moody's Analytics macroeconomic model is available upon request.
[v] Real median household incomes are close to $110 higher by 2027 under the House plan and $125 higher under the Senate plan. This is well below that implied in a study by the Council of Economic Advisors of the relationship between corporate tax rates and wages. One key reason for this is that the CEA study does not consider how lower corporate tax rates are paid for.
[vi] For every 1 percentage point increase in the nation's publicly traded debt-to-GDP ratio, 10-year Treasury yields increase in the Moody's Analytics model by an estimated 4 basis points. Given that the House and Senate plans add 5 percentage points to the debt-to-GDP ratio on a static basis, 10-year yields rise by 20 basis points, all else being equal. The elasticity of 10-year Treasury yields to the stock of Treasury debt estimated by the Federal Reserve in the context of its quantitative easing policy is closer to 6 basis points.
[vii] The business investment equations in the Moody's Analytics macro model are based on neoclassical investment theory in which investment is determined by an accelerator—the change in the growth in demand—and the cost of capital.
[viii] Prices for lower-priced homes in some parts of the country, particularly in more rural and exurban areas where incomes are lower and itemizing by taxpayers less commonplace, should rise modestly if the tax reform plans become law.
[ix] This is shown in a forthcoming paper, "Weighing the Wealth Effects," Mark Zandi, Brian Poi and Scott Hoyt, that is available upon request.
[x] Then-Federal Reserve Chairman Alan Greenspan made this point in 2001 Congressional testimony.
[xi] This is clear in the Congressional Budget Office's most recent long-term budget outlook.