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How the 2017 Tax Act Affected CBO’s Economic and Budget Projections

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Wendy Edelberg

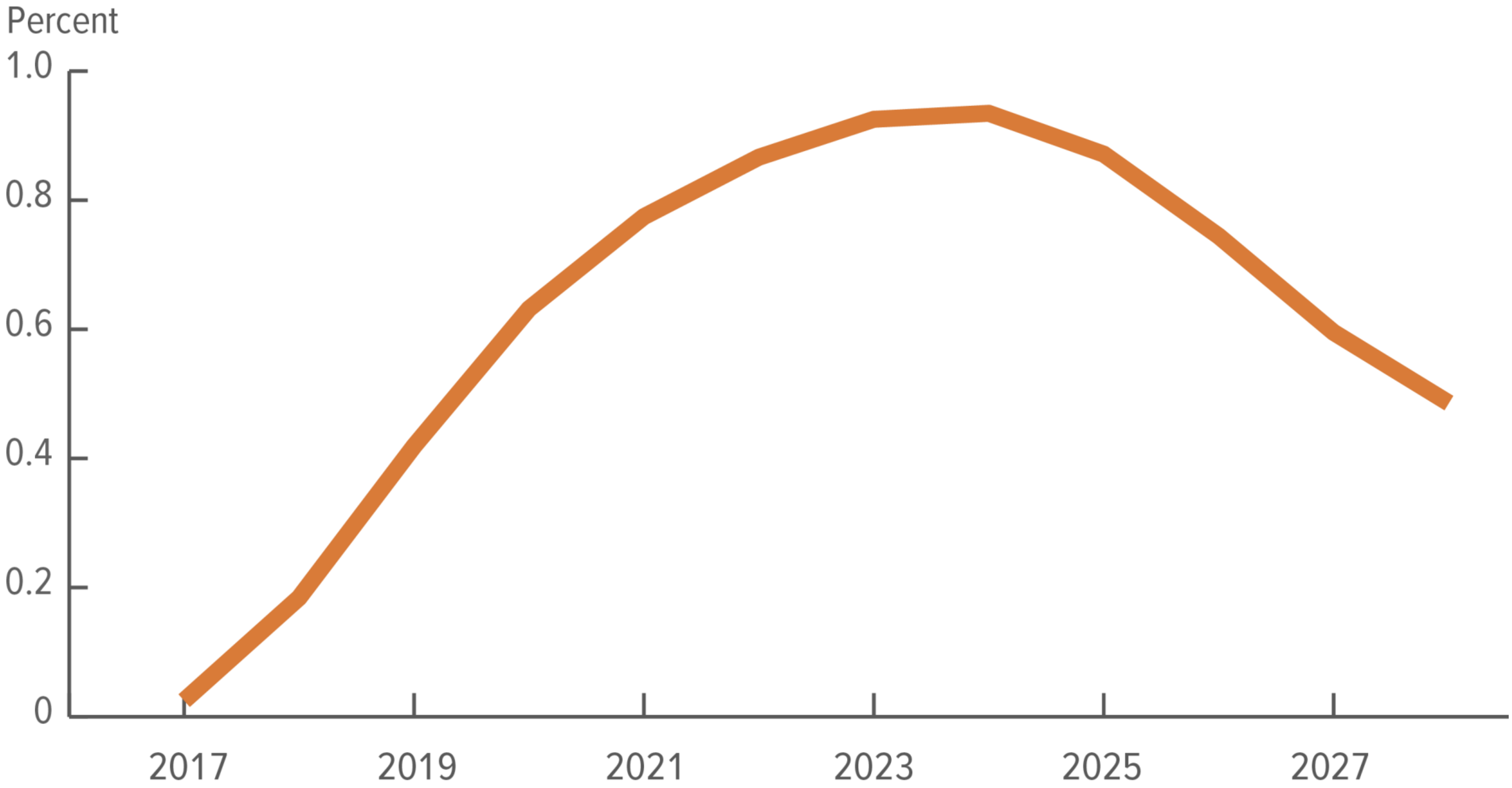
Associate Director for Economic Analysis

This presentation summarizes the analysis in Appendix B of *The Budget and Economic Outlook: 2018 to 2028*, www.cbo.gov/publication/53651.

The 2017 tax act has several major provisions that:

- Change the corporate income tax rate,
- Change international taxes,
- Change the taxation of domestic business activity,
- Change individual income taxes,
- Change estate and gift taxes,
- Eliminate the penalty for not having health insurance, and
- Require an alternative inflation measure to adjust tax provisions.

Effects on the Economy's Productive Capacity



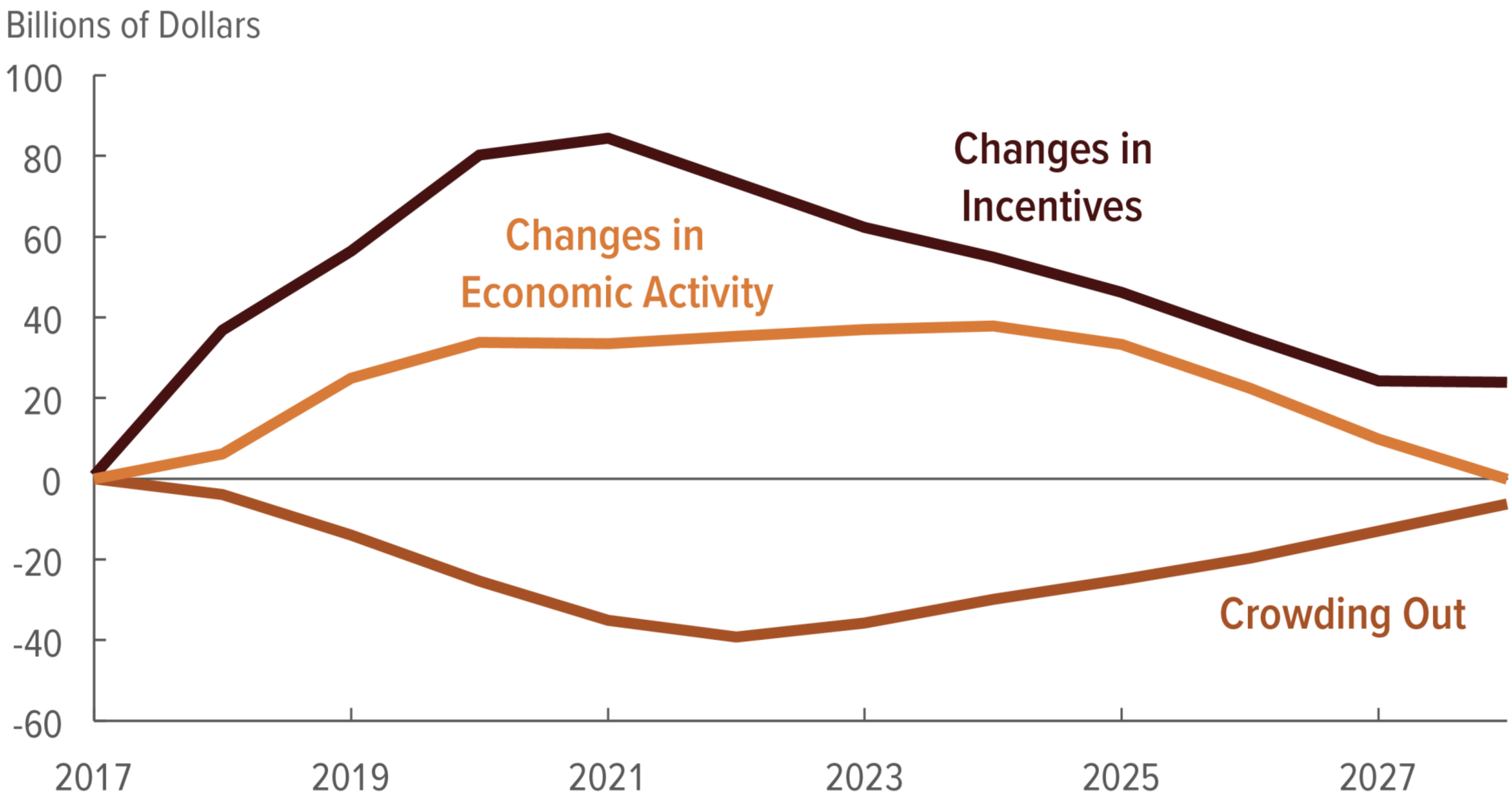
The tax act is projected to increase the level of **potential (maximum sustainable) GDP** by 0.7 percent, on average, over the 2018–2028 period. It does so mainly by promoting greater investment and potential labor supply.

The tax act affects investment through three main channels:

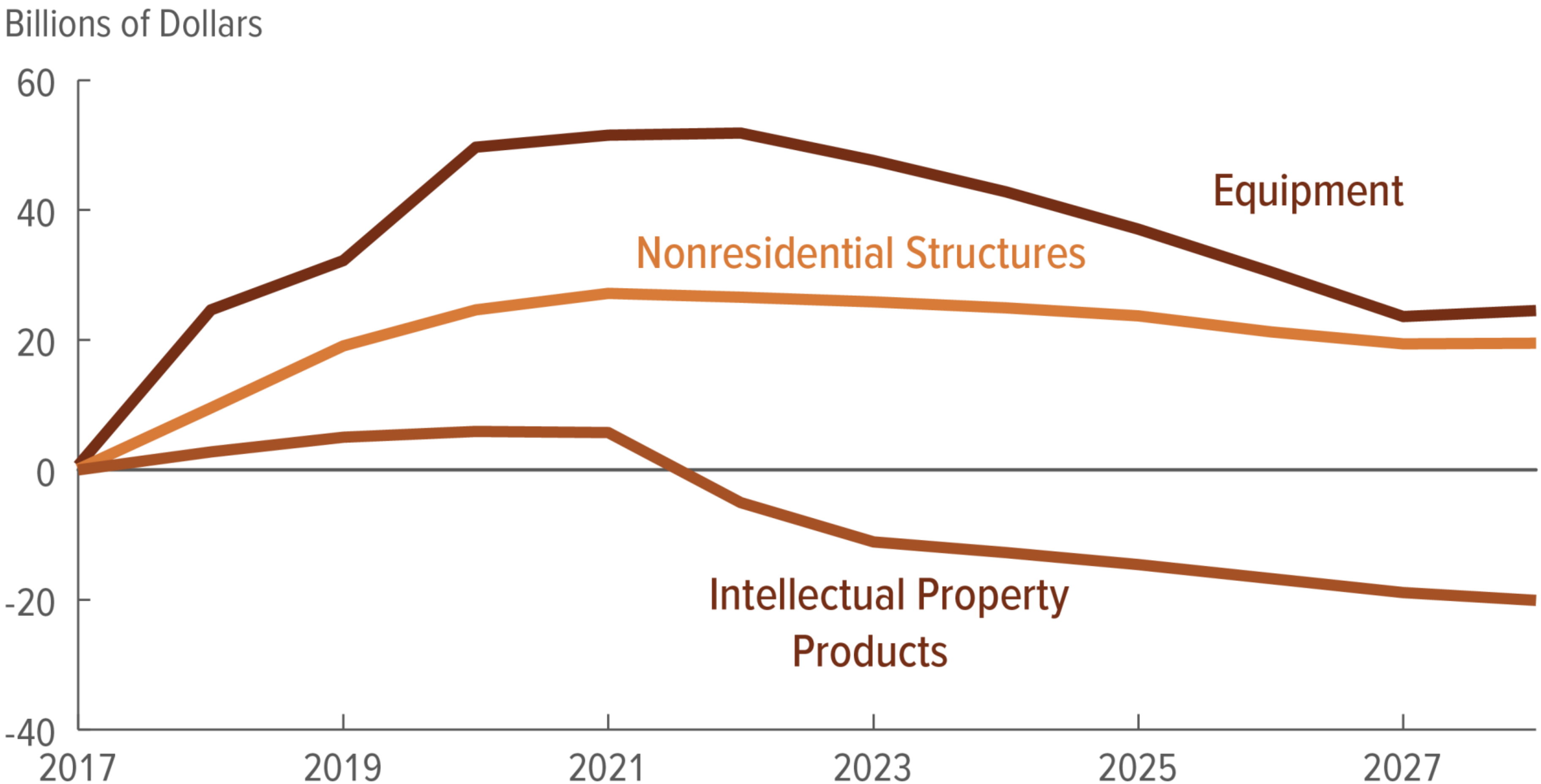
- **Changes in incentives**—changes in the user cost of capital, which is the gross pretax return on investment that provides the required return to investors after covering taxes and depreciation, and changes in the benefits of locating businesses in the United States.

- **Changes in economic activity**—changes in demand for goods and services and changes in the supply of labor.

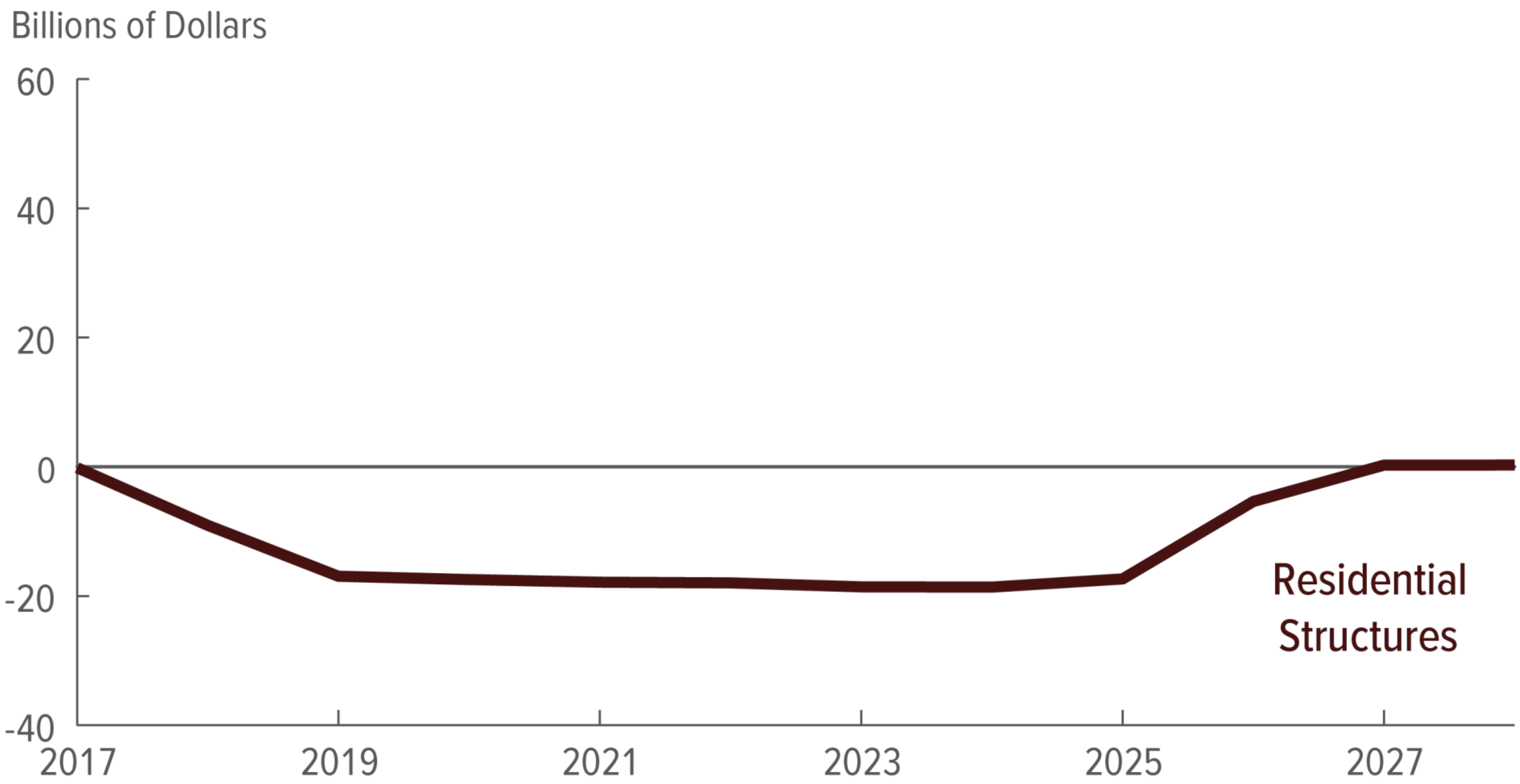
- **Crowding out**—the phenomenon that occurs when larger federal deficits reduce the resources available for private investment.



The **effects of the tax act on business fixed investment**—purchases of equipment, nonresidential structures, and intellectual property products—are positive through 2028, on net.



The **tax act's effects on business fixed investment through changes in incentives** increase over the next few years in CBO's projections and then decline, as changes in the tax treatment of depreciation reduce the effects of incentives on investment in equipment and intellectual property products.



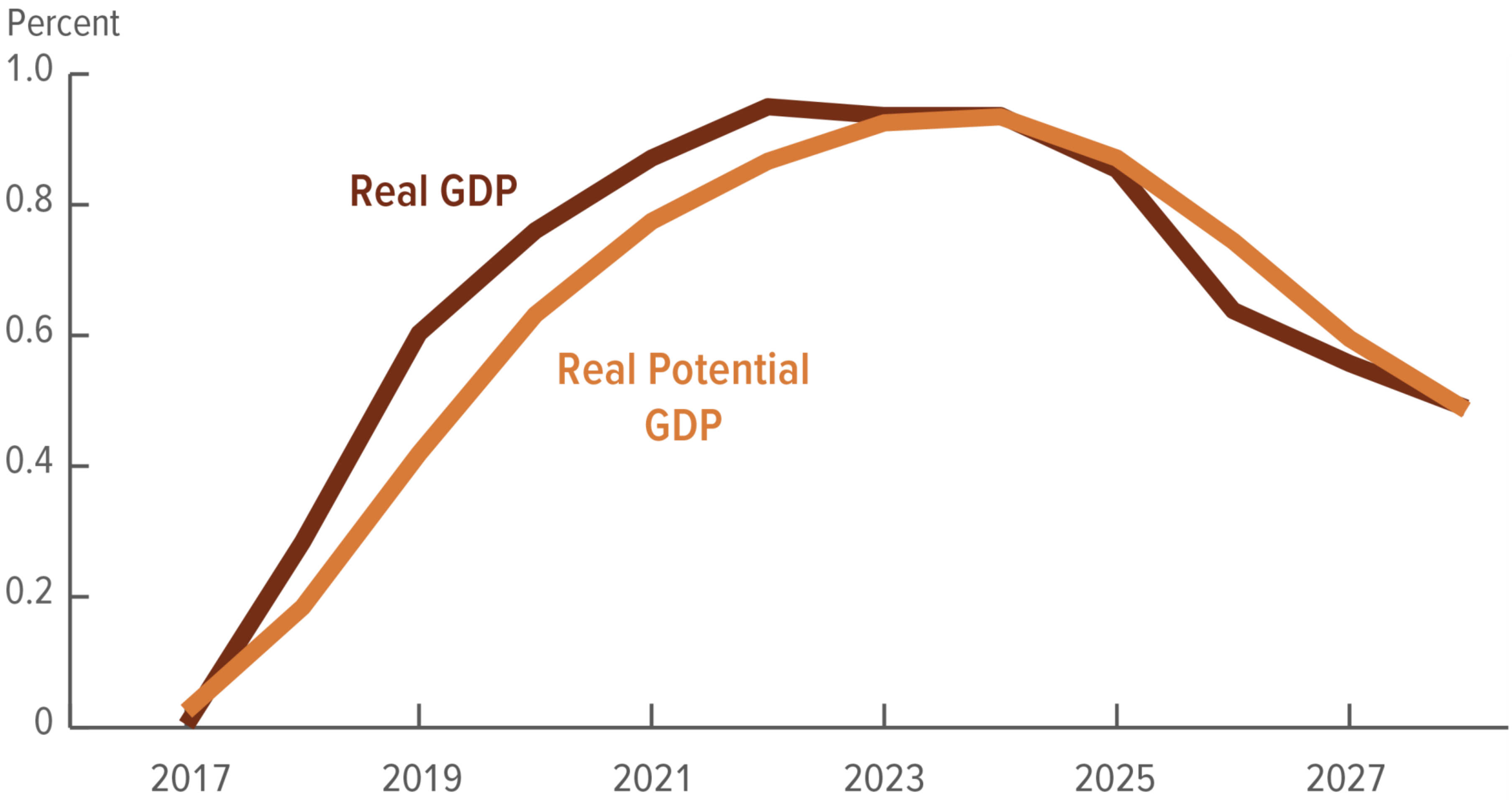
The **tax act's effects on residential investment through changes in incentives** reduce spending on residential structures through 2025. The tax act dampens incentives for such investment by limiting the tax deductibility of payments for property taxes and mortgage interest and by reducing incentives to itemize deductions.

The potential supply of labor—the supply arising from all sources except fluctuations in the overall demand for goods and services—is boosted by the tax act through two developments:

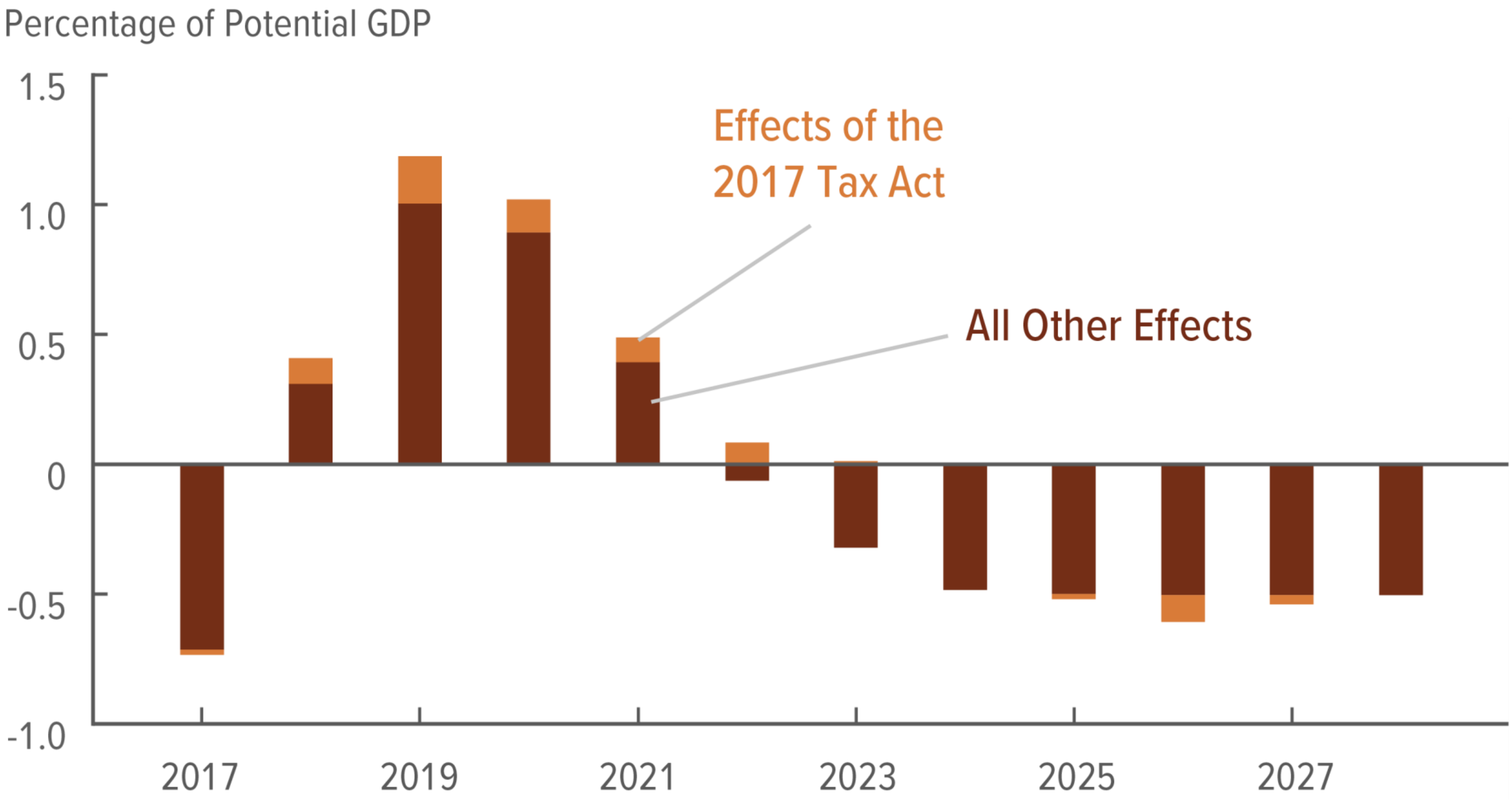
- The **potential labor force participation rate** is higher by an annual average of 0.2 percentage points, and
- **Total potential hours worked** rises by an annual average of nearly 0.6 percent—the result of increases in both the potential labor force participation rate and the average number of hours worked per week**.**

The act is also projected to raise measured total factor productivity (the average real output per unit of combined labor and capital services).

Effects on Actual Output in Relation to Potential Output



The 2017 tax act is projected to boost the demand for goods and services, accelerating the **growth of actual output** in relation to the **growth of potential output** over the first half of the 2018–2028 period.

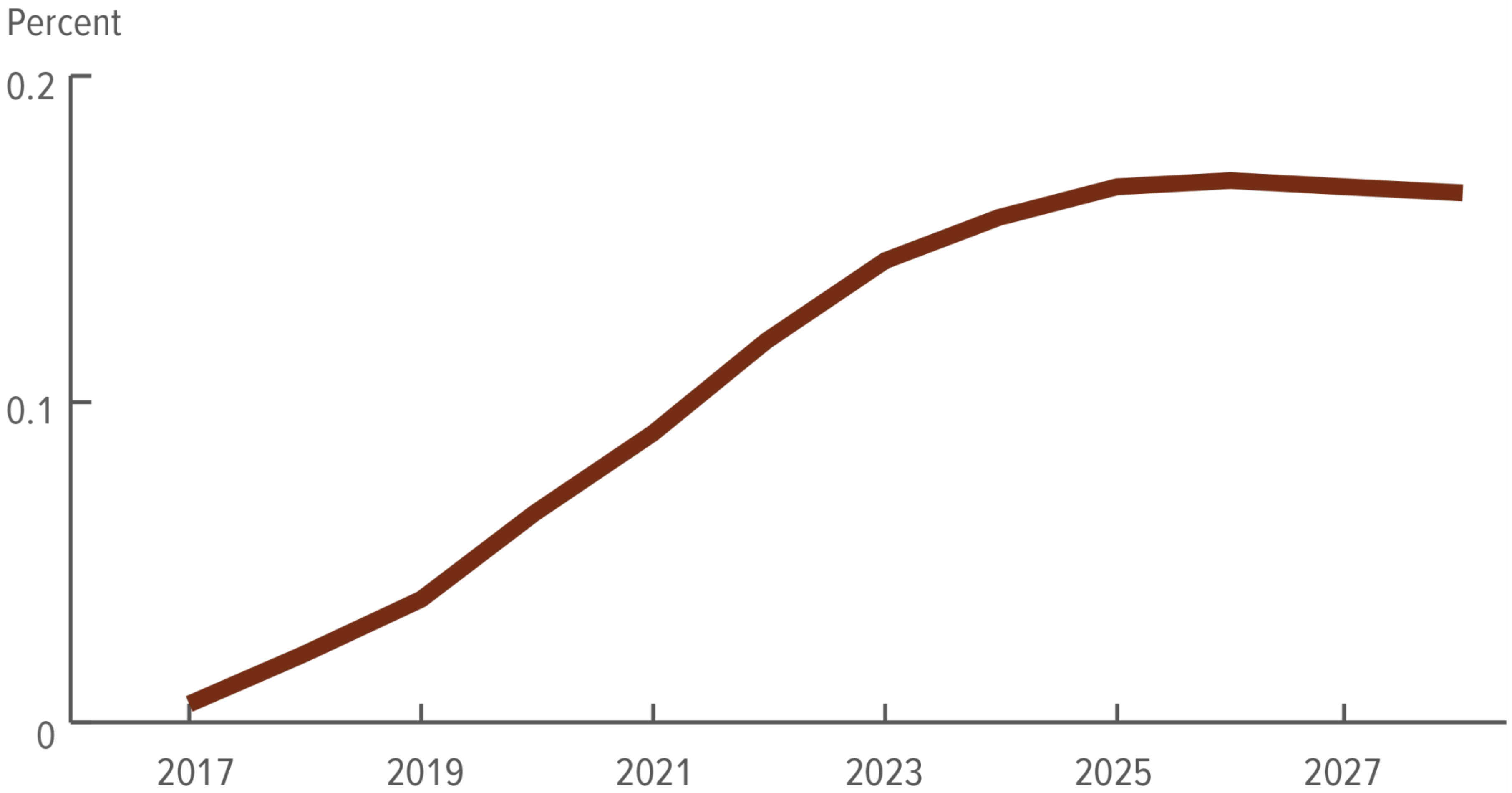


Heightened overall demand is projected to increase spending by consumers and businesses—increasing GDP above CBO's estimate of its potential level and thus making the **output gap** (the difference between GDP and potential GDP) more positive.

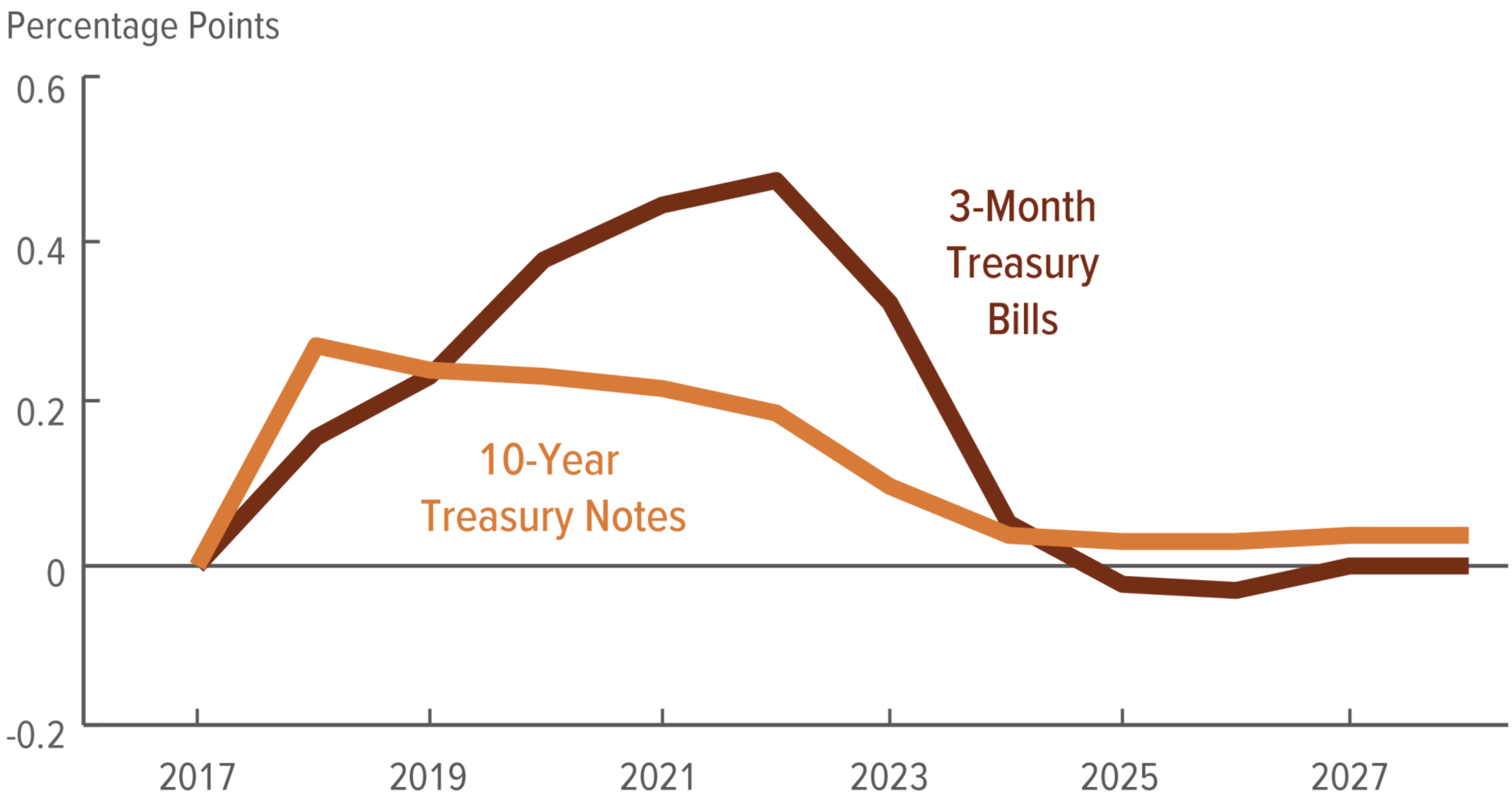
During the 2018–2022 period, heightened demand for workers causes the labor market in CBO's projections to be tighter than it otherwise would have been:

- The **unemployment rate** is 0.1 percentage point lower,
- The **labor force participation rate** is 0.2 percentage points higher, and
- The **total number of hours worked** is 0.7 percent higher.

Coupled with the act's effects on the supply of labor, those effects on demand lead to an increase in **nonfarm employment** in CBO's projections of about 1.1 million jobs, on average, over the 2018–2028 period.



Consumer prices, as measured by the price index for personal consumption expenditures, increase in CBO’s projections because the demand for goods and services exceeds the amount that the economy can sustainably supply.



That excess demand and greater federal borrowing, along with other factors, push up **interest rates**.

Effects on Income

Domestic income that derives from the production of goods and services is projected to rise with GDP.

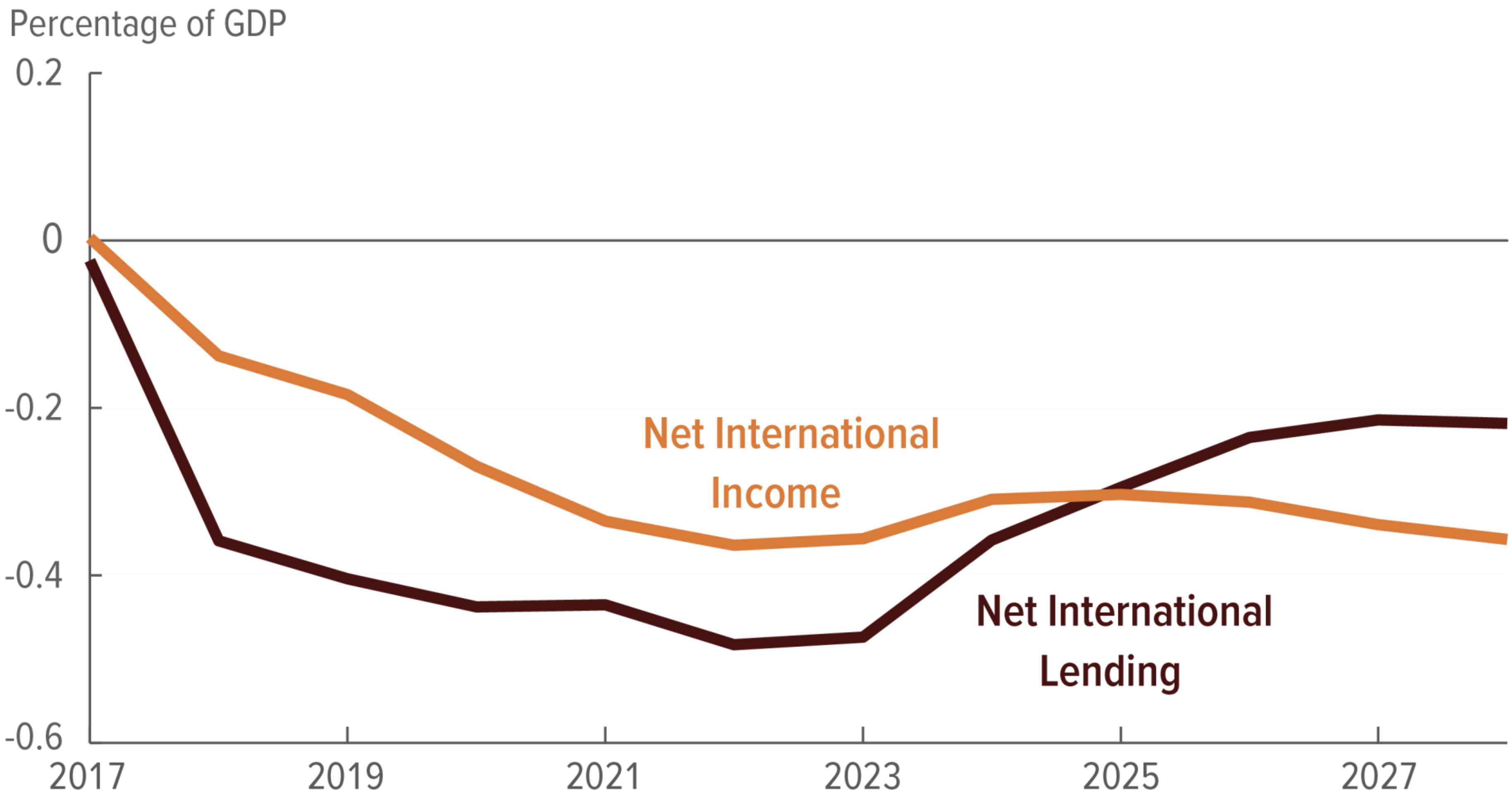
A better measure of the income available to U.S. residents is gross national product (GNP). Unlike GDP, it includes the income that U.S. residents earn from abroad and excludes the income that nonresidents earn from domestic sources.

The 2017 tax act is expected to affect GDP and GNP differently over the 2018–2028 period. On average, in CBO’s projections:

- **Real GDP** rises by 0.7 percent, or about $710 per person (in 2018 dollars), and

- **Real GNP** rises by 0.4 percent, or about $470 per person.

The act is expected to increase GNP by less than it increases GDP because it shrinks U.S. net international income.



Net international income falls because of a reduction in net international lending (national saving minus domestic investment). That reduction occurs because of the increase in foreign investment in the U.S. associated with greater private investment and increased government borrowing. The income generated by that foreign investment in the U.S. accrues to foreign investors. Increases in the return on U.S. assets relative to the return on foreign assets further contribute to the decline in net international income.

Effects on the Budget

Contributions of the 2017 Tax Act to CBO's Baseline Budget Projections

Billions of Dollars

	2018–2028
Effects Without Macroeconomic Feedback	
Effects on the Deficit Excluding Debt-Service Costs	1,843
Effects on Debt-Service Costs	471
Effects on the Deficit	2,314
Effects of Macroeconomic Feedback	
Effects on the Deficit Excluding Debt-Service Costs	-571
Effects on Debt-Service Costs	110
Effects on the Deficit	-461
Total Contributions to Baseline Projections	
Effects on the Deficit Excluding Debt-Service Costs	1,272
Effects on Debt-Service Costs	582
Effects on the Deficit	1,854

Uncertainty Surrounding the Projections

CBO aims to produce estimates that lie in the middle of the distribution of possible outcomes. But projections of how people and businesses will respond to the 2017 tax act nevertheless involve significant uncertainties:

- **Decisions to work, save, and invest.** Many economic effects of the new legislation stem from its effects on individuals' decisions to work and save and on businesses' decisions to invest, which are subject to significant uncertainty.

- **People's expectations.** In CBO's projections, 20 percent of households and businesses expect fiscal policy to change over the 2018–2028 period as the tax act specifies; others are surprised by those changes. Actual expectations could differ.

- **Profit shifting by multinational corporations.** The effect of the tax act's international provisions on profit shifting by multinational corporations is particularly uncertain.

Assessing governments' and the world economy's responses to the 2017 tax act also involves significant uncertainties:

- **Implementation.** The way the various provisions of the tax act are implemented by the Treasury Department will partly determine how businesses and households respond to them.

- **States' and foreign countries' responses.** If state governments and foreign countries change their own fiscal policies in unanticipated ways in response to the tax act, those changes will have implications for the act's economic and budgetary effects.

- **Changes in economic activity.** CBO projects that the tax act will increase labor income and capital income, boosting demand for goods and services over the next several years. But demand may respond more or less to those changes in income than CBO estimates.