The Daily Dish

Some Tax Cut Arithmetic

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As policymakers begin to plan to address the sunset of the 2017 Tax Cuts and Jobs Act (TCJA) at the end of 2025, a central issue is the net budgetary impact of any such legislation. This discussion has elements of three separate considerations:

- The genuine need to address the unsustainable federal fiscal outlook;
- The possibility of undertaking the reforms in the context of the reconciliation process, which would preclude creating deficits beyond the 10-year budget window; and
- The general belief that tax cuts "pay for themselves."

Let's take these in reverse order. First, not all tax policy is pro-growth. Punitive, redistributive taxation that is currently all the rage will not produce growth and cannot, as a result, "pay for itself" in any sense. It is the nonsensical act of making everyone poorer in the interest of making the rich poorer. No thanks.

The issue with pro-growth tax policy is not whether it pays for itself. It does. The question is: How long does it take to pay for itself? To get a flavor for this issue, consider the table (below). The rows represent tax cuts as a percentage of gross domestic product (GDP) in increments of 0.2 percent up to a maximum of 1.6 percent of GDP. (Think of this as predicated on a rough base of 18 percent of GDP). For reference, the first column shows the rough 10-year static revenue loss from the current Congressional Budget Office baseline budgetary projections.

Each column indicates the growth-rate boost from the tax cut and the entries indicate the number of years required for the post-tax-cut revenue to recover the pre-tax-cut level of revenue. So if, for example, a 1.2-percent-of-GDP tax cut generates a 0.3 percentage point increase in trend economic growth – which is really good – then it would take 23 years for revenue to get back to the baseline.

Inspection of the table indicates the theoretical possibility that revenue could recover to the baseline within 10 years, but there are no living examples of tax cuts of that small a magnitude with that big a growth impact. But have even these tax cut unicorns "paid for themselves"? Not really. During all the years until the break-even year, revenues are below the previous baseline. Tax cuts really have paid for themselves when the subsequent higher revenues accumulate to offset these shortfalls.

For good tax policy, it is simply a matter of time.

That being said, this only happens if the tax reform stays in place. If passed in reconciliation, this means that there cannot be projected deficits past the 10-year budget window. (This is precisely why so many aspects of TCJA sunset next year.) The solution to this is not to undo good pro-growth tax policy with a grab bag of (likely anti-growth) revenue raisers. The solution is to provide mandatory spending reforms that slow the growth of outlays and eliminate the deficits. (See, for example, AAF's plan here.)

		Percent GDP			Growth Boost			
	10-year		0.05 %	0.10 %	0.15 %	0.20 %	0.25 %	0.30 %
	705	0.20%	22	11	7	6	4	4
	1,410	0.40%	45	22	15	11	9	8
Revenue Loss	2,114	0.60%	68	34	23	17	14	11
	2,819	0.80%	91	45	30	23	18	15
	3,524	1.00%	114	57	38	29	23	19
	4,229	1.20%	138	69	46	35	28	23
	4,933	1.40%	162	81	54	41	32	27
	5,638	1.60%	186	93	62	47	37	31

This brings us to the federal fiscal outlook. The combination of pro-growth tax reform and mandatory spending reforms is precisely the right recipe to get the debt under control. As Eakinomics has emphasized in the past, there is no solution to the debt projections without Social Security and Medicare reforms. And there is no better addition to spending reforms than pro-growth tax reform. And, to bring it full circle, there is no way to have pro-growth tax reform pay for itself unless it is allowed to stay in place long enough, which requires spending reforms.