Insight

CBO Outlook: Tax Reform and the Trade Balance

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Today, the Congressional Budget Office (CBO) released the Budget and Economic Outlook: 2018 to 2028. A noteworthy component of the report is CBO's projections for the trade balance—a measure of the difference between U.S. exports and imports. The United States is a net importer, meaning it buys more from the rest of the world than it sells. This imbalance is not inherently bad; imports provide immense value to consumers and increase our quality of life, and international trade generates gains in productivity and specialization as well as economic growth. It has, however, resulted in persistent trade deficits since the 1970s.

The trade deficit is projected to increase at a more rapid rate than in CBO's last projection, from June 2017. Specifically, CBO projects that the deficit will increase by $63.1 billion (in chained 2009 dollars) in 2018 and $41.5 billion in 2019. One reason for this increase is the passage of the Tax Cuts and Jobs Act (TCJA)—the first major reform of the tax code since 1986. The TCJA made several important changes to the tax code that will result in a larger U.S. trade deficit.

Fluctuations in the trade balance are primarily governed by changes in national saving and investment. This fluctuation is a function of the national income identity, which states that exports minus imports must equal national saving minus investment. One projected impact of the TCJA is to reduce national saving by increasing the budget deficit, thus adding to the national debt. According to the income identity, this will put downward pressure on the trade balance.

The TCJA is also expected to boost both actual and potential gross domestic product (GDP), which means increasing aggregate demand. This increase will boost the demand for imports and may also decrease the demand for exports, as U.S. businesses focus their resources on fulfilling domestic demand. This outcome should not be surprising, though, as growth in the trade deficit generally rises with growth in overall economic activity.

The TCJA is also expected to increase inbound investment. Among other changes, it lowered the corporate income tax rate from 35 percent to 21 percent and allowed for immediate expensing of capital investment. These provisions increase the incentive for foreign investment in the United States, which (by the national income identity) is also expected to increase the trade deficit.

Finally, the TCJA is projected to increase the value of the dollar as demand for U.S. assets rise. A stronger dollar will make U.S. goods relatively more expensive than foreign goods, causing exports to decline and imports to increase. This exchange-rate effect, however, is expected to dissipate after 2020. Furthermore, if cuts to individual tax rates are allowed to expire, consumer spending will decrease and demand for imports will decline.

CBO's latest Outlook shows that the TCJA is expected to have a positive impact on economic growth, as growth in actual GDP is projected to outpace growth in potential GDP. This overall growth will increase aggregate demand, inbound investment, and the demand for imports. A natural result will be for the trade deficit to rise.