A Conversation with Jason Saving

Federal Tax Law Provides Stimulus to Bustling U.S., Texas Economies

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Q. What does the recently approved federal Tax Cuts and Jobs Act of 2017 do? Is it a large tax cut by historical standards?

The new law is intended to reduce individual and corporate tax liabilities, improve the U.S. business climate and enlarge the economy relative to what it would otherwise be. It would reduce government's tax take by about a percentage point of gross domestic product (GDP) in its first year, which is a relatively large tax reduction, though lower than the 1.6 percent reduction in President Kennedy's Revenue Act of 1964 and considerably lower than the almost 3 percent reduction in President Reagan's Economic Recovery Act of 1981.

Q. Is it unusual to cut taxes during an economic expansion?

Typically, we think of federal fiscal policy as countercyclical, with government running larger deficits during recessions and smaller deficits during expansions. When times are tough, government's tax take naturally falls as individuals lose their jobs and firms find themselves selling fewer products than they otherwise would.

And on the flip side, government spending naturally rises during those periods as more people avail themselves of safety-net programs such as food stamps. As the economy improves, more people are able to find work, and firms find themselves selling more products—increasing government revenue while lowering expenditures.

Many models actually suggest this is optimal fiscal policy—and monetary policy, too, for that matter. What's interesting about the most recent tax legislation is that it cuts taxes at a time when most measures of overall economic activity are fairly strong. While this isn't unheard of, it's more common to cut taxes when the economy is in recession. The object is, in effect, to provide a tailwind when the wind is most needed.

Q. What are the law's main provisions? How will they affect individuals and businesses?

The new tax law has many provisions, but three in particular have macroeconomic implications of note. One is a reduction in the top statutory corporate tax rate from 35 percent to 21 percent, which should incentivize firms to place more business capital in the United States so that more taxable income can be generated here.

Another is a modest reduction in the individual income tax rate schedule, which will somewhat increase short-run take-home pay for many Americans and thereby increase both consumption and (possibly) hours worked. And the third is the ability of firms to more quickly deduct business investment, which should increase such investment and thereby raise GDP.

Q. Will the U.S. economy grow faster as a result of the tax cuts? Does it matter that the cuts are deficit financed and will increase the national debt?

History, buttressed by economic modeling, suggests tax cuts of this type temporarily boost growth while the economy gradually transitions to a new, higher level of economic activity. Over the long run, the best available estimates peg this new higher level as 1.5–2.0 percent above where the economy would have been without the tax package, with about half the impact occurring in the first year.

However, it's also worth noting that the plan is expected to add $1.5 trillion in federal debt over the next 10 years, possibly more if various provisions scheduled to expire end up being extended. Even before the tax change was passed, secular trends such as falling birth rates and rising life expectancies were likely to drive the nation's debt-to-GDP ratio to unsustainable levels over the long run. The primary reason is the nation's pay-as-you-go entitlement system, in which current workers provide benefits for existing retirees without accounting for a shrinking worker-to-retiree ratio. The unfunded nature of the tax law could somewhat exacerbate this situation.

Why does a high debt-to-GDP ratio matter? Well, as government indebtedness rises, the larger debt load (interest payments) begins to "crowd out" other types of discretionary spending such as national defense, food safety or environmental protection. Higher interest payments also decrease the federal government's ability to respond to a recession through fiscal expansion.

One might think states could simply pick up the slack in a situation like that, but they can't because nearly all of them have statutory or constitutional balanced-budget requirements, so constraining the federal government's "fiscal space" matters. Finally, when a country's debt-to-GDP ratio is high enough, its willingness or ability to repay debt may be called into question,

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increasing borrowing costs at the precise moment it may most need to borrow. An example of this occurred during the Greek debt crisis.

Q. Some companies are raising pay and awarding bonuses to employees, citing the new law. Are workers likely to continue seeing more such payments in the future?

The expensing provisions in the new tax law will encourage investment. Over time, this investment should make workers more productive and one would expect employers to respond by raising wages. I'm unaware of any reasons why employers would respond now, before those productivity gains have materialized. That said, the best available estimates suggest we might see a 1.5 percent increase in wages over the long run.

Q. How will the tax law affect Texas? Will we see faster output growth? Will there be more migration?

In general, as firms choose where to locate their increased production and investment, states with a favorable business climate should attract a disproportionate share of this activity. However, Texas is also the state most affected by international trade and, to the extent this tax change places other countries' economies at a competitive disadvantage, slower growth in Mexico and other large trading partners would be expected to disproportionately reduce Texas' growth rate.

Thus, it is unclear whether the short-run impact of the tax law would be larger or smaller in Texas. What is clear, though, is that both the state and the nation can expect somewhat larger capital expenditures and business profits over the short term, consistent with recent trends in the Federal Reserve Bank of Dallas' business outlook surveys.

One provision of the new law that has substantial regional implications is the $10,000 limit on state and local tax deductibility. While Texas' property tax rates are among the highest in the nation, the overall state and local tax burden in Texas is about 15 percent lower than the national average, 29 percent lower than California and about half that of New York.

This means Texans' itemized deductions will tend to be smaller than those in high-property-wealth parts of the country. This also suggests the possibility that the tax law could incentivize some middle-income Californians and New Yorkers to move to Texas, though tax-code differences are only one of many factors that impact migration decisions.

Q. Could the new law affect Texas home prices?

In general, a less-generous state and local tax deduction may cause housing demand to soften because taxpayers for whom the $10,000 limit is binding will face a higher after-tax cost of home ownership. This particular provision has garnered most media attention, but other provisions including the newly raised standard deduction and newly lowered limits on mortgage interest deductibility will similarly impact home ownership costs at the margin.

This softening of housing demand would, with other things being equal, imply somewhat slower home-price appreciation over the near term, especially in areas where house prices are relatively high.

It's important not to overstate this phenomenon, though. While there are certainly neighborhoods in Texas that would fall into this category, this effect will be most severe in areas such as New York City and San Francisco, where a relatively large share of residents itemize and own relatively expensive properties. As a result, the tax law's impact on Dallas and Houston home prices should be comparatively small.

Q. Texas is the largest exporting state in the nation. How will the new law affect international trade and our trading partners?

For many years, the U.S. corporate tax rate has been among the highest in the industrialized world. The new tax law changed this, moving our corporate rate toward the lower end of the industrialized world and, in so doing, improving U.S. competitiveness.

International organizations such as the International Monetary Fund and the World Bank think global output will rise somewhat, but there's no question individual countries—especially those who now find themselves with substantially higher corporate rates than the U.S.—could suddenly find themselves at a competitive disadvantage.

Meanwhile, a number of proposed changes that U.S. exporters and our trading partners had opposed, such as the "border adjustment" tax (a levy on the value added to imports) didn't make it. For that reason, Texas exports will perhaps be more greatly affected by ongoing measures such as the renegotiation of the North American Free Trade Agreement and the decision to pull out of the Trans-Pacific Partnership trade agreement.