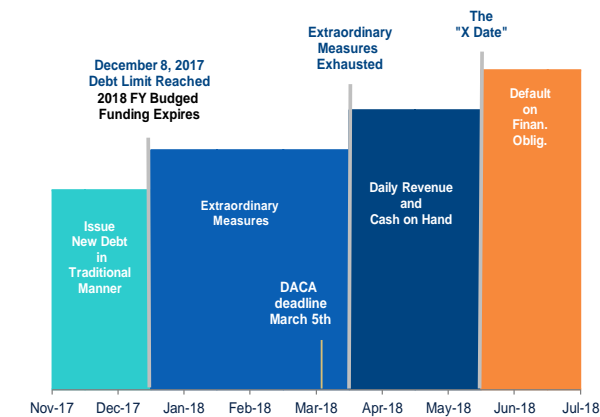


5. Fiscal policy through the lens of business cycle timing

The state of fiscal policy conduct since the change in administration in the White House has not delivered a different course from the past politics of partisanship. As a result of the deal struck between the President and Democrats that included temporary hurricane relief funds for victims of Harvey and Irma, Congress has pushed back the deadline for passing a budget resolution and suspended the debt ceiling until December 8, 2017. Nevertheless, business optimism remains at pre-recession highs and markets are bullish in expectation of tax code reform. This leaves Congress with a packed agenda of fulfilling the expectations of businesses - namely regulatory stability, permanent tax relief, and an end to the debt ceiling drama.

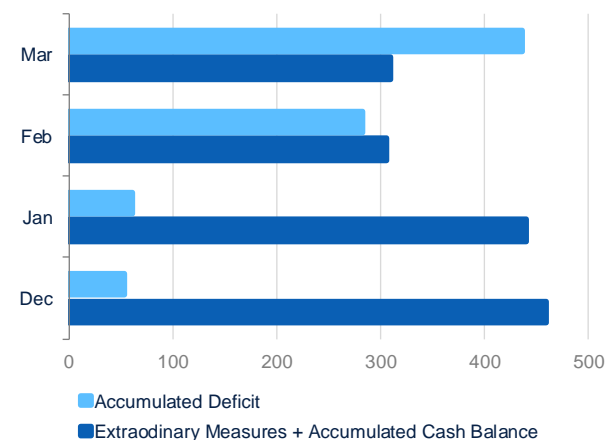
The ability to pass tax reform hinges on Congress allowing the passage of tax reform through the reconciliation process which needs only 50 Yes votes in the Senate. Thus, the overall eagerness to enact a 2018 budget prompted early adoption of a budget plan on October 19th. Congress is likely to overlook the expiration of the debt-limit suspension on December 8th with no negative consequences. Our research, in line with that of the Bipartisan Policy Center, finds that the Treasury secretary can resort to extraordinary measures at least until March 2018, when the debt ceiling negotiations should become imminent.

Figure 5.1 Defense against default



Source: BBVA Research & Bipartisan Policy Center

Figure 5.2 Expected period to exhaust the means to pay the nation's bills (US\$ billions, 2014-2017 average)



Source: BBVA Research & Haver Analytics

With the Senate Budget Committee advancing the budget resolution and with health care legislation put aside, the primary focus of the Congress and the White House has shifted to tax reform.

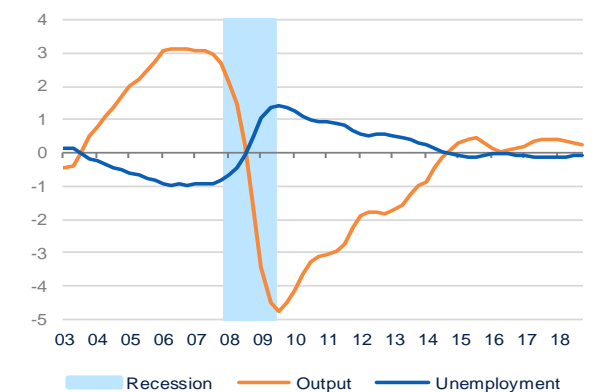
The tax reform proposal from the Trump Administration and the "Big Six", termed the "Unified Framework," was revealed on September 27, 2017. The essential changes proposed in the Unified Framework are a simplification of the individual tax rate structure from seven brackets down to three brackets of 12%, 25% and 35%, a reduction of the businesses pass-

through income tax from 39.6% to 25%, and corporate tax rate reduction from 35% to 20%. These key components of the reform are similar to the tax plan formulated by House GOP leaders in the summer of 2016. The pivotal provisions above are estimated to permanently increase the budget deficit. The preliminary estimate of the effect of the tax reform is that it will add \$2.8 trillion to the national debt over the next 10 years.⁴ This estimate will continue evolving and will be refined when more details of the proposed tax reform become known.

Given the substantial burden that the Unified Framework will place on the federal budget and public debt, the question becomes whether this tax reform will provide the necessary economic stimulus to boost the U.S. growth rate?

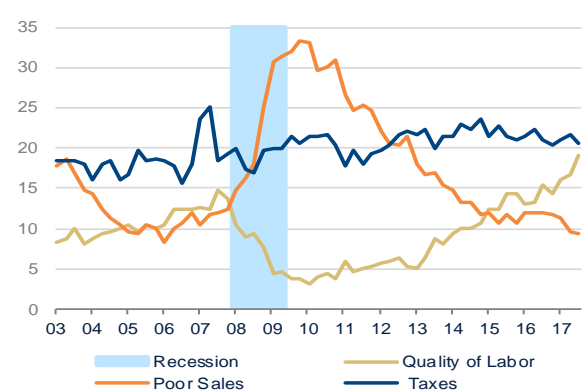
Considering that the U.S. economy is in its eighth year of recovery and is approaching its full potential growth rate, the cyclical slack of the Great-Recession has diminished. In addition to the estimations on near zero output and unemployment rate gaps, the diminished cyclical slack in labor markets is also evident from the small business survey that reports concerns on the structural mismatch between job openings and skills. According to the survey, the concern about labor quality has risen nearly to a level not seen since September 2007 and has consistently exceeded the concern about poor sales in 2017. Similarly, the level of concern about labor quality is now close to the level of concern about taxes. Thus, for the reform to permanently increase the rate of economic growth, it should address the long-term structural headwinds to growth outlined by Gordon in “The Rise and Fall of American Growth”⁵ – demographics, education, debt, and inequality.

Figure 5.3 Output and unemployment rate gaps (%)



Source: BBVA Research

Figure 5.4 Single most important problem (% reporting)



Source: BBVA Research, NFIB & Haver Analytics

In economics terms, for the tax reform to affect potential GDP growth it has to deliver a supply side positive change of technological advancements, reduction in structural unemployment, and/or fresh capital investments. From the Unified Framework stance, incentives to boost technological advancement and to reduce structural unemployment through education and training are not addressed directly. The framework’s provision for “expensing” of new investment “for at least

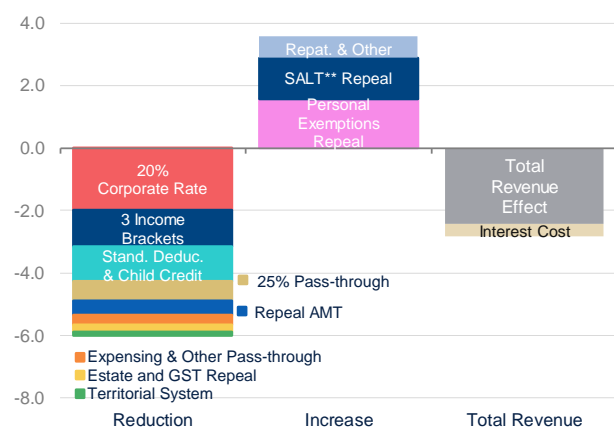
4: Tax Policy Center (2017, September 29)

5: Gordon (2017)

five years” can provide temporary tax incentives for businesses to increase Research and Development spending along with incentivizing a rise in capital expenditures. However, the Unified Framework’s main reform is centered on delivering changes to personal income tax and corporate income tax policy.

Individual provisions: While pivotal details on income tax reform such as the definitions of the three income brackets are still unknown, the proposed switch to a three bracket structure, together with changes to deductions and credits, will on average increase households’ take-home pay thereby prompting additional consumption expenditures and greater economic activity. Income tax multiplier estimates for the U.S. range between 0.8 and 1.1 with the effect being greatest in the first year. The range of estimates of the impact on growth is wide with the average short-term annual impact between 0.8% and 2.6%. Additionally, the consumption expenditures of high-income households are less sensitive, relative to lower income ones, to the increase in income. Meanwhile, assessments suggest that most tax reductions will accrue to high-income households. Thus, the economic impact from the outlined reform has a higher likelihood to emerge as a short-run effect and should fall towards the lower end of the multiplier effect estimates.

Figure 5.5 Revenue 10-year impact of unified framework* (US\$ trillions)

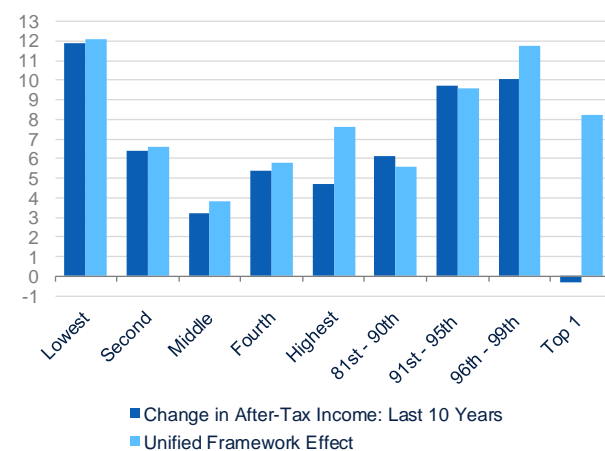


Source: BBVA Research & Tax Policy Center

* Estimates are static

** State and Local Tax Deduction

Figure 5.6 Unified framework 10-year effect on income distribution* (% change)



Source: BBVA Research, CBO & Tax Policy Center

* Estimates are static

The personal income tax reform outlined in the framework is not expected to mitigate the structural challenges of inequality and the decline in the labor force participation rate. Preliminary estimates suggest that the outcome will not alter the widening gap in income inequality and the “hollowing out of the middle.” Over the long-run, the lowest two quintiles are estimated to receive a 0.2% increase in after tax income, compared to a 2.9% increase for the top quintile and a 9.8% increase for the top 0.1 percentile.⁶ Additionally, personal income tax cuts will not alter the future path of the labor participation rate. The compensated labor supply elasticity, which is the responsiveness of labor force participation to

6: Tax Policy Center (2017, September 29)

changes in real wages, is on average fairly small and is near zero for prime age males. Likewise, while personal income tax reform will decrease total personal tax revenue, we do not find evidence for a long-run relationship between potential GDP growth and a decline in real personal tax revenue.

Business provisions: The U.S. top statutory federal corporate tax rate of 35% is the highest among developed nations, and economists agree that corporate tax reform can result in wide economic benefits. Some economists have even proposed the extreme measure of abolishing the corporate income tax altogether. Reducing the corporate tax rate will increase U.S. competitiveness and attract capital and profitable projects that generate higher welfare. At the same time, the overall success of corporate tax reform will depend on complementary factors such as assurance of unobstructed capital flows and political stability.

In the short-run, a decrease in the corporate tax rate can impact not only business at large but also households, altering the incentives to save and invest. On average the annual multiplier for a decrease in the corporate tax rate is much lower, between 0.3 and 0.4, compared to the individual income tax cut multiplier. The relationship between wage growth and the corporate tax rate is weak. Previous estimates on corporate tax cuts in the U.S. find that a rate cut from 35% to 25% has a modest positive effect on wages and GDP. However, the academic findings that corporate taxes depress wages and thus that a lower tax rate should result in stronger wage growth were challenged by cross-country studies that show that most mobile firms are skillful in separating taxable income from their investment and employment choices.

We find evidence of a long-run relationship between a decline in corporate tax income and real GDP growth. Other things equal, our estimates find that a 1% decline in real government tax revenue from corporate income can boost potential GDP growth by 0.4%. Similarly, studies also point to the strong dependence of investment on cash flow and thus a strong response to changes in the tax rate. At the same time, while a permanent change in the corporate tax rate can provide a boost to potential GDP growth by altering incentives to invest and by widening the tax base, the cut to the 20% rate might not be sizable enough to generate these incentives. Corporate tax differentials between countries narrow when weighted to reflect the sizes of the economies. For example, a 14 percentage point statutory tax rate differential is estimated to narrow to 9 percentage points when weighted by the size of the economies.⁷ Additionally, studies indicate that firms make their business location decisions based on effective rates. The U.S. effective rate is estimated at 18.6%⁸ and is comparable with other developed nations.

Overall, the Unified Framework tax reform, in line with any tax reduction, will reduce total government revenue. At the same time the tax cuts can be partially self-financed through an increase in the taxable base. Studies find that the lost tax revenue effect can be lessened by 25-50% if they occur within a stable monetary policy environment. While many details on the tax reform are still unknown, we expect a short-term positive effect on aggregate output if the tax reform is passed.

7: Gravelle (2014)

8: Congressional Budget Office (2017, March)

However, consistent with simulations on tax reforms, the benefits will not be widespread and that there will be groups that will have to bear the burden of the tax cuts.

The plan in its current form is likely to increase the budget deficit, which could trigger tighter monetary policy and higher interest rates that would eventually crowd-out investment and decrease GDP growth to its potential level. The reduction in the corporate tax rate and other incentives that will increase corporate cash flows can potentially boost the rate of economic growth in the long-run. Economic efficiency gains from corporate tax cuts are possible, while estimates suggest that the gains for the U.S. will be small. It has been shown that for the first 10 percentage point cut in the U.S. corporate tax, the world will see a 1.5% efficiency gain and the U.S. portion of that 1.5% gain will be equal to its share of world GDP.⁹ However, the final impact on economic growth depends on further details that are still to be negotiated.

The short-run fiscal stimulus effect of the tax cuts should be positive but the size of the impact on growth is still yet to be determined because of the lack of the details on the bill. The reform could shift upward the levels of the macroeconomic aggregates and put upward pressure on inflation, yielding a faster pace of monetary policy tightening, higher borrowing costs, and a larger crowding out effect.

Long-run growth rates are governed by exogenous shifts in population and factor productivity, and it is not clear whether the reform can have a permanent positive effect on economic choices. Over the long-run, the cut in the corporate tax rate may deliver a boost to the rate of growth while the magnitude of that boost depends on the counterbalancing force of widening income inequality gap, low labor force participation, and servicing of the rising public debt. The suggested move to a territorial system under the Unified Framework can spur additional positive effects with respect to corporate taxation. Estimates suggest that it could substantially increase repatriation of active foreign source earnings of U.S. multinational corporations and reduce the current tax system's lockout effect. However, much of the final effect would depend on how the territorial tax system will be structured in terms of simplifying the system and on the balance between protecting the domestic corporate tax base and exempting foreign business activity.

9: Gravelle and Smetters (2006)

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