Tax Cut Outcomes
Byron A. Ellis – November 17, 2017

Clarity on the winners and losers of the Republican tax cuts is important for taxpayers, because it signals what legislators aim to accomplish and the effects of the tax cuts on them. Tax cuts reduce government revenue and if government spending is not reduced by the same amount of the tax cuts, the deficit increases. When the government deficit increases, it crowds out private investments because the government has to borrow to cover expenses. Additionally, if the government reduces spending to accommodate the tax cuts, private sector suppliers of goods and services, as well as their employees, social security beneficiaries and so on will be adversely affected.

Apparently, the Republican tax cuts return more income to the rich and corporations than to the average tax payer. Thus, the average tax payers will not significantly stimulate demand. Tax cuts targeted to the middle-class would stimulate demand in the short-run. However, if the economy is close to full capacity it is likely to cause inflation, which will lead the Federal Reserve to reduce the money supply (raise federal funds rate), constraining consumers' spending and private investments.

The macroeconomic effects of tax cuts affect people's well-being and it is difficult for the public to anticipate their outcomes, particularly when legislators implement the tax cuts with little or no public debate.

Keynesian economists believe that fiscal policy is a powerful lever to move the economy, because the effect of an increase in government spending or a cut in taxes would be multiplied by stimulating additional demand for consumption goods by households (Nelson, 2006). However, the effectiveness of the fiscal policy multiplier depends on whether fiscal policy changes emanate at low or high level of output relative to the full employment output (Branson, 1979) and if the banking system is increasing money in circulation through lending to compensate for the higher demand for real money balances.

Often, proponents of a tax cut advocate its virtues and ignore the fact that it is income growth that drives demand. Tax cuts do not increase the amount of money in circulation, they merely reallocate funds from government to taxpayers. However, when the largest share of the tax cuts goes to the rich and corporations, they seldom use the windfall to purchase additional goods and services. Moreover, if the money in circulation is not increasing, demand will remain at its current level and business will not invest or hire new workers.

It is the increase of currency in circulation (lower federal funds rate) that increases demand, and hence gross domestic product. Tax cuts do not change the amount of currency in circulation, they merely change the way purchases are allocated in the short-run. Moreover, expectation of rapid inventory decumulation due to the tax cuts will increase selling prices, resulting in an increase in inflation. At any sign of inflation increasing above the 2 percent annual rate will lead the Federal Reserve to remove money from circulation (higher federal funds rate), causing interest rate to rise, demand to fall and employee layoffs.

Thus, the decoupling of tax cuts from monetary policy often leads to unfavorable economic outcomes in the long-run.

References

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Nelson, C. R. (2006). Macroeconomics: An Introduction. Retrieved from http://faculty.washington.edu/cnelson/Chap11.pdf