Memorandum

To: Interested Parties
From: CRFB Staff
Subject: Issues with 11/7/17 Tax Foundation Report
Date: 11/8/2017

While well-designed tax reform can promote strong economic growth, economists broadly agree that debt-financed tax cuts will be less pro-growth – and perhaps even anti-growth – compared to fiscally responsible reform.

The Tax Foundation issued a report yesterday arguing otherwise – essentially making the case that high levels of debt have little negative impact on the economy and that borrowing more is unlikely to significantly "crowd out" private investment. This assertion is inconsistent with economic literature and evidence, relies on a misleading portrayal of the Joint Committee on Taxation's (JCT) methodology, and cherry picks data.

Our first impressions:

The Report Paints a Misleading Picture of Official Scorekeepers

- The Tax Foundation report seems to imply that CBO and JCT assume "full crowd out" – that every dollar of deficits will reduce investment by a dollar – and thus ignore the possibility of higher domestic savings or increased foreign investment.
- In reality, CBO and JCT assume higher debt will increase *both* domestic savings and foreign investment, incorporating the very studies Tax Foundation cites in determining how much.
- CBO actually assumes 33% crowd-out, not the 100% crowd out implied by the report. In other words, for every dollar of deficits CBO only assumes a 33-cent decline in investment – the rest is made up for with private savings (43 cents) and foreign investment (24 cents).
    - JCT's assumptions are likely similar.

The Report Cherry Picks Data

- For instance, the report cites a study by Giavazzi et al. and cites it as "private saving increased by as much as 50 cents" for each spending dollar and "as much as 97 cents for each dollar of deficit spent on tax policy." The study actually says private savings will increase by 10 to 50 cents for additional spending or 50 to 97 cents for tax cuts. CBO's general assumption of 43 cents for a generic policy is therefore well within the range of the study cited.
- As another example, the report cites one study that finds an additional dollar of deficit prompts an additional 31 to 38 cents of foreign investment. CBO notes the study's range drops to 13 to 14 cents when the sample is limited to industrialized countries. CBO incorporated this *and other studies* to generate a central estimate of 24 cents of foreign investment for every additional dollar of deficit.

The Report Suggests Tax Foundation's Model Overstates Dynamic Effects

- While the report suggests the crowd out effect of deficits is small, the Tax Foundation model assumes the effect is *zero* – in other words, the model assumes debt is literally costless.
- While the report implies the stock of savings for investment is plentiful, the Tax Foundation model finds large economic benefits from policies meant to increase the domestic savings rate – for example, repealing the estate tax or reducing capital gains rates.

Debt Matters

- Most research shows higher debt is associated with lower rates of economic growth and vice versa.
- While the crowd out effect may have been small in recent years, it is likely to rise as the Federal Reserve unwinds its balance sheet, the global economy stabilizes, and the U.S. government continues to expand its borrowing.
- To the extent crowd out is mitigated by foreign investment, foreign investors will reap the returns from economic growth – and ultimately, the U.S. will have to pay foreign investors back anyway as trade balances stabilize.
- The best research continues to show that deficit-financed tax reform is less pro-growth than fiscally responsible reform. In 2011, JCT estimated that tax reform producing $600 billion for deficit reduction would produce about one-third more growth over the long run than revenue-neutral tax reform with the same structure.

For more on CBO's assumptions, see this working paper.