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INEFFICIENT TAX CUTS WILL NOT HAVE A SIGNIFICANT IMPACT ON GDP GROWTH DUE TO HIGH INCOME INEQUALITY AND HOUSEHOLD INDEBTEDNESS, NEW LEVY INSTITUTE STUDY SUGGESTS

US economy faces increasing dangers from financial instability

ANNANDALE-ON-HUDSON, N.Y.— The US economy has been expanding continuously for almost nine years, making the current recovery the second longest in postwar history. However, the current recovery is also the slowest recovery of the postwar period. A new study from the Levy Economics Institute of Bard College contends that the weak recovery in output is mainly due to the weak recovery in consumption, restrictive fiscal policy, and weak net export performance (save for petroleum products). Consumption has been undermined by high income inequality and household indebtedness, two factors that will also limit the positive impact of the new tax bill, write Levy Research Scholars Michalis Nikiforos and Gennaro Zezza in their new Strategic Analysis, “‘America First,’ Fiscal Policy, and Financial Stability.”

“It is unlikely that the tax changes will provide a major boost to the US economy, since the ability of large corporations to increase investment does not seem to be constrained by the availability of finance, and the new provisions of the law for households are likely to increase income inequality,” write Nikiforos and Zezza, stressing that the biggest winners of the new tax law are households at the very top of the income distribution. “Higher income households save at greater rates than lower income households; therefore, as the income share of the former rises, their contribution to growth declines. At the same time, a significant role is played by the indebtedness of American households: despite some deleveraging after the crisis, the debt-to-income ratio of households remains high by historical standards. This also puts negative pressure on household consumption decisions.”

Using the Levy Institute’s stock-flow consistent macroeconometric model, Nikiforos and Zezza analyze the medium-run prospects, challenges, and contradictions for the US economy, comparing a baseline projection for 2018–21 in which no budget or tax changes take place to four additional scenarios, in which they isolate the likely macroeconomic impacts of: (1) the recently passed tax bill; (2) a large-scale public infrastructure plan of the same “fiscal size” as the tax cuts; (3) the spending increases entailed by the Bipartisan Budget Act and omnibus bill; and (4) a sharp drop in the stock market that induces another round of private-sector deleveraging. The authors’ simulations estimate that the tax cuts will lead to a cumulative increase in GDP of around 1 percent over a period of four years, and a permanent increase in the government deficit of around
0.9 percent of GDP.

While the spending increases in the Bipartisan Budget Act and omnibus bill will be more effective at boosting growth than the tax cuts, the Levy scholars argue that a more efficient and straightforward way to boost the economy would be through a direct increase in government spending in the form of a public infrastructure plan. Their simulations show that if the same ex ante deficit increase to pay for the tax cuts were used to finance a public infrastructure program, the macroeconomic benefits would be roughly double, with a cumulative increase in GDP of around 2 percent over a period of four years compared to the baseline projections, and—because the economy would grow faster compared to the tax cuts scenario—the ex post permanent increase in the deficit would be smaller (around 0.6 percent of GDP). “Such a plan would improve the quality of life for people around the country, increase aggregate demand, and could lead to productivity gains that would have permanent growth effects and make the US economy more competitive,” they write.

To conclude, Nikiforos and Zezza explore the effects of a financial crisis that would generate a sharp drop in the stock market and a decrease in the expenditure of households and firms, which their simulations show would result in severe effects for the US economy. Such a situation is increasingly likely, they suggest, given the historically high valuation of the stock market and debt-to-GDP ratio of firms, the elevated (by historical standards) indebtedness of households, and the increase in the size of the shadow banking sector. “By all metrics, the stock market is now at or close to its highest level in history,” they write. “There is no convincing reason why this should be the case, or why this accelerated rise in equity prices should be different from the past. The model simulations show that a crisis in the stock market accompanied by deleveraging of the private sector could send the US growth rate into negative territory.”

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Strategic Analysis: “America First,” Fiscal Policy, and Financial Stability

To read the full text of this policy paper or to learn more about the Levy Economics Institute of Bard College, please visit levyinstitute.org/publications/america-first-fiscal-policy-and-financial-stability.

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