Economic Studies
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Tax Cuts Don't Necessarily Increase Long-Term Economic Growth

Although the income tax system can influence the economy, there is no guarantee that tax rate cuts or tax reform will raise the long-term economic growth rate—contrary to the conventional wisdom, according to a new paper by Brookings Senior Fellow William Gale and Dartmouth Professor Andrew Samwick.

In "Effects of Income Tax Changes on Economic Growth," Gale, who co-directs the Urban-Brookings Tax Policy Center and Samwick, who directs the Nelson A. Rockefeller Center at Dartmouth College, examine how the income tax changes can affect long-term economic growth.

To be clear, tax rate cuts can stimulate a weak economy in the short run and may encourage individuals to work, save, and invest. However, if the tax cuts are not financed by immediate spending cuts they will likely also result in an increased federal budget deficit, which in the long-term will reduce national saving and raise interest rates, Gale and Samwick find. Because of the potential to negatively affect investment, the structure of the tax cut and its financing are critical to achieving economic growth, they believe.

Likewise, rate-reducing income tax reforms may raise economic growth, but it is not a given. This holds true for both revenue-neutral tax reforms that do not add to the deficit or debt, and distributionally-neutral base-broadening tax reforms that spread out the tax burden but leave the total revenues to the government the same. Gale and Samwick highlight four key aspects of tax policy that boost long-term growth:

1. Large positive tax incentives (substitution) effects that encourage work, saving, and investment;
2. Careful targeting of tax cuts toward new economic activity, rather than providing windfall gains for previous activities;
3. Leveling the playing field across economic sectors and across different types of income and types of consumption; and
4. Minimal increases in the budget deficit.

Base-broadening measures can eliminate the effect of tax rate cuts on budget deficits, and reduce their impact on lowering effective marginal tax rates and thus on labor supply, saving, and investment. However, they also reallocate resources across sectors toward their highest-value economic use, resulting in increased efficiency and raising the overall size of the economy.

"One strong finding from all of the analysis is that not all tax changes will have the same impact on growth. Reforms that improve incentives, reduce existing subsidies, avoid windfall gains, and avoid deficit financing will have more auspicious effects on the long-term size of the economy, but in some cases may also create trade-offs between equity and efficiency," they write.