Cut Taxes, Sure. But Remember the Budget Deficit.
By N. GREGORY MANKIW

In the debate about federal tax policy, one question looms large: Should we have a tax cut that increases the budget deficit?

President Trump says he wants “a massive tax cut … maybe the biggest tax cut we’ve ever had.” But the Senate majority leader, Mitch McConnell, who is clearly worried about the growing national debt, says tax reform “will have to be revenue-neutral.” The stage is set for another Republican showdown.

Democrats, meanwhile, are likely to sit this one out. The Senate minority leader, Chuck Schumer, argues that passing a tax bill is going to be hard until the president releases his tax returns. Don’t hold your breath.

Mr. Trump wants to cast himself in the role of a tax-cutting Republican president, along the lines of Ronald Reagan and George W. Bush. But before drawing a comparison with these predecessors, let’s recall the economic circumstances they faced.

When Mr. Reagan moved into the Oval Office in January 1981, the economy had recently experienced a recession. The recovery was just six months old. Unemployment was still elevated at 7.5 percent.

Worse yet, another downturn was on the horizon. Within six months, the economy would again be in recession. Unemployment rose to 10.8 percent at the end of 1982, its highest level since the Great Depression.

In August 1981, Mr. Reagan signed into law a bill that phased in tax cuts over three years. These cuts helped usher in a robust recovery. By the end of 1988, as Mr. Reagan was leaving office, the unemployment rate had fallen to 5.3 percent.

To be sure, these large tax cuts, together with the deep recession, reduced government revenue and led to sizable budget deficits. Later in his administration, with the economy in better shape, Mr. Reagan agreed to some tax increases to shrink the deficit. And when he and Congress took up the task of tax reform in
1986, they aimed to make it revenue-neutral. Lower rates were achieved by closing loopholes.

When George W. Bush became president in January 2001, he faced a situation that, in some ways, was similar to that of 1981. (Disclosure: I was one of his economic advisers from 2003 to 2005.)

The economy was heading toward a recession, attributable largely to the bursting of the dot-com bubble. From March 2000 to April 2001, the tech-heavy Nasdaq composite average lost about two-thirds of its value. A recession officially began in March 2001. Unemployment rose from 3.9 percent at the end of 2000 to 6.3 percent by the middle of 2003. Without the tax cuts President Bush signed into law, unemployment would have probably gone higher.

The Reagan and Bush tax cuts combined the logic of supply-side economics and of Keynesian stimulus. Supply-siders argue that lower marginal tax rates give people more incentive to work and invest. Keynesians argue that leaving more money in people’s pockets, rather than in government coffers, increases spending and that greater demand for goods and services expands employment. When the government enacts deficit-financed tax cuts, the two channels can work simultaneously.

Yet Mr. Trump faces a vastly different set of circumstances. The economy has not experienced a recent recession. The recovery from the financial crisis and Great Recession of 2008-2009 is now eight years old.

Moreover, there is no sign we are heading into another recession. Over the past year, unemployment has fallen from 5.0 to 4.3 percent, and the stock market is up about 20 percent. Some firms are complaining about labor shortages.

The Federal Reserve is responding to these events by raising interest rates. It believes, correctly in my judgment, that incipient inflation is a greater risk than recession. Keynesian pump-priming is not what the economy needs now.

The main macroeconomic problem the nation faces is slow productivity growth, which in turn leads to slow growth in average incomes. Increased budget deficits would only make this problem worse. They would cause the Fed to raise interest rates even faster than otherwise. Higher interest rates would discourage capital investments, further depressing productivity.

In short, Mr. Trump finds himself not in the position of Ronald Reagan in 1981 or George W. Bush in 2001 but rather of Ronald Reagan in 1986. He should
follow the Reagan of the later period and aim for revenue neutrality. He should broaden the tax base, lower rates and reform the tax code to promote saving, investment and growth.

A key question is how revenue neutrality is to be judged. Traditional analyses of the effects of tax proposals rely on what is known as static scoring, a method based on the simple but dubious assumption that changes in the tax code do not alter the path of national income. An alternative approach, called dynamic scoring, accounts for the possibility that lower tax rates will promote growth.

Dynamic scoring is potentially more accurate, but it is also more easily abused by those who want to promote their policies with an unhealthy dose of wishful thinking. Tax cuts rarely pay for themselves. My reading of the academic literature leads me to believe that about one-third of the cost of a typical tax cut is recouped with faster economic growth.

Of course, not all tax cuts are typical. One virtue of dynamic scoring is that it would apply a different discount to different tax changes. For example, research suggests that modest reductions in the corporate tax rate would most likely be the most self-financing, while increases in the standard deduction would probably do little to improve incentives and promote growth.

When judging revenue neutrality, policy makers will need to rely on a credible, impartial arbiter, like the Congressional Budget Office. In this era of alternative facts, it would be far too easy to pass irresponsible tax cuts and hand the bill to future generations.