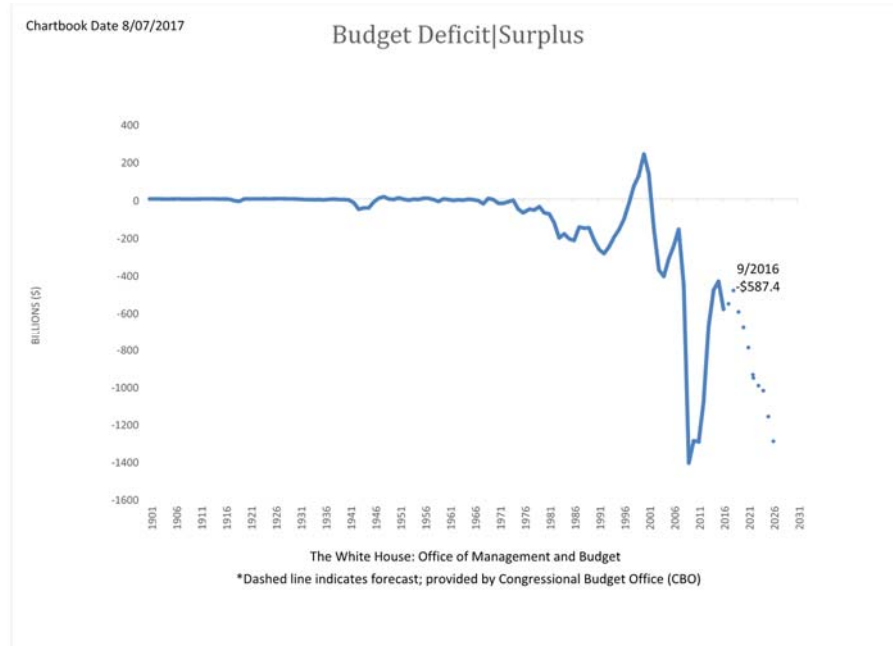




The Fallacy of the Tax Cut Debate

President Trump's tax reform package has now moved front and center in the national debate over how we get the economy growing on a sustained 3%+ basis. The debate is over the ultimate impact of the tax cut on the economy and whether the implied increase in the debt due to perceived lower tax collections will undermine the federal government's financial balance sheet. We appear to be stuck between the benefits of a tax cut and the liabilities of a bigger budget deficit. If politicians can't see through the fallacy of this tradeoff then we are doomed to slower growth and higher not lower budget deficits. Here is why.

First of all, the biggest impact on the size of the federal budget deficit is the level of economic activity. When a recession hits, federal spending explodes as revenues contract. This relationship is evident in the following exhibit that reflects the federal deficit before and after the recession of 2008.



This fact suggests that politicians should be opting for fiscal policies that increase economic output not curtail government spending. When the government reduces spending it simultaneously is reducing someone's income. In other words, lower spending inhibits economic growth as do higher tax rates. The best of all

worlds is an environment where tax rates are reduced and government spending increases. Such conditions existed under President Reagan and the economy boomed.

Second, what are the politicians worried about if a tax cut is not revenue neutral? To the extent that the concern is higher inflation, that concern should be relegated to the G file. Note the huge surge in deficits in 2008-2009 in the exhibit above. During the subsequent period of seven years of government spending, inflation declined, it did not increase. This experience proves there is no direct causality between government spending and inflation. As a matter of fact, mainstream economists are wondering what happened to inflation.

Ted Cruz's endorsement of President Trump's tax program is right when he says to heck with revenue neutrality; let's get the economy growing again and worry about spending and deficits later.

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