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Policy Backgrounder: CBO View: What if Congress Does Not Extend the 2017 Tax Cuts?

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Key Insights

The Congressional Budget Office (CBO) released an analysis of the effects of the expiring individual income tax provisions of the 2017 Tax Cuts and Jobs Act (TCJA) on its ten-year economic forecast, showing that letting the cuts expire would assist with deficit reduction and promote investment, albeit with marginal impact on real GDP. However, extending these expiring provisions is one of the signature priorities of the President-elect and Republicans in Congress next year, and Congress is likely to pass an extension of the cuts in some form.

- CBO estimates that if the individual income tax cuts expires as scheduled, this would increase annual revenues by 1 percent of real GDP, which in turn will lower annual deficits and the overall national debt.
- By borrowing less, the Federal government will "crowd in" (increase) private investment in the economy, increasing real GDP. However, the higher marginal individual income tax rates scheduled to occur in 2026 would reduce aggregate demand and lower the labor supply, thereby reducing real GDP.
- In CBO's analysis, the effects of higher private investment and a lower labor supply roughly offset each other. Thus, CBO's projections of real GDP are not significantly affected by the expiration of the individual income tax provisions of the TCJA.
- The Conference Board's economic modeling of not extending all the expiring provisions of the TCJA shows a short-term drop in real GDP and increases in the unemployment rate in 2026 and 2027, followed by minimal effects over the rest of the forecast period.
- However, most observers anticipate that Congress will extend the TCJA tax cuts in some form, which would increase the deficit if not offset with corresponding reductions in spending.

Deficit Reduction But Minimal Changes to Real GDP

By law, CBO's baseline budgetary and economic forecasts reflect current law and do not make assumptions regarding potential statutory or policy changes. During the 2024 Presidential campaign, the President-elect and Congressional Republicans proposed extending many of the individual income tax provisions of the TCJA that expire at the end of 2025. Given these promises, forecasters both inside and outside of the Federal government have modeled various scenarios of the cost of extending these expiring individual income tax provisions and incorporated them into their forecasts.

The Joint Committee on Taxation (JCT) and CBO have estimated that permanently extending the individual income tax provisions of the TCJA would increase the primary deficit by $3.3 trillion between 2025 and 2034, with net interest outlays also increasing by $470 billion over that period for a total cumulative increase in the deficit of approximately $3.7 trillion over ten years. However, this budgetary

estimate does not incorporate changes in the US economy because of lower taxes, namely increases in hours worked and higher aggregate demand due to workers having additional income.

To provide an accurate comparison between outside economic forecasts and that of CBO, CBO released a presentation outlining how the expiration of the TCJA individual income tax provisions would affect its economic forecast. The tax law affects the economy through three primary pathways: incentive effects, crowding in, and economic activity. The scheduled increase in marginal individual income tax rates if the TCJA expires would reduce the incentive to work. Higher marginal tax rates on business income taxed as individual income would also reduce the incentive for business investment. However, higher revenue from the increase in marginal individual income tax rates would reduce the Federal deficit, which would "crowd in" or increase the amount of funds available for private investment in the broader economy. But in this scenario reductions in aggregate demand and labor supply would reduce private investment.

CBO's model focuses on several key aspects of the economy: the labor supply, private investment, and aggregate demand. In CBO's model, the effects on the labor supply phase in over three years, with some workers choosing to work less in 2026 and others reducing how much they work in 2027 and 2028 as they may not understand the consequences of the change in the law or they expect Congress to retroactively extend the lower marginal rates. After three years, CBO projects the total potential number of hours worked (labor supply) to decrease by roughly 0.45 percent compared to a scenario where the individual income tax provisions are permanently extended.

Regarding private investment, CBO analyzed the effects of smaller budget deficits, the lower cost of capital, and reduced economic activity. CBO projects that reduced Federal budget deficits will lead to more private investment in the economy, increasing this investment by $120 billion in 2027, reaching $191 billion by 2034. There is a small boost of roughly $5 billion from the lower cost of capital. Counteracting these positive effects is a reduction in economic activity from lower aggregate demand and a reduction in the labor supply, which lowers private investment by approximately $50 billion in 2027, though this negative effect is much less significant after 2029. All these factors combine to produce an increase in private investment of $71 billion in 2027, reaching $202 billion by 2034.

In turn, these factors contribute to CBO's forecast of real GDP. CBO estimates a reduction in real GDP of 0.3 percent in 2027 as aggregate demand falls due to the expiration of the individual income tax provisions of the TCJA. By 2030, the reduction in labor supply reaches its full impact on real GDP – partially offset by increased private investment due to lower Federal deficits—lowering real GDP by 0.1 percent. By 2034, the crowding in of private investment roughly balances out the reduction in labor supply, increasing real GDP by 0.1 percent.

The expiration of the individual income tax provisions of the TCJA also affects interest rates and inflation. Higher private investment and lower Federal debt relative to GDP put downward pressure on interest rates, which then reduces net interest outlays. CBO estimates the rate of 10-year Treasury notes would decline by almost 7 basis points by 2027, dropping further to a reduction of 8 basis points by 2034. The reduction in aggregate demand is projected to minimally reduce inflation in the short term (1 basis point in 2028), with a negligible effect in later years.

Taken together, CBO concludes that "[b]ecause the expiration of the provisions does not significantly change CBO's economic projections, the dynamic budgetary effects of that expiration (that is, the budgetary effects after accounting for changes in the size of the economy stemming from expiration) would be very similar to the conventional estimate—a $3.7 trillion reduction in the cumulative deficit over the 2025–2034 period."

The Conference Board's Economy, Strategy and Finance Center has modeled a scenario where all the expiring provisions of the TJCA are not extended, not just the individual income tax provisions. In The Conference Board's projections of the effects of this tax cliff from 2026 to 2035, the economy suffers in the short run as real GDP growth decreases by 1 percent in 2026 and 0.3 percent in 2027. Economic

growth rebounds by 0.7 percent in 2028 with minimal changes for the rest of the forecast period. The unemployment rate increases by roughly 0.3 percent in 2026 and 2027 followed by minimal changes thereafter. Inflation as measured by the Personal Consumption Expenditures (PCE) index increases by 0.1 percent in 2026, with annual decreases of between 0.1 and 0.3 in the rest of the forecast period. The Conference Board also projects that not extending all the expiring TJCA provisions will raise $5.2 trillion in revenue and lower the Federal debt as a share of GDP by 13 percent when compared to a full extension of the TCJA.

Conclusion

CBO and JCT will have an important role in the debates on extending the expiring provisions of the TCJA in 2025. With full control of Congress, Republicans are considering how to pursue a comprehensive tax bill that the President can sign as quickly as possible in the spring or summer, with discussions centering around the magnitude of increases in the deficit Republicans are willing to enact and how the Senate will use reconciliation to pass tax cuts with a simple majority rather than with the 60 votes necessary to overcome a filibuster. This planning comes amid several fiscal deadlines over the next month, including the December 20 expiration of the current continuing resolution funding the Federal government and the expiration of the debt ceiling on January 2, 2025, making fiscal policy one of the dominant themes of the lame duck session and the President-elect's first 100 days. Even as most observers anticipate that Congress will extend the 2017 tax cuts in some form, leading to an increase in debt if not offset by spending reductions, CBO's analysis is nevertheless important in considering the alternative scenario if Congress does not act by the deadline at which tax rates will revert to pre-2017 higher levels.

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