Message From The President

Taxes and the Fed

It's a pleasure to meet you, the readers of *Econ Focus*, for the first time. I've come to the Richmond Fed after a 30-year career in consulting at McKinsey & Company, including serving as chief financial officer, chief risk officer, and the leader of our five offices in the South. While I'm new to Richmond, I'm not totally new to the Federal Reserve System; between 2009 and 2014, I was a member of the Atlanta Fed's board of directors, including two years as the board's chair. I will be relying on these experiences as I look at how economic policy translates "on the ground" and affects businesses' and consumers' decisions.

And I'm still learning. Since I became president of the Richmond Fed in January, I've been spending time with business and community leaders so I can better understand local economic conditions and the economic issues facing the people who live and work in our district. One question many people are asking is how the Tax Cuts and Jobs Act, which Congress passed at the end of 2017, will affect the economy and thus the appropriate path for monetary policy. Among other changes, the legislation lowered corporate and individual tax rates. Many observers expect lower tax bills to give the economy at least a moderate boost.

This is a reasonable expectation; if people are paying less in taxes, then they have more money to spend on other things. But how people respond to tax cuts depends on a number of variables, as Helen Fessenden discusses in the article "A Taxing Question for the Fed" in this issue.

One factor she notes is whether the tax cut is expected or a surprise. In general, research suggests that unanticipated tax cuts have a larger net effect on output and investment than anticipated tax cuts. That's because anticipated tax cuts actually appear to cause some contraction in the short term. She also says it matters if the tax cut is permanent or temporary. It is a basic economic theory that households try to keep their consumption smooth over time, so consumers might be less likely to change their behavior if they know a tax cut is going to expire. The effects of tax cuts could also be muted if people expect they will lead to large deficits, which would eventually need to be addressed via tax increases or spending reductions.

The aggregate effects of corporate tax cuts are especially hard to predict, as companies with different corporate structures may respond in different ways. Corporations also vary in their decisionmaking about whether to channel tax savings into capital purchases or upgrades, employee compensation, or returning value to shareholders. Tim Sablik reviews the recent changes to corporate tax policy in this issue's "Policy Update."

Given these many uncertainties, the Federal Open Market Committee has been cautious when assessing the future impacts of the recent tax legislation. Moreover, fiscal policy is just one of many factors that influence the committee's policy decisions.

For example, we're also looking closely at labor force participation. The labor force participation rate has been drifting downward since around 2000, as baby boomers reach retirement age and more young people enroll in college, among other factors. During and after the Great Recession, the decline accelerated when some people became discouraged about their job prospects. Now, it's possible that a strong economy and labor market have induced some people to look for work who might otherwise not have, thus pushing participation above its long-term trend. This, among other factors, might help moderate the upward pressure on wages from further declines in the already-low unemployment rate.

Another important factor is productivity growth, which influences the economy's growth potential and thus the appropriate policy rate for monetary policymakers to target. Our director of research, Kartik Athreya, discusses this topic in more detail in his "Opinion" column.

I hope you enjoy this issue, and I look forward to continuing the conversation. **EF**

TOM BARKIN
PRESIDENT
FEDERAL RESERVE BANK OF RICHMOND