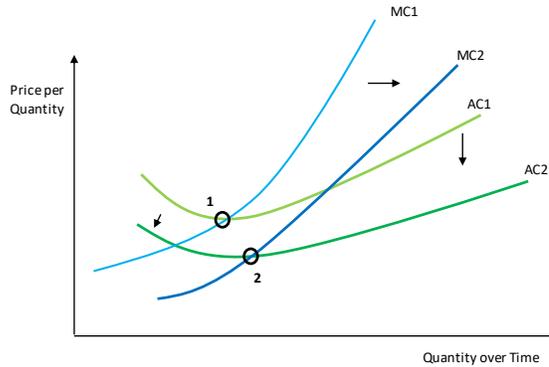


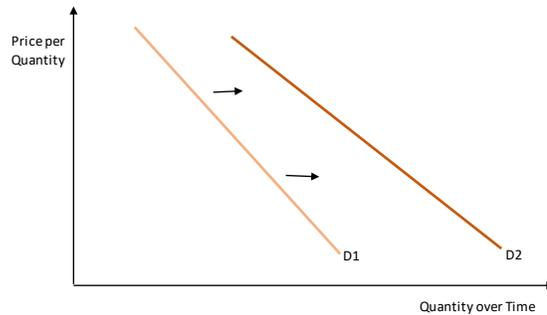
There is a surprising amount of discussion about inflation after years of fearing the lack of it. Higher labor costs and the CPI for the month of January have caused a stir. Some have even linked it to the tax act of 2017. Does anybody remember Microeconomics?

The Tax Act of 2017 resulted in a reduction of the tax rate on corporations. A reduction of the tax rate results in a reduction of the Average Variable Costs (AVC) of production of a corporation. This can be seen below with  $AVC_1$  falling to  $AVC_2$  as a result of reduced corporate taxes. Since the Marginal Cost curve (MC) intersects the minimum point of the AVC, it is the supply curve of the firm. With a cut in corporate taxes the supply curve shifts to the right., i.e. the firm is willing to supply the same amount of goods as before but at a lower price...or more goods at the same price.



Wouldn't you? After taxes you get to keep more, so you'd like to sell more even at a lower price. Therefore, a cut in the corporate taxes, if anything, is deflationary.

The above is all well and good with the magical "all other things being held constant"; (*ceteris paribus*). But they aren't! Some consumers have also received a tax cut. You can only do three things with your income: consume (C), save (S), and pay taxes (T). Given a reduction in taxes a microeconomist would illustrate this as the consumer demand curve shifting to the right:



In this world consumers are willing to pay more for every quantity than before. This can cause higher prices. So, producers are willing to produce more at a higher price and consumers are willing to demand more at a higher price. How does this all end?

The Congressional Budget Office (CBO), along with the Joint Committee of Taxation, on December 15<sup>th</sup> of last year provided its breakdown of the tax act. For this fiscal year and the next two, the estimated reduction in tax bills are as follows;

	Fiscal Year in Billions		
	2018	2019	2020
Tax changes for Individuals	- \$86.1	- \$182.0	- \$171.8
Business Related Tax Changes	- \$127.1	- \$131.5	- \$111.2

Exactly how the tax savings are spent by consumers and corporations will determine the effect on prices. It is not a foregone conclusion that price levels will be impacted at all.