Hassett's flawed analysis of the Trump tax plan

By Larry Summers
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Kevin Hassett, chair of the Council of Economic Advisers, accuses me of an ad-hominem attack against his economic analysis of the Trump administration's tax plan. I am proudly guilty of asserting that it is some combination of dishonest, incompetent and absurd. TV does not provide space to spell out the reasons why, so I am happy to provide them here.

I believe strongly in civility in public policy debates, and before the Trump administration do not believe I have ever used words like dishonest in disagreeing with the policy analyses of other economists. Part of my rationale for speaking so strongly here is that Mr Hassett called into question the integrity of the Tax Policy Center, a group staffed by highly respected former civil servants, by calling their work "scientifically indefensible" and "fiction".

Then, he invokes Art Okun as support for his spurious arguments. To paraphrase Lloyd Bentsen — I worked with Art Okun; I knew Art Okun; Art Okun was my friend. Kevin, you are no Art Okun.

As CEA chair, Okun stood for honest, objective economic analysis rooted in the professional consensus. In the last year of his life, he made clear how dubious he found the claims of supply-side economics. In contrast, Mr Hassett throws around the terms scientific and peer reviewed, yet there is no peer-reviewed support for his central claim that cutting the corporate tax rate from 35 per cent to 20 per cent would raise wages by $4,000 per worker.

The claim is absurd on the face of it. The cut in corporate tax rates from 35 per cent to 20 will cost slightly less than $200 billion a year. There is a legitimate debate among economists about how much the cut will benefit capital and how much it will benefit labor. Mr Hassett's "conservative" claim that the cut will raise wages by $4,000 in an economy with 150 million workers is a claim that workers will benefit by $600 billion or 300 per cent of the tax cut. To my knowledge, such a claim is unprecedented in analyses of tax incidence. Mr Hassett, though, doubles down by holding out the further possibility that wages might rise by $9,000.

Yes, I am aware that some of the wage increase might be expected to come from the growth-inducing benefits of a corporate tax cut. Such a cut might spur investment. But any possible growth benefit is attenuated by the facts that (i) the economy is very close to or at full employment; (ii) costs of capital are already at record low levels; (iii) the tax cuts will put upward pressure on interest rates; and (iv) the move to a territorial system that reduces taxes on overseas income of US companies will encourage outsourcing. None of this is factored into Mr Hassett's analysis or the studies he cites.

At a more technical level, professional economists will recognize that the CEA's analysis and Mr Hassett's Tax Policy Center speech are shot through with error. Some examples: in the presence of full expensing, a corporate rate reduction has no effect on the cost of capital for equity-financed investments and raises the cost of capital for debt-financed investments. Changes in transfer pricing practices induced by tax policy changes do not represent changes in economic welfare or real incomes of Americans.

In modern economic science, regressions of wage growth on tax rates cannot be understood as causal without a theory of the level of tax rates. Theory suggests relationships between

changes in corporate taxes and changes in wages rather than between the level of corporate taxes and wage growth. The observation that low tax rates coincide with significant growth in eastern Europe is of dubious relevance to the US. Lower corporate taxes, as Stefanie Stantcheva and others have argued, raise managerial incentives to hold down wages on behalf of shareholders.

Considering all this, if a PhD student submitted the CEA analysis as a term paper in public finance, I would be hard pressed to give it a passing grade. I predict that as debates on tax policy unfold there will be many serious Republican economists who endorse parts of the Trump plan. I doubt that any will associate themselves with the CEA analysis. If Mr Hassett wishes to preserve the CEA's reputation and his own, next time he will not attack honest analysts and will himself be much more careful.

Commentary by Larry Summers, the former Treasury Secretary and currently the Charles W. Eliot University Professor and President Emeritus at Harvard University.