What Trump's tax cut really means for the US economy

By James K. Galbraith
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The Trump administration's stated economic-policy objective is to increase growth in the United States from the post-financial-crisis rate of around 2% to at least 3%. In historical terms, achieving such growth is not out of the question. Real (inflation-adjusted) GDP growth exceeded 3% in 2005-2006 and 4% in the period from 1997 to 2000; and in each of the past two quarters, the economy has grown at an annualized rate above 3%. The question is whether that pace can be sustained.

Despite low headline unemployment – 4.1% as of December – the US economy is neither at full employment nor constrained by labor supply, as some have argued. The employment-to-population ratio has risen from its post-crisis low of around 58% to just over 60%, but it is still three percentage points below the 2007 level, and five points below its peak in 2000. While many workers retired during and after the post-crisis recession, some could be lured back to work for pay. And while net immigration has slowed, it would pick up, if more workers were needed.

Because infrastructure investment and serious trade protection have (apparently) been removed from the agenda, the growth strategy advocated by Trump and congressional Republicans now boils down to the tax law that they rushed to enact in December. Featuring a major cut in the corporate-tax rate and accelerated expensing for capital investments, the law could have two distinct effects: a fiscal-policy effect on aggregate demand and a "supply-side" effect on the economy's productive capacity.

In the first four years, when the law's net tax cuts will be equal to around 0.9% of GDP per year, the stimulative effect will depend on how much of the additional private income is spent in a given year, and on the fiscal multiplier applied to that spending. Assuming, generously, that 60% of the additional private income is spent each year, and that the fiscal multiplier is 1.5, the tax cut would initially add almost one percentage point to the rate of GDP growth. But that would be a one-time effect. Annual GDP would climb higher once, but the long-run growth rate would not be affected.

Moreover, if the lost revenue is offset by automatic cuts to Medicare or Social Security benefits, or by reductions in spending by state and local governments, the tax package will have even less of a net fiscal effect, because it will drive down public and private purchases of goods and services. Still, on the further generous (and problematic) assumption that the US Federal Reserve does not respond, the tax cut could keep the real growth rate above 3% through 2018, and perhaps also through 2019.

The question of growth

To determine if the tax legislation will have any cumulative effect on the long-run growth rate, we should turn to a debate, published by *Project Syndicate* in December, between Robert J. Barro and his Harvard colleagues Jason Furman and Lawrence H. Summers. In the debate's first installment, Barro used a neoclassical growth model to calculate that the tax law will boost the growth rate by about 0.3% per year, implying a gain of 2.8% in *per capita* GDP over the next ten years.

In their response, Furman and Summers accepted Barro's growth model, but criticized his application of it. Their strategy was brilliant, insofar as it narrowed the killing ground. After making various corrections to Barro's underlying assumptions about the tax plan, they used his own model to show that his calculation is off by "an order of magnitude."

A modest effect was thus rendered essentially negligible.

But Furman and Summers left Barro's core theoretical assumptions unchallenged. So, while they demolished his claim that the tax law will have a significant effect on long-term growth, they seemed to concede that a plan with even greater benefits for corporate profits and even more generous expensing provisions would have done more. To my mind, this inference is false, and could dangerously mislead policymakers in future debates over tax legislation.

To understand why, we should first consider Barro's model, which he insists is in keeping with common practices in the economics profession. Accordingly, he equates the tax law's effect on the "user costs that businesses attach to investment" with the "marginal product of capital" in "economists' most popular model of economic growth." He then estimates an elasticity of 1.25 for the "capital/labor ratio to user cost" in a "Cobb-Douglas production function (commonly used by economists)." Through it all, what he really seems to be saying is: *Don't bother me with quibbles over theory*.

Next come the numbers. Based on his assumptions about elasticity and other factors, Barro calculates a 25% increase in the long-term capital-labor ratio for non-residential corporate structures – bank buildings, shopping malls, and so forth – and a 17% increase for corporate equipment. Let's say the overall increase would be somewhere in the middle, around 20%. That means Barro expects the tax package to add another $10 trillion to the US capital stock, which is worth roughly $50 trillion today.

After making a modest downward adjustment, Barro concludes that this added capital stock would boost long-run GDP by 7%, or by about $1.2 trillion in 2009 dollars. That means he expects a net tax cut of $1.5 trillion over ten years – with just $644 billion of it going to businesses – eventually to generate a six-fold gain in capital stock, and 80 cents on the dollar in real annual output after about 14 years.

This would truly be a miracle of loaves and fishes. Obviously, Barro's numbers are preposterous, and Furman and Summers are right to dispute them. Nonetheless, they still describe Barro's underlying model as "sensible." Perhaps they are adhering to a Cambridge code of *politesse* that enjoins them from calling things by their right name.

Neoclassical fallacies

Barro's model assumes that corporate-tax cuts, by increasing the after-tax productivity of the capital stock, will induce businesses to create more capital until the marginal product of capital (units of output per unit of input) returns to its long-run equilibrium level, as determined by the discount and depreciation rates. If labor is fully employed, the increases in capital will boost total output. And, in the meantime, capital's share in total output will grow as the wage share declines, because the initial capital investment has to be paid for with wage cuts, higher taxes on labor, spending cuts to social programs, or by borrowing and incurring the costs of future interest and principal repayments. After all, in neoclassical economics, nothing comes from nothing.

The first problem with this model is that there is no good reason to assume that higher after-tax profits will generate investments in more capital-intensive modes of production. Barro is confusing the after-tax profitability of *existing* activity with the prospective profitability of *new* investment. Furman and Summers understand this, which is why they favor more expensing for new capital investment and a smaller reduction in the corporate-tax rate.

But Barro adds further confusion with his treatment of the expected profitability of new investment and the resulting capital-labor ratio. His model regards capital as homogeneous, and makes a distinction only between structures and equipment. But the fact

is that firms base investment decisions not just on their view of future profits, but on the state of technology at the time.

Normally, new technologies determine the right mix of structures, equipment, and labor. And because digital technologies tend to *save both capital and labor*, a lower relative price for capital equipment does not necessarily lead to higher relative use of “capital.” If the price of construction or equipment such as computers or touch screens falls while wages do not, the resulting business operation would actually appear to be more labor-intensive than it was before. In fact, this seems to describe many business situations today. The low share of investment in GDP in recent years reflects the relatively low cost of new electronic machinery, which has shifted more of the burden of sustaining growth onto consumption.

It is a neoclassical fallacy to think that businesses can simply swap in structures for labor as a way to boost the capital-labor ratio and achieve their output goal at the desired cost. The entire point of building a nonresidential structure – be it a hospital, a factory, or a big-box store – is to fill it with workers and machines. If businesses take advantage of more generous expensing provisions to build or acquire additional structures without the machines or workers, they won’t be increasing their output or productivity; they’ll just be taking up space.

Moreover, because new electronic machinery is physically compact and tends to displace office and administrative labor, business structures are less necessary today than during the golden ages of automotive manufacturing, insurance, or banking. And because so much new equipment is now imported, the multiplier on many investments will not be felt in the US, but rather in the countries producing the capital goods. No tax law will change these facts.

So, even when future investments do occur, they aren’t likely to raise the capital-labor ratio or the real rate of growth. And even if Barro, Furman, and Summers were to argue that new capital equipment is “better” and thus amounts to “more,” that doesn’t change the fact that the actual cost of equipment and the share of investment in output (in dollar terms) may both be falling.

Back to reality

Clearly, Barro’s model – and not just his particular use of it – is absurd. A better alternative would focus on the political economy and business behavior. Such an analysis yields claims that are less absolute in their certainty; and that is a good thing.

In the real world, businesses invest for two reasons: to expand production and to reduce costs. The first reason requires confidence in future sales growth. The new tax law could be expected to boost sales in the near term, owing to its one-time fiscal effect. And yet it seems to take direct aim at middle-class purchasing power, by capping deductions for mortgage-interest payments and state and local taxes (SALT). That, in turn, will result in less consumer demand and lower spending on public services. Rather than creating a climate favorable to private consumption and investment, the law’s vast upward redistribution of income and wealth is bound to depress spending, regardless of whether businesses are allowed to retain a larger share of their cash flows.

Complicating matters further, the Fed’s response to the tax law, and what effect monetary-policy adjustments will have on the economy, remains to be seen. Historically, there have been occasions when an interest-rate hike set the stage for a long-term business boom, such as in February 1994, when Fed policy prompted banks to move out of safe instruments and back into commercial and industrial loans. But at that time, the technology revolution was still looming, and banks needed a push to decrease their reliance

on a steep yield curve. The same pattern is not likely to repeat itself today.

Today, if the Fed decides to increase interest rates more quickly, the value of the dollar will rise, and imported capital goods will become even more attractive relative to those produced domestically, thus hurting growth. Moreover, some analysts worry about an impending funding crisis in the rest of the world, which would trigger a flight toward safer assets such as Treasuries, further intensifying dollar appreciation. If that led to another financial crisis, the weak position of some of the world's largest banks would be exposed, and the period of growth would end. Barro's model has no place for financial risk. But the firms being encouraged to make new investments certainly do.

One area where the tax law could actually generate a boost is in commercial construction, if incumbent firms collectively decide to expand to protect their market share, an anticompetitive process the economist Joseph Schumpeter called "co-respective behavior." Likewise, the favorable tax treatment on structures might enable dominant firms to muscle in on the remaining market share of small retailers, restaurants, and other service providers. If so, we can expect to see a bubble, followed by a bust, in commercial structures.

The chances of this happening are not negligible. As the architects of the new tax package surely know, the last two economic expansions, in the late 1990s and in the mid-2000s, were the result of asset bubbles generated by co-respective behavior, first on the part of technology investors, and then on the part of speculators in corrupt mortgages. To be sure, a new bubble would generate some applause and political benefits in the short term. But the aftermath would not be pretty.

Oligarchs, rest assured

Barring a construction bubble, there are two other possibilities for the months and years ahead. First, the law might produce a surge in after-tax corporate cash flows, which will be diverted ("stolen" may be too strong a word, though only barely) toward executive compensation, stock buy-backs, and real-estate holdings, especially if homes, having lost their privileged tax status, are sold off and converted into rental properties. In this scenario, America's oligarchy may become somewhat larger and more diverse, and its spending could even provide a modest short-term boost to real GDP growth; but a bust would inevitably follow.

The other possibility is that corporations, having secured more favorable tax treatment, will actually *curtail* their investments. Corporate executives will not be blind to the prospect of a general slowdown in consumption following the law's initial fiscal effect, especially as state and local governments are forced to retrench under pressure from middle-class constituents who can no longer deduct SALT expenses at the federal level.

In this second scenario, the Polish economist Michał Kalecki's adage that "capitalists get what they spend" will apply. After-tax profits might *not* rise by much, and America's oligarchs will remain fat and happy, while doing even less. The cost will be borne by middle-class Americans with mortgages and homes that they might now want to sell; and, as always, by the poor, who will suffer from higher sales taxes, social-spending cuts, and unemployment.

And why should anyone expect a different outcome? After all, this isn't just Trump's tax plan. It is what the Republican donor class has always wanted.

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