Why was Trump's tax cut a fizzle?

By Paul Krugman
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Last week's blue wave means that Donald Trump will go into the 2020 election with only one major legislative achievement: a big tax cut for corporations and the wealthy. Still, that tax cut was supposed to accomplish big things. Republicans thought it would give them a big electoral boost, and they predicted dramatic economic gains. What they got instead, however, was a big fizzle.

The political payoff, of course, never arrived. And the economic results have been disappointing. True, we've had two quarters of fairly fast economic growth, but such growth spurts are fairly common — there was a substantially bigger spurt in 2014, and hardly anyone noticed. And this growth was driven largely by consumer spending and, surprise, government spending, which wasn't what the tax cutters promised.

Meanwhile, there's no sign of the vast investment boom the law's backers promised. Corporations have used the tax cut's proceeds largely to buy back their own stock rather than to add jobs and expand capacity.

But why have the tax cut's impacts been so minimal? Leave aside the glitch-filled changes in individual taxes, which will keep accountants busy for years; the core of the bill was a huge cut in corporate taxes. Why hasn't this done more to increase investment?

The answer, I'd argue, is that business decisions are a lot less sensitive to financial incentives — including tax rates — than conservatives claim. And appreciating that reality doesn't just undermine the case for the Trump tax cut. It undermines Republican economic doctrine as a whole.

About business decisions: It's a dirty little secret of monetary analysis that changes in interest rates affect the economy mainly through their effect on the housing market and the international value of the dollar (which in turn affects the competitiveness of U.S. goods on world markets). Any direct effect on business investment is so small that it's hard even to see it in the data. What drives such investment is, instead, perceptions about market demand.

Why is this the case? One main reason is that business investments have relatively short working lives. If you're considering whether to take out a mortgage to buy a house that will stand for many decades, the interest rate matters a lot. But if you're thinking about taking out a loan to buy, say, a work computer that will either break down or become obsolescent in a few years, the interest rate on the loan will be a minor consideration in deciding whether to make the purchase.

And the same logic applies to tax rates: There aren't many potential business investments that will be worth doing with a 21 percent profits tax, the current rate, but weren't worth doing at 35 percent, the rate before the Trump tax cut.

Also, a substantial fraction of corporate profits really represents rewards to monopoly power, not returns on investment — and cutting taxes on monopoly profits is a pure giveaway, offering no reason to invest or hire.

Now, proponents of the tax cut, including Trump's own economists, made a big deal about how we now have a global capital market, in which money flows to wherever it gets the highest after-tax return. And they pointed to countries with low corporate taxes, like Ireland, which appear to attract lots of foreign investment.

The key word here is, however, "appear." Corporations do have a strong incentive to cook their books — I'm sorry, manage their internal pricing — in such a way that reported profits pop up in low-tax jurisdictions, and this in turn leads on paper to large overseas investments.

But there's much less to these investments than meets the eye. For example, the vast sums corporations have supposedly invested in Ireland have yielded remarkably few jobs and remarkably little income for the Irish themselves — because most of that huge investment in Ireland is nothing more than an accounting fiction.

Now you know why the money U.S. companies reported moving home after taxes were cut hasn't shown up in jobs, wages and investment: Nothing really moved. Overseas subsidiaries transferred some assets back to their parent companies, but this was just an accounting maneuver, with almost no impact on anything real.

So the basic result of lower taxes on corporations is that corporations pay less in taxes — full stop. Which brings me to the problem with conservative economic doctrine.

That doctrine is all about the supposed need to give the already privileged incentives to do nice things for the rest of us. We must, the right says, cut taxes on the wealthy to induce them to work hard, and cut taxes on corporations to induce them to invest in America.

But this doctrine keeps failing in practice. President George W. Bush's tax cuts didn't produce a boom; President Barack Obama's tax hike didn't cause a depression. Tax cuts in Kansas didn't jump-start the state's economy; tax hikes in California didn't slow growth.

And with the Trump tax cut, the doctrine has failed again. Unfortunately, it's difficult to get politicians to understand something when their campaign contributions depend on their not understanding it.