Current Economic Conditions

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PUT UP OR SHUT UP

Republicans are celebrating the most significant tax reform since 1986, but the response of businesses will ultimately determine the impact of tax reform on economic growth, the outcome of the 2018 and 2020 elections, and whether the tax cuts last beyond 2021. If businesses don't respond to tax reform by increasing investment in plant and equipment and if these investments don't boost labor productivity and wages and salaries, a Democratic President and Congress will largely undo the Tax Cuts and Jobs Act when they take power in January 2021.

Three components of the tax reform bill will account for most of its positive impact on investment and economic growth: incentives for the repatriation of foreign-source income, immediate expensing of investment in equipment, and a reduction in the corporate tax rate. The new tax law will apply a special reduced tax rate to the accumulated earnings of foreign subsidiaries of U.S. corporations. Because this "deemed repatriation" tax must be paid whether or not the earnings are actually repatriated, it removes the tax disincentive to bringing foreign-source income back to the United States. But what will companies do with the money they repatriate? Opponents of tax reform argue that companies will use the money to raise dividends, buy back stock, and fund acquisitions. These are not necessarily bad, as some of the money paid to shareholders will find its way into productive investments, but they will not stimulate growth as much as spending the money directly on new plant and equipment.

Immediate expensing of investment in equipment, rather than depreciation over several years, will help steer some of the repatriated earnings and money saved via the cut in the corporate tax rate into such investment. (Real property with depreciation lives of more than 20 years must still be depreciated.) Public-finance economists like expensing because (in theory) it eliminates the impact of the corporate tax on investment decisions. With expensing, the corporate tax will make profitable investments less profitable, but won't make profitable investments unprofitable; the best tax shelter is a profitable investment.

With expensing, the corporate tax rate shouldn't affect the decision **whether** to make an investment, but in an open economy it does affect **where** economic activity takes place. That's why it was necessary to cut the corporate tax rate. As corporate tax rates in the rest of the world fell, while the U.S. rate remained stable at 35%, U.S. companies moved operations (and legal residences) abroad or were acquired by foreign companies. The cut in the corporate tax rate to 21% should stop that and should encourage U.S. and foreign companies to locate operations in the United States. If it doesn't, the rate cut will cause a big decline in federal revenue. If corporations want to keep the 21% tax rate beyond January 2021, they need to shift economic activity (or at least taxable profits) to the United States from abroad.

Greater investment in plant and equipment will boost the productivity of U.S. workers. This should increase real (inflation-adjusted) wages and salaries. If it does, the benefits from tax reform will be spread broadly across the U.S. population and the popularity of the tax reform bill will rise from current low levels. If real wages and salaries don't accelerate, the benefits of tax reform will accrue almost entirely to corporate shareholders. Since most people get most of their income from wages and salaries, real wages and salaries are the best gauge of how well the economy is doing for most Americans.

The tax reform bill will also reduce taxes for some “pass-through” businesses that are taxed on the owners’ individual tax return. Since corporate profits are taxed three times (by the corporate income tax and individual taxes on dividends and capital gains) and the income of pass-throughs is taxed just once, by the individual income tax, the case for a special tax break for pass-throughs isn’t very convincing, but I’m open to the possibility that it will cause these businesses to invest, hire, and increase wages. If it doesn’t, there will (and should) be a backlash, and the tax break should be repealed.

The rest of the changes in the individual income tax will do little to boost growth. Boosting consumer spending by cutting individual taxes makes little sense in an economy near full employment; boosting aggregate demand only makes sense when there is slack in the economy. In an economy that is close to full employment, we need to boost aggregate supply, i.e., the productive capacity of the economy, not aggregate demand. Barring a significant increase in immigration, unlikely under a Trump administration, that must be done through investment that increases the capital stock and boosts productivity. Many who favor cuts in individual income taxes think of themselves as supply-siders, but are just tax-cut Keynesians.

Equity analysts will pressure companies to distribute most of the corporate tax cut and repatriated earnings via dividends and stock repurchases. This would presumably lift stock prices, generally a good thing. In the past, higher stock prices led to more investment (a relationship summarized by Tobin’s q, named for Nobel laureate James Tobin), but this relationship seems to have broken down. Companies seldom fund investment through issuance of new stock, preferring some combination of retained earnings and borrowing. Perhaps limits on the deductibility of interest expenses will make stock issuance more attractive and reestablish the link between stock prices and investment. Barring that, tax reform won’t significantly increase investment in plant and equipment unless CEOs resist the pressure from the analysts and directly invest a significant share of their tax savings.

Companies should not make unprofitable investments to help the U.S. economy or to make tax reform look good – increasing dividends and buying back stock are clearly better than making bad investments – but companies should crunch the numbers and reevaluate whether and where to invest under the new tax system and the stronger economic growth rate it is likely to produce. Economists have long argued that U.S. companies don’t invest enough in plant and equipment. Some of the underinvestment was the result of disincentives in the tax system, but some is due to an anti-investment bias that arises because analysts are good at identifying (and criticizing) bad investments that were made, but not so good at identifying income foregone because of good investments that were not made.

Without a strong growth response, tax reform will cause a significant increase in the federal budget deficit and national debt that could eventually put upward pressure on interest rates and slow economic growth. If the economy grows at the 1.8% rate assumed in the Congressional Budget Office’s baseline forecast, tax reform will increase the national debt by $1.5 trillion over 10 years. If tax reform lifts growth by 0.3 percentage points, as forecast by the CBO and Joint Tax Committee, the increase in the debt is cut to $1 trillion. But if the economy grows at a 2.6% rate, the national debt will be no higher than in the baseline forecast. (That doesn’t imply that tax reform pays for itself if the economy grows at 2.6%; it could mean that the CBO’s baseline growth forecast was simply too low.)

I believe the new tax plan will boost economic growth, but what economists believe and what econometric models tell us matter much less than what leaders of big corporations and owners of small businesses do in response to tax reform. So far, many large companies have responded by paying $1000 bonuses to employees. This will help the economy and the popularity of tax reform in the short run, but if tax reform is to be a long-term economic and political success, and if it is to remain in effect after 2021, U.S. and foreign companies will have to move economic activity to the United States and invest in new plant and equipment, as Apple and Fiat Chrysler are doing. President Trump needs to use the power of the Presidency to encourage such behavior. Nothing else would benefit the U.S. economy or his own political future more.

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