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Why the Tax Act Will Not Boost Investment

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Will lower corporate taxes generate an investment boom? The evidence suggests not.

Michael Brochstein/Sipa USA/AP Images

Wishful Thinking: Kevin Hassett, chair of Trump's Council of Economic Advisors

The centerpiece of the Republican Tax Act signed into law at the end of last year was the cut in the corporate income tax rate. The reduction in the tax rate from 35 percent to 21 percent, along with other reductions in business taxes, accounts for almost 40 percent of the $1.6 trillion projected gross cost of the tax cuts.

Since the law passed, most of the discussion has focused on the division of the benefits of the corporate tax cuts between shareholders and workers. On this score, the shareholders look to be the big winners. According to an analysis by Americans for Tax Fairness that focused on the public announcements from the country's 500 largest corporations, share buybacks announced since the law's passage have totaled more than $400 billion compared with $6.1 billion in announced bonuses or pay increases, with the vast majority of this money falling in the category of one-time bonuses.

It is also worth noting that companies were effectively getting paid to announce bonuses as soon as the law was passed. A bonus announced in calendar year 2017 could be written off against the

35 percent corporate income tax rate in effect that year even if it would be paid in 2018. In contrast, bonuses that were not announced until 2018 could be deducted only at the new 21 percent corporate income tax rate. As a result, a company like AT&T, which announced one-time bonuses of roughly $200 million in December for its employees (equal to less than 10 percent of its annual tax savings), was effectively paid $28 million to make its announcement in 2017 rather than wait until January. This is in addition to the benefits of getting into the good graces of a notoriously capricious president.

However exciting this shareholder-versus-worker scorekeeping might be, it actually is beside the point if we take the Republicans' claims about the tax cut seriously. Their argument was not that if we give tax cuts to corporations, the corporations would pass them on to workers. If that were the case, it would be much simpler just to give the tax cuts to workers. They argued that the big gain to workers would be through an indirect channel. Their story was that lower corporate tax rates would lead to a huge increase in investment, which would in turn increase productivity, which would then lead to higher wages.

Kevin Hassett, the head of Trump's Council of Economic Advisers (and a friend), was the leading promulgator of this view. Hassett was not just arguing this position to justify the Trump tax cut; he is a true believer. He has been doing research for decades that finds investment to be hugely sensitive to tax rates.

Hassett argued that the reduction in the corporate tax rate would spur enough investment to boost the capital stock by roughly a third after a decade over its baseline growth path, increasing output and wages by 10 percent over the baseline levels. That forecast is the basis for the 3 percent annual GDP growth assumed in the Republican projections, as compared with a growth rate of under 2 percent projected by the Congressional Budget Office.

It is also how the Republicans could claim that a tax cut amounting to a bit over $1,000 per year per household would raise family incomes by more than $4,000. The claim depends entirely on the additional growth that will result from the lower tax rates. The distribution of the initial tax cut itself is trivial by comparison.

Looking at a limited set of countries over the last few decades, Hassett's work finds that lower corporate tax rates are associated with higher real wages. Other research on variations in state tax rates in the United States and provincial tax rates in Canada finds similar results, so there is some basis for the claim about growth and higher wages.

These studies, however, have to be put up against a larger body of research that examines the determinants of investment. The primary channel through which a lower tax rate would boost investment is by reducing the after-tax cost of capital. Paying a lower tax rate effectively makes it cheaper to invest.

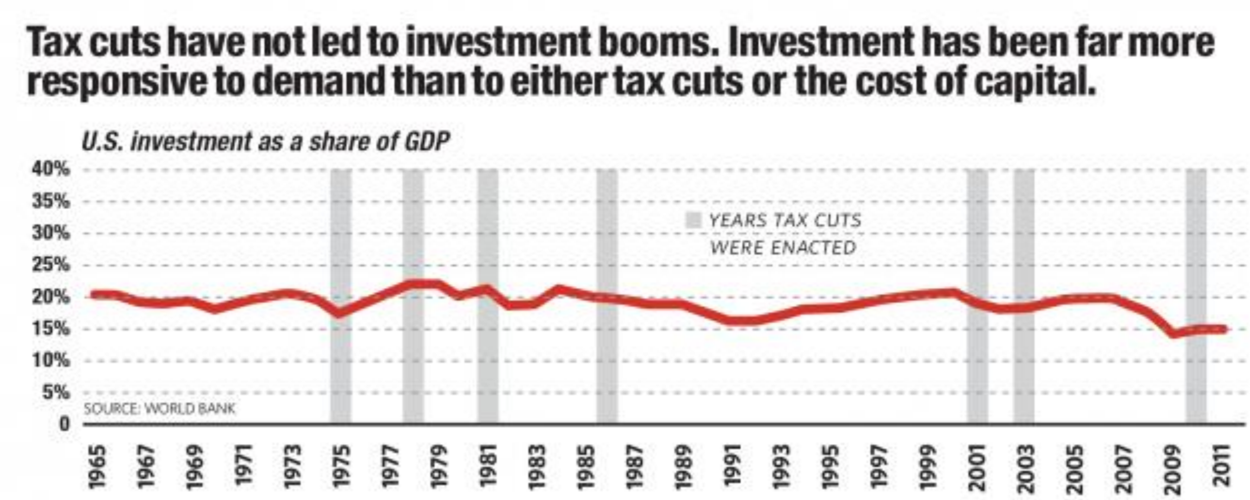
The research on this issue is extensive, and most of it finds that investment is relatively unresponsive to changes in the cost of capital. This is part of the story of weak investment in the recovery from the Great Recession. The interest rate that companies have had to pay in recent years on borrowed money has been at historically low levels. For example, the interest rate on AAA bonds is currently at 4 percent and has been as low as 3.5 percent. With an inflation rate of around 2 percent, this comes to a 2 percent real interest rate. That compares with a real interest rate near 4 percent during the late-1990s investment boom.

The story is the same with lower-quality BAA bonds, which now have a yield of 4.8 percent for a real interest rate of 2.6 percent. In the late 1990s, the real interest rate on these bonds averaged over 5 percent. Investment, in other words, has been far more responsive to demand growth than to the cost of capital.

The same story emerges from careful micro-level analysis of firms' investment decisions. A series of studies that Washington University professor Steve Fazzari did in the late 1980s with Glenn Hubbard, George W. Bush's chief economic adviser, found the cost of capital to be a minor factor in determining firms' investment decisions, especially for new firms. Sales growth was a far more important determinant.

There is another reason for questioning the impact that cutting the corporate tax rate will have on investment: We tried this trick before. The 1986 tax reform lowered the corporate income tax rate from 46 percent to 34 percent. This is almost as large a reduction as the one in the new law. (The way to think about the size of the cut is the share of profit pocketed by the company. The 1986 tax cut increased the share from 54 percent to 65 percent, a 20.4 percent increase. The 2017 tax cut raised the share from 65 percent to 79 percent, a 21.5 percent increase.)

Unfortunately, no investment boom followed the 1986 tax cut. In fact, investment fell slightly when measured as a share of GDP, going from 13.2 percent of GDP in 1986 to 12.6 percent in both 1987 and 1988. This history does not seem consistent with the view that investment is hugely responsive to the corporate tax rate.



But we don't have to rely on history, since for better or worse, the tax cut is now in place. While it is still early in the game, if the Republicans' story were true we should already be seeing higher capital goods orders. Keep in mind, their story is not that the tax cuts would lead to a modest rise in investment; they claimed the tax cuts would increase the size of the capital stock by one-third after a decade. To hit that level would require an increase in annual investment of roughly $600 billion over baseline growth of 25 percent.

Although the bill was signed into law at the end of December, businesses already knew in September that a large cut in the corporate tax rate was likely. If tax rates were a large factor in investment decisions, we would expect that dynamic firms would have begun planning for investments they would make if the tax law passed. The bill then passed the Senate in the middle of December, at which point it was absolutely certain that corporations would be paying a lower tax rate.

To be sure, it takes time to get investment in place, but if there is really going to be a flood of additional investment, it should show up in companies' plans for investment. The best national measure of those plans is the Commerce Department's data on capital goods orders, which is released monthly. The data for December through March don't support the investment-boom story.

If we pull out aircraft, orders for non-defense capital goods were just 0.5 percent higher in March than in December, translating into a meager 2 percent annual rate of growth. Even including aircraft orders, the year-over-year increase was 12.4 percent. This is a respectable growth rate, but very far from a pace that would increase the capital stock by a third over baseline growth in a decade.

In fact, there have been many times where spending increased more rapidly in the recent past without the benefit of a huge tax cut. For example, in the first half of 2012, the growth in orders compared with the prior year averaged 17 percent. Going slightly further back, capital goods orders grew an average of 9.4 percent in the first six months of 2007 compared with year-earlier levels, and 12.2 percent in the first half of 2006. These were not years in which anyone thought we were experiencing an investment boom.

The National Federation of Independent Business provides another measure of intended spending based on a survey of its members. This measure showed a slight increase in the percentage of members planning to increase capital expenditures in the next three to six months immediately following passage of the tax cut, with the share going from 26 percent in November to 29 percent in February. But it then fell back to 26 percent in the March reading. By comparison, the share had been as high as 29 percent back in August 2014 when Barack Obama was in the White House. The index averaged over 30 percent in the years preceding the recession.

Several of the regional Federal Reserve banks conduct surveys of business conditions in their districts that also ask about plans for investment. The results from the New York district, the Philadelphia district, and the Chicago district all tell pretty much the same story. Investment is expanding at a moderate pace along with the overall economy, but there is zero evidence anywhere of an investment boom induced by the tax cut.

The tax cut proponents will undoubtedly object that it is too early to make much of the data we have, but remember, their claim was the tax cut would lead to a huge surge in investment, implying that businesses are very responsive to changes in the tax rate. If investment decisions really depend on tax rates to the extent they claim, it is difficult to believe we wouldn't be seeing evidence, at least in businesses intentions, of more rapid investment growth. And without this growth in investment, the corporate tax cuts look like just another way to give money to the richest people in the country who own most of the stock in the corporations getting the tax cuts.

One additional point about the Republicans' projection of 3 percent GDP growth ought to be mentioned. Contrary to what many economists have claimed, the idea of growth at that pace is not outlandish. GDP growth is the sum of labor force growth and productivity growth. Given the demographic trends, labor force growth will average less than 1 percent, but the productivity part of the story is much less certain. Although productivity growth since 2005 has averaged just over

1 percent annually, it averaged 3 percent from 1947 to 1973 and again from 1995 to 2005. It could approach that level once more.

After all, this is what job-killing robots are all about. If just a small portion of the claims about massive displacement from robots and artificial intelligence prove to be true, the resulting productivity growth could push GDP growth to the 3 percent range promised by the tax cut proponents. But it would have little, if anything, to do with a tax cut that will needlessly transfer hundreds of billions of dollars to the country's richest people.