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Roundtable: Economic Policy in the Age of Trump
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America's Policy Thinking in the Age of Trump

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I hugely appreciate the opportunity to speak here in these worrisome times. I can't help recall that at this very Roundtable last year in Chicago I said that Trump is like the 1920s Mussolini: bullying companies and individuals who get in his way. He is dangerous. Today, however, my subject is the new tax bill – particularly the corporate profits tax cut.

1. What is the illness of the American economy – the symptoms and causes – that the tax overhaul is intended to address?

▪The *symptoms* – for several decades – include meager rates of return to investment, wage rates growing at a snail's pace (total labor compensation has done better), pathological fiscal deficits and rising numbers unwilling or unable to participate in the labor force. (Many are on drugs or in prison)

▪The *immediate cause* of all this is the ongoing *productivity slowdown* that started in America around 1968 and spread to France around 1998, and to Britain and Germany around 2004. The "booms" will not change that.

▪The *underlying cause* of these slowdowns is the *net losses* of *aggregate indigenous innovation* in those nations – despite the digital revolution.

▪And, as I have argued before, these innovation slowdowns stem *not* from a dearth of possibilities and *not* mainly from omissions of the public sector (like infrastructure) but from a major loss of the old *mojo*: a *decline of the* *modernist values* that fuel the *dynamism* of those economies.[1] Economists back then missed this. They were Schumpeterians believing that the innovations we observe were obvious applications by an experienced entrepreneur of a scientist's discovery or Hayekians believing that what we really observe are merely the "adaptations" that result when unseen and evolving opportunities are intuited by an insightful businessman."[2]

A social upheaval has resulted: For one thing, while wage rates have been near-stagnant, private saving – particularly, saving out of profits and enormous capital gains – continued apace, so the wealth-wage ratio and asset prices climbed to vertiginous levels. Established wealth grew more powerful and wealth managers did well. In industries badly hit by foreign trade or automation, many jobs were lost and wages actually declined. As these new developments continued, they exerted increasing pressures on society and, ultimately, there was – figuratively speaking – a shift of the tectonic plates: Some economic groups have shifted their votes.

Remarkably, most politicians took no notice. When Hillary Clinton gave her first campaign speech, she spoke only of social justice for marginalized groups. She focused on groups she judged had no interest in the economy.[3] There was no sense that the nation's economy had largely *lost* – some 6 decades ago – *the sustained growth* it had been generating – despite depressions and inflations – since the 1820s or so.[4]

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[1] This is the main thesis of my book *Mass Flourishing* (Princeton University Press, 2013).

[2] See Joseph Schumpeter's 1912 landmark *Theorie der wirtschaftlichen Entwicklung* and, for example, Friedrich Hayek's widely known article, "The Use of Knowledge in Society," reprinted in his collection *Individualism and Economic Order* (Chicago, University of Chicago Press, 1948.

[3] Hillary Clinton, Speech, Roosevelt Island, New York City, June 2016.

[4] For a vivid portrait of that period see Paul Johnson, *The Birth of the Modern* (New York, Harper Collins, 1991.)

The Democratic Party – the Party of some 80 per cent, I would guess, of the people in this room, including me – became fascinated by notions of "fairness" – of what academics call the *just economy* – apparently without noticing that the nation had been operating for decades without a *good economy*: Many participants had little possibility of earning enough to feel included, little chance of a job that is engaging and little chance of having the experience of succeeding at something. The Democrats put the cart before the horse: We need a *good* economy, then a *just* way of rewarding participants for the contributions that this economy helps them to make.[5]

2. What about the Republican prescription, its effects and values?

On winning the election, Trump and the Republicans in Congress evidently wanted to run with the ball into the opening left by the Democrats. Their tax bill is their response to weak investment and stagnant wage rates in most of the economy. This raises the issue of the deep cut in corporate profits tax – from 35 per cent to 21 per cent.

The theorists supporting the legislation adopt a standard textbook model in which investment activity drives the capital stock to the steady-state level where the after-tax rate of return, or marginal product of capital – $(1-\tau)\, f'(k)$ in the usual notation – has diminished to the level of the real rate of interest – denoted r^*. The latter is exogenous: either the rate of pure time preference in the nation or the exogenous world rate of interest.

These supporters then reason that the tax cut, in causing the after-tax rate of return to jump up, will in turn yank up investment activity and thus cause the capital stock to grow and thus productivity to rise *until* the capital stock

[5] Ancient philosophers spoke of *boni et aequi* – "the good and the just," not "the just and the good." David Sidorsky, revered philosopher at Columbia, wrote me that he agreed with me.

clicks into a new steady state – in around 10 years, they calculate. See the appended supply-and-demand diagram.

But thisis so short-termist. No reason is offered for thinking that growth will be created *after* the 10 years of growth in the capital stock. The lift to the growth rate of capital, productivity and incomes is only *temporary*. As long as the economy is still missing the volume of indigenous innovation needed to generate the high growth of our golden past (stretching from around 1830 to around 1970), the rate cuts of the Republican tax bill are only stop-gap – and even those are far from enough to deliver *fast growth* over the next decade.

More fundamentally, we ought to ask whether it is *sound* to believe that the tax cut can reasonably be expected to generate *some pick-up* in productivity growth. I am not sure. The tax cut can reasonably be feared to add to the annual fiscal deficit and to the public debt at the 10-year mark; and that, I will argue, may block investment, which will impede growth.

When I was a young economist writing a monograph called *Fiscal Neutrality toward Economic Growth*, I would have said, in view of the favorable short term conditions, it would be better to *raise* tax rates across the board to the levels needed to stop the fiscal hemorrhaging in the federal government! Such a move might bring a sharp rise of bond prices and a drop in yields, thus a considerable drop of interest rates over the entire yield curve and a sharp rise of share prices – provided that the Fed did not offset this development with large sales of its bond holdings.

As a young student, I remember when the Republicans in Congress were vocal in their opposition to fiscal deficits – and a Democrat, President Harry Truman, enacted a run of fiscal surpluses aimed at mopping up the federal debt. (Inflation also helped to decimate the real value of the debt.) No depression occurred – only the 1949-50 recession. Now, of course, crude Keynesianism is so deeply ingrained in voters that any program to run a fiscal surplus or just fiscal balance has become unthinkable. (Shame on us that the economics they learned is so awful.)

From that perspective, I am wondering whether the tax bill may arouse worries that the resulting additions to the federal debt – on top of the debt added by supply-sider Bush and Keynesian Obama – may raise concerns about the soundness of the government debt, thus pushing up interest-rate risk premiums in anticipation of these consequences and pushing the dollar down. (Yes, the Republican tax bill does take steps to raise some revenue and cut some spending. But that is not totally reassuring.)

From the supporters' own perspective, it should be noted that the supposed rise in investment activity will immediately cause a real appreciation of the dollar, so that the real value of the dollar will be expected to be depreciating over the future – back to the where it had been. (Otherwise, no one would want to go on holding foreign capital.) In standard models, a consequence of that dollar appreciation is a shrinkage of export demand – paradoxically, something that Trump did not want. Yet we knew something had to give.

In customer-market models, there is also a positive effect: The dollar appreciation will cause domestic firms in import-competing industries to cut their markups so that potential competitors from overseas are less interested in invading the domestic market. The consequence here is that wage rates are pulled up along with the amount of labor supplied. Thus *these* industries will show an expansion of output and employment.

But from a very different perspective, the scenario envisioned by proponents of the tax cut is not a sure thing. Can we depend on the tax cut to quicken business investment and go on doing so until the marginal productivity of *capital* has fallen enough to raise substantially the marginal productivity of *labor*? It is a possible scenario, but it is not clear it will be realized. We have little idea what will happen.

As Roman Frydman and I argued in an op-ed last month, the real-life American economy is not a "mechanical system in which tax parameters and other inputs (such as the capital stock) explain exactly how investment occurs and the economy grows." [6] We possess agency: We can imagine and go on to create what we have imagined! For example, new *visions* by innovators – or losses of some of the visions that exist – and new *confidence* on the part of entrepreneurs – or losses of confidence by entrepreneurs – can place investment and wage rates onto paths that are nothing like the paths described by the textbook model the academic supporters of the tax cut have relied on. We cannot tell what is going to happen following the tax cut because many people may be conceiving, creating, discovering, trying to invent and attempting to innovate – or they may stop doing those things. We just don't know where they are taking us and how far. The tax cut may be a drop in the bucket – and not worth the side-effects on solvency.

I think the uncertainty goes deeper than that. The problem is not only that the *disturbance terms* may be enormous, overshadowing the effects of the tax cut and perhaps making it less valuable. There is the problem that the *coefficients* that are measures of the effectiveness of the tax cut in raising investment and wage rates may have shrunk in recent years or

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[6] Roman Frydman and Edmund Phelps, 'We can't predict the effect of the tax bill on investment and growth,' MarketWatch, 20 December 2017.

decades. In the minds of some, our economy may come to be blanketed by a wave of investment in robots and artificial intelligence and *that* kind of investment may be disastrous for wage rates and employment – at least in the near and medium term. I have suggested recently that what we call the natural unemployment rate can be affected by insecurity and fear.[7] Similarly, that tax cut may scare corporation heads from investing. So, it seems to me we may be far from a return to rapid growth of wage rates.

I would also maintain that the *coefficients* in the equations of our growth models are not foreknown or knowable: If the innovators driving or failing to drive gains in productivity cannot be sure what path their new products or methods will take – or whether they will be adopted at all – how can economists foretell how much investment is going to take place per unit of tax cut and how efficacious this investment will be in driving up the marginal productivity of labor? For example, if artificial intelligence is going to stimulate our technologies that actually reduce wages (and jobs) of many employees in some industries, we cannot be sure whether the new tax cut will be *positive* or *negative* for wage rates and employment. Will the Republican tax plan unleash collapse or noticeably faster growth of both productivity and wages? We do not really know. That does not mean that we ought not to try new departures in the hope of making some progress. As the hero says to Cunégonde in the musical *Candide*, "We'll do the best we know."[8]

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[7] Edmund Phelps, "Nothing Natural About the Natural Rate of Unemployment," *Project Syndicate*, November 2, 2017.

[8] Finale for sextet, *Candide*, music by Leonard Bernstein, lyrics of the sextet by Richard Wilbur.

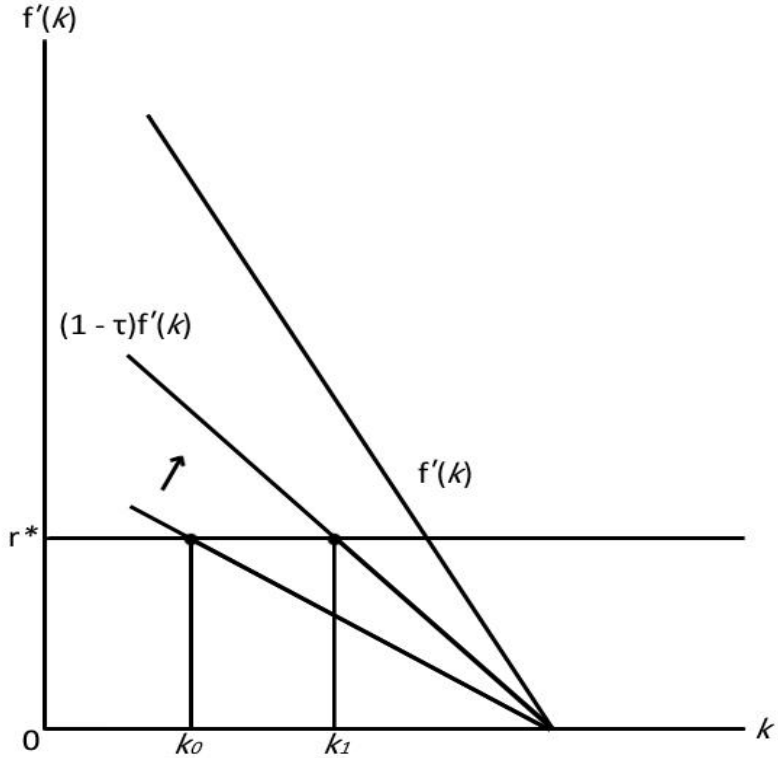

Figure: Rate of Return and Interest Rate Determine the Capital Stock