U.S. Economic Outlook:
Effects from Tax Cuts, Trade War, etc.

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Focus on Four Macroeconomic Policies

• Tax reform

• Regulatory reform

• International trade policy

• Infrastructure investment
2017 U.S. Tax Reform

• 2017 tax change sharply cut C-corporate tax rate—main federal rate fell from 35% to 21%. Also introduced 100% expensing for business equipment.

• For individuals, cut in average US federal marginal tax rate in 2018 substantial—3.2 percentage points. Adjusted to 2.3 points after factoring in reduced deductibility of state income taxes.

• Comparison: smaller tax-rate cut than Reagan 1986 (4.5 points) and Kennedy-Johnson 1964 (3.6 points), similar to Bush 2003 (2.1 points).
Macroeconomic Effects of Tax Cuts

• Individual rate cut found in empirical studies to have substantial short-run positive effect on GDP. Estimated to raise GDP growth rate 0.9% per year 2018-19. No continuing growth effect, but permanent level effect.

• Business tax cuts estimated in my research with Jason Furman (Brookings) to raise capital formation. In long run, corporate capital per worker up 13%, output per worker up 5%. Wage rates up correspondingly.

• Estimated GDP growth rate up 0.2% per year—moderate, but persisting, out 10 years or more.
Bottom Line on Tax Effects

• Estimate that 2017 tax package raised GDP growth rate 1.1% per year 2018-19. Main effect (0.9 points) from individual income tax, remainder from business, especially corporate.

• Over next 8 years, growth rate higher by around 0.2 percentage points per year because of expansionary effects of business tax changes on long-run levels of capital-labor ratios and GDP per worker.

• Hence, main short-run growth response from changes in individual income tax; main long-run response from changes in business taxes, especially C-corporate.
Regulations

• Examples of cuts in energy, environment, financial. Indication that overall growth in U.S. federal regulation stopped by 2017, shown by RegData from George Mason University. Counts number of words in US Federal Register that connote government restraint on economic activity. (Also available by sector.)

World Bank’s *Ease of Doing Business*


• World Bank measure includes cost of starting business, ease of construction permits, cost of electricity, cost of paying taxes, cost of int’l trade, ease of getting credit, cost of registering property, ease of closing business (insolvency), contract enforcement, treatment of minority investors. Also measures for labor market, govt. procurement (pending).
International Trade Policy

• Serious risk from trade war for US and world economic growth. “Trade wars are good, and easy to win,” President Trump, CNBC, March 2018.

• Driven by mercantilist idea that selling goods (exports) good, buying goods (imports) bad. In fact, giving up things (exports) is cost of getting what one wants—imports of final consumer goods, intermediates, investment goods.

• Irony is that mercantilist idea shared by President Trump and Chinese leaders (and many other world leaders).
Benefits of International Trade

• In the main, exports & imports move together; key metric is volume of trade, which captures efficiency benefits from expanded trade.

• Benefits brought out in David Ricardo’s classical theory (comparative advantage) based on differences in factor endowments. Economists Paul Krugman, Elhanan Helpman extended in 1980s to countries’ relative strengths related to investments in different areas of specialization.

• Trump reverses economic logic. “China draining $500 billion per year from US.” Exchange of good quality Chinese goods mostly for US Treasury bonds means that we are dumped on?
Navarro’s Trade Theory

• Trump relying on trade theory advanced by adviser Peter Navarro, who noticed that imports appear with minus sign in identity for GDP (GDP equals consumption plus domestic investment plus exports less imports). Concluded that tariff-induced drop in imports implies GDP up—domestic production magically rises to meet demand for consumption & domestic investment previously serviced by imports.

• In fact, tariffs by U.S. and China lead to drop in overall trade and, hence, in US and China GDP.
China’s Trade Restrictions

• Trump correct that Chinese have been restricting international commerce. Partly by curbing imports, partly by inhibiting entry & operations of foreign businesses.

• Also true that Chinese have been stealing technology, partly directly, partly by insisting that business deals include forced technology transfer. ("Theft" not a word that China will tolerate here.)

• Irony is that relaxation of China’s trade restrictions would help Chinese economy. They have recent laws that might help—protection of intellectual property rights, free-trade zones.
Outcome of Trade War?

• Some months ago, hope that threat of mutually destructive trade war would lead to US/China agreement with reduced restrictions and tariffs. Apparently were close to deal.

• But it was odd to include quantitative list of US exports that China would buy in added volume. China happy to proceed in this command-and-control manner. But US supposed to think of market deciding which goods to trade in what volume. Not dictated by politicians & lawyers specifying amounts of agricultural goods, Ford pickup trucks, Boeing airplanes.
Trump Loves Tariffs

• Core problem is that Trump genuinely loves tariffs—impede “bad” imports and raise revenue. What is there not to love?

• Unlike many economic arguments he has made, tariff advocacy seems sincere, commitment to this approach likely irrevocable. Therefore, hard to see how US can strike deal with China, which wants all tariffs from 2018-19 rescinded. And China knows they cannot trust Trump on terms of deal.

• More broadly, Trump likely to extend trade war to other countries, including Japan, Europe, Mexico, Canada, Brazil, Argentina.

• Highly risky situation, reflected in volatility of US & world stock markets.
Infrastructure Investment

• Needed in US for highways, airports, water systems. Railroads? Major investment could spur productivity & growth. Key issue is costs.

• Situation summarized by April 2019 meeting at White House between President Trump & Congressional leaders.

• Apparently, Trump started by proposing $1 trillion additional spending on infrastructure.
More on Infrastructure

• Congressional Democrats supposedly countered by saying we should spend added $2 trillion.

• Reports are that Trump then agreed. Both political parties happy to spend more money.

• Symptomatic of current Washington idea that government spending free if financed by printing bonds or money.
Further on Infrastructure

• Ricardian equivalence says real cost of government is amount spent, regardless of whether financed by borrowing or current taxation. Does not imply spending free! Cost of infrastructure is amount spent, such as $2 trillion.

• Money creation another form of tax, ultimately related to inflation (which can return).

• Large program of US infrastructure investment might be good idea, but only if included in broader fiscal reform (like 2010 Simpson-Bowles Commission) that includes efficient methods of raising revenue and control over entitlement spending. A key question is whether VAT would be included. No current appetite for broad fiscal package.
U.S. Economic Outlook

• Performance strong through early 2019, in line with Furman & my forecast based especially on tax package. Looked for a while like 3% US GDP growth for some time. Results weaker since 2019.Q2.

• Much of downward movement of growth rate likely reflects destructive trade war. Also fiscal uncertainty coming from Washington DC.

• GDP growth 2019.Q2 and 2019.Q3 2.0% per year. Atlanta Fed’s GDPNow report forecasts 2.0% GDP growth for 4th quarter. Their forecast factors in array of monthly indicators. Forecast as of 11/15 only 0.4%. Up since then to 2.0 because of favorable personal income, manufacturing, last Friday’s strong employment report.