
Tax Cut and Tech Brighten US Economic Outlook

By Stephen Slifer Thu, Nov 22, 2018

'I believe sustained investment spending and faster productivity growth will boost potential GDP growth from 1.8% to 2.8% within a few years,' writes our guest columnist.



“This time is different.” Economists say that all the time, but it never is. But we believe this time really is different largely because of improved fiscal policy and technological developments. The combination of the two is boosting GDP growth, not just for a year or two but for a protracted period, causing our standard of living to climb more rapidly, keeping the inflation rate in check, and fundamentally altering the oil market. The economic future of this country is far brighter today than it was a decade ago.

First, it is difficult to over-estimate the importance of the corporate tax cut. In 2015 and 2016 growth in investment spending came to a halt as business confidence sank. That was the worst performance for investment since the recession. Productivity growth slowed to a trickle. GDP growth shrank to a disappointing 2.0% pace, which became “the new normal.”

But then Trump pushed through his corporate tax package, which included a cut in the corporate tax rate from 35% to 20%, the ability for large multi-national firms to repatriate overseas earnings to the U.S. at a favorable 15% tax rate, an immediate tax deduction for equipment spending, and a massive movement to eliminate unnecessary, conflicting and confusing government regulations. Suddenly corporate confidence soared. Business leaders opened their wallets and began to spend money on investment.

The pickup in investment spending lifted productivity growth from 1% to 2%. That, in turn, boosted GDP growth from a sleepy 2.0% pace to 3.0%.

But is the recent faster GDP growth a temporary spurt triggered by the tax cuts, or something longer lasting? We believe it is the latter. The 20% corporate tax rate is now competitive with almost all other developed countries. Massive deregulation encourages businesses of all types—small firms in particular—to formulate long-term plans and invest

accordingly. The tight labor market encourages firms to spend money on technology to make existing employees more efficient, thus increasing output without increasing their headcount. In economic jargon, they are substituting capital for labor, which boosts productivity growth.

If the pickup in investment spending lasts, productivity growth will accelerate from its anemic 1.0% pace to a steady 2.0%. That will boost the economy's speed by one percentage point from 1.8% to 2.8%. A near-3.0% GDP growth rate is welcome relief from a few years ago.

If GDP growth accelerates by 1.0%, our standard of living will grow by 1.0%, from today's 1.5% to 2.5% by the end of the decade. This faster GDP growth comes about partly because of the fiscal policy described above, but also because of technology.

Technology has altered our way of doing business. The Internet came into existence in 1995. The cloud and apps followed in the early 2000s. Those developments revolutionized the way that we all communicate with each other.

Amazon was founded in 1994 and followed quickly by eBay and Google. On-line shopping skyrocketed. Before we purchase anything today, we check prices on the Internet. We can find the lowest price anywhere around the globe. As a result, traditional brick and mortar stores have no pricing power. Should they choose to raise prices, they lose sales. This is having a profound influence on the inflation rate.

In the past year the core CPI has risen 2.2%. If we split the CPI into two parts—goods and services—we find very disparate movements. In the past year, goods prices have declined 0.3%. In contrast, services have risen 3.0%. This outcome highlights the complete inability of goods-producing firms to raise prices.

In the absence of online shopping, we would be looking at a 3.0% inflation rate today rather than 2.0%. That would be far above the Fed's 2.0% inflation target, and with 3.0% GDP growth (well in excess of the Fed's estimated 1.8% potential growth) the Fed would be raising interest rates aggressively and the end of the expansion would almost certainly be in sight. But technology has changed that scenario. Inflation remains close to the Fed's target, which means the Fed can pursue a very gradual return to higher rates with little risk of dumping the economy into recession. All because of technology.

Finally, think about the oil market. Technological improvements like fracking and horizontal drilling have caused U.S. oil production to double in the past seven years.

As a result, the U.S. has surpassed Saudi Arabia and Russia and become the world's largest producer of crude oil. Next year the U.S. Department of Energy expects U.S. output to climb an additional 10% and further widen the gap between U.S. production and that of its two closest rivals. As a result, OPEC countries no longer have a stranglehold on global oil production. Should they choose to curtail production to inflate oil prices, U.S. drillers can quickly step on the gas and counter much of the shortfall. The U.S. has become a major player in the global oil market. Because of technology.

The world is a different place today than it was 10 years ago. Improved fiscal policy caused by the tax cuts and deregulation have re-invigorated the previously dormant U.S. economy. Technology has changed the entire economic landscape. Because economists have no relevant history to use as a model for the future, we are all flying by the seat of our pants. I believe sustained investment spending and faster productivity growth will boost potential GDP growth from 1.8% to 2.8% within a few years. Others think the recent GDP surge will soon fade and that a recession is looming by 2020. Who is right?

Then, to what extent can we count on technology to suppress inflation?

Finally, how much has the revival of U.S. oil production altered the balance of power between OPEC countries and the rest of the world? What does that mean for oil prices?

Keep in mind that technology is not static, which raises even bigger question. What next "big thing" will fundamentally alter the economic landscape? These sea changes make economics fun—but also challenging.