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Judge US tax reform on wage growth, not share buybacks or staff bonuses

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Even before Donald Trump had signed his tax reform into law, his opponents had company-level stories at the ready.

Pfizer, Coca-Cola and Cisco Systems had said they intended to use any immediate gains from rate cuts to increase dividends and buy their own shares. Instead of increasing wages as promised, Democrat critics were certain this showed wealthy shareholders were the beneficiaries of major cuts to corporate taxes.

So who can blame Republicans for drawing on contrary evidence after the signed Bill slashed the headline rate from 35pc to 21pc? The apparent good news just kept on coming for the president. Wells Fargo increased their company minimum wage to $15 an hour and pledged to donate $400m to charity, citing the tax Bill's effects. AT&T said they would give a $1,000 bonus to more than 200,000 US employees. Others, such as Fifth Third Bancorp, pledged to both give bonuses and increase basic pay.

Yet despite the despair on the Democrat side or the backslapping by Republicans, attaching too much weight to either set of company announcements would be erroneous. The success or otherwise of the corporate tax change cannot and should not be judged by company bonus or share buyback decisions. The acid test of the reforms, which cuts rates and allows immediate expensing on equipment, is whether it increases corporate investment, in turn raising productivity and wages.

Yes, the immediate effect of a corporate rate cut is indeed a windfall to "old capital". Existing investments obtain higher after-tax returns than envisaged. This is a big reason why the stock market surged as tax-reform prospects improved. All else the same, profitable companies find themselves with more cash, deciding what to do with it based upon their short-term investment opportunities, the health of the labour market and much else besides.

Where Democrats are wrong is to assume that dividend payments, or buybacks, are themselves a "bad thing" for the economy. If a company has little near-term investment opportunities, payouts to shareholders might make sense. And it's not as if that money is going to be burned out of existence. It will most likely be reinvested by shareholders elsewhere.

One-off bonuses may likewise help show the trade-off of taxes in terms of more resources left in the private sector. But it's easy to suspect some companies saw a good PR opportunity. Sharing some of the burgeoned post-tax profits with workers helps entrench the tax reform they desired and wins favour with a president who regularly wades in with very public opinions on

companies. Some firms would probably have increased wages anyway, given the health of the economy.

No, the stated aim of the administration was not these short-term "wins", but to reverse the decade of peak-to-peak wage contraction seen between 2007 and 2016. The president's economic team believes the dramatic fall in the rate of capital deepening a key cause of this, reducing the amount of stuff that people can produce per hour. If this is the real problem, then reversing policies that deter capital investment in the US makes sense. There was no lever more obvious than the US's very high statutory corporate rate.

The key judgment on the reforms is whether investment will increase when the after-tax marginal return on it rises. There's strong theory and evidence to suggest it will, and that workers will benefit as a result. But it may take time.

Take the academic research of economist Eric Ohrn. Between 2002 and 2008, he examined a number of US states that adopted a full-expensing policy in their state corporate income taxes, similar to what the Trump plan will deliver for equipment investment. He found this raised investment by 17.5pc and wages by 2.5pc within just two to three years. A more recent, broader study of his estimated that "a one percentage point reduction in [effective] tax rates increases investment by 4.7pc of installed capital".

Basic economics would tell us that in the long run, capital is very responsive to changes in taxes given how mobile it is. In the short term it can be tied up in existing projects, but lowering a corporate rate over time can attract it from overseas and from non-corporate sectors such as housing.

It follows that the factor of production most likely to bear the cost of the corporate tax in the long-term is labour, through lower wages. Lowering corporate tax rates and allowing the scope for more generous wage increases should therefore lift pay.

Earlier this month, economist Robert Barro estimated that the Republican package would do just that. Through reducing the cost to firms of acquiring and deploying capital, he calculates the amount of capital per worker could rise by 14pc for equipment and 20pc for structures in the very long term, raising real wages as much as 7pc.

Over the coming years then, it's not bonuses or the degree of share buybacks from major companies that should obsess us. What we really need to look at is the degree of economy-wide corporate investment, and wage growth. If the likes of Barro and Ohrn are right, then we should start to see rising levels of corporate investment that drive up capital per worker and lead to a noticeable uptick in wages.

It is a fascinating economic experiment. Rarely do major Western economies with mature capital markets engage in such a one-time shift in policy. Books and PhD theses will be written on whether the reforms had the desired effect. But it's important they are judged by their true intentions. While US politicians obsess over the direct flow of money from companies, their government is testing the power of supply-side incentives.

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