Council of Economic Advisers Chairman Says Tax Cuts and Jobs Act Will Help Solve Stagnant Wage Problem

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Chairman of the Council of Economic Advisers Kevin Hassett said the Tax Cuts and Jobs Act may be able to help solve the problem of stagnant wage growth in the United States.

Speaking at a Cato Institute event on Thursday, Hassett said tax reform could lead to about $4,000 in higher wages for a typical family in America.

"The economy up until this year has been very much disappointing, and if you look at real wage growth, it's been as bad as you've ever seen in the recovery," Hassett said. "We found a really interesting disconnect that is this: Historically if profits go up then wages go up and if profits go down then wages go down. The correlation is really almost perfect but the link between profit growth and wage growth has just disconnected."

Hassett explained that over the last eight years profit growth has increased by 11 percent per year. During that same time, however, real wage growth has been almost nonexistent.
"That disconnect is historically unprecedented," he said. "The clear explanation is this—typically what's happened is that when we get profit growth, then firms say I'm doing well, I can expand my business, and I'm going to buy a bunch of capital, a bunch of new machines, or build some new buildings."

Hassett says this occurrence, also known as capital deepening, has added about a percent per year to real wage growth since World War II. During the second half of the Obama administration, however, capital deepening's contribution to wage growth went negative for the first time in American history.

"So there was more depreciation of machines in a typical year than there was investment, so workers' productivity couldn't go up because they are actually using worse machines and fewer machines for the first time in history," Hassett explained.

In addition to a decline in capital deepening, Hassett says that American workers haven't seen an increase in wages because most of the profits are overseas.

"If you dig deeper into the data you can see that's what's happened is that the profits are not in the U.S.," he said. "So those profits that have been growing at 11 percent a year are in Ireland and pretty much every other country that has a lower rate than us."

"Those profits are not located in the U.S. so they are not creating capital in the U.S., they're not creating jobs in the U.S., they're not driving wages in the U.S., and this tax reform will address that, and it addresses it in a very significant way," he said.

Hassett says the council has evaluated what the impact of tax reform would be on a typical worker and expects about $4,000 in higher wages.

"Going through all of the literature we find that you end up with a sort of wage effect in the three to five year range of about $4,000, but there are a lot of papers and literature that say the effects are quite a bit larger than that," he said.

"If the user cost of capital drops 15 percent and capital investment has the elasticity of one, then you get about 15 percent more capital," he said. "Capital is about 30 percent of GDP so there you go—you can very quickly go from that to a wage effect like we're talking about."

Hassett also pointed to a possible link between the lack of capital deepening with a noncompetitive tax code.

"If we start with the puzzle—why haven't wages been growing like they usually are even though profits are growing—the answer to the puzzle is in the existing data," Hassett said. "And while we've had the most disappointing capital deepening in U.S. history, we've had the most noncompetitive tax code in U.S. history because other countries around the world have been cutting their rates."

"So it's not rocket science to link the two and say maybe if we didn't have the worst tax code on earth than maybe we could help workers," Hassett added.