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Headwinds for the Trump Economy

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OVERVIEW

Bottom line: Financial markets rallied following the U.S. election, on hopes that President-Elect Donald J. Trump's fiscal stimulus and deregulation initiatives would spur corporate profits and growth. Perhaps so, but a strong case could be made for the opposite: that Trump's economic agenda will prove disruptive to trade and growth, face growing headwinds in Congress, and exert a contractionary impact on the U.S. economy.

In the days after the election, financial markets exhibited optimism that would have been inconceivable prior to the vote. Within a week, U.S. equity markets had risen around 3 percent, the dollar had strengthened, and bond yields had climbed on expectations of higher inflation. Banks in particular benefited, with the Standard and Poor's 500 Financials Index up by more than 10 percent. Market commentary attributed the rise to expectations that the president-elect, backed by Republican majorities in both houses, would rush ahead with a substantial fiscal stimulus, wide-ranging deregulatory measures, and other market-positive reforms—including in health care. The rotation of confidence from securities to equities markets reflects the hope that Trump's proposed fiscal stimulus packages will promote investment and stronger U.S. economic growth.

At the center of the Trump economic program is an ambitious promise of tax cuts and expanded infrastructure investment. The Trump plan would update individual and corporate tax codes, reducing the number of individual income tax brackets to three. It would also cut tax rates across the board, including a reduction of the nominal corporate income tax rate from 35 percent to 15 percent. Trump also pledges to invest at least $550 billion to improve the nation's infrastructure, and at other times has talked about a $1 trillion package of spending and tax measures to boost infrastructure spending. Details remain scarce. One early proposal relied entirely on private financing (essentially tax breaks in exchange for investment in projects), but most economists argue that reaching these ambitious targets would require a broader approach that included additional government spending and innovative measures to boost private spending (for example, through the creation of an infrastructure bank).

There are a number of reasons to believe that financial markets are getting ahead of themselves in rallying in anticipation of a major fiscal stimulus.

The financial markets are likely getting ahead of themselves, though, in rallying in anticipation of a major fiscal stimulus. These proposed measures would almost certainly trigger congressional opposition, with the tax cut plan potentially facing hostility from Democrats and the infrastructure spending opposed by Republicans unless offset by other spending cuts. Even if Congress approves these policies without much modification, their impact on the U.S. economy will be mixed or even contractionary after an initial boost, as a sharp increase in the government deficit and debt puts upward pressure on interest rates. Finally, though there is broad consensus that fiscal policy needs to take a stronger role in stimulating demand, it cannot do the job by itself. Potentially contractionary monetary policy, coupled with protectionist trade and restrictive immigration policies, could neutralize or even overpower the effects of fiscal expansion on demand and growth.

DIVISION PERSISTS

Tax cuts and infrastructure spending are, on the surface, popular, and the president-elect can make a compelling case that he was elected in part on promises that he made in these areas. The challenge is how to pay for them, if at all. On this issue the incoming Congress remains sharply divided. On taxes, Trump's plan contrasts sharply with Republican proposals in terms of its net impact on the economy. The cost of Trump's tax plan is high: researchers at the Tax Policy Center estimate that it could increase the federal debt by $7.2 trillion in the first decade. Contrast this with Paul Ryan's A Better Way proposal supported by Republicans. The Ryan plan, also known as the House Republican plan, seeks to cut rates and simplify tax codes by, for instance, collapsing today's numerous tax brackets into just three. In contrast to the Trump plan, however, A Better Way proposes more modest rate cuts: for example, it proposes reducing the corporate tax to 20 percent rather than 15 percent. In Ryan's blueprint, the tax cuts would be accompanied by equivalent spending cuts, and would therefore have a neutral effect on the fiscal deficit. Kevin Brady (R-TX), chairman of House Ways and Means Committee, has stated that his committee is preparing legislation based on the Ryan plan to vote on in early 2017.

> *On both the tax and infrastructure fronts, Trump's plans will not go unchallenged in a divided Congress.*

Trump and congressional Republicans will struggle to reconcile the discrepancies between their proposed plans. While Republicans in Congress have historically been willing to tolerate rising deficits under Republican presidents, today's high debt and divided, distrustful public make such a shift harder to imagine. Assuming a budget-neutral bill in order to hold the Republican coalition together, tough decisions will have to be made that will strain any coalition in favor the bill. Budget politics plays a role here. Republican congressional leaders have committed to retaining the "Hastert rule," an informal understanding enforced fairly consistently since the mid-1990s, maintaining that a bill will not be allowed a floor vote unless it commands a majority of the majority party. Some shortfall is likely to be covered by other tax reforms, including a forced repatriation of offshore income to pay for a portion of the deficit (this could provide $150 billion in revenue over ten years). Some portion of the deficit increase—perhaps between 0.25 percent and 0.5 percent of gross domestic product (GDP)—can reasonably be covered by the assumption in the budget calculations that stronger economic growth will boost future revenues—the so-called dynamic scoring approach. To go beyond that would be a transparent attempt to explode deficits and would be likely to trigger an adverse market response. Consequently, Republicans will press for spending cuts, including to entitlements, though the president-elect opposed entitlement cuts in the campaign.

Whatever form the tax plan takes, it will face hostility from Democrats. One important source of contention: neither the Trump plan nor the Ryan plan addresses the equity of income redistribution. One recent study estimates that the highest-income households would benefit the most from Trump's tax proposal. Such households would experience a tax cut equivalent to 14 percent of their after-tax incomes, compared to the 4 percent average for all income groups. Similarly, it can be argued that the white working class that voted for Trump will not necessarily benefit as a result of this tax reform.

Infrastructure investment could be a divisive issue as well. While Trump may be able to gather more Democratic support on this issue, it is questionable whether he can obtain sufficient Republican backing so that he does not damage his coalition going forward. Major disagreements would arise when it comes to how

the investment would be paid for. Trump's current plan relies almost entirely on private funding, an approach that limits the scope of possible projects and could reduce its economic impact. Larry Summers points out that projects such as fixing bridges and modernizing schools are among the most pressing infrastructure issues, yet they do not bring immediate commercial benefits and thus cannot attract sufficient private investment.

That means that the infrastructure investment will fall short of the president-elect's targets under the current plan. Public funding will be requisite to fill the gap. But it is highly likely that Republicans will oppose significant direct government spending on infrastructure, in the same way they blocked President Barack Obama's $447 billion plan that included infrastructure spending in 2011. Nor are they likely to support Obama's proposal for a government-funded infrastructure bank. On both the tax and infrastructure fronts, Trump's plans will not go unchallenged in a divided Congress.

While it is possible that an infrastructure package could be passed on a bipartisan basis, it is equally likely that differences over how to pay for it will force a combined, scaled-down package of infrastructure, tax breaks, and repatriation to be passed primarily with Republican votes. In order for the tax legislation to pass in 2017, Republicans may resort to the "reconciliation" process, which allows for enacting tax and budget measures not subject to filibuster or amendment. Most important, this process permits legislation to pass with simple majority (rather than a three-fifths majority) in the Senate. However, this can only be done through a budget bill, which means only two bills can be passed in the upcoming year. (One bill, associated with the FY17 budget that has been held over from the last congress, is expected to be used for health care reform; this means that only one reconciliation bill, likely in the second half of 2017 and linked to the FY18 budget, can be passed through these accelerated procedures.) In sum, a modest tax cut and infrastructure program, passed through reconciliation with mainly republican votes, will see its fiscal stimulus largely offset.

FISCAL POLICY TAKES THE BATON, BUT CANNOT DO IT ALONE

Even under the most optimistic scenario, in which both tax reform and infrastructure spending are approved in forms resembling Trump's plans, their direct linkages to and immediate impact on economic growth are limited. Academic and policy studies generally call into question the effects of tax changes on economic growth. As for infrastructure, most major projects take years to complete, and their impact will be backloaded. The tax and infrastructure measures are central to Trump's economic plan, but even combined with other measures, they will not generate the 4 percent growth rate he promised.

Absent a dramatic expansion in the supply side of the economy, any fiscal stimulus will likely force the Federal Reserve to tighten monetary policy more quickly than currently expected to counter inflationary pressures in an economy that appears near full employment. Concerns about rising federal deficits are also likely to put upward pressure on interest rates. This continued tightening of monetary policy will neutralize the stimulus effects of Trump's proposed policies. The president-elect has repeatedly expressed his disapproval of low-interest rate policies, and a future Federal Board of Governors nominated by him could be hawkish (though it would not be surprising if, once president, Trump sees the virtue of low interest rates to fund rising federal deficits). Further, as mentioned earlier, the tax cuts and infrastructure spending will contribute to rising deficits that can push up interest rates and curtail public investment.

Other policies that the Trump administration will implement, especially in international trade and immigration, also could overwhelm a fiscal stimulus and ultimately exert contractionary effects. My colleague Ted Alden has written in depth about the incoming president's trade and immigration policies. If U.S. trade policy becomes inward-looking and confrontational with important trade partners—especially China—the results could be disruptive and contractionary. We will witness more cases against China brought to the World Trade Organization, along with more trade barriers such as high tariffs being implemented. In economic literature, the positive link between international trade and economic growth is strong, as is the negative correlation between protectionism and growth. A trade war would significantly dampen investment and consumption, both important components of growth.

Similar to the new trade agenda, Trump's immigration policy will be extremely restrictive, surpassing the severity of the post-9/11 immigration reform. Any effort to expand deportations and limit access of undocumented peoples to the labor market is likely to prove highly distortive. Just one element of the president-elect's agenda, his promise to repeal the Deferred Action for Childhood Arrivals (DACA) policy put in place by the Obama administration, has the potential for substantial dislocations and economic losses, as over one million people have been exempt from deportation and received work permits through this policy. Layoffs by firms concerned about future sanctions, and undocumented workers leaving the formal labor market, would create broad-based shortages in the service, agricultural, and small-scale manufacturing sectors.

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Further, during his campaign, Trump called for "extreme vetting" of immigrants and even a visa ban on Muslims. In my study with colleagues Heidi Crebo-Rediker and Ted Alden to examine the economic impact of a potential Muslim ban, results that would apply equally to the enhanced vetting procedures currently being discussed, we found that Trump's proposed ban would be immediately damaging to the U.S. economy. Those effects would linger for many years, even if the restrictions proved to be temporary. During the "lost decade" following the 9/11 attacks, the U.S. share of total overseas travel fell by nearly one-third, a loss of some 68 million visitors, which the travel industry estimates cost the U.S. economy more than $500 billion over that period. Our research suggests that the direct and indirect cost to the U.S. economy of the proposed travel ban would be substantial. We present two scenarios: one in which the cost to the U.S. economy is at least $36 billion annually (including travel, tourism, and education) and another potentially as high as $71 billion per year. Depending on the response by other countries and by foreign travelers not directly targeted by the ban, the losses could approach or exceed those in the post-9/11 period.

CONCLUSION

Donald Trump faces a tough choice—he can attempt to pass expansionary policies with bipartisan support and risk fracturing the Republican majorities in the House and Senate that support him, with possibly adverse effects on inflation and government debt; or he can pass more narrow bills with primarily Republican support that may involve little net stimulus. Either path will be challenging, and any boost to spending and investment is likely to be backloaded to 2018 and beyond. Meanwhile, the negative effects from a disruptive immigration and visa policy could be felt right away, and financial conditions could tighten as growing concerns about the

possibility of a more hawkish Federal Reserve intensify over the course of 2017. At this point we do not know which way the new administration will choose to go, and it is possible that President-Elect Trump is able to mobilize a bipartisan consensus in support of truly growth-supporting policies while backing away from some of his most disruptive social policies. However, taken together, it is easy to have doubts about the prospect of material economic stimulus. Indeed, a contraction may well be in the cards.

Looking Ahead: Kahn’s take on the news on the horizon

The Federal Reserve

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Capital Flows

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Venezuela

China has agreed to fund additional energy production in Venezuela, but the government will not receive additional cash. Venezuela remains on an unsustainable path.