Current Economic Conditions SPECIAL REPORT

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FASTER GROWTH? IT DEPENDS ON WHICH TRUMP PROPOSALS WE GET

In my July newsletter, I "characterize[d] this year's Presidential election as a choice between sticking with the status quo and taking a chance" and suggested that one candidate "offers the possibility of an upside economic breakout, but with plenty of risk and uncertainty." Now that that candidate, Donald Trump, has been elected the 45th President of the United States, it is time to access the potential impacts of his policy proposals on the economy. Because some of his policies would have a positive impact, while others would have a negative impact, the prospect of an upside economic breakout depends on which policies are enacted and which ones are rejected by Congress or abandoned by the President-elect.

Two policies offer the greatest potential bang for the buck: regulatory reform and a change in the taxation of the foreign profits of U.S. companies. Included under the "regulatory reform" umbrella are "repealing and replacing" Obamacare, repealing or revising the Dodd-Frank law, easing regulations that inhibit the production of oil, gas, and coal, and a general reduction in regulatory burdens. Regulatory reform and simplification will reduce the cost of doing business, especially for small companies, and will likely boost investment and hiring. U.S. oil production, which has declined slightly since oil prices turned down in 2014, could resume its 2008-2015 increase. The expectation of such a resumption, combined with record production from OPEC members and continued rapid improvements in drilling technology, have pushed oil prices down since Election Day and have lowered the likely trajectory of oil prices well into the future. If your business plans are dependent on oil prices, you need to adjust them accordingly.

The United States is the only major developed country that taxes the foreign profits of its companies, but it doesn't tax those profits until they are repatriated to the United States. The combination of a global tax system with a deferral gives U.S. companies a strong incentive to keep their foreign profits abroad, rather than bringing them home and investing them in new plant and equipment or paying them out as dividends. Applying a proposed 10% tax rate to repatriations and switching permanently to a territorial tax system would boost current and future economic growth by boosting investment in plant and equipment.

President-elect Trump and Congressional Republicans have proposed similar tax-reform plans. These plans are a mix of demand-side (Keynesian) tax cuts, which could boost growth in the short run, and supply-side tax reform, which would have a more lasting positive impact. Tax cutters/reformers need to realize that not all tax cuts are created equal. Cutting capital gains taxes and allowing investments to be expensed immediately rather than depreciated over time would stimulate investment and business formation. Small reductions in individual income tax rates (to a proposed 12%, 25%, and 33%) would not have a big impact, but the proposed reduction in the corporate tax rate, from 35% to 15%, could have a much larger impact. Tax reform might be a mild positive to growth in the short run, but given the size of the federal deficit ($587 billion in fiscal 2016) and debt (nearing $20 trillion), a large tax cut could boost interest rates – already up since Election Day – and hurt growth in the long run. A smaller, more-focused plan would be better. Cutting the revenue loss by curbing interest deductions would be a good thing.

Mr. Trump has also proposed a large increase in infrastructure spending. While this spending is being advertised as privately funded, it would largely be funded by an 82% tax credit on the equity invested. Such an infrastructure program would have had a bigger macroeconomic impact if it had been done several years ago, when unemployment was much higher, but decisions about infrastructure should ultimately be based on microeconomics, i.e., cost-benefit analyses that involve calculating the net present value of each project. When infrastructure spending is viewed as “stimulus”, decisions are ideologically driven, with Keynesian Democrats favoring bad projects that should be rejected and anti-Keynesian Republicans rejecting good projects that should be accepted. The former dominated the first two years of the Obama Administration; the latter dominated the last six years. Ironically, Trump’s views on infrastructure seem to be very Keynesian. In terms of its impact on economic growth, a big increase in infrastructure spending would be similar to a big tax cut; it would have a positive impact in the short run, but could have a negative impact in the long run if nothing is done to cut the deficit.

Trump’s proposals on trade and immigration would have negative impacts on economic growth. Immigration currently accounts for about half of U.S. population growth. The U.S. Census Bureau projects that by 2035, immigration will account for two-thirds of population growth. There are good non-economic reasons to reduce illegal immigration, but doing so will reduce U.S. economic growth **unless** it is offset by an increase in legal immigration, preferably targeted towards those with high skills. Mass deportations, if concentrated in a narrow time frame and not offset by legal immigration, would cause a recession.

Trump’s trade policies, if enacted, would also have large negative impacts on economic growth. Remember, tariffs are taxes. Imposing a 40% tariff on China and a 35% tariff on Mexico and withdrawing from current and proposed trade agreements would raise such taxes enough to roughly offset the Trump income-tax cut and would significantly boost the measured inflation rate. If these actions trigger a trade war, the negative impacts will be even larger.

The net economic impact of the Trump proposals depends on what is ultimately enacted. Some proposals can be enacted through executive orders and others through the “reconciliation” process that requires only a majority vote in both houses of Congress, but because Senate Democrats still have recourse to the filibuster, others will require 60 votes in the Senate, meaning they can’t be enacted without at least eight Democratic votes. In all likelihood, there will action on the taxation of foreign profits and significant regulatory reform; these are the low-hanging fruit. There will be significant changes to the Affordable Care Act. President-elect Trump’s comments on 60 Minutes suggest that parts of the ACA will be retained; expect something between “repeal and replace” and “rethink and repair.” Enacting a big comprehensive tax-reform plan is more problematic. Revenue-neutral tax reform is hard to accomplish because the losers make more noise than the winners (and the unbiased economists) and because a big tax cut is hard to justify with deficits and government debt at current levels. Infrastructure spending will increase, with significant Democratic support, but conservative Republicans will limit the increase.

Mr. Trump is already backing away from some of his immigration proposals. He is now open to replacing part of the proposed wall along the border with Mexico with a fence. He is focusing on deporting criminals rather than all illegal immigrants, similar to current policy. He hasn’t backed away from his trade proposals yet, but those who have worked with him and other commercial real estate developers point out that a Trump proposal should be seen as the starting point of a negotiation, not as a final position. He might be willing to declare victory after winning small changes in the North American Free Trade Agreement and Trans-Pacific Partnership and minor concessions from China. Remember, Bill Clinton and Barack Obama both opposed trade agreements as candidates, then supported them as Presidents.

I’m optimistic that the positive parts of President-elect Trump’s agenda will be enacted, but that the negative parts will either be rejected by Congress or abandoned by a President who knows the difference between a platform you can win on and an agenda you can govern with. The result could be stronger growth, albeit with higher inflation and interest rates. Even in an economy close to “full employment”, boosting the labor force participation rate could push growth in real Gross Domestic Product to perhaps 3% for three years. Anything beyond that, in terms of either magnitude or duration, would require a big increase in business investment that boosts productivity growth.