Economic Insight

Fiscal policy in the US: Ghosts of the past?

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Executive Summary

In the past five months, President Trump signed into law the TCJA (Tax Cuts and Job Act, on December 22, 2017) and the 2018 Bi-Partisan Budget Act (on February 9, 2018), which was recently completed with the FY2018 Omnibus Appropriation Bill (on March 23, 2018). They correspond to three pivotal fiscal policy blocks, each having a series of positive effects on the US economy: (i) A series of tax cuts benefitting to both households and companies boosting growth by 0.5 pp and 0.4 pp in 2018 and 2019 respectively; (ii) The repatriation provision included in the program of tax cuts offers a tax break on foreign profits with an expected limited impact on growth; and (iii) An increase of public spending (budget authority) amounting to USD 430bn over two years with a positive impact on growth of 0.2 pp both in 2018 and 2019.

However, President Trump's policy-making is haunted by ghosts of the past. Positive growth effects could prove to be temporary, while negative externalities would prevail:

- **Ghost of President Reagan's tax cuts**. In the eighties, Reagan's Economic Recovery Tax Act (ERTA, 1981) and Tax Reform Act (TRA86, 1986), which were similar in magnitude and ambition to Trump's fiscal reform, did not significantly boost the potential of growth and were swiftly followed by corrective measures of tax hikes in order to bring back public debt on a more sustainable path. This concern is likely to come back as a top priority post Mid-Term elections in November 2018.
- **Ghost of the Homeland Investment Act.** In 2004, the HIA revised section 965 of the internal revenue code (IRC): US corporations with foreign subsidiaries could bring overseas profits at a reduced tax rate of 5.25%. One needs to remember that in 2004, only 20% of repatriated profits were used to invest, while the rest rather boosted dividends and share buybacks with limited impact on investment.
- **Ghosts of pro-cyclicality, higher debt and partisanship**. Late-cycle fiscal spending usually comes with small and subdued multiplier effects. In addition, the absence of a significant rebound of growth and inflation in a time of fiscal profligacy is likely to generate higher public deficits, estimated to 4.5% of GDP in 2019 compared with 3.4% of GDP in 2017. Public debt held by the public is expected to increase by more than USD 2000bn over the two coming years and should be above 100% of GDP at the horizon of 2028, compared with 76.5% in 2017.
- All in all, growth and inflation impact of the US fiscal expansion will be quite moderate, hopes for extended self-financing of fiscal expansion will be disappointed, debt will rise (as was observed in former fiscal expansions)

A sizeable tax bill with limited effects, especially if/when the fiscal hawks are back

Donald Trump has announced one of the largest tax cut programs ever in the US. Losses on fiscal revenues, without taking account of macroeconomic positive feedback effects, are estimated at USD 1.45 trillion over ten years. It represents an average stimulus of USD140bn per year. The estimated size of the tax cut boost ranks fourth in the hierarchy of past tax cut programs, behind 1981 Reagan's program. The TCJA mainly deals with tax cuts and reduction of tax loopholes, which aim at simplifying the US tax system. Besides the size of the stimulus, the composition and targets of the "Tax Cuts and Jobs Act" point toward limited impact on growth. We adopt a differentiated approach of multipliers by categories of agents and by categories of measures. We adopt an average multiplier of 0.9 for tax cuts benefitting to lower income households and a multiplier of 0.35 for higher income households. Regarding tax cuts on profits, the average estimated size of the multiplier reaches 0.2 (see Table 1). In total, cumulating the impact of individual tax cuts and corporate tax cuts, we reach a positive outcome representing a boost of 0.5% of GDP in 2018 and 0.4% of GDP in 2019.

Table 1: Near-term output increase associated with tax cuts

Policy	Tax cuts in 2018 USD bn	Tax cuts in 2019 USD bn	Multiplier	Impact in 2018 as % of GDP	Impact in 2019 as % of GDP
Net cuts individual taxes					
Lower- and Middle-Income Groups	39.2	35.1	0.9	0.18	0.16
Higher-Income Groups	102.8	91.9	0.35	0.18	0.16
Corporate tax provisions	112	118	0.2	0.11	0.12
Total	254	245		0.5	0.4

Sources: CBO, Allianz, Euler Hermes

Ghost of the Past: President Trump's fiscal reform looks like President Reagan's initiatives in the 80s

The net increase of public debt should reach a level of USD 1 trillion over ten years as dynamic effects on growth are generally estimated at USD 400bn, less than offsetting the USD 1.4 trillion of losses in terms of fiscal revenues. This expected surge in public debt is a common feature with Reagan's era as it increased from 31% of GDP to 51% of GDP between 1980 and 1988 following the implementation of different tax cut programs. President Reagan proposed two series of tax cuts: the Economic Recovery Tax Act of 1981 and the Tax Reform Act of 1986 (Top individual tax rate was reduced to 28.5% from 50%, increased home mortgage deductions, reduced tax loopholes). However, the double dip recession of 1982 had eroded fiscal revenues and required some support in terms of public expenditures. As a result, public debt ballooned, inciting the Congress to push for tax hikes in order to restore its sustainability. The Tax Equity and Fiscal Responsibility Act (TEFRA), then significantly counterbalanced the tax cuts decided in 1981 with the ERTA. President Reagan raised taxes 11 times over the course of his presidency thereafter.

Earnings repatriation suggests small boon for investment

One of the highlights of President Trump's tax plan is the reform of taxation of income perceived by foreign affiliates of US companies. In the aftermath of the 2004 Homeland Investment Act (HIA) (foreign subsidiaries could similarly bring overseas profits at a reduced tax rate), US corporations repatriated 25% of their total estimated overseas earning or USD300bn in 2005 alone, but this tax holiday did not result in increased domestic investment, employment or R&D. Instead, a $1 increase in repatriations was associated with nearly as much an increase in pay-outs to shareholders. According to our calculation, we can reasonably estimate that the general impact on investment from repatriated profits will be again negligible.

Bi-partisan budget and Omnibus bill: USD430bn of additional spending over two years but 2000bn of additional debt

The "Bipartisan Budget Act of 2018" (February 9, 2018) and the subsequent adoption of the Omnibus Bill on March 23 are estimated, beside the TCJA's tax cuts, to add another USD 430bn to federal budget deficits over the next two years. Using a low estimated value of multiplier and making the simplifying assumption that USD 130 bn of the additional outlays are spent in 2018 and USD 300 bn in 2019, we have attempted to determine the impact on aggregate demand over time. All in all, GDP growth is expected to increase by around 0.2 percentage points in 2018 and by 0.2 in 2019 as a result of the higher fiscal spending. The combined effect of TCJA and new expenses is presented in Table 2.

Table 2: Impact of US fiscal initiatives (pp)

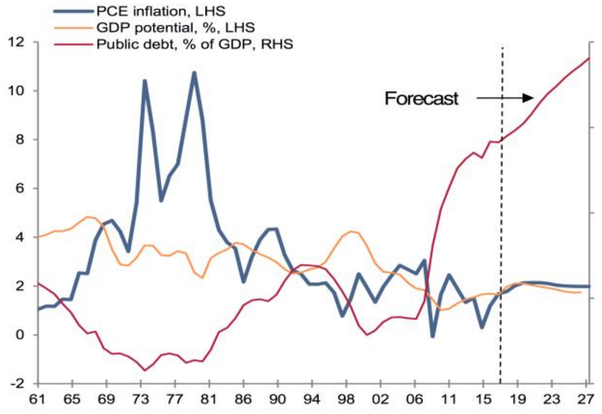
	2018	2019
US GDP estimate prior to policy announcement	2.2	1.9
Estimated impact of TCJA	0.50	0.40
Upward revision due to Bipartisan Budget Act (BBA) of 2018	0.20	0.20
Total TCJA & BBA	**0.70**	**0.60**
Impact protectionism		**-0.10**
Revised GDP forecast	**2.90**	**2.40**

Sources: Allianz, Euler Hermes

Ghost of the past: Debt to markedly increase amid partisanship, low growth and low inflation

As a result of lower fiscal revenues, higher public spending and a muted reaction of activity to these different impulses (the Fed is expected to tighten the US monetary policy and multipliers have typically a low value during late phases of the cycle), we expect the US deficit to reach 4.5% of GDP at the horizon of 2019 compared with 3.4% of GDP in 2017. Between October 2017 and March 2018, the US deficit has already reached USD599.7bn, representing a 14% increase compared with the same period last year. The CBO expects the level of public debt held by the public to reach 100% of GDP approaching 2030 if the current law is maintained until this time.

Figure 1: US public debt outstanding and CPI inflation



Sources : CBO, Euler Hermes, Allianz Research

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