Economic Insight

Trump’s pro-growth agenda: Can it still happen?

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Executive Summary

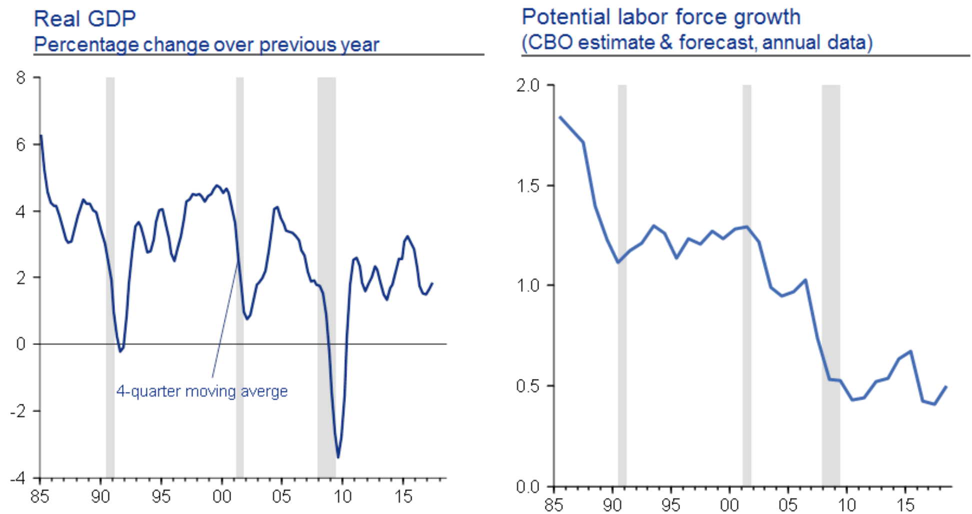
- After eight years of expansion, the US economy has limited spare resources. Hence policy changes that can create room for higher growth in the medium term are needed.
- Given political gridlock in Congress and repeated personnel changes in the administration, uncertainty about the path of policy is very high. Amid the stop-go on healthcare reform in Congress, there are growing doubts whether important items of Donald Trump’s pro-growth agenda will ever be implemented.
- While deregulation is put in train, infrastructure plans are not yet sorted out. Accordingly, most eyes are now on Trump’s tax reform plans.
- With the 2018 mid-term elections drawing closer, we believe that the Republicans will be determined to make at least some progress on their core project of tax reform. So far we assume that tax cuts will not be fiscally neutral in the short term, delivering a fiscal stimulus of around 1.2% to the US economy.
- On this assumption, we leave our 2018 GDP forecast of 2.3% unchanged, for now. The risks to the reform agenda are high, however, and entail a downside for the growth forecast . If progress on tax reform and other items that require congressional approval proves elusive, President Trump might resort to trade restrictions to restore a semblance of control.

I. Why policy reform is key to growth

Moderate GDP growth in the US in recent years has not only been caused by cyclical factors. The economy’s growth potential has also come down. Growth in both labor productivity and the labor force has slowed, which leaves us with the conclusion that, after eight years of expansion, only moderate slack remains in the US economy.

Therefore, if the US economy is to return to higher growth rates sustainably, it needs policy changes that lift the growth potential. Several items on the US administration’s economic policy agenda are designed to generate higher growth over the medium term, notably tax reform, higher infrastructure spending and regulatory changes.

The administration's growth target of 3% is ambitious. Given current labor market conditions – with fairly low rates of unemployment, labor force participation and growth in the working age population – output per worker would have to grow by 2% per year to reach that target over the next three years. That would imply a return to the high labor productivity growth rates seen in 1996-2004.



Source: Thomson Reuters Datastream.

If the administration of Donald Trump is serious about its growth targets, therefore, its pro-growth policy agenda is of utmost importance. At present, it is very difficult to see how the key items on the agenda will develop. Below we give a broad assessment.

Deregulation

A central aspect of the US administration's economic agenda is the review of federal regulations in various areas. The idea is to eliminate two regulations for every new one, with a view to simplifying the regulatory system and reduce regulatory burdens. Changes that raise business profitability encourage investment and innovation. The withdrawal of numerous pending regulations, ranging from those relating to the labor market to resource extraction, are clear signs that the process has been put in train. And it can be expected that relevant government agencies use discretion in how they enforce existing laws and regulations – also in the financial sector. However, in changing the regulatory system, care is needed to avoid negative consequences for, inter alia, the environment and financial stability. So far it is not possible to determine whether the right balance between benefits and costs of deregulation will be found.

Infrastructure investment

The regulatory reform agenda plans to revise regulations that create barriers to infrastructure investment. A basic aim is to reduce permitting times which could reduce costs and expand project lists. Basically, the US administration is looking for alternative ways than direct federal funding in order to increase infrastructure spending significantly. In its attempt to attract greater private sector funding, the administration is considering tax credits, public private partnerships and the establishment of a new infrastructure bank. USD 1 trillion in private and public infrastructure investment are to

be generated. To this end, USD 200 billion in federal outlays over ten years have been earmarked in the president's budget request to Congress.

Underinvestment in infrastructure has become a growing constraint on productivity and long-term growth. Since 2009 investment in public infrastructure has actually declined and as a result the share of gross government fixed investment in structures amounted to just 1.5% of GDP last year. Not surprisingly, the American Society of Civil Engineers earlier this year affirmed its overall assessment of the condition of US public infrastructure at D+, with D meaning poor or at risk. An estimated USD 4.6 trillion would be needed to restore conditions to B, which means good or adequate, by 2025. This implies a funding gap of USD 2 trillion.

The benefits of improved public infrastructure go beyond business productivity and also affect the labor market. Recent research suggests that longer commuting times reduce the labor force participation rates of married women. Thus, the expectation is for shorter commutes as a result of a better transportation system to increase the labor supply.

Overall, the infrastructure plans are not yet sufficiently advanced and will likely take longer to be sorted out and formulated in detail. Moreover, congressional leaders have generally laid out that infrastructure legislation will be dealt with after tax reform. Given the lags between legislation and spending, it is difficult to see that any related spending will already occur in 2018.

Tax reform

The Trump administration is aiming at a comprehensive tax reform that would encourage higher investment spending and thus higher productivity and greater labor supply. The ultimate design of a new tax code is, however, still unknown. What seems clear is that large-scale tax cuts as originally envisaged by the Trump administration will not be realized. The tax relief for corporations and households resulting from the tax plan outlined by the administration in late April had been estimated to amount to USD 5.5 trillion over a ten-year period, i.e. roughly 3% of GDP per year. This seems unachievable at the present juncture. The size, substance and design of any legislation will also be constrained by budget rules that are applied.

But Republicans are under some pressure to show that they can get things done as mid-term elections are approaching. We expect some rate cuts and some widening of the tax base. If tax reform is not implemented for next year, growth above 2% would be hard to achieve. Missing growth effects from fiscal stimulus could only partially be offset by a weaker currency. The currency impact on exports is moderate and it could be counteracted by the negative impact of political uncertainty on spending plans of the private sector.

Temporary tax cuts do not ensure a positive impact on the US real economy in the long term. The eventual withdrawal of tax relief could even severely dampen economic activity and push real GDP below a baseline that assumes no tax changes. To make tax rate cuts permanent, tax reform must at least be revenue-neutral or deficit neutral. There are a number of ways to attain revenue or deficit neutrality. First, it could be achieved with a timing shift, where expenditure restraint sets in with a delay and is accelerated at a later stage. Second, there has been talk of possibly using a longer budget window (perhaps 20 years) so that expenditure restraint could be spread over a longer time period . Thirdly, budget plans can be based on positive assumptions concerning the

growth impact of tax cuts themselves. This third perspective, partly self-financing tax cuts, probably plays the most important role, although we know from historical evidence that it is usually overestimated. This was clearly the case after the election of Ronald Reagan, when budget deficits markedly rose.

But a temporary widening of the budget deficit becomes acceptable to policymakers if they are convinced that it will put the economy on a better growth path. Moreover, the alternative of outright expenditure cuts often has political ramifications that politicians do not tolerate.

The "Joint Statement on Tax Reform" that was released in late July by the White House and the Republican leadership in Congress implies that tax reform would be less ambitious than initially stated by the administration in April. But it lacked the policy detail needed to assess its budgetary impact.

The Statement can be interpreted as an attempt to show unity and progress on tax reform, amid Republicans' protracted struggle to undo the Affordable Care Act. It lays out goals for a tax bill that should be available this fall, namely to

- reduce tax rates as much as possible
- allow unprecedented capital expensing
- place a priority on permanence
- encourage US companies to repatriate profits trapped overseas and to create jobs at home

The Statement clarified that the controversial border tax adjustment – initially expected to deliver windfall revenue to the budget – would not be part of the tax reform proposal. Moreover, as health care reform appears to have failed, the envisaged budget savings from health care reform cannot be counted on. Without these, Congress will have to find additional sources of revenue, for example through broadening the tax base, or enact spending cuts elsewhere to offset lower tax rates. The streamlining of tax preferences and deductions resembles a political minefield. Significant spending cuts will be no easier politically.

We therefore conclude that the first part of tax reform, to be announced later this year, has room for only moderate cuts in corporate and income taxes. The administration will most likely argue that such cuts will generate enough additional growth to be revenue neutral in the longer term. . We do not believe, however, that the tax cuts will be deficit neutral: only a small part will be financed through a reduction in tax exemptions or lower public spending. In the short term, at least, we expect tax reform to raise the federal deficit.

II. Risks to the reform agenda

Ideological divide

The Trump administration's struggle to make headway on domestic reform policies – starting with health care reform – has delayed work in other areas. Several legislative

deadlines need the attention of policymakers in coming weeks. By October, Congress will need to act to lift the debt ceiling and agree to funding for the government in the fiscal year 2018 (which starts in October).[1] Once these votes have passed, we would expect some progress on tax reform.

Major policy changes have become more difficult as the ideological divide in Congress has deepened. The "Partisan Conflict Index", compiled by the Philadelphia Fed, has reached record heights. In the current Congress, only 10% of the members of the House and 22% of Senators are described as "moderate". Such polarization leaves little room for political compromise, for example by crossing party lines on votes, and might even encourage risky tactics. For example, fiscally conservative members of Congress might use the debt ceiling vote as leverage to cut federal spending. Such tactics could render it extremely difficult to reach a compromise comfortably ahead of the deadline, thus throwing financial markets, business and households into uncertainty – potentially causing the private sector to postpone spending decisions.

Knee-jerk trade policy

President Trump and some members of his administration have repeatedly expressed skepticism about the benefits of free trade. Such misgivings can resurface any time. Trade restrictions would be highly disruptive for the US economy and thwart any positive impact from genuine pro-growth policies. US multinationals rely heavily on trade in their international supply chains: some 43 % of total US trade occurs within multinational firms. The share is higher for trade with advanced economies. If trade restrictions reduced prospects for these companies, financial markets would also suffer, since multinationals account for 85% of the stock market capitalization of the S&P 500.

The Trump administration – eager to show that it can act – might yet resort to trade policy, where it does not need congressional approval, to mask its lack of progress in other areas. Such a move would trigger retaliation from other countries. The European Commission, for example, has already warned about possible retaliation if tariffs were to result from the US investigation into steel imports.

III. Outlook

More than six months have passed of the Trump administration's term in office without one major piece of domestic legislation passing Congress. The Republicans must fear that if they cannot deliver on at least some of the President's election promises, voters will punish them at the mid-term elections in 2018. We believe that the political pressure will suffice to spur them into action on tax reform once the debt ceiling debate is out of the way.

Assuming that tax cuts will deliver a fiscal stimulus of 1.2 % of GDP to the economy, we leave our 2018 GDP growth forecast at 2.3%. Given the uncertainties surrounding US fiscal policy, our assumptions may have to be revised over time. In addition to the uncertainties surrounding tax reform, investors should also continue paying attention to the possibility of disruptive trade measures.

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[1] The Treasury will likely run out of cash in early to mid-October, unless Congress raises the federal debt limit. See Congressional Budget Office, "Federal Debt and the Statutory Limit, June 2017", June 29, 2017.
If the debt limit is not increased, the Treasury will not be authorized to issue additional debt that increases the amount outstanding.

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