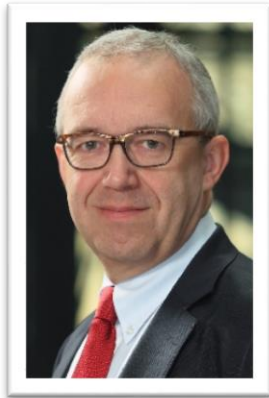


Trumponomics and US Public Finances

The trumpets may blare, but the music is rare



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In this research report we discuss the main fiscal policy proposals that have so far been put forward by the new US President Trump, starting with a brief overview of recent evolutions in US public finances and related projections under current policies. Our main conclusion is that Trump's proposals are not well designed for spurring economic growth significantly, but are likely to further deteriorate the already worrisome fiscal position of the US economy. Notwithstanding the Republican majority in Congress, Trump will have to compromise on his ideas, which will temper sustainability risks of government finances. At the same time, such compromises are likely to lead to disappointment in financial markets that are currently anticipating a strong economic boost.

Introduction

On 8 November 2016 Donald Trump was elected as the 45th President of the United States of America. Despite being perceived as a controversial person, financial markets reacted very positively on his election, resulting in a stock market rally and substantial increases in long-term interest rates. Both reflect a strong anticipation to the expected outcome of new economic policies implemented by the Trump administration. In particular, Donald Trump frequently advocated expansionary fiscal policies



consisting of tax reductions and a rebuild of infrastructure. In this research report we evaluate the possible impact of these policy proposals on US public finances. First, we discuss the recent evolutions in US public finances. Secondly, we provide an overview of the fiscal policy changes that have so far been put forward by Donald Trump. Thirdly, we assess the impact of these expansionary fiscal policies on future US public finances and economic growth. Finally, we draw some conclusions as to the possible impact of these proposed policies on US public finances, including an evaluation of the probability of effective policy implementations and long-term fiscal sustainability.

Our main conclusion is that Trump's proposals are not well designed for spurring economic growth significantly, but are likely to further deteriorate the already worrisome fiscal position of the US economy. Notwithstanding the Republican majority in Congress, Trump will have to compromise on his ideas, which will temper sustainability risks of government finances.

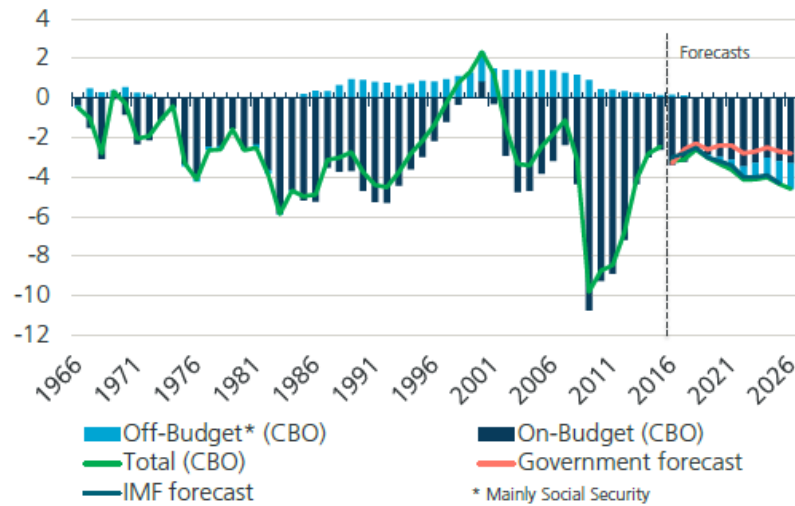
Recent Evolutions in US Public Finances

In our discussion of the recent evolutions in US public finances we focus first on the federal government balance. Subsequently, we look at the evolution in US public debt. We restrict our analysis to the federal level only, unless indicated differently. In general, US public finances are mainly determined at the federal level, including social security, which contains the bulk of US general government debt (see annex).

US Federal Government Balance

After a dramatic increase during the financial crisis of 2008 - 2009, the federal government budget deficit gradually improved to 2.5% of GDP in 2015. The deterioration and ensuing improvement reflect the business cycle, the impact of exceptional crisis measures and consolidation measures. Overall, both defence and non-defence discretionary spending has been reduced by the Obama administration, while the rising trend in health expenditures was stopped and interest expenditures continued their downward path. Significant fiscal consolidation measures, legislated in 2011-2013, reduced the deficit in this period. The Bipartisan Budget Acts of 2013 and 2015 partially reversed the cuts initially scheduled to take place in fiscal years 2014-2017 and replaced them with savings generated through cuts in mandatory spending in later years, tempering the improvement of the balance. The Tax Act of 2015 extended many tax cuts through the medium term and made some permanent. This resulted in some easing of fiscal policy in 2016 and a new increase of the deficit to 3.2% of GDP in the fiscal year 2016 (fiscal years run from October to September).

Figure 1 - US Federal Government Balance (% of GDP)



Source: Congressional Budget Office (CBO, 2016)

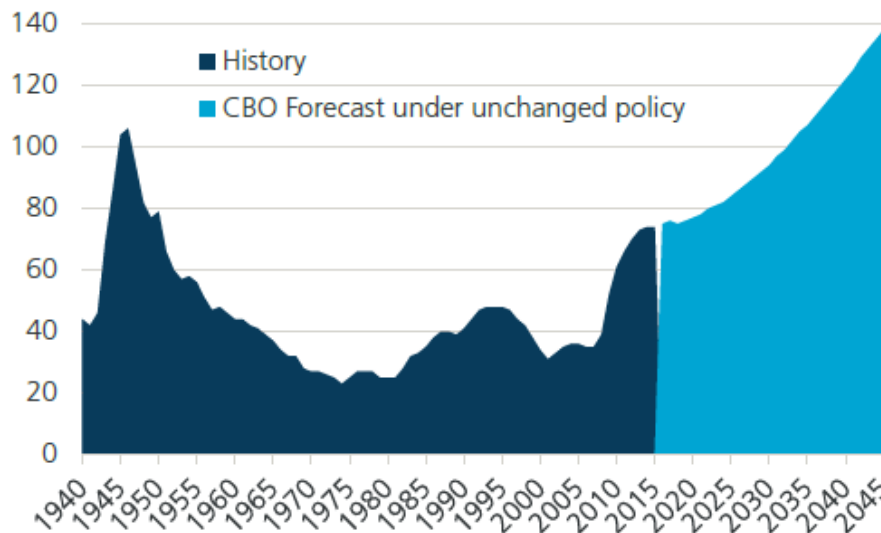
According to projections of both the Congressional Budget Office (CBO) and the International Monetary Fund (IMF), the fiscal balance will further deteriorate in the next decade, after a short moderate improvement in 2017-2018, under unchanged policy assumptions. Deferred cuts in mandatory spending will moderately tighten fiscal policy in the 2017-2018 period, that will be followed by some policy easing. Notwithstanding the continued fall of defence and non-defence discretionary expenditures, this is mainly caused by a new rise of health care expenditures and social security expenditures (mainly pensions due to the baby boom generation's retirement) as well as by rising interest expenses due to increasing interest rates (see annex). Although the budget deficit isn't perceived as much of a problem at this moment, the ageing of the population will bring it to the fore in the medium to long term.

US Federal Public Debt

Before analyzing the recent trends in US public debt it is important to notice that various definitions are used to indicate the US public debt level. With respect to the federal government debt, this relates to the fact that the federal government issues debt for two main purposes. It borrows from the public to finance the federal budget deficit and, secondly, it issues debt to federal government accounts, primarily trust funds related to the federal social insurance and employee retirement programs, that

accumulate surpluses. Of course, only debt issued to and “held by the public” represents past federal demand on macroeconomic savings of other sectors, while debt held by government accounts reflects internal transactions of the government. Consequently, “debt held by the public” is from a macroeconomic point of view much more relevant than total outstanding federal debt (including debt held by government accounts), that is much higher (108% of GDP end 2016, compared to 78% of GDP “debt held by the public”). Yet, the internationally comparable figure of total consolidated US government gross debt (including state and local government debt) is according to the latest IMF estimate (World Economic Outlook, October 2016) around 108% of GDP in 2016, i.e. much higher than e.g. in the Eurozone (92% of GDP).

Figure 2 - US Federal Government "Debt Held by the Public"
(domestic definition, % of GDP)



Source: Congressional Budget Office (CBO, 2016)

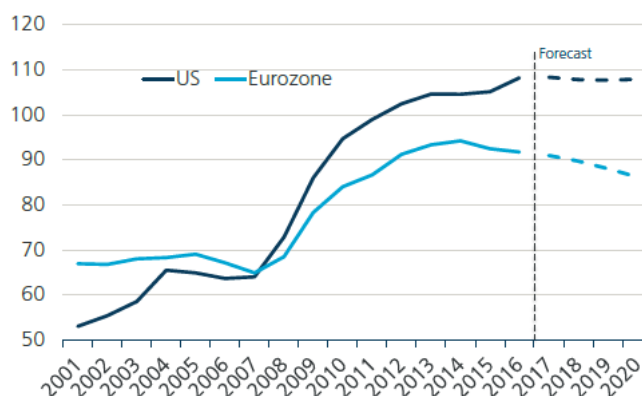
US public debt sustainability is mostly discussed in terms of federal government "debt held by the public". As can be observed in Figure 2, the sharp increase in the budget deficit in the aftermath of the financial crisis triggered an explosion of the corresponding federal debt ratio. The CBO regularly assesses debt sustainability. Figure 2 illustrates that the CBO expects the debt ratio to further increase – under unchanged policy – to 86% in 2026 and to 141% of GDP by 2046, i.e. far above the World War

II-peak of 106% of GDP in 1946. The rising debt ratio results from the persistent budget deficit but also from weaker economic growth, higher interest rates and ageing of the population. In its latest article IV consultation (July 2016), the IMF's debt sustainability assessment was roughly in line with the CBO analysis. Yet, in president Obama's 2017 budget a stabilization of the debt ratio was projected. The general government debt dynamics in the US sharply contrast with the Eurozone, where, according to the latest IMF Economic Outlook (October 2016) the government debt ratio is on a downward path (Figure 3).

Overview of Trump's Fiscal Plans

Many stories have been told about Donald Trump's future economic plans. During his electoral campaign not many details have been revealed about these plans, and after the elections no significant additional information became available. In this research report we attempt to summarize currently available information on Donald Trump's fiscal plans. Table 1 provides an overview of most policy changes, that have been put forward. The figures are based on "rough, rounded and preliminary" estimates of the budgetary impact of the presidential candidates' plans by the Committee for a Responsible Federal Budget (CRFB), a US nonpartisan non-profit organisation focused on fiscal policy analysis.

Figure 3 - General Government Gross Debt
(international comparable definition, % of GDP)



Source: IMF, World Economic Outlook (October 2016)

From this overview one learns that fiscal stimulus would stem almost entirely from tax cuts, roughly equally divided between households and the business sector. There are also significant spending cuts, but these are largely used to fund spending increases in other areas. Many proposed reforms (e.g., Obamacare and tax changes) are a mix of deficit reducing and deficit increasing measures, adding to uncertainty about the net outcome. Particularly, estimates of the impact of the corporate/ business tax reform are highly uncertain, as it is unclear to what extent sole traders will benefit from the proposed cut in the corporate tax rate from 35% to 15%. E.g., the Tax Policy Center (TPC) estimated a much higher negative impact on federal revenue: USD 6.2 trillion between 2016 and 2026 (USD 7.2 trillion including interest payments). The Tax Foundation estimate of the tax plan's cost range from USD 4.4 to 5.9 trillion on a static basis, roughly in line with CRFB's estimate. Also the timing and modalities of Obamacare repeal can affect the estimates significantly, as Obamacare itself was a mix of debt increasing and debt reducing elements.

Table 1 - 10-year fiscal impact of Trump's pre-election proposals (bn USD)

	Expenditures			Revenues			Impact on debt
	Increase	Reduce	Net	Increase	Reduce	Net	
Affecting households	3,950	4,650	700	800	3,570	-2,770	-2,070
Individual income tax	-	-	-	800	1,700	-900	-900
Childcare & caretaking	-	-	-	-	550	-550	-550
Estate & capital gains tax	-	-	-	-	20	-20	-20
Health care reform (incl. Obamacare)	950	2,200	1,250	-	1,300	-1,300	-50
Paid maternity leave	2,500	2,450	-50	-	-	-	-50
Veterans Affairs System	500	-	-500	-	-	-	-500
Affecting corporates / business	-	-	-	-	2,850	-2,850	-2,850
Corporate tax reform	-	-	-	-	-	-2,850	-2,850
Other	1,340	1,000	-340	50	90	-40	-380
Rebuild military	450	-	-450	-	-	-	-450
Non-defence spending	-	1000	1000	-	-	-	1000
Immigration	100	-	-100	50	-	50	50
Net interest payments	700	-	-700	-	-	-	-700
Roundings & omissions	90	-	-90	-	90	-90	-180
Total	5,290	5,650	360	850	6,510	-5,660	-5,300

Source: KBC Economic Research, based on Committee for a Responsible Federal Budget, 22 September 2016. Negative amounts increase the debt.

Moreover, these measures should still be considered as intentions rather than as hard facts. Nevertheless, although "closing the deficit and reducing our debt" has been one of the explicit, but vague statements in the Trump campaign, the intentions clearly point to strongly expansionary fiscal plans. The table does not include figures for infrastructure projects, as the related plans are even more



undefined with respect to their size and funding. Trump has pledged to leverage public-private partnerships and private investments through tax incentives to spur USD 1 trillion in infrastructure investment over ten years. According to the campaign, the plan would be revenue neutral, but its realisation would almost completely depend on private investors, as it mainly works through tax cuts and barely through increased government expenditures, as was the case in the Clinton proposals. The money needed to finance the tax break should come from tax revenues from repatriated corporate funds. It is highly uncertain to what extent tax cuts will increase net-investment dynamics – particularly those resulting in the urgently required improvement of the quality and reliability of US infrastructure – or simply result in a “subsidy” for already planned private investments. Yet, although Trump criticised Clinton’s plan for an infrastructure bank “controlled by politicians and bureaucrats”, Mnuchin, Trump’s nominee as treasury secretary, suggested that the incoming administration is looking at starting an infrastructure bank after all.

One often points to a similar economic thinking during President Reagan’s presidency, although the similarities are only partial. Similar to Trump’s proposals, Reagonomics involved substantial tax cuts supported by the belief that these tax cuts would lead to higher tax revenues thanks to higher economic growth extending the tax base (reflected in the so-called ‘Laffer-curve’). Reagan claimed to limit public spending, although in practice it still grew and he increased military spending. Trump also wants to increase military expenditures, but his plans also contain spending increases in specific social policy fields, which he wants to compensate with cuts in other policy domains. The main difference between Trump’s plan and Reagonomics relate to Trump’s ambition to rebuild American infrastructure, but this remains unclear.

Impact

Donald Trump’s plans are ambitious. This becomes clear by looking at their impact on US public debt as well as by measuring their economic impact. Both the fiscal and economic impact have been assessed by US agencies during the presidential electoral campaign. We discuss these projections in this section. In section 5 we will provide our own assessment of what can be realistically expected.

Impact on Federal Debt

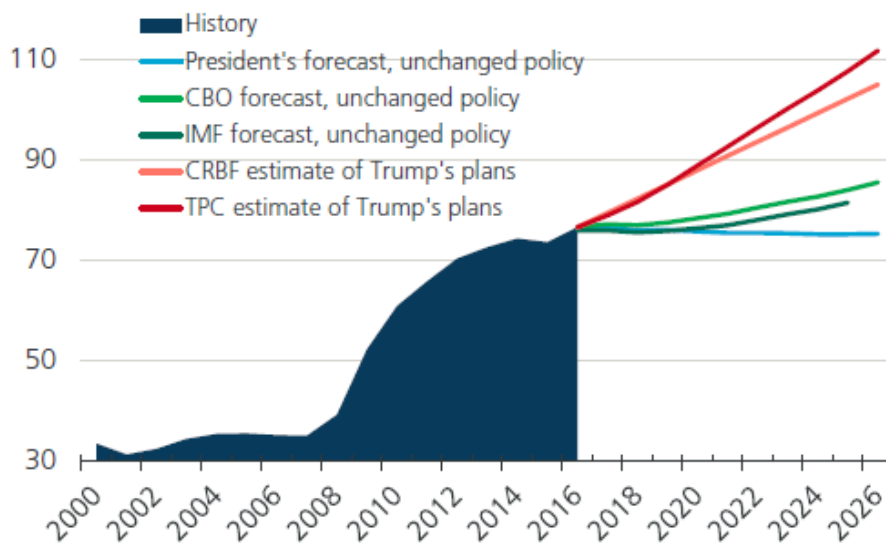
Donald Trump’s plans will have a tremendous impact on US public finances. Table 1 already showed that over a ten-year horizon Trump’s plans would increase net public spending by USD 5.3 trillion. According to this Committee for Responsible Federal Budget (CRFB) estimate, Trump’s plans would bring the debt (held by the public) ratio to the post-World War II record level of 105% in 2026, 20% of GDP higher than the current CBO forecast for 2026. This impact as well as the Tax Policy Center (TPC) estimate is summarized in Figure 4 and compared to the estimates under unchanged policy. The TPC estimates an increase of the debt ratio of 26% of GDP in 2026, bringing it to 111% of GDP. Note that

Hillary Clinton’s plan was almost debt neutral, implying that under her presidency the debt ratio would have increased in line with the CBO forecast of unchanged policy.

Economic Impact

The above assessments of the impact on the debt does not take into account the economic impact. This might of course alter the effective impact on the debt to GDP ratio as a fiscal stimulus may trigger higher economic growth reducing the negative impact. Yet, this impact on economic growth is not straightforwardly assessable as there are many interdependences with other variables. Trump’s campaign suggested that the plans might lead to a 75% increase of the annual real growth rate of the US economy to 3.5%. Yet, the CRFB’s assessment is that the impact on economic growth “is likely to be small and possibly negative”. The TPC highlights the substantial range of uncertainty in this respect. Only in a scenario in which interest rates don’t increase as a result of the higher debt and labour supply and savings are very responsive to wages and interest rates, the impact on the output level is positive in the long run. Given the already high and rising debt ratio and the initial market reaction to Trump’s election, such a scenario is highly unlikely. In a scenario with increasing interest rates and low

Figure 4 - US Federal Government "Debt Held by the Public" (% GDP)



Source: US Government, CBO, IMF, CRBF, TPC (2016)

responsiveness of labour supply and savings, there is only a small positive impact until 2019 and a lower output level afterwards. In an in-between-scenario, Trump plans' effects on investment and labour supply would boost GDP by 1% in fiscal year 2017, but the growth impact would fade out and the cumulative impact on the output level would become negative from 2023 on.

The economic impact of a fiscal stimulus not only depends on the size of the stimulus, but also on its design, duration and timing, as well as on its impact on people's expectations and monetary policy response. Fiscal policy measures have a direct effect on the demand for goods and services, that varies depending on the type of the measure. E.g. in the case of a dollar increase in government purchases, the direct effect is 1 because demand increases by a dollar. In the case of a dollar decrease in taxes, the direct effect can vary considerably, because they affect people with different spending/savings characteristics and the tax decrease may be seen as more or less persistent, resulting in different responses. There are also indirect effects, that arise when the direct effects propagate throughout the economy. Indirect effects can offset or enhance direct effects. For example, the direct effects of lower taxes or higher government spending are magnified when stronger demand for goods and services prompts business to increase investment and hire more workers than they otherwise would. In the other direction, the direct effects are mute if, for example, higher government borrowing caused by tax cuts or spending increases leads to higher interest rates that discourage ("crowd out") spending on investment and durable goods. Consequently, the overall impact of fiscal policy can be different at different moments in time, as it depends on the economy's capacity utilisation and the financial system's condition at the moment of policy implementation.

Figure 5 - Capacity Utilization, All Industries (%)



Source: Federal Reserve (2017)

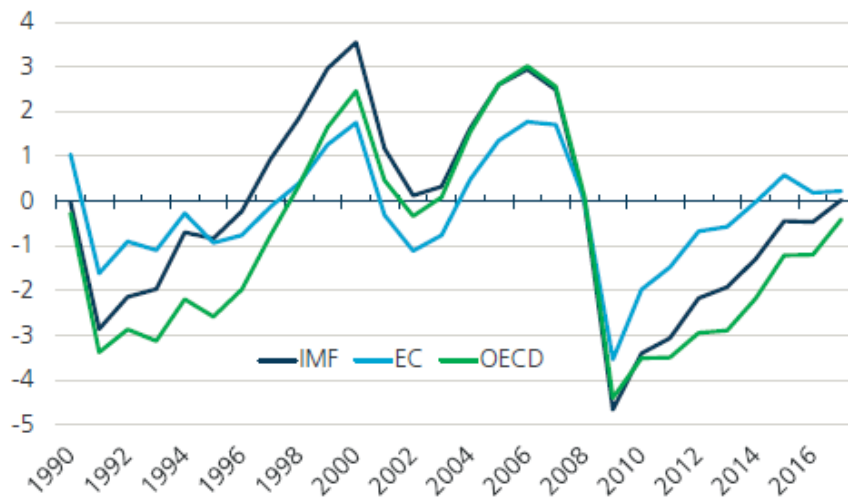
To assess the economic impact in an accurate way, one can use estimates of so-called fiscal multipliers. A multiplier indicates the effect on GDP of a dollar change in fiscal policy. It can be estimated for different types of policy measures and at different moments in the business cycle. Consequently, there is a large range of estimates of fiscal multipliers. Table 2 summarizes the effects for several major fiscal policy measures the CBO has produced to analyse the impact of the American Recovery and Reinvestment Act of 2009 (CBO, 2015). The figures combine the direct and indirect effects, showing the cumulative economic impact of the policy measures over a period of 2 year. It illustrates that purchases of goods and services by the federal government had the highest estimated fiscal multiplier (estimates ranged from 0.5 to 2.5) and a set of corporate tax provisions had the lowest estimated multiplier (estimates ranged from 0 to 0.4).

Table 2 - Fiscal Multipliers for the US Economy
(in %)

Type of policy measure	Estimates	
	low	high
Purchase of goods and services	0.5	2.5
Transfer to state and local government for infrastructure	0.4	2.2
Transfer payments to individuals	0.4	2.1
One-time payments to retirees	0.2	1.0
2-year tax cut for lower- and middle incomes	0.3	1.3
1-year tax cut for higher incomes	0.1	0.6
Corporate tax provisions	0.0	0.4

Source: Congressional Budget Office (2015)

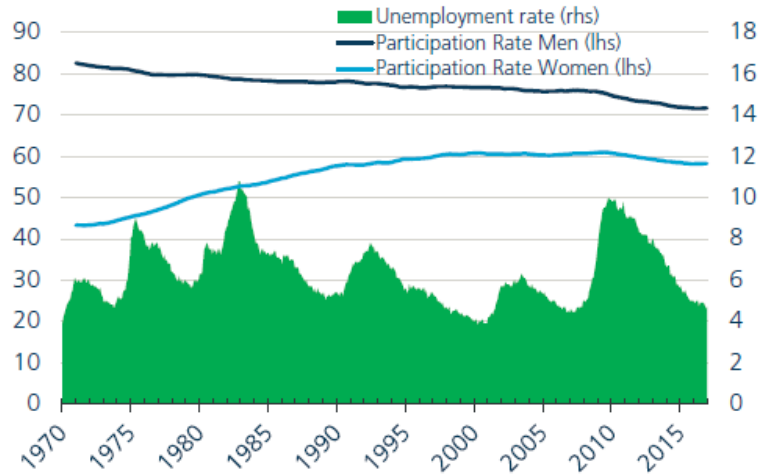
Figure 6 - Estimates of the Output Gap (% of potential output)



Source: IMF, EC, OECD (2016)

Broadly speaking, fiscal multipliers are high during an economic downturn or when the economy suffers from a large negative output gap or when many households and firms are credit-constrained. This is obviously not the current economic situation in the US. Although there remains some discussion on the amount of spare capacity in the US economy, it is clear that there is no large negative output gap. Admittedly, capacity utilization is not extremely high and tends to decline in the recent period (Figure 5). On the other hand, IMF estimates suggest that the output gap will be closed in 2017, while the European Commission (EC) calculates that the output of the US economy has already been above potential since 2014 (figure 6). Only OECD calculations point to a small negative output gap. Also the very low unemployment rate suggest that there is not much spare capacity left in the US economy (figure 7). Yet, labour market participation has barely recovered from post-Lehman crisis lows and particularly for men it still is historically low. This is partially explained by the ageing of the population, but might also suggest that some people could return to the labour market, particularly when income taxes are lowered.

Figure 7 - Labour Market Indicators



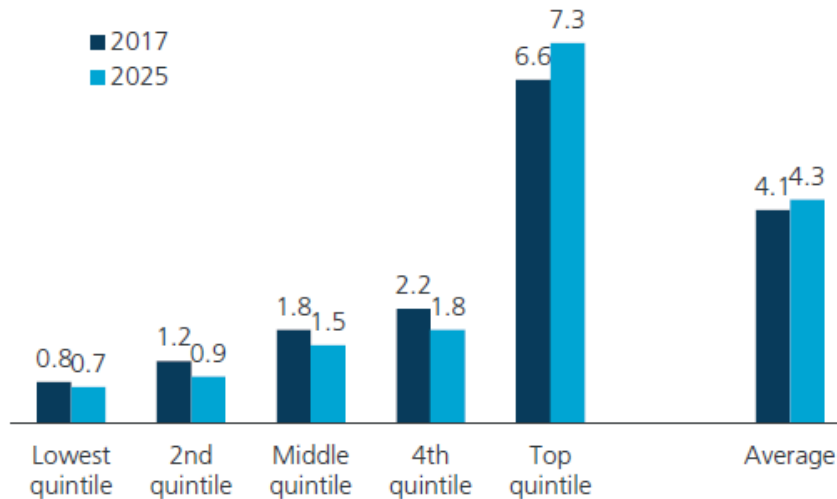
Source: Federal Reserve (2017)

As illustrated by the figures in table 2, fiscal multipliers tend to be larger for increased government spending than for tax cuts. Yet, income tax cuts focused on the low and middle incomes generate a bigger stimulus than tax cuts for the higher incomes, as the latter tend to spend a relatively smaller part of the windfall. In this respect, the Trump ideas are not well designed to be highly effective, as they mainly focus on tax cuts and less on raising expenditures. Furthermore, high incomes are likely to benefit more than low and middle incomes from the proposed tax cuts. The Tax Policy Center (TPC) has calculated that, on average, households on all income levels would receive tax cuts, resulting in an increase of 4.1% of after-tax household income in 2017. But the top quintile would benefit from a 6.6% income increase, while the average tax cut for the 20% lowest-income households would only be 0.8% (Figure 8). Over the long-run, these differences will even increase. This would limit the growth effects stemming from higher consumption. Very positive effects from large infrastructure projects are unlikely too, as they (if any) are likely to be triggered by tax incentives, rather than direct government spending (see above).

Overall we can conclude that enormous growth benefits are unlikely to be realized given the currently advanced business cycle in the US and the design of the fiscal package. Even very expansionary fiscal policies are unlikely to lead to substantially higher economic growth, but rather are likely to lead to increased inflationary pressures. Though a gradual increase in inflation is welcome as part of a gradual exit from the New Normal situation with exceptionally low growth and inflation in recent years, a fast acceleration in inflation will trigger a reaction from the Fed that will fight inflation by a more restrictive

monetary policy. This would again reduce the growth enhancing effects of fiscal expansion. Current anticipation in financial markets is likely to be too optimistic.

Figure 8 - Distribution of Tax Cuts by Household Income
(% change in after-tax household income)



Source: Tax Policy Center (2016)

What will the future bring?

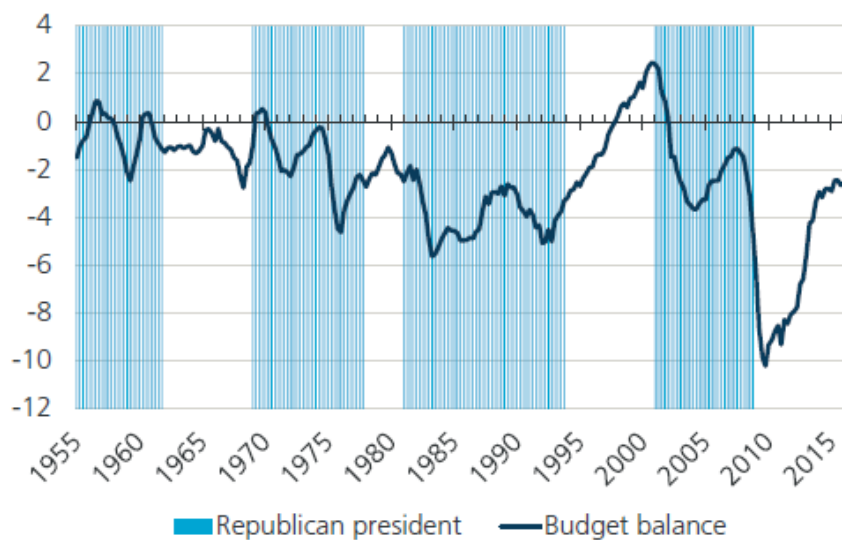
Our analysis indicates that Donald Trump's current plans have a major impact on US public finances. This raises two questions. First, how realistic are these plans and what is the probability that these plans will come through. The answer to this question is mainly of political nature. Secondly, if these plans are implemented, one can wonder whether US public debt is still sustainable, or whether the US will lose its credibility on international financial markets.

In order to answer the first question, it is important to notice that in principle the US president only submits a budget request to the US Congress, that needs to be approved by both the House of Representatives and the Senate. President Trump will be backed by Republican majorities in the House and Senate. Yet, the House Republicans made their own blueprint for a complete overhaul of the income tax system, which is in many ways similar to Trump's plan, but would reduce federal revenues by only half as much, according to Tax Policy Center estimates. In the meantime, House Speaker Paul Ryan has said that the plan will be adjusted to achieve revenue neutrality, if necessary after including

macroeconomic feedback effects. Both Kevin Brady, chairman of the House Ways and Means Committee, and Senate Majority Leader Mitch McConnell have reiterated revenue neutrality. Consequently, Trump will have to compromise with Congress.

Yet, one can take some loosening of fiscal policy for granted, as there are several ways to define “revenue neutrality”, e.g. by discussing the reference base and allowing room for payback effects. Overall, it will be easier for the Republican Congress to support stimulating tax measures than stimulating spending measures and compromising on fiscal policy looks easier than compromising on trade policy, as Trump’s stance in this policy field is much less in line with Republican views. Early January 2017, House Speaker Paul Ryan declared that Congress would not be raising trade tariffs. And when looking at history, it appears that republican presidents mostly run larger budget deficits than democratic presidents (figure 9). Hence one can expect that Donald Trump will succeed in getting parliamentary support for his expansionary fiscal plans, though it seems unlikely that he will get support for all his plans.

Figure 9 - Republican Presidents and the Budget Deficit (% of GDP)



Source: KBC Economic Research, US Treasury

Turning to the second question, the answer depends on a realistic estimate of the growth impact of

Table 3 - Estimate of Fiscal Stimulus over a 2 Year Horizon

	annual	multi-	GDP impact	
	stimulus	plier	bn USD	%
	in USD bn			
Individual tax cut	277	0.5	139	0.8%
Corporate tax cut	285	0.2	57	0.3%
Spending	-36	1.0	-36	-0.2%
Total	526		160	0.9%
P.M. Infrastructure	100	1.0	100	0.5%

Source: KBC Economic Research

fiscal expansion. Based on CRFB's estimates of Trump's plan in table 1 and inspired by the CBO range of estimates for fiscal multipliers (table 2), one could estimate that full implementation of the plans would add around 1% of GDP-growth over a two-year period, that could start mid-2017 (see table 3). Though rather low, this figure is an upper limit, as full implementation of the plans is unlikely. It would increase by around 0.5%-point if we add some net spending increases, e.g. on defence or infrastructure. As mentioned, it is highly uncertain to what extent fiscal stimulus for infrastructure will really add to investment or simply be a substitute for other investments.

The impact could also be higher than the above estimate, if the overall policy change triggers a positive vibe for the US economy, spurring private consumption and investments to faster growth. But downsides look bigger, as at the current state of the business cycle monetary policy is likely to be tightened aggressively to tame inflation, that could also be fuelled by protectionist trade and migration policies. These would temper potential economic growth. Finally, economic growth could be hampered by the rising public debt, crowding out private investments and undermining confidence in the US economy. The latter could come to the fore, as a parsimonious analysis suggests that with only limited positive economic growth effects the rise in the debt ratio would be only marginally tempered (see the KBC estimate in Figure 10). As a result, the US public debt may become unsustainable in the longer run, entailing the risk of a weakened international credibility that could lead to reduced access to international financial means and triggering an interest snow ball due to increased risk premiums on US treasury paper and bonds.



Conclusion

Our analysis indicates that Donald Trump's expansionary fiscal plans, though still vague, may lead to a very substantial increase in US public debt, while generating only limited economic benefits. It is likely that the US Congress and Senate will resist to some of the initial proposals reducing the upward pressure on US public debt. Moreover, the risk of a weakened international credibility will force the US to keep the growth rate in public debt under control as weakened credibility would lead to reduced access to international financial means and an interest snow ball due to increased risk premiums on US treasury paper and bonds. As a result, the US public debt may become unsustainable in the longer run.

Given the conclusion from our analysis, the current wave of optimism in US financial markets may not be realistic. The strong anticipation on expected higher inflation is likely to be correct, but growth expectations may not be fulfilled completely in the future. Moreover, the long-term stability of the US economy is jeopardized by the negative effects on the US fiscal position.

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Annex

Figure A1 - US State, Local and Federal Debt (% of GDP)

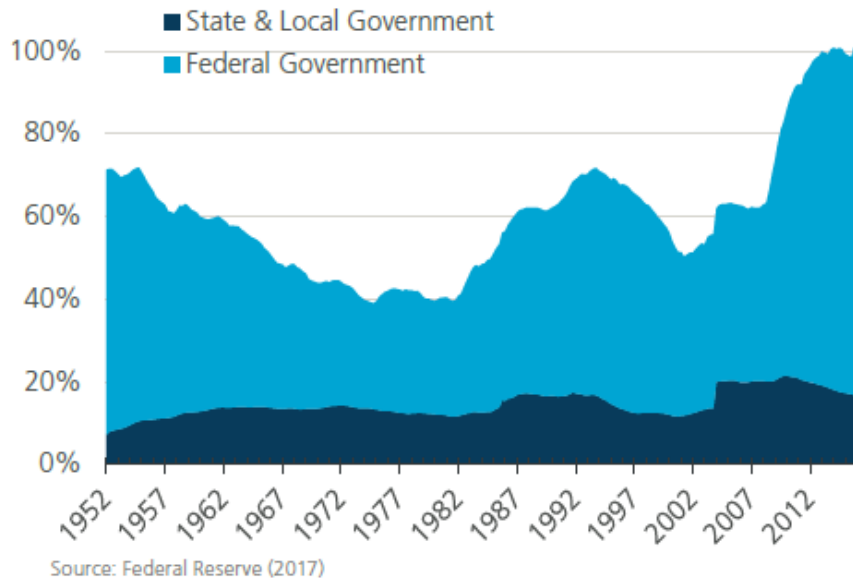


Figure A2 - Federal Government Spending and Revenues (% of GDP)

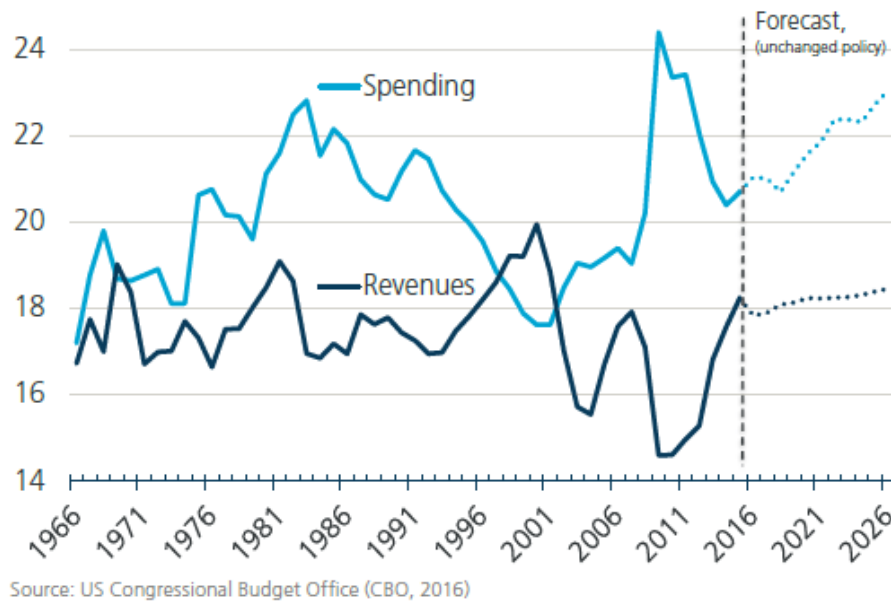
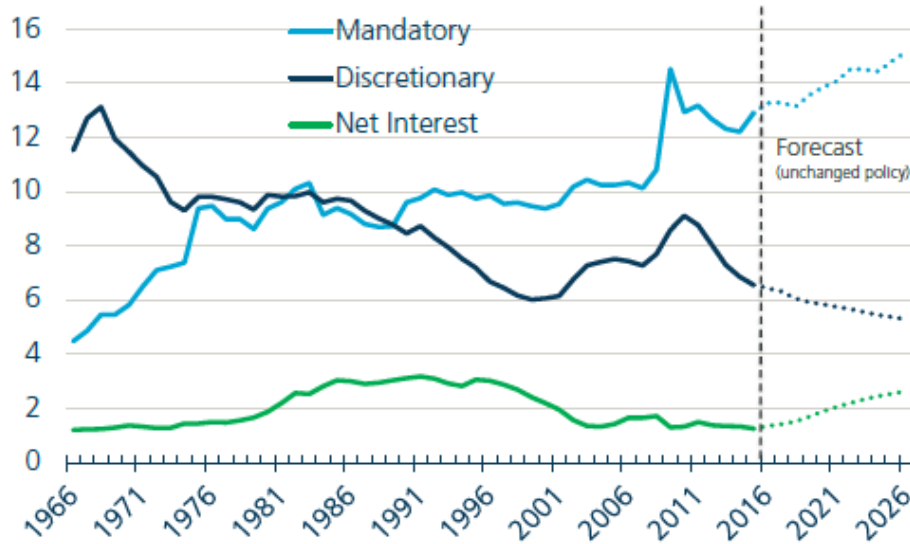
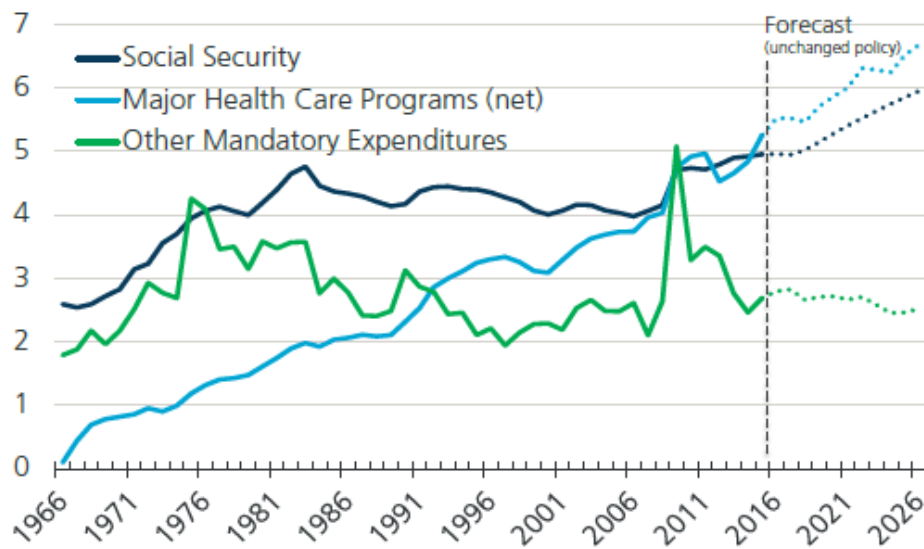


Figure A3 - Federal Government Expenditures (% of GDP)



Source: US Congressional Budget Office (CBO, 2016)

Figure A4 - Detail Mandatory Expenditures (% of GDP)



Source: US Congressional Budget Office (CBO, 2016)