“America First,” Fiscal Policy, and Financial Stability

Michalis Nikiforos

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Three Major Structural Problems

In recent reports we have identified three main structural impediments to a robust, sustainable recovery:

1. high income inequality
2. weak net-export demand
3. the fiscal conservatism
Three Major Structural Problems

- If an economy faces **weak net-export demand** and at the same time there is a **restrictive fiscal policy**, economic growth becomes dependent on rising private borrowing.

- Growth is the result of a spectacular rise in private expenditure *relative to income* and thus an increase in the debt to income ratio of the private sector.

- Because of **rising inequality** this increase in the debt-to-income ratio falls unevenly on households at the bottom of the distribution.

- This process is facilitated by **asset inflation**; the “Main St” is at the mercy of the Wall St to an unusual extent.
Baseline Scenario

- Builds on the CBO’s *The Budget and Economic Outlook: 2017–2027* (June 2017 update)
- Examines the conditions necessary for these projections to materialize.
- Assumptions as neutral as possible (e.g. US trading partners growth and inflation rates as projected by the IMF WEO, FED rate according to the median projection of the FOMC etc.)
- “Business As Usual” Scenario (pressures on foreign sector)
### Table 1: Summary of the Revenue and Spending Effects of the Tax Changes ($ billions)

<table>
<thead>
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</thead>
<tbody>
<tr>
<td>Tax Changes for Individuals</td>
<td>-86.1</td>
<td>-182.0</td>
<td>-171.8</td>
<td>-172.2</td>
<td>-174.0</td>
<td>-169.9</td>
<td>-169.6</td>
<td>-170.9</td>
<td>-62.2</td>
<td>30.4</td>
<td>-787.1</td>
</tr>
<tr>
<td>Business-Related Tax Changes</td>
<td>-127.1</td>
<td>-131.5</td>
<td>-111.2</td>
<td>-90.6</td>
<td>-48.5</td>
<td>-16.5</td>
<td>-16.0</td>
<td>-24.2</td>
<td>-28.5</td>
<td>-49.5</td>
<td>-508.1</td>
</tr>
<tr>
<td>International Tax Changes</td>
<td>68.9</td>
<td>42.6</td>
<td>26.0</td>
<td>28.0</td>
<td>22.9</td>
<td>22.5</td>
<td>36.7</td>
<td>48.7</td>
<td>29.1</td>
<td>-0.8</td>
<td>188.2</td>
</tr>
<tr>
<td>Total Estimated Changes in Revenues</td>
<td>-144.3</td>
<td>-270.9</td>
<td>-257.0</td>
<td>-234.8</td>
<td>-199.6</td>
<td>-163.9</td>
<td>-148.9</td>
<td>-146.4</td>
<td>-61.5</td>
<td>-19.8</td>
<td>-1,107.0</td>
</tr>
<tr>
<td>Total Changes in Direct Spending</td>
<td>-8.6</td>
<td>9.1</td>
<td>1.8</td>
<td>-13.9</td>
<td>-21.8</td>
<td>-26.0</td>
<td>-28.8</td>
<td>-32.1</td>
<td>-21.1</td>
<td>-52.9</td>
<td>-33.3</td>
</tr>
<tr>
<td>Impact on Deficit</td>
<td>135.7</td>
<td>280.0</td>
<td>258.8</td>
<td>221.0</td>
<td>177.8</td>
<td>137.9</td>
<td>120.1</td>
<td>114.3</td>
<td>40.4</td>
<td>-33.1</td>
<td>1,073.7</td>
</tr>
</tbody>
</table>

*Source: CBO (2017c)*
### Table 2 Net Changes in Revenue and Outlays Due to Tax Law, by Income ($ millions)

<table>
<thead>
<tr>
<th>Income Category</th>
<th>2019</th>
<th>2021</th>
<th>2023</th>
<th>2025</th>
<th>2027</th>
</tr>
</thead>
<tbody>
<tr>
<td>Less than $10,000</td>
<td>1,530</td>
<td>5,890</td>
<td>7,540</td>
<td>8,790</td>
<td>10,120</td>
</tr>
<tr>
<td>$10,000 to $20,000</td>
<td>150</td>
<td>8,120</td>
<td>10,700</td>
<td>11,320</td>
<td>16,290</td>
</tr>
<tr>
<td>$20,000 to $30,000</td>
<td>-1,090</td>
<td>7,910</td>
<td>9,440</td>
<td>11,430</td>
<td>17,100</td>
</tr>
<tr>
<td>$30,000 to $40,000</td>
<td>-4,770</td>
<td>310</td>
<td>2,490</td>
<td>2,840</td>
<td>7,850</td>
</tr>
<tr>
<td>$40,000 to $50,000</td>
<td>-6,450</td>
<td>-2,590</td>
<td>-1,240</td>
<td>-590</td>
<td>5,510</td>
</tr>
<tr>
<td>$50,000 to $75,000</td>
<td>-23,050</td>
<td>-18,760</td>
<td>-14,910</td>
<td>-14,380</td>
<td>4,030</td>
</tr>
<tr>
<td>$75,000 to $100,000</td>
<td>-22,580</td>
<td>-21,030</td>
<td>-17,090</td>
<td>-17,240</td>
<td>-1,720</td>
</tr>
<tr>
<td>$100,000 to $200,000</td>
<td>-70,690</td>
<td>-65,880</td>
<td>-50,780</td>
<td>-49,790</td>
<td>-7,600</td>
</tr>
<tr>
<td>$200,000 to $500,000</td>
<td>-65,650</td>
<td>-62,040</td>
<td>-47,250</td>
<td>-48,140</td>
<td>-6,680</td>
</tr>
<tr>
<td>$500,000 to $1,000,000</td>
<td>-23,990</td>
<td>-21,800</td>
<td>-14,180</td>
<td>-13,790</td>
<td>-3,300</td>
</tr>
<tr>
<td>$1,000,000 and Over</td>
<td>-36,940</td>
<td>-30,130</td>
<td>-10,160</td>
<td>-9,960</td>
<td>-8,920</td>
</tr>
<tr>
<td>Total, All Taxpayers</td>
<td>-253,500</td>
<td>-200,000</td>
<td>-125,440</td>
<td>-119,500</td>
<td>32,690</td>
</tr>
</tbody>
</table>

*Note:* A decrease in federal deficits, such as an increase in taxes or a decrease in spending, is shown as a positive value. An increase in federal deficits is shown as a negative value.

*Source:* CBO (2017d)
What happens to investment?

- Supporters of the law have emphasized the major boost in investment
- Higher cash flows provide internal funds for new investment, boost firms’ expectations of future profitability.
- A central macroeconomic stylized fact of the last decades has been the gradual decoupling of investment from cash flows.

Example

Tax holiday in the 2004 American Jobs Creation Act
What happens to investment?

- Supporters of the law have emphasized the major boost in investment
- Higher cash flows provide internal funds for new investment, boost firms’ expectations of future profitability.
- A central macroeconomic stylized fact of the last decades has been the gradual decoupling of investment from cash flows.

Example
Tax holiday in the 2004 American Jobs Creation Act

- Move toward a territorial US tax system: disincentive for US firms to increase their domestic investment
- Corporate tax cuts in the United States are imitated by the other major economies
Tax Cuts and Jobs Act

Figure 9 Scenario 1: GDP Growth Rate (difference from baseline)

Source: Authors’ calculations
Figure 10 Scenario 1: Main Sector Balances, Actual and Projected, 2005–21 (difference from baseline)

Source: BEA; Authors’ calculations
A Public Infrastructure Plan

**Figure 11 Scenario 2: GDP Growth Rate (difference from baseline)**

Source: Authors’ calculations
A Public Infrastructure Plan

Figure 12 Scenario 2: Main Sector Balances, Actual and Projected, 2005–21 (difference from baseline)

Source: BEA; Authors’ calculations
Fiscal Expenditure

- Bipartisan Budget Act of 2018 & Consolidated Appropriations Act, 2018 (omnibus bill)
- Raise the caps on discretionary spending for the 2018 and 2019 fiscal years by $143 and $153 billion
**Figure 13** Scenario 3: GDP Growth Rate (difference from baseline)

Source: Authors’ calculations
Figure 17 Ratio of Market Capitalization to GDP and Net Operating Surplus, 1971Q1–2017Q1 (1971Q1=100)

Note: The index is calculated as the ratio of end-of-period Wilshire 5000 index to GDP and net operating surplus, respectively.

Source: BEA; Wilshire Associates; Authors’ calculations
Financial Markets

**Figure 18** Shiller Cyclically Adjusted Price–Earnings Ratio

P/E 10, 1881–2018

Source: econ.yale.edu/~shiller/data.htm
Scenario 4

Coupled with

1. Elevated indebtedness of households and firms
2. Increase in the size of the shadow-banking sector
3. Increasing interest rates and unwinding of QE

Scenario 4:

- Stock market falls in the second half of 2018 and the first half of 2019, then stabilizes for the rest of the projection period.
- The S&P 500 Index falls to around 1800 by the second quarter of 2018—still above its precrisis levels in 2000 and 2007.
- The fall in the stock market induces a second round of deleveraging lasting from the end of 2017 to the end of the projection period.
**Figure 19** Scenario 4: GDP Growth Rate (difference from baseline)

Source: BEA; Authors’ calculations
Tariffs

- Tariffs on steel and aluminum and Chinese products
- Political motivation
- Unlikely to have significant results:
  1. Global Value Chains: Bilateral trade deficit with China reflects to a large extent the role of China as world’s assembly line (overall and not bilateral deficits matter most)
  2. Possibility of retaliation (likely to be very painful for some sectors)
- G.W. Bush tariffs of 2002
- Contradiction with move to territorial tax system
Conclusion

- Fiscal expansion will have some significant positive short run results
- Inequality will increase
- Trade policy unlikely to solve the weak net export demand
- Likelihood of reversal to fiscal orthodoxy
- Recovery is threatened by the fragility of the financial markets
- Echoes of early 2000s