# “America First,” Fiscal Policy, and Financial Stability

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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)

# Tax Cuts and Jobs Act

**Table 1** Summary of the Revenue and Spending Effects of the Tax Changes ($ billions)

| | 2018 | 2019 | 2020 | 2021 | 2022 | 2023 | 2024 | 2025 | 2026 | 2027 | 2018–22 | 2018–27 |
|---|---|---|---|---|---|---|---|---|---|---|---|---|
| Tax Changes for Individuals | -86.1 | -182.0 | -171.8 | -172.2 | -174.0 | -169.9 | -169.6 | -170.9 | -62.2 | 30.4 | -787.1 | -1,329.3 |
| Business-Related Tax Changes | -127.1 | -131.5 | -111.2 | -90.6 | -48.5 | -16.5 | -16.0 | -24.2 | -28.5 | -49.5 | -508.1 | -644.1 |
| International Tax Changes | 68.9 | 42.6 | 26.0 | 28.0 | 22.9 | 22.5 | 36.7 | 48.7 | 29.1 | -0.8 | 188.2 | 324.4 |
| Total Estimated Changes in Revenues | -144.3 | -270.9 | -257.0 | -234.8 | -199.6 | -163.9 | -148.9 | -146.4 | -61.5 | -19.8 | -1,107.0 | -1,649.0 |
| Total Changes in Direct Spending | -8.6 | 9.1 | 1.8 | -13.9 | -21.8 | -26.0 | -28.8 | -32.1 | -21.1 | -52.9 | -33.3 | -194.1 |
| Impact on Deficit | 135.7 | 280.0 | 258.8 | 221.0 | 177.8 | 137.9 | 120.1 | 114.3 | 40.4 | -33.1 | 1,073.7 | 1,454.9 |

*Source:* CBO (2017c)

# Tax Cuts and Jobs Act

**Table 2** Net Changes in Revenue and Outlays Due to Tax Law, by Income ($ millions)

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

*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

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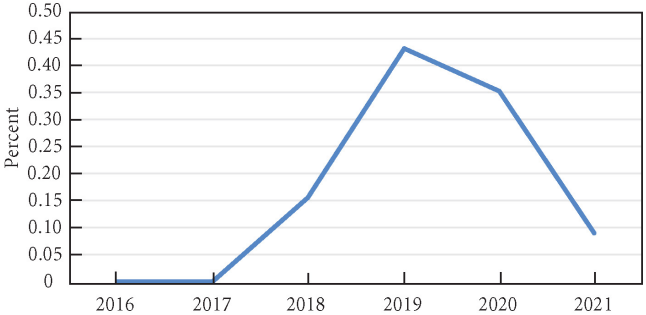
Tax holiday in the 2004 American Jobs Creation Act

- 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

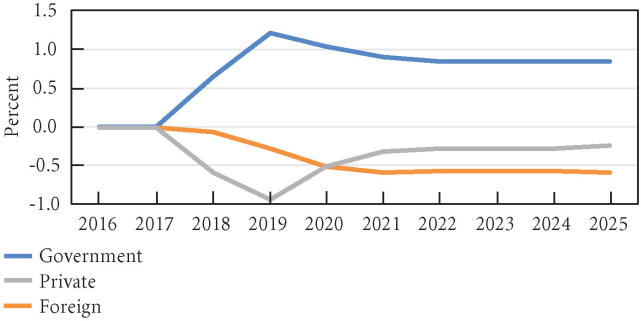
**Figure 9** **Scenario 1: GDP Growth Rate (difference from baseline)**




*Source:* Authors' calculations

# Tax Cuts and Jobs Act

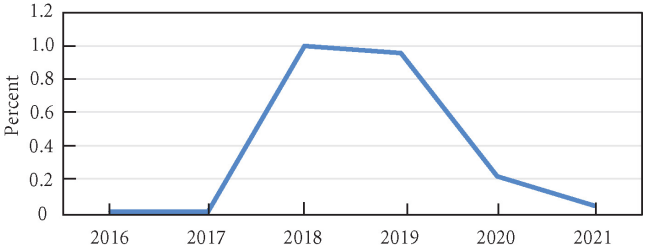
**Figure 10** **Scenario 1: Main Sector Balances, Actual and Projected, 2005–21 (difference from baseline)**




*Source:* BEA; Authors' calculations

# A Public Infrastructure Plan

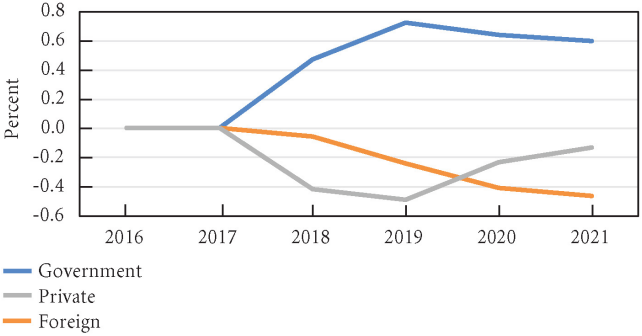
**Figure 11** Scenario 2: GDP Growth Rate (difference from baseline)




*Source:* Authors' calculations

# A Public Infrastructure Plan

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



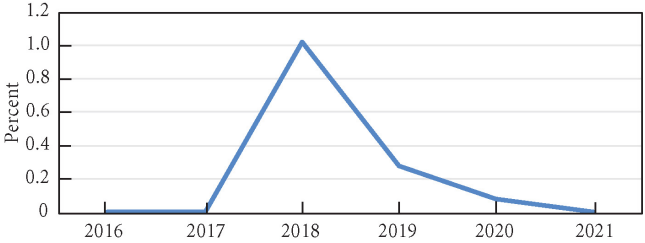

*Source:* BEA; Authors' calculations

# 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

# BBA & Omnibus

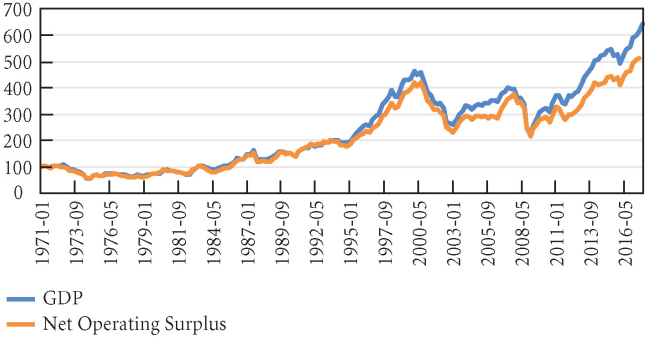
**Figure 13** Scenario 3: GDP Growth Rate (difference from baseline)




*Source:* Authors' calculations

# Financial Markets

**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

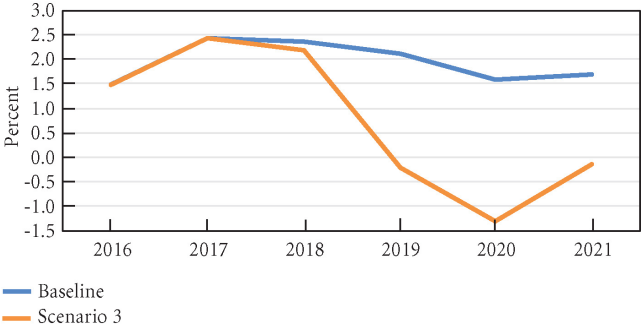
Coupled with

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

# Tarrifs

- 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