

HRI Report

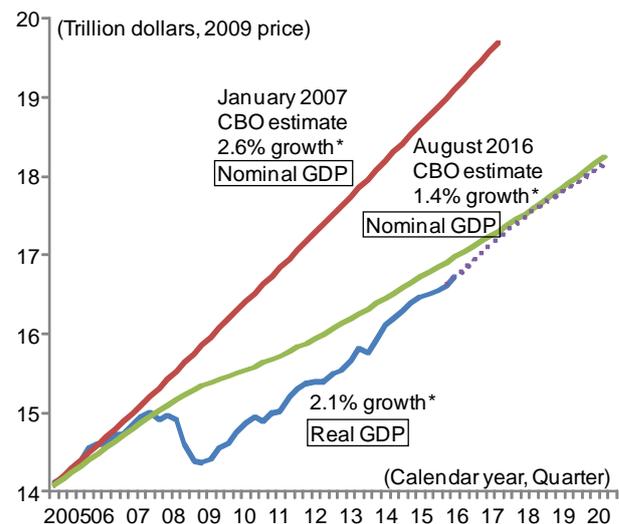
Economic and Trade Policies of the Trump Administration and Their Effects

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To make predictions about the state of the US economy in 2020, it is necessary to speculate about the economic and trade policies which President Trump, who was sworn into office on January 20, 2017, will implement during his four-year term. Although President Trump nominated many of his cabinet members, it is not clear at the time this article is written whether or not certain candidates will be approved by Congress. As a result, the lineup of the new administration is not clear. Furthermore, his feature policies, including large-scale tax cuts and infrastructure investments, must be discussed and legislated with the Republican Party, which holds the majority in both the Senate and the House, so the content and scale of the resultant policies are still unclear. Therefore, in this article, I forecast the state of the U.S. economy in 2020 based on speculations about economic and trade policies inferred from materials the Trump camp released during the election campaign.

1. The US Economy is Close to Full Employment at Present

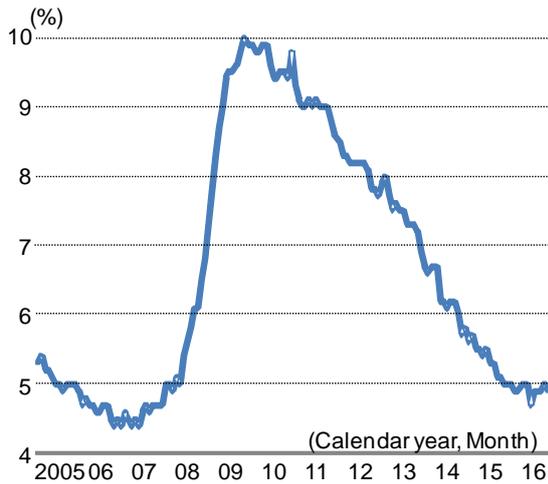
First of all, let us look at the current state of the U.S. economy which the new administration must mark as the starting line for its economic and trade policies. After the Great Recession (from December 2007 to June 2009), the real GDP failed to achieve the V-shape recovery to the potential GDP level (real GDP level that might have been realized in case of full employment) which the Congressional Budget Office had estimated in January 2007 before the recession. Instead, it continued to grow gradually at a pace of 2.1 percent per annum, so the gap between it and the estimated potential GDP continued to widen (Figure 1).



* Figures are the average growth rate from 4Q 2009 to 4Q 2015.
Source: Compiled Hitachi Resource Institute based on data from the U.S. Department of Commerce and Congressional Budget Office (CBO)

Figure1. Real GDP and Potential GDP

Meanwhile, the unemployment rate has fallen to less than 5 percent (Figure 2). People who exited the labor market after giving up on looking for work are not included as unemployed in these numbers. As some of these people will return to the labor market, we are now close to, but not yet at the full employment. The Congressional Budget Office released a new estimate of the potential GDP in August 2016. Growth rate of potential GDP was revised down from 2.6 to 1.4 percent (Figure 1). The deflationary gap of July-September 2016 (gap between potential GDP and real GDP) is now estimated to be 1.5 percent. If this estimation is correct, growth of about 2 percent per annum will be the upper limit, and any attempt to stimulate the economy to achieve growth in excess of this will overheat the economy and trigger inflation.



Source: Compiled by Hitachi Research Institute based on data from the U.S. Department of Commerce

Figure 2. Unemployment Rates

President Trump’s economic and trade policies, to follow through on his campaign promises, appear to coincide with such economic stimulus. During his presidential election campaign, he pledged (*1) to create new employment for at least 25 million people and aim for economic growth of 4 percent per annum through large-scale tax cuts, improvement in trade, deregulation, and abolition of regulatory measures on the U.S. energy production (Table 1).

In the financial market, which has anticipated overheating, share prices are rising along with long-term interest rates, resulting in a strong dollar. The question, however, is whether demand will be created to the extent that it actually overheats the economy. Let us examine this issue in the next chapter.

Table 1. Overview of Pledges Made by President Trump

Pursue with executive orders from day 1 in office	
A)	Clean up the corruption and special interest collusion
B)	Protect American workers
	Renegotiate NAFTA or withdraw from it, if necessary
	Withdraw from the Trans-Pacific Partnership (TPP)
	Label China a currency manipulator
	End foreign trading abuses that unfairly impact American workers
	Abolish regulations on the energy industry, and create \$50 trillion in business
	Approve and promote energy infrastructure projects
	Cancel payments to UN climate change programs, and use money to fix American water and environmental infrastructure
C)	Restore security and the constitutional rule of law
Work with Congress to legislate within 100 days	
A)	Tax Relief and Simplification Act
	Grow the economy at 4 percent per year, and create at least 25 million new jobs
	35 percent tax cuts to a middle-income families
	Reduce the corporate income tax rate from 35 to 15 percent
	American corporate money overseas can be brought back at a 10 percent tax rate
B)	American Energy and Infrastructure Act, and End the Offshoring Act
	Spur \$1 trillion in infrastructure investment over 10 years. It is revenue neutral.
	Establish tariffs when goods produced overseas are brought into the country
C)	Repeal and Replace Obamacare Act
	Replace Obamacare with health savings accounts, and accelerate the approval of new drugs

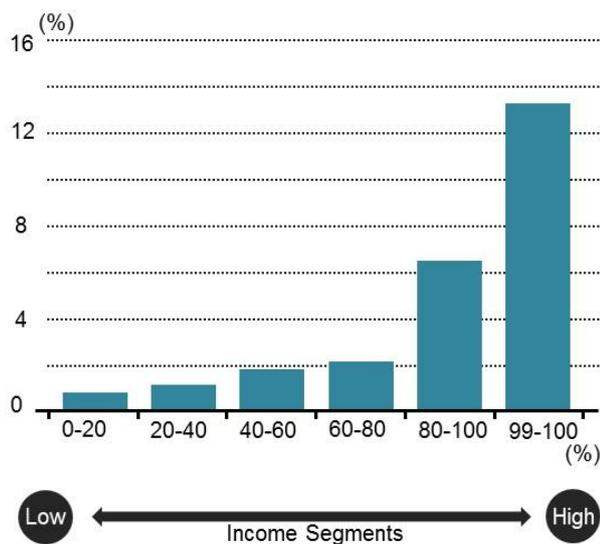
Source: Compiled by Hitachi Research Institute based on the Trump website

2. Outlook for Economic Policy and its Effects

2.1 Large-scale Tax Cuts Based on Supply-side Economics

News is circulating that Larry Kudlow, a TV commentator and economic critic who subscribes to supply-side economics, is to be appointed chairman of the Council of Economic Advisers to the President. Supply-side economics is based on the principle that if taxes of the affluent are reduced, they will start up businesses and the benefits flowing from these will trickle down to middle- and low-income segments as increased

employment and income. At the same time, tax revenue will increase and offset losses from tax reductions. Although this theory has been rejected empirically (*2), the Republican Party, which advocates small government, also believes this theory. While President Trump has announced a large-scale tax reduction plan that is generous to the wealthy (Figure 3), Speaker of the House of Representatives Paul Ryan and House Ways and Means Committee Chairman Kevin Brady have also announced a similar plan (Table 2), and integration talk is on the way.



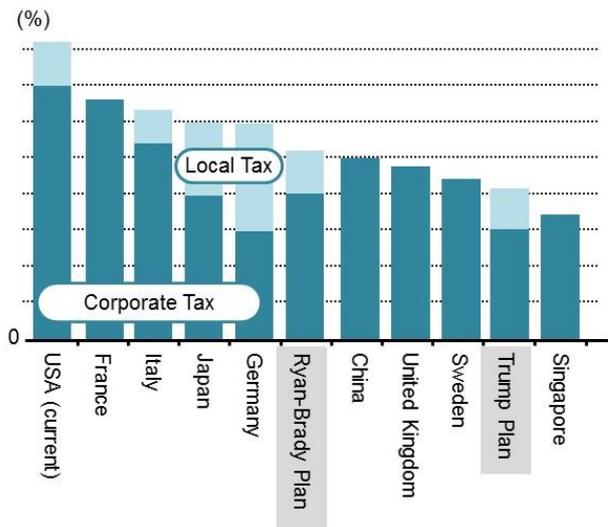
Source: Tax Policy Center (*3)
Figure 3. Percent Change in After-Tax Income under Trump's Tax Reduction Plan

Table 2. Tax Reduction Plans of President Trump and the Republican Party

Item	Current	Trump plan	Ryan-Brady plan
Individual income tax rate	7 stages from 10-39.6%	3 stages from 12-33%	3 stages from 12-33%
Tax rate for earnings from a pass-through entity (partnership, etc.)	Same as individual income tax rate	Flat 15%	Upper limit of 25%
Inheritance tax, gift tax	-	Abolish both taxes	Abolish inheritance tax
Corporate income tax rate	35%	15%	20%

Source: Compiled by Hitachi Research Institute based on data from TPC (*3), AEI (*4), etc.

Corporate income tax rate under Trump's plan would be the lowest of any country excluding Singapore at 15 percent (Figure 4). Under the Ryan and Brady plan, at 20 percent it is lower than corporate income tax rates in Japan and Germany.



Source: Compiled by Hitachi research Institute based on the data from Ministry of Finance
Figure 4: International Comparison of the Corporate Effective Tax Rates

The Tax Policy Center (*3), a U.S. think tank, estimates the scale of tax revenue reductions in individual income tax based on the Trump plan will be a total of \$3.4 trillion over a 10-year period after its implementation. The AEI (*4), a conservative think tank, estimates tax revenue reduction in individual income tax based on the Ryan-Brady plan will be a total of \$0.2 trillion over a 10-year period including the abolition of various tax deductions, and \$2.3 trillion if various tax deductions cannot be abolished. While the proposed total tax reductions for individual income tax eclipse the level of Bush tax reductions in 2001 (\$1.35 trillion over 10 years), in reality, the overall amount is highly likely to settle at less than \$2 trillion over 10 years.

While large-scale tax reductions generous to the wealthy are not likely to produce supply-side effects, such as new business creation, and to increase tax revenue enough to offset tax reduction, they may produce demand-side effects of increased effective demand based on Keynesian economics. However, marginal propensity to consume in the wealthy segment is lower than that of middle- and lower income segments. If total tax reductions

for individual income tax over the 10-year period is \$2 trillion and the multiplier factor is 0.2, demand creation to GDP will be about 0.2 percent, which is unlikely to overheat the economy.

2.2 Increase in Infrastructure Investment Will Rely on Private Sector Funding

The literature that sets out in the most detail President Trump's infrastructure investment plan is probably the paper written by Wilbur Ross, an investor, and Professor Peter Navarro of the University of California, Irvine, both in the Trump camp, released in October 2016 (*5). According to this paper, plans are to invest \$1 trillion in infrastructure over 10 years in an innovative fundraising approach that will require no spending from the public purse. The paper presents a concept whereby an implementing company will be established for each infrastructure project.

In a nut shell, the plan is envisioned as follows: "Implementing companies will raise equity from investors, and 5-fold amount of debt from banks and others. To carry out projects amounting to \$1 trillion, it is necessary to raise equity investment of \$167 billion, 1/6 of the total amount, from investors. The government will provide tax credit equal to 82 percent of the equity amount to investors. \$137 billion, 82 percent of the \$167 billion, will be returned to investors. So, the return which investors require from their equity investment will decrease. Assuming a capital cost of debt 4.5 to 5.0 percent, and that of equity double of that, the capital cost for financing the project will be reduced by 18 to 20 percent through tax credit. As \$1 billion infrastructure investment will be newly implemented, wage income will increase by \$440 billion, and the individual tax revenue will increase by \$123.2 billion at an average tax rate of 28 percent. Corporate income will also increase by \$100 billion, and corporate income tax will increase by \$15 billion at tax rate of 15 percent. As a result, the total tax revenue increase will amount to \$138.2 billion, enough to offset tax reductions of \$137 billion. So this plan is revenue neutral."

Revenue neutral claim is dubious. Increasing infrastructure investment by \$1 trillion from the full employment condition

will result in crowding out of other work. Therefore, we can't get a net increase of \$440 billion in wage income and \$100 billion in corporate income.

Before even considering crowd out effect, let us consider whether there will be profitable projects amounting to \$1 trillion by simply lowering the capital cost by 18 to 20 percent. Based on investment costs of 5 percent for debt and 10 percent for equity, and a ratio of debt to equity of 5 to 1, the weighted average capital cost is 5.84 percent. This will be lowered by 18 to 20 percent after tax credits to 4.67 to 4.79 percent. This makes the difference between before and after tax credits 1.05 to 1.17 percent. With only this modest difference, will \$1 trillion worth of infrastructure projects suddenly become profitable? If so, much more infrastructure investment should have been carried out with lower interest rates after the Great Recession.

The number of \$1 trillion over 10 years came to birth from thin air. First, rival presidential candidate Hillary Clinton announced her infrastructure investment plan for \$275 billion over five years. Then, Donald Trump launched his counter plan by doubling the amount to \$550 billion over the same period. He later revised the number to \$1 trillion and the timeframe to 10 years, without actually doing any detailed calculations on probable projects.

If tax credits are legislated, they may be advantageous to utility companies such as power companies which have already planned profitable infrastructure projects, but there may not be a significant increase in new projects. Under this plan, the maintenance of old roads and bridges, which will have high returns on investment from a social perspective, may not move forward due to lack of profitability from the viewpoint of private investors.

Furthermore, any commitment to giving priority to legislation on an infrastructure investment plan is not evident among the House Republicans at present. Therefore, it is unlikely that infrastructure investment will overheat the economy by 2020.

3. Outlook for Trade Policy and its Effects

3.1 Will GDP Increase if the Trade Deficit is Reduced?

In addition to their paper on infrastructure investment released in October 2016 (*5), Wilbur Ross and Professor Peter Navarro also co-authored a paper on trade policy and economic policy, which they released in September 2016 (*6). Ross has been nominated as Secretary of Commerce, and Navarro as the head of the newly created National Trade Council. They are expected to lead or advise on trade policies in the new administration. To get an overview of the new administration's perception of trade, let us look at some of the points of this paper as stated below:

- Reducing the approximate \$500 billion trade deficit will increase GDP by the same amount, and 3.5 percent growth rather than 2 percent growth will be achievable.
- While outbound foreign direct investment will increase the GDP of the investment destination country, it will reduce GDP by that amount in the country of the investor.
- The VAT (value added tax) adopted by many countries including Mexico is imposed on imports while exports are exempt. This works as a backdoor tariff against American products. WTO rules, which do not recognize this practice as unfair trade, are a poster child of poorly negotiated trade deals.
- China earns a U.S. trade surplus through currency manipulation that keeps the Chinese yuan artificially low.

These views seem to consider only the direct effect of trade and investment, and tend to play down the subsequent effects.

Their argument that reducing the trade deficit will increase GDP by the same amount appears to be a valid point premised on the accounting equation $GDP = \text{domestic demand} + \text{net exports (trade balance)}$. Under full employment conditions, a net export increase will reduce domestic demand, while the GDP will remain unchanged. As perhaps the authors have met with this kind of counterarguments many times before, they also note that 2.2 million potential workers are "missing" from the

unemployment count and, therefore, this is not full employment. If these 2.2 million workers return to the labor market altogether within a year, 3.5 percent growth in that year may be possible. Nevertheless, maintaining 3.5 percent growth over several years is not possible.

In regard to outbound foreign direct investment, if the GDP of the investment destination country increases, exports from the country of the investor will also increase. There may also be inbound foreign direct investment back to the country of the investor. So, outbound foreign direct investment itself will not reduce GDP.

In regard to VAT, there seems to be a misunderstanding based on their view of export exemption and import taxation as export promotion and import restriction. Let us look at taxation on VAT country products and U.S. products respectively in VAT country market and U.S. market. Both products are taxed in VAT country market, and both products are not taxed in U.S. market. There is no difference in tax treatment of both products.

In regard to the Chinese yuan, their understanding may have been reasonable in 2007 when China's current account surplus was close to 10 percent of GDP. At present, however, this figure has fallen to 2 percent. The Chinese government is actually enforcing capital control and intervening in the foreign exchange market to prevent depreciation of the Chinese yuan. The perceptions of the authors can be considered to be out of date.

3.2 Fear of escalation into a trade war

If their perception is that WTO rules are a poster child of poorly negotiated trade deals, it can be assumed that they view all existing trade deals as deals that were poorly negotiated. In fact, the Trump administration announced the U.S. withdrawal from the TPP. It is believed that the administration will also seek renegotiation of NAFTA with Mexico and Canada. To be able to show positive outcomes in its skillful negotiations, the new administration is very likely to give priority to bilateral negotiations rather than multilateral negotiations which require more time.

Based on its understanding of VAT and the Chinese yuan, the Trump administration is likely to impose high tariffs on imports from Mexico and China unilaterally

through executive orders, and to make export profits exempt while not recognizing import as expenses in corporate income tax calculation under its tax reform.

In China, the government cannot respond in a manner that would be perceived as weak-kneed just ahead of a reshuffle of top leaders in the fall of 2017. Depending on the U.S. attitude, there is a possibility that a trade war could develop where both sides will impose high tariffs on each other.

3.3 Intervening in the factory location of individual companies in the name of patriotism

Intervening in free enterprise and targeting individual companies by naming them publicly in efforts to prevent them from relocating offshore can be viewed as a policy that takes into consideration only direct effects. Targeting major corporations like Carrier and Ford, the administration has achieved results, which voters applaud, and it is highly likely that this practice will continue in the future.

In Mexico, however, where efforts to attract factories are being thwarted by the threat of high tariffs and intervention in individual companies, the value of the peso is falling, so export competitiveness may be improving on the net. In this environment, there is even a possibility the number of relocations of SMEs will increase in the future in less visible ways.

3.4 Economic and trade policies are inconsistent

In its economic policy, the administration has set a 4 percent growth target through tax reductions and infrastructure investment. At the same time, its trade policy, as discussed in this section, aims to reduce the trade deficit and bring about a recovery in employment in the manufacturing industry. The understanding of the new administration is that if the trade deficit is reduced, the GDP will increase by that amount. There may be no contradiction in that per se. However, if we take into consideration the impact of the economic policy on the economy as a whole, bearing in mind that we are almost at full employment, the more taxes are reduced and infrastructure investments are implemented on a grand

scale, the more the fiscal deficit will increase, the economy will overheat, long-term interest rates will rise, the dollar will further strengthen, the trade deficit will expand, and employment in the manufacturing industry will further contract.

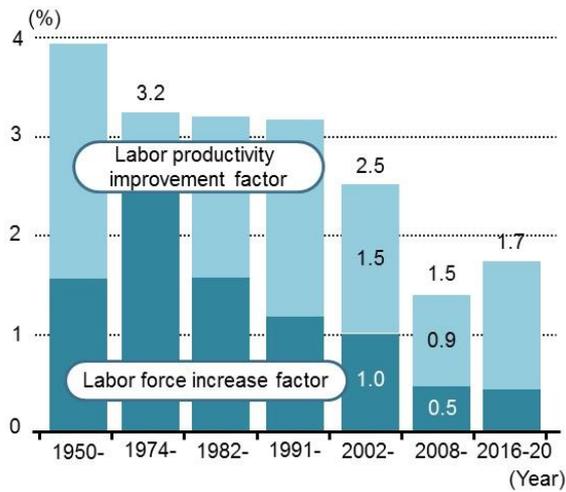
As observed in Section 2, tax reductions and infrastructure investment are actually unlikely to reach a level that will overheat the economy, and discrepancies in the economic and trade policies may not become too visible, but under these circumstances targets in neither policy will ultimately be achieved.

4. The U.S. Economy in 2020

In Sections 2 and 3, I point out that the economic and trade policies of the new administration are unlikely to create demand at a level that will overheat the economy. In Section 1, I also note that even if the creation of significant demand are achieved, it will only result in inflation due to the limitation of potential GDP, and annual economic growth of 4 percent pledged during the campaign will not be achieved.

However, the limitation of potential GDP is not an absolute one. Estimates of potential GDP are often revised, just as a downward revision was made following the Great Recession. The possibility of an upward revision following the start of the Trump administration can't be ruled out.

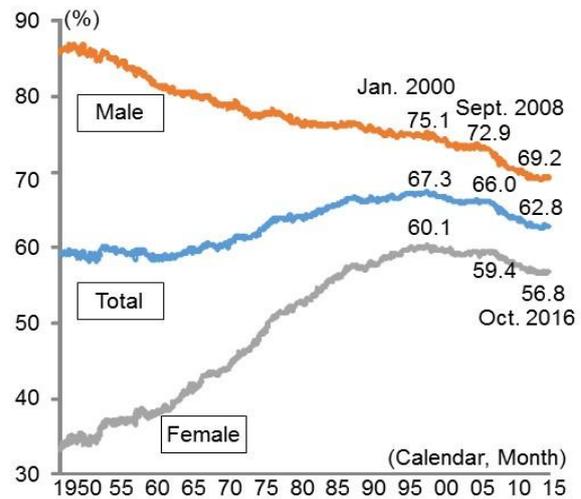
When the Congressional Budget Office made a downward revision of the potential growth rate of 2.5 percent from 2000 to 2007 to 1.5 percent from 2008 to 2015, it estimated that the increase in the labor force and the improvement in labor productivity were almost equally contributing factors for downward revision. It also estimated that the labor productivity improvement factor from 2016 to 2020 would improve by 0.2 percent, bringing about a slight recovery in the potential growth rate, raising it to 1.7 percent (Figure 5).



Source: Compiled by Hitachi Research Institute based on data from the Congressional Budget Office (August 2016)

Figure 5. Potential GDP Growth Factors

The factors that determine growth of the labor force are the growth rate of the population of 16 years of age or older, and the labor participation rate, which is the ratio of people participating in the labor market. Unless the new administration steps up immigration restrictions, the growth of the population of 16 years of age and older is expected to remain at the current level of 1 percent until 2020. The problem is the labor participation rate (Figure 6). While the labor participation rate until January 2000 decreased for men, it rose for women, and increased overall. After that, however, it followed a declining trend for both men and women, and fell particularly rapidly following the Great Recession. Currently, it is leveling but the aging of the population is applying downward pressure, and it may take considerable effort to keep it from falling further. Therefore, the contribution of the potential GDP growth rate factor to the increase in the labor force will remain around 1 percent at the highest.



Source: Compiled by Hitachi Research Institute based on data from the U.S. Department of Commerce

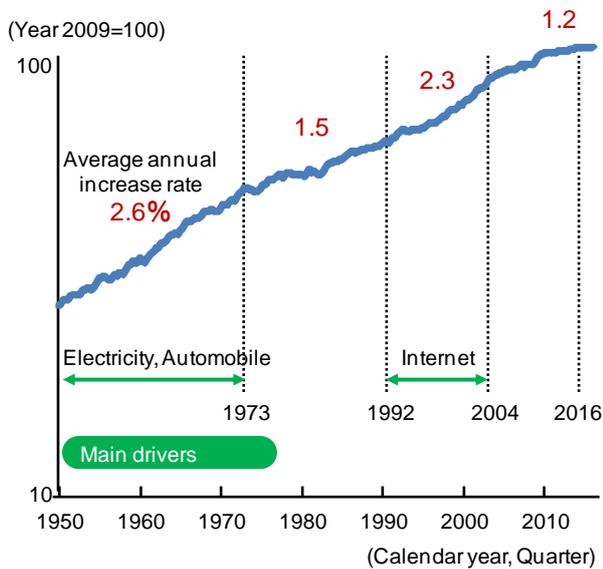
Figure 6. Labor Participation Rate (16 years and older)

The labor productivity improvement factor is determined by the growth of the added value one worker can achieve in one hour (Figure 7). Labor productivity rises as a result of capital investment in machinery and education as well as technological innovation, such as changes in production methods. The main drivers for growth in labor productivity after the World War II until the oil crisis of 1973 were use of electricity and combustion engines. The main drivers from 1992 to 2004 were the Internet and expansion of its use. If widespread penetration of IoT (Internet of Things) and AI (Artificial Intelligence) is achieved by 2020, they will become growth drivers and may be able to bring about growth in labor productivity around 2.5 percent. If this is achieved, in addition to the best case scenario of about 1 percent growth due to an increase in the labor force, it may be possible to achieve around 3.5 percent economic growth.

In regard to the growth of labor productivity, there are those who hold optimistic view (*7) and those who hold pessimistic view (*8). The majority of the Board of Governors of the Federal Reserve System (*9) are pessimistic in the same way as the Congressional Budget Office is, and their forecast for economic growth until 2020 is only about 2 percent.

If the new administration shifts its emphasis on stimulative economic policies and protect-American manufacturing-jobs trade policies to on science and

technology policy that will enhance labor productivity through innovation based on promotion of IoT and AI, the number of people holding an optimistic view may increase.



Note: Non-agricultural sector. The average annual increase rate is calculated based on the first quarter of each year.

Source: Compiled by Hitachi Research Institute based on data from the U.S. Department of Commerce

Figure 7. Labor Productivity (Per Hour)

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