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Economy Sound as Trump Era Begins

Donald Trump was elected on a mix of discontent and hope. The discontent was the result of an economy that never quite advanced to the stage of robust expansion, and a workforce seemingly left behind in the global economy. The hope was based on easily understood solutions proposed for vexing problems such as overseas job losses and rotting infrastructure. This week the President begins the task of turning promises into reality.

As the new president takes office, Americans will be willing to grant him a honeymoon period to enact his promised transformative legislation. The honeymoon will be short if the President prioritizes traditional Republican issues, such as tax policy favoring the wealthy, over the issue of good jobs that won him votes in traditional Democratic Party strongholds.

ECONOMY: REVENUES KEY TO AVOIDING SPIRALING DEFICITS

The solid economy should put wind in the sails of the new administration. But the aggressive program promised by the new president risks undoing the painstaking work on reducing deficits over the past few years.

Donald Trump's policy prescription for boosting GDP growth includes a double dose of fiscal stimulus: tax cuts and government funded infrastructure spending. Even within his own party, critics worry strong fiscal stimulus without accompanying government spending cuts risks blowing up the federal deficit.

The budget deficit, while still a problem, has been reduced during the second Obama administration, both on an absolute basis and as a percentage of GDP. For the recently concluded October 2016 government fiscal year, the federal budget deficit was $587 billion and represented 3.2% of GDP.

Consider that in 2009, the first full year of the great recession, the deficit was $1.41 trillion and represented 9.8% of GDP. The deficit blew up after 2008 as the government swung to emergency fiscal stimulus in the form of Trouble Asset Relief Program (TARP) and other bailout programs; first-time homebuyers credit and HARP (home affordable refinance program); and smaller programs such as Cash for Clunkers.

The summer 2011 showdown between Democrats and Republicans came within a whisker of ending the bull market, but out of that clash came the imperfect solution of sequestration. In subsequent years, the deficit was whittled down as a result of three inputs. (1) Sequestration-mandated cuts reduced government outlays, particularly in defense. (2)Tax receipts were higher as a result of Obama's rescinding of the Bush-era tax cuts. (3) Economic recovery.

The contribution from restoration of rescinded tax cuts is relatively minor. Much more important is that economic recovery has refilled the government's tax coffers. Federal-only income tax revenue fell to $2.1 trillion in fiscal 2009, from $2.52 trillion in fiscal 2008. For fiscal 2016, federal-only tax revenue was $3.28 trillion. Assuming no change in tax policy, federal tax revenue will be about $3.7 trillion for fiscal 2017, within a total tax bill (including state and local) of $7.0 trillion.

The new administration has promised both major changes in tax policy as well as a revenue-neutral approach.

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Achieving revenue neutrality amid major policy changes assumes the elimination of loopholes, inefficiencies, and other dodges, as well as rising revenue from expanded economic activity. As we noted above, the administration begins with economic wind in its sails thanks to the solid economic activity now underway.

ECONOMY: SOLID IF NOT SURGING

Early in the year, U.S. purchasing managers expressed their optimism in what the new administration could bring. The Markit manufacturing PMI index rose to 54.3 in December from 54.1 in November and 51.2 a year earlier. The services PMI index, representing a much larger slice of the economy, exceeded expectations with a 53.9 reading; and the composite (manufacturing & services) index was 54.1, up from 53.7 in November.

Nonfarm payrolls growth appear to have slowed, finally, with the major measure unemployment now in the 4.6%-4.7% range every month. A reading of this level is consistent with "full employment," and it is finally having the effect of pushing up wages. Within the household survey issued as part of the December nonfarm payrolls report, wages were reported to have risen at a 2.9% annual rate – certainly well above the Fed's 2.0% inflation target. Core producer prices are also percolating at a rate much higher than the Fed's target.

Retail sales exploded upward by 0.6% in December, though the number was likely driven by year-end auto sales. Sales at auto dealers were up 2.4% month-over-month in December, likely fueled by year-end incentives and rebates. Rising gasoline prices pushed up receipts at service stations by 2.0%.

Core retail sales, which backs out autos, gasoline, and building materials, was up a more modest 0.2%. Core retail sales are used in the calculation of GDP. According to Bloomberg, economists expect 4Q16 GDP to increase by 2.3%. That number, which captures the final quarter of the Obama presidency, was revised up slightly from 2.2%.

But economists recently offered a GDP outlook for 2017 that substantially lags the growth promised by the new president. According to the Bloomberg survey, GDP is forecast to grow 2.1% in 1Q17; 2.3% in 2Q17; and 2.3% for all of 2017.

CONCLUSION

That level of growth will not compensate for a gutting of tax revenues coupled with aggressive federal outlays to restore infrastructure. Risks of reflation in the budget deficit have increased. And the economic recovery is mature. Any turn in the cycle toward negative GDP growth would only exacerbate a shortfall in government revenue.

However, the pace of government is ponderous. Any final decisions on government spending and tax policy will be many months if not years in the making, as policies wend their way through committees and sub-committees. While the new president's Twitter habits reveal him as impulsive, his administration may be more measured, reined in by the traditions of democratic government.

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