Economic and Policy Outlook

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American Enterprise Institute
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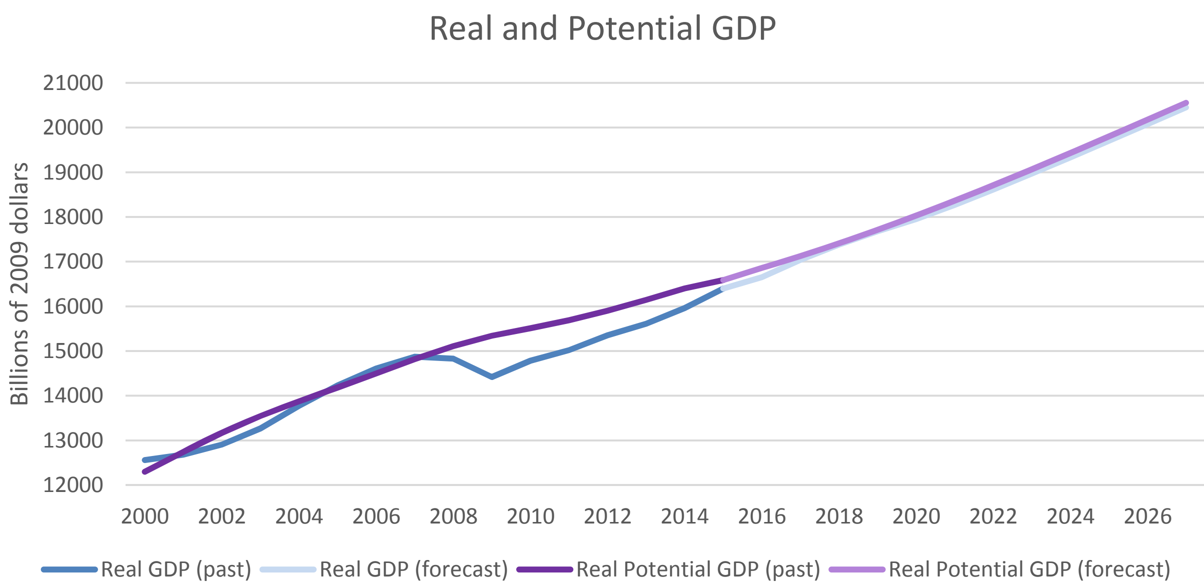
Trends and Forecasts

- GDP Growth
- Inflation and Interest Rates
- Debts and Deficits
- Tax Reform
- Health Care Reform
- Labor Market
- Climate Policy
- Immigration
- Trade
- Infrastructure
- Regulatory Reform
- Uncertainty

GDP Growth

GDP Path



The Great Recession changed the trajectory of actual and potential GDP. It will take a decade to close the output gap.

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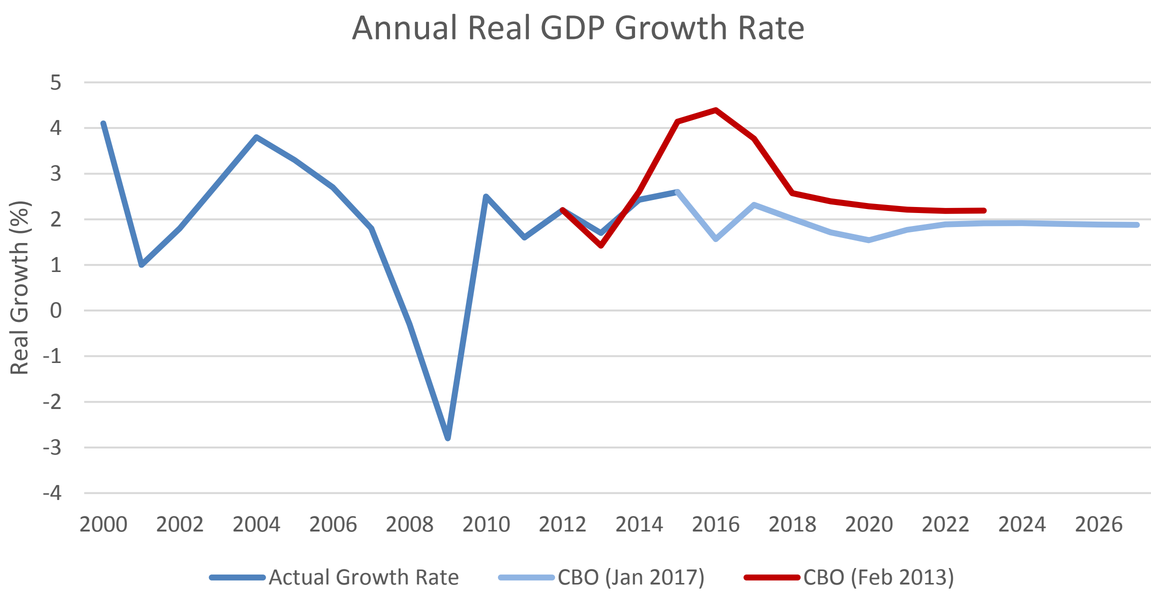
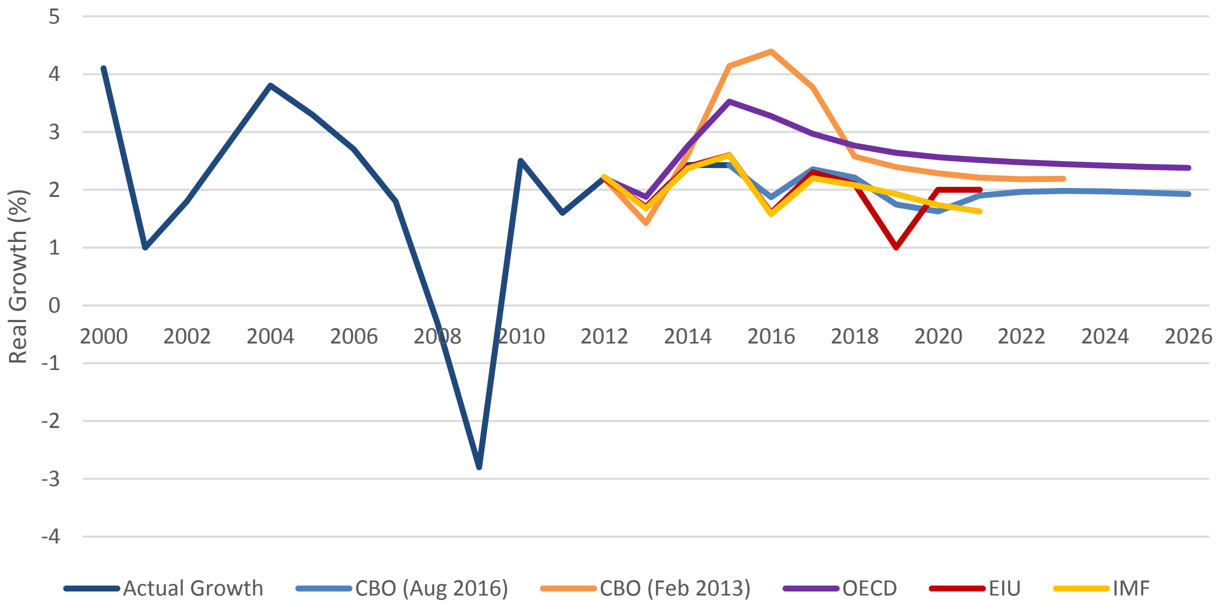
GDP Growth



Unlike previous recoveries, this one has been followed by persistently low growth, disappointing expectations.

Real GDP Growth Forecasts



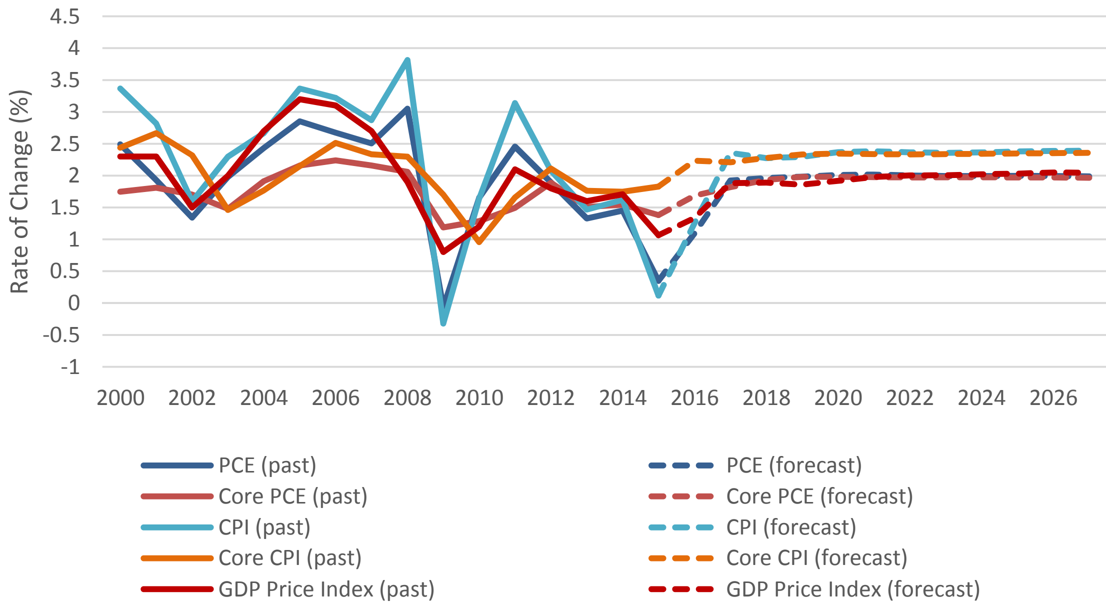
The OECD and the CBO (in 2013) predicted rapid growth for 2014-2017, followed by a slow return to normal. More recent forecasts from the CBO (2016), the IMF and the Economist predict weak to moderate medium-term growth.

GDP Growth Expectations and Policy

- Inflation and interest rates expected to rise under tax cuts, deregulation and infrastructure spending
- However if there are restrictions on trade and immigration, could hurt growth
- Moreover, even if there is a spike in investments and spending due to tax cuts and infrastructure, if these result in high levels of deficits or debts, it would be harmful in the long-run
- More likely response: High GDP growth in the short-run and significant slowing down in the long-run
- Hard to imagine 4% growth

Inflation and Interest Rates

Inflation



The CBO predicts that inflation will recover in 2017 and remain steady at normal levels.

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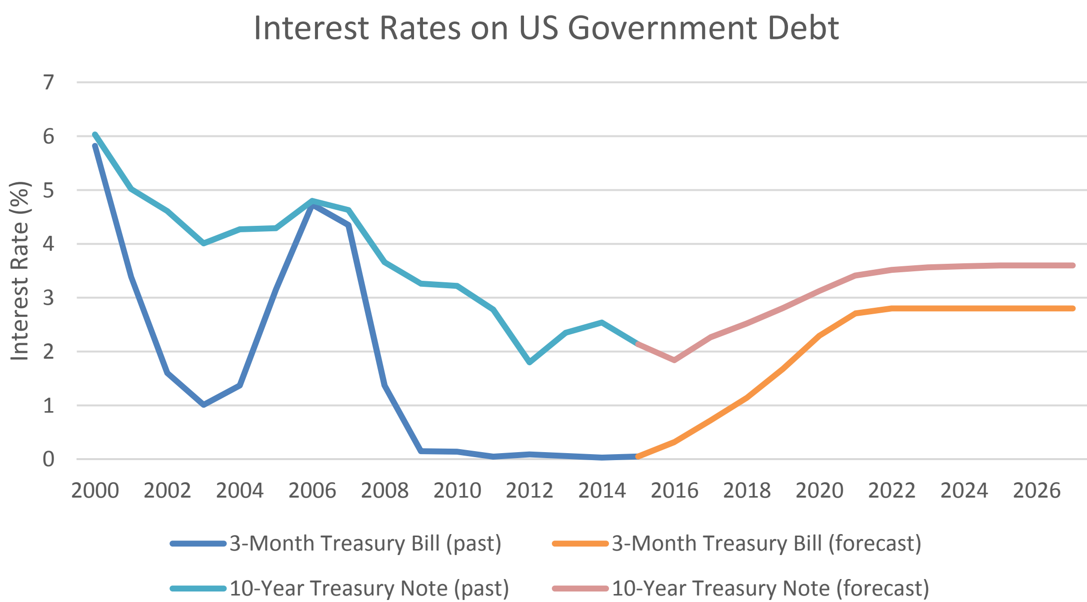
Interest Rates



The CBO predicts a gradual return to normal interest rates over the next three years.

Monetary Policy

- Remains accommodative
- Interest Rates have been kept low in an effort to boost the economy since the Great Recession
- For seven years, interest rates were kept at zero in light of poor labor markets and low inflation.
- Inflation remains below 2% though is forecast to rise
- The Federal Reserve may accelerate its interest rate increases to respond to fiscal stimulus effects of tax reform and infrastructure spending.

Debt and Deficits

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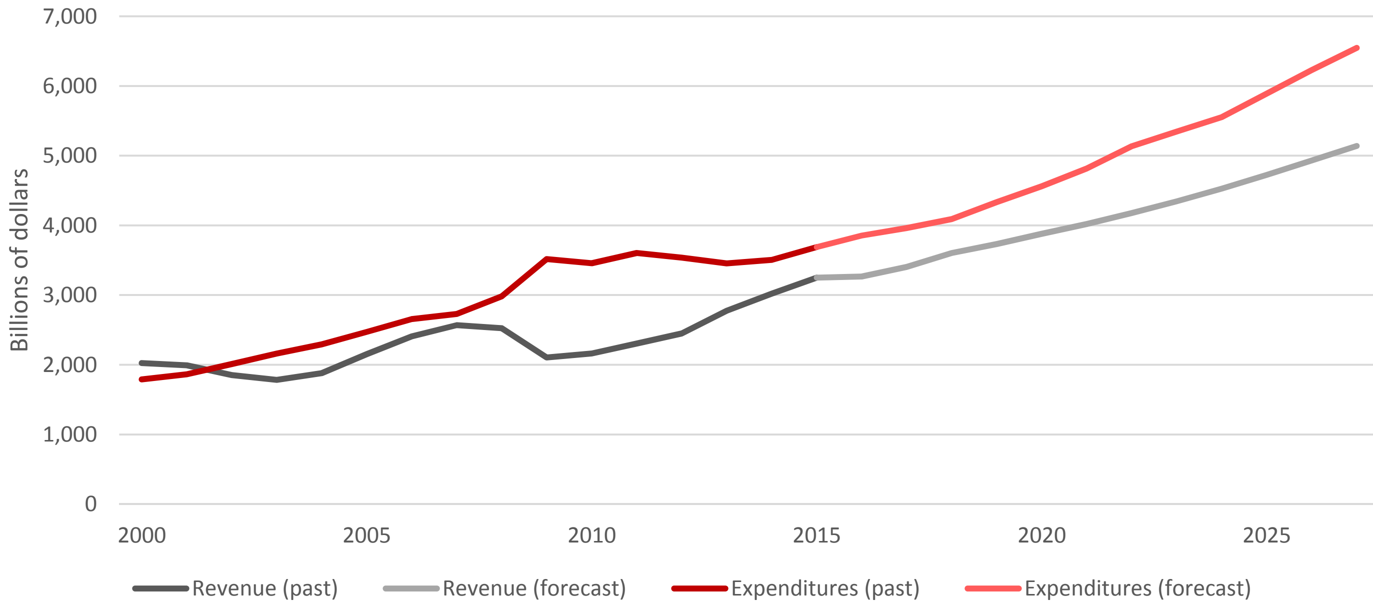
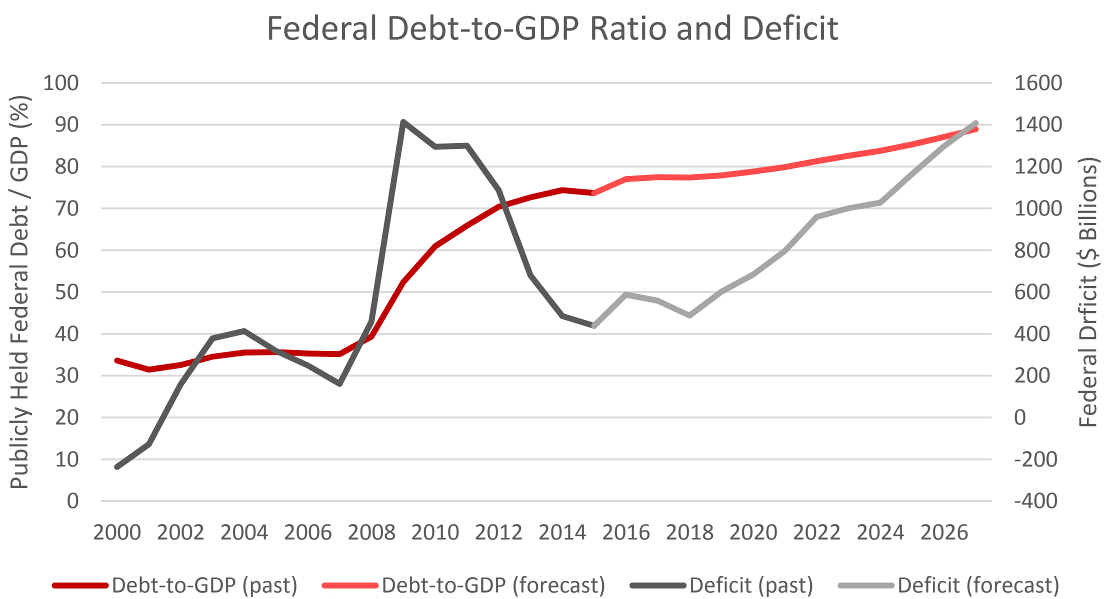
Federal Revenues and Expenditures



Federal Debt and Deficits

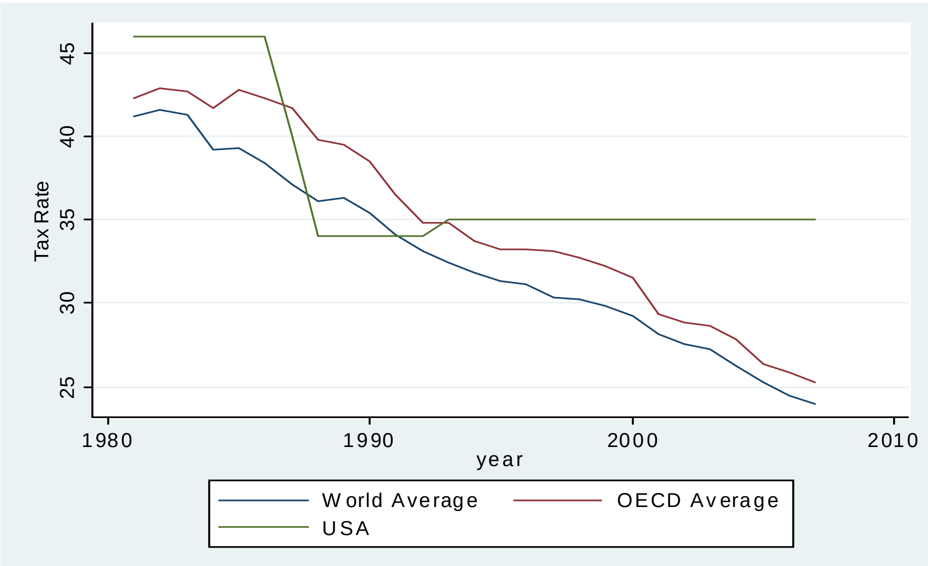


Tax Reform

Current Tax Policy

- The U.S. marginal corporate tax rate is high relative to the OECD
  - Discourages investment, lower wages and employment
  - Encourages tax avoidance and inversion activity
  - Worldwide taxation system has lead to trillions of dollars in cash held overseas
  - Effective tax rates are high relative to OECD as well

Top Marginal Corporate Tax Rate – Central Government Historical Trend: 1981-2010



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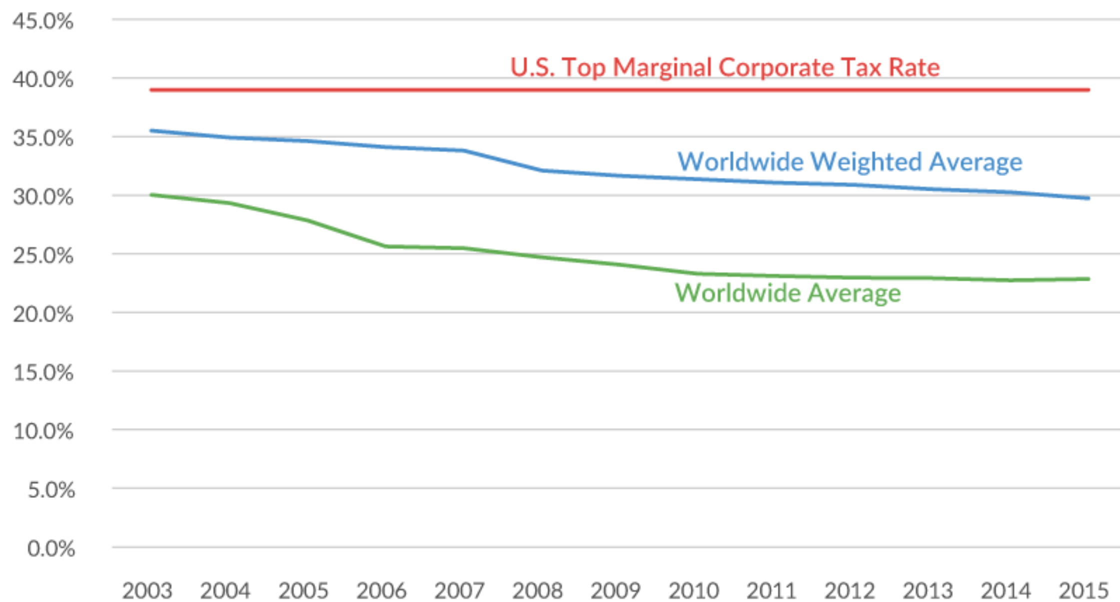
Top Marginal Corporate Tax Rates Have Declined in the Past Decade



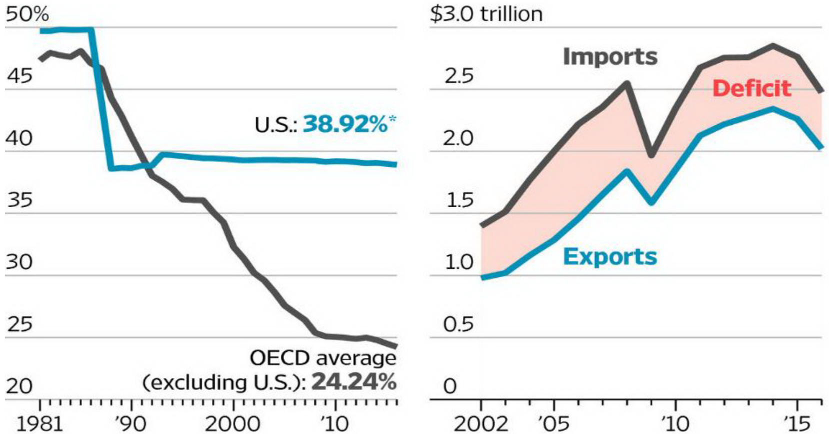
Source: Tax Foundation calculations based on data from the World Bank, OECD, and KPMG.

TAX FOUNDATION @TaxFoundation

Tax the Gap

The U.S. left its corporate tax rate unchanged while others cut. Effective tax rates are more similar across countries. The House plan would cut the federal rate to 20%.

A border-adjusted system would tax imports and exempt exports, operating like a tax on the trade deficit.



*Includes state corporate income taxes Note: 2016 imports and exports through November.
Sources: PricewaterhouseCoopers, OECD (tax rate); U.S. Census Bureau (trade)

THE WALL STREET JOURNAL.

Prospects for Tax Reform

- More than any time in recent years, the prospects for genuine tax reform are high.
- Main plan from House GOP (Brady-Ryan)
- Competing plans from Trump, various senators
- Important that tax reform be actual reform

Brady-Ryan Plan: Provisions

- House Speak Paul Ryan and Ways and Means Chairman Kevin Brady proposed their "Better Way" tax plan last year.
- Reduce statutory and marginal rates on ordinary (33%), investment (16.5)% and pass-through income (25%).
- Expand standard deduction, eliminate personal exemption and all itemized deductions except mortgage interest and charitable contributions
- Repeal personal and corporate AMT and estate tax
- Switch from Corporate Income Tax to Destination-Based Cash Flow Tax
  - Immediate expensing of investment
  - No net interest deduction
  - No tax on profits earned overseas
  - Lower statutory rate to 20%
  - Border adjustment

Brady-Ryan Plan: Border Adjustment

- Destination Based: Tax is levied based on where the goods end up, not where they are produced
- Revenues from sales overseas would not be taxed but costs of goods purchased overseas would not be deductible
- Essentially tax domestic goods and imports alike, but exempt from taxes any exports
- Could have large revenue gains purely from broadening the tax base
- But also have corporate rate cuts and expensing
- Border adjustment removes the incentive to book domestic profits to foreign subsidiaries, and creates an incentive to make investments with supernormal returns here.
- If the currency fully adjusts (as theory says it should), then there is no net impact on consumers or firms. However, it could be painful if the US dollar does not adjust or is slow to adjust.

Trump Campaign Plan

- Reduce statutory and marginal rates on ordinary and investment income.
- Expand standard deduction, repeal personal exemption, cap itemized deductions.
- Eliminate head of household filing status.
  - Substantial tax hike for single parents.
- Repeal AMT
- Tax pass-through income and corporate profits at 15%.
- Tariffs on China and Mexico?

Senate Tax Reform Ideas

- Existing tax reform ideas in the Senate focus on corporate integration to eliminate the double taxation of corporate income.
- Senate Finance Chairman Orrin Hatch has focused on this idea.
- Senator Mike Lee just proposed a plan to eliminate the CIT and replace it with higher capital gains tax rates based on a plan from Alan Viard (AEI) and Eric Toder (TPC).

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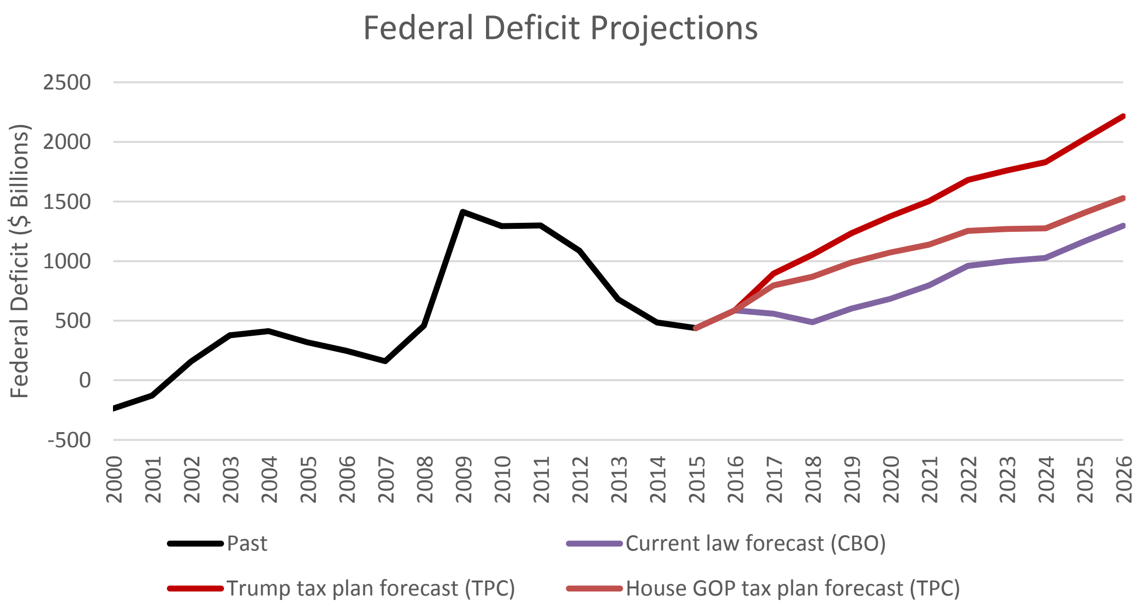
Tax Reform and Deficits



It is imperative that tax reform avoid increasing the debt excessively. If tax cuts are not matched by spending cuts, the deficit will increase dramatically.

Health Care Reform

Repealing the Affordable Care Act

- The GOP has been focused on ACA repeal for years. The new challenge is the strategic approach to repealing and replacing it.
- Republicans must proceed cautiously on this. The will own whatever mistakes they make as Democrats owned the ACA.
- Repeal and Delay
  – Since no Democrats will vote to repeal, Republicans can take the heat for repealing and hope that enough Democrats can joint them in a bipartisan replacement.
- Repeal and Replace
  – Simultaneously repeal the ACA and replace the plan.
  – There is little consensus on a replacement, but it should include various free-market approaches focused on reducing costs in the health care system.

Repealing the Affordable Care Act

- Typical replacement ideas are focused on flexibility, reducing costs and restoring the price mechanism to the health care market.
- Any replacement will almost certainly retain the most popular provisions, such as allowing young dependents to stay on their parents' plans and protection for those with pre-existing conditions.
- Tax credits instead of the individual mandate and subsidies
- Health Savings Accounts with high-deductible plans
- Block-grant Medicaid
- Competition in insurance markets, and across state lines
- Creating subsidized high-risk pools to assist those with pre-existing conditions.

Labor Market

Labor Market

- Unemployment Rates have come down since the end of the Great Recession to long-term levels of 5% or below
- Labor force participation remains weak and is showing long-term trends of declining participation
- Millions of workers are still in involuntary part-time jobs or have been long-term unemployed
- Wage growth is weak

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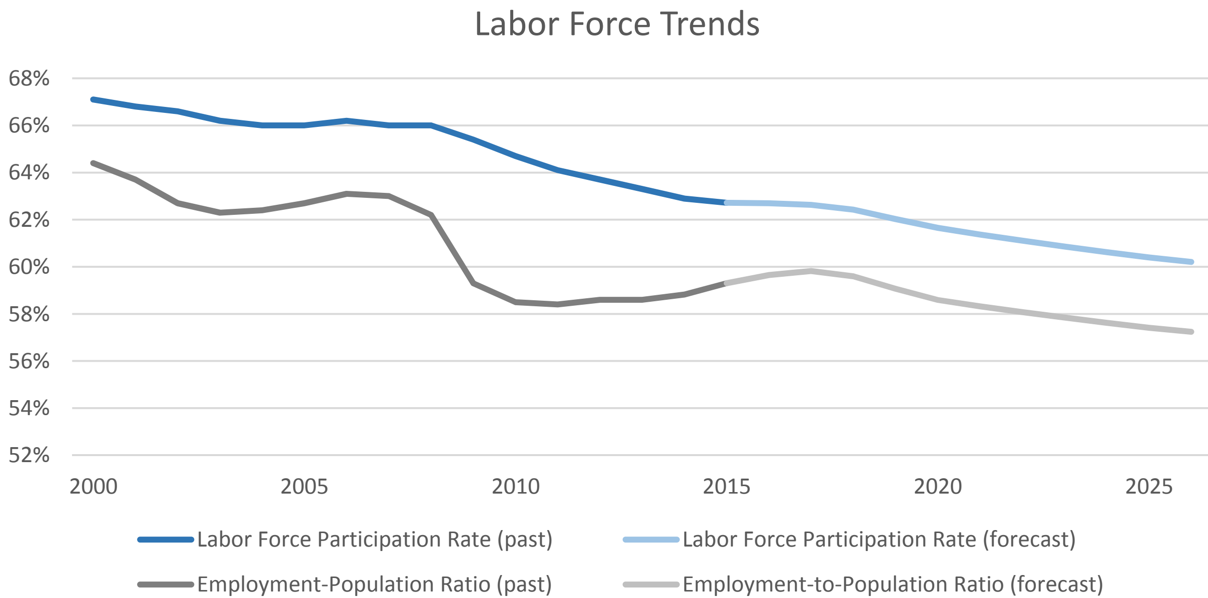
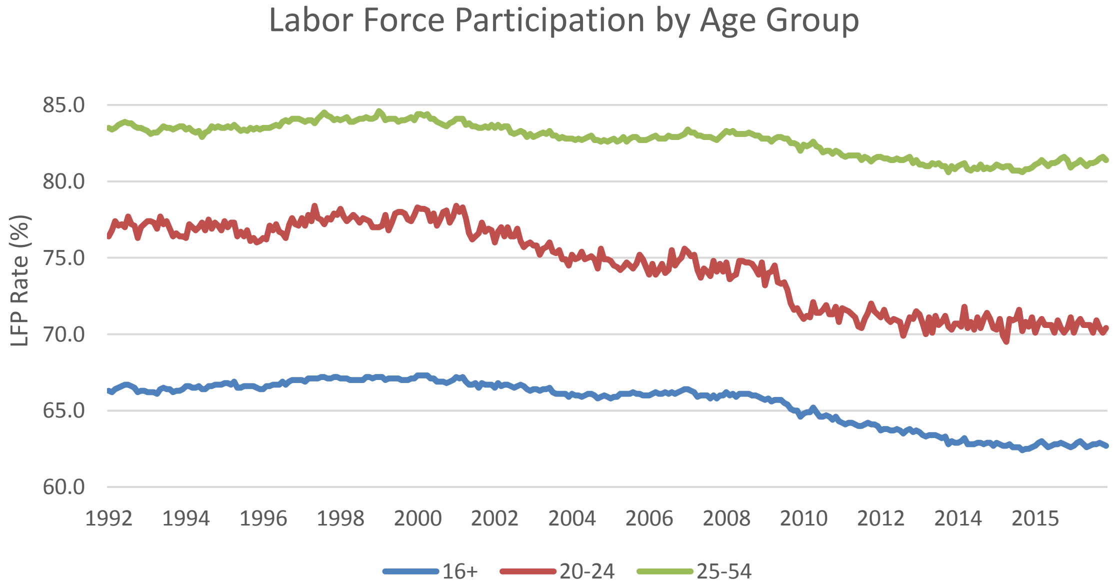
Demographic Effects on the Labor Force



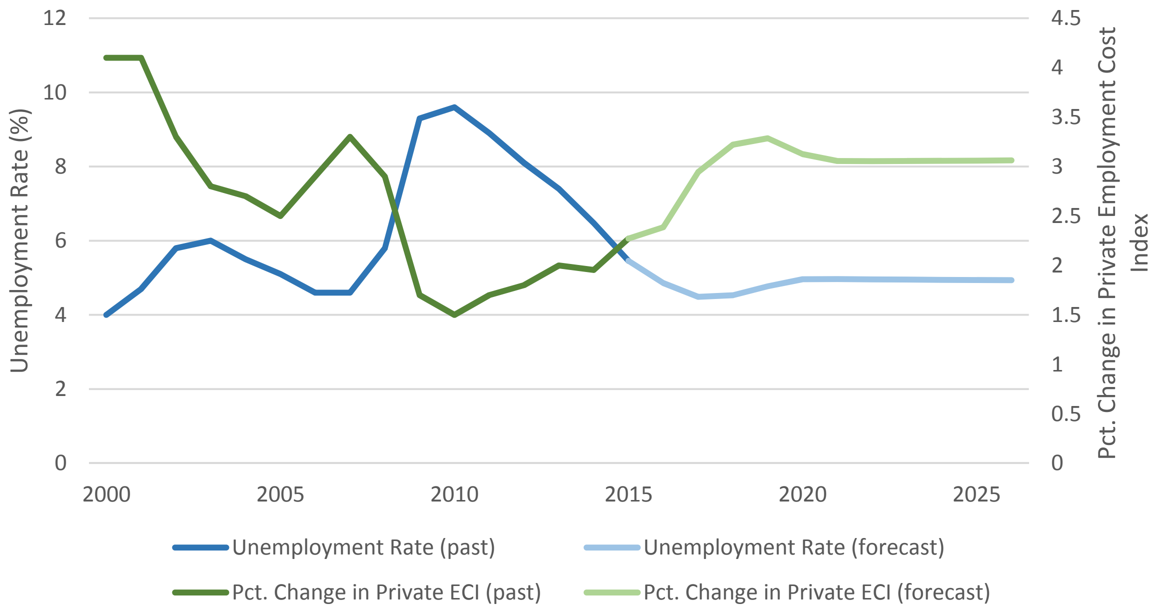
As the baby boomer generation retires, workers will decline as a share of the population.

Demographic Effects on the Labor Force



As the baby boomer generation retires, workers will decline as a share of the population. But prime-age participation remains slightly low historically, and youth participation rates have shown no recovery since the Recession.

Unemployment and Wages



The CBO predicts a takeoff in wage growth and perpetually tight labor markets.

Worker Productivity

- Since labor force is shrinking, we need higher productivity to offset the decline and sustain economic growth
- Since the recession, job gains have been largely in low-productivity service sector jobs
- Productivity growth is weak and has averaged less than 0.5% over the last few years
- Some cite fewer technological breakthroughs, government regulation, uncertainty over the Great Recession holding down investment and spending
- Alan Greenspan: Lower levels of saving due to higher spending on entitlement programs (Social Security, Medicare and Food Stamps) resulting in less investment, less productivity growth since more efficient technologies are embodied in new investments

Labor Market Impacts of New Policies

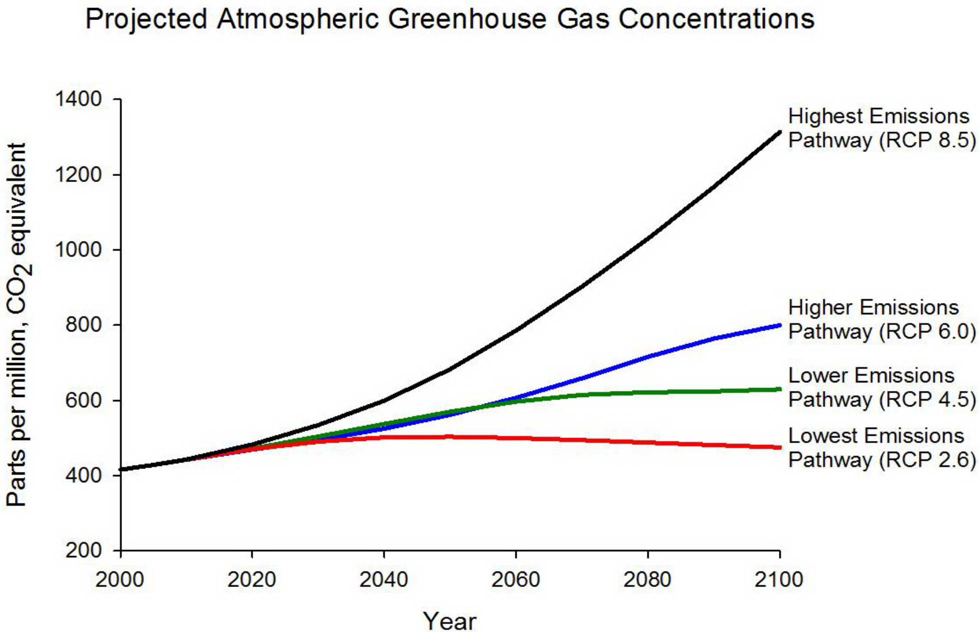
- If the corporate tax cuts go through and there is a surge in investment in conjunction with the infrastructure spending, then job creation should go up.
- Calls for expanded job training programs
- Enterprise Zones
- Tariff wars could hurt workers employed in export-based industries
- If immigrants are restricted from entering the country or illegal immigrants are deported, that could have adverse impacts on the labor market. Research shows that 50% of workers in the U.S. who have PhDs and are employed in STEM industries are foreign born

Climate Policy

Role of the Environmental Protection Agency

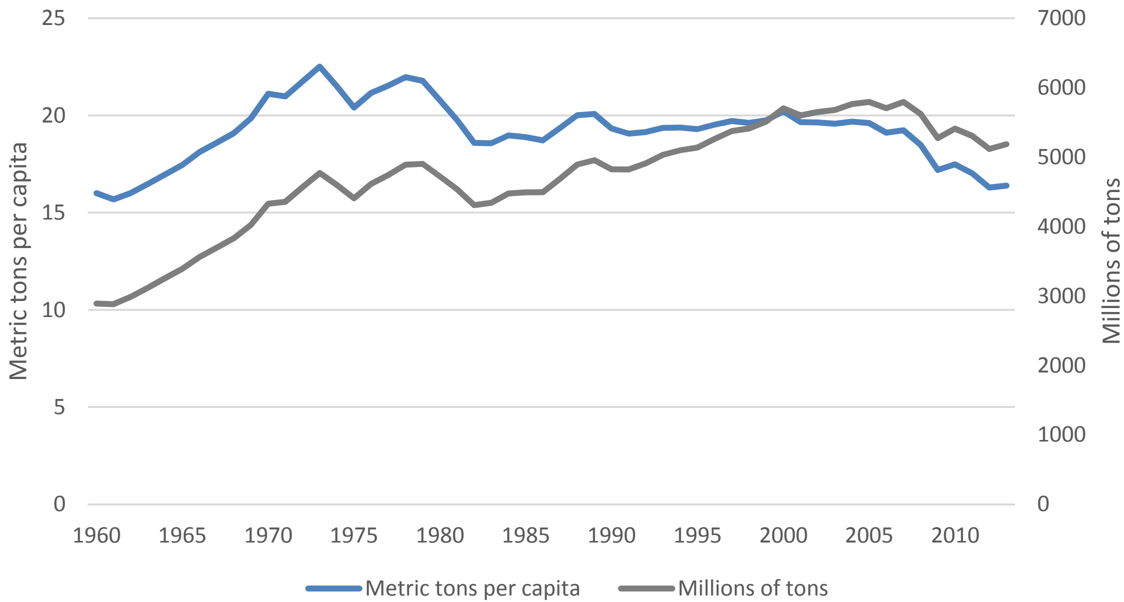
- Under current policy, the EPA is responsible for reducing emissions of greenhouse gases under the Clean Air Act
- It is developing new rules to control emissions from power plants under it's Clean Power Plan
- Under the Paris Climate Accord, emissions would be cut to a third of their level (compared to 2005) by 2030
- States can use market-based instruments such as cap-and-trade or carbon taxes to achieve their target.
- The Clean Power Plan has been put on hold by the Supreme Court because states have ruled it to be burdensome. But states are moving ahead with their implementation plans
- Demand for coal has been decreasing as natural gas prices have come down

Greenhouse Gas Projections



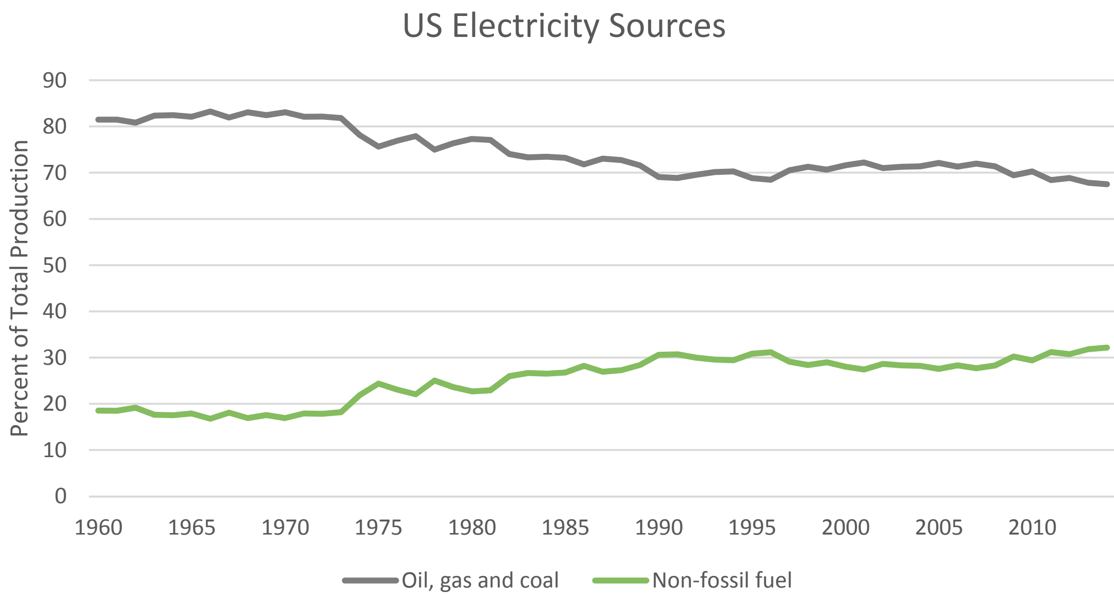
EPA predictions on greenhouse gas concentrations under various scenarios.

US Carbon Emissions



Aggregate and per capita carbon emissions in the US have levelled off and begun to decline.

Energy Production in the US



The share of electricity production from cleaner sources has increased.

New Expectations for Energy and Climate Policy

- The outcome of the election has resulted in a substantial shift in expectations.
- With potential deregulation of energy production and recovering world energy prices, US oil and natural gas production will likely grow dramatically in the coming years.
- Many of the EPA's recent regulations will likely be eliminated or reduced in scope.
- If the US chooses to abandon the Paris agreement, expect China to ignore their commitments as well.

Immigration

New Immigration Policies

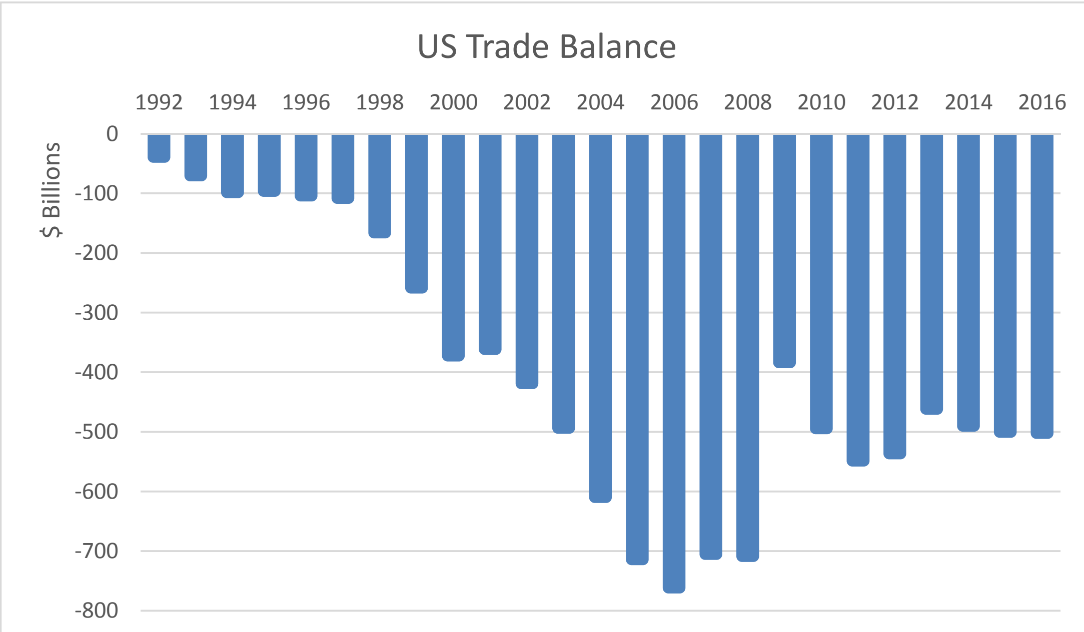
- President Trump campaigned strongly against illegal immigration, but also against immigration in general.
- Border wall with Mexico
- Increased rate of deportations
- Conflict with sanctuary cities
- Further limits on H1-B visas
- Suspension of travel from "terror problem regions"
  - Recent (poorly designed and executed) Executive Order targeted 5 countries in a state of civil war, Somalia (Al-Shabab), and Iran

Immigration Impact

- Adverse Economic Impacts. Immigrants have jobs, children and ties to the U.S.. Would affect not only them and their families but local economies if large scale deportations were to happen.
- Could encourage more illegal migrants as tariffs on Mexico might hurt the Mexican economy and offer fewer job opportunities
- Democrats can oppose all Administration actions on immigration, but they lack much ability to influence immigration policies.
- One option is to cooperate with Congressional Republicans on a bipartisan immigration reform to head off more drastic measures from the President.

Trade

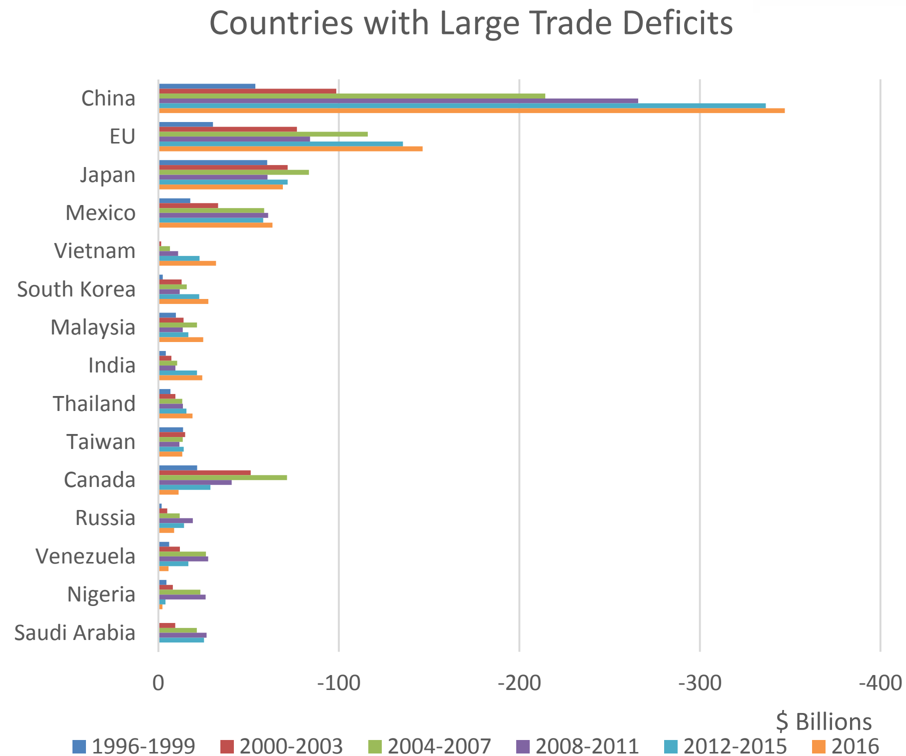
Trade Deficit



The U.S. has run substantial trade deficits both in times of expansions and recessions.

Trade Deficit

- Our trade deficit is driven in large part by China, but other trading partners contribute to it.



New Trade Policies

- President Trump campaigned opposes trade deals.
  - Already withdrawn the US from TPP
  - Raising the prospect of renegotiating NAFTA
  - Import tariffs on Mexico and China
  - Believes that this will reduce trade deficit, bring back jobs
- Impact
  - Possible trade wars are a big risk to the economy. Could lead to spiraling trade barriers, higher import prices and shrinking markets for U.S. exporters.
  - Could allow countries like China and Russia to play a larger role in trade deals
  - Hurt Mexico's economy if NAFTA is renegotiated—might drive more immigrants to the US
  - The combination of tax cuts and government spending could widen fiscal deficit and also trade deficit

Infrastructure

Infrastructure Deficit

- Infrastructure is a key issue on which both parties agree
- The investment gap is identified as being at $1.6 trillion over 10 years by certain organizations (ASCE, 2016)
- Includes maintenance, repairs as well as new investments in surface transportation (roads, bridges and transit), water and wastewater, energy transmission and airports, inland waterways and ports

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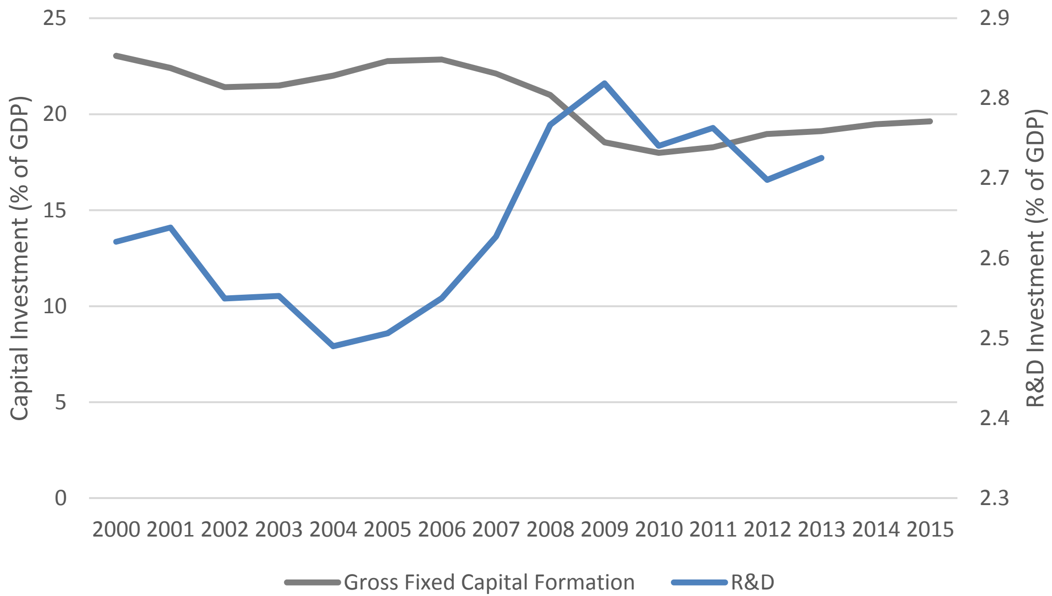
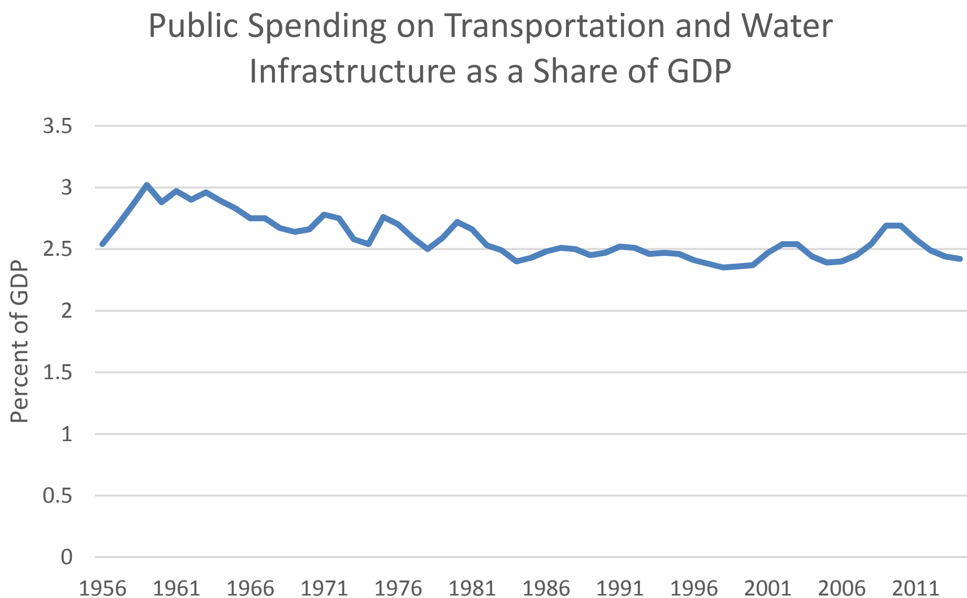
Investment



Unfortunately, investment hasn't kept pace with rising demand. Capital investment as a share of GDP has remained stagnant since the recession, well below historical levels.

Public Spending on Infrastructure



Infrastructure investment has declined as a share of GDP.

New Infrastructure Spending

- There is a good chance of new infrastructure spending.
- The President has proposed $1 trillion of infrastructure spending over the next decade.
- Congressional Republicans are hesitant on new spending.
- Democrats would like more infrastructure spending, but their plan relies almost entirely on federal spending, whereas the President’s plan relies more on tax credits.

Regulatory Reform

Regulations

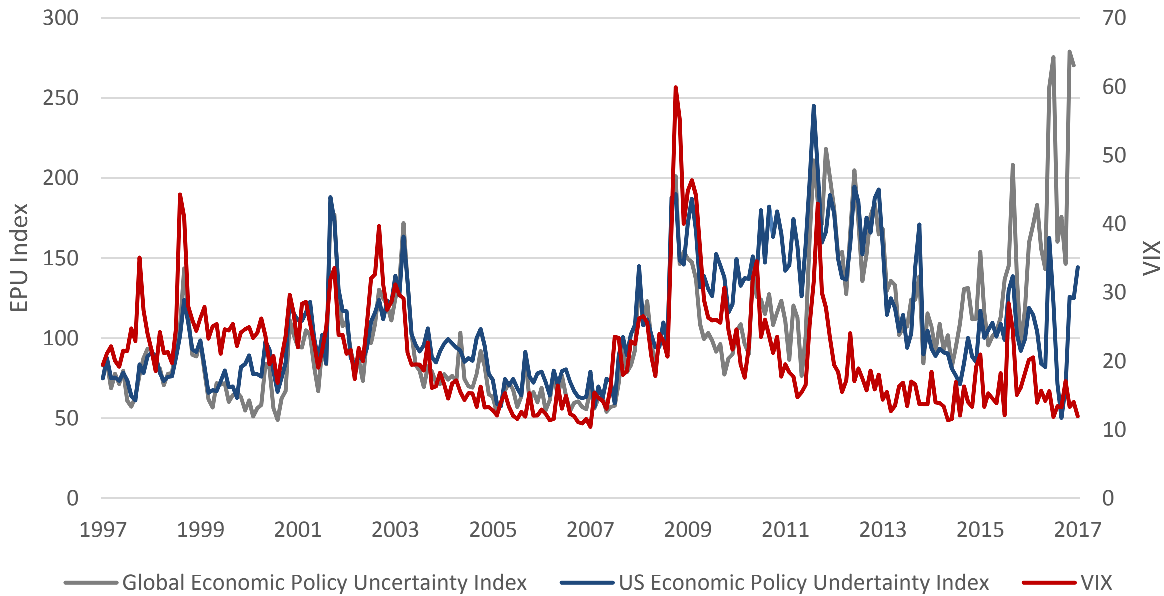
- President Trump has appointed cabinet members likely to focus on deregulation.
- The Administration has already implemented a regulatory freeze and a two-for-one rule, with the potential for a regulatory budget in the future.
- Take away the EPA's mandate through the Clean Power Plan to regulate GHG emissions.
- Other mandates on fuel efficiency rules
- Withdraw from the Paris Climate Accord
- Changes to the Affordable Care Act
- Effective repeal through administrative changes
- Impact:
  - Much more likely that there is a watering down of the rules, rather than complete repeal
  - Could create some more jobs in traditional coal based industries.
  - Help smaller, community banks to lend more and reduce burdens
  - Create uncertainty about coverage.

Regulations: Financial Sector

- President Trump has promised to do a “big number on Dodd-Frank.” His forthcoming executive orders will dismantle much of the new financial regulations.
- Instruct the Treasury Secretary and financial regulators to revise rules from Dodd-Frank.
- Reform of Financial Stability Oversight Council
- Possible replacement of CFPB Director Cordray by a bipartisan commission
- Eliminate Fiduciary Rule
- Potential replacement by the Financial CHOICE Act for banks with high capital levels
- Impact:
  - Much more likely that there is a watering down of the rules, rather than complete repeal
  - Help banks, particularly small and community banks, to lend more and reduce burdens.
  - Uncertainty over whether new regulations will encourage or discourage high capital levels.

Uncertainty

Uncertainty



Uncertainty has been a problem ever since the Great Recession. Although the VIX has been relatively low since the election, policy uncertainty has increased, even more for the world than for the US.