US fiscal policy: growth at any cost?

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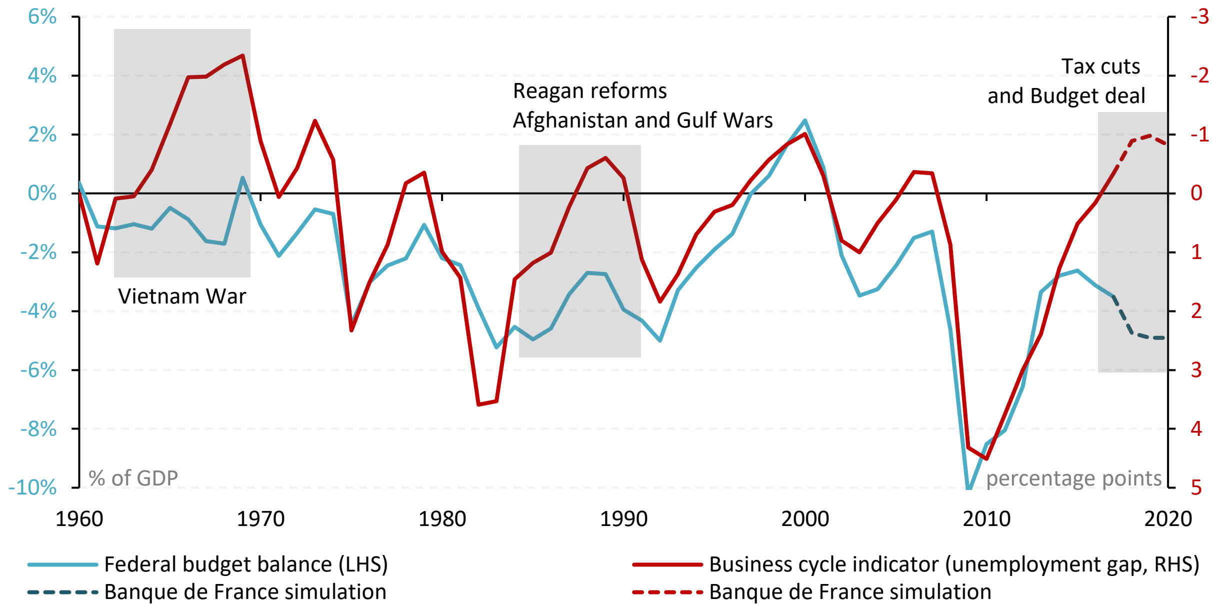
Less than two months after the adoption of the Tax Cuts and Jobs Act, which cut individual income tax and corporate tax, US Congress passed a budget agreement that increases public spending for 2018 and 2019. The effects on the US economy represent a two-edged sword: an additional 1.4 percentage point of GDP over two years, but a widening of the trade and budget deficits to 4% and 6% of GDP respectively. The recent dollar depreciation may reflect the growing concerns of international investors.

Unprecedented fiscal stimulus during an economic upswing

Chart1 – United States: federal budget balance and economic cycle since 1960



Sources: Data from the Bureau of Fiscal Service, Bureau of Labor Statistics and CBO; authors' calculations.

Such fiscal stimulus implemented during an economic upswing, in which deficits generally tends to narrow, has not been seen since the Vietnam War (Chart 1). The measures adopted over recent months were two-pronged:

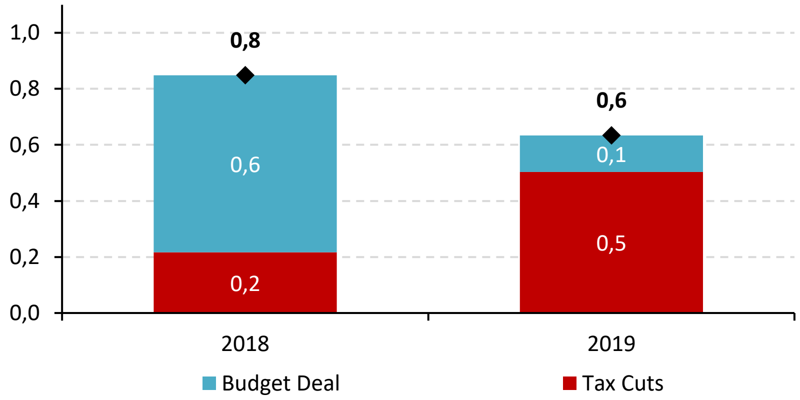
(i) the Tax Cuts and Jobs Act (TCJA), whose bill was signed into law on 22 December, significantly reforms US taxation for the coming decade. This Act reduces taxation for households (notably by lowering tax rates for most brackets and raising deductions and tax credits) and for companies (in particular by cutting the corporate tax rate to 21% and providing for the possibility to write-off the full cost of their equipment investments in the first year). This Act also strives to encourage multinationals to establish or re-establish operations in the United States and to repatriate profits generated abroad, via the implementation of a territorial tax system, in which only domestic activity is taxed at a lower rate.

(ii) the Bipartisan Budget Act of 2018, signed in early February, stems from proposals in the White House's draft budget. This budget agreement increases public spending by about USD 300 billion over two years (mainly in public investment).

More short-term growth...

Using the NiGEM model, we simulate the effects of these tax cuts (representing a little less than 1 percentage point of GDP for the whole year) and the increases in public spending (0.6 percentage point of GDP in 2018 and 0.8 percentage point in 2019). According to our estimates, the annual average gain in GDP growth would be 0.7 percentage point in 2018-2019 (Chart 2).

Chart 2 - Simulated gains in US GDP growth from the budget package



Source: Authors' calculations.

On average, a 1-percentage point tax cut results in a GDP gain of between 0.3-0.5 percentage point (this is what is known as the fiscal multiplier). While this elasticity appears relatively small, the amounts concerned by the TCJA could nevertheless generate significant GDP gains (in red in Chart 2). In particular, the sharp reduction in the corporate tax rate should have a significant and immediate impact, albeit of limited duration. For the reform to be effective, companies must choose to use the profits generated by this tax cut for productive investment. In recent years, the increase in profits has led to a sharp rise in dividends paid and share buybacks which could limit the expected gains from tax cuts in terms of short-term growth. For households, the effects of the income tax cut (and the rise in the deduction ceiling) should be significant but more spread out over time.

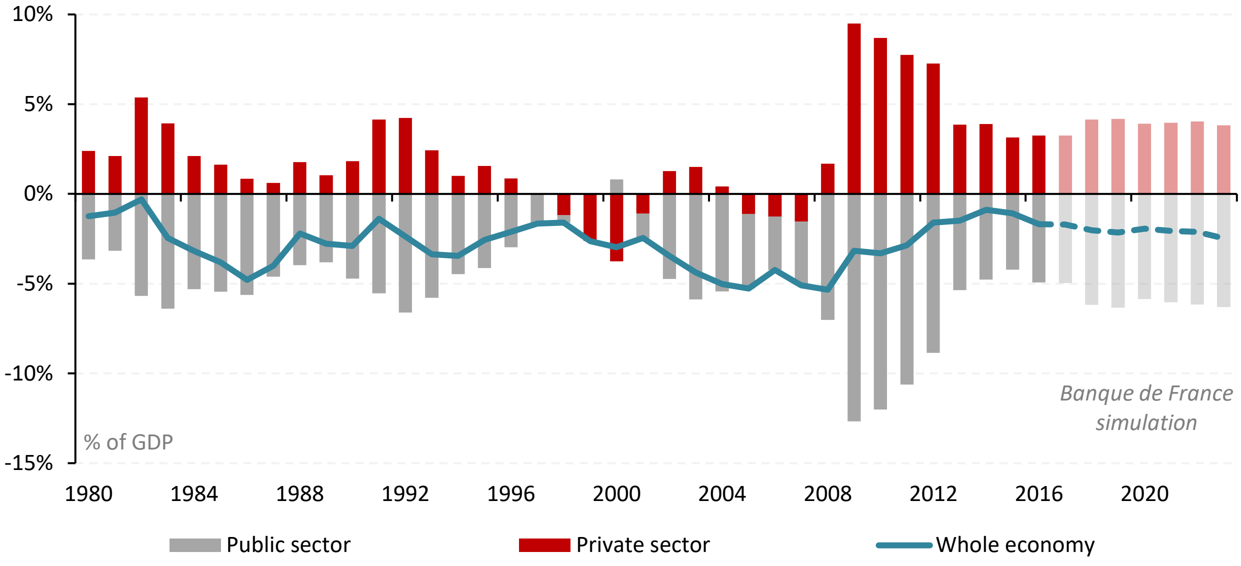
However, the effects of the Bipartisan Budget Act of 2018 appear to be greater than those of the tax cuts. The impact of this Act on growth (in blue in Chart 2) is immediate and considerable for the two years concerned by the rise in public spending (fiscal multiplier close to 1 in the first year).

... at the expense of a severe worsening of the trade deficit and public debt

The positive effects of this fiscal stimulus on demand will result in a marked widening of the US trade and current account deficits, which are expected to reach 4% and 3.8% of GDP respectively in 2019 (against 2.9% and 2.4%, respectively, in 2017).

A breakdown by institutional sector (Chart 3) shows a sharp deterioration in the general government deficit, which should widen from 4.8% of GDP in 2017 to 6.1% in 2019. Conversely, the lower tax burden on the private sector should allow it to mobilise additional savings, reducing the risk to the financing of the current account deficit. With all effects combined, the worsening of the general government deficit is expected to push up public debt by 10 percentage points of GDP, to stand at close to 120% of GDP by 2027.

Chart 3 – General government net lending/borrowing for United States



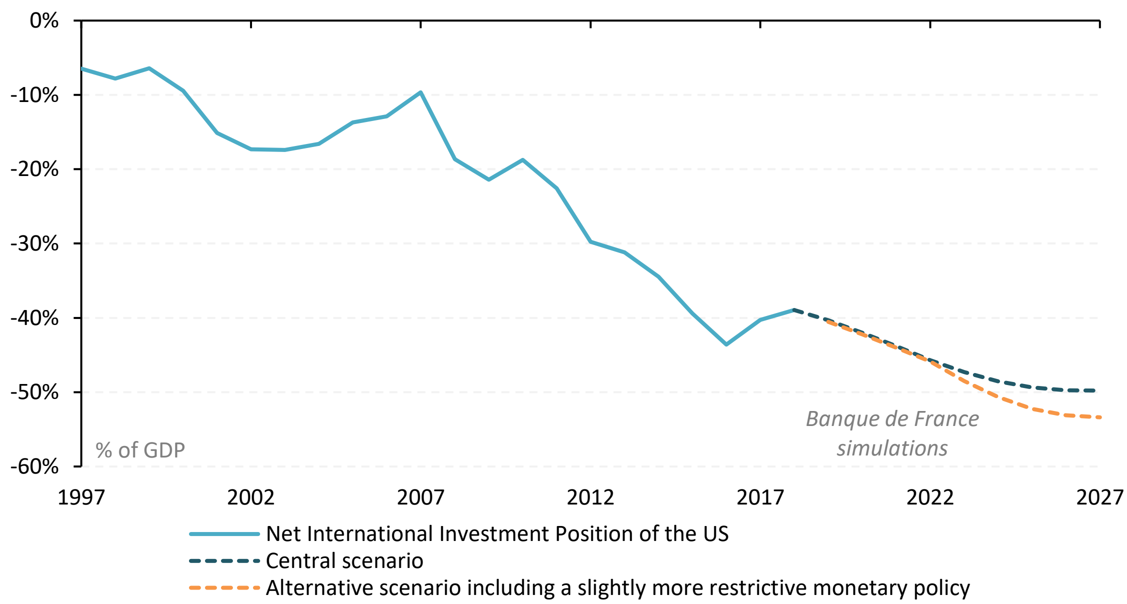
Sources: OECD data; authors' calculations.

A positive/negative sign indicates net lending/borrowing. The net lending/borrowing of an economy is the sum of the current and capital accounts.

Fears over the financing of the US current account deficit appear to be weighing on the dollar

The net international investment position (NIIP) represents its net assets or liabilities vis-à-vis the rest of the world: a negative IIP means that foreign capital inflows exceed outflows to other countries. In this respect, the US IIP may give grounds for concern. It stood at -40% of GDP in 2017 (the United States was a net debtor vis-à-vis the rest of the world) and is expected, according to our estimates, to exceed 50% of GDP in 2027 (Chart 4) - see also the Blog article by Fahri and Maggiori on this topic. Moreover, a scenario in which the Fed tightened monetary policy in four quarter-point hikes in 2018-2019 (as suggested the Fed's last press release of March 2018 and as would be justified if inflation remained persistently over the 2% target in our simulation) could further increase the US deficit vis-à-vis the rest of the world.

Chart 4 - US net international investment position



Sources: Bureau of Economic Analysis data; authors' calculations.

Nevertheless, the change in the tax system for multinationals, which is a key part of the tax reform, could encourage US firms to repatriate profits generated abroad (the US tax corporate rate now appears to be slightly below the OECD average). The impact on the IIP could remain neutral: the repatriation of profits henceforth generated abroad by US firms will have a positive effect on the current account balance via the income balance. However, it is likely that the amount of assets held by US companies abroad would decrease if firms decided to repatriate this income rather than reinvest it in their foreign subsidiaries.

It nevertheless appears that the risks surrounding the financing of the US current account deficit are growing and could explain the depreciation of the dollar whereas the widening of the interest rate differential in its favour should have had a positive impact on the US currency (see also Summers on this topic). In 2017, net foreign direct investment in the United States has declined compared to 2015-2016, which is a possible sign that the US economy has become less attractive for international investors.