November 2016

The Economic Implications of a Resurgence in Fiscal Policy

The 2016 Presidential race has been one of the most divisive and hate-filled elections in modern politics. No matter who comes out on top on November 8th, the winner will almost certainly be the least popular candidate to assume the top office in the United States. Yet amidst all the mudslinging and name-calling, there is one topic that both candidates seem to agree on in some fashion – a return to fiscal stimulus.

After years of playing second fiddle to central banks and monetary policy, fiscal stimulus is shifting back into the spotlight as a tool to catalyze economic growth. Fiscal stimulus, or the increase in government spending to facilitate growth, is an active strategy which stands in direct contrast to monetary policy, whereby a central bank increases the amount of credit available for an economy to utilize. Both Presidential candidates and many well-known economists have called for increased fiscal stimulus to spur growth. With monetary policy losing its effectiveness, we see fiscal stimulus re-emerging as a major driver of economic growth over the next four years.

Easing Back from the Abyss: How Monetary Policy Became the Leading Response to the Financial Crisis

In the wake of the global financial crisis in 2008, central banks, led by the Federal Open Market Committee (FOMC), undertook drastic and unconventional measures to rescue the global economy from a complete meltdown. In addition to reducing short-term interest rates to near zero, quantitative easing, or "QE", became the favorite stimulus tool for central banks in the post-crisis recovery. The process entails central banks buying government bonds and mortgage-backed securities from commercial banks, which theoretically raises the price of those assets while simultaneously expanding the money supply. This in turn drives down interest rates which, in theory, encourages people and businesses to borrow more, therefore stimulating economic activity.

The first round of QE was initiated by the FOMC in November 2008 when the US economy was in the midst of a free-fall. Employment reports show that the economy had lost 500,000 jobs in September and October and the S&P 500 had lost over 20% in the course of three months. The first round of QE involved the purchase of over $600 billion in mortgage backed securities. Over the next six years, the FOMC would launch two additional rounds of quantitative easing, which resulted in the Treasury's balance sheet increasing 397% from $470 billion to roughly $2.3 trillion.

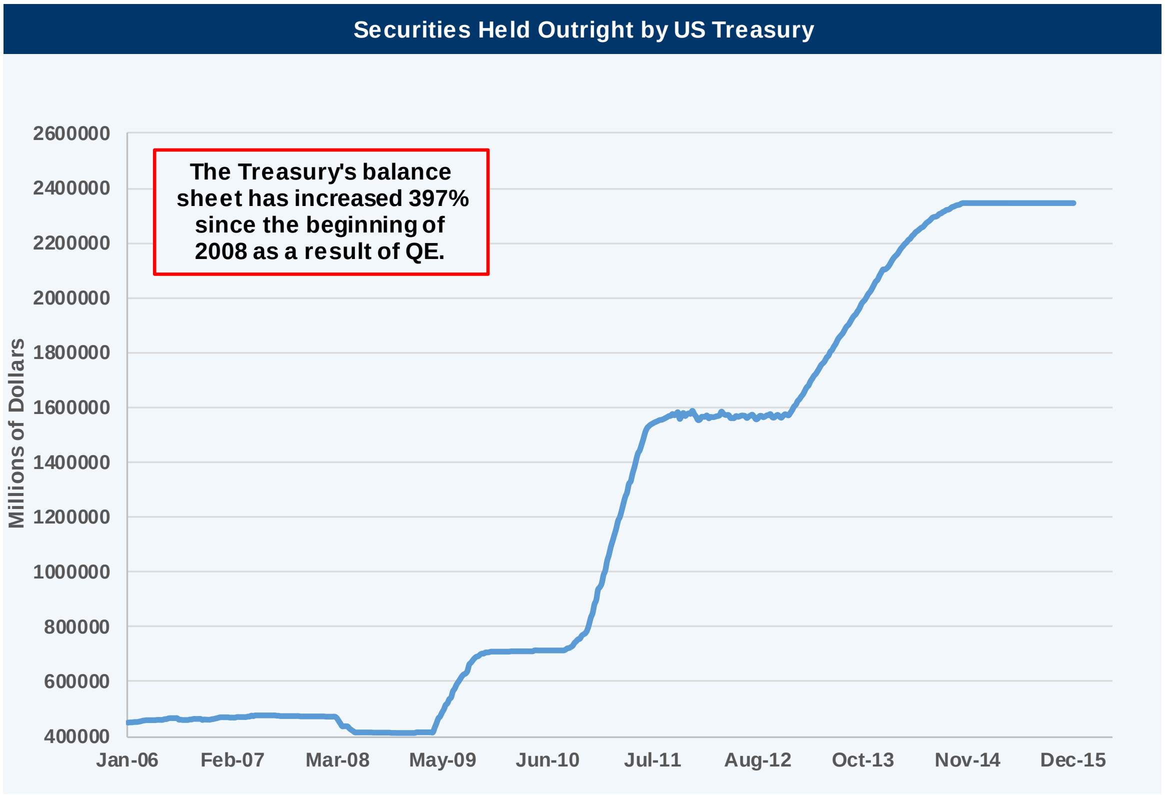

Figure 1: Shows the total assets held by the US treasury from Jan 2006 through Dec 2015. Source – Federal Reserve Economic Data

Many leading economists praise quantitative easing for preventing the US economy from tumbling into a prolonged depression. The Fed's perceived success resulted in central banks worldwide adopting similar programs. The Bank of Japan, the Bank of England, and the European Central Bank have all initiated their own versions of QE since 2008.

Central Banks Out of Ammunition: The Diminishing Results of Monetary Stimulus

Quantitative easing policies have driven interest rates to record lows and equity and bond prices to record highs over the last eight years. Despite these results, monetary policy has failed to inspire anything more than tepid economic growth. While the current economic expansion has been one of the longest, in terms of years, it has also been one of the weakest, in terms of average GDP growth.

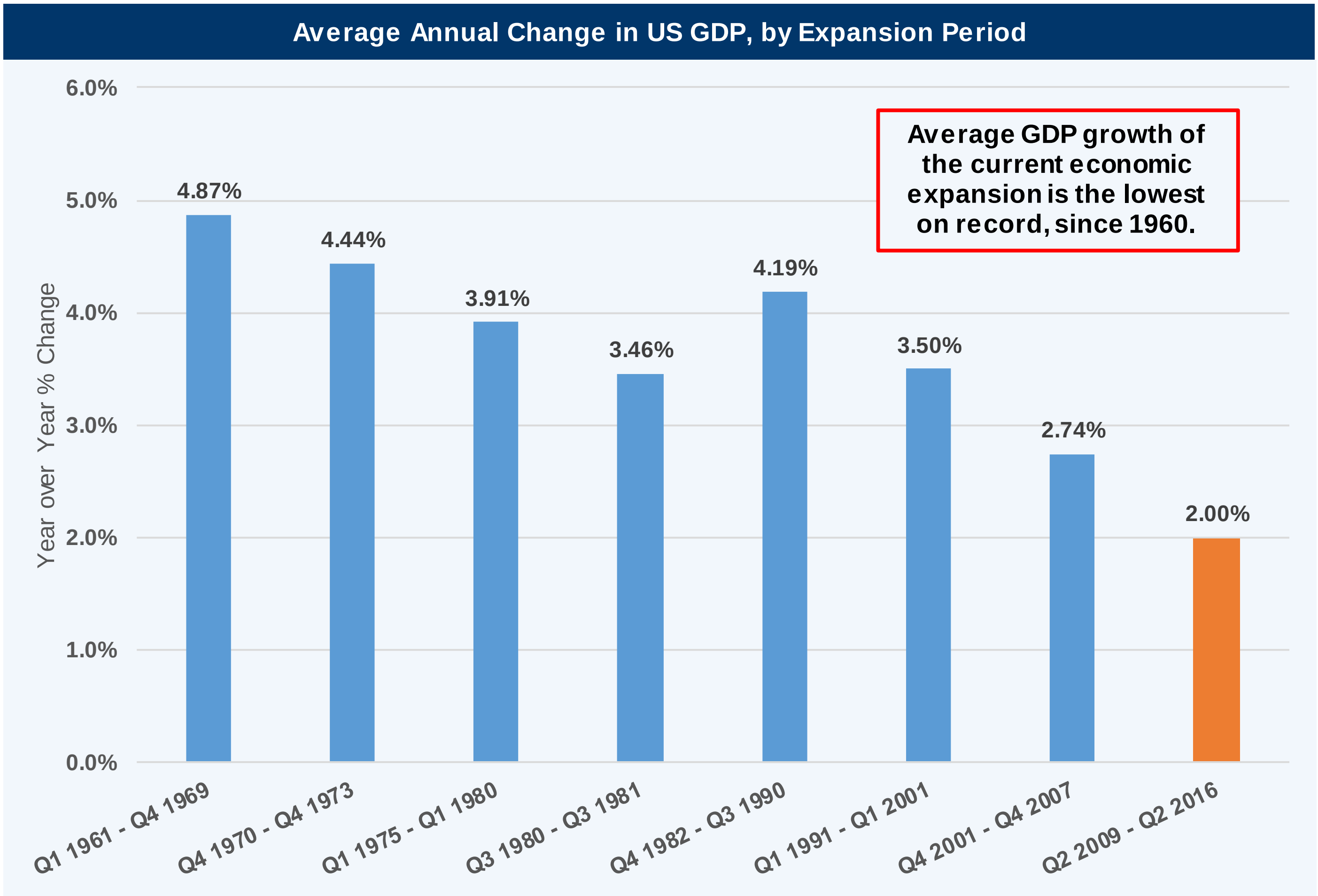

Figure 2: Shows the average year over year percent change in GDP for each economic expansion period since 1960. Source – The Federal Reserve Economic Data

Over the past year, central banks worldwide have eased aggressive monetary policies due to their diminishing effects and a growing risk of financial instability. As the effectiveness of monetary policy fades, proponents of fiscal stimulus have been growing, especially as election cycles in the US, France and Germany occur over the next 12 months.

In fact, some of the leading proponents for more aggressive fiscal policies have been central banks. In June, Federal Reserve Chair Janet Yellen told the Senate Banking Committee that US fiscal policy had “not played a supportive role.” A month later, European Central Bank chief economist Peter Praet added that “monetary policy cannot be the only remedy to our current economic challenges.”

Fiscal Stimulus Returns to the Forefront

While central banks were pulling out all of the stops to stimulate post-recession growth, fiscal stimulus took a seat on the back burner as most policymakers sought to reduce debt burdens following the global recession. Prior to the global financial crisis, fiscal policy was a popular tool to spur economic activity, by lowering tax rates and/or increasing government spending. Yet after the recession, bloated government budgets became a target for critics, including the International Monetary Fund, which argued that these contributed to the global financial meltdown.

The post-recession period was also marked by the repercussions of poor government budgeting, including the double downgrade of US government debt, government shutdowns in the US and a double-dip recession in Europe. Also the consequences of excessive government spending seem to rear its ugly head every year in Greece.

Now, with monetary policy failing to trigger substantial economic activity, some major economic players have shifted back to more aggressive fiscal stimulus over the last year:

- **China**: Government spending in China rose 11.3% in September from a year earlier. China is relying on increased government spending to stabilize economic demand.

- **Canada**: Earlier this year, Prime Minister Justin Trudeau announced higher public spending including a $91 billion infrastructure plan that includes at least ten rail and public transit projects.

- **Japan**: In August, the government announced additional spending of 4.6 trillion yen for the current fiscal year as part of a 28 trillion yen stimulus package that includes 6.2 trillion yen for infrastructure projects.

Even the austere Germans recently floated the idea of implementing fiscal stimulus when their finance minister said that he wants to implement 15 billion euro of tax cuts aimed at low and middle income families after next year’s election.

What Fiscal Stimulus Could Look Like in the US

Infrastructure Spending:

Both presidential candidates have called for a need to upgrade the country’s infrastructure during their campaigns. Vice President Joe Biden and Republican candidate Donald Trump have even gone as far as to call LaGuardia Airport “third world.” The American Society of Civil Engineers agrees that the domestic infrastructure system is in need of a boost. In its annual report card on the state of American infrastructure, only the solid waste category received a passing grade, while areas such as transit, schools, and drinking water all failed. According to the report, US infrastructure requires more than $3.4 trillion through 2020 in order to “become efficient”. Despite dilapidated roads and airports in need of repair, government spending on infrastructure is currently at a 30 year low when measured as a share of GDP.

Infrastructure Levels at Record Lows

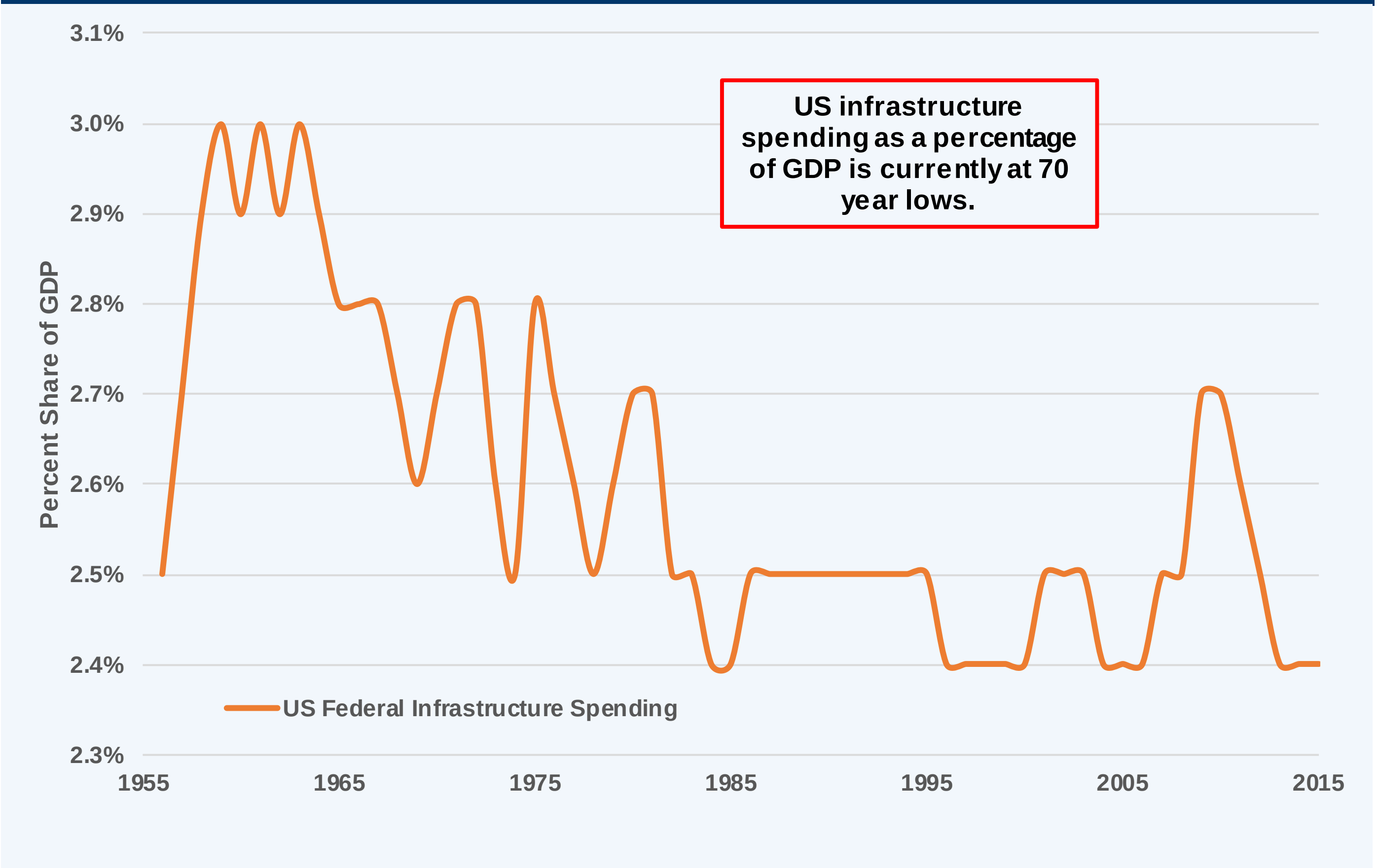

Figure 3: Shows US federal infrastructure spending as a percentage of GDP. Source – ATF and EPI analysis of BEA (2016) and CBO (2015)

Both Clinton and Trump have proposed passing legislation that would bolster infrastructure spending in their first 100 days in office. Clinton has proposed a five-year $275 billion infrastructure plan while Donald Trump has suggested he would double Clinton's proposal by spending $500 billion on infrastructure.

An uptick in infrastructure spending could create more jobs and improve the efficiency of the transport systems that move our goods and people.

Corporate Tax Reform:

Another area both candidates have pledged to address is corporate tax reform. US corporations face some of the highest tax rates in the world. In response, many multinational firms have utilized tax loopholes to declare profits overseas where they are taxed at lower rates. In recent years, offshore corporate profits and the amount of profits held abroad have reached record highs. Some figures have put the amount of taxable revenue abroad as high as $2.4 trillion.

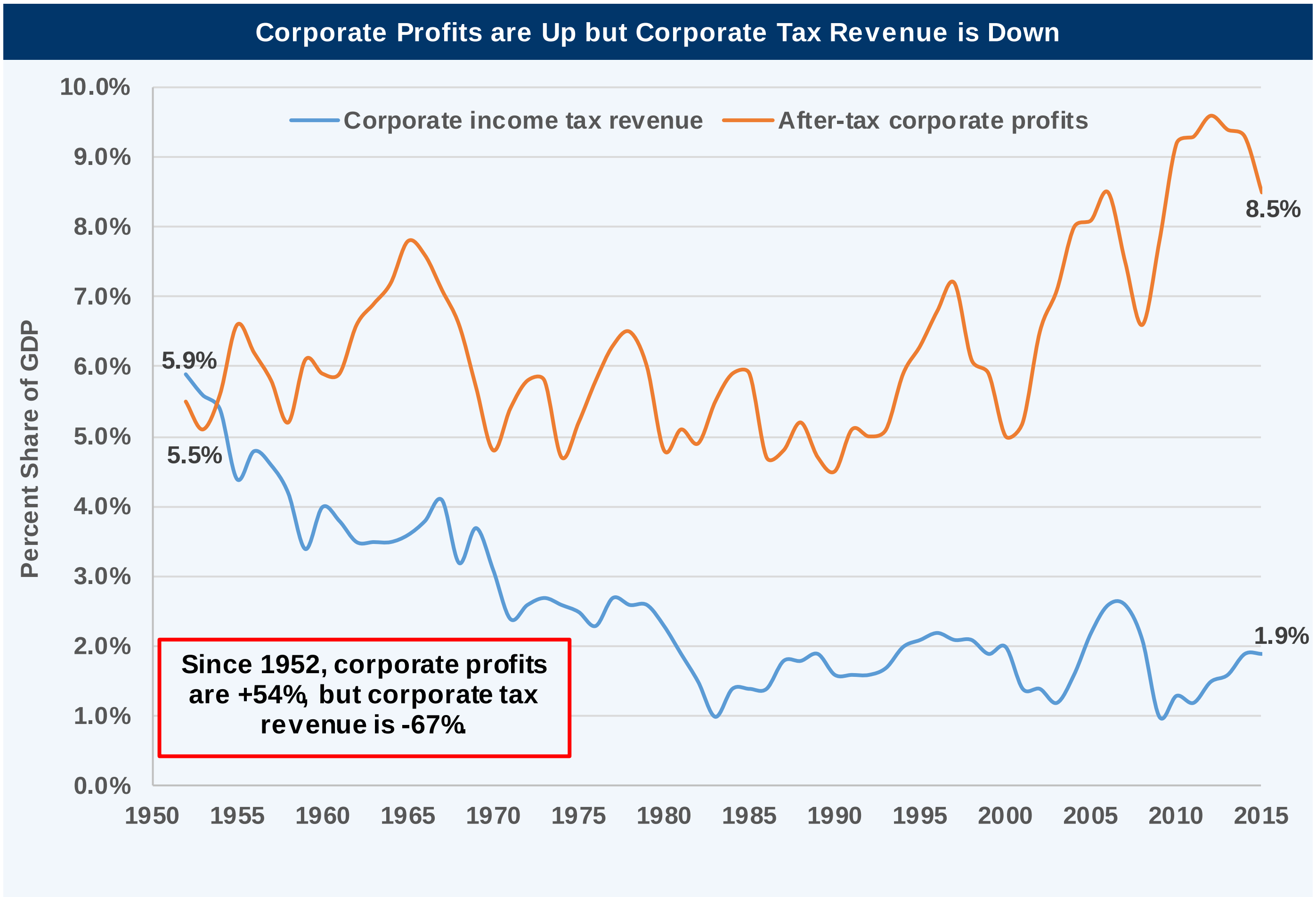

Figure 4: Shows US corporate income tax revenue and after-tax corporate profits as a percentage of GDP from 1952-2015. Source – EPI, adapted from Bivens (2015)

Despite corporate profits increasing as a share of GDP, corporate tax revenue has decreased as a share of GDP at least in part due to corporations declaring profits abroad. In 1952, corporate profits were 5.5% of the economy and corporate taxes were 5.9%. Today, corporate profits are 8.5% of the economy, though corporate taxes account for only 1.9% of GDP.

In an effort to bring back US dollars from abroad, politicians across the political spectrum have called for a repatriation tax break holiday. This would allow foreign profits to be taxed at a significantly lower rate than 35%, which would motivate US companies to bring back earnings from abroad. It is estimated that a one-time tax repatriation could result in a windfall of as much as $700 billion for the federal government.

A tax holiday could provide an incentive for companies such as Apple and Google to send their foreign earnings back to the US and potentially use these earnings to create more jobs and/or expand operations in the US.

Is Fiscal Stimulus in Our Future?

With the election one week away, the polls are suggesting that Democratic candidate Clinton will win the Presidency, but Republicans will retain control of the House, with the Senate race too close to call. If these results hold, the government will be split for at least another two years (The government has remained split since 2010 when the Republicans took back the control of the House from the Democrats.)

While sweeping changes are unlikely under a split government, both sides have touted fiscal stimulus as a means to stimulate growth, which presents an opportunity for passing bipartisan stimulus legislation. Senator Schumer (who would become the Senate Majority leader if the Democrats capture control of the chamber) has expressed optimism in being able to strike a corporate tax reform package that would involve lower rates on repatriated earnings. Specifically, he mentioned that a $100 billion tax revenue windfall from repatriation could be levered to back $1 trillion on infrastructure spending projects.

If lawmakers can make concessions to reach a bipartisan agreement, fiscal stimulus could provide a boost to economic growth. With annual GDP growth stuck below 2% and monetary stimulus experiencing diminishing returns, fiscal stimulus may provide the spark needed to drive economic growth at a faster pace over the next four years.

With fiscal stimulus potentially on the horizon, we continue to favor value stocks over growth stocks. Value sectors, such as industrial and energy stocks, would stand to benefit from greater economic activity. Meanwhile, fiscal stimulus would probably result in accelerated inflation, which would be a negative for growth sectors, such as consumer discretionary stocks which are sensitive to rising prices.