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Economists See Clouds in the Silver Lining

At a time when optimism is rampant in the real estate industry, and the stock market is near all-time highs after a massive run-up, economists lived up to their billing as dismal scientists at the National Association of Business Economists (NABE) annual policy conference in Washington, D.C., last week.

Although the immediate state of the economy is healthy, economists lamented the country's long-term fiscal situation, recently made worse by the tax reform passed by Congress. They were also pessimistic about the prospects for policy solutions, which include prudent immigration reform and fewer—not more—restrictions on global trade, given the growing populism that is producing an electorate with increasingly polarized views in the U.S. and Europe.

"I'm concerned that the political system has not come to grips with sensible fiscal policy," said Alice Rivlin, a senior fellow at the Brookings Institution and former vice chair of the Federal Reserve and director of the White House Office of Management and Budget.

Gloomy Fiscal Outlook

The U.S. budget deficit was a serious problem before President Donald Trump signed a new tax law that will produce $1.5 trillion less revenue to the Treasury over the next 10 years. Tax reform—among other things—cuts the corporate tax rate to 21 percent from 35 percent and reduces individual tax rates, while it increases the personal exemption and reduces some deductions.

The argument for the law is that it will spur growth and inject simplicity to the federal tax code. Indeed, economists forecast GDP to be higher because of the bill. Estimates range from 0.1-1.1 percent, although the consensus is somewhere between a quarter and a half of a percentage point of extra growth. Some 45 million Americans are now expected to use the simpler standard deduction, which means 26 million fewer itemizers than under the old law.

However, the law also creates a fair amount of complications and uncertainty. While the increased standard deduction introduced some simplicity, other elements of the law make the tax code more complex. For example, the law taxes excess returns gained in foreign countries, while at the same time creating incentives to move money offshore. Pass-through entities pay lower tax rates than individuals, an incentive for individuals to set up structures that will enable them to use the lower rate. "The clear winner is tax lawyers and accountants," said William Gale, a senior fellow at the Brookings Institution.

The impact of the corporate tax cut is muddled as well. It remains to be seen how much corporations will use their savings to invest and hire, and lower corporate rates reduce the benefit of interest rate deductions, Gale said. He also noted that lower rates and repatriation will have a "tiny" impact on job growth, and the impact could even be negative if corporations use savings for merger and acquisition activity.

Other areas potentially impacted by tax laws are charitable giving and housing. Fewer itemizers and lower rates provide less incentive to give to charities. Alex Brill, resident fellow at the American Enterprise Institute, said charitable giving could be reduced by $12 billion. The limiting of deductions for home mortgage interest and state and local taxes is likely to exert downward pressure on home prices in costly coastal metros in states such as California, New York and New Jersey. Overall, home prices are expected to drop about 2 percent, while increasing demand for rental housing units. The individual tax cuts accrue the most to the wealthiest Americans, and they are not likely to be an inducement for much new consumer spending. Additionally, the removal of the mandate to buy health care is projected to result in an additional 13 million uninsured individuals.

A poll of NABE economists about the tax law found that two-thirds "deem it 'far better' or 'somewhat better' than the previous corporate tax system, but nearly half regard the individual tax provisions as worse than before," said Jim Diffley,

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survey chair and executive director at IHS Markit. "The panel expects near-term boosts in economic growth, but is less optimistic about longer-term results," he added.

The pessimism about debt comes from the fact that tax cuts won't pay for themselves. Estimates are that the revenue offset will be between 5 percent and 30 percent, and the higher number is optimistic. Maya MacGuineas, president of the Committee for a Responsible Federal Budget, said that the country is on track to borrow $14 trillion over the next decade. The U.S.'s debt-to-GDP ratio has risen to 77 percent in 2017, up from 38 percent in 2008, and that number is projected to balloon to 113 percent by 2028. Higher debt levels mean more tax revenue goes to pay debt service instead of more productive uses and makes it difficult to respond to downturns with fiscal stimulus.

"It's hard to wrap your mind around what's the problem with immigration."

—Jared Bernstein, a senior fellow at the Center for Budget and Policy Priorities

MacGuineas said that the inability to apply fiscal restraints will make it more difficult for future Congresses to address the debt problem, and she said the use of "gimmicks" was a "discouraging sign that things are broken in Congress." She called the tax law a lost opportunity to fix a flawed system: "It's not as pro-growth as it could or should have been."

Immigration: Numbers and Values

Given the dropping native-born birth rate, without immigration the U.S. population would shrink, which could have dire consequences for the economy. Not only is population a component of economic growth but young workers are needed to pay into the Social Security system as the Baby Boomer generation retires. The proportion of foreign-born workers in the U.S. has risen to 17 percent in 2016, up from 11 percent in the mid-1990s.

Studies by organizations such as the Business Roundtable and National Academy of Science contend that well-designed immigration policies, which focus on admitting high-skilled workers, will increase GDP, create jobs and reduce the deficit over time. The biggest impact will be seen in border states that are destinations for immigrants.

Jared Bernstein, a senior fellow at the Center for Budget and Policy Priorities, said that opponents of immigration view the economy as static, in which workers are pitted against each other for resources, while in reality the economy is dynamic. To the extent immigrants have an impact on wages, it is borne most by recent low-skill immigrants, not native workers. What's more, the growth rate in foreign-born workers is concentrated among those with higher educational levels, he said. "It's hard to wrap your mind around what's the problem with immigration," Bernstein concluded.

While proponents talk numbers, opponents of immigration talk values. "If the goal is to increase GDP, I guess we should allow unlimited immigration," said Robert Rector, senior research fellow at The Heritage Foundation. Rector contends that immigration is not a net benefit, as immigrants use more in public benefits such as welfare, public education and municipal services than they contribute in tax payments. Rector also noted that first- and second-generation immigrants overwhelmingly vote for Democrats, which he said is as important a consideration as economic growth.

Policy Amid Political Dysfunction

Reaching agreement about immigration—or really, any sensible and moderate policy solutions—is becoming increasingly difficult in our polarized society. In fact, extreme political views are one of the consequences of the decline in manufacturing jobs, which peaked at 19.7 million in 1979 and fell to 12.4 million in 2016. Manufacturing jobs losses are due to factors that include automation and cheaper labor overseas. One turning point was when China joined the World Trade Organization in 2001. Since then, China's share of global exports has increased to 19 percent, up from 4 percent.

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Economists are nearly unanimous in believing that free trade increases general welfare by lowering costs and more effectively allocating resources among nations. In the U.S., though, there have been consequences for rural communities that once were built around manufacturing and don't have the labor force or resources to adapt to a service-led economy. The loss of manufacturing jobs has primarily impacted low-skilled men, who have declined as a share of the workforce, notes Gordon Hanson, director for the Center on Global Transformation at UC San Diego.

A study by Hanson, David Autor and David Dorn found extreme shifts between 2004 and 2014 in the voting patterns among communities negatively affected by exposure to world trade. Voters in communities with primarily white populations increasingly gravitated toward conservative Republicans, while voters in non-white communities flocked to liberal Democrats. Concentrated economic hardship tends to increase political polarization, which is reflected in the rise of the Tea Party and inability of Congress to negotiate compromise legislation. It also makes voters susceptible to nationalist appeals, which can be seen in the Brexit vote in the U.K., the election of Donald Trump in the U.S. and growing populist movements throughout Europe.

Katherine Cramer, a professor of political science at the University of Wisconsin–Madison, spent years interviewing rural Wisconsinites. She said people in rural communities believe that policy decisions are made by urban lawmakers who don't take their interests into account, and don't give them the resources and respect they deserve. Residents of small towns believe—true or not—that their status is threatened by urban and minority interests, she said.

Positive Change is Hard

To be sure, there is little talk of downturns among analysts and the economy's immediate prospects are positive. The biggest question regarding the next 12-24 months is how much the economy will benefit from the stimulus interjected by tax reform. The longer-term outlook, however, is worrisome. Increasing an already bloated deficit at a time when unemployment and policy rates are low leaves less room to maneuver when growth inevitably starts to slow. The stock market is not a good economic indicator, but recent volatility demonstrates investors' nervousness about the durability of the growth cycle and policies that lead to higher deficits and tariffs.

The Trump administration's enthusiasm for tariffs is a reminder that, after years of steady growth, things can go wrong. The administration put tariffs on washing machines and solar cells and panels earlier this year and have announced tariffs on steel and aluminum. Although the levies may turn out to be inconsequential in the broader picture, they also could ignite retaliation, increase inflation and lead to job losses in a broad range of industries. Yet reversing such short-sighted policies might be difficult, given the recent voting patterns of democratic societies. And the toughest assignment of all might be developing and implementing policies that effectively address the problems that caused the discontent in the first place.

—**Paul Fiorilla**, *Associate Director of Research*

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