First Trust
Monday Morning OUTLOOK
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“Fading” Fiscal Stimulus; Really?

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Fed Chair Jerome Powell and others have started a new narrative about economic “headwinds.” They think past rate hikes, slower foreign growth, and “fading fiscal stimulus” should slow the Fed’s rate hikes. But is fiscal stimulus really fading?

Powell and others think the growth benefits of both the 2018 tax cuts and increased federal spending are winding down. This is pure Keynesian analysis and we think it’s wrong. In our view it reflects a misunderstanding of both how tax cuts work and the actual path of federal spending.

The difference is between demand-side (Keynesian thinking) and supply-side thinking. Keynesians think demand drives growth. In other words tax cuts work by putting more money in people’s pockets, which increases consumption and, therefore, GDP. They say the first year of a tax cut boosts after-tax incomes and demand, but then, stimulus fades as this boost is removed and income falls back to the previous (slower) trend.

Keynesians also believe federal government spending stimulates growth because it, too, is part of demand. In fact, government purchases are a direct part of GDP accounting and so it appears like government spending is a stimulus.

By contrast, supply-siders think incentives for entrepreneurship and investment drive growth. It is the supply of new goods and services that leads to faster economic activity. Say’s Law says “supply creates its own demand.” In other words, the tax cut led to better incentives to invest, work, and invent. And, as long as tax rates remain low a “permanent” change in incentives has been initiated, which will boost growth rates permanently. There is no “fade.”

Before the tax cut, the corporate tax rate in the US was approximately a combined 40% (federal, state, and local). In 2017, Canada had a corporate tax rate of 26.5%. So, there was a 13.5% incentive to invest in Canada over the US. And, at the margin, more investment went to Canada (and other countries with lower corporate tax rates) than would have been the case if the US tax rate was not the highest in the developed world.

Now the combined U.S. corporate tax rate is approximately 27%, radically changing incentives. In other words, at the margin, as long as tax rates stay where they are, there is a permanent incentive to invest more in the US. This does not mean growth will accelerate from where it is now (roughly 3% GDP), but it will not automatically revert back to 2%, where it was from 2010-2017.

The more curious and misguided argument is that fading government spending will slow and reduce GDP. We think this comes from a misunderstanding of the budget deal which was passed last year. Yes, that budget deal increased spending, but so far it hasn’t shown up as a boost to GDP growth.

In Fiscal Year 2018, nominal GDP rose 5.0% over FY2017, while total federal spending went up just 3.2%. Government purchases, which feed directly into GDP, rose just 4.0%. In other words, relative to the private sector, government demand grew more slowly.

On top of this, total federal revenue was ***up*** 1% in FY2018. While corporate tax receipts fell 22%, total individual receipts were up 6%. In other words, while it’s true that the federal government collected fewer tax receipts in FY2018 than it budgeted prior to the tax cut, it still collected more revenue than it did in FY2017.

The bottom line is that the entire demand-side basis for the fiscal stimulus argument has no data to support it. Government spending grew slower than GDP and actual tax receipts went up. As a result, any argument that there will be “fading” fiscal stimulus is based on a data that does not exist.

The reason growth has accelerated is because lower tax rates, and less regulation, increase entrepreneurial activity – a supply-side acceleration in growth, not Keynesian. Anyone waiting for slower economic activity as fiscal stimulus “fades” will be waiting in vain.

The one worry we have is the exact opposite of what Keynesians argue. A new divided government adds to pressure for bipartisan legislation. Bipartisanship often means more government spending. As supply-siders, we view increased government spending as a drag on growth, not a boost.

The more government spends as a share of GDP, the smaller the private sector. That’s how growth will really fade.

Date/Time (CST)	U.S. Economic Data	Consensus	First Trust	Actual	Previous
11-20 / 7:30 am	Housing Starts – Oct	1.225 Mil	**1.267 Mil**		1.201 Mil
11-21 / 7:30 am	Initial Claims – Nov 17	215K	**215K**		216K
7:30 am	Durable Goods – Oct	-2.5%	**-2.8%**		+0.7%
7:30 am	Durable Goods (Ex-Trans) – Oct	+0.4%	**+0.9%**		0.0%
9:00 am	Existing Home Sales – Oct	5.200 Mil	**5.300 Mil**		5.150 Mil
9:00 am	U. Mich Consumer Sentiment- Nov	98.3	**98.3**		98.3