

It's Complicated!

**What the Trump Economic Policies Really Mean for the
Economy**

By Kelly Westfall, CPA, CFA



Republican talk radio host, Hugh Hewitt, referred to Speaker of the House Paul Ryan as “The Boy Scout with the Big Brain”. CNBC’s Jim Cramer whimsically dubbed him the “Academic Einstein Speaker of the House”. This should be a comforting thought. After all, Ryan is generally credited as being the architect of the preeminent (though evolving) proposed Republican tax plan. And similar to Ryan’s other major project, health care, federal tax policy and its effect on the economy is also “unbelievably complex”.

This realization has not dissuaded Republican politicians, the Trump Administration and its surrogates and Trump from espousing with extreme confidence that the proposed changes in tax policy, primarily a reduction in corporate tax rates and favorable tax treatment of repatriated corporate dollars along with bold deregulation, will create “tremendous” growth and opportunity for the American people. In fact, according to proponents, the resulting “Keynesian Boom” will not only cover the corporate tax breaks and favorable repatriation treatment, but will also, along with material cuts to other sections of government, help to pay for the \$21 billion-dollar wall, the \$56 billion increase in defense spending, the \$1 trillion-dollar infrastructure plan which is being developed and may also be designed as tax cuts to financiers rather than going to fund projects directly. The end result, they promise, will be the

salvation of the coal industry, the return of manufacturing jobs and Gross Domestic Product (GDP) growth of 4-6% or higher.

To be clear, corporate and Obamacare high income earner tax breaks and increased spending on Trumpian rally calls like “the wall” are where the Keynesian reference ends. And never mind, by the way, that Keynes advocated lower taxes as a part of a government spending plan in times of depression; not upswing. And... never mind that since the 1970s, the link between productivity growth and average hourly compensation has been eroded; thus, a real problem facing the middle-class economy. These are easily ignored complications for big thinking business men.

Originally, a border adjustment tax was a crucial part of the equation. To his credit,

Ryan's concept is that a consumption tax is the necessary trade-off for the cost of corporate income tax cuts. And despite the fact that the tax would primarily affect the already stressed middle class, he is right. Most recently, however, that idea may be fading due to bad reviews from companies, mostly already embattled retailers who believe they would be decimated. They are also right.

It turns out that the Obamacare repeal (or repeal and replace) is meant to pay for a large portion of the proposed tax cuts. Though it seems that nobody had communicated this to Donald Trump before he blew up the first go at health care reform. Now, with this realization in place, health care reform is back on the table. In his April 6th press conference, Ryan said that "this promise (to repeal and replace Obamacare) is just too important, and the consequences of inaction are just too dire for American families for us to give up". The reality is that the consequences of not cutting Obamacare expenditures are just too dire for the state of the corporate tax cuts in that Republicans will not be able to net savings from Obamacare cuts against the proposed plan. Without this netting, the Republicans would need 60 votes in the Senate to pass their tax bill and that is not going to happen.



Still, drunk on the proposed leveraged buyout of the US Economy and the opportunity to funnel even greater proportions of wealth towards the wealthiest Americans, some Trump surrogates are no longer worried about trying to ensure that the tax plan is "revenue neutral".

CNBC contributor Larry Kudlow euphorically stated that "those business tax cuts are going to pay for themselves in 4 to 5 years! That's my view". He proposes using something called "dynamic scoring" to justify the plan. Another CNBC contributor suggested that the Administration refer to the tax cuts as "tax reform". After all, he reasoned, this would be much more palatable to Trump's working class supporters.

Kudlow has been the most prolific advocate of the premise that we should adopt an attitude of "blind faith" and move forward with the tax cuts trusting that money will find its way down the path to capital investment and jobs. In

the same vein, JP Morgan's CEO Jamie Dimon said during a Squawk Box interview that if "all companies did (with repatriated funds at favorable tax rates) was pay dividends (to shareholders) and buy back stocks, think of that as QE4"! Meaning that even if not one of the dollars which was granted favorable tax treatment for repatriation was spent directly on actual capital investment and jobs, but rather was transferred directly to stockholders, this would still be a stimulus for growth according to Dimon.

Unfortunately, if Larry and Jamie are wrong and their predictions do not pan out, it is unlikely that capital will be refunded back to those who did not participate in the advantageous tax policy. Mainly, middle class Americans and those who lost their insurance due to Obamacare reforms. After all, that would be a redistribution of wealth which is of course untenable.

It seems that rather than Keynesian economics, the Trump economic plan is justified instead by the somewhat embattled theory of "Trickle Down Economics". Very generally, the plan, which has been adopted by the Republican party in one form or another since Reagan, entails setting up a favorable pro-business, unregulated environment with limited government involvement which funnels capital to business owners and industrialists.

As the thinking goes, these are the individuals who have the ability and wherewithal to use capital to create growth for the economy as a whole; thereby benefitting the workers they employ and the economy as a whole by trickling down some of the wealth they were provided via the pro-business policies. The theory, which evolved from Adam Smith's "Invisible Hand" and was further expanded and championed by Milton Friedman in the 1970's, is finding favor in the current Administration and it is being translated through policy to mean low taxes and tax breaks on businesses and business owners as well as rolling back "job killing" regulations.

Friedman's famous article, *The Social Responsibility of Business is to Increase Its Profits*, published by the New York Times on September 13, 1970, laid out his support for free market policies and trickle-down economics.

Growth for Whom?



The reality though is that the path from the event of corporate tax cuts or

repatriation of corporate dollars, which are then distributed to stockholders via dividends or share buy backs, to capital investment and jobs is not so direct. And if the theory does not work, there is a problem: while the economy as a whole cannot survive without middle class consumption which drives 70% of the economy, the individuals who have benefitted along the path to failure get to keep the wealth they have accumulated. They are not going to give it back. The rest of the economy is left to pick up the pieces and move forward with a much smaller pie. divergence facing our economy is that wealth in large part has come from appreciation of financial assets rather than wages; benefitting those who were able to purchase those assets at depressed prices.

We have already been down this path in the wake of the financial crises. For the most part, the individuals who accumulated tremendous wealth in the lead up to 2008, weathered the storm fairly well. It was also these individuals who were able to maintain or increase their investments at much lower prices and in turn, benefit when the market turned around. This dynamic resulted in a massive shift of wealth; rapidly increasing the already dangerous levels of wealth divergence as those from the middle to lower end of the economy were not able to participate in the recovery.

Thus, we have seen that a fundamental characteristic of the alarming pace of wealth divergence facing our economy is that wealth in large part has come from appreciation of financial assets rather than wages; benefitting those who were able to purchase those assets at depressed prices. Additionally, workers have, in terms of average hourly income, barely participated in productivity gains represented as change in GDP. Building to the reality that today, the wealthiest 10% of Americans control 75% of all wealth in the Country.



And it is getting worse. In his book, *The Crises of the Middle-Class Constitution*, Ganesh Sitaraman discusses a study by economic historians Peter Lindert and Jefferey Williamson wherein they determined that wealth dispersion had remained relatively unchanged, with the top 1% of citizens earning 8.5% of income, from 1774 through 1982. Since that time, we have evolved to a place where 1% of Americans receive approximately 20% of income.

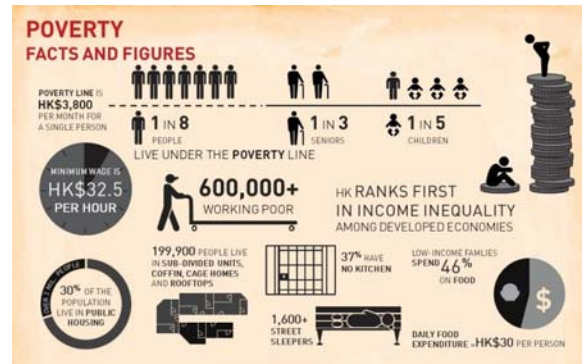
So, live and learn? In light of this, it may be worth a quick review of one of Friedman's favorite narratives and how history has judged "Trickle Down".

Free Markets and Trickle Down Economics Ex-Post

Milton Friedman pointed to Hong Kong as the perfect example of how an unfettered free market provides the only path to personal and economic freedom. That a business-friendly regime, free of rules and regulations, with no licenses or red tape and no tariffs or duties promotes economic growth for everyone.

But, despite their political popularity, Friedman's theories have been widely disputed. The Hong Kong narrative is no exception. Friedman's Hong Kong narrative has been successfully challenged both by economists

theoretically and much more harshly by history, as Hong Kong struggles with some very troubling economic realities.



Hong Kong Council of Social Services, Hong Kong Census and Statistics Department, SOCO, Oxfam Hong Kong; Presented by Feeding Hong Kong

According to Oxfam, the international conglomerate of charitable organizations focused on worldwide poverty, the poverty level in Hong Kong in 2016 jumped 6% from 2011. The percentage of those living in poverty has improved somewhat recently but was pegged at approximately 20% in 2013 and was at the 16% rate more recently. And these numbers may be misleadingly low. According to a Daily Mail article published in 2013, more than 50,000 people in Hong Kong are thought to live in 6ft by 3ft iron and timber shanties, many of which are run illegally.

"Economic Freedom"

The improvements which have occurred have benefitted those on the top of the economic scale disproportionately. While the material divergence of wealth between the wealthiest and the poorest of individuals is a dangerous problem

worldwide, Hong Kong has been affected to a larger extent. Oxfam, referencing its Hong-Kong poverty report covering 2011-2015 released in October of 2016, reveals that “Wealth disparity in Hong Kong is now worse than other developed regions in the world” and “urges the Government to make progressive policy changes to address the problem...” This may be inconsistent with the free market, government free plan which Friedman observed. It appears that, at least in the case of Hong-Kong, the path between free markets and economic growth and freedom has been interrupted. In fact, Oxfam found that the widening divergence of wealth has reached an alarming level.

Other Problems with Friedman's Hong Kong....

As participants in the three-part public television series “Testing Milton Friedman”, world renown economists Kevin Murphy, Raghuram Rajan, Dani Rodrik and Brad DeLong point to other theoretical problems with the Hong Kong narrative. Most obviously, Hong Kong was under British rule and its legal market regime throughout the period; changing hands in 1997. Also, comparisons to both similar and opposite regimes do not support the narrative Singapore for example has enjoyed significant growth under a much different

type of regime; where the role of government has included promoting and leading investment in new industries. Conversely, Calcutta which developed contemporaneously for many years under the same market regime as Hong Kong, did not enjoyed similar growth.

It's interesting to note that the abject poverty in Hong Kong is admittedly surprising to Brad DeLong. He comments that he does not know what happened and that “the verdict of history is that Milton was much too optimistic about the extent to which growing and developing economic freedom would carry personal and political freedom and democracy along with it”.

Now What?

Paul Ryan and others on the team refer to the “free market” as a solution to almost every problem. If only we could “allow” insurance companies to sell policies across state lines, competition would lower premiums and insurance choices would be available to those in rural areas. Except that the problem of insurance company monopolies in rural areas existed BEFORE Obamacare and was one of the issues the Obama Administration had hoped to resolve (but never did). Further, there are no laws preventing insurance companies from selling across state lines. But there are state regulatory requirements.

To remove the state by state insurance market plan, it would be necessary to remove state control; something that Republicans here to date have not promoted. Further, there is no such thing as a “free market” without price discovery.

So, it seems that it may not be that simple. And of course, if the purist example of one extreme is clearly not an option, the other is probably not the right choice either. The truth is better explained by the factual phenomena that as societies evolve towards greater economic freedom, they begin to demand such luxurious things as clean water, safer workplaces, care for the poor and elderly, etc. which their status demands. As a developed nation, Americans decided at some point along the way that we did not want people living in tents along the East River. We also decided that workers should not be trapped in buildings without fire protections and child labor is not acceptable. We recognized that education for all children residing in our country was essential to our continued economic survival, that ownership rights and protections in our courts must be relied upon if we were to invite economic investment. We saw the New Deal provide both short term relief and create successful long term structural reform. And antitrust laws provide fundamental positive protections against monopolies.

Although it may seem obvious, it is clearly necessary to balance free market policies and government involvement by, on one hand, not overreaching and restricting business with regulatory and pricing policies (gasoline shortage) while on the other stepping in to protect certain industries when their existence is threatened (the automobile bail out and maybe right now, coal and retail).



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A Developed Nation

We are after all a “developed” nation and our debt rating reflects this. Dani Rodrik, author and Professor of International Political Economy at Harvard’s Kennedy School of Government, points out that

the richest countries are the “countries in which the role of government is much more important than the poorer parts of the world.”

Betting on the Future

CNBC’s Brian Sullivan noted that markets continue to rise, (regardless of whatever chaos may be going on in Washington), due to optimism about “tax cuts, tax cuts, tax cuts, some deregulation, and tax cuts”. So, with the expectations of investors worldwide focused on tax reform, it is a huge relief to know that we are relying on the man with the “big brain”. Ryan’s credentials on the other hand consist of an undergraduate degree in Economics from Miami University of Ohio and helping to negotiate the 2013 bi-partisan budget act. Before he decided to pursue a career in politics, he worked in construction. To be fair, he has been the chair of a couple congressional committees, has been a speech writer and he points to numerous other successes during his tenure in office. None of these credentials, however, seem to indicate that he should be trusted with anyone’s personal tax return; more or less the tax policy of the United States of the America. Right or wrong, he is, so far, the person Trump is looking to for just that task.

Regarding optimism, Federal Reserve Chair Janet seen increased optimism,

But clarified that, “it’s uncertain just how much sentiment actually impacts spending decisions; and I wouldn’t say at this point that I have seen hard evidence of any change in spending decisions based on expectations about the future.” She went on to say that the Committee members have noted “a more optimistic frame of mind”; but that “most of the business people we have spoken to also have a ‘wait and see’ attitude and are very hopeful that they will be able to expand investment and are looking forward to doing that, but are waiting to see what will happen”. This seems to be the same answer that business owners would give in any atmosphere.

Alternative Facts

Growth projections from the Trump Administration and its surrogates have evolved from the originally lofty goal of 4% proposed during the campaign to as high as 6% more recently. This is great because, with these numbers, there is no need to worry about revenue neutrality. But where it’s clear that investors are happy to participate in markets which are pricing in the tax cuts and deregulation; very few experts are comfortable with the 4% to 6% projections which will pay for themselves. The two commentators who zealously promote the Trump projections include CNBC’s Larry Kudlow and former Starbridge Capital CEO, Anthony Scaramucci who is waiting to be

named for a role in the Administration. There may be others, but not many.

Federal Reserve Chair, Janet Yellen on the other hand, is looking to a sustained growth rate of 2% over the next three years with the possibility of 3% in the long term. Vanguard Founder and legendary investor Jack Bogle agrees. In a recent interview with Michael Smerkonish, he noted that “we don’t see that we can possibly have 4% growth, which is what they are talking about in our GDP. It could be 2% to 2.5%; hard to see it much more than that.” Yellen and Bogle both look to productivity as the primary factor; and with the overarching downward projected labor participation rate, it’s difficult to see how growth can exceed these estimates.

Yellen is somewhat optimistic compared to her peers. Ex Federal Reserve Chair, Alan Greenspan, sees stagflation (inflation and stagnation) as a real possibility. He went as far to say in an interview with CNBC’s Sara Eisen, “Stagflation, I think, is in the process of emerging”.

Then there is the survey of 285 economists released in March by the National Association for Business Economics, showed that 78% of participants had concerns that Trump’s tax plan and spending proposals will in fact widen the federal budget deficit.

On March 21st, the day of Trump’s signing ceremony for the executive

order to review rolling back the “job killing” Dodd Frank Act, Federal Reserve Vice Chairman, Stanley Fischer, expressed extreme concern, stating that:

“we seem to have forgotten that we had a financial crisis which was caused by the behavior in the banking (industry) and other parts of the financial system. And it did enormous damage to the economy. Millions of people lost their jobs; millions of people lost their homes....It was huge and it affected the rest of the world and it affected, to some extent, our standing in the world.

He goes on to say that “the strength of our financial system is absolutely essential to the ability of the economy to continue to grow at a reasonable rate. And taking actions which remove the changes that were made to strengthen the structure of the financial system is very dangerous.” He is most concerned with the planned rollback of the provisions which allow the government to unwind “Too Big to Fail” institutions should there be a systemic risk of failure brought on by severe economic shocks.

Sober Reality

We are reminded pretty much daily, by Trump himself, of the overwhelming success of his short presidency. By publicly intimidating corporate job providers and rolling back environmental regulations (among other things), he has created “tremendous” job growth. (Though one has to wonder how many more coal jobs have actually been created by allowing coal companies to pollute our streams -- since coal is a commodity; with supply and demand being the decisive determinant. But who’s counting? We do know that Coal Magnate, Christopher Cline, contributed \$1 Million dollars to the Trump inaugural, so maybe that has something to do with it.) Anyway, we are told that Trump inherited a “mess”, but he has been busy fixing things and has gotten more done already “than any other president in history”.

On the campaign trail, Trump repeatedly pointed out how the unemployment rate was faulty due to the number of participants who had dropped out. Strangely, however, Janet Yellen commented that labor participation has been “little changed in about 3 years.” And that with the overarching trend being a downward projection, due to the aging of the population, the fact that it is unchanged is seen a slight uptick.

Regarding the economy and projections overall, they are basically unchanged since the previous meeting. Consumption did increase. However, this was primarily a result of energy prices. Yellen commented that, “Our Economic projections are virtually identical to those that we issued in December. They are essentially unchanged both in terms of the path of the economy and the path of the Federal Funds Rate.”

Democracy or Republic?



In closing, it may be useful to reflect on Jack Bogle's observation in his interview with Smerkonish: "This might sound funny, but I worry about us becoming a Democracy when our Founding Fathers created a Republic". He continued, explaining that he pined for the time "where the people that knew more, with a sense of public service, that were educated, were elected to fill those various posts (through) various competition". And that now, "it's more like a Democracy, where the people speak, and sometimes that can be very unfortunate".

Mr. Bogle, I agree!



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