

## **Donald Trump's biggest challenge could be Republican fiscal hawks**

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Many investors betting on a "Trumpflation" stimulus to ignite the global economy would not be familiar with the House Freedom Caucus.

The far-right group of about 40 conservative Republican lawmakers represent one of the hurdles Donald Trump must clear to get his big spending plans passed through Congress to juice the economy.

Equities in developed economy markets have jumped and bond yields spiked on the prospect of an estimated \$US4 trillion in business and personal tax cuts over the next five years and \$US1 trillion in tax breaks for private sector-led infrastructure investment.

Bank of America witnessed the largest weekly inflow into in equities in two years and the biggest outflow from bonds in over three years since Trump's election.

Ignoring for now the uncertainty over whether Trump will execute on his disturbing trade protectionist rhetoric, the implementation of his fiscal stimulus is not a foregone conclusion.

Republican fiscal hawks talk about revenue neutral budget reforms to avoid US government debt blowing out beyond the current \$US19 trillion.

US debt forecast to jump

US federal debt is already around 77 per cent of GDP and forecast to jump to 86 per cent by 2026, excluding Trump's multi-trillion spending plans on tax cuts, infrastructure and defence.

US Federal Reserve chair Janet Yellen warned last week that with the 4.9 per cent jobless rate near full employment and the long-term debt problem facing the government there was not that much spare economic capacity or fiscal space for the US to increase deficit spending.

Kevin Brady, the powerful chairman of the House ways and means (budget) committee, said the goal was to draft legislation that did not add to the deficit.

In Republican language that includes the benefits of so-called dynamic modelling, which assumes tax revenue can rise when tax rates fall due to the extra incentive to invest and work.

Republicans have a dogmatic belief that cutting any tax (even the economically efficient inheritance tax) will deliver an outsized benefit to the economy and generate more government revenue.

To be sure, well-targeted tax cuts should fuel faster growth.

Yet history shows that the extreme Republican ideology on supply-side benefits of tax cuts led to gross overestimation of tax revenue.

Presidents Ronald Reagan and George W. Bush presided over big deficit and debt blowouts after slashing taxes for high earners and failed to generate extra revenue.

Perhaps Trump, the self-described "king of debt", will go down a similar path. Indeed, markets are betting on more debt, higher inflation and stronger growth.

Infrastructure plans face big challenges

Nevertheless, Trump's bold plan to cut the corporate tax rate from 35 per cent to 15 per cent to boost investment, lower the top-up tax on the repatriation of any of the \$US2.6 trillion parked offshore by multinationals and slash the top personal marginal rate to 33 per cent, will face some watering down in Congress to make it appear somewhat affordable.

The bigger challenge for Trump – and investors and commodity producers betting on a huge fiscal stimulus – is his infrastructure plan.

Trump championed "America first" during the campaign, with the real estate developer vowing to fix the country's "crumbling" roads, tunnels, rail, bridges and airports instead of wasting money on wars overseas.

He donned a hard hat on the campaign trail to claim infrastructure projects would create thousands of new jobs in construction and steel manufacturing.

The rallying cry was hailed by the blue-collar working class displaced from their jobs by technology and international trade.

Yet as popular as infrastructure spending is, the program is vulnerable to Republican fiscal hawks.

Trump's chief strategist Stephen Bannon admitted on the weekend the "conservatives are going to go crazy" about his push to "rebuild everything" through a "trillion-dollar infrastructure plan".

Indeed, influential Washington think tanks, the Cato Institute, Heritage Action and the Club for Growth have already shot down Trump's idea of giving 82 per cent tax breaks for equity injected into projects by private investors.

"Trump's plan is more likely to result in new construction of pointless projects than whatever maintenance is needed for existing infrastructure," Cato senior fellow Randall O'Toole says.

Republicans repeatedly stymied Barack Obama's efforts to boost public infrastructure investment, assailing it as big government waste.

### Trump dilemma

If Trump wants to spend more on infrastructure he will come under pressure from small-government Republicans, including House speaker Paul Ryan, to hack into social security for the retired and the universal Medicare healthcare program for Americans older than 65.

The dilemma for Trump is these voters are his core constituency from rust-belt states such as Ohio, Michigan, Wisconsin and Pennsylvania who installed him in the White House.

"One of the dumbest things I've ever seen," is how Trump described Ryan's Medicare privatisation plan during the election.

To protect entitlements of voters and get his infrastructure tax breaks through Congress, Trump may need to negotiate with Democrats who are more sympathetic to infrastructure creating jobs and less concerned about budget deficits.

The real estate mogul will likely be pragmatic and try to use his "amazing" deal-making experience to negotiate a compromise.

The bottom line for investors is that the total size and shape of Trump's budget package faces months of political wrangling and uncertainty.