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Trump’s fiscal policy may have lessons for Britain

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You may be fed up with the various attempts to forecast what Donald Trump’s victory will mean for the US and the world. As I argued last week, across a broad front of issues, we simply don’t know what Mr Trump will do – or how good he will be.

There is one area where his intentions are clear, and where we can bring economic analysis to bear, namely fiscal policy. Mr Trump wishes to reduce both personal and corporate tax rates, as well as reforming and simplifying the tax system, while simultaneously spending a lot more on defence and infrastructure. This amounts to a policy of fiscal expansion.

Despite major differences of detail, it hails from the same stable as the plans of Jeremy Corbyn in the UK. That doesn’t necessarily mean that Trump’s ideas are barmy. You could say that he is a closet Keynesian, although my American friends tell me that there is nothing of the closet about Donald Trump – and I doubt that he himself would use the K-word.

We normally associate the Right with tight budgetary policy, or even balanced budgets. Similarly, we normally associate both high government spending and the preparedness to run significant budget deficits with the Left.

The fact is, however, that the Republican president Reagan cut tax rates significantly and ended up running a fiscal deficit that peaked at almost 6pc of GDP. By contrast, the Democratic president, Bill Clinton, pursued a policy of fiscal stringency and managed to turn the budget into a surplus of over 2pc of GDP in 2000.

The real difference between the Keynesianism of the Left and Right is that the latter tends to favour fiscal expansions driven by tax cuts, whereas the former tends to favour increased government spending. And, of course, the Right thinks of tax cuts as stimulating the supply side of the economy as well as, or even instead of, the demand side.

At the moment, we don’t know the extent to which Mr Trump will want to offset increases in defence spending and infrastructure by reductions in other sorts of spending. But unless he does this, and/or lower tax rates do stimulate a large increase in economic activity and tax revenues, the US budget deficit will rise.

Does this matter? The budget deficit is currently running at about 3pc of GDP. Total federal government debt is currently running at about 74pc of GDP.

Even without any Trumpian expansion, it was on course to reach about 80pc in a few years’ time. It isnow plausible to see the debt ratio moving up towards 100pc of GDP.

I don’t think this spells danger for America. On the contrary, both domestic and foreign investors will continue to be keen to buy US government paper, which will still be regarded as a safe haven in an unstable world.

Mind you, there will probably be a price to be paid. Some commentators have speculated that uncertainty after the Trump victory will cause the US Federal Reserve to put off the interest rate rise that was due to happen on December 14. They could be right, although I reckon that the markets' comparative calm argues otherwise.

But the more important question is what happens to interest rates in the next two years. If President Trump does embark on a significant expansion, then the implication is that interest rates should go up sooner and by more than they otherwise would have done. This would be in accordance with the changing intellectual climate that has already started to swing against monetary stimulus and towards fiscal stimulus.

If a fiscal expansion were implemented, the result would be a faster move towards more normal levels of short-term interest rates and government bond yields. Clearly, this would hurt some groups of people, but it would also benefit others. And it would be warmly welcomed by all those people who have suffered from the long period of extremely low interest rates, and by those who would benefit from the stimulatory effects of the fiscal expansion.

Such a programme would have lessons for all of us on the other side of the Atlantic. The new Chancellor, Philip Hammond, has made it clear that he intends to moderate George Osborne's planned fiscal austerity and also to give some boost to infrastructure spending.

So far, of course, we have yet to see the colour of his (that is to say, our) money. But such a programme from the new Chancellor would sit easily with what is probably going to be happening in America. Moreover, the bolder and more radical President Trump's tax reforms are, the more pressure this will put upon the Chancellor to follow suit.

In the eurozone too, monetary policy should have reached the end of the road. There is room for a significant fiscal expansion in Germany. Yet this is not at all on the cards. The reason is partly that Germany is doing well without such stimulus, largely thanks to its huge export surplus, resulting from aggregate demand created elsewhere. It is a case of: "I'm all right, Giacomo." This policy is also the result of a belief that Germany needs to embrace hairshirt policies in order to encourage the more weak-willed members of the eurozone to stick to austerity.

If this continues, then I suppose the ECB will probably feel obliged to persist with its policy of cutting interest rates and putting money into the system through quantitative easing. In that case we can surely expect the eurozone to continue to perform poorly.

We are in for an interesting experiment. The US and the UK are, I suspect, about to rebalance fiscal and monetary policy, while the eurozone will continue on its current suicide run towards supposed fiscal probity. I know which of these I would back to succeed.