

Pressing issues in fiscal policy

This note covers three fiscal issues: 1) the Federal statutory debt ceiling; 2) the macroeconomic thrust of fiscal policy, that is, whether it is restrictive or stimulative; and 3) projections of persistent budget deficits and rising government debt. Our assessments are:

- Higher-than-expected government budget deficits are quickly pushing debt perilously close to the statutory debt ceiling. The U.S. Treasury has notified Congress the debt limit will be reached January 19, after which time the Treasury will begin to draw down cash balances and use various accounting techniques and “extraordinary measures” that allow the government to issue debt and continue operations. At some point mid-year (in June or July), rising debt will outrun these extraordinary measures and Congress will have to approve legislation raising the debt ceiling. This will involve a contentious debate about spending, taxes, and government finances, and threats of the dire consequences of government shutdown and default. ***Even if political maneuvering results in a partial government shutdown, various budgetary work-arounds will allow the government to continue servicing its debt, conducting basic services including defense, and providing funding for Social Security and entitlement programs, and the probability of government default on its debt is close to nil.***
- Fiscal policy continues to stimulate economic activity, driven by ongoing flows of government spending programs that raise disposable personal income and domestic demand, albeit to a far lesser degree than in 2020-2021 when the surge in deficit spending contributed to a robust acceleration in aggregate demand. The factors and programs underlying the ongoing stimulus are described.
- Higher interest rates and inflation are pushing up projections of already high persistent deficits, government debt as a percent of GDP, and debt service costs. These distressing trends will be detailed in the Congressional Budget Office (CBO) budget outlook report that will be released at the end of January. These accentuated trends of higher government debt impose costs on longer-run economic activity and unknown risks.

17 January 2023

Debt ceiling issues

The debt ceiling is the legal limit on the total amount of federal debt the government can accrue. It was established in 1917 to increase the flexibility in borrowing, facilitating the government's ability to issue debt without Congressional approval. As government debt has mounted, the debt ceiling has been modified approximately 100 times since it was first established. Approving its increase has often been politically contentious. In response to the debt ceiling "crises," a wide array of procedures and "extraordinary measures" have been established that have served to mitigate the degree of disruptions stemming from threats of breaching the debt ceiling. ***The political fighting has led to temporary partial government shutdowns, but none has interrupted the government's debt service, government funding of basic operations such as defense and national security, or funding the payments of Social Security and other entitlement programs.***

Most recently, in December 2021, the Federal debt ceiling was raised by \$2.5 trillion to \$31.4 trillion. The higher-than-expected deficits were driven, to a large degree, by the sharp increase in interest rates, particularly of short-duration Treasury securities. These reflect the Federal Reserve's aggressive increases in the Fed funds rate and have moved up the timing of the expected debt ceiling breach.

Last week, U.S. Treasury Secretary Yellen formally notified Congress that government debt would reach the statutory debt limit on January 19, after which the Treasury will draw down cash balances and use "extraordinary measures" (that have been established and used during prior debt ceiling crises) to maintain government operations. This initiates what is expected to be a rancorous debate about spending and taxes, intricate and arcane budgetary maneuvering, and threats of government shutdown and default. ***While a partial government shutdown is not uncommon, the probability of default on government debt is virtually nil; even members of Congress with little knowledge about the budget or economics understand the dire consequences of an actual default.***

The basic argument surrounding the debt ceiling is about the magnitude of government spending and taxes and the appropriate scope of government. Republicans favor a more limited size of government and Democrats favor higher spending and taxes. This issue is very important and deserves careful and thoughtful debate. But constructive discussion about the appropriate size and scope of the government and critically important topics (e.g., how government spending and taxes affect economic performance; standards of living and the distribution of income and wealth; the appropriate composition of government spending: entitlements vs discretionary spending programs, income support vs investment including investment in education and human capital; appropriate levels of spending on defense and national security) will be overwhelmed by polarized politics, political grandstanding that panders to the media, and the immediacy of the need to do something about the debt ceiling.

Ultimately, the rising debt will outrun the special measures and other budgetary procedures developed during prior debt ceiling episodes, and Congress must either suspend or raise the statutory limit. That is likely to occur by June. The upcoming CBO budget report is expected to clarify the timing of the ultimate debt ceiling deadline.

A partial government shutdown may be very disruptive, temporarily halting the provision of some public services. However, despite the political bluster and threats, a realistic probability of an actual debt default is minimal. An actual default would have deep ramifications. Even in the most strained political skirmish, Congress will steer clear of default and provide funding for defense and national security and funding for spending on entitlement programs such as Social Security, Medicare, Medicaid, and other income support programs. Nevertheless, the disruptions are potentially harmful to many normal government functions and are detrimental to the government's credibility.

For financial markets, history shows that however contentious and ominous prior debt ceiling episodes have been—including those involving partial government shutdowns—they have had little lasting impact on the trajectory of the government's spending and taxes or economic performance. Debt ceiling skirmishes occasionally lead to temporary financial market stresses and higher volatility (witness July-August 2011), but have no lasting impact on financial market behavior.

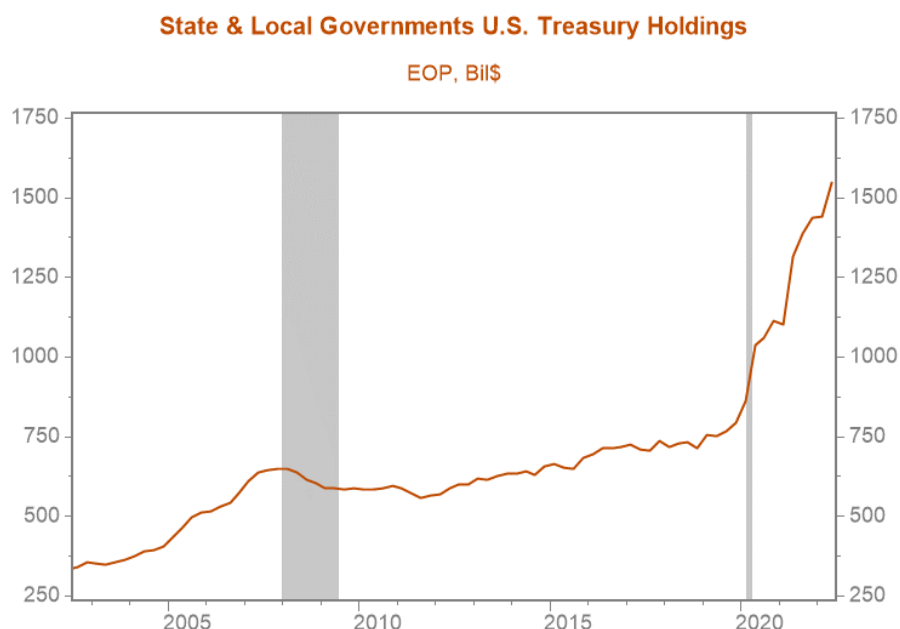
Thrust of fiscal policy—restrictive or ongoing stimulus?

In summary, fiscal policy is significantly less stimulative than in 2020-2021, when pandemic response legislation authorized over \$5 trillion of deficit spending, but the government continues to pump funds into the economy and provide financial incentives to spending, and fiscal policy remains stimulative. As described below, the sources of the ongoing stimulus include: 1) continued spending of unspent Federal budget authorization legislated in 2020-2021, sizable cost of living adjustments (COLAs) of government entitlement programs that boost disposable incomes, and inflation adjustments to individual taxes that constrain tax increases; 2) the lagged spending of personal savings cushions; and 3) the increased spending of the American Infrastructure and Jobs Act of 2021 and the tax reductions of the Inflation Reduction Act. Suggestions that fiscal policy is restrictive are overlooking some of these key features of government initiatives.

Unspent budget authority. The vast majority of the spending authorized in the CARES Act of March 2020 (\$2.3 trillion), the Consolidated Appropriates Act of December 2021 (\$0.9 trillion), and the American Rescue Act of March 2021 (\$1.9 trillion) have already been spent, largely in the form of direct transfer payments to households and small businesses, but a sizable portion has not been spent and is still flowing into the economy.

The largest portion of the unspent budget authorization is from the federal grants to state and local governments that totaled \$500 billion, allocated in the CARES Act and the American Rescue Act. The federal grants were supposed to be used for COVID-related health spending, but that did not unfold. Surging tax receipts generated by the robust economic rebound generated bulging surpluses, just the opposite of what had been predicted. State and local governments saved the federal grants, holding the bulk of the proceeds in U.S. Treasury securities, which have bulged from \$750 billion before the pandemic to \$1.55 trillion in Q3 2022 (Chart 1). The increase represents over 3% of GDP.

Chart 1



Source: U.S. Treasury, Haver Analytics

The surge in state and local holdings of U.S. Treasuries, presumably of short duration, most likely does not represent a permanent rise in the desired level of savings. Instead, over time the excess savings will be spent and, in some cases, used to finance tax cuts. Some of these savings are already being spent; for example, some states have distributed funds to citizens to offset the financial burdens of high energy costs. That's not what the COVID fiscal legislation had in mind, but it's common and expected for politicians to bend

the rules. ***The eventual spending of these savings will stimulate economic activity, regardless of what is happening to the Federal government budget deficit.*** In a sense, it will represent the delayed lags of the Federal government's fiscal stimulus.

Inflation impacts that increase government deficit spending and taxes. Large cost of living adjustments (COLAs) to Social Security benefits, many programs within Medicare and Medicaid, government pensions, and many other programs are boosting federal deficit spending and disposable personal incomes. The 8.7% COLA of Social Security alone will increase benefits by over \$100 billion in 2023, and inflation adjustments to other government programs exceed that amount. While this is a catch up to the reduced real purchasing power of recipients imposed by inflation in 2022, the total adjustment for inflation will increase disposable income in 2023 by over 1% of total disposable income.

Besides Social Security, the COLA also applies to Military Retirement, Civil Service Retirement, Veterans Pensions, and Railroad Retirement (the CBO estimates government outlays for federal civilian and military retirement programs plus Veterans programs to be \$373 billion in fiscal year 2022). Other large programs whose benefits are indexed to CPI inflation include SSI (Supplementary Security Income), Veterans Disability, Unemployment Compensation, and the refundable Child Tax Credit. SNAP (Supplemental Nutrition Assistance Program, formerly Food Stamps) and Children Nutrition Programs are indexed for the rise in the food component of the CPI, which has been higher than the rise in the overall CPI.

Key provisions of the personal tax system are indexed for CPI inflation, including personal income brackets, the standard deduction and personal exemption, the Alternative Minimum Tax (AMT) exemption, the Earned Income Tax Credit (EITC), and capital gains brackets. These adjustments to inflation will constrain tax increases, and for many households they will lower taxes withheld from earnings and increase nominal take-home pay.

Student debt forgiveness and other forms of debt forgiveness raise personal disposable income and encourage spending. The estimated magnitudes of debt forgiveness vary, but a ballpark amount is approximately \$400 billion, roughly one quarter of total outstanding student debt.

Consumer savings cushion. Household savings spiked as consumers saved a sizable portion of the excess government income support provided in response to the pandemic. Following the last bulge in income transfers provided by the American Rescue Plan in March 2021, household savings were estimated to be roughly \$2.5 trillion above pre-pandemic levels. Since then, consumers have been spending a rising portion of their disposable incomes, as reflected in the historically low rate of personal saving. However, the cushion of savings remains roughly \$1.25 trillion, or 6.6% of disposable personal income. Over time, this cushion of savings is expected to be spent, lagging stimulus provided by the earlier federal deficit spending.

The government's COVID fiscal policies also provided sizable income support to small businesses. While it is difficult to track these transfers, businesses still hold very large cash reserves that will also be a source of future spending that will add to economic activity.

The American Infrastructure and Jobs Act of 2021 authorizes \$1.2 trillion in spending. This cost estimate is based on a 10-year budget projection. As these authorized funds are spent, they will add to economic activity and jobs and will be a source of fiscal stimulus. The spending will focus on roads, bridges, basic transportation systems, public transit, electric and clean air initiatives, urban renewal, expanded broadband access, cybersecurity, and environmental cleanup.

Unlike the government transfer payments of the fiscal policy responses to the pandemic, virtually all of the infrastructure spending will involve government investment measured directly in GDP, with most of the jobs created in the private sector (along with new government jobs created to manage the infrastructure initiatives). This will add materially to GDP; assuming the spending is spread evenly over ten years, \$120 billion of spending in the first several years will add roughly 0.4% per year to GDP. Importantly, history shows that fiscal policy multipliers of government investment spending are far higher than government transfer payments.

Tracking the actual spending authorized by the American Infrastructure and Jobs Act is very difficult. Despite the government's efforts to be transparent and the new government bureaucracies that have been created to implement and monitor the infrastructure

initiatives, there is no easy source of information on the actual spending. Most likely, driven by politics, a larger share of the authorized spending will be spent in the earlier years.

The Inflation Reduction Act provides tax credits that subsidize purchases of clean energy products (electric vehicles, solar panels, etc.), puts caps on select prescription drugs, lowers costs of select health insurance, imposes minimum taxes on corporations, and enhances IRS tax collection from high wealth individuals. The CBO estimates that the energy and climate related tax credits will reduce tax receipts by \$391 billion over the 10-year projection period, while the health care subsidies will cost \$108 billion. The CBO estimates that these costs will be offset by savings in drug prices and higher revenues from taxes. The incentives provided by the tax credits are expected to stimulate economic activity.

In sum, the ongoing fiscal stimulus is expected to add to aggregate demand and provide a partial cushion against the tightening of monetary policy.

Longer-run budget projections

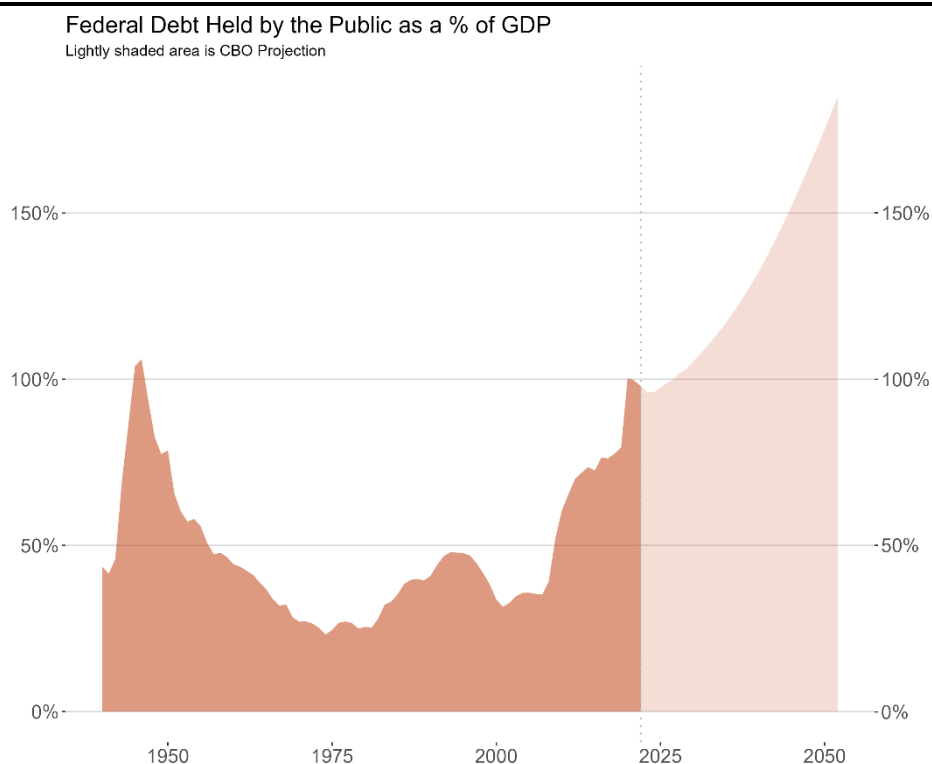
Since the CBO's most recent budget projections were published in May 2022, inflation and interest rates have risen significantly higher than the CBO had projected. Consequently, budget deficits and federal debt have risen above the CBO's projections, and the higher debt and debt service costs will compound in its longer-run projections.,

The CBO had projected that CPI inflation would average 6.1% in 2022 and 3.1% in 2023. Instead, CPI rose 8.0% in 2022. The CBO projected the 3-month Treasury bill would average 0.9% in 2022 and 2.0% in 2023 and the 10-year Treasury bond would average 3.4% and 2.9%. Instead, in 2022, the 3-month Treasury bill averaged 2.0% (3.5% average in the second half of 2022) and the 10-year Treasury bond averaged 3% (3.5% average in the second half of 2022).

The CBO estimated in its May 2022 report that under current law, net interest costs of \$399 billion in 2022 (6.8% of total federal spending and 1.6% of GDP) would rise to \$1.19 trillion, doubling the shares to 13.4% of total spending and 3.3% of GDP in 2032. The net interest costs compound in longer-run projections and, along with Social Security, Medicare, and Medicaid, are the primary sources of upward-spiraling spending and debt. Updated projections will be much higher, reflecting the higher-than-projected interest rates. ***Even if interest rates settle down to the CBO's longer-run projections, the higher levels to date will have compounding impacts, pushing up government debt-to-GDP ratios and debt service costs that are already projected to rise dangerously high.***

As shown in Chart 2, the government's debt-to-GDP ratio has doubled since the 2002-2009 Financial Crisis and is projected to rise dramatically further. Government spending as a percent of GDP is projected to rise sharply under current law, primarily due to higher projected spending for entitlement programs (Social Security, Medicare, Medicaid, and others) that reflects the aging of the population, higher real costs of health care, and soaring net interest costs. The higher-than-expected inflation is significantly boosting spending on Social Security, pensions, and other entitlement programs indexed to inflation, and these increases will also compound. At the same time, the decline in real wages and the adjustment of the individual income tax brackets constrain increases in tax receipts.

Chart 2



Source: Congressional Budget Office

The risks stemming from high and rising debt and debt service costs have been widely described: risks of financial instability, higher interest rates and inflation, foreign demand for U.S. debt securities, constraints on spending on government programs, and the negative implications for economic growth; the list goes on. These issues deserve close scrutiny, but there is little political appetite to address the programmatic changes in the mandatory entitlement programs that would be required to even stabilize projections of debt-to-GDP ratios.

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