Global Political Analysis

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Is the US headed blindly towards the fiscal abyss?

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Andy Langenkamp

+31(0)30 232 8000
ecr@ecrresearch.com

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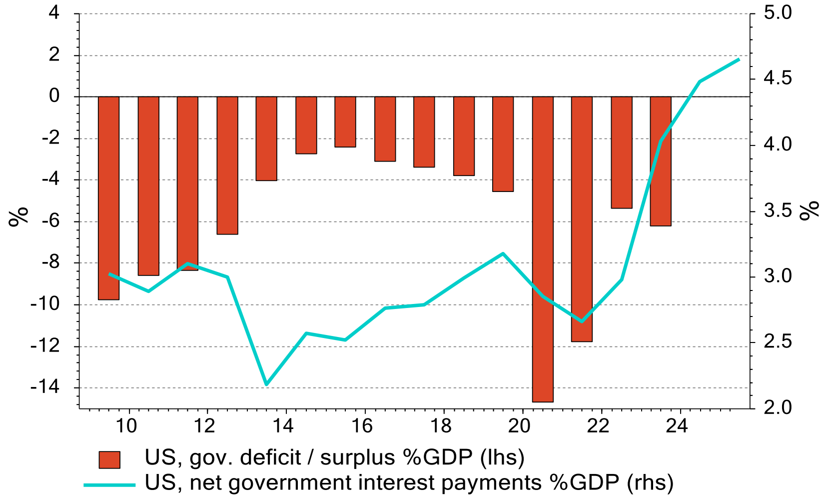
Levels from times of crisis

In the previous GPR, we gave a broad outline of the policies likely to be pursued if Donald Trump won a second presidential term. This week, we will zoom in on the fiscal policies we can expect if Trump becomes president again, but also if American voters allow Joe Biden to stay on in the White House. Indeed, we have indicated many times that if the election were to take place at this time, it would be a coin flip. Trump has a slight advantage, but a Biden sequel is by no means out of the question.

Based on projections of the US federal government's finances published by the Congressional Budget Office (CBO), the US fiscal-economic situation is not too rosy anyway. If current tax and spending laws remain generally unchanged, the federal budget deficit relative to gross domestic product would increase substantially over the next 30 years. This increase would result from rising interest charges and large primary deficits (deficits excluding net payments for interest). Growing aggregated deficits would push the federal debt to unprecedented heights. Such a large and growing debt would have vast economic and financial consequences: it would likely slow economic growth, drive up interest payments to foreign holders of US debt, increase the risk of a fiscal crisis, and make the US far more vulnerable to rising interest rates.

Higher US government interest payments could crowd out necessary spending that generates future growth



Source: LSEG Datastream / ECR Research

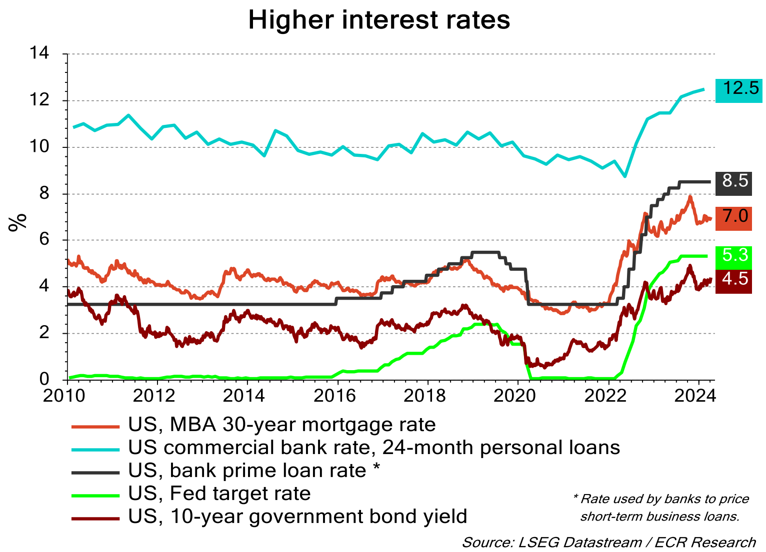
More specifically, the CBO states that the deficit will be 5.6% in 2024, grow to 6.1% in 2025 and shrink to 5.2% in 2027 and 2028. Also, by the end of this decade, the government's interest charges will rise to 4% of GDP, which is far more than the US spends on defence, for example.

After 2028, the deficit as a percentage of GDP will increase; it will return to 6.1% in 2034 and be at 6.9% in 2039. Since the Great Depression, deficits have exceeded this level only during and shortly after

World War II, during the 2007-2009 financial crisis and during the corona pandemic. Furthermore, public debt will rise from 99% of GDP to 116% and 127% in 2034 and 2039, respectively.

As various percentages are being mentioned here and there, it is important to point out that this concerns debt held by the public rather than gross public debt. Debt held by the public measures the amount of US debt held by entities other than the federal US government that is freely tradable. This includes debts to individuals, corporations, banks, insurance companies, state and local governments, pension funds, mutual funds, foreign governments, foreign companies and individuals, and the Fed. This therefore excludes debts that government organisations owe to each other.

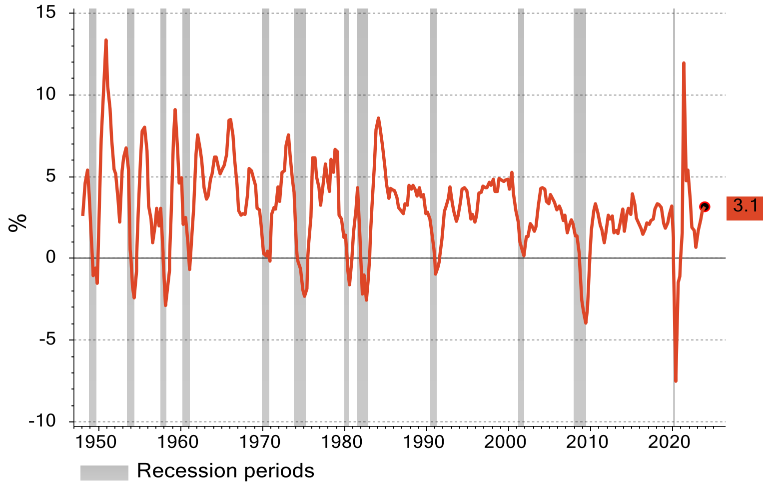
Most economists regard debt held by the public as the most economically meaningful measure of debt, as it determines the extent to which debt provides fiscal stimulus, crowds out private investment, affects interest rates, et cetera.



So, if policy does not change significantly, debt and deficit levels will be rising to levels known only from crisis times. To make matters worse, however, underlying the CBO's projections is the optimistic view that federal government spending will remain more or less contained, a recession will not occur, revenues will rise and interest rates will decline.

If we make the assumptions slightly more realistic - although they remain fairly optimistic - the data become even more alarming. *Calculations by the American Enterprise Institute*, for example, assume nominal growth of 4% (2% real growth, 2% inflation), slowly rising primary deficits starting from the average of 3% over the last five years (excluding pandemic years) and steadily rising interest rates, which will likely be at 6% by 2039.

US real GDP growth %YoY



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These figures lead to a deficit of up to 8.8% of GDP in 2029, 11.1% in 2034 and 14.4% in 2039. Outstanding debt will then increase to 115% of GDP in 2029, 138% in 2034 and 168% in 2039. These are levels at which the IMF assumes a US financial crisis erupts, and the CBO assumes that they will not be reached until 2053 - again, if policies remain unchanged.

Tricky issues

We should also mention that Washington keeps spending additional money, while shares are at record highs, wages have risen sharply, unemployment is around record lows and growth is robust. Normally speaking, one would expect that, in these circumstances, the government would tighten its belt somewhat to build up buffers for tough times.

However, US policymakers generally make a dog's dinner of the budget, as only four times has Congress passed the necessary budget bills on time since 1977. The situation is once again deplorable this year, with the government being kept afloat through partial laws that are consistently passed at the last minute, and with legislative rules and procedures being handled in an utterly creative manner. For example, bills should be known at least 72 hours before the vote to allow time to study the legislation. However, the leader of the House of Representatives has not always been in compliance with this rule.

Meanwhile, yet another imminent government shutdown was averted last month and the government can keep running until the end of September. By that time - which is very close to election time - we will probably see the same circus again. (Incidentally, support for Israel, the Ukraine and Taiwan has fallen victim to the political battle surrounding keeping the government doors open: Democrats and Republicans were very far apart on this, to the point where these tricky issues were postponed). It is likely that, in the autumn, Congress will once again pass a so-called continuing resolution for the 2025 fiscal year. This would postpone the FY 2025 decisions until after the elections.

The fiscal elephant in the room

We have previously discussed assumptions of unchanged policies for debt and deficit projections. In this case, unchanged also means that it is assumed that phaseouts in existing tax laws will indeed occur. This brings us to what will be the first major course on the new Congress and President's fiscal menu after the election: what to do with the 2017 *Tax Cuts and Jobs Act* (TCJA)?

The TCJA was passed in December 2017 under President Trump. It made sweeping changes to the federal tax code. For example, the corporate tax rate was cut from 35% to 21%, individual tax brackets were reduced across the board, and the standard tax deduction was doubled. Budget analysts estimated at the time that the measures would reduce federal revenues by a net $1,500 billion over the next decade. However, this law will largely expire by the end of 2025. This is due to the fact that the Democrats were not very keen on the TCJA, forcing the Republicans to resort to the so-called budget reconciliation enabling the GOP to bypass the filibuster in the Senate (In practice, the filibuster means that 60 votes rather than a simple majority of 51 will be required to pass bills in the Senate). However, this emergency measure also came with a major drawback for the Republicans: a bill passed via budget reconciliation must not raise the budget deficit beyond the budget window, which is typically 10 years. To comply with this rule, the Republicans decided to let part of the TCJA expire after a number of years and make another part permanent.

Most corporate tax policy changes are permanent, while many individual income tax changes will expire by the end of 2025. For example, the reduction of the corporate tax rate to 21% will not change under the current law. However, the lower individual tax brackets, higher standard deductions and expanded child tax credits on the one hand, and increases in individual income tax rates on the other (e.g. the elimination of personal exemptions and tighter restrictions on the mortgage interest deduction) will expire without intervention.

All in all, it is estimated that a full extension of all expiring provisions would cost $3,500 billion over the next 10 years. This would raise budget deficits by $400-$500 billion annually, increasing the budget deficit as part of GDP by 1.0-1.5 percentage points. As a result, the federal government debt would be 261% of GDP in 2050 rather than 226% in the event of expiration of the tax cuts, as shown by Wells Fargo's research, among others. If corporate tax hikes from the TCJA were reversed, the total budget deficit would even amount to $5,000 billion over the next 10 years (including interest charges).

Incidentally, an extension of the TCJA measures would disproportionately benefit top earners. For example, the Section 199A provision provides a 20% tax break for some recipients of passthrough business income. Roughly 55% of the benefits this brings will go to the top 1% of the richest households, while only 3% of the cuts will provide relief to the bottom half in the income distribution. Extending this provision would cost approximately $700 billion over the 2026-2035 period. Another example is the reduction of inheritance tax. This provision is only relevant to the most expensive 2 out of 1,000 estates/homes. If this reduction continues, it will cost $170 billion over a period of 10 years.

Incidentally, the decelerating force on the US economy of any lapsing tax cuts in isolation would probably not be enough to trigger a recession; belt-tightening would reduce growth by a few tenths of a percentage point, according to most estimates.

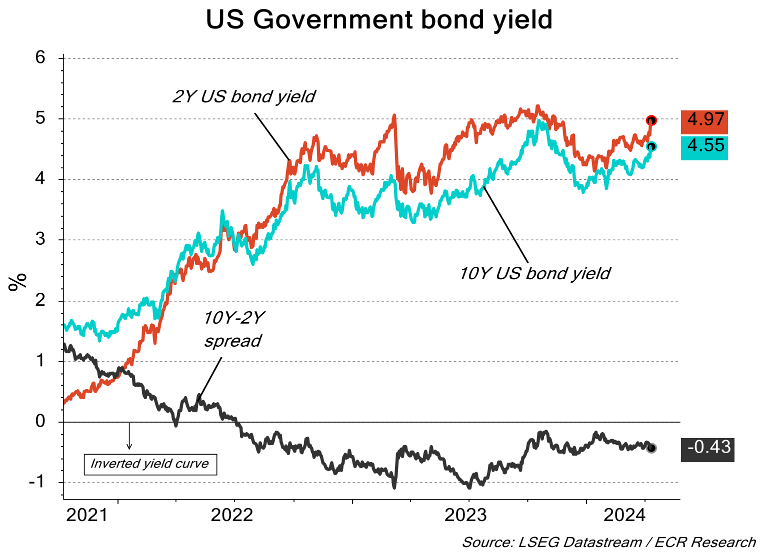
TCJA scenarios

Republican hegemony

If, in November, the Republicans take control of all three houses (the White House, the House of Representatives and the Senate), an extension of the existing tax cuts becomes likely. Given the aforementioned budget reconciliation rules, it will once again be difficult to make these tax cuts permanent and certainly to pass even larger tax cuts, as the chances of the GOP gaining 60 or more seats in the Senate are slim. Although, with a red Congress and White House, there will be a tendency and political pressure in and on the GOP to implement additional tax cuts, as a continuation of existing cuts or the avoidance of tax hikes will not be seen as an improvement for voters. Trump has stated recently that additional tax cuts would be on the table, and during his first term he wanted to cut the tax rate for corporations to 15% (it became 21%).

As mentioned, however, the filibuster, for example, will likely ensure that households and companies can expect little additional reduction in their tax burden, but a Republican House and Senate and a President Trump would avoid tax hikes that would have been implemented had Congress not taken action.

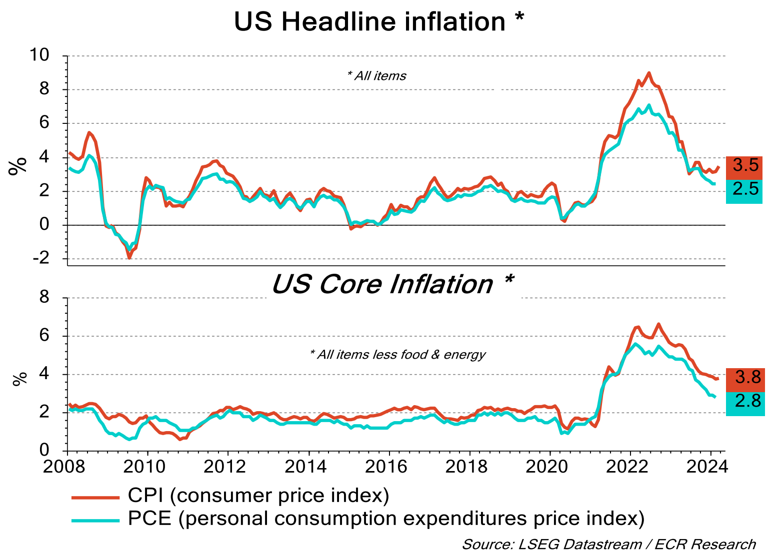
A Republican sweep would not give the economy a massive boost, but an extension and a small expansion of the TCJA could certainly have an effect. For example, the original TCJA gave economic growth and inflation a boost of several tenths of a percentage point, according to most estimates. More fiscal stimulus would likely entail larger budget deficits, upward pressure on long-term interest rates and a steeper yield curve.



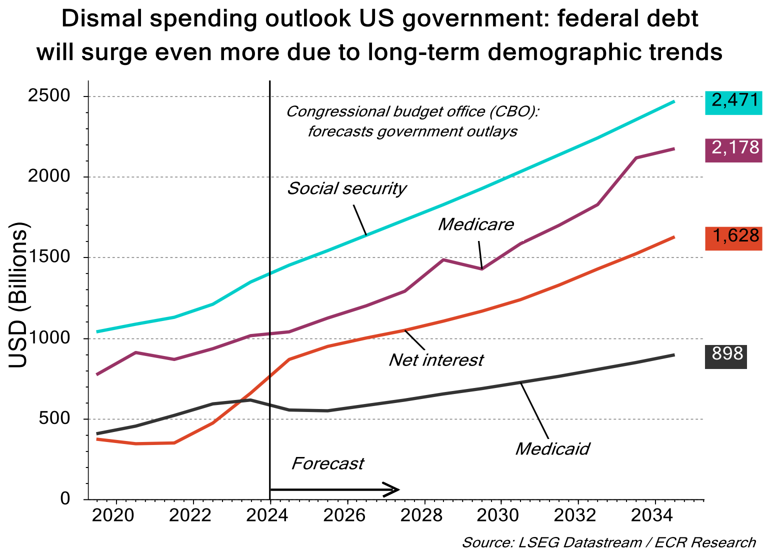
Wells Fargo, among others, pointed out that a one-percentage-point increase in the structural budget deficit has historically been associated with a 15-30 basis-point increase in longer-term interest rates.

Should Trump succeed in cutting taxes for companies even further, for example, it remains to be seen whether this will provide much of a boost to economic growth or whether it will mainly boost corporate profits somewhat. Indeed, these taxes are already fairly low, and even lower rates are likely to have little effect on productivity and investment, as pointed out by Zűrcher Kantonalbank, among others. By way of illustration, America is already in the bottom 10 per cent of countries in terms of corporate tax revenues expressed as a percentage of GDP, even though the US houses a disproportionately large share of the world's most profitable companies.

A Trump administration will likely raise budget deficits. Moreover, it would increase labour market tightness through tougher migration policies and push up import prices through tariffs (and - as we have pointed out in previous reports - possibly try to influence the Fed). These measures would be inflationary and would boost growth only (very) marginally, certainly under the current financial and economic conditions.



It is not a given that an entirely Republican Congress will be on Trump's leash. For example, a group of fiscally conservative Republicans in the House (which includes 80% of the GOP delegates) recently made proposals that go against promises made by Trump, including a proposal to raise the age of entitlement to Social Security benefits.



A divided Washington

In the scenario of a divided Washington, the TCJA will likely only be partially extended. Treasury Secretary Janet Yellen has said that a second Biden administration would try to preserve tax cuts for households earning less than $400,000 a year.

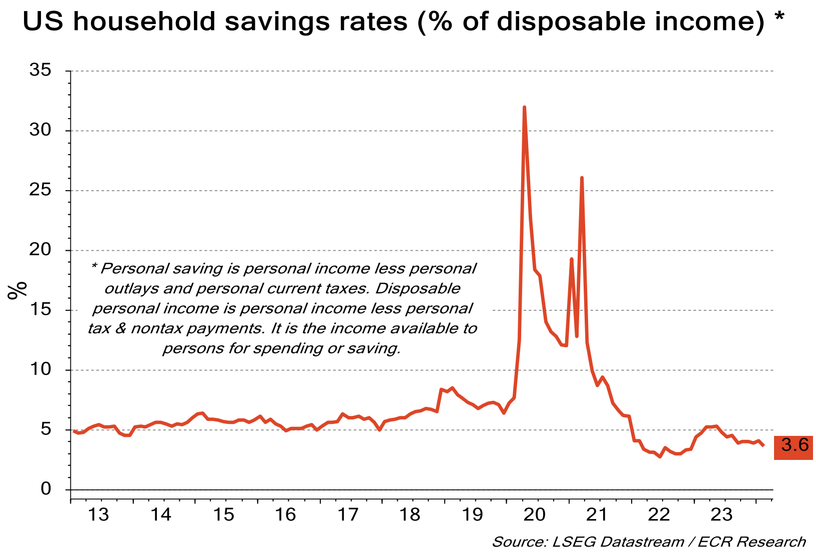
A partial extension of the TCJA along these lines would put very slight upward pressure on economic growth and inflation. Relative to the previous scenario, budget deficits would then remain slightly smaller (but probably still relatively sizable), long-term interest rates would rise somewhat less, and the yield curve would remain somewhat flatter. Furthermore, we expect smaller budget deficits, lower Treasury bond yields and a flatter yield curve, with the magnitude of change for these variables being relatively modest.

Democratic supremacy

The least likely scenario is one in which Congress and the White House turn entirely Democratic blue. This is partly due to the highly disadvantageous electoral situation for the Democrats in the Senate. 34 out of 100 seats are at stake, and of those 34 the Democrats have to defend 23, with at least seven already clearly at risk of falling into the Republican camp, while the GOP only needs to gain a net two seats to clinch the majority of 51. The House is also inclined towards Republican, but this is far more uncertain: the Democrats need only six additional seats, while around 20 seats are toss-ups.

That said, this scenario cannot be completely ruled out (also because incumbent presidents won in 67% of cases where they ran for a second term and this percentage rises to 80% in cases without a recession in the election year). Hence, we do want to focus on the possible fiscal consequences. In this scenario, it is very likely that the Democrats will extend the TCJA tax cuts for those with incomes below the $400,000 threshold, while allowing higher rates to take effect for incomes above this threshold. In addition, subsidies for health insurance and energy transition will be increased. The effects of cuts and hikes will then roughly balance each other out, which means that there will be relatively little impact on economic growth, inflation, budget deficits and long-term interest rates.

That said, a small shift in purchasing power from the higher to the lower incomes could give a modest boost to growth, as lower income earners are more inclined to spend more money. Also, said lower income earners have run through their additional savings accumulated during the corona pandemic: savings of households with incomes below $45,000 have since returned to 2019 levels; only roughly the top 20% of incomes still have additional savings and could still boost consumption.



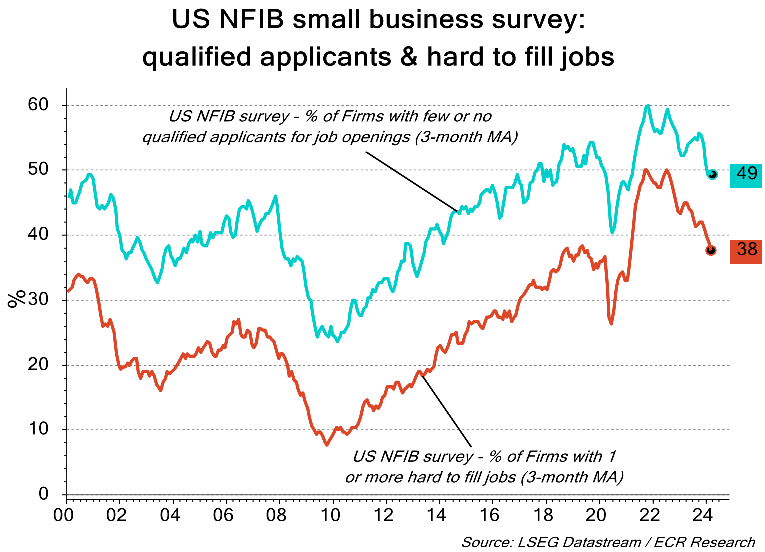
Hitting the ceiling

In addition to the TCJA, there is another fiscal issue that is sure to quickly land on the plate of the new Congress in early 2025: the raising of the debt ceiling. We have written extensively about the debt ceiling in recent years, but in a nutshell: the debt ceiling is the statutory maximum of debt held by the federal government. Because government revenues are generally lower than expenditures, the debt ceiling must be raised periodically to allow for additional borrowing. The debt ceiling was suspended in June 2023 until 2 January 2025 as part of the *Fiscal Responsibility Act* (FRA). Without Congressional action, the maximum debt for the US government will automatically be the level of government debt on 2 January. With a bit of creative accounting, the Treasury Department could carry on until sometime in the summer of 2025, but in some scenarios the so-called X Date could also fall in February or March. In these months, seasonal deficits are traditionally large, for example, because income taxes are refunded.

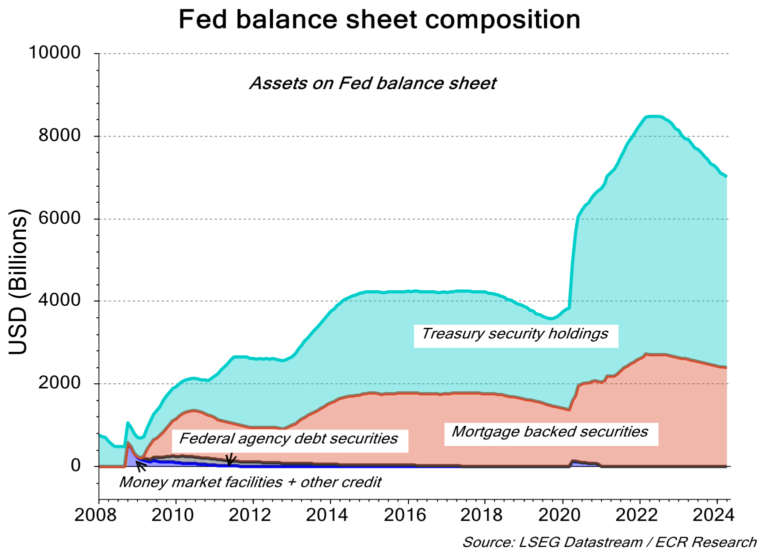
A different climate

In the above analysis, we wish to point out - based on research by Credit Agricole, among others - that tax cuts, rising deficits and so on in 2025 will take place in a very different climate compared to the first years of Trump's first term, which means that they will have a different impact and that, in some respects, Trump's plans go much further than they did eight years ago. As for this other climate:

- Deficits are far higher now than in 2016 and far more government bonds are being issued at higher interest rates. In 2024, the Treasury will raise 35% more on capital markets than last year, according to Torsten Slock. Apollo Global's chief economist says: "*Normally, it's very easy: when the economy goes down, long rates go down. When the economy goes up, long rates go up. But today there is a new factor in town, which is Treasury supply. Who's going to buy, when auction sizes increase so much?*"
- Inflation is at higher levels.
- The labour market is far tighter.



- The geopolitical climate has deteriorated.
- China is weakening.
- The Fed is likely to reduce its balance sheet further.



During Trump's first years as president, the negative effects of his trade war were still offset by tax cuts and deregulation. At this point, these tax cuts will have less effect and their scope will be smaller - if they can be implemented at all. This is because the US is forced to pursue a tighter fiscal policy due to rising interest rates and debts, for example.

At the same time, Trump wants to go much further with his tariffs on imports, and we would not be surprised if there were more political scope for this due to heightened geopolitical tensions, among other factors. During Trump's first term, his import tariffs focused on specific items such as washing machines, steel and aluminium and they were targeted against China. However, the average tariff on imports did not even rise much and is currently around 3%. This would change with Trump II if he were to practice what he preaches, according to the SEB Group, for example. A 10% import tariff across the board would amount to $300 billion in additional taxes for US consumers, or 1% of GDP. A 60% tariff on Chinese imports would translate into 0.5% of GDP in additional taxes for Americans. According to

France's central bank, the 10% rate would initially deal global GDP a 2% blow, and this would rise to 3% after two years.

Import tariffs will boost the Treasury's coffers. However, the negative impact of higher import tariffs on public finances (downward pressure on economic growth and mounting upward pressure on long-term interest rates) will ultimately carry more weight.

A final remark to offer some perspective

Finally, and in addition to the above, it is important to keep one thing in mind. However the election turns out, a great deal will remain the same. Even if Trump wins and does some 'weird things', America and therefore the dollar and Treasuries will most likely retain a safe haven status for the time being. This is because a number of essential features of the US and the US economy will not change any time soon and are ingrained in America and/or because the political parties still agree on various issues despite their animosity.

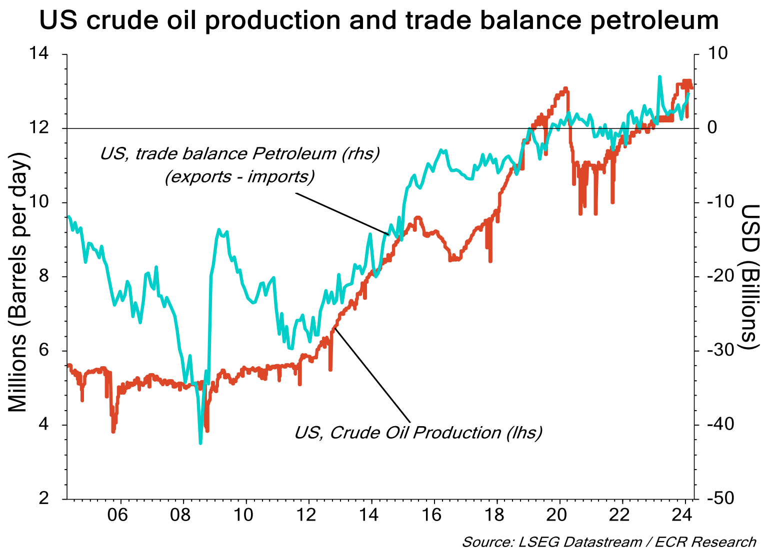
Barclays cites the following examples in a recent research report:

- The US is still almost as economically 'closed' as it was 30 years ago, rendering the US economy less sensitive to global shocks than, say, Europe. The US will hide behind its own barricades more rather than less.

- The US has managed to achieve stable and high returns on capital for decades, in part because of the technology revolution (largely driven by US companies) and because of fiscal policies that attract capital towards the US, for example.

- The US is often better capable of conducting anti-cyclical policies than many other economies. This stimulates the domestic economy more effectively in the event of so-called output gaps.

- The US has actively pursued and largely succeeded in achieving energy independence. This has reduced both its external financing needs and its exposure to energy crises (which has also created a positive correlation between the dollar and oil prices).



- As a result of crises and problems in Europe and China, safe-haven alternatives to the dollar and Treasuries have so far barely been developed, if at all.