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WEEKLY ECONOMIC COMMENTARY

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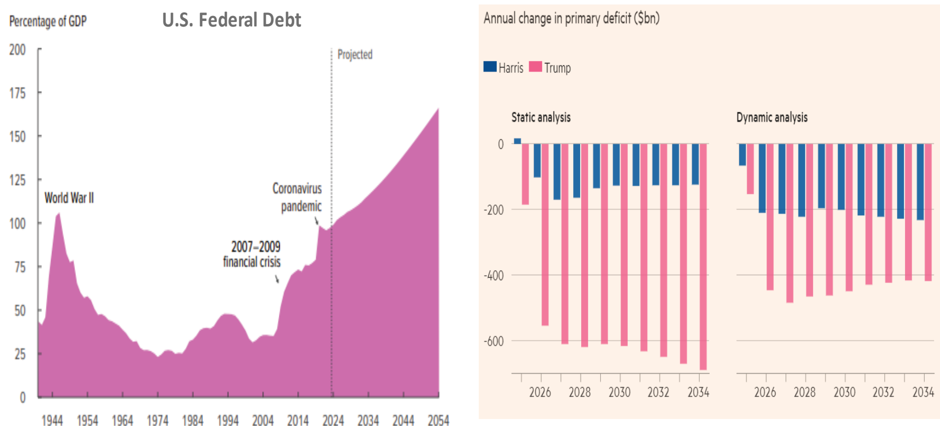
In Shakespeare's "Hamlet," a father gives his son the following advice as the younger heads off to college:

Neither a borrower nor a lender be,
Because loan oft loses both itself and friend
And borrowing dulls the edge of husbandry.

Husbandry, in this context, refers to the control and judicious use of resources.

In America, responsibility for financial husbandry was vested by our founders in the U.S. Congress. Unfortunately, successive editions of the institution have indulged in borrowing that is unparalleled. This year's candidates for high office are promoting policies that could make matters even worse. Unfortunately, it appears that fiscal responsibility will remain an oxymoron in the United States.

It has been hard for Congress to focus on long-term fiscal policy because the basic task of keeping government open has proven more difficult than it should be. As they battle over continuing resolutions and the debt ceiling, the national debt just keeps on increasing. We now owe more than 100% of our of gross domestic product for the first time in almost 80 years. Projections suggest that level could almost double by the middle of this century. Our essay on how we got into this mess can be found here.



Sources: Congressional Budget Office, Financial Times, Wharton School

Unsurprisingly, Vice President Harris and former President Trump have been reluctant to consider austerity. Instead, each has offered a menu of proposals that are politically appealing but fiscally worrisome. Third-party projections show that both party platforms will likely add significantly to the national debt.

On the revenue side of the ledger, the foremost issue to be addressed next year is the expiration of most individual tax policies within the 2017 Tax Cuts and Jobs Act (TCJA). Among them are:

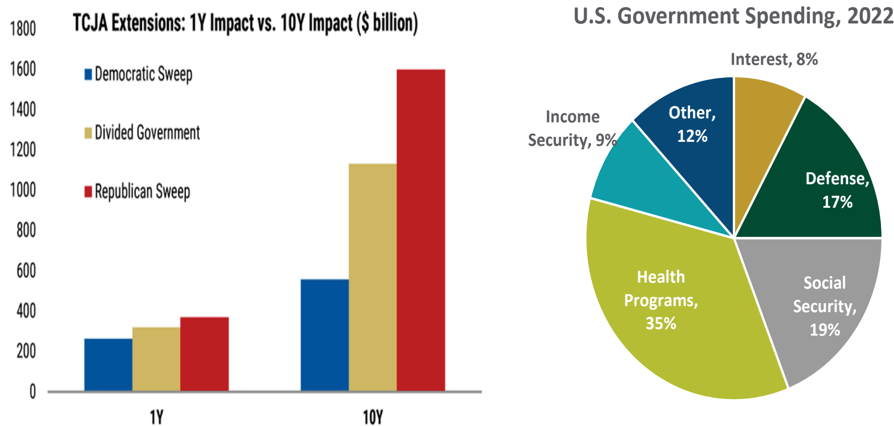
- Increases in standard deductions for taxpayers and reductions in personal exemptions
- The lowering of the top marginal individual tax rate from 39.6% to 37%
- Caps on the deduction for state and local taxes
- Increased thresholds for the alternative minimum tax (AMT)
- The doubling of the estate tax exemption

Another "fiscal cliff" looms in 2025.

These kinds of "cliffs" have become more common in recent decades, as major fiscal bills passed under a reconciliation procedure cannot increase the deficit beyond a ten-year window. (This is known as the "Byrd rule" after the Senator that championed it.) Early sunsets help limit projected costs, but they are often extended to avoid creating a sudden drag on the economy.

While sustaining the TCJA provisions would be very costly from a budgetary perspective, neither side is anxious to let all of them go. Vice President Harris has proposed sustaining relief for taxpayers earning less than $400,000, offsetting the revenue loss with higher taxes on wealthier households. She has also proposed increasing corporate income taxes; such a step might prompt companies to shift profits overseas. Efforts to enact a global minimum corporate tax have stalled.

Former President Trump has promised to make all of the TCJA favors permanent. On top of that, he has proposed additional reductions in individual and corporate taxes and ending the taxation of Social Security benefits, gratuities and overtime pay. No tax revenue offsets have been recommended; the Republican platform is hoping their policies will generate incremental growth that will broaden the tax base and reduce any loss of tax revenue.



Sources: Morgan Stanley, Congressional Budget Office

With regard to spending, the main initiative for Vice President Harris is a reinforcement of the Child Tax Credit. The benefit was doubled under the TCJA and temporarily increased in 2021 to offer support during the pandemic. Benefits will revert to their pre-2017 levels of $1,000 per child next year unless extended by Congress. The nominal cost of enhancements to the program is estimated to be $1.35 trillion over ten years, although some of this would be offset by tax revenue generated when households spend the money.

Former President Trump seeks to reinforce defense capabilities and border security. He proposes to pay for them by halting some funding for energy transition authorized under the Inflation Reduction Act (IRA), which would save $650 billion over 10 years.

Proponents of federal programs offer that spending generates economic activity and tax revenue. They add that addressing needs now can head off higher costs later.

But as we discussed in our article on budget math, the notion that tax cuts and spending programs will pay for themselves should be viewed cautiously. Projections rely on what are known as "fiscal multipliers," which gauge the effects that taxes and spending programs have on economic activity. Different forecasters can have very different views of how large these multipliers are.

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Federal spending cannot be contained without placing a foot on one of the third rails of American politics. About 85% of government outlays go to defense, Social Security, medical programs and interest. In an uncertain world, military spending does not appear to be a candidate for cuts. Social Security provides important retirement support for many Americans, and will need to be sustained. Economizing on health care will be difficult, given the nation's demographics and the complexity with which care is delivered. We'll have more on this latter topic in a few weeks.

Setting a course for improved fiscal health will be challenging. Political parochialism had been the enemy of progress; the two-year election cycle for Representatives (which is effectively one year for districts where primary elections decide the outcomes) is mismatched with the long horizons associated with tax and spending policies.

I share the worry expressed by many of our clients about the scale of the national debt. Unfortunately, it does not appear that the election outcome will provide any comfort on this front. I would urge members of the new Congress to remember their responsibility for husbandry, and to their own selves be true.

Hole In The Wall

Frustrated voters sometimes ask how governments can run up debt so freely, when ordinary people need to live within their means. A key difference is that governments can tax their citizens when they need money, and borrow freely in public markets. While we caution against making analogies between household and government finances, the public sector needs to prioritize more revenue over more debt.

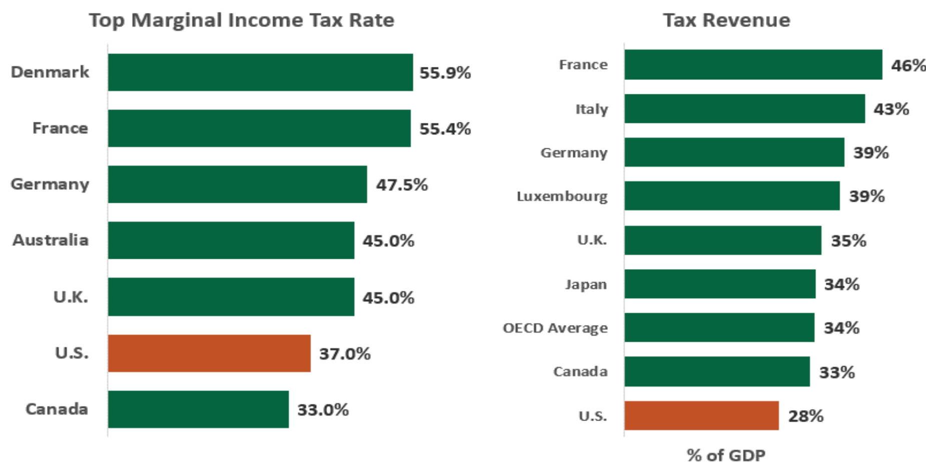
Nations in continental Europe learned this lesson the hard way during the sovereign debt crisis a decade ago, and the United Kingdom's bond markets had quite a scare in 2022. American politicians haven't faced this kind of stress, but they would do well to heed the lessons that these episodes offer as they consider tax policy.

Corporate and personal taxes are key sources of revenues for governments of developed nations. There are large differences in tax levels and structures across countries, which reflect a range of political choices and administrative capabilities. On average, around half of the revenues in high-income nations comes from income and payroll taxes, one-fourth from value added taxes (VAT), 10% each from corporate income and other consumption taxes and the remainder from property taxes. The U.S. is the only major economy without VAT. Instead, it levies a sales tax, collected by state and local governments.

U.S. taxes are low relative to other advanced economies. The U.S. corporate income tax rate of 21% is below the global average of about 24%. The top personal income tax rate of 37% is also one of the lowest in the developed world. By contrast, the average statutory top personal income tax rate in major European countries is about 43%. The ratio of tax revenues to gross domestic product in the U.S. is 26%, the lowest among high-income economies.

In recent years, European governments have implemented a host of tax reforms. But given the already impoverished state of public finances across most of Europe, the policies were aimed at maintaining tax revenue levels while protecting consumers and firms from the post-pandemic cost of living crisis. These measures included temporary reductions in value-added taxes and excise duties, indexing the income tax to inflation and cutting tax rates for low-income families.

These programs were paid for by increasing taxes for higher-income groups through assessments on wealth and windfall profits. Similar measures have been contemplated by American Democrats during the current election campaign.



Sources: Tax Foundation, OECD

There is no room for large-scale tax cuts in the U.S., nor in Europe.

Proposed wealth taxes on financial assets are hard to implement, requiring global cooperation to prevent capital flight. We would need broad implementation of the proposed global minimum corporate tax deal to avoid losing revenue from that source to other jurisdictions. However, the future of the agreement still hangs in the balance.

Given the discontent surrounding tax increases, many governments have been content to accumulate mountains of debt. The costs of that strategy are burdening public finances and reducing the wealth of nations. Against this backdrop, the risk of potential revenue losses should be taken very seriously as tax policy is being contemplated.

A household in excessive debt can sell assets or, in the extreme, declare bankruptcy to find relief. Remedies for overindebted nations are not so straightforward, and default would burden societies in the extreme. No one likes taxes, but keeping them at a reasonable level will be essential to long-term fiscal health.

Checks and Imbalances

"I don't go looking for trouble. Trouble usually finds me." – Harry Potter

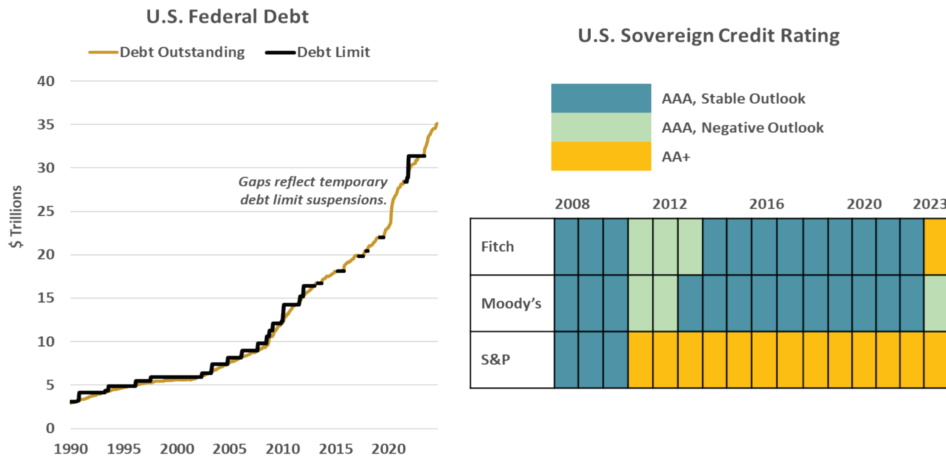
Outside of the rancor of the election, we have enjoyed a relatively quiet year for U.S. policy. The Biden administration has not pushed for major legislation, and Congress has not needed to react to any crises. But an end to the calm is foreseeable as the fiscal year ends and the debt ceiling returns to force.

Setting a budget with over $6 trillion of outlays is no simple matter, let alone obtaining bipartisan agreement for the proposal. Routinely, Congress temporarily extends the prior year's budget through a continuing resolution (CR) after the fiscal year starts October 1. But each CR vote brings

an opportunity for conflict, raising the risk of a funding gap and government shutdown. Just last week, a draft CR bill was dropped due to its complexity, leaving little time for a new measure. A shutdown looms at the end of the month if a CR does not pass.

The budget specifies the nation's spending plans, which outpace its tax receipts, requiring continual debt issuance. The U.S. Treasury issues debt, up to a limit that is set by the Congress. Occasions where the ceiling must be raised can be used to extract concessions from the President.

The next President could be greeted by a budget crisis.



Sources: U.S. Treasury, Haver Analytics, Reuters

The deal that ended the last debt ceiling showdown in 2023 rescinded the limit through the end of this year. It will bind at whatever level of debt is outstanding on January 2, 2025. At current funding levels and with typical quarterly tax collections, the nation can stay afloat into summer of 2025. After that, a new agreement will be needed, just as negotiations over the nation's tax laws also kick into high gear. The 2023 showdown brought a high degree of volatility and risk of a technical sovereign default, which would be a seismic event in financial markets. The nation lost its AAA credit rating from Fitch in the wake of the incident. More brinksmanship may bring more consequences.

If the election yields unified control of government, the necessary bills should pass without conflict, though the nation's fiscal health will worsen. And if Washington is divided, getting through the year ahead without some sort of fiscal stress will be an act of expert wizardry.

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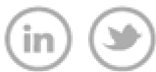

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