US Economic Viewpoint

Another fiscal frenzy

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Economics
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US Economics
BofAS

Stephen Juneau
US Economist
BofAS
+1 202 442 7429
stephen.juneau@bofa.com

Michael Gapen
US Economist
BofAS
+1 646 855 3270
michael.gapen@bofa.com

See Team Page for List of Analysts

Shutdown unlikely, but this can't go on forever

Congress faces the first of two funding deadlines this Friday (March 1), when funding expires for four of twelve appropriation bills. The second deadline for the remaining appropriations bills is March 8. We expect Congress to pass a continuing resolution and avert a shutdown. If it fails to do so, we think a brief shutdown cannot be ruled out, but a long one looks unlikely in an election year. Congress cannot kick the can down the road forever. A 1% across the board cut would kick in on April 30 if no spending deal is reached.

The real deadline is April 30

Government shutdowns garner headlines but tend to have minimal economic consequences. Full government shutdowns shave about 0.1pp from quarterly annualized growth per week, though most of the lost activity can be made up when the shutdown ends. However, a 1% across the board cut in discretionary spending would have more serious consequences for growth. We estimate that these cuts could result in a 0.4pp drag on growth.

Tax and aid bills are also stuck in the system

Funding is not the only area of stalemate. Congress is currently considering two fiscal bills: the "Tax Relief for American Families and Workers Act of 2024" and an aid package for Ukraine and Israel. The former has been passed in the House and the latter through the Senate, but neither looks likely to be signed into law any time soon. We therefore exclude them from our baseline forecasts, but they pose upside risks to our deficit and growth projections.

Deficit outlook may improve even if the bills become law

If they become law, the tax and aid bills would add an extra $137bn (0.5% of GDP) to our current FY 2024 deficit forecast of $1.750tn (6.2% of GDP). Yet the deficit could still come in below our expectations given strength in revenue growth, which is outpacing our forecast. The CBO, which uses a more favorable revenue outlook than our baseline, expects a deficit of "only" $1.507tn this year (5.3% of GDP).

Tax bill would also provide a small boost to growth

We estimate the policies in the tax bill would boost growth by up to 0.2pp this year and 0.1pp next. The impact is smaller than the deficit expansion, since most of that comes from retroactive business tax credits, which have relatively small stimulative effects. In the long run, though, the bill is unlikely to materially affect growth due to the temporary nature of the major policies.

Deal, no deal, or can-kicked?

Congress is once again coming up against a funding deadline, reigniting the risks of a government shutdown. The first of two continuing resolutions ends on March 1 and the second on March 8. If Congress fails to pass an appropriations package or another continuing resolution, then the Government would at least experience a partial shutdown. We think a shutdown will be averted through a continuing resolution. Or at the very least, any shutdown will likely be brief. The risk of a drawn-out shutdown is not zero but it is small in our view, given the potential for high political costs in an election year.

Potential outcomes and their impact on growth

The funding deadlines over the next two weeks present a few potential outcomes for Congress, in our view. We discuss these below in order of most to least likely.

1. **Congress funds the government and averts a shutdown.** Congress has a couple of options to do this: 1) pass another continuing resolution to buy more time or 2) pass appropriations bills. We see another continuing resolution as the likely outcome at the end of this week since progress on appropriations bills has been slower than expected. Either outcome would have no impact on our growth outlook.

2. **Congress fails to extend funding and we enter a partial shutdown**. Funding for four- of-twelve appropriations bills expires this Friday. These include Agriculture, Energy-Water, Military Construction-VA, and Transportation-HUD which comprised about one-fifth of total appropriations in FY 2023. We think the economic effects of allowing funding to lapse for these bills would amount to a rounding error.

3. **Congress fails to extend funding this week and next resulting in a full shutdown**. This would be the worst outcome for growth, in our view. A full shutdown would trim 0.1pp from annualized growth per week. However, this could be made up quickly once the shutdown ends.

A continuing resolution may affect House leadership

Though we see a lengthy shutdown as unlikely, we cannot completely rule it out. Any deal to fund the government and avert a shutdown would need to be brokered with House Democrats. This is because of the narrow majority that House Republicans hold, and the lack of support from members of the House Freedom caucus.

Speaker Johnson has twice relied on support from Democrats to avoid a shutdown. However, the honeymoon period could be nearing an end. Members of the House Freedom Caucus have grown increasingly disgruntled with the speaker, resulting in more threats to vacate the current speaker (a motion to vacate can be brought forward by just a single member of Congress). Recall that former speaker Kevin McCarthy (R-CA) lost his gavel in this manner. Like McCarthy, Johnson may now have to seriously weigh the tradeoff between avoiding a shutdown with losing his job. If a shutdown seems likely, Johnson would likely face the following options.

- Bring a continuing resolution under suspension of the rules to avoid a shutdown. The risk with Option 1 is that one member of the House Freedom Caucus could raise a “motion to vacate” against Johnson. This could result in Johnson losing his job as speaker and once again thrust the House into a period without leadership.

- Shutdown the government and avoid any risk of losing his job. However, there are costs to this option. A shutdown, depending on duration, would result in large cuts to discretionary spending and it would likely be politically costly too.

We think the costs of a shutdown outweigh the risks of a “motion to vacate.” Therefore, we think the risk of a lengthy shutdown is unlikely.

April 30 is the real deadline to watch

While a continuing resolution will likely solve this funding deadline, Congress is running out of time before a 1% across-the-board cut to discretionary spending kicks in. Recall that Section 102 of the Fiscal Responsibility Act (FRA) stated that if Congress funded any part of the government using a continuing resolution after January 1, 2024, then discretionary spending by agencies would be cut by 1% from FY 2023 levels. In practice, the true deadline is April 30, 2024. This means that Congress can only keep using continuing resolutions until April 30.

Sequestration is much more painful than a brief shutdown

If Congress fails to pass an appropriations bill by April 30, then the impact to growth from sequestration would be painful. In January, the Congressional Budget Office (CBO) published estimated of what sequestration would mean in practice. Assuming the current run rate of defense and nondefense spending continued through April, defense and nondefense spending would need to be cut by 2.4% and 12% respectively for the remainder of the fiscal year. This would amount to a cut of roughly $120bn annualized or 0.4% of GDP. In short, sequestration would be a negative shock to growth.

Sequestration is not our base case, but the risk is not zero

Our base case is for Congress to ultimately avoid sequestration and pass a funding package before April 30. While it does not seem like it at times, we think progress on appropriations has been made. Congressional leadership earlier this year agreed to a top line appropriations number, allowing committees in both chambers to discuss appropriation levels for the 12 individual bills needed to fund the government.

The reason we think Congress will avoid sequestration is simply that most members do not want it. Defense hawks in the Senate have little appetite to see cuts to defense spending, especially during the current geopolitical climate. Meanwhile, Democrats in both chambers do not want to see any cuts to non-defense spending.

That said, the risk of sequestration is not zero given that a segment of Republicans in the House is comfortable with the automatic cuts. This means that any appropriations package would have to be bipartisan in nature, and up to Speaker Johnson to bring to the floor under suspension of the rules.

More than just appropriations

In addition to the expiration of government funding, Congress is considering two spending bills: "Tax Relief for America Families and Workers Act of 2024" and an aid package for Ukraine and Israel. The former has been passed by the House and the latter has been passed in the Senate. A stopgap spending bill presents a vessel for Congress to attach either of these bills to. However, the fate of both remains uncertain. Therefore, we have yet to factor either bill into our baseline economic and deficit forecasts.

Tax relief bill

The bipartisan tax bill would be a tax break for both households and businesses. Over the ten-year budgetary period the bill is roughly deficit neutral owing in part to an early end to the Employee Retention Tax Credit and because the largest provisions sunset after a few years. Here is a summary of the major provisions within the bill:

- **Child Tax Credit (CTC) expanded and extended through 2025**. The bill would expand the Child Tax Credit through 2025 and increase the maximum credit by $100 to $2100 in FY 2024 and FY 2025. It would increase the tax credit received for families that do not currently qualify for the full credit because their incomes are too low. The changes to CTC would expire in 2025.

- **Retroactively restore full expensing for domestic Research and experimental spending**, also known as R&D amortization. This provision expired at the end of 2021 and was part of the Tax Cuts and Jobs Act (TCJA). The original rule allowed for full expensing for both foreign and domestic R&D. It would apply retroactively for 2022 and 2023 which explains its large revenue impact in FY 2024. It would expire at the end of 2025.

- **Restore 100% bonus depreciation for equipment and other short-lived assets through 2025**. This was originally part of TCJA but it expired in 2022 when the 100% depreciation began to decline by 20pp/year.

- **Net interest expense deduction**. Restore a less restrictive limit on business deductions for net interest expense to levels enacted in 2017 as part of the TCJA that were tightened in 2022.

- **End the Employee Retention Tax Credit (ERTC) early**. To offset the lost revenue from the above measures, the application window for ERTC would end on January 31, 2024, instead of April 15, 2025. The ERTC was originally part of the CARES act designed to incentivize companies to keep employees on payrolls during the pandemic. Future policies made changes to the credit. These included, increasing the maximum from $5000 to $7000 per employee, and extending the time period from March 13, 2020 to December 31, 2020 to March 13, 2020 to December 31, 2021.

The ERTC has proven to be hugely popular but also subject to fraud. When it was first enacted, the ERTC was estimated to cost $55bn, but estimates suggest the IRS has paid out $230bn as of last July and has received a total of 3.1mn applications The IRS suspended new claims for the ERTC last September due to fraud. Ending it earlier is expected to help offset the costs of the tax provisions discussed above.

Details of the aid bill

Meanwhile, the Ukraine and Israel aid package amounts to $95.3bn in spending over a ten-year period. The outlays would be front-loaded as more than two-thirds of the total package would be spent through FY 2026. In terms of the details, the bill would include $48.4bn in aid for Ukraine, of which $19.9bn would be used to replenish Department of Defense stock. The bill also includes $10.6bn in aid for Israel. The State Department would also receive funds for humanitarian assistance, and economic support for Ukraine.

Two-sided risks to our deficit forecasts

We expect a deficit of $1.750tn (6.2% of GDP) in FY 2024 and $1.800tn (6.1% of GDP) in FY 2025. Interest expense will account for a large portion of the deficit this year and next. Excluding interest, we expect a primary deficit of ~900bn (3.2% of GDP) in FY 2024 and ~$850bn (2.9% of GDP in 2025). We see risks to both sides of our forecast.

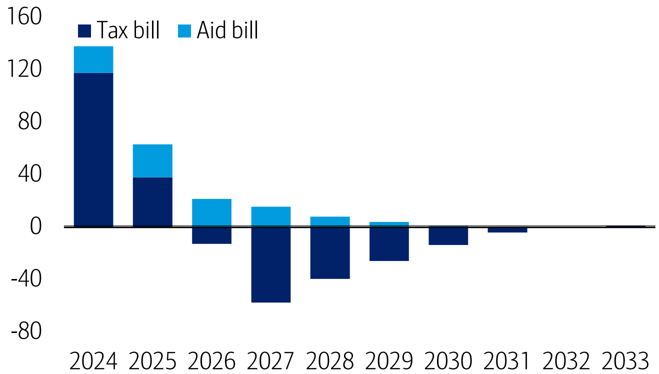
Upside risk: Congress opens up the checkbook

The key upside risk to our near-term deficit forecasts is if both the tax bill and aid bill are signed into law (and more bountiful revenue projections by the CBO, which we discuss below, do not materialize). In total, the two bills would add $137bn to the deficit in FY 2024 (or 0.5% of GDP) and $63bn in FY 2025 (or 0.2% of GDP).

While the tax bill is deficit neutral over a ten-year period, it would reduce revenue in the near-term according to the Joint Committee on Taxation. Their estimates show declines in revenue of $117bn and $38bn in FY 2024 and FY 2025 respectively. Unlike the tax bill, the aid bill is not deficit neutral and would increase spending in each of the next ten years. Additionally, most of the spending is frontloaded over the first three fiscal years.

Exhibit 1: Increase/decrease to deficit from bills currently under consideration in Congress (FY, $bn)

The tax and aid bill will boost the deficit in the near-term



Source: Joint Committee on Taxation, Congressional Budget Office (CBO), Haver Analytics

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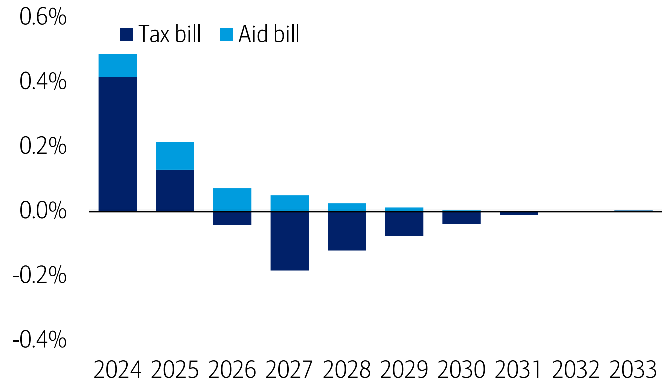
Exhibit 2: Increase/decrease to deficit-to-GDP ratio from bills currently under consideration in Congress (FY, % of GDP)

The tax and aid bill will boost the deficit in the near-term



Source: Joint Committee on Taxation, Congressional Budget Office (CBO), Haver Analytics

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Downside risk: revenues are better than expected

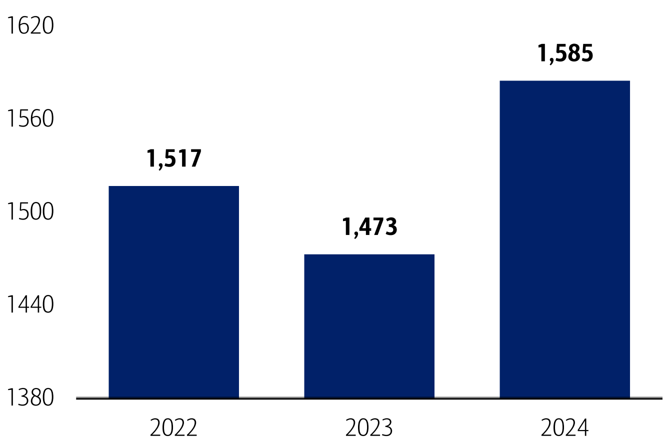
The key downside risk to our deficit projections is better than expected revenue collection. The Congressional Budget Office recently published its latest budget and economic outlook. It estimates that the deficit is likely to end the year at $1.507tn (5.3% of GDP) and for the primary deficit to end the year at $637bn (2.3% of GDP).

Revenue projections are one reason for the difference between our and CBO estimates. We expect revenue growth to be 6.1% y/y in FY 2024 compared to the CBO’s 11.2%, for a difference of about $225bn. The data we have on hand do suggest there are upside risks to our revenue forecasts. Indeed, year-to-date revenues are running above our full year expectations at 7.6% suggesting that there are upside risks to our own projections (Exhibit 4). Moreover, tax filing statistics to date suggest that refunds are down 23.2% from a year ago despite returns processed being down only 6% (Exhibit 5).

The upshot is that if revenues are more in line with CBO's estimates than our own, then our deficit forecast for FY 2024 is too high even if both the tax and aid bill are passed.

Exhibit 3: Federal tax revenue (FYTD through Jan,$bn)

Revenues are tracking well above 2023 levels through the first four months of the fiscal year



Source: US Treasury Department, Haver Analytics

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Exhibit 5: Individual tax filing statistics as of Feb 16 2023

The number of refunds is down significantly more than the amount of returns processed suggesting increased revenue relative to last year.

	Level	% y/y
Total returns received (bn)	34.7	-5.7
Total returns processed (bn)	34.5	-6.0
Total Refunds		
Number (bn)	20.9	-24.8
Amount ($bn)	67.0	-23.2
Average refund ($)	3207	2.1

Source: IRS

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Tax breaks: positive for near-term growth

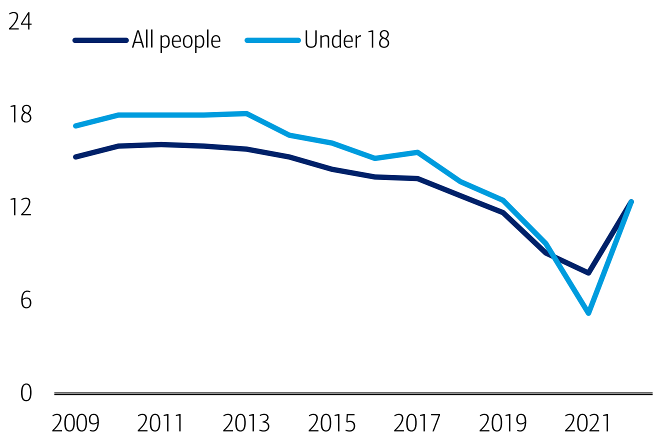
The economic implications from the two bills currently being debated in Congress will primarily be a function of the tax bill. The Ukraine and Israel aid bill would only impact growth through restocking of defense stocks, which is only a small part of the bill. The increase in exports from sending defense equipment to Ukraine and Israel would be offset by an inventory reduction, and foreign aid is not counted towards GDP.

Meanwhile the main provisions of the tax bill would improve the welfare of working families, and provide some incentive for businesses to invest, particularly in R&D. We estimate the bill would likely be a small boost to growth in the short-run reflecting the deficit expansion, but it would have little, long-run impact.

A reduction to poverty rates

The proposed changes to the Child Tax Credit would likely result in a reduction in the poverty rate as previously seen during the previous expansion of the credit. Indeed, the expanded CTC, which was part of the American Rescue Plan, contributed to the sharp decline in poverty rates in 2021 (Exhibit 6). Studies found that the expanded CTC likely lowered poverty rates by 2.0 to 3.1pp. Meanwhile, the Center for Budget and Policy Priorities, a left-leaning think tank, estimates that 16 million children would benefit from the changes and that 400,000 children would be lifted above the poverty line.

Exhibit 5: Supplemental poverty measure (%)
The Expanded Child Tax Credit helped reduce poverty rates in 2021



Source: Census Bureau, Haver Analytics

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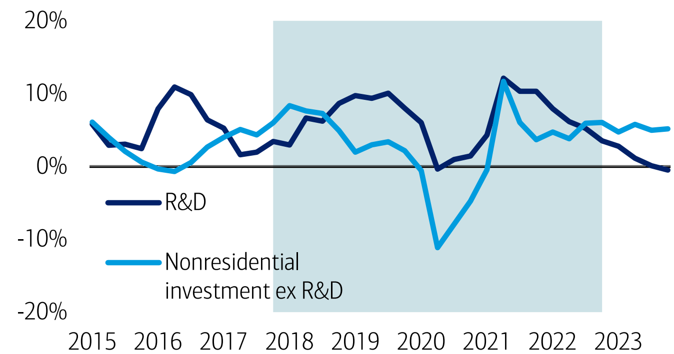
Exhibit 6: Growth in real nonresidential investment (% y/y, shaded region is when at least one R&D tax incentive was in place from TCJA)
R&D investment grew more quickly than other nonresidential investment when tax incentives were in place



Source: Bureau of Economic Analysis, Haver Analytics

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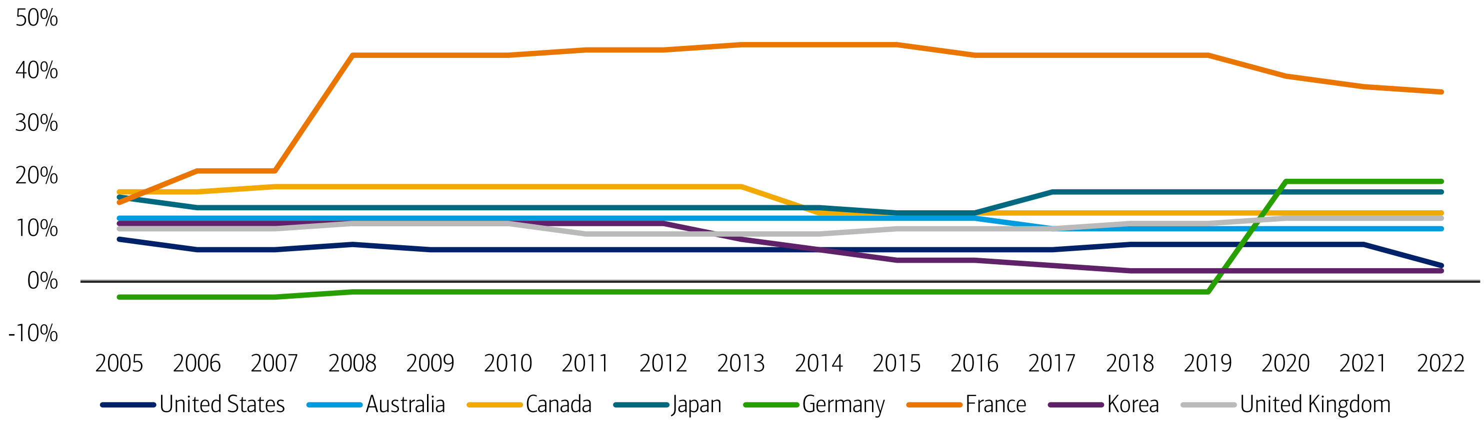
A jolt to R&D investment

The changes to business tax provisions would likely spur investment in R&D which accounts for roughly 2.7% of GDP. When the provisions were originally enacted, R&D investment growth did outperform the rest of non-residential investment (Exhibit 7). The US changes would make US tax code more competitive with other major countries who generally have higher tax subsidies for R&D expenditures (Exhibit 8). Additionally, the temporary nature of the provisions could lead business to pull forward R&D investments but also limits the long-run effect on growth.

Exhibit 7: Implied tax subsidy rates on R&D expenditure
US tax subsidies for R&D expenditures are less than subsidies in many other major countries



Source: OECD

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In aggregate: a modest near-term boost to growth

While the tax bill is deficit neutral over the 10-year period FY 2024- FY2033, it would add to the deficit in both FY 2024 and FY 2025. We estimate how these changes might affect growth in the near-term and find a small but positive effect in the near-term.

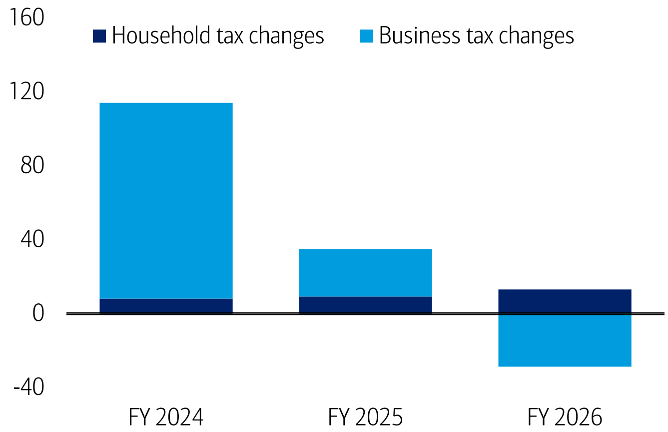
First, we group the provisions of the bill into two broad categories: (1) household tax changes (CTC) and (2) business tax changes (R&D, bonus depreciation, ERTC, etc.). Exhibit 9 illustrates that business tax changes are much larger than the CTC. Next, we use fiscal multipliers from the CBO (see Whalen 2015) for these broad categories. Based on this approach, we estimate that the boost to growth from the bill would likely be 0.2pp or less in FY 2024 and 0.1pp or less in FY 2025 (Exhibit 10). Notably, the effect on growth in FY 2024 is less than the 0.4% increase in the primary deficit-to-GDP ratio. This is because most of the deficit increase is from the tax provisions for businesses, which have fiscal multipliers that are less than one.

The risks to our estimates are likely tilted to the upside for a couple of reasons. First, since the business tax provisions expire in a couple of years, there is a risk that businesses pull forward investment to take advantage of the credits. Second, businesses may also opt to use some of the tax savings to pay shareholders through increased dividends or stock-buybacks, which would increase the wealth of shareholders.

Ultimately, however, we do not view this bill as a game-changer for our medium term economic or monetary policy outlook. The bill would help growth on the margin, but the effect is not large enough, in our view, to meaningfully alter the path for inflation or to deter our expectation for a gradual Fed cutting cycle.

In the long run, the Tax foundation estimates that the bill is unlikely to affect GDP growth over the 2024-2033 period. They argue that this is partially due to the expiration of the major provisions at the end of 2025. If made permanent, the provisions would likely be more positive for growth but would also mean much greater deficit expansion.

Exhibit 8: Deficit impact from the tax relief bill ($bn)
In the near-term, business tax changes will add much more to the deficit than the changes to the Child Tax Credit



Source: JCT, CBO, BofA Global Research.

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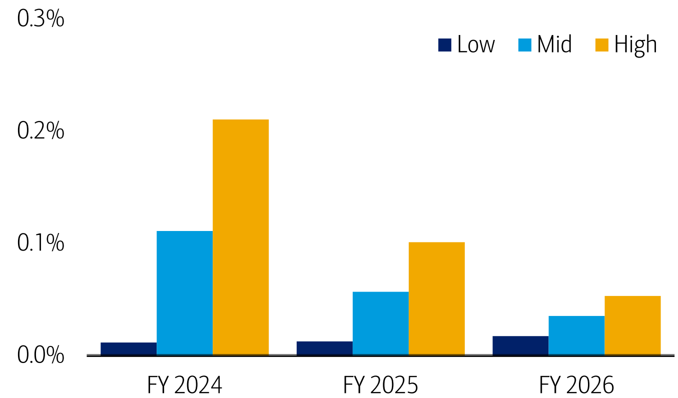
Exhibit 9: Estimate impact to growth from the Tax relief for American workers and families act based on different multipliers
In the short-run, deficit expansion from the bill will likely boost growth modestly



Source: BofA Global Research

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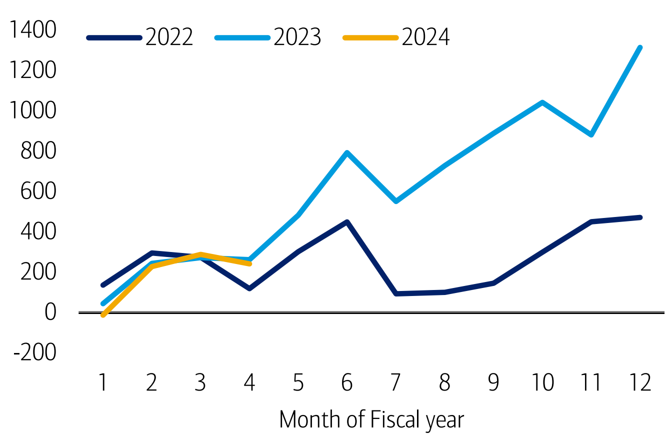
Fiscal impulse likely to be a headwind

While the tax bill would boost growth and the deficit in the near-term, we still expect the Federal fiscal impulse to be more of a headwind for growth this year. Though the size of the headwind depends on how revenue and spending evolve relative to our expectations.

A simple measure of the Federal fiscal impulse is to look at the change in the primary-deficit to GDP ratio (For a more detailed discussion see: [US Viewpoint: Fiscal impulse: running out of steam 16 November 2023]). Currently the primary deficit is tracking slightly below that in FY 2023, when the US ran a primary-deficit-to-GDP ratio of 5.0% after adjusting for accounting quirks associated with Student Loan forgiveness. Through the first four months of FY 2024, the primary deficit is down about 8% from the same prior year period.

Currently, we expect the primary deficit-to-GDP ratio to be 3.2% of GDP, a decline of 1.8pp suggesting that the federal fiscal impulse will be a headwind for growth. If we tack on the additional deficit spending associated with the tax and aid bills, then the primary deficit would still decline to 3.6% of GDP. Whereas, if CBO's deficit projections

Exhibit 10: Primary deficit ($bn, Fiscal year-to-date)
Through the first four months of FY 2024, the primary deficit is down about 21% from the same prior year period



Source: US Treasury Department, BofA Global Research

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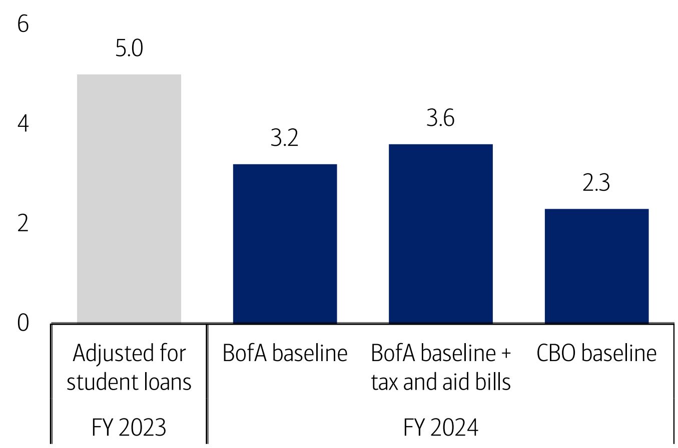
Exhibit 11: Primary deficit-to-GDP (%)
The primary-deficit-to-GDP ratio is set to decline this year suggesting that federal fiscal policy will be more of a headwind for growth than last year



Source: US Treasury Department, Congressional Budget Office (CBO), BofA Global Research,

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are closer to the truth the primary deficit would fall to 2.3% of GDP. In short, even with additional spending Federal fiscal policy is unlikely to be as material to the growth picture as it was last year.

An even larger fiscal cliff…

Importantly the tax bill would set up the next Congress to deal with an even larger fiscal cliff at the end of 2025. Most of the individual tax changes from the 2017 TCJA are slated to expire at the end of 2025. This bill would add business tax provisions and the expanded child tax credit to this deadline. In our view, tying more policies to the 2025 deadline increase the likelihood that Congress will extend the current tax law without any modifications.

This is because the fiscal cliff would become even more significant. The Committee for a Responsible Federal Budget estimates that extending TCJA without any offsets would add $3.3tn to the deficit over a ten-year period. Assuming that the deficit increase is evenly distributed across the ten-year period, the expiration of TCJA would equal 1.2pp of GDP. We think a fiscal cliff of this magnitude would be unpalatable for most members of Congress.

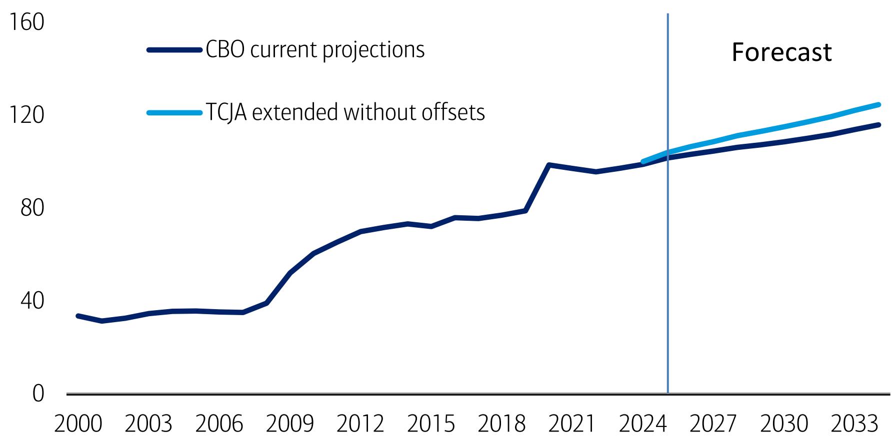
…and ongoing sustainability concerns

While we think the 2025 fiscal cliff is a tough pill to swallow, it also is the first major opportunity for Congress to address growing concerns over fiscal sustainability. Under current law—assuming all TCJA provisions expire as originally outlined—the CBO estimates that the ratio of debt held by the public to GDP would climb from 97.3% in FY 2023 to 116% in FY 2034 (Exhibit 13). However, if the TCJA were extended, assuming the increase in the deficit is equal each year, then the ratio of debt-to-GDP would likely climb to 125% or higher in FY 2034.

Congress could address sustainability concerns by offsetting extensions of these tax cuts through other means—cutting spending or raising taxes. However, the outcome of negotiations around TCJA will depend heavily on the outcome of the elections—both Presidential and Congressional—which remain unclear at this moment.

Exhibit 12: Debt held by the public to GDP (%)

The ratio of public debt to GDP will continue to climb over coming years



Source: CBO, Haver Analytics, BofA Global Research

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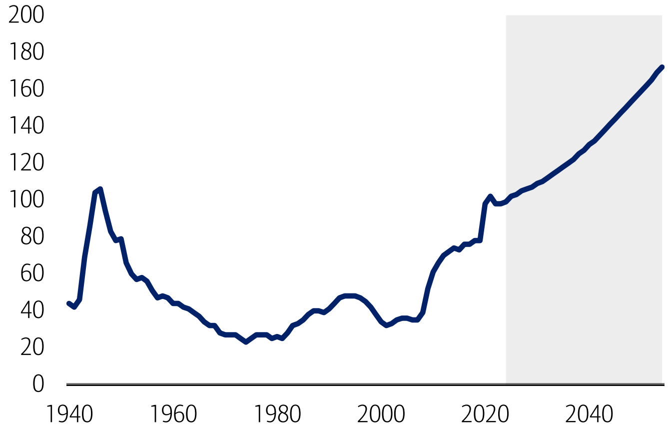
Only one direction: up

Sustainability concerns are not new and would likely remain even if Congress let TCJA provisions expire at the end of 2025. Indeed, the latest long-run deficit projections from the CBO project the debt-to-GDP ratio to reach 172% by 2054 (Exhibit 14). If there is a silver lining, the latest projections are below previous projections from June 2023, which showed a debt-to-GDP ratio of 180.6% in FY 2053.

According to CBO's projections, the key driving force of the upward trajectory is rising interest costs and entitlement spending—social security and healthcare (Exhibit 15). Indeed, CBO projects that net-interest-to-GDP will increase from 2.5% in FY 2023 to 6.5% in FY 2054. Entitlements spending, meanwhile, is expected to be driven higher primarily by healthcare spending. Spending on Medicare and Medicaid will amount to 8.5% of GDP by FY 2054 compared to 5.8% in FY 2023. An aging economy and rising healthcare costs will make these programs increasingly more expensive.

Exhibit 13: Debt-to-GDP (%, FY)
The Debt-to-GDP ratio is set to keep climbing to new highs



Source: Congressional Budget Office (CBO)

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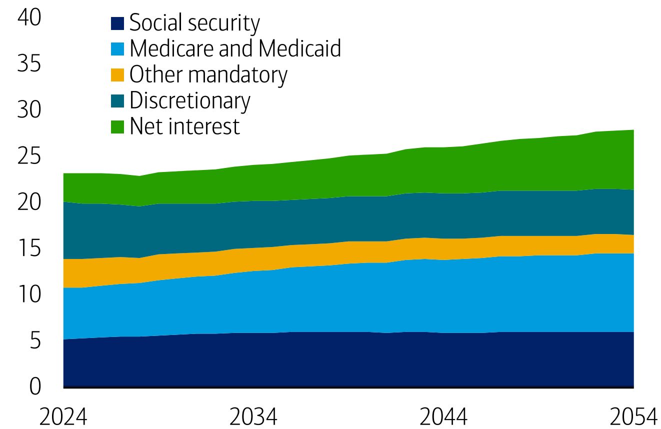
Exhibit 14: Outlays of major line items as a share of GDP (%, FY)
Interest and healthcare outlays will continue to climb as a share of GDP, pushing total debt up higher



Source: Congressional Budget Office (CBO)

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A painful adjustment

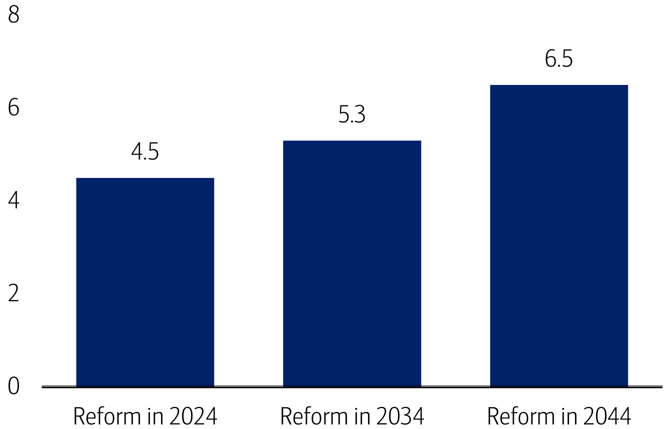
The CBO's latest long run deficit forecasts also underscore the difficult choices Congress faces to address growing sustainability concerns. Higher interest payments, which are a function of past deficits, and increased entitlement spending are expected to quickly drive-up debt-to-GDP.

Congress can only address future interest payments by reducing primary deficits. However, this is a slow process as most of interest is determined deficits that have been previously incurred. Meanwhile, rising healthcare spending are a function of our aging economy and increasing healthcare costs. Congress may be able to address the latter in some way, but it has no control over the former.

For Congress to put fiscal policy on a sustainable pace it will need to make a painful adjustment. According to the US Treasury's latest Financial Report, the US primary-deficit-to-GDP ratio is expected to average 3.8% over the next 75 years. If the US wanted the debt-to-GDP ratio in 75 years, to be equal to its level in FY 2023, the US would need to average a primary-surplus-to GDP ratio of 0.6%. In other words, the fiscal adjustment would need to a staggering 4.5% on average. The size only increases the longer the US waits to address the issue (Exhibit 16).

Exhibit 15: Average size of fiscal adjustment as a % of GDP needed for Debt-to-GDP in 2098 to equal Debt-to-GDP in 2023

To arrest the growth in the debt-to-GDP ratio a large fiscal adjustment is needed. The size only increases the longer Congress waits



Source: US Treasury Department

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Fiscal policy will likely remain a key issue

Since the pandemic, fiscal policy has taken on an increasingly large role. We do not expect this to change anytime soon. Gridlock is likely to remain an issue for the remainder of the fiscal year. After the election, Congress would need to address the debt limit as the suspension ends on January 1, 2025. Then in 2025, we think the debate will shift to what to do with the Tax Cuts and Jobs Act. Not to mention, that the outcome of the election will likely lead to different policy outcomes. In short, we think focus will remain on policymakers in Washington DC— both Congress and the Fed.

Disclosures

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Research Analysts

US Economics

Michael Gapen
US Economist
BofAS
+1 646 855 3270
michael.gapen@bofa.com

Aditya Bhave
US Economist
BofAS
+1 646 855 9929
aditya.bhave@bofa.com

Stephen Juneau
US Economist
BofAS
+1 202 442 7429
stephen.juneau@bofa.com

Shruti Mishra
US and Global Economist
BofAS
+1 646 855 1040
smishra44@bofa.com

Jeseo Park
US Economist
BofAS
+1 646 855 8688
jeseo.park@bofa.com