Taxing finances, middling politics

Look beyond partisan finger pointing. When it comes to U.S. fiscal policy, policymakers are already starting to adjust to the swiftest rate hiking cycle in living memory.

In a nutshell

– Political dysfunction, partisan finger pointing and fiscal brinkmanship have long been perfectly normal on Capitol Hill. Heading into 2024, that is no reason to panic.

– Policymakers just like markets, have just been through the swiftest rate hiking cycle in living memory.

– They are starting to adjust and there are already tentative reasons for cautious optimism.

"Market experts generally cite political dysfunction as a prime reason why they've become more pessimistic about the [U.S.] fiscal outlook," the Washington news outlet Politico recently reported.[1] We added the italics to highlight what we find most puzzling about this particular bit of Wall Street thinking. Where, exactly, have these market experts been these past few decades?

As it happens, 2023 has actually not been all that bad, by Capitol Hill standards. Many of the gloomiest forecasts – sometimes by some of the same market experts still fretting – failed to materialize. In June, Congress lifted the debt ceiling, meaning that the government could keep on paying for expenses already incurred.[2] In September, Congress again acted, admittedly very late, to avoid government shutdown, which maintained government funding for roughly six weeks and cost Speaker Kevin McCarthy his job.[3] In November, McCarthy's successor, Mike Johnson ushered another temporary extension.[4]

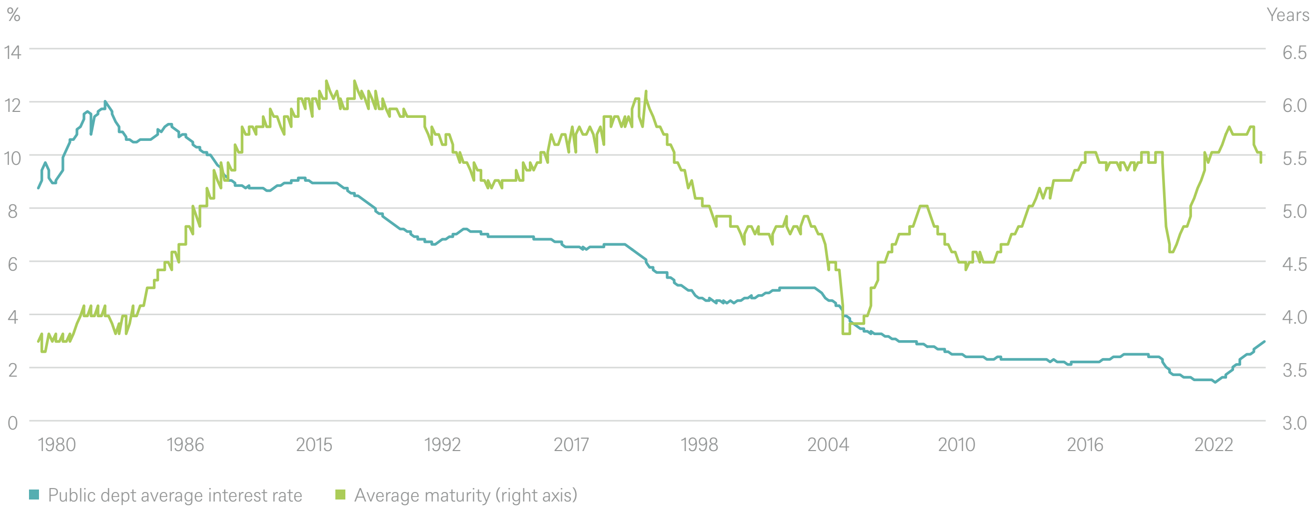
Keeping the government open throughout the year was not just a one-off. During the past 20 years, there have actually been far fewer government shutdowns than in the 1980s and 1990s.[5] In both economic and political terms the backdrop now is very different, and in some ways reminiscent of previous periods of high inflation. To take economics first, the pandemic saw massive fiscal spending and many overlapping, often quite ad hoc policies at different levels of government amidst plenty of uncertainty over their impact on the economy.

This may not have been the best possible policy response, and not just with the benefit of hindsight. In so far as there were pandemic forecasting errors about the longer-term costs of fiscal largesse, however, there is plenty of blame to go around. As we described at the time, many economic practitioners working in financial markets and even at central banks were dreadfully slow in understanding post-Covid inflationary dynamics and what they would imply for interest rates.[6]

Policymakers just like markets, have just been through the swiftest rate hiking cycle in living memory. By historical standards, average interest rates on public debt are actually not all that high (see chart). But with both federal government debts and deficits are now at similar output levels as last seen in the aftermath of the second world war, rising rates are having a far bigger impact on debt servicing costs.[7]

[1] The government won't curb spending. Wall Street will make it pay. – POLITICO. [2] America avoids financial Armageddon but stays in fiscal hell (economist.com). [3] GOP holds emotional meeting on next speaker – but fails to unite on one – POLITICO. [4] America's government isn't shutting down just yet (economist.com). [5] America's next government shutdown could be the strangest yet (economist.com) ; for further details, see R41759 (congress.gov). [6] Sense and nonsense in inflationary times (dws.com). [7] America may soon be spending more on debt service than defence (economist.com); See Rockoff, H. (2012) „America's Economic Way of War: War and the US Economy from the Spanish-American War to the Persian Gulf War" Cambridge University Press; pp. 162-174 on government finances during wartime. For a basic overview, also see: Gross Federal Debt as Percent of Gross Domestic Product (GFDGDPA188S) | FRED | St. Louis Fed (stlouisfed.org)

By historical standards, interest rates on U.S. government debt are not all that high



Sources: Haver Analytics, DWS Investment GmbH as of 11/15/23

Politically, the debt and the deficit have long been dormant issues.[8] That is likely to change swiftly, as the 2024 presidential elections approach. Rising debt servicing costs are what it usually takes to turn deficits into the sort of issues voters care about and politicians – eventually – deliver on. This is how politics tend to work in democratic countries. It is hard to get voters or policymakers to genuinely worry about deficits as long as market participants themselves cannot envision, or price in, interest rates and debt servicing costs rising up at some point. Conversely, the increase in rates will probably give the issue salience, at least for a while, even after interest rates start to fall again.

With elections looming in 2024, there is now a decent chance some candidate could emerge – similar to Ross Perot in 1992 - willing to confront the issue. Donald Trump's income-tax cuts, which were passed in 2017, are due to expire in 2025. Whether or not to renew these tax cuts is very likely to be a hot election topic. Both major parties' frontrunners are old and unpopular among the general electorate.[9] Given their respective track record, neither has much credibility on balancing budgets or reducing federal spending. Among the many unpredictable ways how the election year could unfold, a third-party candidate running on the deficit looks increasingly plausible.

Until then, there are good reasons to be somewhat less concerned about Washington dysfunction than was appropriate at this time last year, upon learning about the results of the last midterms. To be sure, the U.S. way of Congress authorizing government spending is somewhat bizarre.[10] For example, shutdown fights typically concern only roughly 25% of the federal budget, and hardly any of the items that drive longer-term deficits.[11] However, this is hardly more bizarre than political constraints on budgeting in other democratic countries.[12]

As 2023 draws to a close, it appears that most House Republicans seem inclined to avoid a shutdown – and the electoral blowback it could bring for their party. Under the latest temporary measure, the federal government would not have to shut down all at once. Funding for the first set of items of discretionary spending would stop on January 19th, with the remainder cut off on February 2nd. We would expect compromises to emerge in time for February, maybe even the January deadline. Recent Senate efforts to simultaneously provide military funding for Ukraine, Israel, the Indo-Pacific, while at the same time enhancing border security, may provide an indication of what such a compromises might look eventually like.

In the longer-term, a major issue for the U.S, and even more so in many other advanced economies is how to cope with an ageing population. It has been for the past 40 years, since the Regan era "National Commission on Social Security Reform", under none other than the later Fed chair Alan Greenspan.[13] It is hardly breaking news that eventually, spending will need to be limited, revenues will need to be increased or policymakers will have to agree some combination of both. "Of course, all such longer-term projections are tricky," explains Christian Scherrmann, U.S. economist at DWS. "Lots of assumptions must be made, from growth, inflation and policy rates to the future behavior of firms, households and indeed policy makers.

[8] Why Isn't Anyone Talking About The Deficit Anymore? | FiveThirtyEight. [9] Joe Biden : Approval Polls | FiveThirtyEight und Donald Trump : Favorability Polls | FiveThirtyEight. [10] Economically, strict limits on borrowing almost always tend to be arbitrary and ultimately futile, usually with unwelcome side-effects, as policymakers and their advisors find innovative ways around those rules. See: America's debt ceiling is a disaster, though fiscal rules can help (economist.com). [11] This is due to the somewhat arbitrary distinction "mandatory" spending, such as on health care and social security, and "discretionary" spending. Discretionary spending requires annual authorization, so that if Congress fails to act, the federal government may need to furlough employees and freeze non-essential payments. See, for example, Forget the shutdown. America's real fiscal worry is rising bond yields (economist.com). [12] Germany is in a bizarre fiscal mess of its own making (economist.com).

Therefore, longer-term projections should only be taken as a rough guideline of what might happen – knowing full well that what actually does happen is likely to be very different."

For example, spending on health care and social security is likely to rise under current policies, if only for demographic reasons. Most of the long-term pressure on America's budget comes from rising mandatory spending, especially Medicare, health care for the over-65s. Then again, reforms of the past 13 years have actually been surprisingly effective in improving health results, while limiting medical cost inflation, making attacks on "Obamacare" a losing electoral issue for Republicans in recent years.[14]

The bottom line is that Washington eventually does tend to find ways to muddle through. Political dysfunction and partisan finger pointing along the way, have long been perfectly normal on Capitol Hill, as are last minute fixes to temporarily stabilize the situation again. A decade ago, a good political science guidebook on similar standoffs back then lamented about " a decades-long failure to settle on an income tax code that is predictable, efficient and fair" and another "victory of gimmicks and position taking over the hard work of genuine policy making and compromise."[15] That will probably still be said a few years from now about whatever emerges next. But exactly why this should make any market expert more pessimistic today than one, five or 10 year ago, is hard to say.

Glossary

A budget deficit is created whenever the spending in a public budget exceeds the income within a given time period.

Inflation is the rate at which the general level of prices for goods and services is rising and, subsequently, purchasing power is falling.

ObamaCare is the colloquial term for the Patient Protection and Affordable Care Act, the reform of the health-care industry introduced by U.S. president Barack Obama in 2010.

The U.S. Federal Reserve, often referred to as „the Fed," is the central bank of the United States.

[13] Social Security History (ssa.gov). [14] Trump revives talk of repealing Obamacare after reading WSJ op-ed – POLITICO. [15] McCarty, N., Poole, K., Rosenthal H. (2013), Political Bubbles: Financial Crises and the Failure of American Democracy, Princeton University Press; p. 279