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US midterms: Republicans are back, (fiscal) policy impasses too

09 November 2022

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EXECUTIVE SUMMARY

- **With the Republican party now in control of the House of Representatives (results for the Senate to follow), no major economic and fiscal legislation will be pushed through in the next two years.** As the GOP campaigned on curbing social spending, at odds with President Biden's agenda. Larger family subsidies and higher taxation on wealthy individuals have now close to zero chance of being passed. Conversely, President Biden will likely veto any legislation initiated by the Republicans.
- **The US faces a deteriorating fiscal outlook compounded by a flagging economy. Fiscal discipline will be scrutinized for its support with taming inflation.** Much of the improvement in the fiscal deficit is down to temporary factors that will be soon reversed. We expect the US to enter a recession at the turn of the year which should push up the deficit at -6.6% of GDP in 2023 (General Government), up from -4.3% in 2022. Fiscal policy has had a much bigger impact in boosting inflation than monetary policy in the wake of the pandemic (3.5pps vs 1pp in 2021). Tighter fiscal policy will help push down inflation early 2023 (by around –1pp), yet the Fed will have to keep interest rates at 4.75% until at least next summer to rein in inflation.
- **A debt-ceiling standoff could spur market turbulence in the first half of 2023. We expect a fiscal compromise to support the economy.** According to our forecasts, the debt ceiling would be breached as early as Q2 2023 because of the deteriorating fiscal outlook. Political infighting with the Republicans threatening to not lift the ceiling will add headwinds to an already weakening economy. A bipartisan increase of the debt ceiling to the tune of 0.2pp of GDP in 2023 is thus plausible; failure to do so would be politically costly for the Republicans ahead of the 2024 presidential elections. Spending on defense and industrial policy will be increased. Modest tax cuts for households could also be pushed through.
- **With a Republican majority in the House, restrictive measures on China will likely accelerate. The relationship with Europe will be tainted by stronger industrial policy.** As attention will turn towards the build-up to the 2024 presidential election, both the Democratic and Republican parties will likely continue the "tough on China" stance, which will lay the path to further bolster US competitiveness and increase restrictions on China's access to critical technology. Across the pond, the European Union has highlighted its concerns over the Inflation Reduction Act (IRA)'s distorting transatlantic competition.

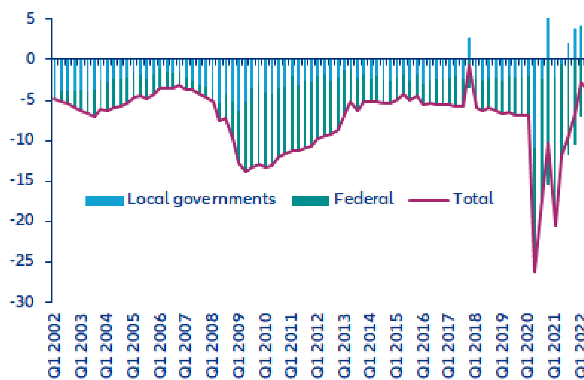
What does a GOP-dominated House mean for the fiscal outlook?

We expect the US economy to slip into recession at the turn of the year, and project GDP to slump -0.7% in 2023, dragged down by a combination of soaring borrowing costs, tightening credit standards and negative wealth effects. The weakening economy, along with the waning of the temporary factors that bolstered public finances, will deteriorate the fiscal outlook. We

expect the flagging economy will eventually force Congress and the White House to agree on lifting the debt ceiling and slightly easing fiscal policy.

A tight labor market and the unwinding of pandemic measures have pushed the US deficit to historically low levels. At the peak of pandemic in Q2 2020, the US general government (GG) deficit (federal + local governments) stood at more than 26% of GDP (USD5100bn annualized) as the government unleashed massive support and the economy slumped (see Figure 1). In the whole calendar year 2020, the GG deficit stood at close to -15% of GDP, from -6.7% in 2019.

Figure 1: Federal and local governments' public deficits (% of GDP, rolling four quarters sum)

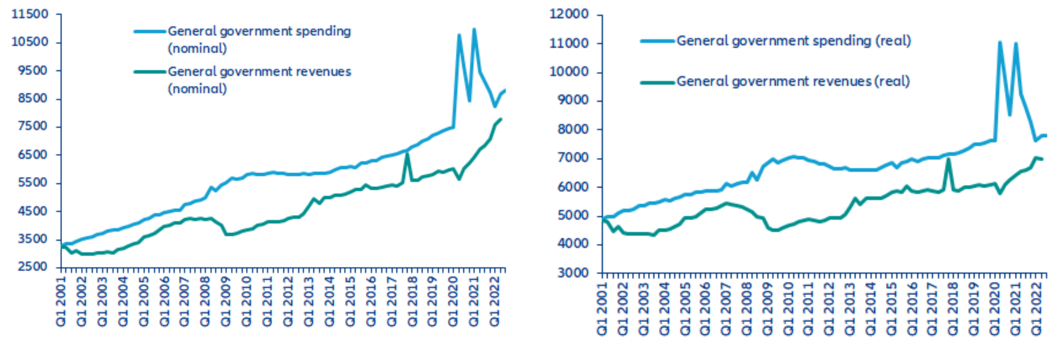


Sources: Refinitiv, Allianz Research

However, since the second half of 2021, the US GG fiscal deficit has been dwindling at an impressively rapid clip. It stood at a historically low level of -3.6% of GDP in Q2 2022 – much lower than most European countries as well as Japan. On the expenditure side, government spending has been strongly curtailed (at around USD8800bn annualized in Q2 2022). In fact, adjusted for inflation, government expenditure is now back to pre-pandemic levels and even below the pre-pandemic implied trend (see Figure 2, right side). This spending restraint has been driven by i) the winding up of pandemic-era support measures and ii) lower social-benefits spending amid record low unemployment.

On the revenue side, while the sharp uptick in inflation since early 2021 has boosted tax revenues (see Figure 2, left side), revenue collections have also been buoyant in inflation-adjusted terms (see Figure 2, right side). This is the result of strong personal income-tax collections, which hit a historically high level of more than 12% of GDP (see Figure 3, right side). Indeed, the effective personal tax rate has soared to close to 15% (see Figure 3, left side). Meanwhile, corporate tax revenues have remained low.

Figure 2: General government spending and revenues: left: current USD bn, quarterly (nominal), right: 2021 USD bn, quarterly (real)



Sources: Refinitiv, Allianz Research

Figure 3: Personal and corporate income taxes: left: effective rates, right: revenue collection in % GDP

Sources: Refinitiv, Allianz Research

Strong income tax collections can be attributed to the temporary spike in households' disposable income in 2020-21. Aggregate wage growth outpaced inflation by a wide margin during the pandemic in 2020-21. Since individuals pay their income taxes with a one-year lag, the US Treasury is seeing a boost of tax collections in 2022. Furthermore, tax brackets have not been lifted by much because 2021 inflation was low[1], meaning many wage earners have been pushed into higher tax brackets.

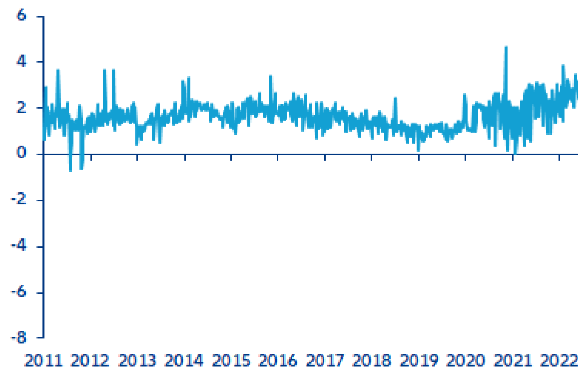
Disposable incomes were also pushed up in 2020-21 on account of the pandemic cheques and supplemental unemployment benefits. Households are now paying extra taxes on their inflated incomes, which comprise the government transfers. In other words, the Federal government is taking back some of the money it sent out to households during the pandemic.

At the same time, the Fed's losses will mean a 0.5% GDP fiscal boon will be stripped from the Treasury. With the Fed increasing interest rates sharply, the cost on its interest-bearing liabilities has been mounting rapidly. In fact, the costs of these interest payments are now overtaking the interest income on the Fed's assets and the Fed is making losses (see Figure 4: negative figures mean losses). Over the past decade, the Fed has remitted profits equivalent to

[1] *Tax brackets are adjusted on a yearly basis to inflation.*

around 0.5% of GDP per year – a non-negligible amount. This will leave a hole in the federal government's sources of revenue for a few years at least.

Figure 4: Weekly Fed remittances due to Treasury (USD bn, negative number = Fed losses)

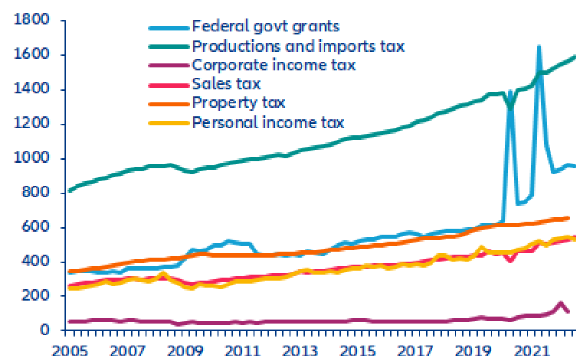


Sources: Refinitiv, Allianz Research

While the federal government' fiscal shortfall has dwindled rapidly, the improvement in local governments' (LC, essentially, the states) finances has been spectacular. The LCs have been running consistent public surpluses since the middle of 2021 (see Figure 1 again).

One reason is booming government revenues in mining states on the back of elevated energy prices and ramped up LNG shipments to Europe. For instance, in New Mexico, oil and gas account for over 40% of state-government income, a share that is rising amid the war in Ukraine. However, at the aggregate LC level, the improvement in public finances is mostly down to a big jump in federal grants (see Figure 5) - the second-largest source of revenue for LCs. On the expenditure side, LCs have not shown the same restraint as the federal government, with total LC spending growing at a healthy clip since the pandemic.

Figure 5: Local governments' main sources of revenue (USDbn)



Sources: Refinitiv, Allianz Research

A divided US government means no major legislation will be pushed through in the next two years. The Republicans' economic and fiscal pledges are rather vague. GOP House Minority Leader Kevin McCarthy released a "Commitment to America" agenda in September, which promises to "curb wasteful government spending" and to "create good-paying jobs," along with a pledge to hire 200,000 more police officers. Earlier this year, the Republican Study Committee, the House's conservative caucus that comprises nearly 75% of the House GOP, released a 122-page manifesto that pledged to cut Medicare and Social Security benefits by raising the eligibility age as well as pushing beneficiaries to enroll in private Medicare and retirement plans. President Biden has promised he would veto any cuts to Social Security and Medicare. On the other hand, the GOP-dominated Congress means that Biden's agenda (universal pre-kindergarten, fatter family subsidies, the overhaul of health insurance and higher income and capital-gains taxes on high-income households) has now close to zero chance of being passed.

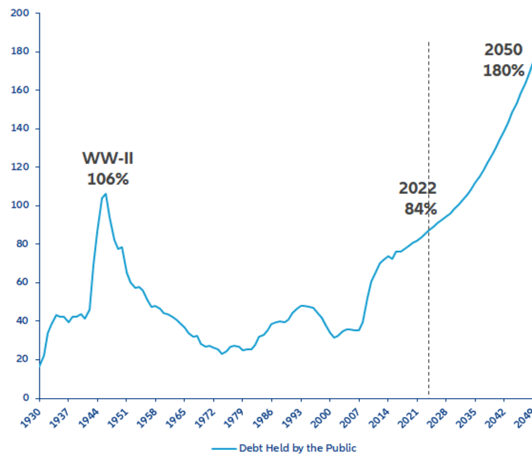
The debt ceiling[2] standoff could add major headwinds for the economy and financial markets in the first half of 2023. The debt ceiling was last raised in December last year by USD2.5trn to USD31.381trn. As of October 2022, federal debt stood at USD31.1trn. The exact date, or the "X" date, of when the ceiling will be hit is unknown because of unpredictable Treasury cash flows, but it is likely to be around Q2 because of the recession we expect, which will increase the deficit (see below). Since 1960, Congress has raised the limit 78 times, often without excitement.

But the concern for the first half of 2023 is that debt-limit negotiations could become so contentious that they could harm the economy – at a time when it will likely already be in a recession. A historical parallel is the 2011 debt-limit crisis, which demonstrated how a party in control of only one chamber of Congress can block the debt-limit increase, hitting the economy. The Republican Party had retaken the House the prior year, and Republicans demanded that President Obama offer deficit reduction in exchange for increasing the debt limit. An agreement was eventually struck, but it was only two days before the debt limit was about to be hit. Global financial markets faced severe losses during this time period, and Standard & Poor's made the previously unthinkable decision to downgrade the US's credit rating from AAA to AA+. The Government Accountability Office (GAO) estimated that the delay in raising the debt limit alone increased government borrowing costs by USD1.3bn in 2011, and further increased costs in later years.

If the 2023 debate to raise the debt limit pushes the US towards default, it could prove to be even more costly. Interest rates on Treasury securities could rise sharply, and US and global financial markets could suffer very steep losses. A September 2021 report from Moody's Analytics estimated that a default would have catastrophic results: a -4% decline in GDP, the loss of 6mn jobs and the unemployment rate soaring to 9%. A default could also eliminate USD15trn of household wealth, which would cripple consumer spending. And the timing couldn't be worse: The US will still likely be in a recession, with already high interest rates, job losses and a decimated housing market. The negative spillovers to the rest of the world could be extremely large.

[2] *The debt limit is the maximum amount the Treasury may borrow to pay the obligations it has already incurred such as Social Security and Medicare benefits, military salaries, interest on the national debt, tax refunds etc.*

Figure 6: Projected net federal-debt-to-GDP ratio according to the CBO



Sources: CBO, Allianz Research

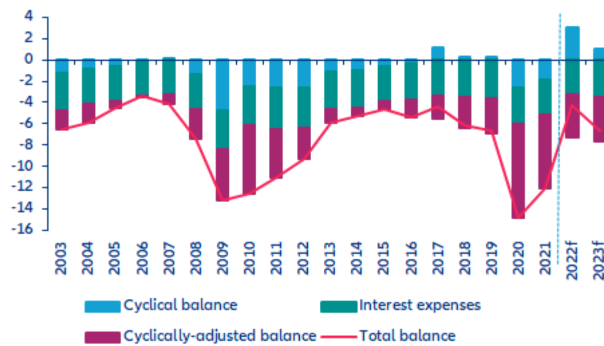
This risk and the possible costs of even approaching a default raises the question as to why the US has a debt limit. Only two other countries do: Denmark, which has one so high it will almost certainly never be breached, and Poland, which has debt limit set at 60% of GDP. Setting the debt limit as a percentage of GDP makes sense as it constrains the debt to grow no faster than the economy.

Unfortunately, this would not work in the US as it suffers from an aging population that is growing faster than planned for. That strains the ability of Social Security to maintain benefits, and strains Medicare because people are living longer and staying sicker longer. In addition, the US has a substantial income-security program. Taken together, these "entitlement" or "mandatory" programs account for nearly two-thirds of the budget, are politically untouchable and are slated to rise. In fact, because of this demographic trend, the Congressional Budget Office projects that the debt-to-GDP ratio will increase to 180% by 2050. Because of this inexorable demographic trend, it would seem wise not to incur the costs that holding up the debt-limit increase would cause in 2023.

We expect the Republicans and the Democrats to eventually agree on lifting the debt ceiling amid a flagging economy and the associated political cost of the failure to do so. We project the GG fiscal deficit to widen from -4.3% in 2022 to -6.6% in 2023 (above USD1700bn, from USD1100bn, see Figure 7). We forecast the federal government deficit to widen to USD1600bn in fiscal year 2022-23, after USD1377bn in 2021-22. Our forecasts pencil in a modest easing of fiscal policy – to the tune of 0.2% of GDP – amid a weakening economy.

In this environment, the most likely scenario is that the divided government (Dem. White House, Rep. Congress) will find a compromise to lift the debt ceiling and loosen fiscal policy – in a bid to support the flagging economy – on the few items they can agree on. If Republicans refuse to lift the debt ceiling during a recession (or at least a very weak economy) then they could be accused of playing political games, which would be politically harmful. This means increased spending on defense and cybersecurity (amid the rivalry with China), and the ramp-up of aid to the industrial sector (through subsidies or tax credits), which already started during Biden's first two years in office with the passing of the semiconductor act. We also expect Congress to agree on temporary personal income-tax cuts to bolster household spending during the recession.

Figure 7: General government public deficit forecast (% GDP)



Sources: Refinitiv, IMF, Allianz Research

In any case, the appetite for large fiscal stimulus has evaporated among US politicians on both sides of the spectrum amid the widely acknowledged role of loose fiscal policy during the pandemic in boosting inflation. Admittedly the Biden administration has pushed through three ambitious infrastructure and industrial policy bills: the USD1.2trn infrastructure law, the USD208bn semiconductor-and-science act, and the USD390bn climate-spending package (Inflation Reduction Act). However, this USD1.7trn spending spree – around 6.5% of GDP – is spread out over several years. What's more, the latest fiscal bill projects roughly USD740bn in additional revenues (also spread out over several years). The main provisions are the creation of a 15% alternative minimum tax rate for large corporations, a 1% tax on stock buybacks and increased resources for the IRS to boost tax enforcement.

What does a GOP-dominated House mean for the Fed and inflation outlook?

We find that fiscal policy was the main factor responsible for boosting inflation in the wake of the pandemic (by 3.5pps vs 1pp for monetary policy). Using an econometric estimation to infer quarterly discretionary fiscal shocks (see appendix) we find that fiscal policy has boosted growth by nearly 8pps over Q4 2020-Q4 2021 (see figure 8). This 8pps fiscal policy-induced growth boost in the wake of the pandemic has pushed up inflation by more than 3.5pps according to an estimated Phillips curve. In contrast, we find that monetary policy – which affects the economy through financial conditions[3] – supported inflation by less than 1pp over the same time span Q4 2020-Q4 2021 (with a boost to growth of less than 2pps).

Admittedly, fiscal stimulus during the pandemic was in part supported by large purchases of Treasury securities by the Fed, which makes it a bit artificial to separate the role of fiscal and monetary policy. The Fed purchased more than USD3000bn of Treasury securities on the secondary market in 2020 alone, almost the equivalent of the USD3400bn US federal government fiscal deficit in the same year.

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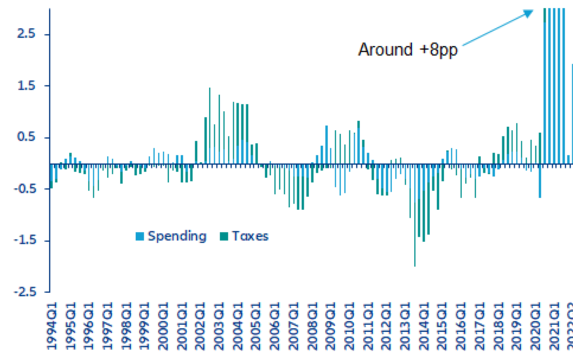
[3] *See more details on our financial conditions index and its impact on GDP in our report [US housing market: The first victim of the Fed (allianz.com).](#)*

Figure 8: Estimated GDP impact of fiscal shocks (in pp contribution of % y/y GDP growth)

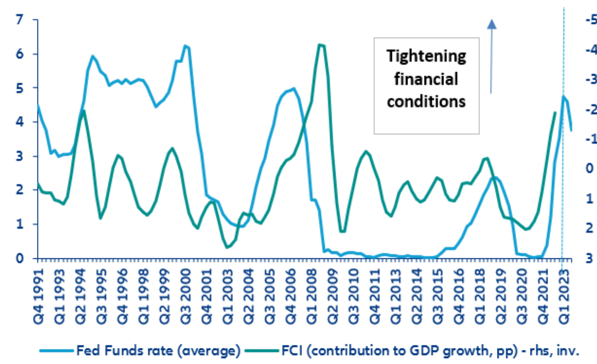


Sources: Refinitiv, Allianz Research

Ongoing tight fiscal policy will help the Fed in end 2022-early 2023. The shift to fiscal tightening since the second half of 2021 will help to bear down on inflation very soon. Because of the lagged effects of fiscal policy, we expect the impact on inflation to play out in end 2022-early 2023, pulling down inflation by around -1pp. This supports our inflation call: we see core inflation to pull back in the next couple of months to +5.4% y/y in March 2023, from +6.7% in September.

But our assumption on the stance of fiscal policy next year – 0.2% GDP of easing – means that fiscal policy will slightly support inflation. Therefore, the Fed will have to do the job alone to decisively tame inflation. This supports our view that the Federal Funds rate will have to stay high through at least the first half of 2023, at 4.75%, and financial conditions will have to tighten further (see Figure 9).

Figure 9: Fed Funds rate & financial conditions index



Sources: Refinitiv, Allianz Research

What does a GOP-dominated House mean for the geopolitical outlook?

Domestic issues such as inflation, crime and abortion dominated the midterm election campaigns, but the election outcome is likely to bear consequences for a host of pressing international concerns. While it is important to note that Congress has less leverage over foreign affairs, due to the president's broad powers as commander-in-chief, a split Congress may still complicate and further politicize international relations. Russia's invasion of Ukraine remains the second-highest priority on the US geopolitical agenda, secondary only to US-China relations. A Republican takeover of the House will constrain the Biden administration's support

to Ukraine. Since the beginning of the war, Congress has approved approximately USD60bn in aid for Ukraine without explicit conditions. House Minority Leader Kevin McCarthy, who will most likely be the next House speaker, recently made a statement that there would be no more "blank checks" for Kyiv when Republicans gain majority in Congress. This has led to concern that Republicans may restrict aid efforts to Ukraine, especially if the US economy further sinks into a recession in the months to come, forcing a more domestic focus. However, while these statements do indicate a more critical stance on the ongoing aid efforts, Republican control of one or both chambers of Congress is not expected to materially affect support for Ukraine as bipartisan support for the effort remains strong.

Increasing US-China tensions on issues such as Taiwan, human rights, trade, tech and China's reluctance to condemn Russia's war in Ukraine are expected to continue to cause strain between the countries after the midterms. According to PEW research center, more than 80% of Americans hold negative or strongly negative views of China – an unusually high number compared to 40% in 2012. As such, there is political momentum for a restrictive policy against China. Similarly, Chinese public sentiment toward the US indicates increased hostility since US House Speaker Nancy Pelosi visited Taiwan in August. This general negative sentiment between the countries, combined with a lack of trust between the two administrations, is a major cause for concern for bilateral relations in the next two years.

The trade war against China, initiated by the Trump administration in 2018, certainly caused a major strain on US-China relations by introducing massive tariffs on imports as well as an array of measures to restrain China's technological advances. The Biden administration has been building on some of these measures to bolster US competition with China, and has made it clear that China remains a strategic priority for the US. This sentiment was illustrated in Biden's first national security strategy, where the challenges that both China and Russia pose to the international order were clearly outlined.

Furthermore, Biden's recent ban on semiconductor exports to China appears to mark a major milestone in the administration's China strategy and is set to be consequential for technology and geopolitics. In the coming two years, the US will likely to impose further restrictions on China's access to critical technology on national security grounds. While China has mostly abided by the sanctions regime imposed by the West against Russia, it does act as a lifeline for Moscow where possible. As such, it remains to be seen how Russia-China relations evolve in the coming years.

With a Republican majority in the House, restrictive measures on China will likely accelerate. As attention will turn towards the build-up to the 2024 presidential election, both the Democratic and Republican parties will likely continue the "tough on China" stance, which will lay the path to further bolster US competitiveness and increase restrictions on China's access to critical technology.

The new composition of Congress may also have significance for US-EU relations. If Republicans demand a stricter stance on aid efforts for Ukraine, this could cause a strain on the EU in meeting Ukraine's financing needs. The US has provided nearly USD25bn in financial and humanitarian aid to Kyiv, as well as USD27.5bn in military supplies, which far exceeds the EU's spending. Less support from the US would certainly add pressure on the EU to increase their contribution – a challenge in the context of the current energy crisis and a dire economic outlook.

Furthermore, recent tensions over the consequences of the Inflation Reduction Act (IRA) for the EU have highlighted possible discrimination against European companies through the Act. The EU has called on the US to amend the IRA as its financial incentives "unfairly tilt the playing field to the advantage of production and investment in the United States at the expense

of the European Union and other trading partners" which in turn can risk "creating tensions that could lead to reciprocal or retaliatory measures". It remains to be seen to what degree a Republican-run Congress will impact the implementation of this newly enacted legislation. While it is highly plausible that there will be pushback on the implementation Biden's climate policy and some halt to the tax provisions prescribed the Act, it is unlikely that Congress will repeal the IRA in the coming two years.

APPENDIX: How to infer discretionary fiscal policy and its impact on inflation?

There is an identification issue in breaking down movements in spending and in tax owing to a structural shock (discretionary exogenous fiscal policy) from those owing to changes in the business cycle (automatic stabilizers). We extract (quarterly) discretionary fiscal shocks (expenditures and taxes) using the structural VAR (SVAR) methodology first set out in a seminal paper by Blanchard and Perotti[4] (B&P). This methodology allows us to strip out the movements of spending and taxes due to automatic stabilizers and to focus on the pure effect of new fiscal measures. The SVAR embeds three variables: real GDP, real government primary expenditures and real government receipts. All the variables are adjusted by population growth. Our estimation sample starts in the early 1990s.

B&P impose restrictions on some parameters in their SVAR framework (otherwise there are too many unknown parameters and the SVAR cannot be identified). The restrictions need to make institutional and economic sense. B&P assume that i) the government does not change spending in response to GDP within the quarter, ii) spending decisions are taken before those on taxation, or the reverse and iii) the elasticity of tax receipts with respect to GDP is a constant (generally about 1-1.5). While these assumptions are broadly satisfactory, the first assumption can be a bit of a challenge in times of acute economic crisis. The Covid-19 crisis, in particular, has shown how quickly governments have acted in rolling out fiscal stimulus.

For this reason, we circumvented this identification issue by adding a dummy variable in Q2 2020. Dummy variables are useful in this framework to identify large structural fiscal shocks that are easily singled out – typically, the unprecedented spikes in spending observed in Q2 2020. The fiscal impulse is then simply calculated as the difference between the observed fiscal shock and the coefficient of the dummy (plus a residual). This identification strategy leads to a much more satisfactory identification of the structural fiscal shock in Q2 2020 compared with a non-dummy estimation. We find that in Q2 2020 about two-thirds of the total increase in government spending was down to new measures, and one-third reflected the working of automatic stabilizers.

The fiscal impulse we retrieve from this methodology is akin to the cyclically adjusted balance produced by the IMF, but with the advantage of being available on a quarterly basis, and to breaking down tax shocks from spending shocks. Within our SVAR framework, we also infer the fiscal multipliers, i.e. the effect of fiscal shocks on GDP growth. Our fiscal multipliers – at around 0.7 on average for both spending and taxes – are found to fall within the range of generally estimated values, though there is no consensus in the literature over their size. Figure 8 displays the estimated GDP impact of fiscal policy through time, calculated as the product of the fiscal shocks by the fiscal multiplier.

The model captures well the GDP impact of the tax cuts rolled out by the Bush administration in the early 2000s, as well as the fiscal consolidation of 2013-15 under the auspices of the Obama administration. The pandemic stimulus packages are found to have supported growth by nearly 8pp annualized between end-2020 and end-2021.

We estimate the impact of fiscal policy on inflation through a basic Phillips curve, which related headline inflation to its lag, inflation expectations, oil prices, and the output gap (i.e. GDP growth, relative to potential). Our estimation sample starts in the early 1990s. Interestingly, the slope of the Phillips curve (i.e. the coefficient of the output gap) increases when we include the pandemic period in the estimation: inflation has become more sensitive to the economic cycle.

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[4] *Olivier Blanchard and Roberto Perotti, "An Empirical Characterization of the Dynamic Effects of Changes in Government Spending and Taxes on Output", NBER Working Paper 7269, July 1999*

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