What will be of the US fiscal policy? Whatever will be, will be

After growing by 2.9% in 2018, the US finds itself with a labour market in virtually full employment, an easing of trade tensions with China and a monetary policy on neutral ground: the US economy is enjoying good times. However, there are latent risks that could affect the steady pace of economic activity. In this article, we analyse how one of them – fiscal policy – could define the scenario over the coming quarters.

Determining factors for fiscal policy

Let us remember that, at the end of 2017, a significant tax cut was approved[1] and that, in early 2018, President Trump gave the green light to an increase in public expenditure equivalent to 0.7% of GDP, both for 2018 and for 2019. Without a doubt, these clearly expansionary policies have a significant impact on economic growth in the short term (amounting to 0.7 pps in 2018 and 0.2 pps in 2019, according to our estimates).[2] However, their effect will fade over the next few quarters and, thereafter, the role of fiscal policy will depend to a greater extent on three new factors: (i) potential government shut-downs, (ii) automatic spending cuts, and (iii) infrastructure spending (see first chart).

After starting the year with the longest federal government shutdown in US history (35 days), the need for Congress to pass both the federal spending budget and a new debt ceiling could trigger another government closure in 2019. Before the end of the fiscal year, on 30 September, Congress must approve (and the president must ratify) a new budget. Without a budget, many government services are at risk of coming to a standstill. President Trump's current budget proposal, which includes a special provision to finance the famous «wall» with Mexico, is unlikely to generate sufficient consensus in a divided Congress (we should remember that the Lower House is in the hands of the Democrats, while the Upper House is in Republican hands). In this case, Congress must approve a temporary extension to the funding of the federal government – something which in the past has led to many shutdowns of government agencies.

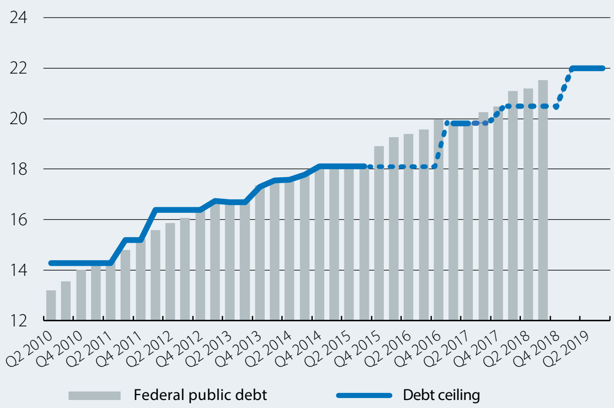
1. Key elements of the tax reform included the cut in corporate tax (from 35% to 21%) and the reduction of the top marginal rate for personal income tax (from 39.6% to 37%).
2. According to estimates by CaixaBank Research, in 2018, the impact of the fiscal stimulus on economic growth was 0.73 pps, with 0.36 pps coming from the tax reform and 0.37 pps from the increase in expenditure. In 2019, the impact of the fiscal stimulus is estimated at 0.24 pps, mainly stemming from the tax reform.

US: key dates

2 March 2019	**The debt ceiling is reinstated** (after being suspended in February 2018).
From August to October 2019	It is estimated that the **Treasury will run out of sufficient liquidity** to continue executing the public expenditure budget.
1 October 2019	Risk of a federal government shutdown: being the beginning of a new fiscal year, **various items of expenditure must be passed**.
1 January 2020	**The expenditure rule of 2017 is reinstated,** which could result in a significant decrease in public spending (~100 billion dollars).

Source: *CaixaBank Research.*

US: public debt and debt ceiling
(USD trillions)



Note: *The dotted line shows periods when the debt ceiling has been suspended.*
Source: *CaixaBank Research, based on data from the US Treasury.*

Secondly, after the First World War, the US Congress established what is known as the debt ceiling: a limit above which the country's Treasury cannot issue any new debt to finance the government. If this figure is reached without the ceiling being increased, or without the enforcement of the ceiling being suspended, the government is also forced to close its doors. After being suspended for a little over a year, on 2 March 2019 the debt ceiling came back into force, with a limit of 22 trillion dollars (see second chart). It is estimated that the limit could be reached between August and October 2019. Thus, the risk of another government shutdown is by no means negligible.

The second factor that could have a negative (and substantial) impact on the growth of the US economy in 2020 is what is known as sequester. US laws establish a series of constraints on the growth of the public budget and limits on public expenditure. On numerous occasions, these limits are suspended and do not apply (as was also the case with the debt ceiling). In fact, these spending caps are currently suspended until 31 December 2019. However, if Congress fails to approve new limits or does not suspend them again before this date, on 1 January 2020 automatic cuts in federal spending of 126 billion dollars would come into force (71 billion in defence and 55 billion in other areas of expenditure).[3] Although the information available suggests that new, less restrictive limits will be agreed, some kind of spending cut is highly likely, especially in the face of a structural budget deficit which, in 2018, exceeded 5% of GDP.

Finally, and in contrast to the first two fiscal factors mentioned above, the approval of a substantial increase in infrastructure spending could boost growth in 2020. In the 2016 presidential election, one of the few points that the then-candidate Trump and the Democratic candidate Clinton had in common was the need to increase spending on infrastructure. The fact is, the quality of infrastructure in the US has seen one of the most marked declines among advanced countries.[4] However, at present, there seems to be little chance of Congress reaching an agreement on this matter. The plan submitted by the Trump Administration in early 2018 promised 1.5 trillion dollars for infrastructure expenditure in 10 years, of which only 200 billion would be financed specifically by federal expenditure (the bulk of the funds would come from investments from public-private partnerships, which in the US are still rare). However, this plan is more of a wish than a reality, since there is no consensus on the proposal between Democrats and Republicans. Furthermore, in a clearly divided political environment and with the Democratic primaries taking place this summer, it seems unlikely that the Democrats will want to support one of Trump's electoral promises before the 2020 presidential election.

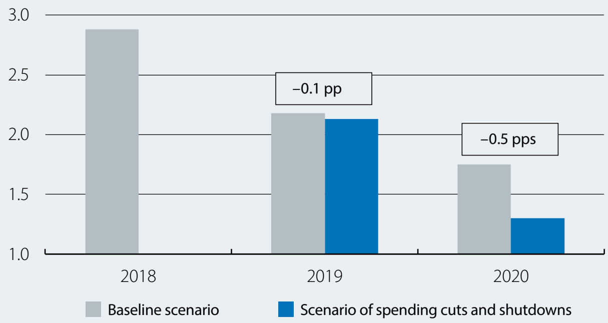
Economic impact

What could be the economic importance of the fiscal factors we have just gone over? To answer this question, we imaged a scenario in which most of the negative fiscal impacts explained above occur. In particular, we assumed that during 2019 there will be another government shutdown with a similar impact to the one that occurred in the closing days of 2018 and in early 2019. We also assumed that the sequester will take effect, resulting in automatic spending cuts of 126 billion dollars, and that Democrats and Republicans will not agree on any significant infrastructure plan.

3. Spending cut estimated by the Senate Committee on the Budget Bulletin (7 June 2018). «Spending Caps and the New Fiscal Cliff». The total value of the automatic spending cut is not known with certainty, but all the estimates place it at around 100 billion dollars.
4. See the article «The US: to invest or not to invest, that is the question» in the Dossier of the MR03/2017.

US: GDP growth scenarios

Annual change (%)



Note: *The baseline scenario assumes only short-lived government shutdowns, with a very contained economic impact. The scenario of spending cuts and shutdowns includes automatic public spending cuts of 126 billion dollars in 2020 and another government shutdown on a scale similar to that of Q1 2019. The boxes in the chart indicate the difference between the baseline scenario and the scenario with spending cuts.*
Source: *CaixaBank Research.*

For the economic impact of the hypothetical government shutdown at the end of 2019, we use the estimates produced by the Congressional Budget Office for the shutdown at the beginning of 2019, according to which it shaved 0.4 pps off annualised quarter-on-quarter GDP growth in Q1 2019.[5] To calculate the potential impact of the sequester, we take different estimates of US fiscal multipliers and apply them to the expected amount of the spending cuts, both in defence and in other areas.[6]

As shown in the third chart, under these assumptions, while economic growth would hold up quite well during 2019, in 2020 it would be significantly affected (5 decimal points below the baseline scenario, reaching 1.3%). The greater resistance of 2019 is due to the fact that most fiscal shocks would occur in late 2019 and early 2020, as well as the fact that 2019 is still propped up by the fiscal stimulus approved in late 2017 and early 2018.

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5. See Congressional Budget Office (January 2019), «The Effects of the Partial Shutdown Ending in January 2019». The negative effects on growth have primarily been due to the decline in the economic activity of federal civil servants who were sent home, and to a lesser extent due to the lower expenditure on goods and services by federal agencies and the lower demand resulting from the suspension of federal wages (which will be paid retrospectively). Although the negative effect on growth in Q1 2019 will be offset by a rebound in economic activity in the coming months, a portion of the economic activity will not be recovered.
6. For defence expenditure, we assume a multiplier of 0.4 (based on R.J. Barro and C.J. Redlick (2011), «Macroeconomic Effects from Government Purchases and Taxes», The Quarterly Journal of Economics, 126(1), 51-102). For other areas of expenditure, we use multipliers between 0.7 and 1.0 (C.J. Whalen and F. Reichling (2015), «The fiscal multiplier and economic policy analysis in the United States», Contemporary Economic Policy, 33(4), 735-746). In general, these figures correspond to the lower limit of the estimates, since, in an economy where the output gap has been positive since 2017, the impact of fiscal measures should lie within this lower range of the estimates.