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Debt Ceiling Update: A Resolution At Last

Economist(s)

Michael Pugliese
Senior Economist | Wells Fargo Economics
Michael.D.Pugliese@wellsfargo.com | 212-214-5058

Karl Vesely
Economic Analyst | Wells Fargo Economics
Karl.Vesely@wellsfargo.com | 704-410-2911

Summary

- Over Memorial Day weekend President Joe Biden and Speaker of the House Kevin McCarthy struck an eleventh hour agreement to suspend the debt ceiling through year-end 2024. The House of Representatives intends to vote on the deal today, and it is widely expected to pass. This would tee up a vote in the Senate within the next few days, allowing President Biden to sign the bill into law shortly thereafter.
- The most important macro drivers in the bill are the discretionary spending budget caps for fiscal years 2024 and 2025. Despite the caps, discretionary spending should continue to grow at a modest pace over the next couple of years, in contrast to the outright spending cuts seen in the wake of the 2011 debt ceiling episode.
- The debt ceiling bill contains numerous other policy changes, such as rescinding some unspent COVID relief money, streamlining some energy project permitting and tweaking work requirements for the Supplemental Assistance Program (SNAP) and Temporary Assistance for Needy Families (TANF). However, we doubt these policy changes will have a material impact on our U.S. economic forecast. The bill also codifies the end of the student loan payment moratorium 60 days after June 30. This was already the stated intention of the Biden administration, but the debt ceiling bill ensures another extension will not occur without an act of Congress.
- These policy changes present a small downside risk to our current economic forecast. Incorporating this agreement into our forecast probably will reduce real GDP growth by a modest 0.1-0.2 percentage points per year over the next couple of years.
- The Congressional Budget Office estimates that the bill will reduce budget deficits by about $1.5 trillion over the 2023-2033 period. Admittedly, CBO projections rely on a host of assumptions about what future Congresses will do, and the actual deficit reduction could be much bigger or smaller than the $1.5 trillion figure.
- Setting aside the specific figures, we think this bill marks an important inflection point in federal fiscal policy. The past several years have been marked by highly accommodative federal fiscal policy. This era may be coming to an end as federal fiscal policy is shifting to a more neutral stance.
- It is important to note that the debt ceiling bill is not the end of the road for the FY 2024 budget process. Now that topline spending levels have been set, Congress must pass the 12 annual appropriation bills before the start of the next fiscal year on October 1. If Congress does not pass the 12 appropriation bills or a continuing resolution (CR) by September 30, a government shutdown would ensue.
- Assuming a government shutdown is avoided, the debt ceiling and budget drama should subside until after the 2024 election. However, the next president and Congress will face a long list of fiscal policy items to address in 2025. These include another debt ceiling increase, setting new discretionary spending levels, the expiration of major parts of the 2017 Tax Cuts and Jobs Act, and the expiration of more generous subsidies for purchasing health insurance under the Affordable Care Act.
- We do not expect Congressional action on these items anytime soon, but we highlight them to remind readers that a potential lull in the federal fiscal policy action over the next 18 months might be followed by major fiscal policy shifts after the 2024 presidential election. In the coming months we will explore the potential policy implications of next year's election. Stay tuned.

What's in the Debt Ceiling Deal?

A debt ceiling resolution has been reached. Over Memorial Day weekend President Joe Biden and Speaker of the House Kevin McCarthy struck an eleventh hour agreement to suspend the debt ceiling through year-end 2024. The House of Representatives intends to vote on the deal today, and it is widely expected to pass. This would tee up a vote in the Senate within the next few days, allowing President Biden to sign the bill into law shortly thereafter. The agreement comes just in time. On Friday, May 26, Treasury Secretary Janet Yellen sent a letter to Congress pinpointing June 5 as the most likely date by which Treasury would have insufficient resources to satisfy all of the government's obligations.[1]

Discretionary spending will continue to grow over the next couple of years, albeit at a relatively modest pace.

The most important macro drivers in the bill are the discretionary spending budget caps for fiscal years 2024 and 2025. Defense discretionary spending will be increased by roughly 3.3% in fiscal year 2024, while nondefense discretionary spending appears to be roughly flat after accounting for anticipated appropriations adjustments.[2] In FY 2025, the budget caps increase 1% for both categories (Figure 1). These figures suggest that base discretionary spending will continue to grow over the next couple of years, albeit at a relatively modest pace. In dollar terms, we estimate that these spending caps imply roughly $46 billion less in discretionary spending in FY 2024 and $72 billion less in FY 2025 compared to the Congressional Budget Office's baseline projections.

Figure 1

Federal Discretionary Spending Budget Authority

Fiscal Year	Defense (YoY % Change)	Nondefense (YoY % Change)
2023	$858.4B (+9.8%)	$767.2B (+7.1%)
2024	$886.3B (+3.3%)	$767.2B (0.0%)*
2025	$895.2B (+1.0%)	$774.9B (+1.0%)*

*For more information on these estimates, please see endnote 2

Source: The White House, Congressional Budget Office and Wells Fargo Economics

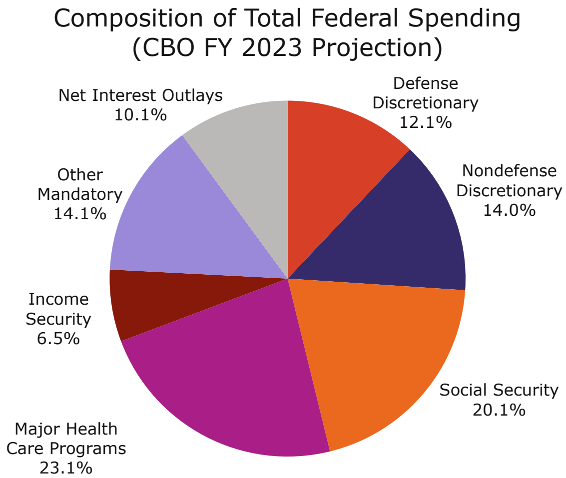
Incorporating this agreement into our economic forecast will probably reduce real GDP growth by a modest 0.1-0.2 percentage points per year over the next couple of years.

That said, it is important to note that this slower spending growth is coming off of a relatively high base. Discretionary spending grew rapidly during the pandemic, and even in FY 2023 Congress approved a nearly 10% increase in discretionary spending budget authority. Furthermore, other previously-enacted bills continue to provide a fiscal tailwind, such as the Infrastructure Investment and Jobs Act and the CHIPS Act. The debt ceiling bill also leaves tax policies and most mandatory spending such as Social Security and the major healthcare programs unchanged (Figure 2). Discretionary spending accounts for just one quarter of total federal outlays. Accordingly, this bill presents a small downside risk to our current economic forecast. Incorporating this agreement into our economic forecast will probably reduce real GDP growth by a modest 0.1-0.2 percentage points per year over the next couple of years.

The Congressional Budget Office estimates that the bill will reduce budget deficits by about $1.5 trillion over the 2023-2033 period relative to its May 2023 projections

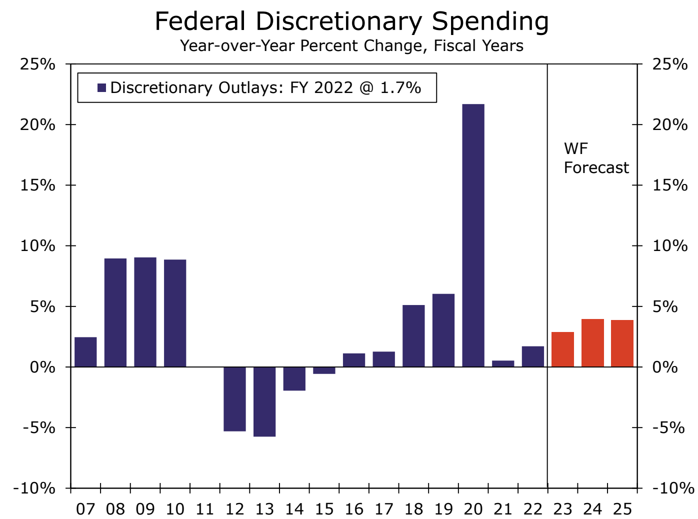
The Congressional Budget Office estimates that the bill will reduce budget deficits by about $1.5 trillion over the 2023-2033 period relative to its May 2023 projections.[3] Admittedly, CBO projections rely on a host of assumptions about what future Congresses will do, and the actual deficit reduction could be much bigger or smaller than the $1.5 trillion figure. But setting aside the specific figures, we think this bill marks an important inflection point in federal fiscal policy. The past several years have been marked by highly accommodative federal fiscal policy. This era may be coming to an end as federal fiscal policy is shifting to a more neutral stance. That said, the shift is hardly draconian. As mentioned previously, tax increases or mandatory spending cuts were avoided. And despite the caps, discretionary spending should continue to grow at a modest pace over the next couple years, in contrast to the outright spending cuts seen in the wake of the 2011 debt ceiling episode (Figure 3).

Figure 2



Source: Congressional Budget Office and Wells Fargo Economics

Figure 3



Source: The White House, Congressional Budget Office and Wells Fargo Economics

The debt ceiling bill contains numerous other policy changes, such as rescinding some unspent COVID relief money, streamlining some energy project permitting and tweaking work requirements for the Supplemental Assistance Program (SNAP) and Temporary Assistance for Needy Families (TANF). However, the deficit impact from these policies is relatively small, and we doubt they will have a material impact on our U.S. macroeconomic forecast. The bill also codifies the end of the student loan payment moratorium 60 days after June 30 (August 29). This was already the stated intention of the Biden administration, but the debt ceiling bill ensures another extension will not occur without an act of Congress.[4] Critically, the bill does not weigh in on President Biden's sweeping student loan forgiveness plan. The fate of that executive action will be determined by the Supreme Court, potentially as soon as June.

It is important to note that the debt ceiling bill is not the end of the road for the FY 2024 budget process. Now that topline spending levels have been set, Congress must pass the 12 annual appropriation bills before the start of the next fiscal year on October 1. The appropriations process involves allocating the pot of money to all the various discretionary programs and activities funded by the federal government. Imagine a household that has developed a high-level budget for its major spending categories such as rent, groceries, etc., but still has to choose which individual items to purchase at the grocery store. If Congress does not pass the 12 appropriation bills or a continuing resolution (CR) by September 30, a government shutdown would ensue. If a CR is still in effect on or after January 1, the debt ceiling bill stipulates that even lower discretionary budget caps would kick in. This provision is designed to push lawmakers to complete the annual budget process without too much of a delay.

Now that topline spending levels have been set, Congress must pass the 12 annual appropriation bills before the start of the next fiscal year on October 1.

A Fiscal Cliff Is Coming in 2025

Assuming a government shutdown is avoided this year and next, the debt ceiling and budget drama should subside until after the 2024 presidential election. However, the next president and Congress will face a long list of fiscal policy items to address in 2025. First, the debt ceiling will once again need to be increased or suspended by the summer/fall of 2025. Second, topline spending levels for FY 2024 and FY 2025 are now set, but starting in FY 2026 the budget caps implied in the debt ceiling bill are non-enforceable. So, Congress and the president will once again need to sort through the appropriate level of discretionary spending. Third, major parts of the 2017 Tax Cuts and Jobs Act (the tax cut bill passed under President Trump) are set to expire at the end of 2025. Generally speaking, most of the individual income tax cuts are set to expire, while most of the business tax cuts were made permanent. Fourth, the Inflation Reduction Act (IRA) passed under President Biden included an extension of more generous subsidies for individuals purchasing health insurance through the Affordable Care Act. These too will expire after 2025.

The next president and Congress will face a long list of fiscal policy items to address in 2025.

Thus, the next election will have elevated stakes for the federal fiscal policy outlook. Looking out a bit further, there is a chance the next president will also need to grapple with the looming exhaustion of the Social Security Trust Fund. The most recent annual Trustees report estimated that the Old-Age and Survivors Insurance Trust Fund (the main Social Security Trust Fund) will be able to pay 100% of scheduled benefits until 2033. At that time, and absent Congressional action, the fund's reserves will become depleted and continuing program income will be sufficient to pay just 77% of scheduled benefits.[5]

We do not expect Congressional action on these items anytime soon, but we highlight them to remind readers that a potential lull in the federal fiscal policy action over the next 18 months might be followed by major fiscal policy shifts after the 2024 presidential election. In the coming months we will explore the potential policy implications of next year's election. Stay tuned.

Endnotes

[1] Yellen, Janet. "Debt Limit Letter to Congress Members" U.S. Department of the Treasury. May 26, 2023. (Return)

[2] In the bill, the nondefense discretionary spending caps are set at $703.7B and $710.7B for fiscal years 2024 and 2025, respectively. Using these numbers, total discretionary spending budget authority would be lower by $110 billion and $136 billion in fiscal years 2024 and 2025, respectively, relative to CBO's baseline projections. However, the White House has signaled that after accounting for agreed upon appropriation adjustments, nondefense discretionary budget authority will be roughly flat in FY 2024 relative to FY 2023. Figure 1 assumes base nondefense discretionary budget authority is held flat in FY 2024 at $767.2B and then grows by 1% in FY 2025, though we acknowledge this could be a bit different once the appropriations process is completed.

For more information on the recent developments as seen from the White House, please see: "Background Press Call on the Bipartisan Budget Agreement" The White House. May, 28, 2023. (Return)

[3] Swagel, Phillip L. "CBO's Estimate of the Budgetary Effects of H.R. 3746, the Fiscal Responsibility Act of 2023" Congressional Budget Office. May 30, 2023. (Return)

[4] U.S. Department of Education Press Office. "Biden-Harris Administration Continues Fight for Student Debt Relief for Millions of Borrowers, Extends Student Loan Repayment Pause" U.S. Department of Education. November 22, 2022. (Return)

[5] Trustees of the Social Security and Medicare trust funds. "A Summary of the 2023 Annual Reports" Social Security Administration. March 3, 2023. (Return)

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Economics Group

Jay H. Bryson, Ph.D.	Chief Economist	704-410-3274	Jay.Bryson@wellsfargo.com
Sam Bullard	Senior Economist	704-410-3280	Sam.Bullard@wellsfargo.com
Nick Bennenbroek	International Economist	212-214-5636	Nicholas.Bennenbroek@wellsfargo.com
Tim Quinlan	Senior Economist	704-410-3283	Tim.Quinlan@wellsfargo.com
Sarah House	Senior Economist	704-410-3282	Sarah.House@wellsfargo.com
Azhar Iqbal	Econometrician	212-214-2029	Azhar.Iqbal@wellsfargo.com
Charlie Dougherty	Senior Economist	212-214-8984	Charles.Dougherty@wellsfargo.com
Michael Pugliese	Senior Economist	212-214-5058	Michael.D.Pugliese@wellsfargo.com
Brendan McKenna	International Economist	212-214-5637	Brendan.Mckenna@wellsfargo.com
Jackie Benson	Economist	704-410-4468	Jackie.Benson@wellsfargo.com
Shannon Seery	Economist	332-204-0693	Shannon.Seery@wellsfargo.com
Nicole Cervi	Economic Analyst	704-410-3059	Nicole.Cervi@wellsfargo.com
Jessica Guo	Economic Analyst	212-214-1063	Jessica.Guo@wellsfargo.com
Karl Vesely	Economic Analyst	704-410-2911	Karl.Vesely@wellsfargo.com
Patrick Barley	Economic Analyst	704-410-1232	Patrick.Barley@wellsfargo.com
Jeremiah Kohl	Economic Analyst	704-410-1437	Jeremiah.J.Kohl@wellsfargo.com
Coren Burton	Administrative Assistant	704-410-6010	Coren.Burton@wellsfargo.com

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