

Special Commentary — December 11, 2023

# The Fiscal Tailwinds Are Still Blowing

## Summary

- Government hiring and output have accelerated this year even as indicators of private sector economic activity have shown some signs of slowing. Nearly one-quarter of the 2.6 million jobs added to the U.S. economy year-to-date have been in government, with payrolls up 2.9% over the past year versus 1.6% in the private sector. The government component of GDP (you may recall the formula  $GDP = C + I + G + NX$  from an economics class back in the day; G is government output) was up 4.7% year-over-year in Q3, near the strongest growth rates of the past 30 years.
- Some of this pick-up can be attributed to a delayed rebound from the pandemic. October 2023 marked the first month in which government employment was above its February 2020 level, a threshold private nonfarm employment eclipsed in April 2022.
- Flush state and local (S&L) government coffers also explain some of the strength. The vast majority (nearly 90%) of public sector workers are employed by S&L governments, and the fiscal situation for many of these entities has been relatively healthy over the past couple years. Robust tax receipt growth, significant federal aid and generally strong balance sheets have bolstered S&L governments' fiscal flexibility.
- At the federal level, new policy initiatives have helped to boost output and hiring growth. More spending has started to come online for veterans, national defense, infrastructure and other areas, contributing to an acceleration in government hiring and production.
- How long can this boom continue? In the near term, we believe the solid growth in government hiring and output will persist. S&L governments are still playing catch-up on hiring from the pandemic hit, and this momentum should continue a little while longer. Although S&L tax revenues are not growing as fast as they once were, they are also not collapsing. Federal aid from the pandemic is dwindling much like excess savings are for households, but the evidence suggests that these funds are not yet fully spent. Infrastructure funding from the federal government is also still ramping up, and the impact on economic growth likely will not peak for another year or two.
- However, we believe the tide is starting to turn. At the federal level, the willingness to expand the deficit seems to be waning. There have been no new major fiscal expansions in 2023, a sharp contrast to the numerous bills passed from 2020-2022. As we look to next year, it strikes us as unlikely that Congress will pass any new major fiscal initiatives in an election year. At the S&L level, tax receipt growth is unlikely to return to double-digit territory anytime soon, and eventually leftover federal aid from the pandemic will be exhausted.
- More broadly, fiscal austerity as a political issue may be slowly coming back into vogue amid a period of high inflation, elevated federal debt levels and rising interest costs.
- On balance, the fiscal tailwinds are still blowing, but they are not as strong as they once were, and we believe they will keep fading as we get closer to 2025 and beyond. Government hiring and output can serve as one of the pillars propping up economic growth and the labor market in the near term. That said, this boost will not last forever, and the headwinds from restrictive *monetary* policy are still exerting a drag on the U.S. economy. In order to achieve a "soft landing," sooner or later a Federal Reserve pivot will be needed to keep this expansion going.

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## Examining Government's Role in Extending the Cycle

The biggest economic story of 2023 in our view has been the remarkable resilience of the U.S. economy in the face of numerous headwinds. Despite restrictive monetary policy, the resumption of student loan payments, the regional bank failures earlier this year and several other hurdles, the U.S. economy has continued to expand at a solid pace. The unemployment rate remains below 4%, and real GDP looks set to grow nearly 3% for the year—a growth rate above what most analysts consider to be the economy's long-run sustainable trajectory.

There have been several factors that have contributed to this economic resilience, and we have written about them at various points this year. As an example, household balance sheets entered this tightening cycle with relatively low debt levels and a mountain of "excess" savings, helping to sustain consumption growth. Fiscal policy also has played a meaningful role in extending the life of this expansion. Fiscal policy influences the economy through indirect channels, like when changes in tax policy or transfer payments affect the economic decisions of households and businesses. Fiscal policy can also impact economic outcomes directly via government hiring and output. Like businesses, governments hire workers to produce goods and services, whether that be for national defense, education, transportation, or the many other kinds of government production.

In this report, we examine the recent acceleration in government hiring and output. We then discuss the drivers of this pick-up in hiring and economic activity and analyze the outlook for this sector of the economy in 2024 and beyond.

## After a Slow Start, Government Hiring Has Accelerated

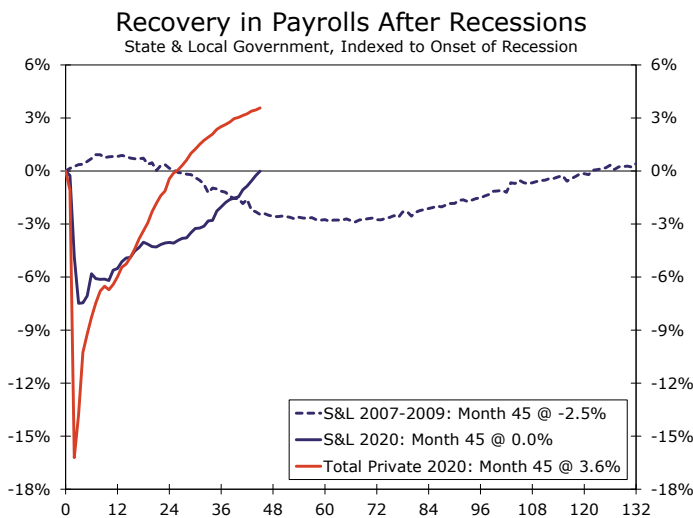
One clear avenue in which the public sector has helped to keep the economy growing at an above-trend rate this year is hiring. Nearly one-quarter of the 2.6 million jobs added to the U.S. economy year-to-date have been in government, with payrolls up 2.9% over the past year versus 1.6% in the private sector.

The vast majority (nearly 90%) of public sector workers are employed by state and local (S&L) governments, so it is not surprising that the lion's share of gains have been at the state (+218K) and local (+345K) levels. The sizable number of jobs added have come as the sector is still playing catch up when it comes to pandemic-related job losses. While the S&L jobs' recovery this cycle has been quicker than what ensued after the 2008-2009 financial crisis, it has nonetheless trailed the private sector, and S&L payrolls regained their pre-COVID peak only this past month. (Figure 1).

**Fiscal policy has played a meaningful role in extending the life of this expansion.**

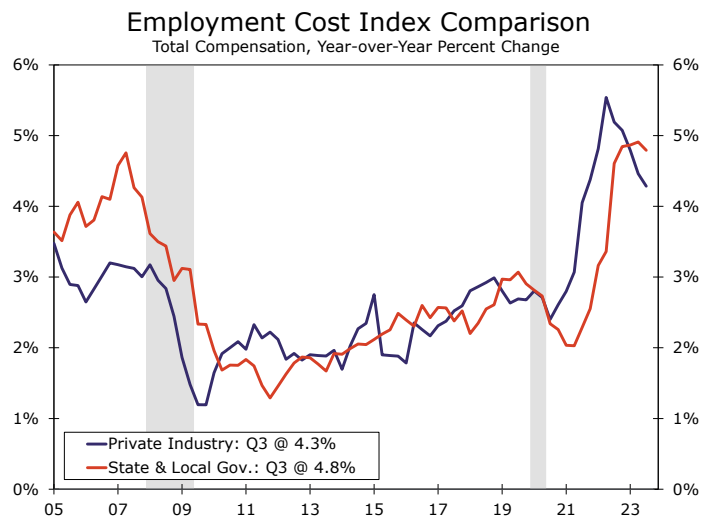
**Nearly one-quarter of the 2.6 million jobs added to the U.S. economy year-to-date have been in government. The sizable number of jobs added have come as the sector is still playing catch up when it comes to pandemic-related job losses.**

Figure 1



Source: U.S. Department of Labor and Wells Fargo Economics

Figure 2



Source: U.S. Department of Labor and Wells Fargo Economics

A remaining employment deficit lies within education. Despite the return of in-person instruction, S&L education payrolls are still down 0.7% relative to early 2020. However, more recently public education hiring has recovered some ground as campus activity is firmly back in swing and labor supply has come back online. Public education employment is up a strong 2.8% year-over-year. Ex-education, S&L hiring

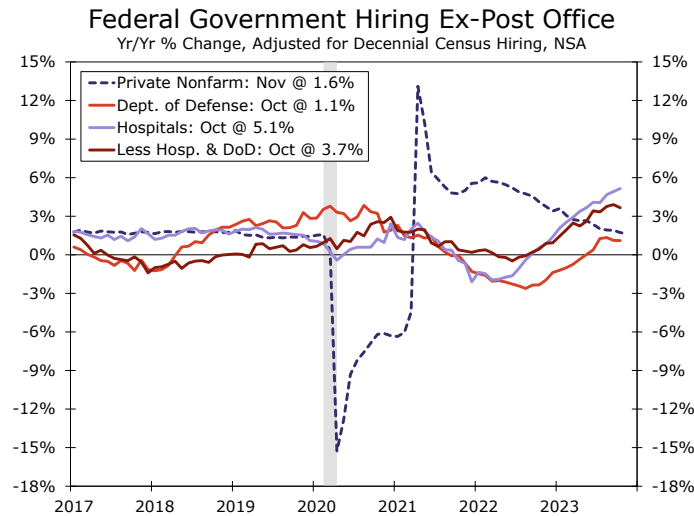
also has outpaced the private sector over the past 12 months, particularly at hospitals (+4.1%) and transportation authorities (+3.8%).

Stronger compensation growth likely has helped state & local governments fill jobs. After trailing for most of the cycle, public sector compensation growth is now running ahead of the private sector (Figure 2). Yet even with some ground made up this past year, S&L government compensation has increased about two percentage points less than in the private sector since the end of 2019, with education pay growth lagging behind both S&L health care and S&L administration.

Although only a fraction of total public sector payrolls, federal government hiring also has packed an outsized punch this past year. Excluding workers employed by the self-funded Post Office, federal payrolls are up more than 3% since last November. Greater funding for the Veteran’s Administration has helped fuel hiring at federal hospitals, where payrolls were up over 5% for the 12-month period ending in October (Figure 3, most recent monthly data available). Employment in other nondefense agencies also has risen solidly (+3.7%) over the past year. In contrast, civilian defense employment has grown at a more middling pace (+1.1%) as defense outlays over the past year have been more geared toward investment.

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Figure 3



Source: U.S. Department of Labor and Wells Fargo Economics

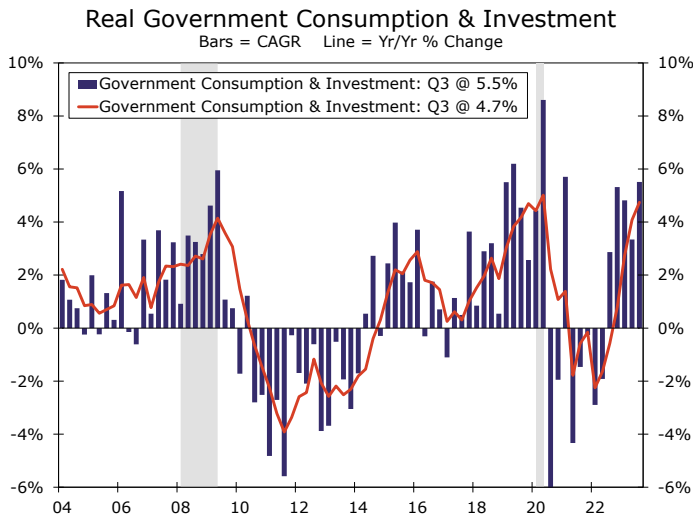
### Government Output Is Boosting Real GDP Growth

More robust government hiring and an acceleration in public investment have led to faster output growth this year. The government component of GDP (you may recall the formula  $GDP = C + I + G + NX$  from an economics class back in the day; G is government output) was up 4.7% year-over-year in Q3 (Figure 4).

***The government component of GDP does not drive headline growth quite as much as it did in the past.***

The government component of GDP does not drive headline growth quite as much as it did in the past. In the mid-20th century, government consumption and investment were a larger share of the economy amid the building of the interstate highway system, the space race, the Cold War arms buildup and other policy initiatives. Today, government output is just 17.3% of GDP, near the all-time lows (Figure 5). Government spending is now much more concentrated on transfer payments to households (e.g., Social Security, Medicare and Medicaid) compared to the past. This shows up in the GDP accounts as consumption ("C" in the above formula) when households spend the funds on goods and services, or when the government spends on households' behalf. That said, the direct contribution of the "G" line to GDP—the value of government services and government investment—shows government output growth contributing at least half a percentage point to real GDP growth over the past four quarters.

Figure 4



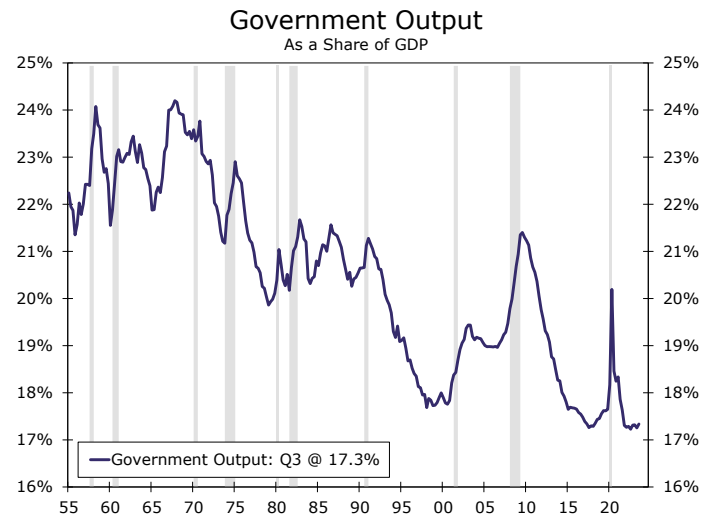
Source: U.S. Department of Commerce and Wells Fargo Economics

Both state & local (+4.2%) and federal (+5.7%) have contributed to the robust pace of government output growth over the past year. Since most government-provided services are not purchased (e.g., education and public safety), "consumption" for the sector is measured by the costs induced to provide services—largely labor, materials and capital costs. The solid pace of hiring at the state & local level over the past year has therefore helped drive a pickup in S&L output, with inflation-adjusted consumption expenditures rising 2.3% year-over-year in Q3—the largest increase since the spring of 2020. Even more impressive has been investment in hard assets. In inflation adjusted-terms, S&L government spending on structures is growing at the fastest pace in two decades, while equipment investment has also grown at a double-digit pace over the past year.

Growth in federal government output also has been propelled in no small part by investment. Nondefense investment has risen nearly 8% in real terms over the past year amid a pickup in software and R&D. Nondefense consumption looks nearly as impressive (+6.3% year-over-year). While some strength in this component is genuine based on the sector's hiring spurt, its recent strength is overstated to some degree by the ending of sales from the Strategic Petroleum Reserve (SPR). The net sales from the SPR in 2022 and early 2023 created a drag on the federal government's contribution to GDP growth as, rather than purchasing inventories, non-fixed assets were sold. With SPR inventories stabilizing in recent months, this drag has faded (Figure 6).

Meanwhile, defense outlays over the past year have increased at the strongest rate in four years (Figure 7). Both consumption (mostly spending on military and civilian personnel) and investment have picked up, although growth continues to be led by investment (particularly software and R&D), which over the past few years has grown to account for nearly a quarter of defense outlays.

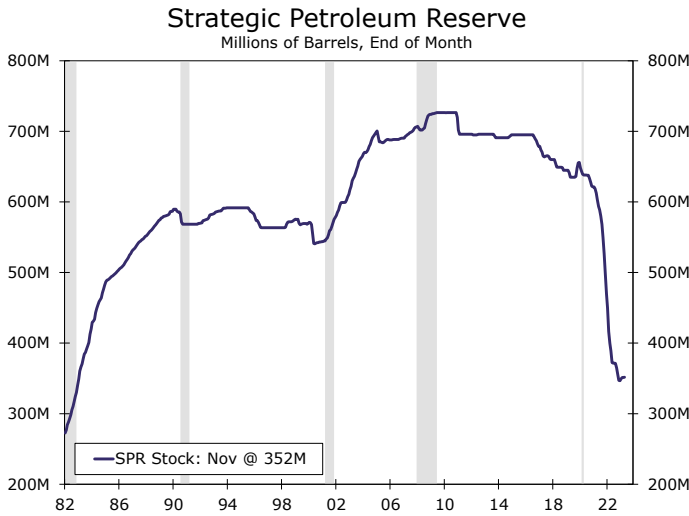
Figure 5



Source: U.S. Department of Commerce and Wells Fargo Economics

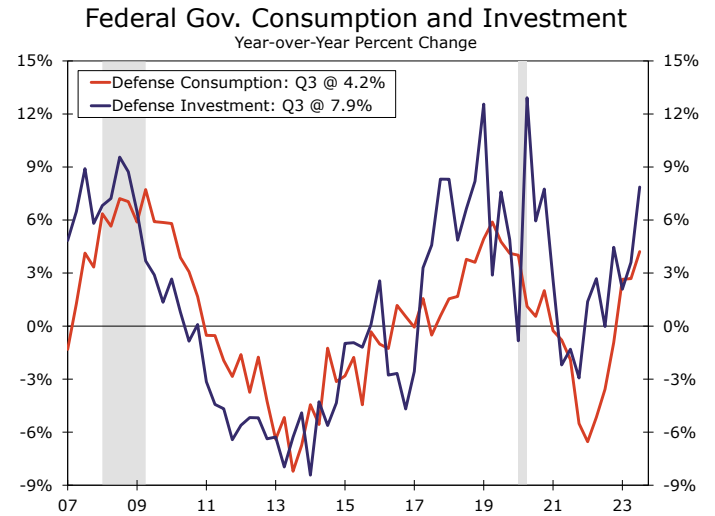
***In inflation adjusted-terms, S&L government spending on structures is growing at the fastest pace in two decades, while equipment investment has also grown at a double-digit pace over the past year.***

Figure 6



Source: Bloomberg Finance L.P. and Wells Fargo Economics

Figure 7



Source: U.S. Department of Commerce and Wells Fargo Economics

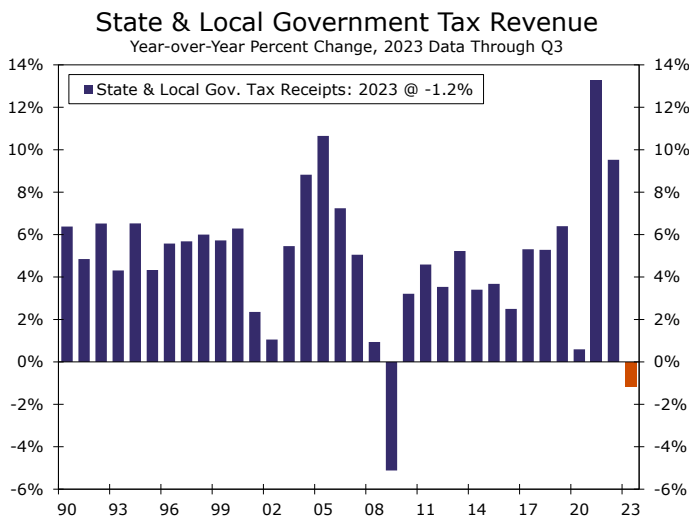
### What Is Driving This Strength?

What is the source of this strength in government output? For state and local governments, the funding has come from a few places. In 2020, state and local government tax revenue was about flat for the year, an impressive feat given the economic carnage that occurred due to the pandemic. In 2021 and 2022, S&L tax receipts surged by 13.2% and 9.5%, respectively, which marked some of the fastest growth rates over the past 30 years (Figure 8). The rapid recovery in employment, robust wage gains and skyrocketing asset prices helped drive these strong tax receipt collections.

**What is the source of this strength in government output? For state and local governments, the funding has come from a few places, most notably strong tax receipt growth and robust federal aid.**

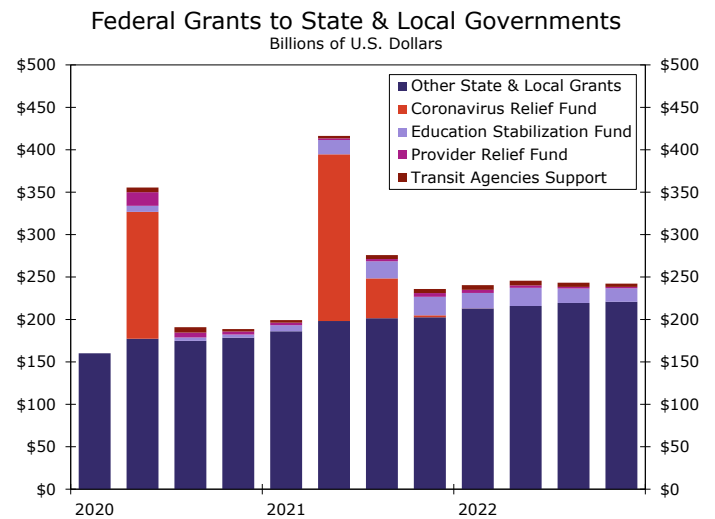
Enormous amounts of COVID aid from the federal government also contributed to the plentiful coffers for S&L governments. The funds originated from a few different bills enacted during the pandemic and came with various strings attached. Some money was specifically for dealing with the public health needs of the pandemic, some funds were targeted at specific S&L government activities such as public transit or education, while other grants were open-ended. In total, S&L governments received more than \$600 billion in pandemic-related grants (Figure 9). This is equivalent to about one quarter of the amount that S&L governments collect in tax revenues in a year.

Figure 8



Source: U.S. Department of Commerce and Wells Fargo Economics

Figure 9

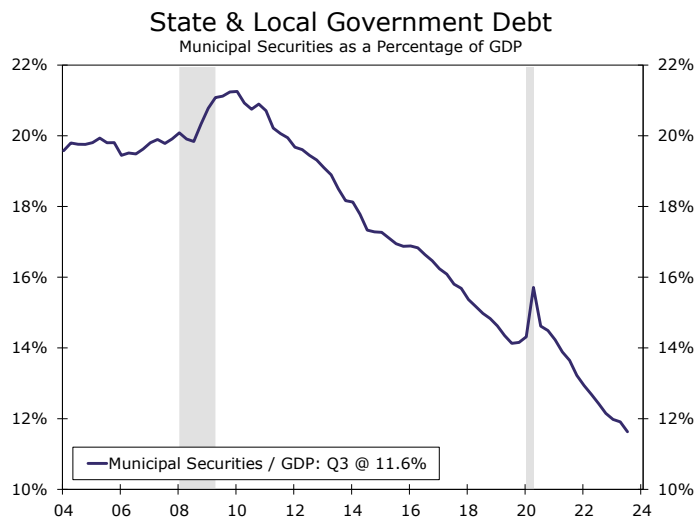


Source: U.S. Department of Commerce and Wells Fargo Economics

The strength in S&L government finances extends beyond just solid inflows from tax revenues and federal aid. From a balance sheet perspective, there are reasons to believe S&L governments are on firmer footing today compared to pre-pandemic. On the asset side, S&L government "rainy day funds" hit an all-time high of 15.4% of expenditures in FY 2022, up from 9.1% in FY 2019 and just 4.8% in FY 2007 on the eve of the Great Recession.<sup>1</sup> On the liability side of the balance sheet, many S&L governments have balanced budget requirements, and thus they tend not to run sizable budget deficits the way that the federal government does. That said, borrowing still does occur, particularly for public investment initiatives. Municipal debt as a share of GDP has fallen over the past several years and is a relatively modest 12% (Figure 10). The other primary liability for S&L governments is the obligation to public sector workers for their retirement pensions. Here too there has been some modest improvement relative to the 2010s. In the aggregate, the S&L pension funding ratio is off its recent high but has risen by nine percentage points since Q4-2019 (Figure 11).

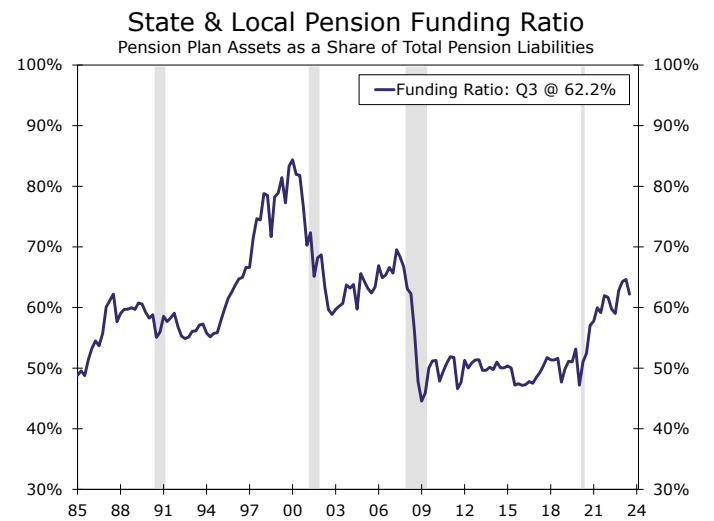
**S&L government "rainy day funds" hit an all-time high of 15.4% of expenditures in FY 2022.**

Figure 10



Source: Federal Reserve Board, U.S. Department of Commerce and Wells Fargo Economics

Figure 11



Source: Federal Reserve Board and Wells Fargo Economics

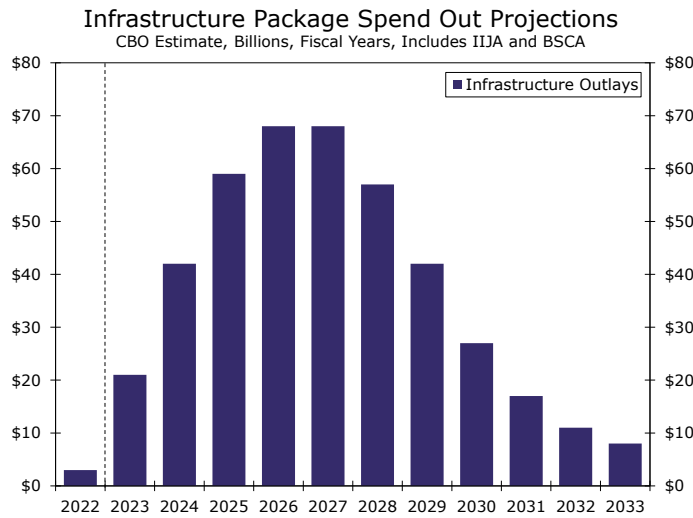
On the federal side of the equation, there have been several policy initiatives that have helped boost federal output growth. At a basic level, annual appropriations for discretionary spending have grown faster in recent years than was the case pre-pandemic. The FY 2022 and 2023 budget agreements increased appropriations by roughly 6% and 9%, respectively. These funds, which are set in the 12 annual appropriation bills, dictate funding for a broad variety of government activities, including national defense, homeland security, environmental protection and education. These spending increases do not include the supplemental funding that has been enacted for natural disasters, the Russia-Ukraine war and other spending deemed emergency in nature.

**More spending on veterans, infrastructure and base federal government operations have boosted federal output growth recently.**

As mentioned earlier, a hiring spree has occurred at the Veterans Health Administration, boosted by the PACT Act which included a variety of new spending for military veterans. The infrastructure bill passed in November 2021 has come online more meaningfully this year, and outlays should continue to climb over the next couple of years as peak spending rates are hit (Figure 12). The major project announcements so far have had a strong bend toward transportation investment including roads, bridges and public transit (Figure 13).

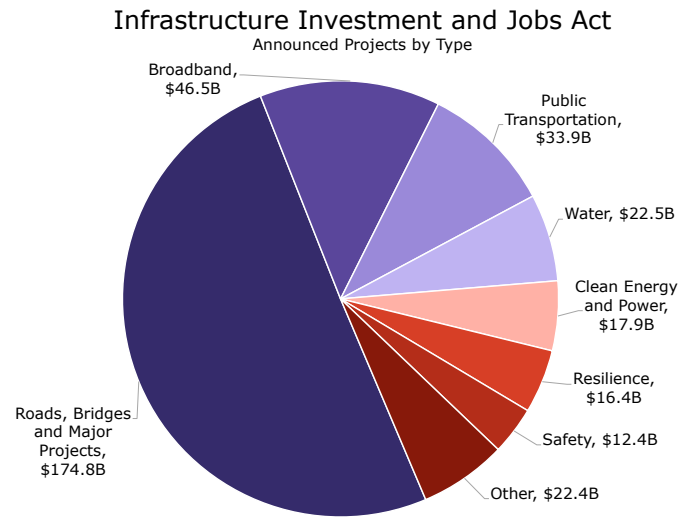
Taken together, these various spending initiatives are boosting federal government output growth. Note, once again, that government hiring and output are not fully inclusive of the federal fiscal policy impulse. For example, the tax credits and revenue raisers in the Inflation Reduction Act may be expansionary/contractionary, but this impact generally would be seen in private consumption, investment and hiring.

Figure 12



Source: Congressional Budget Office, U.S. Department of Commerce and Wells Fargo Economics

Figure 13



Source: U.S. Department of the Treasury and Wells Fargo Economics

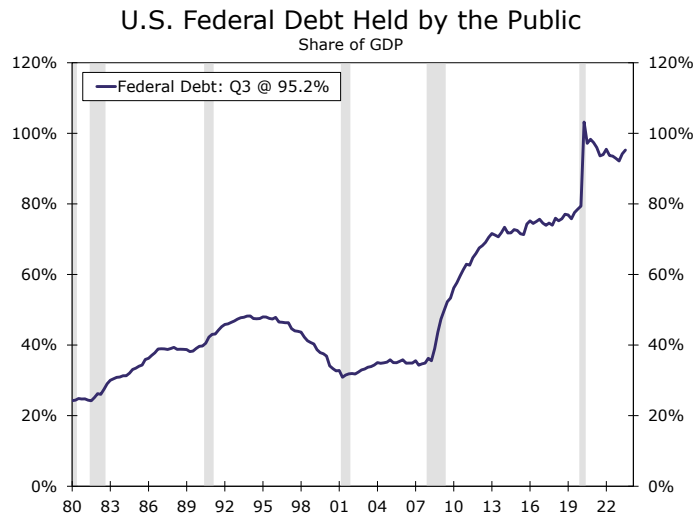
### How Long Will the Boom Last?

In the near term, we believe the solid growth in government hiring and output will continue. S&L governments are still playing catch-up on hiring from the pandemic hit, and this momentum should continue a little while longer. Although S&L tax revenues are not growing as fast as they once were, they are also not collapsing. Federal aid from the pandemic is dwindling much like excess savings are for households, but the available evidence suggests that these funds are not yet fully spent. A study by the Government Accountability Office found that as of March 31 S&L governments had spent less than half of the federally-provided \$350 billion Coronavirus State and Local Fiscal Recovery Funds.<sup>2</sup> Infrastructure funding from the federal government is also still ramping up, and the impact on economic growth likely will not peak for another year or two.

However, we believe the tide is starting to turn. Eventually, federal aid will be exhausted, and S&L tax receipt growth is unlikely to return to double-digit territory anytime soon. At the federal level, the willingness to expand the deficit seems to be waning. There have been no new major fiscal expansions in 2023, a sharp contrast to the numerous bills passed from 2020-2022. Annual funding for the government's base operations appears likely to be roughly flat in FY 2023 after material increases in the preceding few years. As we look to next year, it strikes us as unlikely Congress will pass any new major fiscal initiatives in an election year. More broadly, fiscal austerity as a political issue may be slowly coming back into vogue amid a period of high inflation, elevated federal debt levels and rising interest costs (Figures 14 & 15).

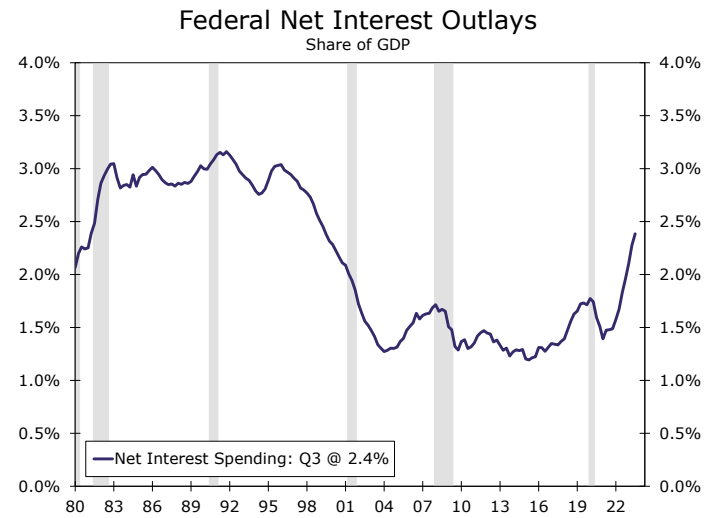
***In the near term, we believe the solid growth in government hiring and output will continue.***

Figure 14



Source: U.S. Department of the Treasury, U.S. Department of Commerce and Wells Fargo Economics

Figure 15



Source: U.S. Department of the Treasury, U.S. Department of Commerce and Wells Fargo Economics

On balance, the fiscal tailwinds are still blowing, but they are not as strong as they once were. We believe they will keep fading as we get closer to 2025 and beyond. Government's direct contribution to real GDP growth of more than half a percentage point this year is unlikely to be sustained over the medium to longer run, in our view. Similarly, we doubt one quarter of nonfarm payroll growth will be derived from the public sector over that time horizon. Government hiring and output can serve as one of the pillars propping up economic growth and the labor market in the near term. That said, this boost will not last forever, and the headwinds from restrictive *monetary* policy are still exerting a drag on the U.S. economy. In order to achieve a “soft landing,” sooner or later a Federal Reserve pivot will be needed to keep this expansion going.

***The fiscal tailwinds are still blowing, but we believe they will fade as we get closer to 2025 and beyond.***

**Endnotes**

1 - National Association of State Budget Officers. [The Fiscal Survey of States: Spring 2023](#). 2023. [\(Return\)](#)

2 - U.S. Government Accountability Office. [COVID-19 Relief: States' and Localities' Fiscal Recovery Funds Spending as of March 31, 2023](#). October 11, 2023. [\(Return\)](#)



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