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The 2024 U.S. Elections Part III: Fiscal Policy Implications

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Summary

The 2024 U.S. election will determine who is in charge of Congress and the White House come January 2025, which will have critical implications for the federal fiscal policy outlook, and by extension, the U.S. economic outlook.

- **The debt ceiling will be reinstated on January 2, 2025**. Our base case is the "X date" (the date when Treasury would be unable to meet all its obligations on time) falls in the summer of 2025. However, there is a risk it falls as early as February 2025.
- **The looming expiration of large parts of the Tax Cuts and Jobs Act (TCJA) at year-end 2025 will be the most important post-election fiscal policy topic, in our view**. The TCJA was enacted in 2017 and reduced taxes for individuals and businesses alike. Though most of the changes for corporations were made permanent, many of the tax changes for individuals and smaller businesses are scheduled to expire.
- **The fiscal cost of extending the TCJA is sizable and comes at a time when budget deficits are already quite large**. The Congressional Budget Office estimates that fully extending the TCJA's expiring provisions would cost $3.5 trillion over the next decade, amounting to deficits that are 1.0-1.5% of GDP larger per year. A one percentage point increase in the structural budget deficit is associated with an increase in longer-term yields on Treasury securities of roughly 15-30 bps, all else equal.
- **Allowing the TCJA to expire would improve the budget imbalance, but it would likely come with some short-run pain**. We doubt that the expiration of the TCJA would be enough to push the economy into a recession single-handedly, but it could knock a few tenths of a percentage point off growth and inflation in 2026.
- **There is significant uncertainty about the impact of tax policy changes that may or may not take effect in 2026**. That said, we want to give readers some rough guideposts on our initial thoughts.
    - ***Republicans sweep***: A Republican sweep seems most likely to result in extending the 2017 tax cuts. An *expansion* of the cuts is more uncertain but strikes us as plausible. Should it occur, more fiscal stimulus should be associated with somewhat faster economic growth, higher inflation, larger budget deficits, higher Treasury yields and a steeper yield curve, all else equal.
    - ***Divided government***: We view a Republican president/Democratic Congress (or vice versa) as the election outcome most likely to yield some fiscal policy tightening on the margin. A partial expiration of the TCJA probably would modestly depress the 2026 outlook for growth, inflation, government borrowing and yields.
    - ***Democrats sweep***: A sweep by the Democrats could also lead to more fiscal policy accommodation, but we suspect Democrats are more inclined to offset new policy initiatives with higher taxes, particularly for higher-earning households and corporations. From an accommodation standpoint, we view this scenario as somewhere between the Republican sweep and divided government scenarios.
- **Serious long-run fiscal challenges are likely to remain regardless of the 2024 election outcome**. Even if the TCJA expires in full as scheduled, federal budget deficits are poised to remain wide in the years ahead (5-6% of GDP) in the absence of even higher federal taxes, entitlement reform or much lower interest rates.

Welcome to the 2024 Election Cycle

The 2024 election cycle has arrived, and with it have come questions about what the election means for the U.S. economic outlook. In Part I of our series on the U.S. presidential election and its implications for the economy, we provided some background on this year's election. In Part II, we reviewed what history tells us about Federal Reserve monetary policy decisions in election years and discussed how election outcomes impact the FOMC. In this report, we explore the post-election fiscal policy outlook. Specifically, we examine the timeline for the next debt ceiling showdown, the outlook for the annual budget process and the economic implications of the looming expiration of large parts of the Tax Cuts and Jobs Act (TCJA).

The First Order of Business: The Nuts and Bolts of Governing

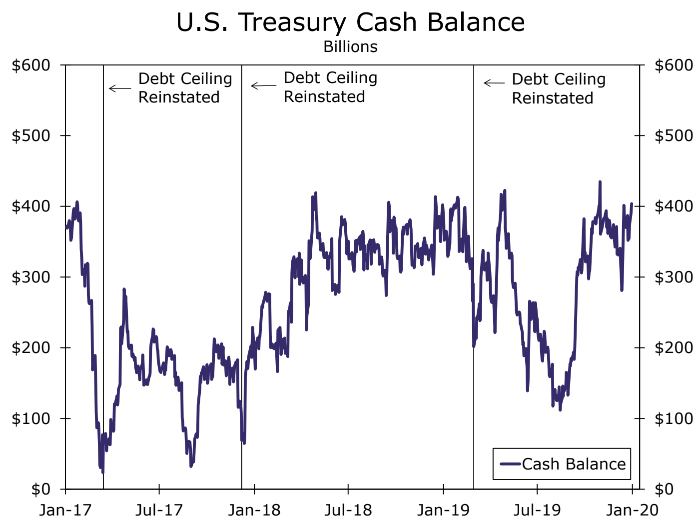
Happy New Year. Now Deal with the Debt Ceiling.

Unless Congress deals with the debt ceiling in advance of its scheduled reinstatement on January 2, 2025, the Treasury will need to tap its cash balance and employ "extraordinary measures" to make up the difference between revenues and outlays.

When the 119th Congress convenes for the first time in January 2025, one of the first orders of business will be dealing with the debt ceiling. As a reminder, the debt ceiling (also known as the debt limit) is a legal limit on the total amount of outstanding debt for the federal government. Since the federal government's revenues are generally less than its outlays, the debt ceiling must be increased periodically to accommodate additional borrowing. The debt ceiling was suspended in June 2023 as part of the Fiscal Responsibility Act (FRA). The FRA suspended the debt ceiling until January 2, 2025, at which point it will be reinstated at the prevailing public debt level on that date. Unless Congress acts in advance of January 1, the U.S. Treasury will need to tap its cash balance and employ "extraordinary measures" to make up the difference between revenues and outlays.

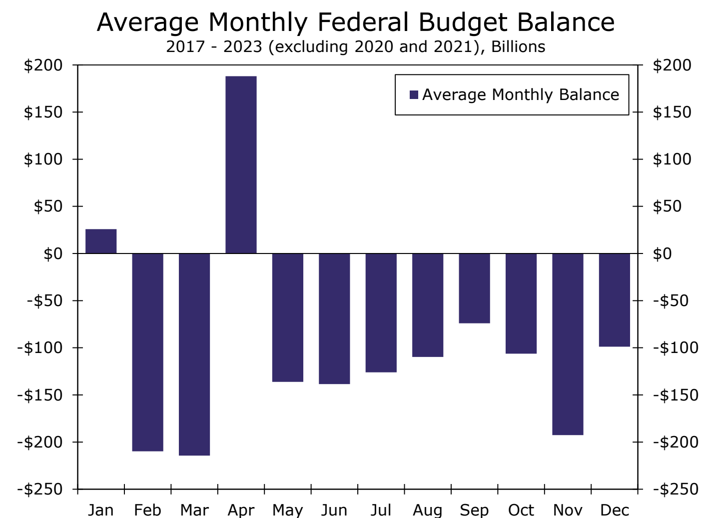
This far out, it is not possible to forecast the "X date," or the date on which the Treasury would be unable to meet all of its obligations on time, with much precision. Uncertainty about the economic and fiscal outlook creates a wide range of possible outcomes. In addition, it remains unclear to us whether Treasury will need to draw down its cash balance in advance of the January 2 debt ceiling reinstatement. The FRA states that the Treasury shall not issue debt for the purpose of increasing its cash balance above "normal operating balances." Our best guess is that the Treasury will be able to maintain business as usual when it comes to running its cash balance in the $700-$800 billion range through year-end. However, there have been instances over the past decade when Treasury felt legally compelled to rapidly reduce its cash balance in the days ahead of a debt ceiling reinstatement (Figure 1). If this were to occur, Treasury could reduce its cash balance down to the ~$50 billion level that prevailed when the FRA was enacted in June 2023. We await further guidance from Treasury on this topic.

Figure 1



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

Figure 2



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

If Treasury *does not* reduce its cash balance to low levels and instead finishes 2024 with its cash balance near current levels (about $750 billion), we suspect the hard deadline for action on the debt ceiling will fall sometime in the summer of 2025. If Treasury *does* reduce its cash balance back to the low level that prevailed in June 2023 when the FRA became law, the "X date" could occur as early as February 2025. February and March typically see large seasonal deficits as income tax refunds are sent out, and under this scenario we doubt Treasury would have the funds necessary to remain solvent until the seasonal April budget surplus (Figure 2).

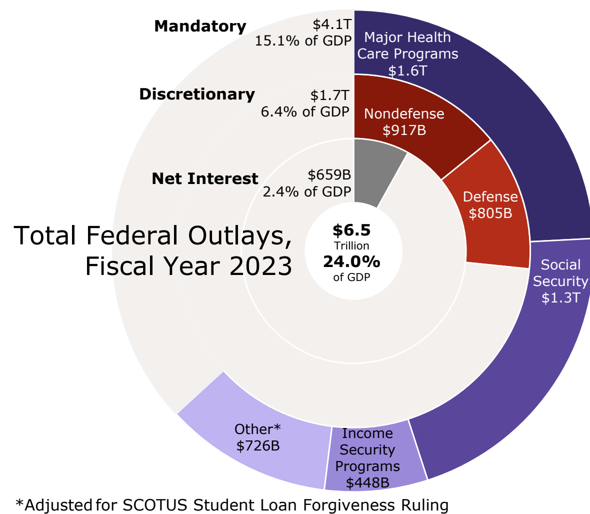
Our base case is that the "X date" falls in the summer of 2025, but there is a risk it could be as early as February 2025.

Appropriations Drama Not Going Away

The incoming Congress will also need to tackle the annual budget. Each year, Congress passes 12 appropriation bills that account for roughly 25% of federal spending. This segment of the federal budget is often referred to as “discretionary” spending given that Congress must appropriate the funds each fiscal year (Figure 3). In contrast, “mandatory” spending is not set during the annual appropriations process. Instead, the level of mandatory spending is dictated by a variety of eligibility requirements, such as income or age. Medicare, Medicaid and Social Security are examples of mandatory spending programs.

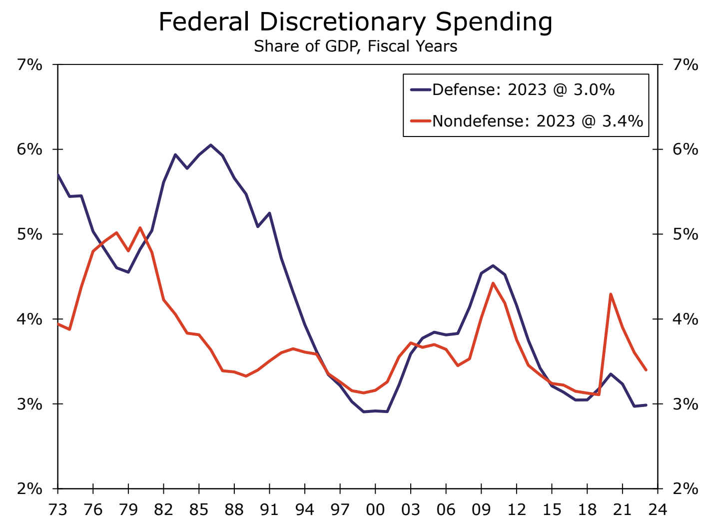
The annual appropriations process for fiscal year (FY) 2024, which began on October 1, has been plagued by challenges. The FRA set caps on defense and nondefense discretionary spending for FY 2024, with defense spending getting about a 3% boost and nondefense spending held roughly flat compared to FY 2023. However, House Republicans' razor-thin majority (219 Rs and 213 Ds at present), internal divisions over the FRA and other political tensions have held up the appropriations process. As we go to print, none of the 12 appropriation bills have become law for FY 2024. Congress has resorted to a series of continuing resolutions to keep the government open and running. FY 2025, which is just seven months away and will begin right before the election, looms as yet another hurdle, as does the ongoing debate about whether to provide supplemental funding for Ukraine, Israel, Indo-Pacific allies and border security.

Figure 3



Source: Congressional Budget Office and Wells Fargo Economics

Figure 4



Source: Congressional Budget Office and Wells Fargo Economics

Our best guess is that Congress will enact a discretionary spending agreement for FY 2024 in the coming weeks, with spending levels roughly in line with the FRA. The impact on the economic outlook of such a move would be negligible and is already baked into our forecast. For FY 2025, it would not surprise us if Congress passes a continuing resolution this fall that punts the FY 2025 decisions until after the election. This would tee up a broader negotiation on discretionary spending and the debt ceiling for the lame duck session of Congress or the new one that will begin in January.

Regardless of the election outcome, budget pressures emanating from tax cuts and rising mandatory spending are likely to keep discretionary spending growing at a relatively modest pace in the coming years.

Regardless of the election outcome, discretionary spending generally has been on a downward trajectory as a share of the economy in recent years. At 3% of GDP, spending on national defense is near the lows of the past half century, and nondefense spending is set to reach a similar level in FY 2024 and FY 2025 as the pandemic-induced spending bump continues to fade (Figure 4). In our view,

the budget pressures emanating from tax cuts and rising outlays on mandatory spending (more on those later) are likely to keep discretionary spending growing at a relatively modest pace of in the coming years.

TCJA: The Defining Four Letters of Fiscal Policy in 2025

The fiscal policy agenda item that we believe will most impact the economic outlook is the looming expiration of large parts of the Tax Cuts and Jobs Act (TCJA).[1] The TCJA was enacted in December 2017 under President Donald Trump, and the legislation made sweeping changes to the federal tax code. The corporate income tax rate was reduced from 35% to 21%, individual income tax brackets were slashed across-the-board and the standard deduction was doubled, among numerous other changes. Budget analysts estimated at the time that the law would reduce federal revenues by about $1.5 trillion on net over the following decade.[2]

The fiscal policy agenda item we believe will most impact the economic outlook is the looming expiration of much of the Tax Cuts and Jobs Act. Large parts of the law have sunset dates at year-end 2025, setting up a miniature "fiscal cliff."

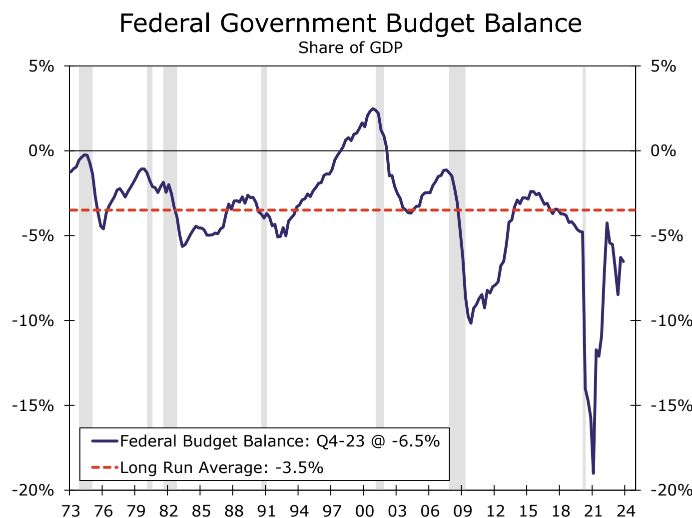
However, large parts of the law are set to expire at year-end 2025, setting up a miniature "fiscal cliff" with which policymakers will need to grapple next year. Democrats did not support the TCJA, and as a result Republicans resorted to a process known as budget reconciliation that allowed them to bypass a Senate filibuster. This approach had the advantage of lowering the threshold for passage in the Senate from a de facto 60 votes to a simple majority of 51, but it came with a major drawback: a reconciliation bill cannot increase the budget deficit *beyond* the budget window (traditionally 10 years). In order to comply with this rule, Republicans sunsetted some of the TCJA for nearly a decade later.

A full list of the expiring provisions in the TCJA can be found here. In short, most of the corporate tax policy changes were made permanent under the TCJA, while many of the changes to the individual income tax code are scheduled to lapse. For example, the reduction in the corporate income tax rate to 21% is not scheduled to change under current law. However, many individual income tax cuts (the lower tax brackets, higher standard deduction, expanded child tax credit, etc.) as well as many individual income tax increases (the elimination of personal exemptions, the cap on the state and local tax deduction, tighter restrictions on mortgage interest deductibility, etc.) are slated to expire in 2025.

The path forward for tax policy will have important implications for the federal budget and U.S. economy. The fiscal cost of extending the tax cuts is sizable and comes at a time when federal budget deficits are already quite large (Figure 5). The Congressional Budget Office (CBO) estimates that fully extending the TCJA's expiring provisions would cost $3.5 trillion over the next decade, inclusive of debt service costs.[3] Budget deficits would be $400-$500 billion larger per year starting in fiscal year 2027 compared to a baseline that assumes the tax cuts expire as scheduled. This amounts to deficits that are 1.0-1.5% of GDP larger per year (Figure 6). A separate analysis from the Penn Wharton Budget Model projects that federal debt held by the public would be 261% of GDP in 2050 if the tax cuts are extended, compared to 226% of GDP if they are allowed to lapse.[4]

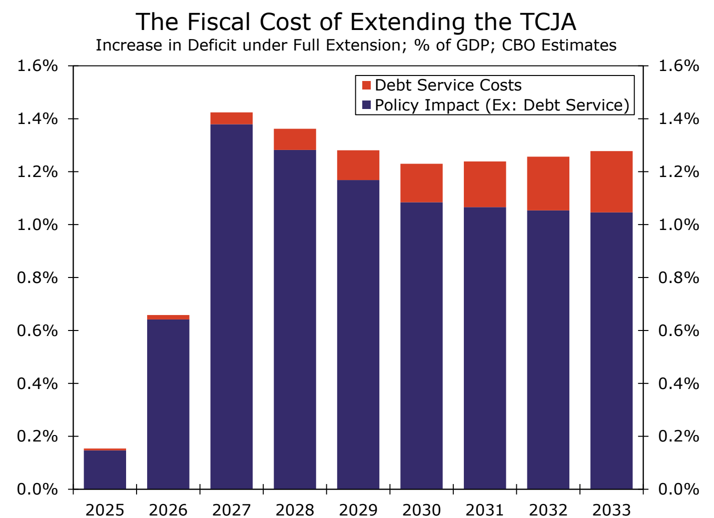
The CBO estimates that fully extending the TCJA's expiring provisions would cost $3.5 trillion over the next decade, inclusive of debt service costs.

Figure 5



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

Figure 6



Source: Congressional Budget Office and Wells Fargo Economics

Of course, fiscal tightening via higher taxes would improve the budget imbalance, but it would likely come with some short-run economic pain. We doubt that the expiration of the TCJA would be enough to knock the U.S. economy into a recession single-handedly. The U.S. economy avoided a recession in 2013 when the belt tightening from the original "fiscal cliff" was much larger.[5] Furthermore, CBO estimated in 2018 that the tax cuts would boost real GDP growth by about 0.3 percentage points per year in 2018 and 2019, with the positive impulse to growth fading thereafter.[6] Subsequent research suggests CBO's initial estimate likely was in the ballpark.[7] This time around, CBO's baseline economic projections suggest that the *hit* to economic growth from the expiration of the TCJA would be just a couple tenths of a percentage point.[8] A slowdown of this magnitude probably would not cause a recession for an economy that is growing at about 2% per year on trend, although the ultimate outcome will depend on the state of the economy at that point in time.

We doubt that the expiration of the TCJA would be enough to knock the U.S. economy into a recession single-handedly.

Election Scenario Analysis: The TCJA

It is very difficult to project the countless permutations of the tax code that could emerge on the other side of the 2025 deadline. At the micro level, the fortunes of each individual provision of the tax code will be rigorously fought over. At the macro level, there is also significant uncertainty. Sitting in March 2024, we must remain humble about being too precise when discussing the economic impact of tax policy changes that may or may not take effect in 2026. That said, we want to give our readers some rough guideposts and rules of thumb with which to work, and we do believe there are some initial positions that have been staked out on the looming tax policy debate.

Republicans Sweep

If Republicans gain control of Congress and the White House, we believe they will make it a priority to protect the TCJA. An extension of the existing tax cuts seems most likely in our view. Given the rules of budget reconciliation, it might once again prove challenging to make these tax cuts permanent. Another sunsetting several years down the road might be needed to remain compliant with budget reconciliation, particularly if Republicans wish to *expand* the TCJA, i.e. make the tax cuts bigger.

It is important to remember that extending the TCJA simply maintains the current policy status quo. Under this scenario, households and businesses will not see any new reduction in their tax burden. Rather, they would just avoid the tax *increases* that would have occurred in the absence of Congressional action. This dynamic may create political pressure to reduce taxes further in order to achieve something new. At a recent rally in South Carolina, Donald Trump suggested that additional tax cuts would be on the table.[9]

A Republican sweep of Congress and the White House would most likely lead to an extension, and possibly an expansion, of the TCJA.

Extending the TCJA would be a continuation of current policy and probably would not warrant any major forecast revisions on our part. *Expanding* the tax cuts is far more uncertain and difficult to assess, but if it becomes probable, we would need to incorporate additional fiscal stimulus into our forecast. If realized, these forecast revisions would be largely dependent on the magnitude and structure of the stimulus, in addition to the state of the U.S. economy at that time. More stimulus in an economy with a negative output gap likely would boost economic growth, while more accommodation in an economy with a positive output gap would only stoke more inflation.

On balance, this election scenario strikes us as the most likely one to include more fiscal stimulus, or at least no fiscal tightening. That said, the original TCJA illustrates that even a fairly sizable bill may only move economic growth and inflation forecasts by a few tenths of a percentage point. More fiscal stimulus likely would also be associated with larger budget deficits, higher Treasury yields and a steeper yield curve, all else equal. As we have written previously, a general rule of thumb that emerges from the research literature is that a one percentage point increase in the structural budget deficit is associated with an increase in longer-term yields on Treasury securities of roughly 15-30 bps, all else equal.

Divided Government

Under divided government, the two parties will need to work together to handle the looming TCJA expiration. We anticipate that some but not all the TCJA would be extended under a Republican White House and Democratic Congress (or vice versa). Treasury Secretary Janet Yellen has suggested that a second term Biden administration would seek to retain the tax cuts for households earning less than $400,000 per year.[10] A similar dynamic occurred in 2012-2013 during that period's "fiscal cliff" debate. Expiring tax cuts paired with a slew of spending cuts threatened to materially tighten fiscal policy at a time when the unemployment rate was near 8%. Then Vice President Joe Biden helped

We think a divided government scenario is most likely to yield some modest fiscal tightening.

negotiate a deal that extended most tax cuts for earners below certain income thresholds, while allowing the tax cuts to lapse for higher earners.

We would expect something similar to occur in 2025 should the election yield a divided government outcome. Some modest fiscal tightening may occur via higher taxes on upper-income households. Under this scenario, we doubt our forecast adjustments would be major, as this outcome is not too much of a departure from the status quo. With so much uncertainty about the specifics and a long way to go until 2026, quantifying the magnitude of such an outcome is difficult. That said, a partial extension of the TCJA along these lines probably would dent economic growth and inflation in 2026 by just a couple tenths of a percentage point. We would expect smaller budget deficits, lower Treasury yields and a flatter yield curve, all else equal, with the magnitude of the change for these variables relatively modest.

Democrats Sweep

As we wrote in Part I of our election series, the challenging Senate map for Democrats makes a sweep for the party a steeper hill to climb. That said, Election Day remains a long ways away, and a Democratic sweep is far from impossible. We doubt Democrats would allow the TCJA to completely expire as scheduled. As mentioned earlier, the Biden administration has signaled support for extending the tax cuts for households below a certain income threshold. That said, Democrats may want to pair higher taxes on the wealthy and corporations with additional spending on some of their policy priorities. For example, Democrats could seek to make permanent more generous Affordable Care Act (ACA) subsidies for purchasing health insurance, a current policy in the Inflation Reduction Act that also lapses at year-end 2025.

That said, another bill that is similar to the Inflation Reduction Act probably would not have sweeping implications for our macroeconomic forecast. Higher taxes suggest some fiscal tightening on the margin, but greater spending and/or more generous tax credits for things like purchasing health insurance and green energy development provide an offsetting tailwind. The Biden administration's sizable COVID relief bill, the American Rescue Plan, supercharged the economic recovery and had major implications for the outlook at that time. But, the unusual pandemic-induced circumstances make another such bill unlikely, in our view.

Even if Democrats sweep on Election Day, we doubt they would allow the TCJA to completely expire as scheduled.

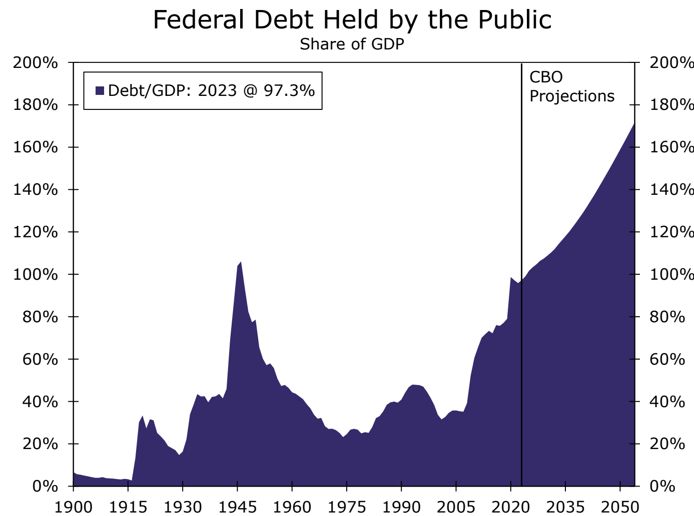
We view the fiscal impact of this scenario as between the Republican sweep and divided government scenarios. Our best guess is that Democrats would extend the TCJA for earners below the $400K income threshold while letting higher tax rates take effect for upper-income earners. These tax increases may be paired with some marginal expansions of spending on Democratic priorities, such as ACA health insurance subsidies and green energy initiatives. On balance, we are skeptical that these policies would have a major impact on our forecasts for economic growth, inflation, budget deficits or Treasury yields in 2026/2027.

Longer-Run Fiscal Outlook: Challenges Under All Scenarios

Taking a step back, what about the longer-run fiscal outlook? Even if the TCJA expires in full as scheduled, federal budget deficits are poised to remain wide in the years ahead. CBO's baseline 10-year outlook uses current law for its assumptions, and as a result, the expiration of the TCJA is included in its projections. Despite a boost to tax collections starting in 2026, CBO still expects the debt-to-GDP ratio to rise substantially in the years ahead (Figure 7). Federal spending that is above its long-run average is primarily driven by the rising costs of mandatory spending programs such as Social Security and Medicare as well as higher interest costs on the national debt, issues we covered in a recent special report (Figure 8). Neither party's leading candidate for president seem keen on materially reducing mandatory spending growth, and absent even larger increases in federal taxes, federal budget deficits are likely to remain large for the foreseeable future. In a recent interview with 60 minutes, Chair Powell made clear that the "U.S. is on an unsustainable fiscal path." We agree with that assessment, but based on what we know now, sweeping fiscal reform that would narrow the fiscal imbalance seems unlikely in the aftermath of the 2024 election.

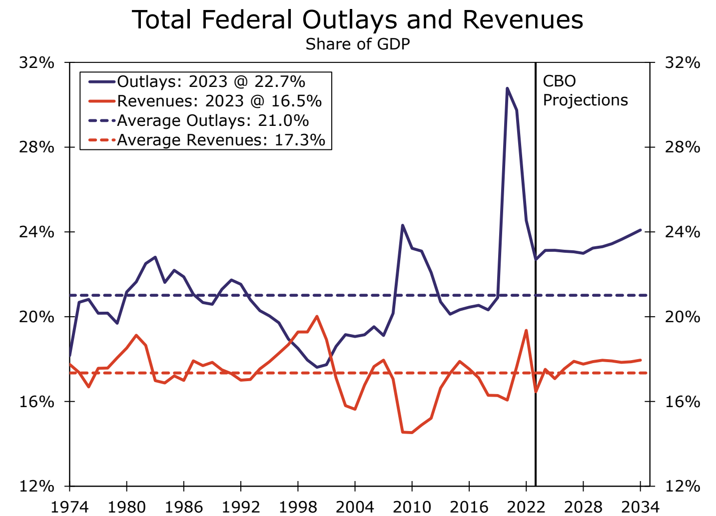
Neither party's leading candidate for president seem keen on materially reducing mandatory spending growth. Absent even larger increases in federal taxes, federal budget deficits are likely to remain large for the foreseeable future.

Figure 7



Source: Congressional Budget Office and Wells Fargo Economics

Figure 8



Source: Congressional Budget Office and Wells Fargo Economics

Conclusion: Elections Have Consequences

Monetary policy often steals the spotlight from its fiscal policy sibling as markets hang onto every word from the nation's central bankers. Yet, the power to tax and spend has critical implications for both short- and long-run economic outcomes. The 2024 election will determine who is in charge come January 2025, and the incoming fiscal policymakers will face difficult decisions. Fiscal restraint in the form of higher taxes and/or lower spending can dent economic growth and the labor market in the near term, but a perpetual, yawning gap between revenues and outlays creates its own set of long-run economic problems.

The debt ceiling and annual budget process will undoubtedly create ripples in financial markets and in the economic outlook after the election. However, in our view, the most important fiscal policy topic in 2025 will be the debate over the looming expiration of the TCJA. We expect both parties to have interest in retaining parts of the law, but Republicans seem far more likely to maintain or even expand the landmark tax cut bill enacted under former president Donald Trump. Given this, and given that tax policy changes fit well within the rules of budget reconciliation, we think a Republican sweep of the White House and Congress is most likely to yield more fiscal stimulus, or at least no fiscal tightening.

A sweep by the Democrats could also lead to more fiscal policy accommodation, but we believe there are a couple of reasons this may be less likely. We suspect Democrats may be more interested in offsetting new policy initiatives with higher taxes, particularly for higher-earning households and corporations. In addition, some Democratic policy priorities may be harder to squeeze into the rigid budget reconciliation process. Divided government seems most likely to yield some marginal fiscal policy tightening, in our view. Regardless of who wins, serious long-run fiscal challenges are likely to remain amid an aging population, rising outlays on mandatory spending programs and rapidly growing debt service costs.

Election Day is still roughly eight months away, and it will be even longer before the fiscal policy decisions of the new president and Congress are felt in the U.S. economy. As we get closer to 2025, we will update and refine our analysis for the U.S. economic and fiscal policy outlook. Stay tuned.

Endnotes

1 – Technically, the 2017 tax law is "An Act to provide for reconciliation pursuant to titles II and V of the concurrent resolution on the budget for fiscal year 2018." For brevity's sake, we refer to it by its colloquial name, the Tax Cuts and Jobs Act. (Return)

2 – The Joint Committee on Taxation. Estimated Budget Effects Of The Conference Agreement For H.R.1, The Tax Cuts And Jobs Act. *JCX-67-17*. December 18, 2017. (Return)

3 – Congressional Budget Office. Budgetary Outcomes Under Alternative Assumptions About Spending and Revenues. May 16, 2023. (Return)

4 – Penn Wharton Budget Model at the University of Pennsylvania. The Long-Term Budget Effects of Permanently Extending the 2017 Tax Cuts and Job Act's Expiring Provisions. April 11, 2023. (Return)

5 – For more detail on the fiscal drag on the economy around this time see Jane G. Gravelle. "The "Fiscal Cliff": Macroeconomic Consequences of Tax Increases and Spending Cuts." Congressional Research Service. January 9, 2013; and Parinitha Sastry and Louise Sheiner. "The Fiscal Headwinds Have Finally Subsided." The Hutchins Center on Fiscal and Monetary Policy at The Brookings Institution. November 3, 2014. (Return)

6 – See Table B-2. Congressional Budget Office. The Budget and Economic Outlook: 2018 to 2028. April 2018. (Return)

7 – Congressional Research Service. "The Economic Effects of the 2017 Tax Revision: Preliminary Observations." June 7, 2019; and Filippo Occhino. "The Macroeconomic Effects of the Tax Cuts and Jobs Act." Federal Reserve Bank of Cleveland. December 13, 2019. (Return)

8 – Congressional Budget Office. The Budget and Economic Outlook: 2024 to 2034. February 7, 2024. (Return)

9 – Stephanie Lai. "Trump Pledges to Slash Taxes If He Returns to the White House." Bloomberg. February 23, 2024. (Return)

10 – Christopher Condon. "Yellen Says Biden Would Seek Extension of Some Trump Tax Cuts." Bloomberg. January 25, 2024. (Return)

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