

Taxing Times Ahead

America's good fortune with interest rates may be about to change.

By Carl Tannenbaum



Spring is spreading across the Northern Hemisphere. Fruit trees are blossoming, birds are nesting and patio furniture is being uncovered. The spring holidays (Easter, Passover, Ramadan) are being celebrated, with families able to gather in larger numbers in the wake of COVID's decline. The spirit of renewal that attends the season has been especially powerful this year.

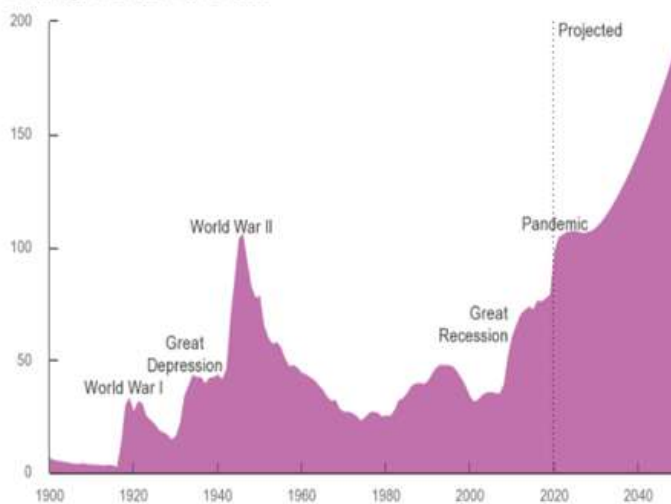
All of this was very uplifting. But then, I realized that my taxes were due.

No one likes preparing tax returns. The United States has one of the most complicated tax codes in the world; the rules currently cover more than 70,000 pages. The Internal Revenue Service (IRS) estimates that the average American spends 13 hours assembling the needed documents; by contrast, a number of countries do tax preparation for their citizens. Every April, I consider moving to one of them.

It's not just the time required to prepare a return, of course. Most people think their taxes are too high, and mumble about government waste when hitting the send key to file. But as discontending as the process is today, it will likely become much more so in the years ahead. The national debt has mushroomed, and rising interest rates will make it harder to service. Society may finally be putting the pandemic in the past, but the bill for surviving it is coming due.

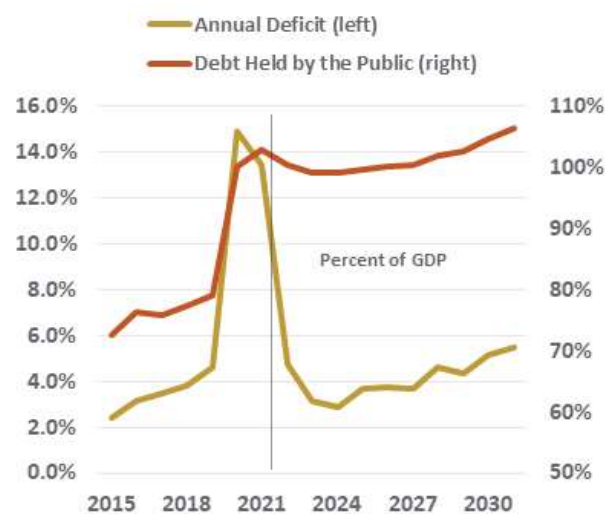
Federal Debt Held by the Public, 1900 to 2050

Percentage of Gross Domestic Product



Source: Congressional Budget Office

**U.S. Budget:
Recent History and Projections**



The United States was not in the strongest fiscal position before COVID-19 arrived. The economic repair after the 2008 financial crisis doubled the ratio of Federal debt to gross domestic product (GDP). Long-term budget projections assembled prior to the pandemic, which reflect the costs of increased retirement, suggested that borrowing could reach 200% of GDP by the middle of the century.

That would be double our previous high of 100%, which was reached after World War II. We were fortunate in the decades that followed that War: favorable demographics and an economic boom allowed the United States to grow its way out of debt. Unfortunately, our population and our economic potential are much more limited this time around, making it unlikely that we will enjoy a repeat performance.

The pandemic had a profound impact on the U.S. federal budget. Fiscal initiatives amounting to 26% of GDP were implemented to safeguard public health and backstop the economy. The menu of programs was broad: stimulus checks, supplemental unemployment benefits and aid

to small businesses topped the card. This produced an annual deficit of more than \$3 trillion in 2020.

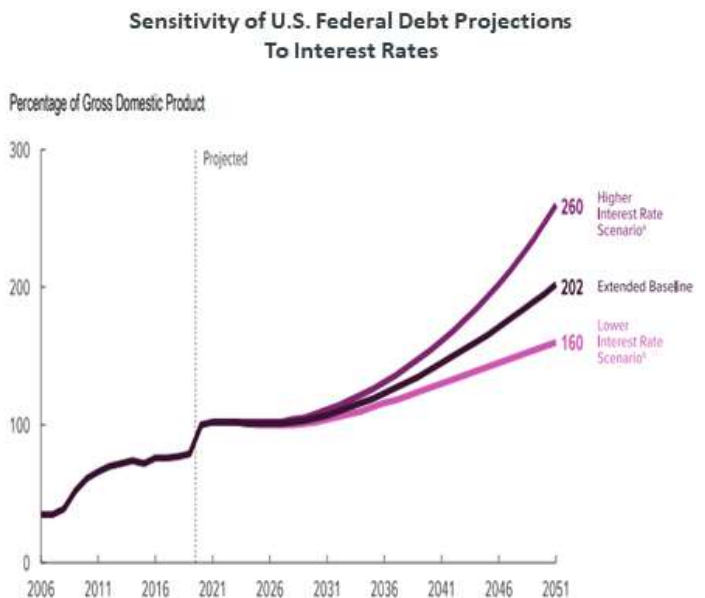
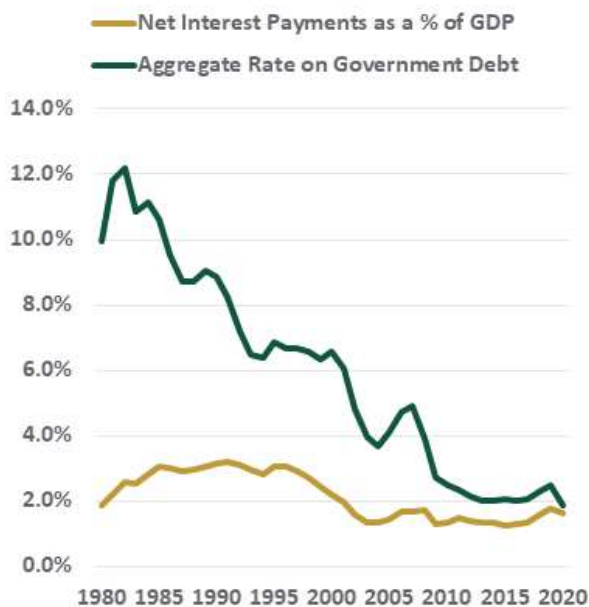
The outlays were viewed as necessary to avoid a very serious economic downturn. They were successful in that mission: the recession of 2020 was one of the shortest on record. Output surpassed its pre-pandemic level in the third quarter of last year, and the American unemployment rate is once again well under 4%.

With the benefit of hindsight, pandemic relief was excessive.

In hindsight, the amounts of money spent to overcome COVID-19 were more than adequate. There remain unspent pandemic relief funds in several government programs, and on the balance sheets of millions of households. The excess demand generated has contributed to the recent rise in inflation, which stands at a 40-year high.

But it is difficult to criticize fiscal policy in retrospect. When rescue programs were initiated, time was of the essence and uncertainty was extreme. Congress deemed the risk of doing too little to be greater than the risk of doing too much; deficit spending was viewed as an investment in preserving economic health, and thereby the tax base.

The consequences of the overshoot on borrowing costs have been modest, at least so far. Despite a massive increase in Treasury debt, interest rates have remained very well behaved. Demand for government bonds has stayed strong in spite of record performances by equity markets. The yield on the 10-year U.S. Treasury note only recently surpassed its pre-pandemic level.



Sources: Haver Analytics, CBO

More broadly, the average rate on Treasury borrowings has been on a 40-year decline. Federal interest payments as a percent of GDP have remained relatively stable, even though the national debt has expanded by 25 times during that interval. That illustrates a key element of debt sustainability: as long as the rate of economic growth exceeds the rate of interest paid on borrowing, the risk of running deficits is manageable

But applying this rubric to the future offers cause for concern. Over the long term, the potential growth rate for the U.S. is modest. Demographic trends have already limited the size of the labor force; **productivity growth** has been good over the past two years, but some of this result is due to **labor force limitations** created by the pandemic.

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On the other side of the equation, long-term interest rates have nearly doubled this year. The Congressional Budget Office (CBO) estimates that higher borrowing costs could have an immense impact on the national debt through the middle of the century.

It is impossible to contain interest costs without containing other types of spending.

Mandatory programs, Social Security and Medicare chief among them, account for three-quarters of non-interest expenditures. The aging of the American population will create substantial escalation in social costs in coming decades; this is a central driver of future debt projections. Military costs account for another 12% of non-interest spending; geopolitical uncertainty probably rules out a "peace dividend."

Congress has proven very reluctant to tackle these major areas, because they are politically sensitive. The fact that borrowing has been inexpensive has allowed legislators to defer difficult budget choices, but that comfort may diminish as interest rates increase.

So as unpleasant as tax season may be this year, we might one day look back on the present and conclude that things weren't so bad.

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Carl R. Tannenbaum

Executive Vice President and Chief Economist

Carl Tannenbaum is the Chief Economist for Northern Trust. In this role, he briefs clients and colleagues on the economy and business conditions, prepares the bank's official economic outlook and participates in forecast surveys. He is a member of Northern Trust's investment policy committee, its capital committee, and its asset/liability management committee.