WEEKLY ECONOMIC COMMENTARY

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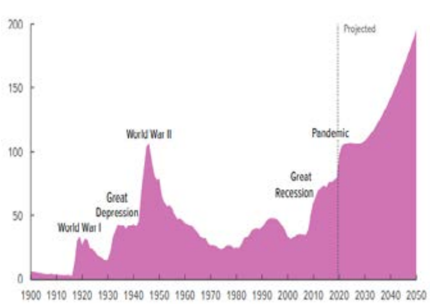
Editor's Note: This is the first in a series of pieces that will examine key economic issues surrounding the 2020 U.S. election.

Almost 40 years ago, Ronald Reagan was elected president of the United States. He came into office promising to cut taxes and shrink government. His advisors suggested that low taxes would benefit economic growth, resulting in a balanced budget. This approach became known as "supply-side" economics, and it has informed Republican platforms ever since.

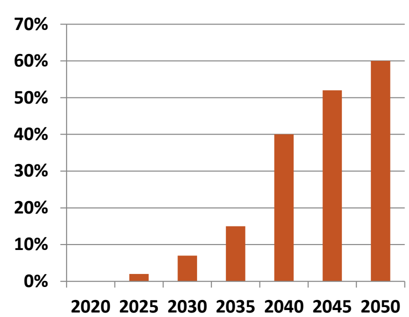
Contrary to expectations, the U.S. federal deficit more than doubled during the first two years of the Reagan administration. U.S. debt grew from 31% of gross domestic product (GDP) in 1980 to 40% by the end of 1984. Changing tune, supply-siders began to embrace the notion that deficits don't matter.

In the present day, the United States is certainly putting that contention to the test. The federal deficit will come in at around 16% of GDP this year, and federal debt is now 100% of GDP, its highest level since the end of World War II. The situation is poised to get considerably worse in the years ahead, but neither political party seems especially interested in doing much to correct the situation.

Projected U.S. Federal Debt (% of GDP)



Increase to Federal Debt If Tax Cuts Made Permanent and Discretionary Spending Escalates By The Rate Of Inflation



Sources: Congressional Budget Office, Brookings Institute

There is no sugar-coating the sorry state of the nation's finances. The Congressional Budget Office (CBO) released updated long-term estimates this week that illustrate significant deterioration in the nation's past and prospective finances. Over the next 30 years, the national debt is forecasted to approach 200% of GDP, a shocking figure.

And the reality may be even worse. The CBO analysis is required to assume that recent tax reductions will be allowed to expire as scheduled, and that spending programs that have expiration dates will not be renewed. In reality, both of these policies are likely to be extended, making the true debt picture substantially worse.

There are three main contributors to this situation. First, supply-side theories have not worked out well in practice. As a recent example, the White House projected that the tax cuts implemented at the end of 2017 would support real economic growth of 3% annually. That number was viewed skeptically at the time, as it was substantially higher than private estimates.

Slow growth, pandemic relief, and demographics are headwinds for the U.S. budget.

In reality, real growth averaged 2.5% in 2018 and 2019, before the pandemic hit. Looking ahead, the CBO projects long-term real growth of just 1.6% annually. The underperformance of growth relative to the figure assumed in the legislation will translate into trillions of dollars of additional debt in the coming decades.

The second contributor is the pandemic. Almost $3 trillion in spending and lending programs was approved with wide bipartisan support last spring, as part of an effort to offset the economic damage caused by COVID-19. The effort has been expensive, but without prompt corrective action, the economy would have endured a much more severe recession that would likely have left an even deeper hole in the federal budget. As we have discussed, more support will likely be necessary to keep the recovery going.

The final contributor is the long-term impact of demographics on the federal budget. As the country ages, the costs of Social Security and Medicare will increase substantially. The fiscal challenge posed by the retirement of the baby boom generation was apparent 30 years ago, but neither party has shown an appetite to tread on what some have called the third rail of American politics.

Regardless of the 2020 election outcome, deepening indebtedness is likely in the years ahead. While the course of policy will depend importantly on who controls the White House and Congress, neither side seems inclined to tighten the nation's fiscal belt. Details on the fiscal plans of the presidential candidates can be found here; some highlights follow.

JOE BIDEN	POLICY AREA	DONALD TRUMP
• Retrace some of the 2017 Tax Cut and Jobs Act (TCJA) tax reductions and raise capital gains taxes • Limit itemized deductions • Restore estate tax rates to "historic norms"	**Taxes**	• Extend TCJA provisions beyond 2025 • Reduce income tax on the middle class by 10% • Reduce the 22% tax bracket to 15%
Proposes a $1.7 trillion infrastructure plan, focused on clean energy, broadband, and transportation.	**Infrastructure**	Proposed two infrastructure plans during his first presidential term – one for $1.5 trillion, the other $2 trillion.
• Student debt forgiveness; free community and public college • Broader public medical coverage; allow Medicare to negotiate drug prices	**Spending**	• Tighter screening for disability benefits • Reductions in Medicare and Medicaid spending, including drug prices

The Biden campaign intends to reverse some of the 2017 tax reductions, but also plans to expand spending. Higher taxes on corporate profits and capital gains could diminish capital formation and prompt global companies to move operations offshore. To discourage companies from relocating, the Democratic platform includes a series of restrictions and disincentives.

On the spending side, the Biden campaign advocates additional outlays for public health programs, tuition subsidies and student debt forgiveness. This is part of a Democratic push for more "inclusive" capitalism, an effort that includes an increase in the federal minimum wage.

Should the Republicans control the economic agenda, additional tax cuts would be considered. Reductions in payroll taxes and capital gains taxes have already been proposed. On the spending side, the Trump platform would seek reductions in Medicare and Medicaid spending.

Interestingly, both sides have included infrastructure investment on their list of priorities. Apart from long-overdue maintenance on physical infrastructure, both campaigns are seeking to modernize the country's digital infrastructure. (The importance of upgrading the nation's wireless networks has been highlighted during the pandemic.) With bipartisan interest, infrastructure spending could progress even in the case of divided government.

It isn't clear which party's platform will be harder on the Federal budget.

Exactly how the competing platforms will affect the federal budget is difficult to discern. Both spending programs and tax reductions can increase the rate of economic growth, broadening the tax base and producing new revenues. The degree to which these offsets will accrue is the topic of considerable debate, with differences of opinion often following ideological lines. With so few specifics and such uncertain math, it is not possible to say which party's platform will be more fiscally responsible.

The United States has been very fortunate that the rapid rise in national debt and the promise of more to come has not triggered an increase in borrowing costs. But its lack of fiscal discipline may one day test the patience of investors, leading them to demand higher rates. Rising interest expense could make the national debt unsustainable.

In sum, deficits may indeed come to matter someday. Our elected officials must do more to ensure that day never comes.

National Insecurity

National security is a broad term invoked by political leaders seeking to protect their sovereignty, territorial integrity and internal stability from external forces. But an increasing number of countries are using concerns over national security to justify changes to economic policies. In many cases, China is the target of nations' renewed focus on economic security.

China, often called the world's factory because of its manufacturing prowess, grew quickly from a global manufacturer into a global investor. Increasing outbound foreign direct investment (FDI) is part of Beijing's long-term economic and political strategy. Foreign investments offer Beijing a platform not just for bolstering its own economy through increased exports, but also for leveraging its economic muscle to increase its influence overseas.

The "Go Out" policy, announced in 2000, is at the center of these efforts. Chinese firms have quickly emerged as prominent global investors in important sectors like infrastructure, energy, telecommunications and technology. Starting in the early 2000s, foreign investments by Chinese enterprises grew at a rapid pace, reaching a peak of $196 billion in 2016. Despite a drop in recent years, China remains the world's third-largest foreign investor, after the U.S. and Japan.

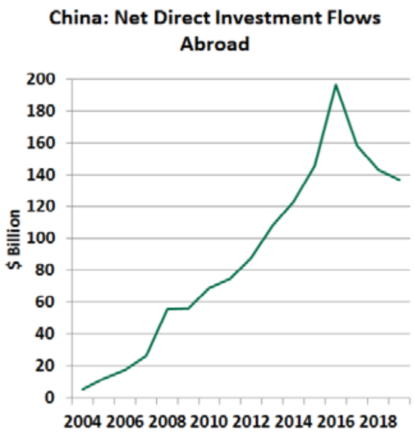
While China's investment program was intended to earn influence, it has also attracted apprehension. Governments around the globe are increasingly pushing back on investments from China, especially in the technology space. Concerns over surveillance and the vulnerability of domestic providers have prompted restrictions on national security grounds.

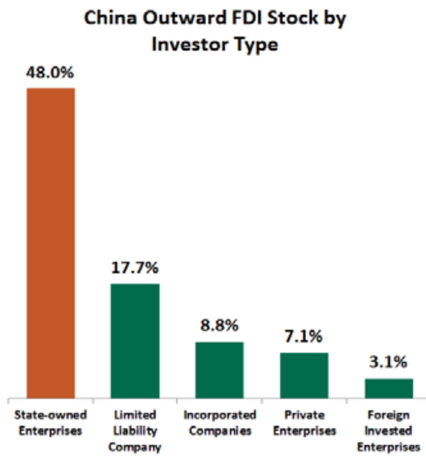
European nations are pushing for more stringent screening of foreign investments. Australia has blocked bids by Chinese companies for domestic corporations. A Chinese takeover of a major Canadian contractor was prohibited by the Canadian government. India has stepped up scrutiny of

Chinese foreign direct and portfolio investment to avoid takeovers of firms weakened by the pandemic.

China's much-touted Belt and Road Initiative (BRI) is also facing criticism for creating unsustainable debt burdens. According to the Council on Foreign Relations' Belt and Road Tracker, overall debt owed to China has soared, surpassing 20% of GDP for some nations. In 2018, Sri Lanka was forced to give up control of its major port to China after it failed to repay loans, while Malaysia's new administration sought to renegotiate costly Chinese projects.

China has emerged as a major foreign investor, but its funds often come with strings attached.





Source: Haver Analytics

Apart from international hesitation, domestic constraints may also be limiting China's outbound investments. State-owned enterprises, which account for almost half of China's total direct investment abroad, have been ordered to control their debt levels. This has affected the flow of finance into BRI projects. China's 2017 move to tighten terms for capital outflows and restrict "irrational" investments in sectors like real estate, hotels and entertainment have also contributed.

The benefits of FDI, Chinese or otherwise, are well documented. In most cases, it has been a major catalyst for development, employment and income growth for the receiving nation. (China itself has benefitted importantly from FDI in recent decades.) But while Chinese investment has often been beneficial for host countries, concerns around competition, national security and exploitation of natural resources are leading many nations to reconsider the attraction of Chinese money.

Given its growing wealth, China's desire to go global is understandable. But its efforts to expand its international investments will face an uphill battle. To continue being a financier to the world, Beijing needs to be more transparent about its intentions and more responsive to the concerns of borrowers.

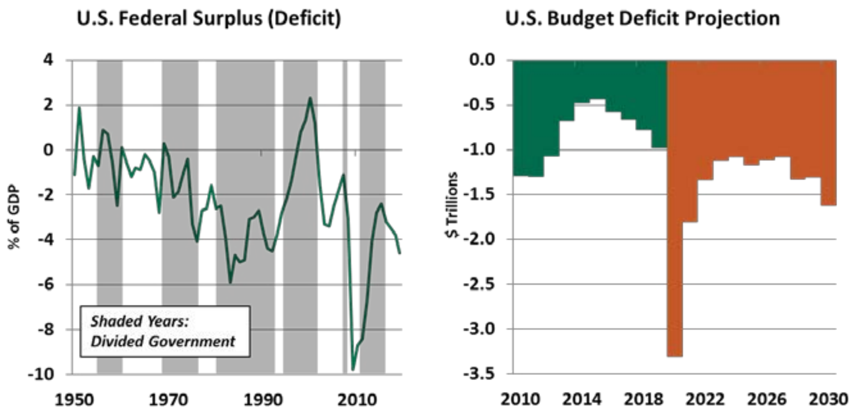
An Object At Rest

In chess, a stalemate is the condition in which no player has an advantageous move; the game ends without a winner. And if the U.S. sees a divided government in its upcoming election results, we must prepare ourselves for years of neither side winning.

Legislative debates are vital, but they do need to end in a decision. Stalemates deprive both sides of a final outcome. In years in which the president and both chambers of Congress are led by the same party, agendas are advanced more easily. New initiatives usually entail new costs—or, in the case of tax breaks, new revenue shortfalls. And conversely, when the president has only minority support in Congress, the parties may not find common ground on new programs, but can often agree to spend less. Budget deficits tend to fall in divided governments. The only recent years in which the U.S. had a balanced budget occurred under divided government, and the often-tense years following the global financial crisis witnessed real progress toward deficit reduction.

Opposition also serves as a check on aggressive agendas. Presidential candidates can set a platform of bold promises, but no laws change without action from Congress. For many voters, government accomplishing nothing is preferable to government making dramatic changes. And bipartisanship can still shine through in moments of crisis, such as the recent unopposed passage of the CARES Act as the severity of COVID-19 became clear.

The president needs Congress to enact an agenda.



Sources: OMB, CBO, Haver Analytics, Northern Trust

Most stalemates, however, merit no applause. Most recently, debate over the next round of fiscal stimulus has led to continual disappointment. House Democrats passed a bill with an estimated cost of $3.2 trillion; Republicans, in due course, offered a rebuttal package costing about $1 trillion. When both sides agree to spending, a compromise should be achievable. But once both sides are braced for a stalemate, it can prove impossible to break, no matter how high the stakes.

If November brings either a Biden presidency and Republican-majority Senate, or a Trump reelection with a Democratic Senate, stalemates will be the default outcome. Whatever the result, the next administration will face a mounting set of fiscal challenges. Repairing the nation's finances may require an occasional checkmate.

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