US Fiscal Policy in 2018 and 2019
November 5, 2018

Ernie Tedeschi
Managing Director | Policy Economist & Head of Fiscal Analysis
ernie.tedeschi@evercoreisi.com
### Table of contents

<table>
<thead>
<tr>
<th>Page</th>
<th>Section</th>
</tr>
</thead>
<tbody>
<tr>
<td>2</td>
<td>Market summary</td>
</tr>
<tr>
<td>3</td>
<td>Growth effects</td>
</tr>
<tr>
<td>4</td>
<td>Midterms</td>
</tr>
<tr>
<td>5</td>
<td>Upside fiscal scenario</td>
</tr>
<tr>
<td>6</td>
<td>Household benefits so far</td>
</tr>
<tr>
<td>7</td>
<td>Withholding v refunds</td>
</tr>
<tr>
<td>8</td>
<td>Repatriation and buybacks</td>
</tr>
<tr>
<td>9</td>
<td>Capex</td>
</tr>
<tr>
<td>10</td>
<td>Deficits and the business cycle</td>
</tr>
<tr>
<td>11</td>
<td>Treasury issuance</td>
</tr>
<tr>
<td>12</td>
<td>Treasury purchasers</td>
</tr>
</tbody>
</table>
Market summary

- There is concern in markets about the durability of the firming in economic growth and consumer strength.

- We think that the federal fiscal impulse (the tax cuts and spending deal) will support growth in all the quarters through the end of calendar year 2019, with real GDP growth effects of around 70-80bp both this year and next.

- However, trade policy uncertainty and tariffs may weaken or delay the fiscal impulse.

- In the event the midterms produce divided government, we expect some market-led “sugar high” optimism over the prospect of further bipartisan impulse. But we think such optimism will be premature.

- Nevertheless, regardless of midterm outcomes we expect the tax cuts to be preserved and the budget deal to be extended for 2020 and beyond.

- Households have seen roughly $85/month in higher disposable income this year from the individual tax cuts. Refunds next year will average $650 per household.

- Firms have repatriated about $500 billion in overseas earnings so far this year. Share buybacks have surged but dividends have not.

- Evidence on capex is mixed. Core capital goods orders do not seem to have broken out, nor have survey-based measures, but broader core fixed investment is up $115 billion so far over last year, though the rise in Q1 tapered somewhat in Q2 and Q3.

- Larger deficits and Fed rolloff are driving a historically-large rise in private Treasury supply this year and next. So far, this surge has been absorbed almost entirely by domestic investors.
We expect the tax cuts and budget deal to boost real GDP growth by 70-80 bp on average for the next two years.

The tax cuts and spending deal are both supporting the US economy over the next two years, but with different multipliers and timing.

Tax burden on individuals and businesses will fall by $300 billion each of the next two calendar years. Tax cuts tend to be low multiplier in the short-term, but with long lags. Moreover, the individual tax cuts did not start showing up in household paychecks until the revised withholding tables took effect at the end of 2018 Q1.

On the spending side, the bipartisan deal increases funding by $150 billion for fiscal years 2018 and 2019, slightly weighted more to defense versus nondefense. We assume and expect Congress makes these higher funding levels permanent in 2020.

Actual outlays, not funding, are what matter for economic accounting however. Funding only gets spent out with a lag, though the short-term multipliers tend to be higher for government spending than for taxes. Also, Congress only passed the deal at the end of Q1, which means the augmented federal spending didn’t start hitting the economy until Q2, and even then probably at a less-than-fully-phased-in pace.

Converting these raw costs into calendar year space and applying assumptions about fiscal multipliers and spend out, we get a total real impulse of $80 billion for CY 2018 and $240 billion for CY 2019. That implies a real growth impact of about 70-80bp each year.

US federal fiscal impulse
Percentage point effect on quarterly SAAR real GDP growth

Source: Treasury, CBO, JCT, FRB, Haver, Evercore ISI.
The midterms may signal further fiscal support in 2019 & 2020.

The biggest drivers of fiscal impulse over the next two years are likely to remain the budget deal and the tax cuts, regardless of the outcome of the midterm elections. However, different election outcomes may influence the magnitude and tenor of any additional fiscal support between now and 2020.

We think that markets will have a momentary “sugar high” under a divided government outcome, with renewed optimism in particular for a large bipartisan infrastructure deal. But we think this will be premature and underweight the political difficulties of a deal between Republicans, who will likely retrench to fiscal conservatism, and Democrats, who will insist that any payfors come from gas taxes or TCJA repeal. A deal will be possible but much harder than meets the eye.

However, in no scenario do we expect fiscal reversal in the short-term. We see the TCJA remaining intact and the budget deal being extended come 2020.

### Midterms Scenarios

<table>
<thead>
<tr>
<th>Scenario</th>
<th>Fiscal Outcomes</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Senate: R</strong></td>
<td><strong>House: D</strong></td>
</tr>
<tr>
<td><strong>Senate: R</strong></td>
<td><strong>House: R</strong></td>
</tr>
<tr>
<td><strong>Senate: D</strong></td>
<td><strong>House: D</strong></td>
</tr>
<tr>
<td>Attempted infrastructure action; conflict over payfors (TCJA repeal etc.)</td>
<td>Budget deal extended in 2020.</td>
</tr>
</tbody>
</table>
Though unlikely, the upside fiscal risk case adds another ~20bp to growth in 2020.

While we expect that under most scenarios the two parties will agree to extend the tax cuts and spending deal, we do not see much in the way of added infrastructure spending or tax cuts in our base case of divided government.

The upside fiscal risk however is that Congress and the White House agree to large further impulses on both the tax and spending side. We see the likelihood of this rising if the GOP keeps both houses of Congress, though the path to enactment is still difficult even then particularly for infrastructure.

Below, we illustrate the growth effects of one possible pair of policies in such an upside case: a 10 percent cut to the bottom two individual income tax brackets and a $500 billion / 5 year infrastructure plan.

The tax cut costs roughly $50 billion a year and begins boosting disposable income right away since it mostly changes withholding. Infrastructure has long spending out lags – only 5 percent of the funding in year 1 gets out the door – but boosts growth for a much longer period of time.
The average household is seeing $85/month lower withholding in 2018 so far.

So far, the TCJA has primarily affected household budgets in the form of lower ongoing withholding. We estimate that in 2018 Q3, the average household is seeing $363 per month in higher disposable income versus the end of 2017. Of this, $85 per month is due to lower income tax withholding.

Withholding isn’t the largest factor driving disposable income growth, however. Higher labor income is responsible for more than $200 of the rise if benefit growth is included. This is the result of both a rise in employment (households becoming more likely to have wage earners) and a rise in wages (existing wage earners getting raises).

Non-withheld taxes have been a drag on income YTD, but this is primarily just a compositional effect from higher wages and employment, which cause households to pay more in payroll and income taxes as a consequence.

Change in average monthly disposable income per household, 2018 Q3 versus 2017 Q4
$/month/household

Average disposable monthly income per household was $363 higher in 2018 Q3 than in 2017 Q4.

More than half of the total increase was due to a rise in average wages & salaries per household.

Changes in personal income tax withholding added an average of $85/month to household DPI...

...but other tax bills grew, primarily as a result of compositional changes in employment & income.

Source: BEA, BLS, Evercore ISI
The individual tax cuts will affect growth primarily through withholding in 2018 and through refunds in 2019.

JCT’s analysis and our own modeling suggest that the individual income tax changes in the TCJA will ultimately reduce tax liability by about $180 billion for each of tax years 2018 and 2019.

But only about $100 billion of tax year 2018’s benefit will actually hit consumers in calendar year 2018, and that will be in the form of lower ongoing withholding. The other $80 billion comes from tax refunds that families will not claim until they file in calendar year 2019. The story is similar for tax years 2019 and 2020. JCT takes these calendar year numbers and further adjusts them to be on a federal fiscal year basis in their score.

The literature is mixed on the relative economic punch of a tax refund windfall versus lower ongoing withholding. Some analyses suggest refunds elicit higher marginal propensities to consume, while others suggest they are more likely to be saved or used for deleveraging.

We therefore use similar multipliers for withholding and refunds in our quarterly analysis of growth impacts. We find that the TCJA’s individual refunds hit in calendar year 2019 just as the impulse from 2018’s withholding benefit gets fully based in and fades away. The individual income tax provisions of the TCJA go from adding 10bp to real growth in 2018 Q4 to 40bp in 2019 Q1.
Repatriation and stock buybacks are up significantly in 2018.

According to BEA data, in the first half of 2018 US multinationals repatriated almost $500 billion in overseas earnings due to the policy changes of the TCJA. Over this same period, share buybacks have surged. S&P 500 buybacks in 2018 H1 were more than $100 billion ahead of the 2017 H1 total.

By contrast, so far this year S&P 500 dividends have not obviously broken from their previous trend. Nor have core capital goods orders, which began firming in late 2016, though broader measures of capex may be showing some movement (see next page).

Repatriation, buybacks, dividends, and capital goods orders
$billions, quarterly

Source: BEA, FRB, Bloomberg, Census, Evercore ISI.
Core capex is up YTD in 2018 but no signs yet of a lasting surge.

Actual private investment (top right) has firmed since the end of 2016, but much of this can be attributed to a rebound in mining and extraction investment linked to the recovery in energy prices.

Stripping away mining, core nonresidential investment has been largely flat as a share of GDP since mid-2015. However, it has jumped 20bp of GDP on average so far in 2018 (+$115 billion YTD), which may be at least in part a reaction to the tax bill. Q2 and Q3 however showed signs of a slight tapering.

We also looked at individual components of core structures and equipment (bottom right) and compared them to their 2016 levels relative to GDP so as to filter out possible anticipatory effects in 2017. Most core investment components in 2018 are running close to their 2016 paces. Standout gains since 2016 are warehousing and computers. But autos and manufacturing structure investments have been areas of weakness since 2016. This may be evidence of countervailing effects from tariffs. Moreover, the NFIB survey (bottom left) shows that while capital plans ticked up a bit in 2017 and 2018 YTD, the share of firms reporting actual capital outlays has been largely flat over the last 3 years.

**NFIB Survey: Capital Outlays**
Percent of firms, annual average

**Private nonresidential fixed investment**
Percent of GDP

**Private investment components in 2016 and 2018 YTD**
Percent of GDP, nonresidential nonenergy structures & equipment

Source: BEA, NFIB, Evercore ISI.
Deficits are unusually large given the state of the economy.

US federal primary deficits and output gaps since 1950
Federal fiscal years

Deficits organically rise and fall with the business cycle due to automatic stabilizer programs such as unemployment insurance as well as the cyclical sensitivity of revenues.

Over the last 68 years, the US has typically run primary (noninterest) surpluses when the CBO output gap has been positive.

But thanks in part to the recent fiscal impulse, primary deficits in 2018 and 2019 will buck this broad trend. They will be the largest primary deficits relative to GDP in a period of positive output gap since the end of World War II, exceeding the deficits of 1953 and 1968.

Source: CBO, OMB, BEA, Evercore ISI.
Rising deficits will elevate Treasury issuance.

Private Treasury supply has risen markedly in 2018 – we project by year’s end private supply will have risen $1.4 trillion over the year, versus a less than $600 billion increase in 2017. Most of this ($1.2 trillion) is due to a rise in issuance driven by the tax cuts and spending deal as well as long-term structural fiscal factors.

Another $210 billion is due to rolloff of the Fed’s Treasury balance sheet. We project that both issuance and Fed rolloff will remain significant in 2019 and 2020 and keep private Treasury supply growth around $1.3 - $1.4 trillion in each of the next two calendar years.

Source: FRB, Treasury, CBO, Evercore ISI.
So far the recent rise in debt has been absorbed domestically.

Federal debt held by the public was steady for much of 2017, then began rising again in September (left). Virtually all of this rise has been absorbed by private domestic holders; the Fed of course is reducing its Treasury balance sheet, and foreign investors have only expanded their holdings by $40 billion of the $1.4 trillion increase in federal debt. This is in stark contrast to the crisis years and subsequent recovery, when private domestic purchasers absorbed less than half of the run-up in federal debt (right).

**Cumulative change in federal debt held by the public since January 2017, by holder**

<table>
<thead>
<tr>
<th>Holder</th>
<th>$billions</th>
</tr>
</thead>
<tbody>
<tr>
<td>Jan 2017</td>
<td>0</td>
</tr>
<tr>
<td>Mar 2017</td>
<td>-500</td>
</tr>
<tr>
<td>May 2017</td>
<td>500</td>
</tr>
<tr>
<td>Jul 2017</td>
<td>1,000</td>
</tr>
<tr>
<td>Jan 2018</td>
<td>1,500</td>
</tr>
<tr>
<td>Mar 2018</td>
<td>2,000</td>
</tr>
<tr>
<td>May 2018</td>
<td>2,500</td>
</tr>
<tr>
<td>Jul 2018</td>
<td>3,000</td>
</tr>
</tbody>
</table>

**Cumulative change in federal debt held by the public, Jan 2008 – Dec 2016, by holder**

Source: FRB, Treasury, Evercore ISI.