October 31, 2024

Fiscal Policy and Deficits Post-Election Scenario

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We believe that the most bearish views on fiscal policy and deficit implications of the various election scenarios are unlikely to come to fruition. In short, even if the bond market doesn't keep a check on deficit spending, the political realities likely mitigate the candidates' desires to spend unabatedly, even in a sweep scenario for either party. (A GOP sweep is still our base case, though it's a very close call.) In addition, we see little material difference in the deficit projections of the various election scenarios unlike many prognosticators, especially, in our view, if you factor in Donald Trump's desire to raise tariffs. To be sure, deficits are likely going up under any election scenario, unless Congress and the White House can't reach an agreement on extending the Tax Cuts and Jobs Act (TCJA) in the next year-plus. Of course, all of this could affect monetary policy as well.

There has been a lot of ink spilled analyzing both presidential candidates' proposals and evaluating the potential resulting various deficit scenarios. However, we see this as somewhat of a fool's errand as neither candidate is likely to have most of his or her agenda enacted by Congress, even in a sweep scenario.

In addition, many of the candidates' ideas haven't been fleshed out and the translation from a simple campaign concept to a more detailed policy plan sizably shapes the price-tag and may not align with estimated cost assessments to date. Importantly, under any election outcome, we expect offsets to help pay for the potential main driver of increased "spending"—tax cuts—where little focus has been paid. Rather than focusing on the exact details of the candidates' plans, many of which are certain to change dramatically, we will hone in on what might happen broadly regarding fiscal policy.

Finally, changes in discretionary spending probably won't differ much under any election scenario, given that discretionary spending levels almost certainly will need to be passed on a bipartisan basis, assuming the filibuster remains in place, which we expect.

We assume that discretionary spending will increase at the growth rate of GDP after 2025, which is an assumption Congressional Budget Office (CBO) makes. Again, this is probably true under any election outcome.

Amount Discretionary Spending is Estimated to add to the Deficit

Year	2026	2027	2028	2029	2030	2031	2032	2033	2034	Total
Y/Y Deficit Increase	16	40	68	99	132	166	202	238	276	1.2 T

Source: CBO. Note: Years are in billions; total is in trillions.

The above CBO projection doesn't account for disaster/emergency funding, like hurricanes, the Ukraine war, etc., which we expect to be enacted and will likely increase the numbers in the table.

Tax Cuts

In general, we believe the tax cuts from the TCJA are likely to be extended next year or early 2026. However, in a divided government scenario, we put a ~20% probability that the tax cuts simply *expire*, therefore creating a fiscal *drag* and lowering the deficit.

Nevertheless, even under the above scenario, the tax cuts are likely to be extended. In our view, the main driver likely to bring Democrats to the table is not the risk of tax rates on the middle class going up, though that clearly is a major factor, but the expiration of the enhanced Obamacare subsidies at the end of next year, coinciding with the expiration of individual tax cuts under the TCJA.

In short, Republicans will want to hold the enhanced Obamacare subsidies hostage to ensure the tax cuts are extended. Democrats are then likely to be willing to give in more to GOP tax demands in order to secure additional availability of these federal tax credits subsidizing Americans' purchasing individual health insurances on the exchanges. In the unlikely event, the enhanced Obamacare subsidies are funded *apart* from a tax bill, odds of a tax cut extension under a divided government would go down in our view.

We would also point out that not all divided governments are created equal. One where House Republicans have a slim majority, and the presidency is won by Vice President Kamala Harris would prove more difficult to get a major tax bill passed into law vs. a GOP Senate and Harris presidency.

Extending the Tax Cuts: Costs and Offsets

Estimates are going to vary widely on any tax bill Congress might tackle next year since the measure is almost assuredly going to include more, and maybe much more, than just an extension of the expiring 2017 Trump tax cuts.

However, the CBO estimates that extending just the expiring tax cuts will cost $4.6 trillion over 10 years. However, those estimates don't include bringing back the full deductibility of the **R&D tax credit**, **interest deductibility,** a larger **child tax credit** or a host of provisions Trump and Harris have offered on the campaign trail, many of which will likely never see the light of day.

One thing that is generally left out of the tax debate is offsets. If one party sweeps, the tax bill will almost certainly have to be done using reconciliation, the process by which bills can pass with only a simple majority in the Senate. However, reconciliation also requires that a bill can't add to the deficit beyond the 10-year budget window. That means that either the provisions that increase the deficit must expire before the end of the 10-year period or there have to be offsets to defray the impact.

Given the political dynamics, we believe there will be robust offsets under any election outcome, regardless of any bond market reaction. There has been much talk, for example, about getting rid of most of the green energy tax breaks under the Inflation Reduction Act (IRA), which the Joint Committee on Taxation (JCT) has estimated could raise $663 billion over 10 years. Some policymakers have also eyed federal changes to Medicaid as providing hundreds of billions in federal savings to help reduce the impact to the deficit. One little-discussed offset is extending the various expiring tax *increases* under the TCJA since pushing out their respective expirations could help offset the cost.

Expiring Tax *Increases* Under the TCJA

Provision	10-Year Offset (2018-2027)
Repeal of Personal Exemptions	$1.2 trillion
Repeal of Itemized Deductions (including SALT)	$668.4 billion
Set the Affordable Care Act Mandate at $0	$314.1 billion
Disallow Active Passthrough Losses in Excess of $500,000	$149.7 billion
Change the Inflation Measure IRS uses to Adjust Provisions of Tax Code (income thresholds, etc.)	$133.5 billion
Miscellaneous Revenue Raisers	$49.7 billion
Total	$2.5 trillion

Source: Joint Committee on Taxation

Back in 2017, the JCT estimated that $2.5 trillion would be raised by individual tax increases that also expire on December 31, 2025 (see table above). That $2.5 trillion number is surely much higher today, seven years since the TCJA was enacted.

What might give us a good idea of the annual deficits resulting from a net tax cut next year is to look at the JCT's net total yearly deficit estimates for the TJCA. In the table below based on JCT's estimates in 2017, we see that the total deficit for the TCJA over ten years came in at $1.5 trillion.

Year	2018	2019	2020	2021	2022	2023	2024	2025	2026	2027	Total
Deficit	135.7	280.0	258.8	220.8	178.3	137.9	120.1	114.6	40.6	+32.9	1.5 T

Source: JCT. Note: Yearly numbers in billions' total in trillions.

Under reconciliation, it would be difficult to extend the tax breaks for the entire 10 years given the revenue needed to be raised to do so. Instead, we are likely to see Congress pass a short-term extension with offsets that could span five years or longer.

Keep in mind, congressional Republicans have also stated that they would try and use claw backs in already approved federal spending to offset the cost of extending the TCJA tax provisions. Republicans might attempt to target some advanced funding in the Infrastructure Investment and Jobs Act (IIJA) for example, though we think much of that dedicated spending, especially the **highway bill** funding, is safe from cuts. Savings from reductions to discretionary spending are likely to be limited. At this early stage, with little to go on, it's hard to estimate, but perhaps the GOP could drum up ~$200 billion from this bucket.

Finally, while not necessarily our view, we could make the argument that a divided government could be the worse outcome from a deficit standpoint. Under a split Congress, presumably any bipartisan tax bill would likely secure the 60 Senate votes needed for overcoming a filibuster, and avoiding the budget reconciliation process, which would mean the required offsets under reconciliation wouldn't have to be adhered to. Translation: Republicans and Democrats could jointly decide to pass a tax bill without being fully offset and mostly ignore the deficit.

While we don't believe such a scenario is likely – especially if the Republicans control the House in a divided government scenario – it might prove a fallback position if the two parties can't agree on a tax bill and simply extend the current law at the end of 2025.

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