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Before the U.S. House Budget Committee

*"Fiscal State of the Union"*

March 29, 2023

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Fiscal policy since the COVID-19 pandemic hit three years ago has been critical in supporting the U.S. economy's quick and full revival. Unemployment is about as low as it has ever been. The economy is currently struggling with high inflation and the Federal Reserve's aggressive interest rate hikes in response, but inflation is moderating and should continue to do so as the economic fallout from the pandemic and Russian War in Ukraine abate. Recent legislation increasing [infrastructure investment](#), incenting semiconductor development here at home, and [addressing climate change](#) will also support the economy's long-term growth.

Lawmakers' most immediate challenge is to increase the federal debt limit. The U.S. Treasury will run out of cash to pay all of the government's bills on time sometime this summer. The longer it takes for lawmakers to act, the more damage it will do to financial markets and the economy. If they fail to act before someone is not paid on time, the blow to the economy will be devastating. Lawmakers must also address the nation's considerable long-term fiscal challenges. Under current law, the nation's budget deficits and debt load will significantly increase and ultimately become unsustainable. Lawmakers must quickly change this outlook through additional revenues and government spending restraint.

**Fiscal policy in the pandemic**

The U.S. economy has recovered quickly from the debilitating COVID-19 pandemic. Three years since the pandemic struck, the U.S. has recovered the GDP lost in the severe recession and the economy has returned to full employment. This strong performance is due in significant part to the quick and massive monetary and fiscal policy response. No other nation responded more aggressively to the pandemic than the U.S. In total, the fiscal support was well over \$5 trillion, equal to nearly 25% of GDP (see Table 1). This compares to less than 18% of GDP in the U.K., the country that provided the next most fiscal support, and the approximately 10% of GDP provided on average by all countries across the globe.

**Table 1: U.S. Federal Fiscal Response to the COVID-19 Pandemic**

Legislation	Actions	\$ bil
Coronavirus Preparedness and Response Supplemental Appropriations Act	Funding for healthcare agencies and testing, funding for vaccine and other therapies across various agencies, subsidized SME loans	8.3
Families First Coronavirus Response Act	Tax credits to firms for COVID-19-related paid sick leave and paid family medical leave, food assistance via Supplemental Nutrition Assistance Program and Supplemental Nutrition Program for Women, Infants, and Children, federal assistance for increased state unemployment insurance benefits, expand Medicare and Medicaid coverage to COVID-19 tests	192.0
Coronavirus Aid, Relief, and Economic Security Act	Household cash transfers, federal assistance to expand state unemployment insurance benefits, grant-convertible loans to SMEs under the Paycheck Protection Program, grants to states and municipalities via \$150 bil Coronavirus Relief Fund, student loan deferrals, expand Medicaid coverage to telehealth services, various tax deferrals and credits	1,756.0
Paycheck Protection Program and Health Care Enhancement Act	Addition of \$320 bil to Paycheck Protection Program; loans to smaller financial institutions; grants for hospitals; additional funding for states/municipalities for COVID-19 testing	484.0
President Trump's executive orders	Extension of plus-up to federal unemployment insurance benefits amounting to \$300 per week, with an additional \$100 to be provided by states. Additional executive orders extend student loan deferral for loans held by Department of Education; declare temporary payroll tax holiday; instruct government agencies to assist renters and homeowners with eviction orders	174.0
Coronavirus Response and Relief Supplemental Appropriations Act	Extension of unemployment insurance benefits by \$300 per week through Mar 14; second round of stimulus checks; additional funds allocated for Paycheck Protection Program, virus-combat and vaccination efforts, supplemental nutrition programs, emergency grants to entertainment venues, relief for airline workers, and increased federal spending on transportation	915.0
American Rescue Plan Act	Stimulus checks of up to \$1,400, extends weekly unemployment insurance top-ups through the beginning of Sep, additional provisions for renter and homeowner relief, increased outlays for state and local governments, expansion of tax credits, financial assistance to businesses and healthcare providers	1,821.0
	<b>U.S. total</b>	<b>5,350.3</b>

Sources: CBO, CRFB, JCT, Moody's Analytics

The unrivaled U.S. fiscal response was motivated in part by the nation's meaningfully weaker automatic fiscal stabilizers—tax and spending policies that automatically counteract declines in economic activity without direct action by lawmakers—compared with those in other advanced economies.<sup>1</sup> It was likely also motivated by lessons learned during the financial crisis a little over a

<sup>1</sup> N. Girouard and C. André (2005), "Measuring Cyclically-Adjusted Budget Balances for OECD Countries," OECD Economics Department Working Papers, No. 434, OECD Publishing, Paris, <https://doi.org/10.1787/787626008442>. M. Dolls, C. Fuest and A. Peichl (2012), "Automatic stabilizers and economic crisis: U.S. vs. Europe," Journal of Public Economics, Elsevier, vol. 96(3), <https://www.sciencedirect.com/science/article/abs/pii/S0047272711001642>.

decade ago, when the policy response was slower in coming and much smaller, contributing to what was a painfully slow economic recovery.<sup>2 3</sup>

The U.S. economy's rapid recovery was not just due to the scale of the fiscal support by policymakers, but also to how quickly they responded to the pandemic. The pandemic slammed the U.S. in February 2020, the massive CARES Act was passed into law in late March, and approximately one month later more than \$1 trillion in fiscal support was already disbursed to households and businesses. There was a similar ramp-up in fiscal support in early 2021, largely via the American Rescue Plan, which was passed into law in March 2021.

To assess the contribution of the fiscal policy response to the economy's performance, the Moody's Analytics Global Macroeconomic Model is used to construct a counterfactual scenario in which lawmakers had not provided economic support to households and businesses during the pandemic. This counterfactual scenario is then compared with a baseline scenario that includes the macroeconomic impact of fiscal policies implemented by lawmakers. There are several simplifying assumptions in this analysis. First, it is assumed that the course of the pandemic and the development and rollout of vaccines proceeded as they did. Second, monetary policy is determined endogenously in the model. That is, global central banks set interest rate and balance sheet policies based on their reaction functions that account for the economy's performance, inflation, inflation expectations and financial conditions.<sup>4</sup> Finally, the fiscal measures considered are only those that explicitly address the fallout from the pandemic.

In the counterfactual scenario where this fiscal support was not provided, real GDP falls by a stunning 11% in calendar year 2020, more than three times its actual decline. The economy would have also succumbed to a double-dip recession in early 2021 (see Chart 1). A recovery begins in earnest in the second half of 2021, but even then, the economy never fully returns to its pre-pandemic path, as real GDP is permanently reduced.

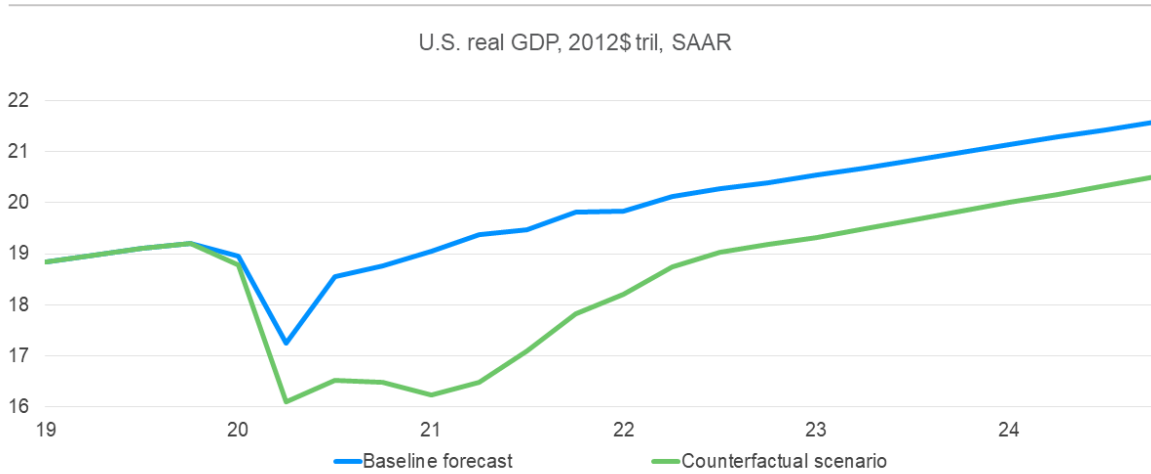
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<sup>2</sup> U.S. discretionary fiscal support during the financial crisis, including the Recovery Act that was passed into law in February 2009 and some modest additional support, totaled less than 10% of U.S. GDP.

<sup>3</sup> See "[Blinder and Zandi: Policy Responses to Great Recession a Resounding Success](#)," white paper for Center on Budget Policy and Priorities, October 2015.

<sup>4</sup> A central bank's reaction function is the estimated historical relationship between the bank's monetary policy and the economic, financial and other variables that monetary authorities use to set monetary policy.

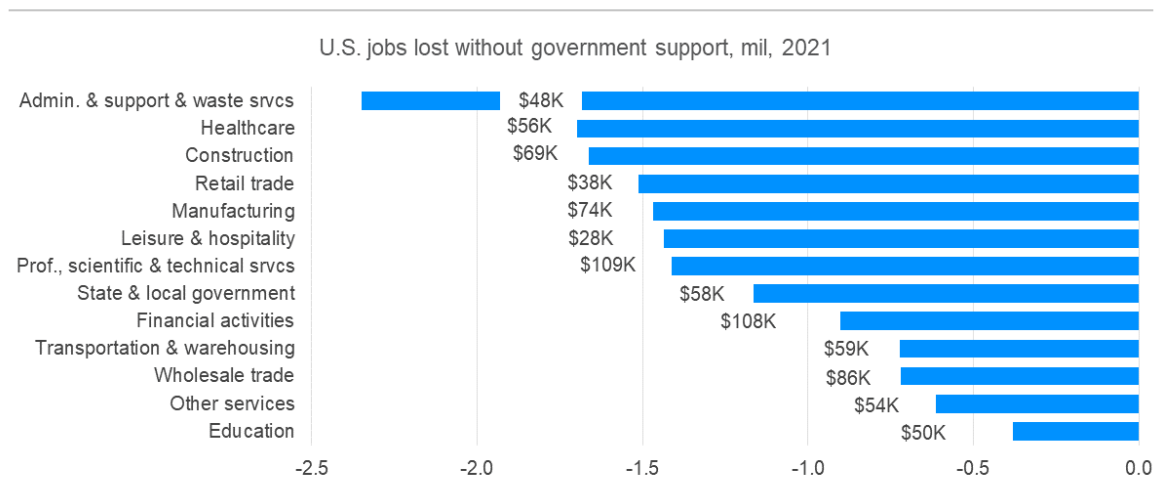
**Chart 1: Fiscal Policy to the Rescue**



Sources: BEA, Moody's Analytics

The impact on the U.S. job market would have been equally grim. The economy is currently on track to recoup all of the jobs lost during the pandemic recession by late this year. Without government support, this milestone would not have been achieved until summer 2026. Low-wage workers, who have suffered most financially during the pandemic, would have been set back even further since they work in industries that have desperately needed government support during the pandemic. Those industries include administrative and support services, healthcare, retail trade, and leisure and hospitality (see Chart 2).

**Chart 2: Low-Wage Industries Most Hurt**



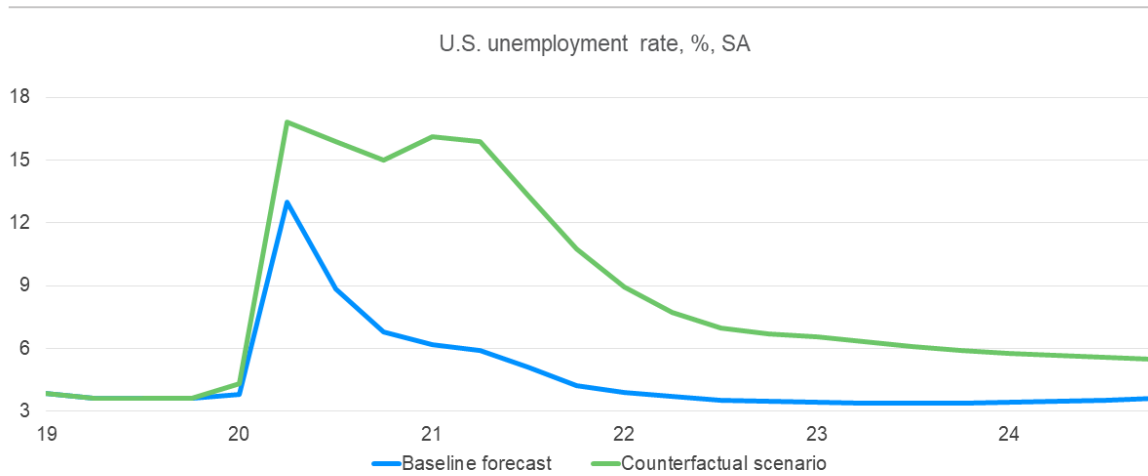
Sources: BEA, BLS, Moody's Analytics

Note: Figures are avg industry wage in 2020. Avg for all industries was \$66K.

The weaker job market in the counterfactual scenario means that unemployment remains stuck in the double digits through 2021, declines only slowly after that, and ultimately never returns to its pre-

pandemic full-employment unemployment rate (see Chart 3).<sup>5</sup> Moreover, with the economy operating at high unemployment for an extended period, wage growth sharply slows to an all-time low.<sup>6</sup>

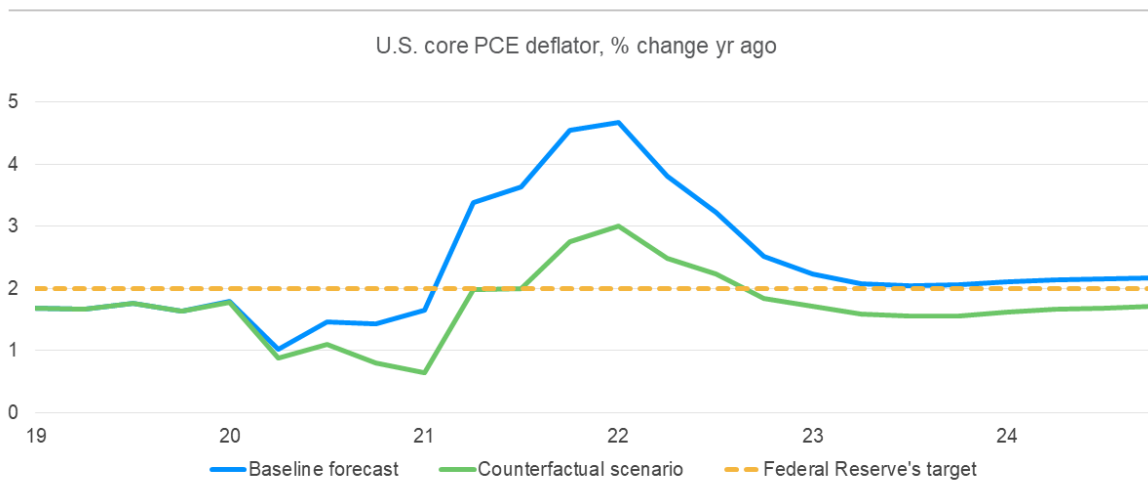
**Chart 3: Stubbornly Painfully High Unemployment**



Sources: BLS, Moody's Analytics

In the counterfactual scenario, inflation picks up in early 2021 as the distribution of vaccines prompts a reopening of the economy and a surge in consumer demand. However, it falls back below the Federal Reserve's inflation target by the second half of 2022. The Fed is not struggling with uncomfortably high inflation as it is now, but with uncomfortably low inflation, as it did in the decade after the financial crisis (see Chart 4).

**Chart 4: Return of Too-Low Inflation**



Sources: BEA, Moody's Analytics

<sup>5</sup> The full-employment unemployment rate, or NAIRU, is estimated to be 3.5%.

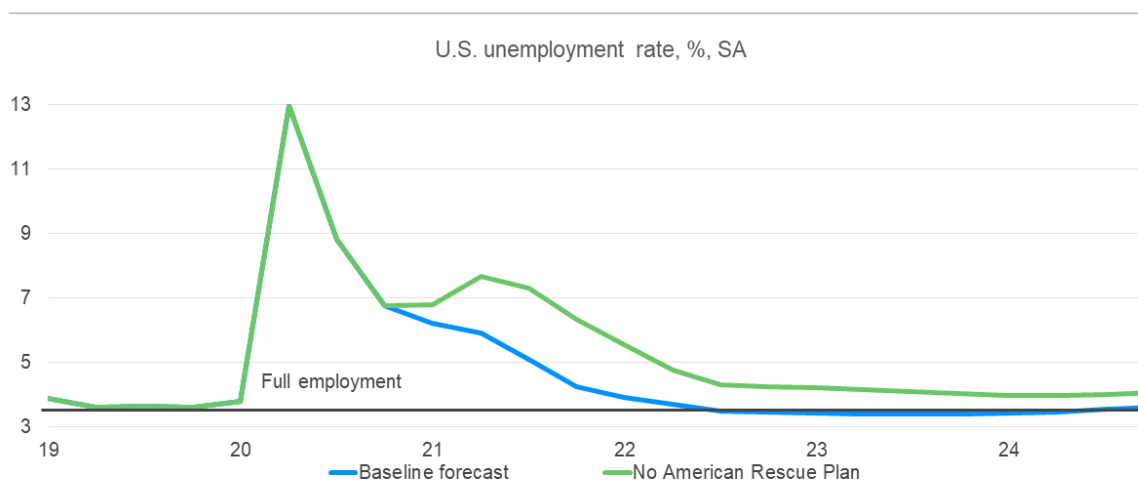
<sup>6</sup> Wages as measured by the Bureau of Labor Statistics' Employment Cost Index.

## American Rescue Plan

Arguably the most controversial of the U.S. fiscal support packages was the nearly \$2 trillion [American Rescue Plan](#) that became law in March 2021. The ARP has been criticized as being too large, overstimulating an already fast-improving economy and significantly contributing to the currently uncomfortably high inflation.

This perspective is not consistent with our results. Without the ARP, the U.S. economy would have come close to suffering a double-digit recession in spring 2021. Based on a simulation of our macro model assuming no ARP, real GDP declines in the second quarter of 2021 and ekes out only a small gain in the third. Because of the weakened economy, unemployment rises back over 7% in summer 2021 and remains materially higher after that (see Chart 5).<sup>7</sup> The ARP is responsible for adding well over 4 million more jobs in 2021, and the economy is currently on track to recover all the jobs lost in the pandemic by the second quarter of this year. If there had been no ARP, it would have taken another year for the economy to recover all of these jobs.

**Chart 5: More Unemployment Without ARP**



Sources: BLS, Moody's Analytics

The American Rescue Plan did contribute to the acceleration in inflation by supporting increased consumer demand, but this occurred almost entirely in the first half of 2021, when higher inflation was not considered a problem. Indeed, at the time it was thought of as more of an economic benefit since the Federal Reserve had long been struggling to lift inflation. The apex of the ARP's impact on year-over-year consumer price inflation occurred at the start of 2022, when it added 35 basis points to CPI growth. However, this boost to inflation has quickly faded, and without the ARP, inflation would have settled back to just below the Fed's inflation target.<sup>8</sup>

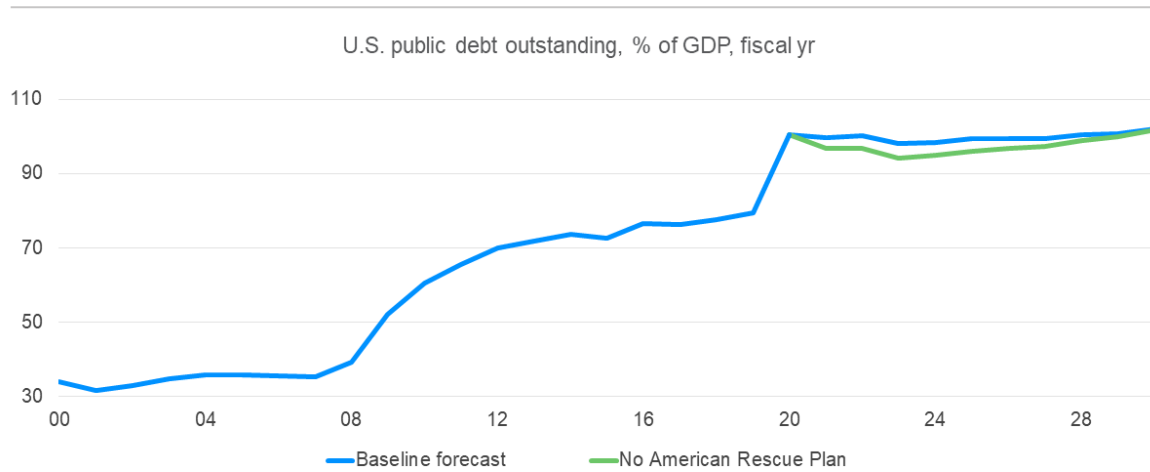
While the American Rescue Plan was costly, if there never had been an ARP, U.S. taxpayers would have ultimately suffered just as much. Because of the weaker economy and automatic fiscal stabilizers,

<sup>7</sup> Due to the much weaker economy, the Federal Reserve keeps the federal funds rate target at the zero lower bound and engages in quantitative easing through the end of 2022.

<sup>8</sup> The Fed's inflation target is 2% for the core consumer expenditure deflator, which, given conceptual and measurement differences, is consistent with consumer price inflation of well over 2.25%.

tax revenues would have been lower and government outlays higher. By the end of this decade, the nation's debt burden would have been equally as large as it will end up being with the ARP (see Chart 6).

**Chart 6: ARP Did Not Materially Increase the Debt Load**



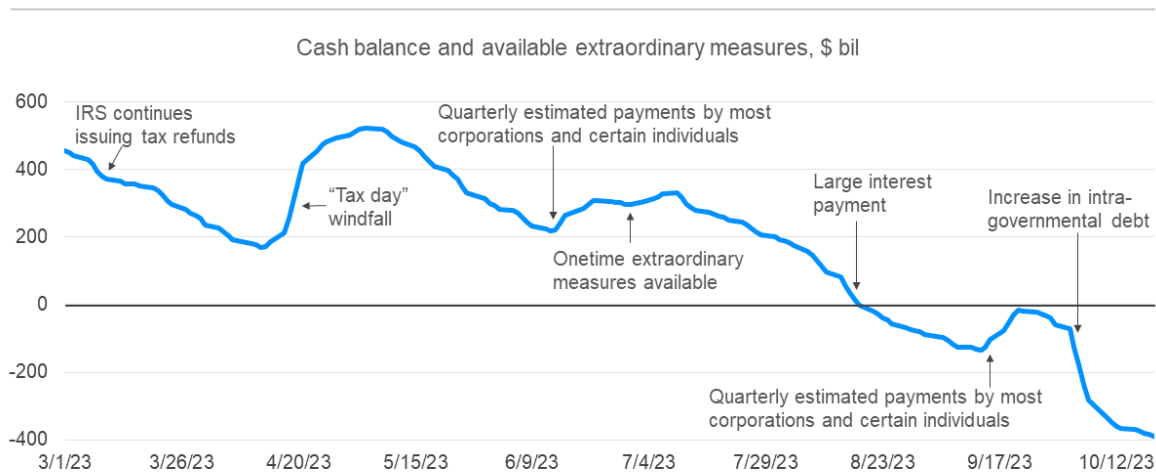
Sources: BEA, U.S. Treasury, Moody's Analytics

### Debt Limit Rabbit Hole<sup>9</sup>

The [Treasury debt limit](#) is an immediate threat to the economy and poses a long-term threat to the nation's finances and economic growth. Unless lawmakers increase, suspend or eliminate the limit, Treasury will not have the cash to pay all its bills on time later this summer (see Chart 7). Financial markets and the economy would be hit hard. There is a temptation to brush off the developing debt limit drama by thinking it will end as have similar episodes over the years with lawmakers coming to terms and signing legislation just in time. But that thinking seems mistaken given the heightened dysfunction in Congress and the large political differences gripping the nation.

<sup>9</sup> A more detailed analysis is provided in "[Going Down the Debt Limit Rabbit Hole](#)," Moody's Analytics white paper, March 2023.

**Chart 7: Treasury Will Run Out of Cash in Mid-August**



Source: Moody's Analytics

The [Treasury debt limit](#), which puts a statutory cap on the amount of Treasury debt outstanding and thus the ability of the Treasury to issue securities to fund the government's obligations, was [reached on January 19](#). Treasury must now use "[extraordinary measures](#)" to come up with the additional cash needed to pay its bills. But those measures are likely to be exhausted by mid-August. Someone will not get paid in a timely way. The U.S. government would default on its obligations. A default is defined as occurring when the Treasury fails to make any payment obligation on time, regardless of whether it is Treasury debt or any other payment that is due.

A default would be a catastrophic blow to the already-fragile economy. Global financial markets and the economy would be upended. Even if resolved quickly, Americans would likely pay for this default for generations, as global investors would rightly believe that the federal government's finances have been politicized and that a time may come when they would not be paid what they are owed when owed it. To compensate for this risk, investors will demand higher interest rates on the Treasury securities they purchase. That will exacerbate our daunting long-term fiscal challenges and be a lasting corrosive on the economy, diminishing it significantly.

### Debt limit workarounds

There is considerable debate over whether the Treasury could prioritize its payments and pay investors in Treasury securities first to avoid defaulting on its debt obligation. While the Treasury may have the technical ability to pay bond investors before others, as those payments are handled by the [Fedwire payment system](#) while a different computer system handles other government obligations, it is unclear whether Treasury is legally able to do so. It would be challenged in the courts. Bond investors, unsure of how this legal uncertainty would be resolved, would demand a much higher interest rate in compensation. Moreover, politically it seems unimaginable that bond investors, including many [foreign investors](#), would get paid ahead of American seniors, the military, or even the federal government's electric bill for long. Then there is the question of how all the other bills would be prioritized. It is not possible for the Treasury to sort through the blizzard of payments due each day. More likely, as outlined



in a [report by Treasury's inspector general](#), the Treasury would delay all payments until it received enough cash to pay a given day's bills.

Treasury bond investors also know that other often-proposed workarounds to the debt limit, like minting a \$1 trillion platinum coin, would be unworkable. Federal law does give Treasury the authority to mint platinum coins, and [the idea is that](#) Treasury would mint a \$1 trillion coin, deposit it at the Fed, and draw it down to pay the government's bills. But the law authorizing platinum coins envisaged commemorative coins, and not circumventing Congress' power of the purse. This would also put the Fed in the middle of the battle, badly politicizing the central bank and significantly jeopardizing its independence, which is critical to a well-functioning economy.

Another idea is to have Treasury issue premium bonds rather than par bonds as Treasury debt comes due, lowering the face amount of debt outstanding and subject to the debt limit. Of course, the present value of the Treasury's debt obligation will not have changed, so this is just a budget gimmick, but so too is the debt limit. While this is creative financial engineering, it is not something Treasury could roll out quickly and would be very costly, committing Treasury to higher and higher interest payments. It also threatens the well-functioning of the Treasury bond market, the world's largest and most liquid market. Besides, interest rates likely would still spike as investors view the chicanery as putting the nation's fiscal discipline at risk.

Yet another proposed workaround to the debt limit is to have the president invoke [Section 4 of the 14th Amendment](#) and order the Treasury to keep issuing bonds and paying the government's bills. The 14th Amendment states that the "validity of the public debt of the United States...shall not be questioned." If push comes to shove and lawmakers are about to breach the limit, a 14th Amendment declaration seems the most viable option, because it highlights the sanctity of the nation's debt. But Section 4 of the 14th Amendment was passed in the wake of the Civil War to ensure the federal government was not on the hook for the war debt of the Confederate states. Investors would rightly wonder if using the amendment to abrogate the debt limit law would stand up in the courts, and if it did, what it means for our political system's checks and balances. Given the constitutional crisis this would set off, financial markets would still be roiled, and a recession ensue.

Despite these dark scenarios, financial markets have yet to react to the possibility of a government default. Of course, the reckoning is still a few months away, and it has become standard practice for Congress to run down the clock but in the end figure out a way to raise the debt limit when absolutely necessary.

### **Economic costs of a debt limit breach**

However, as the deadline gets closer, global investors will rightly begin to worry that lawmakers will err and fail to act in time. Uncertainty will push interest rates higher and stock prices will fall, slowly at first but then more quickly. And if policymakers do fail to increase or suspend the limit before the Treasury runs out of cash and defaults, interest rates will spike, and stock prices will crater at an enormous cost to taxpayers and the economy.

If lawmakers are unable to resolve the debt limit in time and the Treasury begins paying its bills late and defaults, financial markets would be roiled. A [TARP moment](#) seems likely. This harks back to that

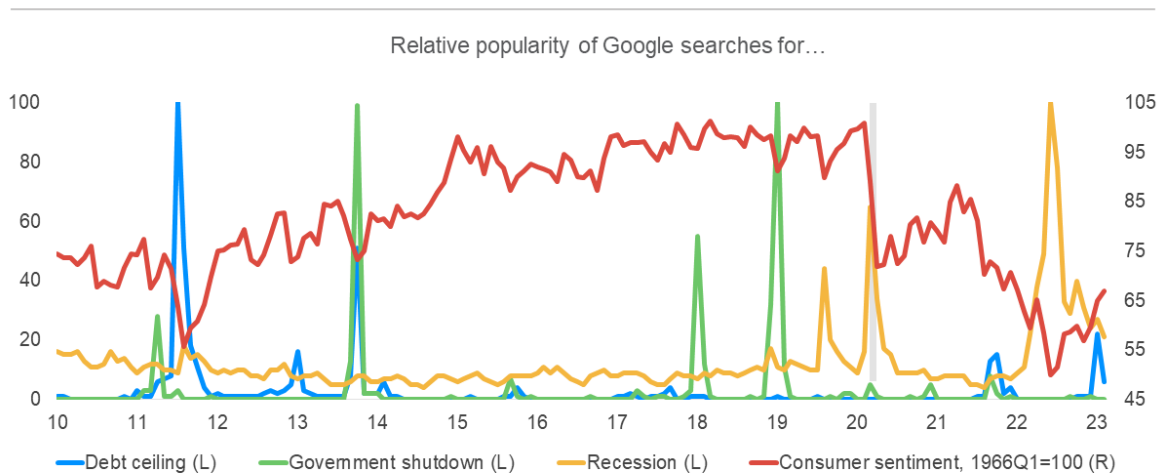
dark day in autumn 2008 when Congress initially failed to pass the Troubled Asset Relief Program bailout of the banking system, and the stock market and other financial markets cratered. A similar new crisis would be ignited, characterized by spiking interest rates and plunging equity prices. Short-term funding markets essential to the flow of credit that helps finance the economy's day-to-day activities likely would shut down as well.

It is unimaginable that lawmakers would allow things to get to this point, but as the TARP experience highlights, they have done the unimaginable before. Still, if that experience is a guide, lawmakers would reverse course within a few days and resolve the impasse to allow the Treasury to resume issuing debt again and pay its bills. Much damage already will have been done, and although markets would right themselves, it would be too late for the already-fragile economy, and a recession would ensue.

However, if lawmakers do not reverse course quickly and the impasse drags on for even a few weeks, the hit to the economy would be cataclysmic. Immediately, the federal government would have to slash its spending. For example, if the debt limit was breached on October 1 and dragged on all month, the Treasury would have no choice but to cut government spending by an estimated \$125 billion. And if there still is no agreement in November, another close to \$200 billion in spending would need to be cut. The hit to the economy as these government spending cuts cascade through the economy would be overwhelming.

Adding to the economic turmoil would be the loss of consumer, business and investor confidence (see Chart 8). Political brinkmanship over the operations of the federal government has been frightening for Americans to watch. In both the 2011 and 2013 debt limit episodes, households were closely attuned to the political hardball being played in Washington, and consumer sentiment slumped. The brinkmanship is also unnerving for businesses, which will pull back on investment and hiring. And financial institutions will quickly turn more cautious in extending credit to households and businesses.

**Chart 8: Debt Limit Battle Will Hit an Already-Fragile Collective Psyche**



Sources: Google Trends, Univ. of Michigan, Moody's Analytics

The timing could not be worse for the economy since many CEOs and economists believed a recession likely this year even before the specter of a debt limit breach. With the Federal Reserve ramping up

interest rates to quell wage and price pressures, avoiding a recession would be difficult even if nothing else went wrong. Most leading indicators of recession, including the prescient policy yield curve—the difference between 10-year Treasury yields and the federal fund rate—point to recession beginning later this year at about the time lawmakers will be doing battle over the limit.

Based on simulations of the Moody's Analytics model of the U.S. and global economies, the economic downturn that would ensue would be comparable to that suffered during the global financial crisis. Treasury yields, mortgage rates, and other consumer and corporate borrowing rates would spike at least until the debt limit is resolved and Treasury payments resume. Even then, rates would not fall to where they were previously. And the economy's long-term growth prospects would be materially diminished.

### **What's next**

It is unclear how lawmakers will resolve the current impasse over the debt limit. Given the severe economic and political costs of a debt limit breach, the most likely path is for lawmakers to come to terms just in time to avoid it. This might include an agreement on the debt limit in tandem with an agreement on the federal budget for fiscal 2024 that begins on October 1.

Coming to terms after much drama would be consistent with the long, arduous history of agreements on the debt limit, and it is fitting given the bipartisan nature of the financial obligations the debt would cover. Both Republicans and Democrats supported the close to \$3 trillion in deficit-financed fiscal aid provided to the economy to manage through the pandemic under President Trump in 2020. And while only Democrats supported the almost \$2 trillion deficit-financed American Rescue Plan passed early in the Biden administration to help with the fallout from the pandemic, only Republicans supported the nearly \$2 trillion deficit-financed [Tax Cut and Jobs Act](#) passed early in the Trump administration that cut corporate and personal income taxes.

Having said this, odds that lawmakers are unable to get it together and avoid a breach of the debt limit appear to be meaningfully greater than zero. The difficulty House Republicans had electing Kevin McCarthy as Speaker, and the terms Speaker McCarthy agreed to in order to win election, including having a battle over the debt limit with Democrats, does not augur well. Getting any bill through the legislative process is tough under typical circumstances, but getting highly contentious debt limit legislation through this Congress before a breach will be highly problematic.

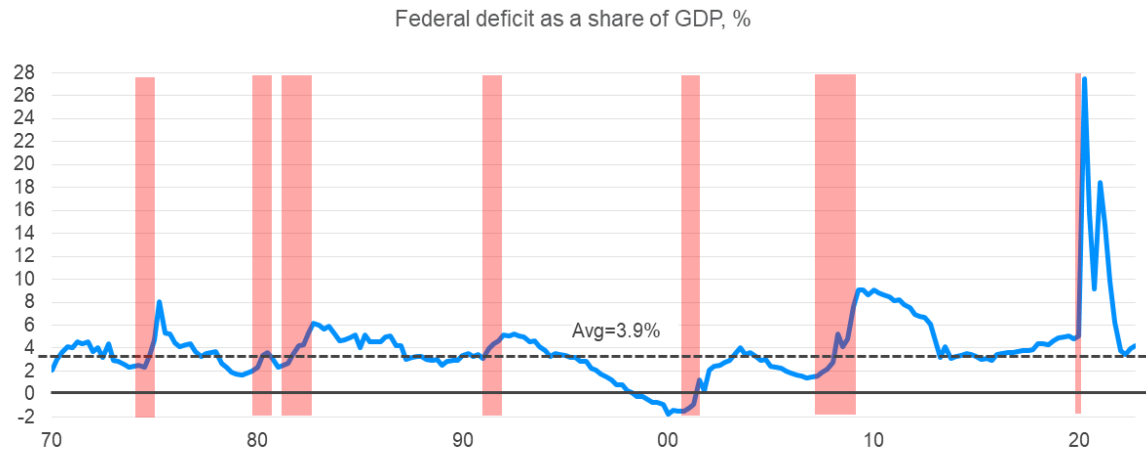
Adding to the concern is the growing number of lawmakers openly contemplating whether Treasury could navigate a breach of the debt limit by prioritizing payments to bondholders. They may be earnest in questioning whether a breach would lead to turmoil in financial markets and the economy as described in this analysis, but they are badly misguided.

### **Long-term fiscal challenges**

The nation's fiscal situation has significantly improved as the economy has recovered from the pandemic and the end of the extraordinary support to households and businesses. By the end of calendar year 2022, the federal deficit as a percent of GDP was near its average of the past half century (see Chart 9). However, the fiscal situation is set to weaken and under current law will meaningfully deteriorate over the coming decade. That is, if lawmakers make no changes to fiscal policy, the

Congressional Budget Office projects that the deficit-to-GDP ratio will increase from 5.2% in fiscal 2022 to 6.9% by 2033 (see Table 2). The nation’s debt will quickly pile up, as debt held by the public will surge from 97% of GDP in fiscal 2022 to 118% by 2033. During the past half century, the nation’s debt-to-GDP ratio has averaged well below 50%.

**Chart 9: Federal Deficit Back to Its Long-Run Norm**



Sources: BEA, Moody's Analytics

**Table 2: U.S. Federal Government Budget Outlook**

Fiscal yrs

	% of GDP				\$ bil		
	Avg 1973-2022	2022	2023	2033	2022	2023	2033
Total revenues	17.4	19.6	18.3	18.1	4,896	4,812	7,098
Individual income tax	8.0	10.5	9.6	9.7	2,632	2,523	3,803
Payroll tax	6.0	5.9	6.0	5.9	1,484	1,562	2,307
Corporate income tax	1.8	1.7	1.8	1.4	425	475	539
Other	1.6	1.4	1.0	1.1	356	251	449
Total outlays	21.0	24.8	23.7	24.9	6,208	6,206	9,799
Mandatory outlays	10.9	16.3	14.6	15.3	4,076	3,825	5,997
Social Security	4.4	4.8	5.1	6.0	1,213	1,336	2,355
Healthcare programs	3.3	5.6	5.7	6.7	1,404	1,508	2,629
Medicare	2.0	2.8	3.1	4.1	710	820	1,623
Medicaid, CHIP, subsidies	1.2	2.8	2.6	2.6	695	688	1,005
Other	3.2	5.8	3.7	2.6	1,459	981	1,014
Discretionary outlays	8.0	6.6	6.6	6.0	1,657	1,741	2,373
Defense	4.3	3.0	3.1	2.8	746	800	1,105
Nondefense	3.8	3.6	3.6	3.2	910	941	1,269
Net interest	2.0	1.9	2.4	3.6	475	640	1,429
Deficit	(3.6)	(5.2)	(5.3)	(6.9)	(1,312)	(1,394)	(2,702)
Primary deficit	(1.5)	(3.3)	(2.9)	(3.2)	(837)	(755)	(1,273)
Debt held by the public	46.9	97.0	98.0	118.2	24,257	25,716	46,445

Sources: CBO February 2023 Budget Outlook, Moody's Analytics

This fiscal outlook is not sustainable. It will ultimately lead to meaningfully higher interest rates weighing more and more heavily on business investment, housing, consumer spending, and long-term productivity and economic growth. For every 1-percentage point increase in the federal debt-to-GDP ratio, 10-year Treasury yields are estimated to increase by approximately 2 basis points.<sup>10</sup> The expected increase in the nation's debt load will thus add an estimated close to 40 basis points to the 10-year Treasury yield over the next decade. This will not drive the economy over a cliff, but it will be corrosive to the economy's long-term growth potential.

The higher interest rates will also add to the federal government's borrowing costs and reinforce its fiscal problems. According to the CBO, federal interest expense will increase from 1.9% of GDP in fiscal 2022 to 3.6% by 2033. Consider that the nation will spend about 3% of GDP on national defense over the next decade. In the past, when the interest expense on the national debt rose to more than spending on critical national priorities such as defense, lawmakers acted. The last time they did so was in the early 1990s, which contributed to the last time the nation enjoyed a budget surplus—in fiscal 2000. It is time for lawmakers to act aggressively again to address the nation's fiscal challenges.

### **Addressing the fiscal challenges**

Both increased revenues and spending restraint will be needed to address the nation's fiscal challenges. Most significantly, lawmakers should consider [rolling back some of the cuts in the marginal corporate tax rate](#) implemented under the Tax Cuts and Jobs Act of 2018. The TCJA reduced the rate from 35% to 21%. Increasing it back to 28% and implementing other reforms, including revising the global minimum tax regime and limiting inversions, will raise an estimated more than \$1.4 trillion in tax revenue over the next decade.<sup>11</sup>

Another proposal would be [to increase the Net Investment Income Tax](#) on earned and unearned income above \$400,000 from 3.8% to 5%. The NIIT is a tax on qualifying investment income such as interest, dividends, capital gains, rents, royalties, and passive income from businesses not subject to the corporate income tax. This option would also require all pass-through business income of high-income households to be subject to the same rules as other types of income. Together, these tax increases will generate close to an estimated \$650 billion over the coming decade.

A third proposal would [apply the 12.4% payroll tax to earnings over \\$400,000](#) in addition to earnings below the maximum taxable amount under current law. In 2023, all earnings below \$160,200—the taxable maximum for that year—would be taxed, as would earnings above \$400,000. Earnings between \$160,200 and \$250,000 would not be taxed. The taxable maximum would continue to grow with average wages as under current law, but the \$400,000 threshold would not change, so the gap between the two would shrink. The current-law taxable maximum would still be used for calculating benefits, so scheduled benefits would not change under this alternative. This option would raise an estimated \$550 billion in revenues over the coming decade and go a long way to addressing the solvency of the Social Security trust fund.

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<sup>10</sup> This is a Moody's Analytics estimate consistent with CBO research in "[The Effect of Government Debt on Interest Rates: Working Paper 2019-01](#)," Gamber and Seliski, March 14, 2019.

<sup>11</sup> A wide range of options to address the nation's deficits are provided by the CBO in "Options for Reducing the Deficit, 2023 to 2032, [Volumes 1](#) and [2](#)," December 2022.

There are sure to be concerns that raising taxes on wealthier households and corporations will have serious negative economic consequences. To be sure, all else being equal, higher taxes will weigh on economic growth, but the impact on the economy from the higher proposed taxes will be small. In part, the tax increases being considered on high-income and wealthy households would be the first meaningful tax hike on individuals since the early 1990s. And from a historical perspective they are, on net, modest. Effective tax rates will remain close to historical norms.

In a similar way, the proposed tax increases for corporations only partially roll back the large tax cuts they received with the TCJA. The top marginal corporate tax rate was reduced from 35% to 21% in the TCJA, and we assume in the reconciliation package they would be increased back to 25%. Moreover, there is [little evidence](#) to date that the TCJA led to a meaningful sustained increase in business investment, hiring or wages, or prompted businesses to shift production to the U.S. from overseas as intended. While it is difficult to disentangle all that is going on in the economy to isolate the impacts of the TCJA, it is difficult to conclude that the tax cuts in the TCJA have supported a stronger economy. This suggests that partially undoing those tax cuts will not meaningfully hurt the economy.

Lawmakers should also consider policy steps to slow the growth in government spending. Given that discretionary defense and nondefense spending has already grown more slowly than GDP in recent years and will continue to do so under current law, this does not appear to be a good candidate for further reductions in spending: neither does reducing mandatory Social Security and healthcare benefits per beneficiary. Given the [ongoing aging of the population](#) and the increasing numbers of Americans receiving retirement and healthcare benefits, this leaves efforts to reduce the growth in healthcare costs as the most viable way to restrain government spending. One proposal would be to build on the Medicare drug reforms enacted in the [Inflation Reduction Act](#) by allowing Medicare to negotiate prices for more drugs earlier and to extend the inflation rebate rule for drug companies to commercial health insurance. Together these steps would save \$200 billion over the next decade and would extend the life of Medicare and reduce Medicare beneficiaries' out-of-pocket drug costs. But more broadly, lawmakers will need to take up efforts again to accelerate improvements in the efficiency of the nation's healthcare system.

## Conclusions

The aggressive fiscal policy response to the pandemic deserves significant credit for limiting the severity and length of the recession that occurred when the pandemic struck, and for the subsequently strong economic recovery. There has been criticism of policymakers for going overboard on the fiscal support, with critics pointing to the currently high inflation and bigger government deficits and debt loads. Yet even without the fiscal support inflation would be a worry—not because inflation would have been too high, but because inflation would be too low, as it had been since the financial crisis.

Further, our fiscal situation would have already been even worse if policymakers had not provided the fiscal support, since a much weakened economy would have caused tax revenues to plummet and government expenditures to automatically increase. It is thus misguided to second-guess the aggressive fiscal policy response during the pandemic. Policymakers had no choice but to act quickly and massively. Perhaps in hindsight some of the specific policy steps taken during the crisis could have been better designed. However, policymakers' decisiveness in pushing forward with substantial government support was an economic game changer.

Policymakers must quickly confront the Treasury debt limit and increase it before the Treasury runs out of cash this summer. That the U.S. government is “money good,” meaning it pays the government’s bills on time, is a bedrock of the U.S. economy and global financial system. Alexander Hamilton, the nation’s first Treasury secretary, established this principal at the founding of the nation when he agreed to [pay Revolutionary War bond investors](#) at 100 cents on the dollar. This despite that the bonds were trading at pennies on the dollar because few believed the new American government would make good on its debts.

When the government did make good, it established the sound credit of the U.S., ensuring that we are the global safe haven. Hamilton’s action said that when times are tough, even here at home, capital still flows, keeping interest rates down and paving the way for the U.S. dollar to become the global economy’s reserve currency. The economic benefits over the generations are incalculable. Lawmakers must put a quick end to their wrangling over the debt limit so future generations can enjoy the same benefits.

Lawmakers must also quickly address the nation’s daunting long-term fiscal challenges. At the very least, any new tax or spending proposals must be fully paid for. That is, legislation that reduces taxes or reduces spending relative to current law, must be paid for through other tax increases or spending cuts. But even if policymakers can achieve this, the nation’s deficits and debt load will continue to mount, ultimately becoming unsustainable as interest rates rise and economic growth slows, further exacerbating our fiscal problems. Both increased revenues and spending restraint will be needed to address them. This will not be easy, but if history is a reasonable guide, lawmakers will be up to the challenge, and they will come through.