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Economics Group

Special Commentary

Fiscal Policy to the Rescue?

Executive Summary

One of the key reasons U.S. fiscal policy is seen as so important in the current economic environment is that conventional monetary policy ammunition is relatively limited. There is a common perception, however, that fiscal capacity in the U.S. is equally as limited. Is this true? In our view, while there is some truth to it, the answer is mostly no. The United States currently has the fiscal capacity to implement a large-scale fiscal stimulus, should it choose to do so.

That said, we believe at this point in time a large scale fiscal stimulus is still in the early stages, meaning a few weeks away at a minimum. But, should economic and financial market conditions continue to deteriorate, this could provide the spark needed to get lawmakers moving faster. Should this occur, we believe it would most likely combine increased government spending on things like unemployment insurance and infrastructure, which would appease Democrats, and tax cuts, which would appease Republicans. Micro measures would also likely be included, particularly for workers and industries that are the hardest hit, and could come as an initial “Phase I” package. At such a preliminary stage, it is impossible to estimate the impact to GDP growth or the federal budget deficit given the lack of details regarding design or size. In the weeks ahead, we will be monitoring the situation closely, and as these details emerge we will update our analysis accordingly.

Does the U.S. Even Have the Fiscal Capacity to Stimulate the Economy?

Financial markets have begun to assess the prospects for a fiscal stimulus in the United States as conventional monetary policy approaches its limit. There is a common perception, however, that fiscal capacity in the U.S. is equally as limited. Is this true? In our view, the answer is mostly no. The U.S. currently has the fiscal capacity to implement a large-scale fiscal stimulus, should it choose to do so. Admittedly, the federal fiscal outlook is bleaker than it was prior to the last recession. The federal budget deficit was just 1.1% of GDP in 2007, compared to 4.6% in 2019 (Figure 1), and the stock of debt has more than doubled as a share of GDP over this period (Figure 2).

Figure 1

Federal Budget: Deteriorating in an Expansion
4-Quarter Moving Sum, Percent of GDP, Wells Fargo Forecast in Blue

Figure 2

U.S. Federal Debt Held by the Public
Share of GDP

Source: U.S. Department of the Treasury, U.S. Department of Commerce and Wells Fargo Securities

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But, just because budget deficits and debt are historically high, that does not mean that there is no capacity for additional stimulus. Despite this rising debt burden, the federal government’s interest costs as a share of GDP are historically low and right around the level that prevailed in 2007 (Figure 3). Furthermore, these data are as of Q4-2019, before Treasury yields plunged by more than 100 bps across the curve. At present, real interest rates on federal government debt, as implied by yields on Treasury Inflation-Protected securities (TIPS), are firmly in negative territory for the first time since 2013. This implies that the U.S. federal government could borrow $1,000 today and pay back less than $1,000 ten years from now, after adjusting for inflation. This suggests that the federal government can, at least for the time being, quite easily service both its existing debt and some new debt, should it so choose.

In FY 2019, the federal government collected $1.24 trillion in payroll taxes, which amounted to 36% of all revenue.

Source: U.S. Department of the Treasury, International Monetary Fund and Wells Fargo Securities

In addition, there is no widely agreed upon level of government debt above which economic problems arise. When compared to its developed market peers, U.S. government debt levels are fairly average (Figure 4). And as we have discussed in previous research, there are good reasons to believe that the United States can carry a higher debt burden than most other countries. Specifically, the U.S. dollar is the world’s reserve currency, the U.S. economy is the largest in the world and Treasury bills, notes and bonds are the gold standard for liquid, safe assets. Of course, this is not to say the U.S. government’s borrowing capacity is unlimited, or that perpetually rising debt levels will never have any economic consequences. But a stimulus effort that amounts to a few percent of GDP is something we believe the federal government has the capacity to implement at this time, should it so choose.

What Might a U.S. Fiscal Stimulus Look Like?

As the economic outlook has worsened due to the COVID-19 outbreak and the ongoing oil price war, numerous possible fiscal stimulus proposals have been swirling around. In our view, it makes the most sense to group these ideas into two different camps: macro policies designed to bolster aggregate demand and micro policies designed to provide targeted relief to industries or individuals most significantly impacted by recent developments.

Perhaps the macro policy that has gotten the most attention is a payroll tax cut. Payroll taxes are generally used to fund specific government programs, with the bulk of payroll taxes going towards Social Security and Medicare. In Social Security’s case, there is a 12.4% tax on wages and salaries up to $137,700. The rate is split evenly between employees and employers, although economists generally believe employees ultimately bear the bulk of the tax’s burden. For Medicare, the tax rate is 2.9%, once again split evenly between employees and employers. The Medicare payroll tax differs from the Social Security one in that there is no cap on the wages subject to it. In FY 2019, the federal government collected $1.24 trillion in payroll taxes, which amounted to 36% of all federal government revenue (Figure 5).
The major benefit of a payroll tax cut is that it is fairly easy to administer and it is generally speaking a fairly progressive way to reduce tax burdens, since almost everyone with a job pays the flat tax. This type of policy move has been used before to stimulate the economy. The employee side of the Social Security payroll tax was cut from 6.2% to 4.2% from 2011-2012 as part of legislation that extended the Bush tax cuts. Should a similar policy be adopted today, lasting for one year, we estimate that this would amount to roughly a $150 billion tax cut, or roughly 0.7% of U.S. GDP.

President Trump has expressed support for a payroll tax cut, or possibly even a complete suspension of payroll taxes altogether. If one assumes that this means the entire $1.2 trillion in payroll tax revenue is foregone, that would amount to a tax cut of about 5.7% of GDP. For some context, the stimulus bill passed in February 2009 during the Great Recession was approximately 5.5% of GDP.

Some policymakers, particularly Democrats in the House of Representatives, have expressed skepticism that a payroll tax cut may not be all that effective. A white collar worker earning $100,000 a year who works from home would see a $2,000 tax cut under such a plan, but a leisure & hospitality worker whose tips have dried up or who has lost their job would not see any direct relief. Furthermore, if individuals are delaying consumption due to fears about the virus, a sizable portion of the tax cut may be saved rather than spent, limiting the boost to demand the stimulus would provide.

What other macro options are on the table? Some policymakers have suggested expanding or making more generous certain automatic stabilizer programs, such as unemployment insurance and the supplemental nutrition assistance program (SNAP). There are multiple ways that Congress could enhance these measures to boost the economy. It could make the size of the benefits larger, for example, or it could extend the amount of time individuals could claim the benefits. Congress passed legislation during the last recession that extended unemployment benefits beyond the typical 26 week maximum. This “emergency unemployment compensation” was in effect from July 2008 through December 2013. At its peak, this extension of benefits amounted to an extra $72.1 billion of federal spending in FY 2010, or roughly 0.5% of GDP at the time (Figure 6).

Infrastructure spending is another possible macro tool that policymakers could adopt to boost faltering demand. We have repeatedly expressed skepticism that leaders in Washington could find a way to pass a large-scale bipartisan infrastructure plan, and thus far that has proven correct. However, we have always caveat-ed this by saying that, should a material economic slowdown emerge, it could provide the impetus needed for a deficit-financed infrastructure plan. Borrowing money for additional infrastructure spending would have clear merits in a time of negative real interest rates. Investment in infrastructure has the dual benefit of boosting near-term demand while also providing a boost to potential output by increasing the capital stock. Infrastructure

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**Source:** Congressional Budget Office, U.S. Department of Labor and Wells Fargo Securities

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spending also has one of the biggest fiscal multipliers according to research done by the Congressional Budget Office.¹

The downside to this policy tool is that the boost to growth from greater infrastructure spending would likely occur with a sizable lag, as it takes time to get large scale projects off the ground. In the federal stimulus bill that was passed in February 2009, for instance, only about 10% of the Department of Transportation’s spending increase occurred within the first seven months of enactment. Furthermore, there are some questions about how implementing large-scale construction projects might work in a time of quarantines and social distancing.

On a micro level, some of the leading policy ideas are delaying the April 15 tax payment date, expanding/mandating paid sick leave and providing direct financial support to households and businesses significantly impacted by the virus outbreak, such as airlines or hourly workers in the leisure & hospitality industry. Some of these policies could potentially be done through executive action rather than legislation, but it once again depends on policy details that we do not have at this point. Although the adoption of these policies could help alleviate individual suffering or industry-level challenges, from a macro standpoint we doubt they would move the needle much in our forecasts for real GDP growth or the Federal Reserve’s monetary policy path.

At this point in time, a large scale fiscal stimulus is still in the early stages in Washington D.C, meaning a few weeks away at a minimum. But, should economic and financial market conditions continue to deteriorate, this could provide the spark needed to get fiscal policymakers moving faster. Should a large scale stimulus take place, we believe it would most likely combine increased government spending on things like unemployment insurance and infrastructure, which would appease Democrats, and tax cuts, which would appease Republicans. Micro measures are also likely to be included, particularly for workers and industries that are the hardest hit. At such a preliminary stage, it is impossible to estimate the impact to GDP growth or the federal budget deficit given the lack of details on design or size. In the weeks and months ahead, we will be monitoring the situation closely, and as these details emerge we will update our forecasts accordingly.
