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Spending, Borrowing, and the Public Debt

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Former Vice President Joe Biden has led in the polls since he announced his intention to run for president in April—and his platform is more moderate than those of the other Democratic candidates. This campaign spotlight is part of our series on the 2020 presidential campaign.

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Spending and the debt limit deal

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Annual U.S. budget deficit:
Nearly $1 trillion

Total federal interest expense:
$523 billion today
(versus $361 billion in 2000)

Source: U.S. Treasury Department, August 12, 2019.

Key takeaways

- Lawmakers recently passed a spending deal that suspends the federal debt ceiling through July 2021 and increases spending by $320 billion over the next 2 years.
- We expect that the resolution of the debt ceiling issue and increased federal spending will be modest positives for U.S. equity markets in the short term.
- Over the long term, high government debt levels are likely to lead to low inflation, low bond yields, and lower returns in U.S. financial markets.

Spending has no limit

A bipartisan federal budget deal was recently passed that increases spending and suspends the debt ceiling through July 2021, well past the next election cycle. This agreement eliminates the threat of a federal debt default and the political brinkmanship that normally accompanies the debt ceiling debate. The spending increase passed by Congress will still need to be appropriated to keep the federal government open past October 1—but the federal spending deal and agreements to avoid poison pill language in the appropriations bill make the prospects of a government shutdown relatively low.

The deal passed this summer effectively puts fiscally conservative lawmakers on the defensive and permanently removes the threat of sequestration that was agreed to by lawmakers in the Budget Control Act of 2011. The budget deal boosts U.S. federal spending by $320 billion over 2 years and increases discretionary spending to more than $1.3 trillion.

Over the past two years, we have seen a significant increase in U.S. deficit spending—both on an absolute basis and relative to gross domestic product (GDP)—due to tax reform. The latest agreement to boost discretionary spending will continue this trend. It is unusual to see legislators ramp up spending during periods of healthy economic activity, since significant increases in fiscal deficits are often reserved for periods of economic weakness as a tool to pull economies out of recession. Regardless of economic timing, in the short run, both the economy and politicians can benefit from deficit spending. Thus, federal spending is a popular tool for those looking to appeal to voters' interests. As we move toward a presidential election year in 2020, the motivation to keep U.S. economic growth on a positive trajectory is clear.

Increased U.S. deficit spending is likely to have longer-term consequences for investors. It is impossible to predict exactly how much federal debt the country could bear before investors start to lose faith in the U.S. government's fiscal accountability. Our expectation is that the U.S. can support a meaningfully higher federal debt level than it has today, given the country's dominant global economic position and the U.S. dollar's stance as the world's reserve currency. But even if a U.S. fiscal crisis is not imminent, the consequences of significant national debt are likely to be real and far-reaching for investors.

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Rapidly rising federal spending and debt levels can translate to:

A "crowding-out" effect—A large amount of federal borrowing and debt issuance leads to a greater portion of investment capital being diverted to Treasury debt from private borrowing and investment. A smaller pool of capital available for private investment could lower economic output and incomes.

Decreased fiscal flexibility—An increasing level of federal debt could restrict policy makers' ability to respond to unexpected events. Whether future shocks are economic, geopolitical, or natural, they may have a more significant negative economic impact as lawmakers lack the flexibility to fiscally deal with such a crisis.

Borrowing costs—There are many reasons to expect interest rates to remain low for an extended period of time—even as U.S. government debt grows. If Treasury yields were to materially increase, the added interest cost would require increasing federal revenues, reduced spending, or some combination of both.

While it might not be popular in Washington, D.C., significantly slowing the pace of federal spending and debt growth could help the U.S. to reduce its reliance on unsustainable long-term debt trends. Yet, this development does not seem likely today as the most recent federal spending deal actually takes the country in the other direction. The federal spending deal may help to sustain U.S. economic growth in the short term, but over the longer term, high debt levels can lead to lower inflation, low bond yields, and lower U.S. financial-market returns for investors. For more information about the debt and deficit, please ask your financial professional for a copy of our report "Paying America's Bills".[1]

[1] Wells Fargo Investment Institute, "Paying America's Bills," published in August 2018.

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Total federal debt:
$22.3 trillion today
(versus $5.7 trillion in 2000)

Source: U.S. Treasury Department, August 12, 2019.

Expected budget deficit in 2020:
$1 trillion

Sources: Congressional Budget Office, Wells Fargo Investment Institute, July 22, 2019. Projection is partly based on the terms of the federal budget deal.

Key takeaways

- Modern Monetary Theory has been attracting attention as some presidential candidates have used it to support their platforms and fiscal spending growth. The theory is that countries like the U.S. should not be limited by revenues, taxes, or borrowing for government spending, since they can print as much currency as they need. This differs from a traditional view that rising federal debt has implications for private investment, and financial markets.
- Modern Monetary Theory does not account for the fact that private and public budgets do not have the same constraints. Therefore, government deficits and borrowing are not the only sources of demand for the local currency, and they may undercut demand for money.
- We favor evaluating risk and reward with any investment, but we do not see U.S. public debt as a high investment risk at this time.

What investors should know about Modern Monetary Theory

Modern Monetary Theory has been attracting more attention recently as U.S. federal budget deficits grow and presidential candidates propose deficit widening. The concept reframes theories dating to the early 20th century, mainly in economist George Knapp's treatise, "*The State of Money*." The theory maintains that money does not take its value from its desirable characteristics (measurable, divisible, difficult to counterfeit, and easily exchangeable).

Instead, the theory claims that money has value because the government accepts it to pay taxes. Since future generations will have tax liabilities, the theory concludes that the government can borrow or print money indefinitely—as long as it issues debt in the national currency. The implication is that investors will freely hold the country's bonds as wealth, because the government will repay the investors in the currency that they will need to pay their future taxes. If the spending generates inflation, the theory goes, then the government can raise taxes to slow private spending and cool inflation. Today, interest in the theory seems greatest among proponents of large deficits, irrespective of political party—and among advocates of public projects like universal, government-provided health care (or converting the U.S. economy completely to non-carbon-based energy sources).

What about in practice?

It is not hard to illustrate that money has value beyond its ability to satisfy tax obligations. Japan's government debt was 53% of its GDP in 1990, and this debt-to-GDP ratio rose to 234% by April 2019.[2] In the interim, the Bank of Japan bought securities from Japan's banks in exchange for cash (it now owns nearly 45% of all Japanese government debt). But there is little demand for borrowing in Japan, so the cash sits as bank reserves. Low public loan demand translated to average annualized Japanese money supply growth of only 2.0% from 1990-2018.

Japan is not the exception. U.S. total government debt (federal, state, and local) averaged 46.0% of U.S. GDP between 1971 and 1981, while the average annualized pace of money supply and inflation were 9.8% and 7.2%, respectively. Low government debt levels did not block rapid money supply growth and inflation. From 2010-2018, however, total U.S. government debt

[2] Federal Reserve Bank of St. Louis, 1990; International Monetary Fund, April 2019.

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averaged 118% of GDP, but money supply growth (M3) and inflation eased to 6.0% and 1.7% on an average annualized basis, and the U.S. economy slowed.[3]

These experiences illustrate that rising government debt does not necessarily create a proportionately larger economy, increase money supply growth, or fuel inflation. People hold money, but they don't hold it only to pay taxes. They may look to hold other currencies in other economies, if they perceive that the government is wasting the economy's resources.

Ultimately, Modern Monetary Theory does not address the basic issue that people and governments have different budget constraints. In general, individuals have much less flexibility than the government to borrow as much as they want in any period. This difference drives the "crowding out" effect, discussed in the previous section.

Theorists may propose that limitless government bond issuance over the span of decades can delay repayment indefinitely. However, private individuals, or their heirs, must run a surplus at some point to repay the anticipated future tax increases. If the government bonds finance government spending that fails to promote growth, then private investors can and do invest their wealth in other countries, using their savings to generate growth for other economies, instead of at home, in order to meet the future tax obligations. This has been Japan's situation since 1990. In the worst case, investors may come to fear that the government may never be able to collect enough future revenue to repay the bonds. At that point, history shows that money can lose value, even very rapidly.[4]

We favor an allocation to investment-grade debt in portfolios, including exposure to U.S. Treasury securities as part of a diversified fixed-income allocation. Yet, investors should weigh the potential risk and reward of any investment, including government debt. Our view is that prudent governments will manage their expenditures and revenues responsibly over time to help ensure their country's ability to repay its obligations in the future. U.S. federal and several local (municipal) authorities face challenges regarding debt and deficits in the coming years, but we believe that the U.S. debt load is manageable today.

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[3] Total government debt is based on marketable and unmarketable federal debt, plus state and local obligations. Inflation is measured by the average annual gross domestic product (GDP) deflator. M3 money supply includes currency, deposits with an agreed maturity of up to two years, deposits redeemable by notice of up to three months, and repurchase agreements, money market fund shares/units, and debt securities with maturities of up to two years.

[4] For more information on rapid inflation when money loses value, please see "World Hyperinflations," Steve H. Hanke and Nicholas Krus, Cato Institute, August 15, 2012.

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Former Vice President Joe Biden:

Polling average in the first half of 2019: 31.6%

Source: FiveThirtyEight, August 2, 2019.

Mentions on CNN, Fox News, and MSNBC so far this year: 63,458

Source: Data from the Internet Archive's Television News Archive processed by the GDELT Project, as of August 18, 2019.

Number of Twitter followers: 3.7 million

(Well behind Senator Bernie Sanders' 9.6 million Twitter followers)

Source: Twitter, as of August 20, 2019.

This is the first in a series of spotlights on the five highest-polling candidates for the Democratic presidential nomination.

Democratic presidential candidate spotlight—Joe Biden

As the current frontrunner in the crowded Democratic field, former Vice President Biden has claimed much of the spotlight and absorbed much of the criticism during the first two presidential debates. Candidates such as Senator Kamala Harris, Senator Kirsten Gillibrand, and former Housing and Urban Development Secretary Julián Castro have denounced him on his voting record and past comments on issues such as busing, the Iraq War, and criminal justice. Yet, former Vice President Biden retains a significant lead in most national polls.[5]

Health care

As a moderate candidate, former Vice President Biden does not support Medicare for All as Senator Bernie Sanders and Senator Elizabeth Warren do. Former Vice President Biden's proposed health care plan equates to a major expansion of the Affordable Care Act (also known as Obamacare), but it would be less dramatic than rival candidates' plans to implement Medicare for All. His health care plan would give people the choice to purchase a public health insurance option like Medicare.[6]

Former Vice President Biden's plan would cap insurance premiums at 8.5% of a person's income, give premium tax credits to the middle class, and empower Medicare to directly negotiate drug prices, along with hospital and health care provider costs.[7] He would pay for the plan by increasing the long-term capital gains tax rate (and taxes on wealthy individuals), while rolling back the Trump administration's recent tax cuts to restore the 39.6% top federal income tax rate for individuals. Former Vice President Biden's health care plan would cost an estimated $750 billion over 10 years.[8] Passing such a public option would have a major effect on the American private health insurance market, in our view, but it would be less disruptive than moving to a single-payer health care system.

Taxes

Former Vice President Biden has said he supports the implementation of a tax code that rewards the middle class. He advocates rolling back President Trump's Tax Cuts and Jobs Act, but his plan would leave corporate tax rates lower than they were before 2017.[9] As noted, he also wants to increase the capital gains tax rate—and double the tax rate for those making more than $1

[5] RealClear Politics Poll averages.
[6] "Health Care," JoeBiden.com, as of August 1, 2019.
[7] "Health Care," JoeBiden.com, as of August 1, 2019.
[8] John Whitesides and Mike Stone, "Biden healthcare plan draws contrast with White House rivals," Reuters, July 15, 2019.
[9] The 2017 Tax Cuts and Jobs Act cut the corporate income tax from 35% to 21%.

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Key takeaways

- Although former Vice President Biden's proposed health care plan (an expansion of the Affordable Care Act) likely would disrupt the private health care industry, in our view, his government-managed public health insurance option would have a higher chance of congressional passage than a comprehensive, single-payer Medicare for All plan (which would effectively eliminate private health insurance).
- Former Vice President Biden wants to roll back some of the recent tax cuts and close tax loopholes to fund key platform initiatives. His plan would increase taxes for corporations and high-earning individuals—while also significantly raising the long-term capital gains tax rate.
- While former Vice President Biden does not endorse the Green New Deal, his climate change plan proposes significant federal investment in clean energy over the next 10 years. We believe this investment would be beneficial for the renewable energy sector, but it would hurt traditional energy producers.

million annually.[10] He plans to introduce tax increases that would help to finance programs such as the Child Tax Credit and other middle class assistance programs. The budgetary cost of financing his tax plan, in our analysis, is relatively modest compared to the cost of other Democratic candidates' tax plans.

Climate change

Former Vice President Biden introduced one of the first climate change bills to Congress in 1986. More recently, he was an integral part of the Obama administration's participation in the landmark Paris Agreement (also known as the Paris Climate Accord). Today, he has produced his own climate plan that includes similar environmental goals to those of the Green New Deal, which he describes as "a crucial framework" for tackling climate change.[11] Former Vice President Biden has outlined a plan for the U.S. to reach net zero carbon emissions by 2050, which would be enforced by a pollution tax introduced by his administration before 2025. He also proposes a $1.7 trillion federal investment in clean energy initiatives to be funded by the reduction of corporate tax incentives introduced by President Trump—and by ending fossil fuel subsidies and closing various tax loopholes for corporations.[12]

Key dates for 2020 presidential election

2019	
September 12 - 13, 2019	Third Democratic primary debate (Houston, Texas)
October (Date to be determined)	Fourth Democratic primary debate
November (Date to be determined)	Fifth Democratic primary debate
December (Date to be determined)	Sixth Democratic primary debate
2020	
February	Early primaries and caucuses to be held (i.e., Iowa caucuses, New Hampshire primary)
March 3, 2020	States begin holding their primary or caucus on "Super Tuesday"
June 6, 2020	Final states to hold their primary or caucus
July 13 - 16, 2020	Democratic National Convention (Milwaukee, Wisconsin)
November 3, 2020	Presidential Election Day

Source: Democratic National Committee, as of August 19, 2019.

[10] Brian Faler, Aaron Lorenzo, and Bernie Becker, "2020: The Issues," Politico, updated on August 5, 2019.
[11] "Climate," JoeBiden.com, as of August 2, 2019.
[12] "Climate," JoeBiden.com, as of August 2, 2019.

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