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American Gothic

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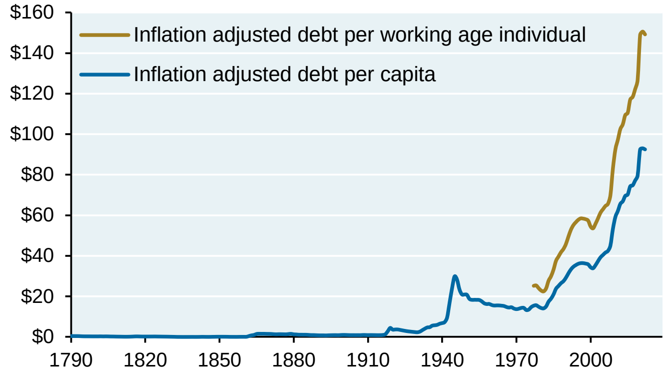
MR. MICHAEL CEMBALEST: Good morning, everybody. This is the debt ceiling version of the Eye on the Market Outlook. So see if you can guess what the following people have in common, Erskine Bowles, who is the Democratic White House Chief of Staff, Kevin Warsh, who was on the Federal Reserve Board for a few years, Peter Orszag, an Obama appointee, ran both the OMB and the CBO, Michael Bennett, a Senator, a Democratic Senator from Colorado, Geoffrey Canada of the Harlem's Children's Zone, Mike Mullin, the 17^{th} Chairman of the Joint Chief's of Staff, Richard Kogan of the very progressive Center of Budget and Policy Priorities, Mike O'Pake, who's an economist at the Federal Reserve, Bank of St. Louis. These aren't people you would necessarily associate with conservative points of views on fiscal policy.

That said, all of them have either written papers, given speeches, or worked on negotiated solutions on the issue of deficits, entitlements, and generational theft. They haven't had a lot of luck so far. The first chart in the Eye on the Market this week looks at the inflation adjusted federal debt since 1790. After the surge in spending in World War II, every American was responsible for about $30,000 in debt in today's dollars. That figures now almost 100,000. And when you look at the debt burden on the working age population, it looks even worse.

US inflation adjusted Federal debt per capita

US$, thousands



Source: US Treasury, Fed Reserve, Minneapolis Fed, Census. JPMAM. 2022.

In addition to overall issues about the levels of debt, you've got a bigger issue, in my opinion, on the composition of spending, because what's happening is that discretionary spending, that contributes to productivity and growth, is shrinking relative to entitlement spending. And entitlements are important and critical, we all understand the purpose, why they were created in the late 1960s. But as a reminder, non-defense discretionary spending includes all sorts of things related to transportation; infrastructure, renewable energy, energy demonstration projects, inner-city rail, high-speed rail, air traffic control, education and training, job retraining, education subsidies for low-income students, vaccine development, border control, all sorts of things go in that category.

What is non-defense discretionary spending?

Transportation infrastructure
Air, ground and water infrastructure
Air traffic control and aviation safety
Coast Guard and transportation security
High speed intercity rail
Army Corps of Engineers

Science and energy
Renewable energy grid integration
EPA superfund and arsenic/lead exposure programs
Nuclear/clean coal demonstration projects
Pollution control and abatement
Space exploration, National Science Foundation

Law Enforcement
FBI and Border Control
IRS and Federal Courts

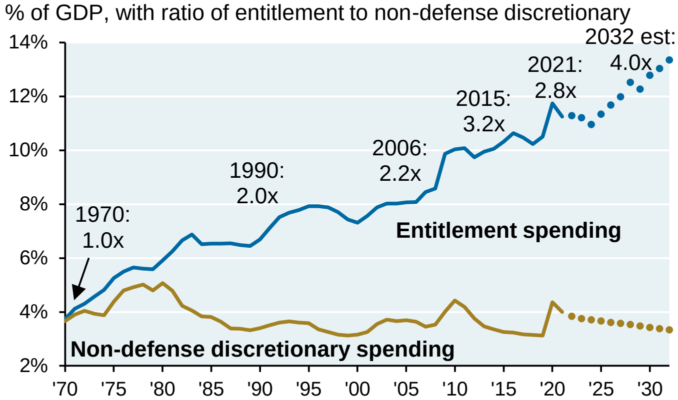
Healthcare
Vaccine development
NIH bioterrorism programs
CDC disease control programs
Food & Drug Administration

Education and Training
K-12 education, including subsidies for low income and disabled students
College Pell grants and Head Start pre-school programs
Job retraining and apprenticeship programs

And in the late 1960s, once the entitlement system was created, the federal government spent a dollar on each. A dollar on the entitlements, and a dollar on all the other non-defense discretionary spending categories. By the 1990s, it was two to one in favor of entitlements. It's now around in favor of entitlements. And by 2032, in 10 years, it'll be four to one in favor of entitlements. And so, it's not just the level of the debt, it's the composition of government spending that's creating some issues.

Now, there's a lot of solutions one could—one could think about here. Both Senator Sanders and Senator Warren have proposed large increases in income and capital gains taxes on people earning over $250,000 or wealth taxes in excess of 20 million. You could raise taxes, spend that money entirely on non-defense discretionary spending and close that gap. You could do means testing of Medicare Part B and D. You could have higher Medicare copays and deductibles, higher eligibility retirement ages, increased rebates by Medicare Part D manufacturers. In other words, things to bring down the level of entitlement spending relative to non-defense discretionary spending.

What does the Federal government spend money on?
% of GDP, with ratio of entitlement to non-defense discretionary



Source: CBO, JPMAM. May 2022. Dots are CBO projections.

You could also cut defense spending and use some of that money to boost non-defense discretionary spending. Right now, defense spending in the US is close to a 70 year low, believe it or not, as a share of GDP. Although, as you might suspect, on a per capita basis, we're the third highest in the world. And so, with this backdrop, the Visigoths, as I've chosen to call them in this piece called American Gothic, the Visigoths now say they're going to block the debt ceiling increase unless the White House agrees to spending cuts and a balanced budget agreement within 10 years.

So here are some questions I've been getting on this, and my answers to them. So most importantly, if there were a technical default of some kind, would it be followed shortly thereafter by some kind of negotiation to put things back on track, such as the Budget Control Act of 2011, there was the Graham-Rudman-Hollings Deficit Control Act in '85, and then a Balanced Budget Reaffirmation Act in '87. I think so. I don't know how long it would take to get there, but I certainly think the sequence of events would be, if there were technical default, you could have some kind of negotiations, things get back on track rather than any kind of restructuring of the federal debt in any emerging markets context.

Will the Visigoths be able to maintain their united partisan front to fight this debt ceiling increase? Unclear. It would only take five GOP defections to join the Democrats to go ahead and allow a debt ceiling increase. So it's unclear. According to CNN, there are some swing state Republicans from districts that were purple, that you'd consider most likely to break ranks with GOP leadership, who are—who are also saying, like the leadership in the caucus, that they don't want to back a clean debt ceiling increase unless there's some kind of fiscal agreement.

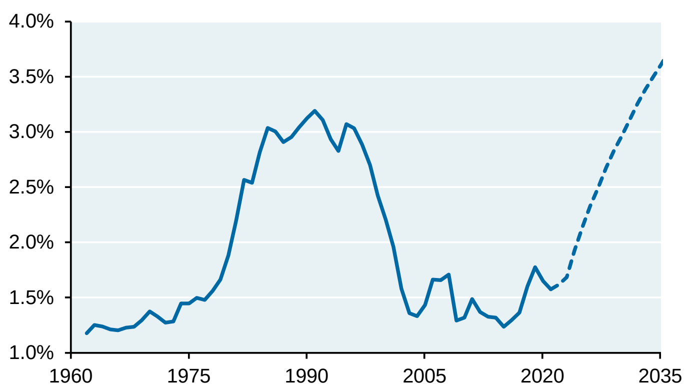
And look, nobody—it doesn't matter very much, but nobody knows whether the Visigoth concerns about government spending is genuine. And the fact that these same issues don't get raised quite as vividly when the GOB con—when the GOP controls the White House is politics. But again, that doesn't matter, because we are where we are. In 2011, you had a debt downgrade and stock market correction. And sometimes that causes politicians to change the things that they're doing.

But the bottom line from this week's piece is that reasonable people have had around 25 years to try to do something to fix both the debt levels and the spending composition issues in a sustainable way. And they haven't accomplished anything. So I'm not surprised that the Visigoths are going to try to do it for them, and with a lot more economic disruption and political turmoil. Now, I suspect the problem will go away this year in some way. But that doesn't mean that it's not going to come back again and again in the future, given the excessive levels of debt and also, some of the spending imbalances that we've—that we've mentioned here.

So there are some interesting charts that we've got here to look at for context; the net interest payments on the federal debt as a percentage of GDP, a history of US tax increases since 1950, and showing that the Sanders and Warren proposals would only get you part of the way of where you need to be if you really wanted to close that spending gap, some history on the estimated cost of healthcare entitlement systems and how the actual costs were generally much, much higher, some information on defense spending, et cetera, et cetera, and then a glossary of terms that you will need or may need over the next few months as you're trying to decipher the political jargon coming out of DC as these negotiations go ahead. So anyway, just a brief note for us on the debt ceiling issues. And look forward to talking to you again soon. Bye.

US government net interest payments as % of GDP

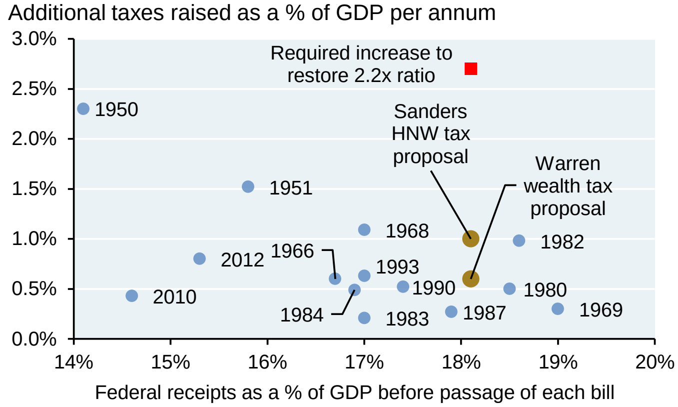
Percent



Source: CBO, JPMAM. 2021. Dotted line indicates estimates.

A history of US tax increases by year of legislation

Additional taxes raised as a % of GDP per annum



Source: US Treasury, Tax Policy Center, JPMAM. May 2022.

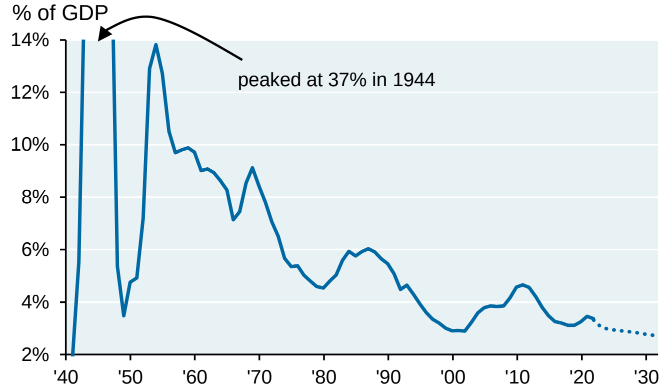
Initial estimates vs. actual costs of healthcare

Benefit	Year	Annualized Cost (USD billions) Est.	Annualized Cost (USD billions) Actual	Actual to estimated cost ratio
Medicare hospital insurance	1965	9.0	67.0	7.4 to 1
Medicare (entire program)	1967	12.0	110.0	9.2 to 1
Medicare ESRD program	1972	0.1	0.2	2.3 to 1
Medicaid DSH program	1987	1.0	17.0	17 to 1
Medicare home care benefit	1988	4.0	10.0	2.5 to 1
Medicare catastrophic coverage*	1988	5.7	11.8	2.1 to 1
Massachusetts Health Reform	2006	0.7	0.9	1.2 to 1

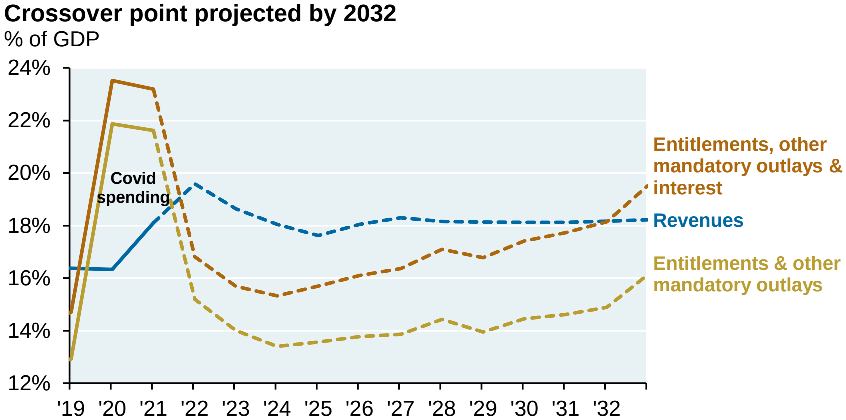
Source: US Congress Joint Economic Committee. July 2009. * = multi-year estimate

Federal spending on defense

% of GDP



Source: CBO, JPMAM. May 2022. Dotted line = CBO projections.



Source: CBO, Budget and Econ Outlook, JPMAM. May 2022.

Defense spending per capita (top 15)

Country	US$
Qatar	3,955
Israel	2,769
US	2,405
Kuwait	2,085
Singapore	1,885
Saudi Arabia	1,572
Norway	1,510
Australia	1,231
Oman	1,107
Finland	1,064
Brunei	1,026
United Kingdom	1,002
South Korea	979
Denmark	927
France	866

Source: SIPRI database. 2021.

Debt ceiling glossary of terms

Debt Prioritization. Several Republican House members may pursue legislation to force "debt prioritization," under which the Treasury would only pay some obligations and not others, as spelled out in a specific bill. The Senate is unlikely to pass this, and it might create discord within the GOP based on whose oxes are gored. Secretary Yellen has stated that Treasury does not have the ability to carry out debt prioritization, and believes that it might still be viewed by the rest of the world as a default. However, as indicated in footnote #4, the FOMC in the past has discussed a plan to make interest and principal payments on time during a debt ceiling impasse.

Spending Cuts with a Debt Limit Vote: Speaker McCarthy and the House Republican caucus have agreed to tie any debt limit votes to new budget agreements and fiscal reforms. The demands appear to include limiting discretionary spending to FY22 levels, and adoption of a budget that balances within ten years. These are still general demands and not detailed proposals.

Bipartisan Commission: Senator Manchin (D-WV) has called for a commission to negotiate spending cuts to pair with a debt ceiling vote. At this time, Democratic Leadership has shown no interest in agreeing to this. In 2011, in exchange for GOP votes on the debt ceiling, a Congressional commission was formed to recommend deficit reduction roughly equal to the size of the increase in the debt limit.

The Trillion Dollar Coin. Could Treasury solve the impasse without Congress by pursuing options like such issuance of a $1 trillion coin to deposit at the Fed, using the funds to all bills due? Secretary Yellen dismissed this approach as a "gimmick."

Special Procedures - House of Representatives Discharge Petition. If Democrats can find 5 or more GOP members to agree to a clean debt ceiling increase, they can try to force House Speaker McCarthy to bring the debt ceiling bill to the floor by pursuing a "discharge petition". This would effectively force a vote on any legislative proposal in the House, and generally requires weeks of procedural steps to accomplish.

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