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Before the U.S. Senate Budget Committee

"The Default on America Act: Blackmail, Brinkmanship, and Billionaire Backroom Deals"

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The Treasury debt limit is fast becoming a serious threat to our economy. With April tax receipts coming in weaker than expected, at least so far, it appears that the X-date, when the U.S. Treasury will run out of the cash needed to pay the federal government's bills on time, may hit as soon as early June. House Republicans recently passed legislation to increase the limit, and it comes none too soon. In exchange for increasing the debt limit just enough so that it will not be a problem again until about this time next year, House Republicans want to significantly cut discretionary federal government spending over the next decade, impose stricter work requirements on healthcare, food and other assistance for low-income households, and roll back much of the Biden administration's agenda on climate change and student lending. In this written testimony, I assess the macroeconomic consequences of the House Republican debt limit legislation.[1]

The X-date

The Treasury debt limit—the maximum amount of debt that the Treasury can issue to the public or to other federal agencies—was hit on January 19. Since then, the Treasury has used "extraordinary measures" to come up with the additional cash needed to pay the government's bills. Nailing down precisely when these extraordinary measures are exhausted and Treasury will run out of cash and thus be unable to pay everyone on time—the so-called X-date—is difficult. It depends on the timing of highly uncertain tax receipts and government expenditures.

Since Moody's Analytics began estimating the X-date beginning early this year, we thought it to be in mid-August. But April tax receipts are running 33% below last year's pace, meaningfully weaker than anticipated (see Chart 1). And despite weaker-than-anticipated tax refunds, the X-date may come as soon as early June. If not, and Treasury is able to squeak by with enough cash, then the X-date looks more likely to be in late July. That is because Treasury will get a cash infusion from non-withheld tax payments around the June 15 estimated tax deadline, and then another tranche of extraordinary measures will become available on June 30, providing Treasury with enough cash to pay the government's bills for a few more weeks.

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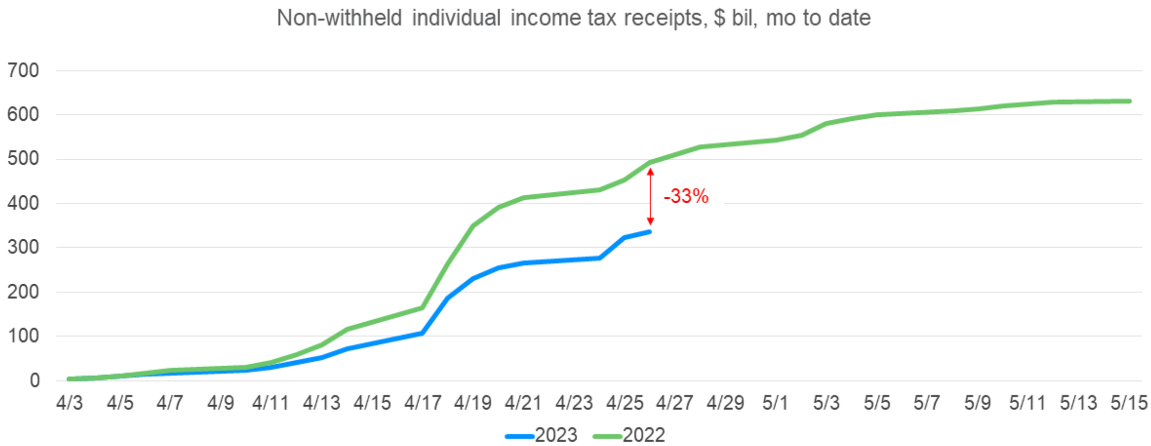
[1] This testimony draws heavily from the Moody's Analytics white paper "The Debt Limit Drama Heats Up." The white papers "Down the Debt Limit Rabbit Hole" and "Debt Limit Brinkmanship (Again)" provide additional relevant analysis on the Treasury debt limit.

Chart 1: Tax Receipts Are Weaker Than Anticipated

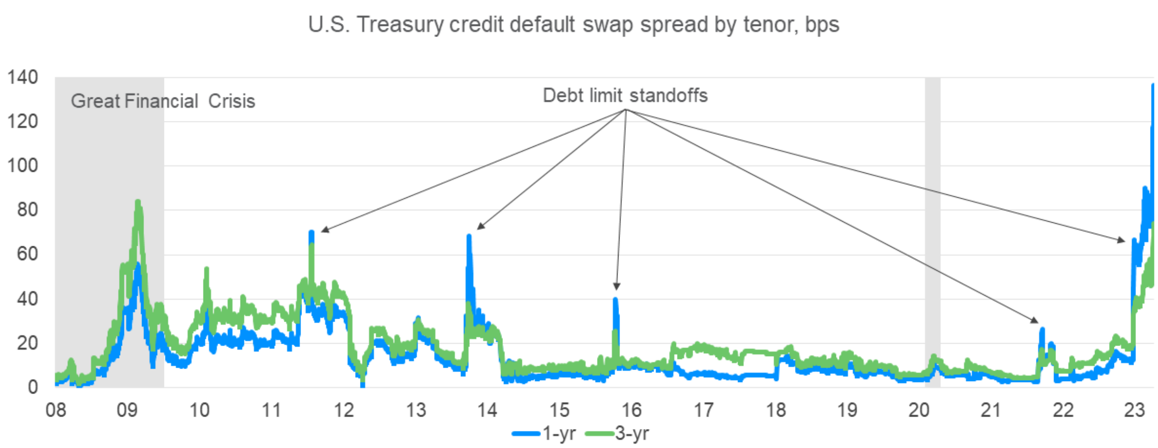


Sources: U.S. Treasury, Moody's Analytics

Investors take notice

Regardless, time is running out for lawmakers to act and increase or suspend the debt limit, and global investors are suddenly focusing on the risks posed if they do not act in time. Credit default swaps on Treasury securities—the cost of buying insurance in case Treasury fails to pay its debt on time—have jumped in recent weeks (see Chart 2). At close to 140 basis points, CDS spreads on one-year Treasury securities are already substantially more than in 2011 when that debt limit drama was so unnerving it caused rating agency Standard & Poor's to strip the U.S. of its AAA rating.[2]

Chart 2: Debt Limit Breach Begins to Worry Investors...



Sources: ICE, Moody's Analytics

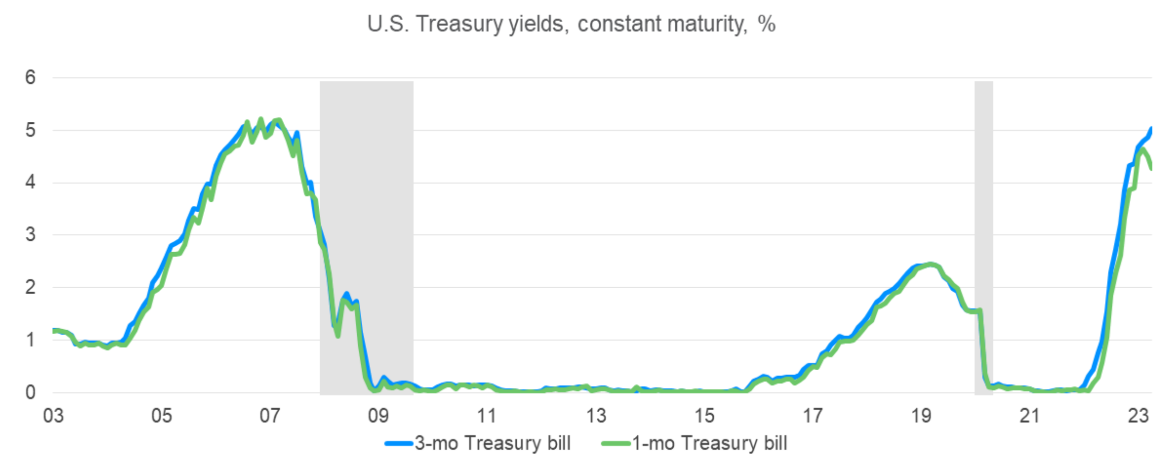
The CDS spread on U.S. Treasury securities measures the cost of purchasing insurance to protect against a default on that Treasury. For example, a 100-bp spread means it costs $100 to insure $10,000 worth of Treasuries.

[2] A CDS spread of 100 basis points means that it costs $100 to insure $10,000 worth of Treasury securities against a default on those securities.

This may overstate investors' angst since the CDS market for buying insurance in the case of a Treasury default is not actively traded, and little trading is needed to push up the cost of insurance. A few hedge funds speculating on the CDS could drive up the cost—they are purchasing something akin to a lottery ticket. Moreover, the current spread is far from a signal that investors see much probability of a default. For context, during the European debt crisis in 2011, the CDS spread on the sovereign debt of stressed countries in the periphery of the euro zone, including Greece, topped out at 1,400 basis points. Even the CDS for core euro zone countries such as Germany and France were over 200 basis points at the time.

That said, the runup in Treasury CDS should not be dismissed out of hand. The recent sharp decline in one-month Treasury bill yields also signals mounting investor angst (see Chart 3). As it has become clear that April tax receipts were coming in weak and the X-date may be just a few weeks away, investors have piled into the safety of one-month Treasury securities. Yields plummeted from 4.75% at the start of April to less than 3.4% at recent their low; they have since recovered somewhat. At the same time, yields on three-month Treasury bills have continued to rise. The difference between one- and three-month Treasury bill yields were at one point in mid-April the widest they have ever been. Global investors thus appear to attach non-zero odds that the debt limit drama will end with a default sometime in June or July.

Chart 3: ...More Than a Little Bit



Sources: ICE, Moody's Analytics

House Republican proposal

So, it was none too soon that House Republicans passed the "Limit, Save, Grow Act of 2023" on April 26. They hope the legislation will put political pressure on President Biden to negotiate changes in fiscal policy in exchange for an increase in the debt limit. The president continues to reject these efforts, arguing for a so-called clean debt limit increase—an increase in the debt limit without substantive changes to policy. His position is that increasing the debt limit is necessary to pay government bills that reflect past fiscal policy decisions over which there can be no negotiation.[3]

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[3] Those past policy decisions resulting in budget deficits and more government debt are bipartisan. Both Republicans and Democrats supported the close to $3 trillion in deficit-financed fiscal aid provided to the economy through the COVID-19 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 in 2021, 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.

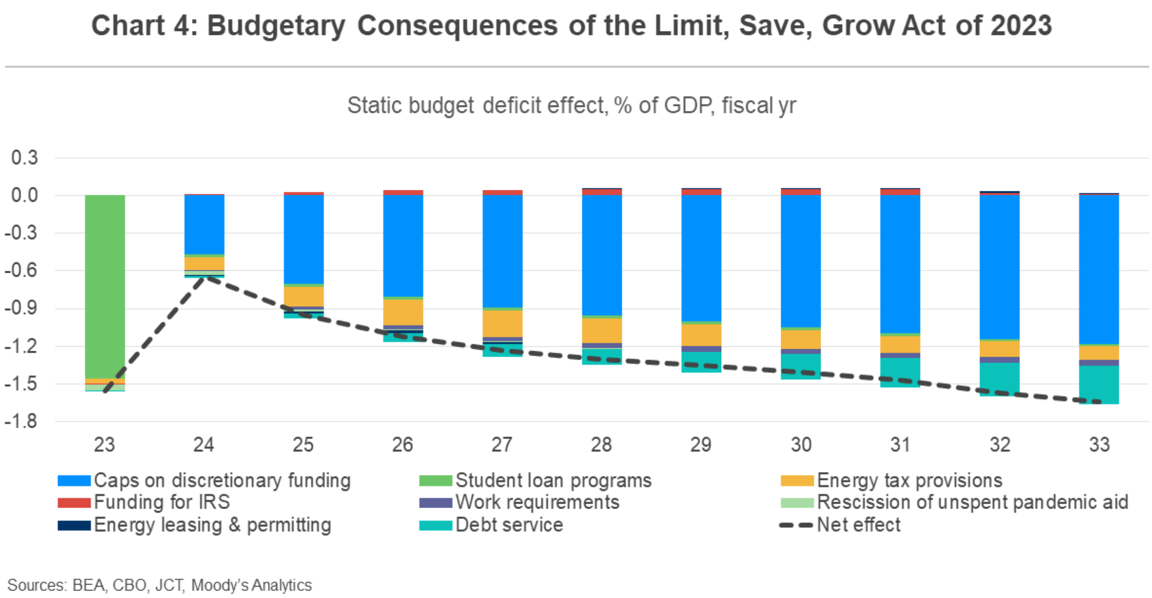
Table 1: Budgetary Consequences of the Limit, Save, Grow Act of 2023

Effect on cumulative budget deficits from fiscal 2023 to 2033, $ bil

Reduce discretionary budget authority to fiscal 2022 level and limit growth to 1% per annum over the next decade	-3,195
Block student loan forgiveness of up to $20,000 per borrower and revamped income-driven repayment plan	-460
Repeal clean energy tax breaks under the Inflation Reduction Act*	-531
Increase work requirements in TANF, SNAP and Medicaid*	-120
Rescind unexpired unobligated balances under COVID-19 relief funding*	-39
Implement energy leasing and permitting provisions	-3
Claw back IRS funding for enforcement, taxpayer services and operations	120
Interest savings	*-547*
Total	**-4,775**

Incorporates the budgetary effects of Amendment 22 to the Limit, Save, Grow Act of 2023

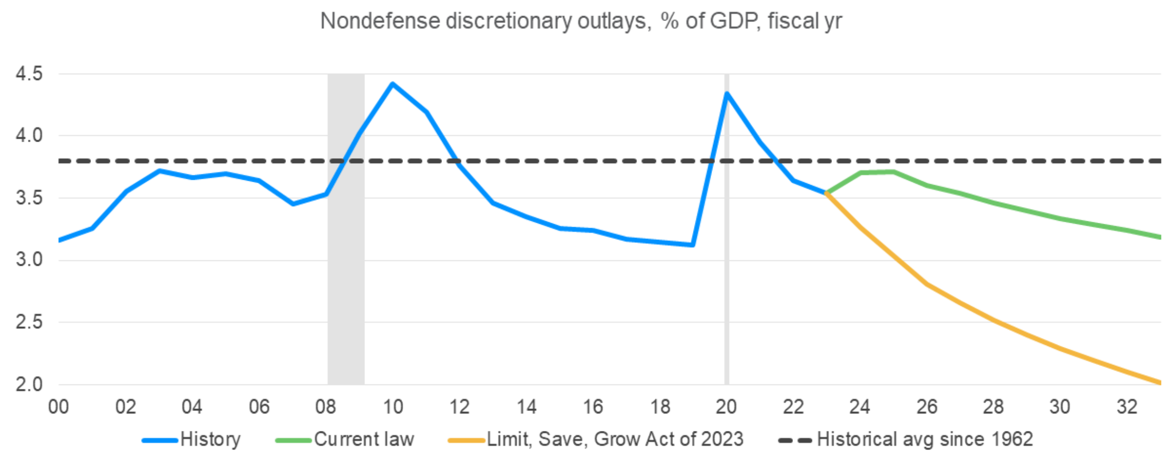
Sources: CBO, JCT, Moody's Analytics



The House Republican legislation would increase the debt limit by $1.5 trillion or until March 31, 2024, whichever comes first. In exchange, it would save the government $4.8 trillion over the next decade and implement a number of consequential changes to fiscal policy (see Table 1 and Chart 4). The most significant spending cuts would come by setting fiscal 2024 discretionary spending equal to fiscal 2022 spending levels. Annual spending growth would then be capped at 1% for the next decade. While not stipulated in the legislation, Republicans would likely work to exclude discretionary spending on defense and veterans' benefits from the cuts, putting the burden of the cuts on nondefense non-VA discretionary programs.[4] If nondefense discretionary outlays were to bear the full brunt of the proposed budget cuts, they would fall to 2% of GDP by fiscal 2033, the lowest since at least the early 1960s (see Chart 5).

[4] Discretionary spending comprises outlays that lawmakers control through annual appropriation acts. Nondefense, non-VA discretionary spending includes a wide range of government programs, from spending on affordable housing assistance and air traffic control to NASA and job training, to name a few.

Chart 5: What If the Nondefense Discretionary Budget Bears the Full Brunt?



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

The House Republican debt limit legislation also works to roll back a number of President Biden's policy initiatives. On energy policy, the legislation would focus on increasing fossil fuel supplies through the enactment of the House Republicans' energy package, which aims to boost oil and gas production and mining by cutting down on the time it takes to greenlight energy projects. It would also end tax breaks for clean-energy projects and qualifying electric vehicles included in the Inflation Reduction Act.

On student lending, the legislation would prevent a couple of key executive orders by the Biden administration, including the White House's plan to provide up to $20,000 in student loan forgiveness for some borrowers. That hit a roadblock last year when it was met with legal challenges, and the Supreme Court is expected to decide its fate later this year. An income-driven repayment plan rolled out by the Education Department earlier this year is also in the crosshairs.

The House Republican legislation also imposes restrictions on income support programs, including work requirements on Medicaid recipients who do not have children, an increase in the age limit for work rules under the Supplemental Nutrition Assistance Program (food assistance), and a requirement that states report on work outcomes under the Temporary Assistance for Needy Families program.

Finally, the legislation eliminates much of the additional funding provided to the IRS last year to help increase tax enforcement efforts and improve taxpayer services, and it rescinds unspent COVID-19 relief funds. The legislation also would require congressional approval before major regulations could take effect.

Macroeconomic impacts

The Limit, Save, Grow Act of 2023 would cut into near-term economic growth if passed into law. Compared with a scenario that includes a clean debt limit increase and no other significant changes to fiscal policy under current law, real GDP growth in the year ending in the fourth quarter of 2024 would be 0.67 percentage point lower (see Table 2).[5] That is, in the Clean Debt Limit scenario, real GDP is expected to grow 2.23% in the year compared with 1.61% if the House Republican legislation becomes law.

Table 2: Macroeconomic Impact of House Republican Debt Limit Plan

	2022Q4	2023Q1	2023Q2	2023Q3	2023Q4	2024Q1	2024Q2	2024Q3	2024Q4	2033Q4	% change 22Q4 -23Q4	% change 23Q4 -24Q4	Ann % change 23Q4 -33Q4
Real GDP													
Clean Debt Limit, 2012$ bil	20,182	20,236	20,309	20,342	20,403	20,493	20,613	20,739	20,857	25,533	1.09	2.23	2.27
Annualized % change	*2.57*	*1.06*	*1.45*	*0.65*	*1.21*	*1.78*	*2.35*	*2.47*	*2.30*				
House Republican Plan, 2012$ bil	20,182	20,236	20,309	20,342	20,389	20,454	20,533	20,614	20,716	25,342	1.02	1.61	2.20
Annualized % change	*2.57*	*1.06*	*1.45*	*0.65*	*0.93*	*1.28*	*1.55*	*1.60*	*2.00*				
Difference, %	0.00	0.00	0.00	0.00	-0.07	-0.19	-0.39	-0.60	-0.67	-0.75			
Nonfarm employment													
Clean Debt Limit, mil	154.3	155.3	155.7	155.9	156.0	156.1	156.3	156.5	156.7	162.7	1.12	0.45	0.42
Change, ths	*948*	*1,024*	*420*	*171*	*118*	*89*	*150*	*219*	*248*				
House Republican Plan, mil	154.3	155.3	155.7	155.9	155.9	155.9	155.8	155.8	155.9	162.1	1.08	-0.01	0.39
Change, ths	*948*	*1,024*	*420*	*171*	*50*	*(42)*	*(66)*	*(28)*	*121*				
Difference, ths	0	0	0	0	-68	-199	-415	-662	-790	-589			
Unemployment rate													
Clean Debt Limit, %	3.60	3.50	3.59	3.66	3.87	4.01	4.10	4.18	4.21	4.14			
House Republican Plan, %	3.60	3.50	3.59	3.66	3.91	4.12	4.31	4.51	4.58	4.25			
Difference, bps	0	0	0	0	3	10	21	32	37	11			
Consumer price index													
Clean Debt Limit 82-84=100	298.5	301.3	303.2	305.3	307.6	309.4	311.2	312.7	314.3	378.6	3.05	2.16	2.10
Annualized % change	*4.16*	*3.81*	*2.55*	*2.79*	*3.04*	*2.33*	*2.30*	*2.01*	*2.01*				
House Republican Plan 82-84=100	298.5	301.3	303.2	305.3	307.6	309.4	311.1	312.7	314.2	377.8	3.05	2.14	2.08
Annualized % change	*4.16*	*3.81*	*2.55*	*2.79*	*3.04*	*2.32*	*2.28*	*1.99*	*1.98*				
Difference, %	0.00	0.00	0.00	0.00	0.00	-0.01	-0.02	-0.03	-0.06	-0.06			
Federal publicly traded debt to GDP													
Clean Debt Limit, %	93.8	93.2	92.7	95.0	95.3	95.5	95.7	95.9	96.6	115.1			
House Republican Plan, %	93.8	93.2	92.7	95.0	95.3	95.5	95.8	96.1	96.7	105.0			
Difference, bps	0	0	0	0	0	0	10	19	8	-1006			
10-yr Treasury yield													
Clean Debt Limit, %	3.83	3.65	3.80	3.93	3.96	3.98	3.93	3.84	3.78	3.79			
House Republican Plan, %	3.83	3.65	3.80	3.93	3.96	3.97	3.91	3.80	3.72	3.58			
Difference, bps	0	0	0	0	0	-1	-2	-4	-6	-21			

Note: Forecast begins in 2023Q2

Sources: BEA, BLS, Federal Reserve, U.S. Treasury, S&P, Moody's Analytics

While the economy skirts recession in both scenarios, recession risks are uncomfortably high, with a consensus of economists and many investors and business executives expecting a downturn beginning late this year or early next. The timing of the government spending cuts in the Limit, Save, Grow Act is thus especially inopportune—it would meaningfully increase the likelihood of such a downturn. Indeed, under the legislation, GDP growth is so weak that employment declines in the first three quarters of 2024, and the unemployment rate rises by more than a percentage point to nearly 4.6% by the fourth quarter of 2024. Compared with the Clean Debt Limit scenario, by year-end 2024, employment is 790,000 jobs lower, and the unemployment rate is 0.37 percentage point higher.

The significant government spending cuts in the Limit, Save, Grow Act are a substantial headwind to near-term economic growth. The cuts reduce nondefense outlays by $129 billion in fiscal 2024 compared with the Clean Debt Limit scenario, equal to about half a percentage point of GDP. The multipliers on this spending—the change in GDP a year after a change in spending—are estimated to be just over 1.0,

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[5] The Clean Debt Limit scenario assumes that the moratorium on student loan payments ends this summer, but that President Biden's student debt forgiveness and income-driven repayment plans remain in place. This scenario also assumes lawmakers agree to increase the debt limit just enough to ensure that it will not get caught up in the 2024 presidential election.

because the programs suffering budget cuts are essential government services and tend to benefit lower-income households that quickly spend any support they receive from the government (see Table 3).

Table 3: Federal Fiscal Multipliers

$ change in GDP in 2024Q1 for a once-and-for-all $1 change in federal spending or revenue in 2023Q1

Federal spending	
Supplemental Nutrition Assistance Program (SNAP)	1.57
Supplemental Unemployment Insurance	1.42
Work-Share Unemployment Insurance	1.32
Aid to State and Local Governments	1.27
Low Income Home Energy Assistance Program (LIHEAP)	1.27
Transportation Infrastructure Spending	1.23
Defense Spending	1.20
Child Care (Universal Child Care Act)	1.18
Universal Pre-K (3 and 4 yr olds)	1.16
Home and Community Based Care	1.16
Federal revenues	
Earned Income Tax Credit	1.25
Child Tax Credit	1.23
Economic Impact Checks	1.04
Payroll Tax Holiday for Employees	1.02
Payroll Tax Holiday for Employers	0.93
Nonrefundable Lump-Sum Tax Rebate	0.91
Personal Income Tax Rate	0.85
Housing Tax Credit	0.80
Student Loan Debt Forgiveness	0.58
Dividend and Capital Gains Tax Rate	0.36
Corporate Tax Rate	0.30
Accelerated Depreciation	0.25
15% Minimum Corporate Book Tax	0.23
Net Operating Losses	0.21

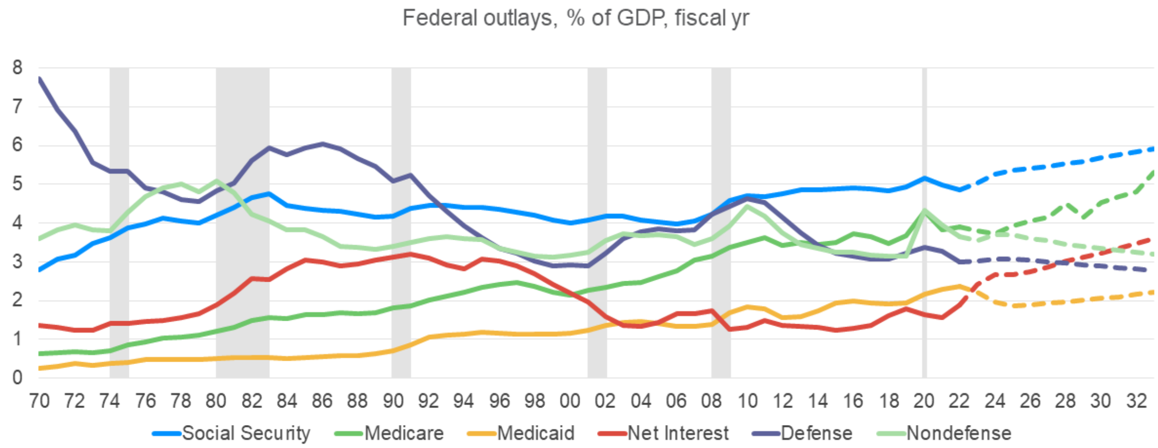
Source: Moody's Analytics

Adding to the economic headwind created by the legislation is the considerable uncertainty created by having to address the debt limit again a year from now. Given that 2024 is a presidential election year, that future debt limit drama may well be even more heated than the current one. This is sure to weigh on investor, business and consumer confidence and thus economic activity.

Cushioning the negative near-term economic consequences of the legislation are lower interest rates. The Federal Reserve begins to lower interest rates late this year soon after the passage of the legislation given the weaker economic growth and heightened recession risks. Long-term Treasury yields are lower in part because of the weaker economy but also because of prospects for smaller long-term budget deficits and a lower government debt load. A decade from now, the nation’s debt-to-GDP ratio is expected to be 105%. This is up from 97% in fiscal 2022, but more than 10 percentage points below the debt-to-GDP ratio expected in the Clean Debt Limit scenario at the end of the 10-year budget horizon.

Though the nation's fiscal situation is better under the House Republican legislation, it does not address the long-term fiscal challenges posed by the old-age entitlement programs, which, if left unaddressed, will keep the federal budget on an unsustainable trajectory (see Chart 6).

Chart 6: On an Unsustainable Fiscal Path



Note: Dotted lines reflect CBO's projections of mandatory and discretionary spending under current law.

Sources: BEA, CBO, Moody's Analytics

What's next

The Treasury debt limit drama is heating up and is sure to get much hotter in coming weeks as we have a better understanding of the 2023 tax filing season and the actual X-date. If the X-date is as soon as early June, it seems a stretch for lawmakers to come to terms fast enough, and they instead will decide to pass legislation suspending the limit long enough to line the X-date up with the end of fiscal 2023 at the end of September. This will buy time and combine the debt limit decision with the federal government's fiscal 2024 budget, which is also must-do legislation for lawmakers to ensure the government is funded and avoids a shutdown.[6]

Getting legislation that funds the government in fiscal 2024 and increases the debt limit across the finish line into law will surely be messy and painful to watch and will generate significant volatility in financial markets. Indeed, a stock market selloff, much wider credit spreads in the corporate bond market, and a falling value of the U.S. dollar may be what is required to generate the political will necessary for lawmakers to avoid a government shutdown and breach of the debt limit. Lawmakers will not be sufficiently motivated to find a political path forward and act until they recognize the severe economic and political costs of not doing so.

But when all is said and done, the legislation that lawmakers ultimately pass will likely be anticlimactic, allowing both House Republicans and President Biden to declare political victory. For

[6] To assure maximum political pressure to get this all done by the start of October, the legislation that suspends the limit could require the Treasury to have the same cash balance at the end of fiscal 2023 as it had at the start of the suspension when the cash balance was virtually exhausted. The legislation could also prevent the Treasury from targeting the G Fund of Federal Employees' Retirement System Thrift Savings Plan, which normally provides the Treasury significant headroom under the debt limit.

House Republicans, the legislation may include some restraint on the future growth in discretionary spending, a clawback of unused COVID-19 relief funds, and a streamlining of permits for energy development to allow House Republicans to declare victory. For the president, he can argue that these concessions were modest and simply part of the typical budget process and not a quid pro quo for a debt limit increase: a happy enough outcome to ensure the government is funded and the economy avoids financial calamity and recession. Of course, the nation's daunting long-term fiscal challenges remain.