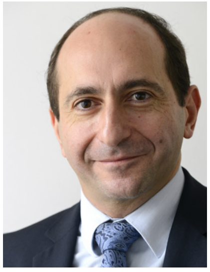
THEMATIC GLOBAL VIEWS



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Will the US policy mix "build back better"?

On 19 November, the House of Representatives (HoR) passed the Build Back Better Act (BBB). The bill will now be considered by the Senate. This is a big step forward for the Biden administration, especially since this vote comes just after President Biden signed the infrastructure plan into law.

The BBB act, adopted by HoR, will be examined in the Senate in the coming weeks. Several questions arise. Why implement stimulus measures in the current environment? What measures are envisaged by this new program, and what are the chances that BBB will be passed by the end of the year? Is there a risk of deadlock in the Senate? Will US fiscal policy increase the deficit and public debt in the long run? And could it increase inflationary pressures? If so, is it a game changer for the Fed? We offer some answers.

Why the big fiscal plans?

The economic situation in the US is normalising. By the end of next year, the economy should return to full employment. Inflation is at its highest level in over 30 years. Normally, this context would not be compatible with continuing an expansionary policy mix.

However, the BBB plan is not about stabilising the economy in the short term. It is primarily about putting in place a package of social spending and tax breaks for lower and middle-income households. The objective is to make growth more inclusive in the medium and long term, in line with the Democrats' election promises.

There is thus a triple motivation for the Biden administration: economic (to increase growth potential in the medium term), societal (to have a more inclusive and less unequal growth model), and political (to retain the Senate in the mid-term elections).

Ultimately, the objective is to make growth more inclusive in the medium and long term

Will the Senate block the "Build Back Better" plan?

Moderate Democrats are openly concerned about implementing expansionary fiscal policy in an economy that, for some, is already showing signs of overheating. Even though the economy is not at full employment, wages have already accelerated significantly, with the employment cost index (in its compensation component) up by an annualised 6% in Q3 (4.2% YoY).

In this context, moderate Democrats in the Senate will seek to roll back some of the provisions proposed by the House or even repeal them. Three spending items are in their sights: immigration spending, paid leave and adjustments to the SALT deduction (see box).

- The $120bn increase in immigration spending likely to be trimmed
- Paid leave (an extension of about $200bn) may have to be dropped to receive the approval of all Democrats
- The SALT deduction cap will probably have to be lowered and/or means-tested (see box)

The reconciliation procedure theoretically allows the bill to be passed by a simple majority. However, in the Senate, this procedure gives more power to the opposition, which has the means to slow down passage of the text and sow discord among Democrats. Each budget provision must be found to comply with certain budget rules (otherwise the provisions are dropped, this is the so called "Byrd rule"[1]). In addition, Republicans can filibuster, filing numerous amendments that can force votes on difficult issues (i.e., the "vote-a-rama"[2]).

Joe Biden wants the bill to be passed before Christmas, but there is a significant risk that it could be delayed until later in January, which would diminish its chances of being passed.

Joe Biden wants the bill to be passed before Christmas but this is not a given

It seems to us, however, that the Republicans will not get their way. The Democrats will want to stick together. Their drop in popularity in the polls bodes for an uphill battle in the November 2022 mid-term elections. Current projections show that the Democrats will most likely lose control of the House. If they want to retain a majority in the Senate, they must avoid giving the Republican camp a victory.

With the bill currently before the Senate, this is likely to be the last budget measure that the Biden administration will be able to pass. Time is of the essence, as the election campaign will begin in January. The risk of a new epidemic wave should help cement the Democrats, as the Omicron variant threatens to further slow down aggregate demand next year (with less risk of overheating).

What impact on the deficit and growth?

The text envisages a myriad of measures. It is therefore difficult to estimate the impact precisely. The legislation is more-or-less paid for, according to the CBO. But since spending will be concentrated in the early years (2022-25), and taxes in the later years, the impact on the

[1] *A Senator opposed to the inclusion of extraneous provisions (extraneous to the purpose of implementing budget resolution policies) in reconciliation legislation may offer an amendment that strikes such provisions from the legislation.*
[2] *The procedures allow members of Congress to propose an unlimited number of amendments to budget-related measures, and these amendments are all voted on one after the other after the time allotted for debate expires.*

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The economic impact will ultimately depend more on private demand than on public demand

federal deficit will be higher over the next four years.

Given that the measures that will be trimmed or even cancelled by the Senate, the impact on the federal deficit should be fairly small (especially compared to the impact of the Covid crisis in 2020). However, some of the provisions that are set to expire (such as the child tax credit), if extended, would weigh on the federal deficit later. The HoR plan's impact on growth is also estimated to be very moderate next year (no more than half a percentage point in 2022, which is already factored into our current forecast). That said, the BBB act should help anchor expectations of growth and a sustainable recovery in the labour market, and thus encourage households to mobilise the excess savings they accumulated during the crisis. The economic impact will ultimately depend more on private demand than on public demand.

Monetary policy: the return of a risk management approach?

US growth accelerated in Q4 and inflation is at a 30-year high. Although growth will slow next year, we believe it will remain slightly above potential in late 2022. Inflation will also slow but will remain above the Fed's target.

Under normal circumstances, an expansionary fiscal stance would be accompanied by a less accommodative monetary stance. But following the revision of its strategy review, the Fed has *de facto* changed its reaction function. On the one hand, the BBB program, if passed by the Senate, will strengthen the camp of those who believe that it is time to rebalance the policy mix, with less monetary support (accelerated tapering). On the other hand, threats from the new Omicron variant are likely to weigh on growth next year.

In the past, such periods of uncertainty have generally led the Fed to opt for a risk management approach (i.e., to favour maintaining growth over fighting inflation). Ultimately, we believe the Fed will remain more cautious than the markets expect, even if the BBB plan passes the Senate. The Fed may reduce/end its asset purchases, but it is still far from hiking its key rates. The bottom line is that real interest rates are not about to move back into positive territory, despite the fiscal stance.

Finalised on 30 November 2021

The infrastructure and the Build Back Better acts in a nutshell

1. The Infrastructure Investment and Jobs Act

The plan was passed by the HoR on 5 November, with the support of 13 Republican representatives but the opposition of six progressive Democrats who had made their vote conditional on the Build Back Better Act. It had already passed the Senate in bipartisan fashion (69-30) on 10 August. It has since been signed into law by the president.

- **More than $1,000bn** in spending on transportation and other physical infrastructure over the 2022-2031 decade, including nearly $600bn in additional funding.
- **Strongly increasing:** spending on roads and bridges, power systems, railways, broadband, water networks and public transport (of which $274bn in transport infrastructure and $239bn in public utilities).
- **Objectives:** lower costs for companies, improved competitiveness and productivity, and reduction of carbon emissions.
- **One of the main arguments in favour of this plan is that it is the right time to do it:** the expected return on public infrastructure is estimated to be much higher than its financing cost (with 30-year Treasury yields below 2%).
- **Ex-post, the cost is modest.** There is no substantial impact on the deficit and debt over the next 10-year budget horizon, once the expected multiplier effects on growth over 10 years are taken into account.

2. The Build Back Better (BBB) Act, as passed by the House

This plan, which still needs to be approved by the Senate, provides:

Approximately $2100bn in spending:

- $2100bn in new spending and tax credits on social programs (child care, education, health care), which can be broken down into three:
  - Social programs ($1100bn).
  - Climate and housing ($700bn).
  - Other expenditures ($300bn).
- Increased spending on climate and housing investments.

To finance them, several measures would generate about $2,000bn in revenue:

- Corporate taxes ($820bn).
  - The corporate tax rate would remain stable at 21%.
  - A new alternative minimum tax coming into effect in 2023 ($320bn).
  - A 1% tax on share buybacks ($120bn).
  - A tax increase on multinationals ($280bn).
- Taxes on high-income households ($640bn).
  - For high-income earners (over $400,000/year): $400bn in revenue.
  - For very-high-earners (over $5 million/year): $230bn.
  - However, the adopted plan raises the current $10,000 cap on state and local tax (SALT) deductions to $80,000. This will result in a significant tax cut for high earners beginning in 2022-25.
  - Savings from drug pricing reform ($300bn).
  - Better enforcement of tax laws ($200bn, according to CBO estimates). The White House is more optimistic, hoping for $400bn in revenue.

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