



U.S. Debt Deal May Mark New Era in Federal Spending

Here's what it could mean for the economy, industry, and policy.

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First and foremost, the deal to suspend the U.S. debt ceiling, formally known as the Fiscal Responsibility Act (FRA), averted a U.S. sovereign default. However, the compromise may also mark a new era where government spending grows more modestly, in our view. It also could open the door for additional bipartisan legislation in the run-up to the next presidential election.

FRA Likely a Modest Drag on Economy Over Next Two Years

The bulk of the fiscal drag over the next two years would come from caps on non-defense discretionary spending, or the portion of the budget that Congress sets each year. This category includes a wide range of federal programs, from scientific research to education, housing, and law enforcement. Spending on Social Security and Medicare is excluded.

In fiscal year 2024, which begins October 1, 2023, these limits ultimately could translate into a roughly 0.2% drop in government spending after planned adjustments that include diverting funding from the Internal Revenue Service. The FRA limits spending increases in fiscal 2025 to 1%.

Both caps would represent a savings relative to the Congressional Budget Office's previous baseline for the



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assumed annual growth rate in federal spending.

The legislation also expanded work requirements for certain government assistance programs and includes a separate requirement that the federal government restart student loan payments in August, a month earlier than the Biden administration had planned. Repayments on federal student loans have been paused since March 2020 to provide relief during the coronavirus pandemic.

Ultimately, the hit to the economy in 2024 could be moderated by the positive effects of spending from last year's budget, which was about 10% higher than that of fiscal 2022. Private investment in clean energy infrastructure could also accelerate more than expected, fueled by the generous tax subsidies enacted by the Inflation Reduction Act.

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Bottom Line: The FRA's binding caps on government spending are limited to the next two years and, on their own, should not be a game changer for the U.S. economy over the coming 12 months. The trajectory of inflation and the lagging effects of the Federal Reserve's monetary tightening are likely more important drivers for the domestic economy, in our view.

One risk factor, however, bears watching. The compromise deal automatically imposes a temporary 1% cut if all appropriations are not approved by January 1. Appropriation bills set the funding for discretionary government programs each year. The FRA only sets the topline spending numbers; appropriations lay out the details.

Defense Dodges a Cut, and Energy Receives Permitting Relief

The FRA carves out a 3% increase in defense spending in fiscal 2024. This favorable treatment does not extend to fiscal 2025, when the uptick in military expenditure will be subject to the same 1% cap as the rest of the government's discretionary budget. Given concerns about geopolitical tensions, we would not be surprised if Congress were to pass supplemental defense spending.

Changes to the approval process for energy infrastructure should benefit both fossil fuel and clean energy companies by shortening the duration of environmental reviews and giving

project developers legal recourse if regulators fail to meet these deadlines. We think the limited scope of these reforms should preserve the political momentum behind an overhaul of energy permitting.

Potential losers from the FRA are harder to identify at this juncture. However, the fall should bring greater clarity as the budgeting process reveals which government programs will face the largest cuts.

Potential for Other Compromise Legislation

The debt limit saga and its ultimate resolution demonstrated that Speaker of the House Kevin McCarthy (R-Cal.) can overcome internal differences to wrangle his caucus, suggesting the possibility of additional bipartisan legislation.

We'll be monitoring the progress of initiatives related to permitting for energy projects, a new farm bill that sets agricultural and food policy, and the tax treatment of expenses related to research and development.

A New Era in Fiscal Policy?

The debt deal may mark the start of a new era of fiscal policy where moderate spending growth or modest austerity become the norm.

That's one aspect of the agreement that may get overlooked in the rush to sort out its near-term implications.

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