The U.S. presidential election and the outlook for fiscal policy

September 2020

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Key insights

With the economy only just emerging from a historic contraction and monetary policy largely exhausted, fiscal policy has taken on an increasingly important role in supporting the recovery. As such, we have put together a thorough analysis of the likely path for fiscal policy under different election outcomes.

The fiscal outlook will be influenced not just by the presidential election, but the outcome of Congressional races. Prediction markets are pricing meaningful odds of a Democratic "clean sweep" – control of the executive branch and both houses of Congress. Under this scenario, sustained fiscal support for the economy throughout 2021 would be more likely.

This scenario also holds the greatest likelihood of significant changes to tax law, accompanied by increased spending on Democratic priorities.

Divided government scenarios, under either a Biden or Trump presidency, would raise the risk of insufficient or halting fiscal support for the nascent recovery.

This note identifies the fiscal policy priorities of a Biden presidency and a second Trump administration, and also highlights the likelihood that these policies can be implemented based on party control of the Senate and the House of Representatives. Based on polls and prediction markets, market focus is squarely on three scenarios – a Biden presidency with Democrats gaining a slim Senate majority while also retaining a House majority; a Biden presidency with Republicans retaining a Senate majority; and a Trump presidency with Republicans retaining Senate control but Democrats still holding a majority in the House. Under these last two "divided government" scenarios, Congressional gridlock would lead the next administration to focus on policy areas such as immigration, trade and financial and environmental regulations, where presidents have some leeway to act without Congressional authorization.

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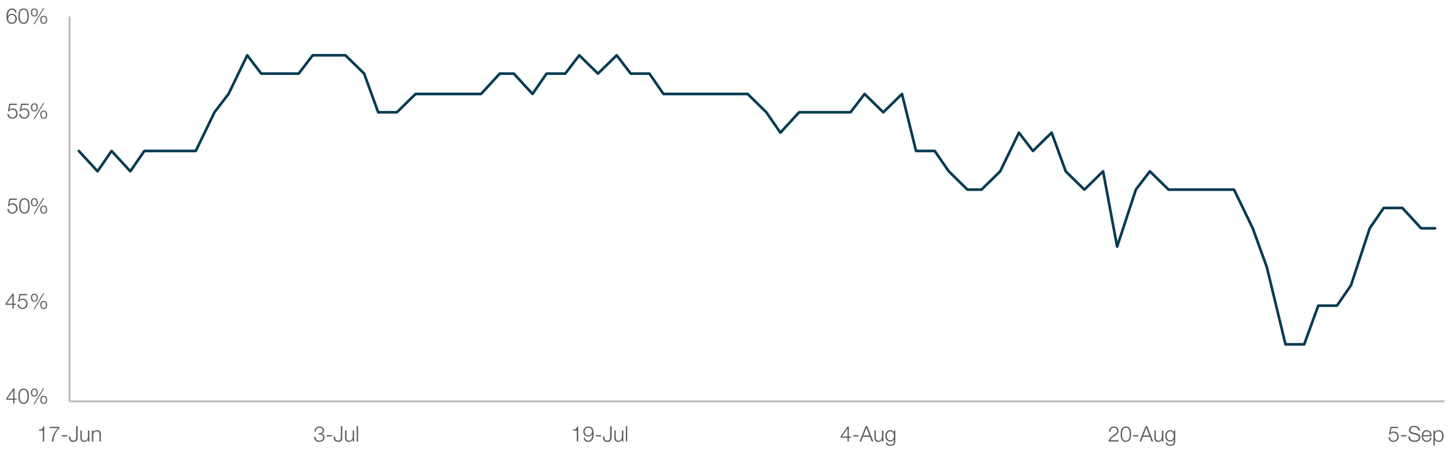
Subsequent publications in this series, to be released in the coming weeks, will focus on four policy areas where there are important differences between the two parties and that are also of keen interest to investors – financial regulation, technology, health care and the energy sector.

A sea change in fiscal priorities

According to most national and state-level polls as well as prediction markets, former Vice President and current Democratic presidential nominee Joe Biden has retained a fairly steady lead over President Trump heading into the November Presidential election. For example, FiveThirtyEight.com's polls-based model has assigned Biden an election win probability of between 69 and 79 percent since June 1, with Biden's win probability currently standing in the middle of that range. As importantly, state-level polls suggest Democrats could emerge from the election with a small Senate majority. Democrats thus stand a reasonable chance of winning both the presidency and control of Congress. In fact, contracts on PredictIt.org that pay out in the event of a Democratic clean sweep currently imply almost a 50 percent chance of such as an outcome (**Figure 1**).

Figure 1: Odds of a Democratic clean sweep



Source: PredictIt.org, as of 9/6/20.

A Democratic clean sweep would be the most consequential of the election scenarios considered most likely, as it would set the stage for significant changes in fiscal policy in the years ahead. Working with House and Senate leadership, a Biden administration would stand a reasonable chance of enacting legislation to increase spending on health care, education and infrastructure, with much of these spending priorities paid for by raising taxes on higher-income households and partially reversing the corporate tax cuts in Republicans' signature Tax Cuts and Jobs Act of 2017.

In addition, a Biden presidency combined with Democratic control of Congress increases the likelihood of fiscal support through much of 2021 that would provide households, small businesses and state and local governments with resources to weather what will remain a challenging economic environment. A Democratic-controlled Senate might also encourage the Federal Reserve to redesign some of its credit facilities – particularly the Main Street Lending Facility and the Municipal Liquidity Facility – to take more risk in support of the recovery. These facilities have lent substantially less than the maximum sizes that the Federal Reserve and Treasury initially set. A Biden-appointed Treasury Secretary would likely be in favor of more active use of the central bank's balance sheet to support the flow of credit, even if it meant realizing modest losses in the future on Treasury's equity stake in the facilities.

On net, the mix of policy changes under a Biden administration would likely be growth-positive. More sizeable and sustained coronavirus relief would boost aggregate demand in 2021 and support stronger labor market outcomes. While this spending would be financed through debt issuance, continued Federal Reserve quantitative easing throughout next year suggests the pass-through to interest rates (and hence crowding out of private investment) could be limited. Meanwhile, the mix of tax law changes and spending initiatives in health care, education and infrastructure tend to have high fiscal multipliers (see **Figure 2**).

Figure 2: Estimates of U.S. fiscal multipliers

	Estimated Multiplier	
Activity	**Low Estimate**	**High Estimate**
Federal purchases of goods and services	0.2	2.5
Transfer payments to states for infrastructure	0.2	2.2
Transfer payments to individuals	0.4	2.1
Transfer payments to states for other purposes	0.4	1.8
Tax cuts: lower-and middle-income households	0.3	1.5
Tax cuts: higher-income households	0.1	0.6
Corporate tax provisions	0.0	0.4

Source: Congressional Budget Office, 2015.

Higher corporate tax rates and increased environmental and other regulations under a Biden administration could have a negative effect on corporate spending and hiring, but this drag on growth could be offset by a more certain trade environment. Similar to the Trump administration, a Biden administration would look to redress perceived imbalances in the US relationship with China, especially in the areas of technology transfer, intellectual property protections and access to Chinese markets. However, a Biden administration would be far less likely to pursue these objectives through unilateral tariffs. Tariffs would also not be used for leverage in any negotiations with other major trading partners, including the European Union. The experience of Trump's first term suggests that tariffs and the threat of trade wars reduced business confidence and weighed on capital expenditures.

Covid-19 and the risk of gridlock

While markets have focused on the prospects of a Democratic clean sweep given the consequential changes to fiscal policy that would result, the race is far from over and is expected to tighten further as the election approaches. If President Trump is re-elected, he is most likely to face a Congress in which Democrats retain control of the House. Similarly, Republicans may succeed in preserving their Senate majority even if Biden wins the election. These two divided government scenarios would bring few if any major legislative changes, an outcome which markets have often viewed as favorable since it implies a more certain policy environment. However, this interpretation of gridlock in 2021 and 2022 (i.e., until the next mid-terms) may not be particularly insightful in the context of Covid-19. With divided Congress currently, the federal government is already struggling to deliver consistent fiscal support to the economy: heading out of the summer months, talks on a follow-up to the CARES Act remain deadlocked over a number of issues, including the size of federal contributions to state unemployment insurance programs, and the size and necessity of aid to state governments. If this represents a blueprint for next year, when Covid-19 will still present meaningful challenges to many households, businesses and state and local governments, then divided government could bring halting and insufficient fiscal support, risking a more sluggish recovery and worse labor market outcomes.

Figure 3: Implied odds from prediction markets of congressional balance of power after the election

Outcome	Probability
Democratic house, democratic senate	53%
Democratic house, republican senate	37%
Republican house, republican senate	16%
Republican house, democratic senate	2%

Source: PredicitIt.org, as of 9/6/20.

Beyond the Covid-19 response, split government would leave a re-elected Trump or a President Biden to focus on areas where the administrative branch has some leeway to act without Congressional authorization – areas such as trade, immigration and environmental and financial regulation. President Trump would have to set aside his outstanding tax policy priorities, such as “Made in America” tax credits, expanding tax breaks for investing in lower-income communities, and a broader “Tax Cuts 2.0” as follow-up to the 2017 Tax Cuts and Jobs Act. Instead, trade policy would remain a significant focus of a second Trump term, with tariffs again used as a form of leverage in negotiations not just with China, but with other major trading partners and on issues that go beyond trade.

One area where there is scope for compromise between Democrats and Republicans, and which could become a focus in either divided government scenario, is infrastructure. There is broad recognition of the country’s dire need for infrastructure investment, as well as the near-term economic benefits that government spending in this area could deliver as the economy continues its recovery. However, there are at least two roadblocks to a major infrastructure agreement between the two parties. First, a Democratic House would likely put forward an infrastructure bill with a strong orientation towards green investments, which could meet resistance in a Republican-controlled Senate. Second, the two parties have very different philosophies for infrastructure investment, with Republicans envisioning a much stronger role for the private sector, and public-private partnerships in particular. A significant, bipartisan infrastructure effort would still be possible, but these two differences in party priorities would need to be addressed within the context of a highly polarized political environment.

Figure 4: Key policy proposals of the two campaigns

Policy Area	Trump	Biden
Financial regulation	Some further easing of regulations for smaller banks	Strengthen oversight of larger banks and non-bank financial entities such as insurance companies, asset managers and private equity
Health care	Drug pricing controls, end surprise medical billing, invalidate the Affordable Care Act	Expand access and lower costs through the Affordable Care Act and a public option
Energy	Continued allowance of drilling on federal lands and expedition of pipeline reviews and permitting	Ban new permits for drilling on federal land and impose new restrictions on pipeline permitting. Accelerate clean energy transition
Technology	Continued review of Chinese technology through national security lens; enhanced antitrust scrutiny of Big Tech	Enhanced antitrust scrutiny of Big Tech, potential for stricter data privacy standards
Infrastructure	$1 trillion over ten years on highways and transit, rural broadband, 5G cell service and other non-transportation infrastructure	$2 trillion investment in “sustainable infrastructure” and clean energy, 5G cell service and rural broadband
Tax policy	“Made in America” tax credits; expand tax breaks for investing in lower-income communities; reduce capital gains tax rate	Raise corporate tax rate from 21% to 28% and institute minimum 15% tax on global income over $100 million; increase top individual rate to 39.6%

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