Phronesis Insights, LLC

Policy & Economic Outlook

August 20
2024

Volume: I
Issue: 1

Inaugural Issue: The Road Ahead

Phronesis Insights is pleased to launch a unique product for clients, presenting a realistic assessment of the federal policy landscape, and how it's probable near-term development will affect businesses and the economy.

Clients will gain perspective drawn from a quarter-century of experience in economics, federal policy, budgeting, congressional procedure in both chambers of Congress, and engagement with federal departments and agencies, including Treasury, the Federal Reserve, the Office of Management and Budget, and data agencies like the Bureau of Labor Statistics. Particular economic understanding was honed over more than a decade of work with the Joint Economic Committee, Congress's macroeconomic experts.

The *Phronesis Insights Policy & Economic Outlook* focuses on those policies and regulations that are most likely to affect the economy. Phronesis Insights will go beyond the spin and talking points to provide a realistic assessment. We aim to help clients better understand the broader landscape from a practical and historical standpoint for critical decision-making.

Americans face perilous times in the coming years. Total federal debt now exceeds $35 trillion (around 125% of GDP), and the Congressional Budget Office projects worsening trillion-plus dollar deficits in every year through 2054.

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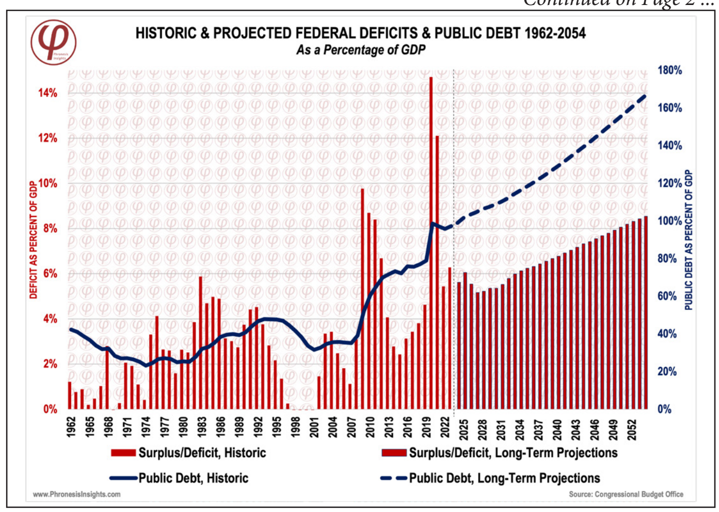


POLICY SNAPSHOTS

Congress has yet to pass any annual discretionary appropriation bills. Discretionary now constitutes only 26% of all federal spending (mandatory is 61%; interest is 13%). The House passed 6 of 12 bills (Defense; Energy; Homeland Security; Interior; Military Construction-Veterans; and State-Foreign Operations) and rejected Legislative Branch. No bills have passed the Senate. Wide differences remain between the Chambers. In a presidential election year, expect a continuing resolution that will fund government through the election and likely into spring. "Shutdown" odds are low. Contractors will again be left with uncertainty, which may ultimately increase costs to the federal government.

Labor markets softened in July, leading to a swoon in equity values as recession fears increased. Some called for an emergency Fed rate cut in relation to the early-August market dip, but such calls were misplaced. The market has already rebounded with the emergence of additional data points.

Meanwhile, though post-pandemic **inflation** is locked-in, year-over-year inflation has decreased the past few months with many economists projecting the Federal Reserve will cut interest rates a quarter-point in September.

The Securities Exchange Commission (SEC) is among the first regulators facing legal challenges for overreach following the Supreme Court overturning its Chevron doctrine. Phronesis Insights will soon explore the economic effects of this SCOTUS decision. Businesses should keep a close eye on this.

Inside Discussion

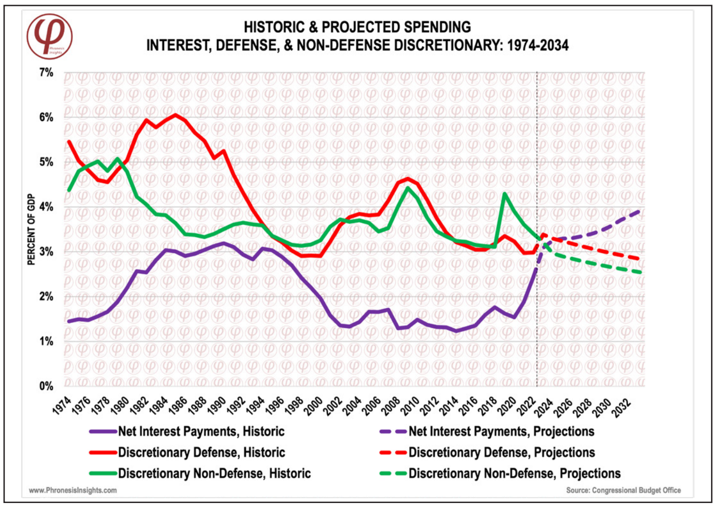
About

J. Douglas Branch II founded Phronesis Insights after 25 years in senior roles in both House and Senate, including the Joint Economic Committee and Homeland Security and Governmental Affairs Committee. He has worked in many areas including federal tax, budget, financial services, monetary policy and economics, and congressional procedure and strategy.

To subscribe, contact, or follow Doug:
Doug.Branch@PhronesisInsights.com
www.PhronesisInsights.com
X: @DougBranch

The Road Ahead, Continued

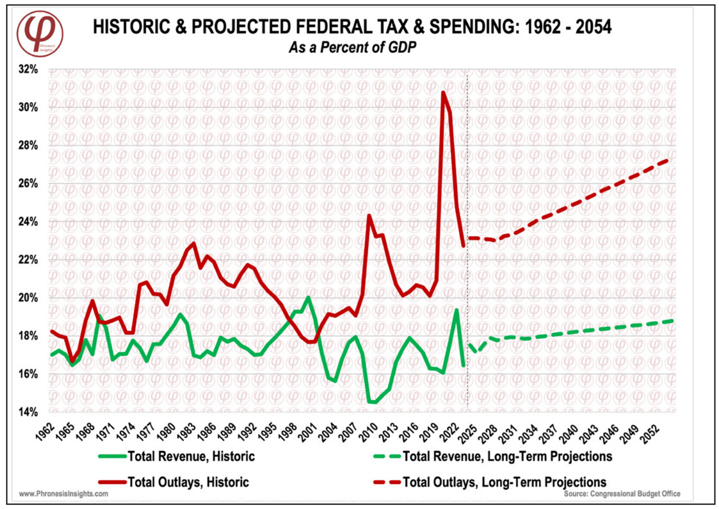
In 2010, Harvard professors Carmen Reinhart and Kenneth Rogoff found that national debt exceeding 90% of GDP correlates with a percentage point decline in the nation's GDP. The scholars' contention was reaffirmed in 2013. Historically, nations with a 60% to 90% debt-to-GDP ratio have a median economic growth rate of 2.8%, whereas nations with a 90% or greater debt-to-GDP ratio have only a 1.8% growth rate. A high debt-to-GDP ratio "crowds out fiscal space and limits the economy's capacity to respond to shocks," increasing the risk that "interest rates might suddenly take the country from a seemingly safe debt situation to an unsustainable one."



In FY 2024 the nation's net interest payments are projected to reach around $900 billion, which is on par with what the nation will spend on national defense, and only slightly less than all other non-defense discretionary spending. Interest outlays are never projected to be less than $1 trillion after this year. Returning to the Reinhart-Rogoff finding, 1% of a $25 trillion economy is a consequential amount. Between the debt's drag on productivity and output and the dead-weight interest payments, credit agencies are right to be concerned.

With the U.S. dollar serving as the world's reserve currency and U.S. economic strength relative to the rest of the world, America has not yet been swamped by the growing risks. However, the risks are real, and it must be acknowledged that events could quickly change trajectory with increased borrowing costs for consumers and businesses. Even the act of raising the federal debt limit is political and can lead to market and economic shocks.

Historically, regardless of tax rates that federal policymakers establish for individuals and corporations, revenue collection has held steady, ranging between 15% and 18.5% of GDP. The evidence confirms that individuals change behavior in response to federal tax rates. Spending remains completely disconnected from revenue collection with a trajectory that



is increasingly inconsistent with historical revenue. This raises serious questions like how long can the U.S. continue to deficit-finance without any realistic possibility of returning to balance?

Worse yet, demographic changes are happening. These changes seem likely to affect the nation's economic productivity. While 21st century population in the U.S. is projected to hold steady (unlike many other countries) due largely to immigration, tomorrow's replacement workers lack the same training and skills as today's workers. Certainly, the nation needs to ensure that our federal laws and regulations do not get in the way of private sector efficiency improvements (like artificial intelligence) that have the potential to strengthen our nation's economy and output. This is our nation's hope for addressing our fiscal situation and creating more and greater opportunities for our nation's children and grandchildren.

At Phronesis Insights, our biases lean toward maximizing individual liberty through an economy in which individuals are responsible for their actions with the freedom to take risks and innovate; where property rights are fully respected; and the government does not present unnecessary obstacles to the American entrepreneurial spirit. We like a robust tort system for remedying and deterring unjust actions and holding bad actors accountable. That said, our *Policy & Economic Outlook* is not intended to advocate for any specific policy, but rather present policy and economic reality as it is.

Insider Interview: William Beach on the Labor Market

DB: Bill, from being BLS director, what stands out in the medium- and longer term for our labor force?

WB: We have a substantially changing labor force. It is changing on the human front, where you had a lot of workers who are older, retiring, just millions upon millions. That's a good thing for them, retiring in their golden years. But, when I look at it as an economist, I'm thinking about a knowledge-drain from the economy.

William W. Beach, D. Phil. *served as the fifteenth Commissioner at the Bureau of Labor Statistics under Presidents Trump and Biden. He is Senior Fellow in Economics at the Economic Policy Innovation Center (EPIC) and the Coffin Fellow at the Calvin Coolidge Presidential Foundation. He previously was VP for policy research at George Mason University's Mercatus Center and Chief Economist at Senate Budget Committee.*

I look then at the educational system and its capacity to train and educate people, to replace workers who are retiring. I don't see the quality in the education system that would give me confidence that the knowledge that I'm now going to lose, because someone's retiring, is going to be replaced by better knowledge.

On the other hand, the labor force is changing because we are introducing artificially intelligent machines that maybe make up for some of that poor educational system. I don't honestly think it does, but let's just for a moment imagine it does. I call it enhanced labor. It's like human labor, but it is driven by software and learning by software. And it's going to be major in countries that have declining populations like China, India—India is declining now, Japan, of course, they're all going to have to rely on enhanced labor to keep their output up and to keep their productivity up.

[In the U.S.], we're going to use [AI] to increase our productivity, but we'll have a slightly increasing population by 2100 thanks to, or because of—depending on your political view—the tremendous amount of immigration, which we expect in the 21st century.

Right now, about 55% of labor force growth is coming from first generation immigrants. So just in a sketch there, the labor force is changing terrifically. That's one thing that challenges us unlike perhaps any other time, except for the 1870s and 1880s, when we had equally massive changes to our population.

DB: What strikes you about our current workforce?

WB: When I was Commissioner of Labor Statistics, I spent quite a bit of time with the Secretaries of Labor, both Republican and Democrat, because I served under both President Trump and President Biden. I was consistently struck that we were finding it really hard to get first-time job entrants the jobs for which they were trained.

Let me elaborate. One of the fastest growing job categories in the U.S. right now is heating and air conditioning installation and repair, HVAC. Almost no training is available for that in our public-school systems. In our private school system, there's no training at all. You would think, no one should be trained in high school in HVAC, but it's the elements of training, like metal-working and electrical working. How do you solder pipes together? We just don't train, either well or adequately, for that.

What does that mean? It means we have, almost a constant shortage of people who are entering that little segment of the marketplace. Now, expand that out to almost all the trades. Anything dealing with electricity or telephony, or plumbing—these are places where people can make $150,000 - $200,000 a year when they become master plumbers, electricians; they get home businesses and become millionaires.

It is a quick way to make a lot of money, but instead, what we're training our kids to do is to read Sanskrit. Right? Maybe 3 or 4 people of every generation should know how, but not millions. Then even the teaching of standard things like writing, reading, arithmetic, history are poorly done. Company after company told me, while I was commissioner, "We spend 8% to 10% of our funds on training. And that training is teaching people how to write and how to read, how to communicate, how to shake your hand."

Public education should probably be redesigned to do limited liberal arts. Then manual and training arts for everyone to have a skill by the time they graduate from high school, regardless of your life's aspirations.

When I went through school, you were expected to have a

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Insider Interview with William Beach, Continued

skill when you left. You were trained for that. And you were also trained to read and write. Then if you wanted to go to college and become a logician or a mathematician or something, then you could, but you could always step back from that and [have] a skill.

That's the way public education goes forward in many countries around the world, but it is not the commitment we have made in the past 30 to 40 years. We need to get back to that, because we really have underprepared people for our labor force, where we're lacking and falling behind every year.

If I had to put priority on public problems, I would put education in my top three because it is so fundamental to the entire future of our country. Our educational system has failed us badly, and it continues to fail. And it's not only execution of education, but it is the priorities that the educational system and our educational planners have in mind that are inappropriate for the future labor force.

DB: Could you say a bit more on enhanced labor?

WB: We're finding a lot of change inside jobs. Every job has a certain amount of tasks. More and more, robotics, automated processes, AI-enhanced automated processes are coming in to do those tasks that are repetitive and require little innovation. That should be making the labor force more productive. And I think in the long run it will. I'm fairly high on AI. AI is also producing new jobs, too, so we don't have to worry about people not having jobs in the future.

DB: What do you see policy-wise in Congress?

WB: I don't think we've ever faced such an inadequately prepared Congress than we do now. The experience level is very low in Congress. We have both in the House and the Senate, less so in the Senate, tremendous turnover in membership, and then we've had even greater turnover in staff.

There is a failure to solve major public policies like our entitlement programs: Social Security, Medicare, and Medicaid. But also the tax system, which is creating economic inefficiencies and slowing revenue growth. We've got this huge challenge on the fiscal side with over a one-and-a-half to $2 trillion in additional deficit every year. We have this massively changing population with new challenges to put in front of legislators.

You get this feeling that this is a turning point. Maybe not today and maybe not tomorrow, but certainly in the next few years. We will either solve or address or begin to address constructively our fiscal challenges—adopt budgets, adopt priorities, figure out where we're going, and then go there—or countries that fail [to address their challenges] are the countries that we read about in the history books under the title "the decline of countries." Let's hope we're not in that part of the writing of history.

DB: Do you have any advice for businesses?

WB: Far be it for me to give advice to successful business people, but, let me say—this being a period of great change in both labor and in the capital markets, lots of innovation, lots of technology change—and then the challenges that government is going to face [and]cause for the business sector:

I would be very cautious about taking great risks with your capital structure. Make sure that you're making investments for productivity purposes. When you have a choice between retaining your earnings to do something on the financial side as opposed to expending those earnings on new plants and equipment, I would do the latter, not the former.

I think to be successful in business now, first off, you have to be at the cutting edge with respect to your capital structure, your infrastructure. Then with respect to labor, if I'm even partially right that our educational system is in such poor shape right now, I would make investments in in-house education, to quickly bring workers to a point where they can communicate in writing to each other, that they have the correct calculating skills so they don't make simple mistakes in subtraction, addition, division, and multiplication. I hate to say that's an investment that has to be made, but every business person will know that that is exactly right.

Finally, look at what the U.S. Chamber of Commerce, or some of the larger associations are doing to help workers get back into work, and to get the skills they need to get back to work. I think from a public-spirited standpoint, business people should be looking for ways that they can support the retooling of workers who have been out of the labor force. In the end, that's good for them. They'll have a more skilled labor force in place. They will have a higher likelihood of filling open positions. There are lots of open positions right now. This is probably a better way to spend their dollars that they might normally spend on a political party. Spend it on the trade association that is looking to improve the skill level of those people who are out of the labor force, as well as those people who are in the labor force.