Research @ Citi Podcast, Episode 37: U.S. Economy — Debt, Duty & Dollars

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Transcript:

Veronica Clark (00:00)

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Robert Rowe (00:20)

Hi, everyone. I'm Rob Rowe, U.S. Regional Director of Research at Citi. Welcome to the Research @ Citi podcast and our guest today is Veronica Clark from our U.S. Economic team. Veronica, welcome.

Veronica Clark (00:31)

Thank you for having me.

Robert Rowe (00:32)

I want to start off with taxes because as Ben Franklin said, “in this world, nothing is certain except death and taxes.” And right now, we have a major-league tax bill coming into focus. Love to get your view of that and how you think it may affect the U.S. economy.

Veronica Clark (00:49)

Yeah, absolutely. Maybe taxes are a bit uncertain right now, I guess we're about halfway through the process of the latest big reconciliation bill. This is termed the Big Beautiful Bill.

A couple of weeks ago, a version of the bill passed in the House. The Senate is back in session as of this first week of June. So, the bill is not final yet. It's not law. We're waiting on any changes that the Senate might make. Of course, then the bill would be signed into law by President Trump. The goal is to have this completed throughout June, have it signed into law by July 4. There may be some delays to that, but it looks like they’re on that kind of timeline.

So, what is in the bill, as we know right now, the version from the House? There are obviously a lot of tax changes. That's a key focus of the bill. But first and foremost, it is extending the individual tax cuts from President Trump's first term back in 2017. These tax cuts were supposed to expire at the end of this year. This bill will make those tax cuts permanent.

It also does include some additional tax cuts, no tax on overtime, no tax on tips, a tax deduction for seniors, you know, making up for some Social Security. There's increased expensing of research-and-development investment projects in this bill. There's also an increase to the cap on deductions for state and local taxes, which is rising from a $10k cap to something like $40k. So, a lot of tax changes, cutting taxes overall.

There are some spending cuts, though, in this bill. One big one is a reduction of Medicaid spending, essentially done by increasing work requirements to qualify for Medicaid really by the end of 2026.

Also, some "pay-fors" are revoking some clean-energy credits from the Inflation Reduction Act. Some other increases on taxes; maybe we can come to that later. Section 899 has gotten a lot of attention, but overall, the bill itself is supposed to increase deficits. It's scored as increasing deficits something like $2.3 trillion over 10 years, that is relative to current law, which has some of these tax cuts expiring at the end of this year.

But importantly, the scoring of this bill is not going to incorporate increases in tariff revenue. So, we have that separate from this bill. Of course, we know that there have been tariffs already in place through this year. A lot of uncertainty, of course, around where effective tariff rates ultimately end up and how much revenue that will raise. That can be maybe figured out in the next couple of months.

But in the end, we are assuming that there will be a big increase in effective tariff rates, at least something like 10%. That could raise maybe around $200 billion or so of revenue, and that will help offset the cost of this bill — not exactly fully offsetting, but ultimately assuming that we end up with something like deficits flat.

So right now we've had about 6% of GDP deficit, expecting that that is going to be the case for this year for 2025 into 2026. And the first way that we think about changes in fiscal policy as economists, we think of it very simply just as, "What is the change in the deficit?"

That's the easiest way to think about what the growth impulse is, and so flat deficits really have very little impulse. Deficit shrinking would be contractionary. A wider deficit would be expansionary. Of course, even in some of the details of the bill, just extending the personal tax cuts, that's not going to do much at all to growth. That is just extending the tax rate that people have already had for the last eight years or so.

So, we are expecting flat deficits, which essentially means very little impulse on the economy for next year. There is maybe a bit of a timing issue, though, in that we have had the increase in tariffs this year already, sooner than we would maybe see some of the tax cuts showing up from the bill. So maybe you get contractionary drag from higher tariffs sooner than you get the expansionary impulse from things like cutting tax on overtime or tips. Overall though, we’re expecting a pretty flat growth impulse for the economy.

Robert Rowe (04:57)

And Veronica, when people are making these CBO assumptions, you said it would add $2.3 trillion to the deficit.

Veronica Clark (05:08)

Yes. Relative though to current law, which has those tax cuts expiring.

Robert Rowe (05:13)

Is that $2.3 immediately or is that over 10 years or how is it?

Veronica Clark (05:18)

It's over 10 years. And so this is getting into the details of what deficits look like over this 10-year period, and maybe one reason why some investors are expecting that this could add even more to deficit is if you look at the details of some of these tax provisions, yes, it costs $2.3 trillion over 10 years, but a lot of that is actually front-loaded.

So it’s coming from these new tax measures, the no tax on overtime and no tax on tips. The way that the bill is written is those are supposed to expire at the end of 2028. So, they're not costing nearly as much in the last five years of the scoring as they are in the first five years of the scoring.

That is a kind of a trick to make the costs look lower. But part of the issue is, and this is exactly what we're experiencing with this bill itself, it's really hard to let those tax cuts expire. It was really hard to let the 2017 tax cuts expire this year. They're not expiring. That's what this bill does. And once we get to the end of 2028, it's probably going to be really hard to let those no tax on tips and no tax on overtime cuts expire, too, which means those later years, which in theory look like even lower deficits, are going to end up also being pretty wide.

Robert Rowe (06:27)

Veronica, I've heard this argument against the idea that it's going to increase deficits, saying that people are using the wrong growth projections. What is the growth projection for the [Congressional Budget Office] vs. the administration?

Veronica Clark (06:47)

CBO is scoring this. [The Joint Committee on Taxation] will do the tax scoring of it. They're essentially assuming something close to 2% GDP growth. JCT does a dynamic scoring of it, so trying to make the assumptions for growth impulse. But part of the issue, I think, is that the biggest chunk of tax cuts in this bill are extending the current ones. And so we've already gotten the growth impulse from that. That happened back in 2017.

The new ones, of course, will be a modest boost to growth. But then you have to consider that maybe it's offset with higher taxes, AKA tariffs. That's a tax increase.

It seems like the administration, at least from comments, is assuming at least 3% growth every year, and that maybe seems certainly higher than what the CBO would have.

Robert Rowe (07:32)

And Veronica, why do you think that our 6% estimate on the fiscal deficit will remain the same if this is actually increasing it?

Veronica Clark (07:40)

So we don't know first, right? One question is going to be what the Senate does. If anything, there is a chance it could get more expansionary in the Senate.

Rowe (07:52)

I see.

Veronica Clark (07:53)

The Senate would maybe be inclined to reduce some of those Medicaid cuts. Maybe they would try actually to make those additional tax cuts, the no tax on tips, no tax on overtime actually permanent for the full 10 years and not expire in 2028.

What they also might try to do walk back some of the repeals of the IRA tax credit. So, if anything, it could get more expansionary in the Senate, but I think the additional deficit add that might happen in the Senate and will happen probably eventually is not so much coming from 2025 into 2026. It's really those 2028 and beyond years.

Robert Rowe (08:29)

And what is the impact of Section 899? What is that all about?

Veronica Clark (08:35)

This has obviously gotten a lot of attention, and we are by no means tax-policy experts or lawyers or anything. And I think it's really unclear what exactly this will do. So, this is a gradual but large enough 5%-a-year increase on taxes of U.S. investment income essentially on foreign persons, foreign companies in certain countries that have what are deemed unfair taxes.

This could be the EU, it could be Canada, countries that maybe have these digital services taxes, anything that's deemed unfair. So, there's a lot of levels of uncertainty here. The first one just being what are those countries? And it seems like with Section 899, it's going to be up to the Treasury to determine which countries.

It’s unclear the scope of foreign investors who would face this, unclear what could be exempted or not. But I think where people are coming down in the end is that this will not include raising taxes on Treasury interest income, investment-grade, corporate income.

There is this portfolio-investment exemption, interest exemption, and that seems like it will hold. It could mean that dividends paid to foreign holders of U.S. equities might be subject to the tax increase. It could be real-estate investment would be subject to this tax increase, but I think the first way that we're thinking about it is that this is a negotiation tool, almost like a tariff kind of threat, and maybe in the end, some of these countries reduce their taxes and these never actually come into effect. Maybe there would be further carve-outs.

One last point of uncertainty is it's not so clear if this could get passed in this reconciliation bill under the rules of reconciliation in the Senate. I think we're assuming it will be in the final bill. Maybe the Senate will make some clarifications though to what's exempt or not.

But the CBO scoring of it, they are assuming it does raise some revenue, so maybe it comes into effect at some point, something close to around $10 billion a year. So it's small enough, but I think the concern is it would be some kind of deterrent for foreign investors in the U.S. Maybe if there are more exemptions that get clarified, then that won't be too much of a concern.

Robert Rowe (10:50)

That's a little confusing because if you want to promote U.S. industry, it's hard to tax foreign investment or foreign direct investment.

Veronica Clark (11:00)

Yeah, absolutely. And I think that's why we're for now assuming that it's really just going to be used as a negotiating tool to get some of these other countries to change their tax policy.

Robert Rowe (11:11)

Veronica, let's switch to tariffs for a second also because where do we estimate these tariffs are going to event? And I realize it's an unfair question because there's a lot of volatility on this, but what kind of assumption are you making currently in terms of where these tariffs settle?

Veronica Clark (11:27)

So where we are now, at least in the tariff story, is we have a 10% blanket tariff on most countries, excluding Canada and Mexico, although they have their own sector tariffs because there are sector-level tariffs on steel and aluminum, on autos. And then China also has this additional 20% for national-emergency fentanyl tariffs. So, China overall is facing something like a 30% tariff.

There was a court order last week that said the administration could not use the economic-emergency provision to do some of these tariffs. So that would include the fentanyl ones which are faced by mostly China, but some tariffs on some goods from Canada and Mexico, and the 10% blanket tariff.

Now, within the same day that that court order came out, another court said that is stayed for now. The tariffs are in place as of right now. Obviously, a lot of uncertainty. We're waiting for trade negotiations to resolve. The larger reciprocal tariffs were delayed for most countries until July 9, for China until early in August. So we're waiting for those negotiations to happen to see where those tariff rates eventually end up, waiting for clarity on if this court order in the end will hold, and the administration can't use those economic-emergency powers to do the tariffs.

If that is the case, there are other ways in which the administration can levy tariffs. There could be investigations for unfair trade practices for national security. It might take a bit longer for those to happen, but we would think that the administration would rely more on those other powers, and there would still be some kind of broad-based tariffs.

In the end, we are assuming that there will be an increase in the effective tariff rate of something around 10%, maybe a bit more. That's basically where we are now. There's been about an 11% increase in the effective tariff rate from actions taken this year. There still are a number of other sector tariffs that might come into effect — you know, pharmaceuticals or lumber, electronics potentially.

So, in the end, the composition might look a lot different than what we have now, but assuming that we'll see something like a 10% increase in the effective tariff rate — which of course can change — what does that do to inflation, what does that do to the economy overall? It could change the revenue raise, depending on substitutes of certain goods.

But then, we'll just have to wait and see how the next six months or so evolve.

Robert Rowe (13:49)

And Veronica, putting it all together, I know that coming into the year, you all on the team felt like we were having a slowdown.

Veronica Clark (13:58)

Yeah.

Robert Rowe (13:59)

You had taken the recession call off, but you were thinking there's going to be a slowdown.

Now we've had a certain amount of high volatility and uncertainty. We've had the implementation of tariffs. We are on the edge of passing this tax bill, and we're on the edge of having potentially higher fiscal deficits. What does this all do for the U.S. economy and its growth?

And inflation, mind you, also.

Veronica Clark (14:23)

We were already of the view that rates are high, they're restrictive. They are very gradually slowing, weighing on activity. And that's where we are coming into the year.

That is still the case. You know, certainly, the wide deficit issue is not helping that rate backdrop. We have mortgage rates that have stayed close to 7% as you know, 10-year yields are close to 4.5%. We have seen actually renewed slowing in the housing sector. So, I wonder if that is just more evidence that as rates are restrictive they will weigh on those rate-sensitive sectors.

Obviously, tariffs themselves can be costly enough that they're going to slow production in certain sectors. Now I should mention that we're supposed to have this week a 50% tariff now on steel and aluminum. That's increased from 25%. That was announced late last Friday.

So, we will have the effects of tariffs, weighing on sectors like manufacturing. We have seen some softness in manufacturing surveys. Certainly, the survey data in general have looked a lot weaker. Business sentiment, consumer sentiment, tariff delay, I think has caused somewhat of a rebound. We'll see that volatility for a while. Certainly, you see volatility in trade data had a large drop in imports in April data that was released last week.

So, we would expect that this just magnifies the slowing that was already happening from rates being high, from the tariffs themselves. So far, the story seems to be that activity is resilient enough, but I would worry that it's just a bit too soon to see a lot of these effects.

You know, the tariffs from Trump 1.0 were much smaller, even than the increase that we've had so far, but we did see manufacturing slowing then. It took maybe four to six months though, to really become obvious.

Maybe there's more of a lag now. And, where we would have the most concern is the labor market, where hiring has already been very low for a while. It does seem like there's been another leg lower in hiring. Continuing jobless claims have been rising.

And then of course at some point we'll probably see the price increase from it. We haven't seen that yet, but we are expecting core inflation to end the year, something close to 3%. That is a pickup from where we are now at around 2.5%.

But ultimately, if the labor market is weakening, I think the Fed will look through that. We are expecting that the unemployment rate could get close to 5% by the end of the year, but I think that's a Fed that's going to be cutting, much more focused on the employment side of their mandate.

Robert Rowe (16:44)

Now Veronica, you all are still looking at five cuts by the Fed.

Veronica Clark (16:49)

Total, yes.

Robert Rowe (16;50)

Confirm on what you'd call a neutral rate of interest.

Veronica Clark (16:53)

Yeah, exactly. When they start those cuts again is really going to depend on the data, of course. We'll get May employment data on Friday. We do think there could be another increase in the unemployment rate. We'll see how things evolve into June, but we do have them cutting in July.

For now, the risk, of course, would be that it could be later than that, but the longer they wait, I almost wonder if we're risking the repeat of last year where we could get some bigger cuts. You know, maybe they're cutting 50 basis points again, even if inflation is high because of tariffs.

Robert Rowe (17:24)

And they'll be motivated more by unemployment than you think inflation?

Veronica Clark (17:28)

Yeah, I think so. I think if the unemployment rate is rising, which we think it will be even as soon as this May data, then even if inflation is high, you would have conviction at least that higher unemployment means you're not in the same scenario as we were post-pandemic, where you got this self-reinforcing kind of inflation and wages were rising and home prices were rising.

It would just be a very different demand backdrop than a couple of years ago. It would be the traditional tariffs are a supply shock and you get a one-time level shift higher in prices. But if we were thinking about a sales tax, you know, the Fed would not be so concerned about the inflation from a sales tax. The macro employment backdrop would be a lot more important then.

Robert Rowe (18:08)

Got it, Veronica. Well, thank you so much for being on the podcast with us today.

Veronica Clark (18:12)

Thank you for having me.

Robert Rowe (18:14)

Fantastic. This podcast was recorded on June 2, 2025. Be sure to join us for our next Research @ Citi podcast, which will feature Vikram Bagri, our alternative and renewable energy analyst, providing insights on current developments in that sector. Thanks so much, everyone.

Disclaimer (18:29)