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JimSadPA051523Newsletter

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What You Should Know About the Federal Reserve's New Instant Payments System

The use of mobile payment apps and person-to-person (P2P) payments are more popular than ever, giving businesses and consumers the ability to send and receive money instantly. According to a recent study, the share of P2P payments made with mobile apps nearly doubled in one year, increasing from 15% in 2020 to 29% in 2021.[1] In response to the growing demand for these types of instant payments services, the Federal Reserve will be launching its own real-time, instant payments system called the FedNow Service (FedNow).

What is the FedNow Service?

Payments between depository institutions (e.g., check and ACH transfers) typically require "clearing" and "settlement" and can sometimes take a couple of days to process. The FedNow Service will change that by providing interbank clearing and settlement that enables funds to be transferred from the account of a sender to the account of a receiver in near real time, around the clock, 365 days a year. By participating in the FedNow Service, financial institutions will be able to process funds instantly.[2]

How can the FedNow Service benefit consumers?

The Federal Reserve hopes that this new, more efficient instant payments system will facilitate and encourage economic activity by making it faster and easier for individuals and businesses to pay for goods and services. By having immediate access to funds, businesses and consumers will have greater financial flexibility, especially when making or receiving time-sensitive payments. In addition, the FedNow Service can reduce the risk to consumers of incurring overdraft and late fees and allow businesses to gain better control of their corporate budgeting and cash flow management.[3]

Who can use the FedNow Service?

The FedNow Service will be available to all U.S. depository institutions, such as banks and credit unions. Businesses and consumers will be able to access the FedNow Service through their depository institution and send instant payments through their bank and/or credit union accounts. The FedNow Service will offer depository institutions the flexibility to choose from a combination of participation types within the FedNow Service in order for them to meet their specific business needs. Although some depository institutions are already preparing to adopt the system, others will need to explore an implementation and participation strategy, and some may decide not to participate.[4]

When is the FedNow Service scheduled to take effect?

The initial launch of the FedNow Service is scheduled for July 2023. Additional features and service enhancements will be released over time in phases.[5] For more information, visit explore.fednow.org.

1) The Federal Reserve Bank of San Francisco, 2022

2-5) The Federal Reserve, 2023

The Trustees continue to urge Congress to address these financial shortfalls soon, so that solutions will be less drastic and may be implemented gradually.

Rescuing America's Safety Net

A March 2023 survey found that more than 90% of Americans worry about the Social Security program, and about half of those said they worry a great deal.[1] A separate survey the same month found that more than 80% of Americans worry Medicare will not be able to provide the same level of benefits in the future.[2]

These concerns are well-founded, because both of these programs — the cornerstones of "America's Safety Net" — face serious fiscal challenges that require Congressional action. And the longer Congress waits to act, the more extreme the solutions will have to be. Even so, it's important to keep in mind that neither of these programs is in danger of collapsing completely. The question is what type of changes will be required to rescue them.

Demographic Dilemma

The fundamental problem facing both programs is the aging of the American population. Today's workers pay taxes to fund benefits received by today's retirees, and with lower birth rates and longer life spans, there are fewer workers paying into the programs and more retirees receiving benefits for a longer period of time. In 1960, there were 5.1 workers for each Social Security beneficiary; in 2023 there are 2.7, dropping steadily to 2.2 by 2045.[3]

Dwindling Trust Funds

Payroll taxes from today's workers, along with income taxes on Social Security benefits, go into interest-bearing trust funds. During times when payroll taxes and other income exceeded benefit payments, these funds built up reserve assets. But now the reserves are being depleted as they supplement payroll taxes and other income to meet scheduled benefit payments.

Each year, the Trustees of the Social Security and Medicare Trust Funds provide detailed reports to Congress that track the programs' current financial condition and projected financial outlook. These reports have warned for years that the trust funds would be depleted in the not-too-distant future, and the most recent reports, both released on March 31, 2023, suggest that the future may arrive even sooner than expected.

Social Security Outlook

Social Security consists of two programs, each with its own trust fund. Retired workers and their families and survivors receive monthly benefits under the Old-Age and Survivors Insurance (OASI) program; disabled workers and their families receive monthly benefits under the Disability Insurance (DI) program.

The OASI Trust Fund reserves are projected to be depleted in 2033, one year earlier than in last year's report, at which time incoming revenue would pay only 77% of scheduled benefits. Reserves in the much smaller DI Trust Fund, which is on stronger footing, are not projected to be depleted during the 75-year period ending 2097.[4]

Under current law, these two trust funds cannot be combined, but the Trustees also provide an estimate for the combined program, referred to as OASDI. This would extend full benefits another year, to 2034, at which time, incoming revenue would pay only 80% of scheduled benefits.[5]

Put simply, the current outlook suggests that Social Security beneficiaries might face a benefit cut of 23% in a decade unless Congress takes action.

Medicare Outlook

Medicare also has two trust funds. The Hospital Insurance (HI) Trust Fund pays for inpatient and hospital care under Medicare Part A. The Supplementary Medical Insurance (SMI) Trust Fund comprises two accounts: one for Medicare Part B physician and outpatient costs and the other for Medicare Part D prescription drug costs.

The HI trust fund reserves are projected to be depleted in 2031. This is three years later than in last year's report, due to lower costs and higher payroll taxes, but still more imminent than the Social Security shortfall. At that time, revenue would pay only 89% of the program's costs.[6]

The SMI Trust Fund accounts for Medicare Parts B and D are expected to have sufficient funding because they are automatically balanced through premiums and revenue from the federal government's general fund, which provides about 75% of costs, a major outlay from the federal budget.[7]

Possible Fixes

The Trustees of both programs continue to urge Congress to address these financial shortfalls soon, so that solutions will be less drastic and may be implemented gradually.

Any permanent fix to Social Security would likely require a combination of changes, including some of these.[8]

- Raise the Social Security payroll tax rate (currently 12.4%, half paid by the employee and half by the employer). An immediate and permanent payroll tax increase to 15.84% would be necessary to address the long-range revenue shortfall (or to 16.55% if the increase started in 2034).[9]
- Raise the ceiling on wages subject to Social Security payroll taxes ($160,200 in 2023).
- Raise the full retirement age (currently 67 for anyone born in 1960 or later).
- Change the benefit calculation formula.
- Use a different index to calculate the annual cost-of-living adjustment.
- Tax a higher percentage of benefits for higher-income beneficiaries.

Options for reducing the Medicare shortfall include a combination of spending cuts and tax increases. These are some possibilities.[10]

- Improve the payment system for Medicare Advantage Plans (private plans that receive partial funding from Medicare).
- Modernize cost sharing between Medicare and Medigap (supplementary insurance).
- Increase the Medicare payroll tax rate (currently 2.9%, shared equally between employee and employer, with an additional 0.9% on income above $200,000 for single filers and $250,000 for joint filers).[11]
- Broaden the tax base subject to Medicare payroll taxes (there is no income ceiling for Medicare payroll taxes, but certain income is currently not subject to the tax).

Based on past changes to these programs, it's likely that any future changes would primarily affect future beneficiaries and have a relatively small effect on those already receiving benefits. While neither Social Security nor Medicare is in danger of disappearing, it would be wise to maintain a strong retirement savings strategy to prepare for potential changes to America's Safety Net.

All projections are based on current conditions, subject to change, and may not come to pass.

1) Gallup, April 6, 2023

2) Kaiser Family Foundation, March 2023

3–5, 9) 2023 Social Security Trustees Report

6–7, 11) 2023 Medicare Trustees Report

8) Social Security Administration, February 21, 2023

10) Committee for a Responsible Federal Budget, June 16, 2022

41% of employees with access to a retirement plan at work had saved at least $250,000 by 2022.

Source: Employee Benefit Research Institute, 2022

SECURE 2.0 Helps Small Employers Help Their Employees

Approximately 78% of people who work for companies with fewer than 10 employees and about 65% of those who work for companies with 10 to 24 employees do not have access to a retirement plan at work.[1] That's unfortunate, because workers with a retirement plan are far more likely to save for retirement than those without a plan. In 2022, 62% of those without a retirement plan had accumulated less than $1,000 for retirement, compared with 71% of those with a plan who had saved at least $50,000. More than four in 10 workers with access to a work-based plan had amassed a quarter million dollars or more.[2]

In December 2022, Congress aimed to address this issue (among others) by passing legislation that will help small employers more efficiently and cost-effectively offer retirement plans to their workforces, while providing incentives to help improve participation rates among lower-income workers. The SECURE 2.0 Act of 2022 — so named because it builds upon the original Setting Every Community Up for Retirement Enhancement (SECURE) Act passed in 2019 — is a sweeping set of provisions designed to improve the nation's retirement-planning health. Here is a brief look at some of the tax perks, rule changes, and incentives included in the legislation.

Tax Perks for Employers in 2023

Perhaps most appealing to small business owners, the Act enhances the tax credits associated with adopting new retirement plans, beginning in 2023.

For employers with 50 employees or less, the pension plan start-up tax credit increases from 50% of qualified start-up costs to 100%. Employers with 51 to 100 employees will still be eligible for the 50% credit. In either case, the credit maximum is $5,000 per year (based on the number of employees) for the first three years the plan is in effect.

In addition, the Act offers a tax credit for employer contributions to employee accounts for the first five tax years of the plan's existence. The amount of the credit is a maximum of $1,000 for each participant earning not more than $100,000 (adjusted for inflation) in income. Each year, a specific percentage applies. In years one and two, employers receive 100% of the credit; in year three, 75%; in year four, 50%; and in year five, 25%. The amount of the credit is reduced for employers with 51 to 100 employees. No credit is allowed for employers with more than 100 workers.

Rule Changes and Relevant Years

In 2024, employers will be able to adopt a deferral-only starter 401(k) or safe-harbor 403(b) plan, which are designed to be lower cost and easier to administer than traditional plans. Both plan types have auto-enrollment features and accept employee contributions only. Employees are enrolled at minimum contribution rates of 3%, not to exceed 15%, and may opt out. The plans may accept up to $6,000 per participant annually ($7,000 for those 50 and older), indexed for inflation.

SIMPLE plans may benefit from two new contribution rules. First, employers may make nonelective contributions to employee accounts up to 10% of compensation or $5,000. Second, the annual contribution limits (standard and catch-up) for employers with no more than 25 employees will increase by 10%, rather than the limit that would otherwise apply. An employer with 26 to 100 employees would be permitted to allow higher contributions if the employer makes either a matching contribution on the first 4% of compensation or a 3% nonelective contribution to all participants, whether or not they contribute. These changes also take effect in 2024.

Beginning in 2025, 401(k) and 403(b) plans will generally be required to automatically enroll eligible employees and automatically increase their contribution rates every year, unless they opt out. Employees will be enrolled at a minimum contribution rate of 3% of income, and rates will increase each year by 1% until they reach at least 10% (but not more than 15%). Not all plans will be subject to this new provision. Exceptions include those in existence prior to December 29, 2022; those sponsored by organizations less than three years old or employing 10 or fewer workers; governmental and church plans; and SIMPLE 401(k) plans.

Incentives for Participation

SECURE 2.0 drafters were creative in finding ways to encourage workers, particularly those with lower incomes, to take advantage of their plans. For example, effective immediately, employers may choose to offer small-value financial incentives, such as gift cards, for joining a plan. Beginning in 2024, employers may provide a matching contribution on employee student loan payments, which should help encourage younger workers to plan for their future. Also in 2024, workers will be able to withdraw up to $1,000 a year to cover unforeseeable or immediate emergencies without having to pay a 10% early distribution penalty, which should help address the fear of locking up retirement-plan contributions for many years. Employees will have up to three years to repay the emergency distributions and will not be able to take a second emergency distribution during this three-year period unless the first has been reimbursed.

1) AARP, July 2022

2) Employee Benefit Research Institute, 2022

SECURE 2.0 Adds New Early Withdrawal Exceptions

Withdrawals covered by these new exceptions can be repaid within three years.

The SECURE 2.0 Act, passed as part of an omnibus spending bill in December 2022, added new exceptions to the 10% federal income tax penalty for early withdrawals from tax-advantaged retirement accounts. The Act also expanded an existing exception that applies specifically to employer plans. These exceptions are often called 72(t) exceptions, because they are listed in Section 72(t) of the Internal Revenue Code.

The 10% penalty tax generally applies to withdrawals prior to age 59½ from IRAs, employer-sponsored plans [such as 401(k) and 403(b) plans], and traditional pension plans, unless an exception applies. The penalty is assessed on top of ordinary income taxes.

New exceptions

Here are the new exceptions with their effective dates. Withdrawals covered by these exceptions can be repaid within three years to an eligible retirement plan. If repayment is made after the year of the distribution, an amended return would have to be filed to obtain a refund of any taxes paid.

- **Disaster relief** — up to $22,000 for expenses related to a federally declared disaster if the distribution is made within 180 days of the disaster occurring; included in gross income equally over three years, beginning with the year of distribution, unless the taxpayer elects to report the full amount in the year of distribution (effective for disasters on or after January 26, 2021)
- **Terminal illness** — defined as a condition that will cause death within seven years as certified by a physician (effective 2023)
- **Emergency expenses** — one distribution per calendar year of up to $1,000 for personal or family emergency expenses to meet unforeseeable or immediate financial needs; no further emergency distributions are allowed during the three-year repayment period unless the funds are repaid or new contributions are at least equal to the withdrawal (effective 2024)
- **Domestic abuse** — the lesser of $10,000 (indexed for inflation in future years) or 50% of the account value for an account holder who certifies that he or she has been the victim of domestic abuse (physical, psychological, sexual, emotional, or economic abuse) during the preceding one-year period (effective 2024)

Expanded exception for employer accounts

The 10% penalty does not apply for distributions from an employer plan to an employee who leaves a job after age 55, or age 50 for qualified public safety employees. SECURE 2.0 extended the exception to public safety officers with at least 25 years of service with the employer sponsoring the plan, regardless of age, as well as to state and local corrections officers and private-sector firefighters.

Previously established exceptions

These exceptions to the 10% early withdrawal penalty were in effect prior to the SECURE 2.0 Act. They cannot be repaid unless indicated. Exceptions apply to distributions relating to:

- Death or permanent disability of the account owner
- A series of substantially equal periodic payments for the life of the account holder or the joint lives of the account holder and designated beneficiary
- Unreimbursed medical expenses that exceed 7.5% of adjusted gross income
- Up to $5,000 for each spouse (from individual accounts) for expenses related to the birth or adoption of a child; can be repaid within three years to an eligible retirement plan
- Distributions taken by an account holder on active military reserve duty; can be repaid up to two years after end of active duty to an individual retirement plan
- Distributions due to an IRS levy on the account
- (IRA only) Up to $10,000 lifetime for a first-time homebuyer to buy, build, or improve a home
- (IRA only) Health insurance premiums if unemployed
- (IRA only) Qualified higher education expenses

These exceptions could be helpful if you are forced to tap your retirement account prior to age 59½. However, keep in mind that the greatest penalty for early withdrawal from retirement savings may be the loss of future earnings on those savings. Some employer plans allow loans that might be a better solution than an early withdrawal.

Retirement account withdrawals can have complex tax consequences. Consult your tax professional before taking specific action.

"We want to make sure that the troubles that exist at one bank don't create contagion to others that are sound." — Treasury Secretary Janet Yellen

Source: The Wall Street Journal, March 12, 2023

Bank Failures Shine Light on Interest Rate Risks

Financial markets reacted turbulently to the collapse of Silicon Valley Bank (SVB) on March 10, 2023, followed two days later by the failure of Signature Bank of New York. With $209 billion in assets and $175 billion in deposits, SVB was the nation's 16th largest bank and the second largest to fail in U.S. history.[1-2]

This news was alarming to savers who worried their own bank accounts could be at risk and investors who feared a wider financial crisis. To help restore confidence in the U.S. financial system, the federal government pledged to make all depositors whole and to support other banks that might face liquidity issues stemming from the rapid rise in interest rates.[3]

These events have drawn new attention to how banks operate and the risks they take to earn money on customer deposits, as well as the government's role in regulating and supervising bank activities.

What is the FDIC?

The Federal Deposit Insurance Corporation (FDIC) is an independent agency backed by the full faith and credit of the U.S. government. FDIC insurance is intended to reassure depositors and offer protection in case an insured bank becomes insolvent, is liquidated, or experiences other financial difficulties. Most banks in the United States are insured by the FDIC, which protects deposits up to $250,000 (per person, bank, and account category).

When a member bank fails, the FDIC issues payments to depositors (typically up to the limits provided by law) and takes over the administration of the bank's assets and liabilities. Generally, the FDIC will try to arrange for a healthy bank to take over the deposits of a failed bank. If no bank assumes that role, the FDIC taps a fund that is financed by premiums paid by insured banks.

Why are banks under pressure?

In its quest to bring down inflation, the Federal Reserve has raised the benchmark federal funds rate from near zero to more than 4.5% over the past year.[4]

Banks earn money by investing customer deposits, often in relatively safe long-term Treasuries and other government-backed bonds. U.S. Treasury securities are backed by the full faith and credit of the U.S. government as to the timely payment of principal and interest. But as interest rates rise, bonds lose value on the secondary market, which becomes a problem if banks must sell bonds before they mature. At the end of 2022, U.S. banks had booked about $300 billion in unrealized losses on bonds they planned to hold to maturity.[5]

At SVB, poor balance-sheet management also came into play. A California bank that catered to technology start-ups, SVB was highly — and knowingly — exposed to weakness in that volatile sector. As start-up valuations fell and venture capital funds dwindled, withdrawals increased and forced the bank to sell $21 billion in securities at a $1.8 billion loss. More than 90% of customer deposits at SVB were uninsured, which made depositors more likely to panic and pull their money once the bank's losses came to light.[6]

Signature Bank's challenges were similar in that a large share of customer deposits were uninsured — and it was a primary servicer of high-risk cryptocurrency businesses.[7]

What actions did the government take?

In a joint statement, the U.S. Treasury, the Federal Reserve, and the FDIC guaranteed that depositors of SVB and Signature Bank would have access to all their money. Concluding that the failures posed a risk to the financial system gave the FDIC greater flexibility to return funds that exceed the $250,000 cap. Any resulting FDIC insurance fund losses will be recovered through a special assessment charged to banks. The banks' shareholders and unsecured bondholders did not receive any government support.[8]

In addition, the Federal Reserve will help ensure that all banks have enough liquidity to meet depositors' needs — without selling bonds prematurely — through a new facility called the Bank Term Funding Program (BTFP). The BTFP allows banks to use their government bonds as collateral for one-year loans. Fragile U.S. banks borrowed $164.8 billion combined from the new BTFP and the Federal Reserve discount window, a pre-existing liquidity backstop, during the week ended March 15, breaking a record from the 2008 financial crisis.[9]

How will other banks be affected?

Moody's Investors Service cut its outlook for the entire banking sector from stable to negative, due to the "rapidly deteriorating operating environment." Lower credit ratings could push up borrowing costs and cut into earnings. First Republic Bank (FRB) was one of five banks that were put on review for ratings downgrades due to substantial unrealized losses and exposure to the risk of outflows by uninsured depositors.[10] FRB's credit rating was later cut to junk status despite a $30 billion rescue package from a coalition of the nation's largest banks.[11]

The current situation is fluid, and it's too soon to know if more distressed banks will buckle. Regulators emphasized that the U.S. financial system remains resilient and has a solid foundation, in part due to safeguards put in place during the last financial crisis.[12]

The Federal Reserve launched an internal review to determine what went wrong and whether regulators missed signs of trouble. This may cause officials to refocus attention on smaller institutions and strengthen those regulatory requirements accordingly.[13]

Are your savings protected?

If you have multiple accounts at one bank, you might check to see who is listed as the owner(s) of each account, what category it falls into, and whether it overlaps with other categories that might affect the amount that's covered. Ownership categories consist of individual accounts, joint accounts, retirement accounts, trust accounts, and business accounts, among others.

You can't increase your coverage by owning different product types (a checking account, savings account, or CDs, for example) within the same ownership category. A tool on the FDIC's website (FDIC.gov) can help you estimate the total FDIC coverage on your deposit accounts.

If your assets aren't fully insured, you might consider shifting them to increase your coverage. If you are married, for example, you could expand your total coverage up to $1 million at one bank by opening two separate individual accounts in addition to a joint account. If you have personal or business account balances that regularly exceed $250,000, you might consider diversifying your holdings between multiple financial institutions — or possibly rethink your cash-management strategy altogether.

All investing involves risk, including the possible loss of principal.

1) Reuters, March 13, 2023

2) Federal Deposit Insurance Corporation, March 12, 2013

3-4, 8, 12) Federal Reserve, March 12, 2023

5-6) Bloomberg, March 12, 2023

7) *The Wall Street Journal,* March 14, 2023

9) Bloomberg, March 16, 2023

10) CNBC, March 14, 2023

11) Reuters, March 19, 2023

13) *The Wall Street Journal,* March 14, 2023

The IRS has determined the federal income tax status of special payments made by 21 states in 2022.

IRS Issues Guidance on State Tax Payments

The IRS has identified 21 states that made special payments to taxpayers in 2022. After a review of those special payments, the IRS has determined that taxpayers in many states will not need to report those payments on their 2022 federal income tax returns. Special payments in four of those states should be treated as refunds of state taxes paid, and taxation is determined under the general federal income tax rules for state tax refunds. Special payments in 17 states are treated as made for the promotion of the general welfare or as a disaster relief payment and are excluded from income for federal tax purposes. Illinois and New York are listed in this category but seem to have provided a mixture of payments that fell into multiple categories (see below).

If you have already filed your 2022 federal income tax return and omitted one of these special payments when it was required to be included in income, you may need to file an amended tax return and pay any additional tax due. If you included one of these special payments in income when it did not need to be included, you may need to file an amended tax return in order to get a federal income tax refund with respect to the special state tax payment.

Refund of state taxes paid

The IRS has concluded that the special payments from the following states in 2022 are treated as a refund of state taxes paid, and the appropriate analysis under the general state tax refund rules should be made.

- Georgia
- Massachusetts
- South Carolina
- Virginia

Under general rules, if the payment is a refund of state taxes paid, the payment is excluded from federal income tax unless the recipient received a tax benefit in the year the taxes were deducted on the federal income tax return. Thus, the recipient does not need to include the payment in income if the recipient claimed the standard deduction or the taxpayer itemized deductions but did not receive a tax benefit (for example, because the $10,000 tax deduction limit applied) in the year the state taxes were deducted.

General welfare and disaster relief payments

The IRS has determined that the special payments from the following states in 2022 were made for the promotion of the general welfare or as a disaster relief payment and are excluded from income for federal tax purposes.

State	State Payment Program
Alaska*	Energy Relief Payment (supplementing the Permanent Fund Dividend)
California	Middle Class Tax Refund
Colorado	Colorado Cash Back
Connecticut	Child Tax Rebate
Delaware	Relief Rebate Program
Florida	Pandemic Temporary Assistance to Needy Families
Hawaii	Act 115 Refund
Idaho	2022 Tax Rebate
Illinois**	Individual Income Tax Rebate/Property Tax Rebate
Indiana	Automatic Taxpayer Refund #1/Automatic Taxpayer Refund #2
Maine	Pandemic Relief Payments
New Jersey	ITIN Holders Director Assistance Program
New Mexico	Multiple rebate and relief programs
New York**	Supplemental Child Credit and Supplemental Earned Income Tax Credit

Oregon	One-Time Assistance Payments
Pennsylvania	One-Time Bonus Rebates
Rhode Island	2022 Child Tax Rebates

*Exclusion is only for the supplemental Energy Relief Payment received in addition to the annual Permanent Fund Dividend.

**The IRS stated that "Illinois and New York issued multiple payments and in each case one of the payments was a refund of taxes, which should be treated as noted above, and one of the payments is in the category of disaster relief payment." It seems that additional guidance from the IRS is needed here to identify the tax treatment of specific payments.

Other payments

The IRS adds that other payments that may have been made by states (e.g., payments from states provided as compensation to workers) are generally includable in income for federal income tax purposes.

It's unlikely that the current situation will lead to a default, but pushing negotiations close to the edge can be damaging in itself.

The Debt Ceiling and Deficit Spending

On January 19, 2023, the outstanding debt of the U.S. government reached its statutory limit, commonly called the debt ceiling. The current limit was set by Congress at about $31.4 trillion in December 2021.[1]

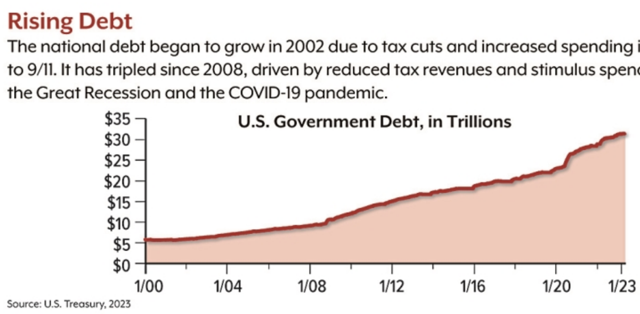
On the day the limit was reached, Treasury Secretary Janet Yellen instituted well-established "extraordinary measures" to allow necessary borrowing for a limited period of time. While Yellen projects the extension will last until early June, the Congressional Budget Office (CBO) estimates it may last until sometime between July and September. However, the CBO cautions that if April tax revenues fall short of its projections, the Treasury could run out of funds earlier.[2–3]

Flexibility vs. Fiscal Fights

A debt ceiling was first established in 1917 to give the federal government more flexibility to borrow during World War I. Before that time, all borrowing had to be authorized by Congress in very specific terms, which made it difficult for the government to respond to changing needs.[4]

The modern debt ceiling, which aggregates almost all government debt under one limit, was established in 1939. Since 1960, it has been raised, modified, or suspended 78 times, mostly with little fanfare. That changed in 2011, when a political battle over the ceiling pushed the Treasury so close to the edge that Standard & Poor's downgraded the credit rating of the U.S. government.[5–6]

The debt ceiling limits the amount that the U.S. Treasury can borrow to meet financial obligations already authorized by Congress. It does not authorize future spending. However, beginning with the bitter battle of 2011, it has been used as leverage for partisan negotiations over government spending. With the White House and the House of Representatives — which must authorize spending — held by different parties, this year's negotiations could be particularly difficult.



Potential Consequences

If the debt ceiling is not raised in a timely manner, the U.S. government could default on its financial obligations, resulting in unpaid bills, higher interest rates, and a loss of faith in U.S. government securities that would reverberate throughout the global economy. While it's unlikely that the current situation will lead to a default, pushing negotiations close to the edge can be damaging in itself. It was estimated that the 2011 impasse cost U.S. taxpayers $1.3 billion in increased borrowing costs in FY 2011 with additional costs in the following years.[7]

The Deficit and the Debt

Put simply, the federal government runs at a deficit when tax revenues are not sufficient to meet spending obligations. Federal spending has outpaced revenue for the last 50 years, except from 1998 to 2001.[8] Annual budget deficits add to the national debt.

The current debt of $31.4 trillion is the highest in U.S. history.[9] However, measuring the debt as a percentage of gross domestic product (GDP) provides a better comparison over time. More specifically, economists look at debt held by the public — funds the government has borrowed to meet operational expenses and liabilities, primarily through issuing Treasury securities. Interagency debt — funds borrowed from government accounts such as the Social Security trust funds — is also subject to the limit but does not directly affect the economy or federal budget.

At the end of fiscal year 2022 (September 30, 2022), debt held by the public was equivalent to 97% of

GDP. In 2019, before the pandemic, it was 79% of GDP, and in 2007, before the Great Recession, it was 35%. Both of these crises caused explosions of the deficit and debt due to lower tax revenues and high spending on government stimulus programs. The last time the debt exceeded current levels was at the end of World War II.[10-11]

In a new February 2023 analysis, the CBO projected that the debt will rise steadily over the next decade to 118% of GDP in 2033, which would be the highest percentage in U.S. history. The driving forces behind this increase would be higher spending on Social Security and Medicare, and rising interest costs (due to increasing debt and higher rates). If current laws remain unchanged, the debt is projected to rise even more quickly in the next two decades, reaching 195% of GDP in 2053.[12]

No Easy Answer

The only way to change this trajectory is to increase revenue, reduce spending, or both. The rosiest scenario would be decades of high GDP growth that increases revenue at current tax rates, but this seems unlikely. The CBO projects real (inflation-adjusted) GDP growth to average a tepid 1.7% annually over the next decade.[13] Raising tax rates may be necessary, but that is always a difficult political option.

There is also little room to maneuver on the spending side. Only 28% of federal spending is "discretionary," meaning Congress can set amounts through annual appropriations bills, and almost half of that spending goes to national defense, which few leaders would want to cut in the current global climate. The rest is mandatory spending, including Social Security and Medicare (which will account for nearly 36% of federal spending in 2023) and interest on the national debt.[14] While both parties have indicated that Social Security and Medicare are off the table, other mandatory spending could be reduced through Congressional action.

The White House is expected to release its budget proposal for FY 2024 in March, followed by a counterproposal from House Republicans in April, setting up what is sure to be an intense period of budget negotiations. President Biden and House Speaker Kevin McCarthy have already begun to discuss the debt ceiling issue, and it remains to be seen whether the ceiling can be addressed outside of the budget process or whether it will be caught in the crosshairs. In either case, the ceiling will have to be raised or suspended in order to maintain U.S. government operations.

U.S. Treasury securities are guaranteed by the federal government as to the timely payment of principal and interest. The principal value of Treasury securities fluctuates with market conditions. If not held to maturity, they could be worth more or less than the original amount paid. Forecasts are based on current conditions, are subject to change, and may not come to pass.

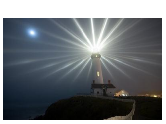
1, 3, 10, 12–14) Congressional Budget Office, 2023

2, 6, 9) U.S. Treasury, 2023

4–5) Bipartisan Policy Center, 2023

7) U.S. Government Accountability Office, July 23, 2012

8, 11) U.S. Office of Management and Budget, 2023



After years of numerous delays, the U.S. Department of Homeland Security has once again extended the REAL ID enforcement deadline from May 3, 2023, until May 7, 2025.[1]

What is a REAL ID?

A REAL ID is a type of enhanced identification card. The REAL ID Act, passed by Congress in 2005, set minimum security standards for state-issued driver's licenses and identification cards. Under the Act, residents of every state and territory are required to have a REAL ID-compliant license/identification card, or another acceptable form of identification (such as a passport), in order to:

- Access federal facilities
- Board federally regulated commercial aircraft
- Enter nuclear power plants

When traveling internationally, you will still need your passport for identification purposes, including travel to Canada or Mexico. If you are traveling domestically, you will only need to show your REAL ID or another acceptable alternative.

In order for a REAL ID license or identification card to be compliant, it must have a star marking on the upper portion of the card. Enhanced Driver's Licenses that are issued in Michigan, Minnesota, New York, Vermont and Washington do not have a star marking but are still acceptable alternatives to REAL ID-compliant cards and will be accepted for official REAL ID purposes.

How Do You Get a REAL ID?

The U.S. Department of Homeland Security (DHS) oversees the enforcement and implementation of the REAL ID Act, but each state's driver's licensing agency has its own process for issuing REAL ID-compliant license/identification cards.

In order to obtain a REAL ID, you will need to provide documentation that shows your:

- Full legal name, date of birth, proof of lawful presence (e.g., U.S. passport, birth certificate)
- Social Security Number (Some states may not require physical documentation of your Social Security Number.)
- Two proofs of address of principal residence (e.g., driver's license, utility bill)

If you have a name change (e.g., marriage, divorce or court order), you will also need to bring in documentation that demonstrates proof of your name change. States may impose additional requirements, so be sure to contact your state's driver's licensing agency for more information.

1) U.S. Department of Homeland Security, 2023

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