the fiscal mess, part deux*

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november
2013

Two significant events took place October 1. First, the federal government opened the health insurance exchanges provided by the Affordable Care Act (the ACA, sometimes nicknamed "ObamaCare"). Second, fiscal year 2014 began without Congress raising the debt ceiling or passing a new budget, and the lack of a budget triggered a partial shutdown of the federal government. These events were connected. Congress passed the ACA in 2010 without a single Republican vote, and the repeal of the ACA has topped the Republican agenda since then.

The Republican-dominated House of Representatives initially passed a budget that would have funded the government but terminated funding for the ACA. The Democrat-dominated Senate refused to pass the House's budget. It is doubtful that Republicans expected to succeed in defunding the ACA; rather, they were making a gesture for next year's Congressional elections, during which the ACA is sure to be a major issue. Subsequently, the House passed a budget that made smaller changes to the ACA, such as delaying its implementation, but to no avail. The Democrats declared that any change to the ACA was unacceptable, and the House-Senate impasse resulted in the nearly three-week government shutdown that inflicted economic harm, damaged the US's international reputation, and undermined public confidence. It only ended because the Treasury was running out of cash, and without a rise in the debt ceiling, the federal government would have defaulted on its financial obligations with catastrophic consequences.

Senate leaders worked out a simple last-minute deal on October 16 to raise the debt ceiling and pass a "continuing resolution," which ended the federal shutdown.

But the US is not out of the woods, fiscally speaking.

The continuing resolution enacted in October will expire on January 15. If a budget, or at least another continuing resolution, is not passed by then, the federal government will suffer another partial shutdown. January 15 is also when the next round of sequester spending cuts starts, as required under the Budget Control Act of 2011. The sequestration will lower federal spending authority from $986 billion (the fiscal year 2013 level) to $967 billion. Congress comes back into session from holiday break on January 7 and is likely to negotiate right up to the January 15 deadline. This is likely to be the key window of opportunity for reaching an agreement.

As part of the compromise for the continuing resolution, the legislation created a 29-member bipartisan House-Senate conference committee, which has been given a target of December 13 to reach an agreement on the budget. This committee is unlikely to succeed in its mission. A similar committee, dubbed the Super Committee, had the same mission two years ago and it failed. Congress is so politically polarized that it will be very difficult for any budget committee to succeed. The Republicans will keep demanding reform to entitlement spending and the ACA, which the Democrats won't accept, and the Democrats will keep demanding tax hikes, which the Republicans won't accept. But it is possible that the sequestration for fiscal year 2014 might be replaced with an alternative, more backloaded set of spending restraints.

The debt ceiling issue will also have to be revisited. In October, Congress authorized the president to raise the debt ceiling by enough to allow the Treasury to borrow what it needs through February 7. It is important to note that Congress raised the debt ceiling through a calendar date, not by a dollar amount. Come February 7, the Treasury will not be able to issue more public debt (although it can roll over existing debt), but it will be able to use "extraordinary measures" to keep the government going for a while longer. When those extraordinary measures will be exhausted is anyone's guess, but it is reasonable to expect the

**This is a follow up to a previously published paper, "The Fiscal Mess," October 2013.*

drop-dead date in mid-March or early-April. The expense of tax refunds could drain the extraordinary measures rapidly. If the debt ceiling is not raised by the drop-dead date, the federal government would go into technical default on its financial obligations, probably causing massive financial sector distress. In any event, the inability to borrow would force the federal government to balance its budget overnight solely by spending cuts, and such rapid and substantial fiscal contraction could trigger a new recession.

In our view, another continuing resolution will likely be passed by January 15, and we consider another shutdown improbable. We also believe the debt ceiling will be hiked by mid-March, or possibly earlier, as part of a continuing resolution in January. The continuing resolution is likely to fund the government through the end of the fiscal year on September 30. The debt ceiling will likely be raised high enough to take the government past the November elections and perhaps into early 2015, so the next Congress can deal with the issue.

Opinion polls show that Congress has become very unpopular, particularly since the budget wars of October. With Congressional elections scheduled for November 4, 2014, neither party is likely to engage in a bruising fight and jeopardize the chances of electoral success. Moreover, a shutdown and debt ceiling debate in winter 2014 could delay income tax refunds for weeks, a measure that would do no good for Congressional approval ratings. Finally, a Treasury default, financial panic, and new recession certainly would not help any member of Congress get reelected, to put it mildly.

Senate Republican Leader Mitch McConnell has stated bluntly that there will not be another shutdown. He would rather have the public complaining about the ACA and blaming the Democrats than complaining about a shutdown and blaming the Republicans. The ACA is likely to be the central domestic issue of the 2014 elections, and the American voters will have to decide what to do with it. Congress seems to have figured out that shutdowns and threatened defaults are not the way to resolve the issue.