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Shutdown Showdown

Government shutdowns have no economic upside.

"In Fitch's view, there has been a steady deterioration in standards of governance over the last 20 years, including on fiscal and debt matters….In addition, the government lacks a medium-term fiscal framework, unlike most peers, and has a complex budgeting process."

When Fitch's downgrade of U.S. debt was announced in August, we were puzzled by the timing **but understood the rationale**. The debt-limit showdown that concluded in early June frustrated all observers, and it risked a fiscal collapse of our own making. The right time to make the case for lower spending is in the annual budget process. Now, with the deadline looming, negotiations in the "complex budgeting process" are poised to fail, taking the federal government into a shutdown.

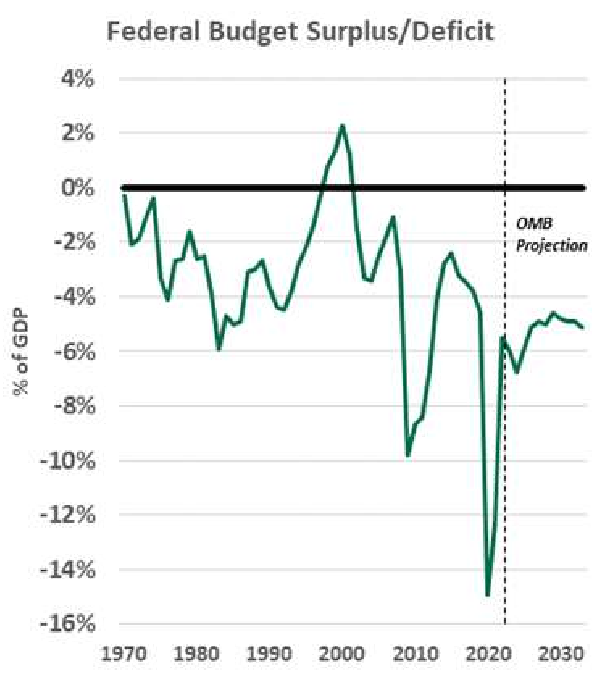
By the start of each fiscal year (October 1), Congress must agree upon a set of 12 appropriations bills to fund federal agencies in the year ahead. Absent passage of these bills, a continuing resolution (CR) can be used to temporarily carry on using the prior year's budget. Without appropriations or a CR, government functions enter a funding gap and are shut down if they are not essential. Employees are furloughed or asked to work without pay. Essential services including healthcare, active duty military and air traffic control are continued.

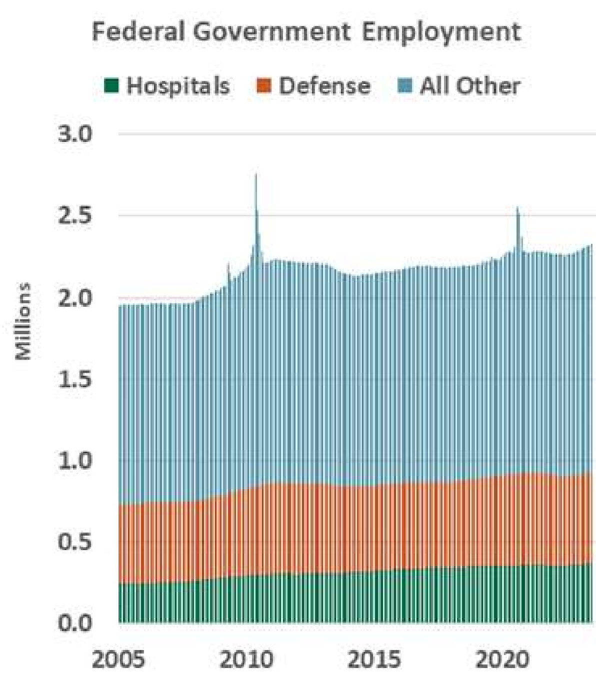
The current round of wrangling is disappointing in light of the **debt ceiling agreement**, which set a top-line cap on spending for fiscal years 2024 and 2025. But a cap is not a budget; some within Congress interpret those values as a maximum spending level, and are pushing for further cuts.

The stakes today are much lower than the worst-case potential outcomes of the debt ceiling debate. The government has shut down **21 times since 1976**, though most of those were brief gaps with little disruption. For better or worse, these episodes have become routine. Markets do not react, and the private sector carries on. Many quasi-governmental agencies, like the U.S. Postal Service, Federal Reserve banks and market regulators, are not subject to appropriations and do not close.

Disruptions to nonessential government services will vary in their degrees of disruption. In the 2013 shutdown, national parks were closed; in 2018, parks stayed open, but services like garbage removal were curtailed. The Food and Drug Administration and Environmental Protection Agency reduced their inspections of food and waste facilities, respectively, in past shutdowns. The Internal Revenue Service tax collection agency had faced shutdowns in the past, but recent legislation has guaranteed its funding.

Crucially for this moment in the economic cycle, government statistical agencies including the Bureau of Economic Analysis, Bureau of Labor Statistics and Census Bureau are facing closure. A delay in publication of data around growth, employment and inflation will leave us in the dark and impair the Federal Reserve's ability to make rate decisions.





Sources: Office of Management and Budget, Bureau of Labor Statistics, Haver Analytics. Note: Employment excludes U.S. Postal Service.

Reduced pay to government workers is one reason we anticipate a **slower fourth quarter**. In the 2013 and 2018 shutdowns, approximately 850,000 employees were furloughed, a major disruption to those households' income. And the furloughs illustrate the futility of shutdowns as a check on spending. Employees received back pay (a practice now guaranteed through 2019 legislation); the government paid people for time not worked.

The overall drag on the economy is visible in the data. The Congressional Budget Office estimated the five week shutdown in 2018-19 reduced economic activity by **$11 billion** across two quarters, of which $3 billion was a deadweight loss, never to be recouped. Relatedly, Moody's is the last ratings agency that still rates U.S. debt as AAA. This week, they warned a shutdown would be "**credit negative**," a stern warning in financial parlance.

Events from here will be unpredictable, and we cannot offer a confident forecast. A CR to prevent or limit an October shutdown is plausible, but that would be only a temporary reprieve before another round of negotiation. That same setup yielded the record-setting 35-day shutdown in December 2018. CRs have been chained together to cover entire fiscal years, as happened in 2011 and 2013. A hostile showdown could cost Speaker McCarthy his leadership role, which would do nothing to facilitate the passage of a budget.

We take this episode as one more example of government dysfunction. The debt is rising, the population is shifting, the climate is changing and the economy is reorienting. Washington has more important work to do.

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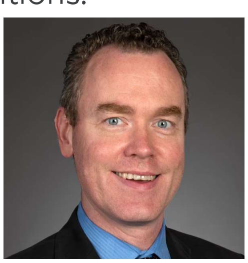

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