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## WASHINGTON POLICY STRATEGY

# Potomac Perspective

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This is a follow up to notes sent prior to the election of Representative Kevin McCarthy as Speaker of the House. In our current base case, the prospects for a government shutdown in October are high. House Republicans are pursuing overall cuts in discretionary spending (capping spending at fiscal year 2022 levels) which are unlikely to pass the Senate (if the bills even pass the House) and will likely lead to a shutdown in the next fiscal year (starting October 1). Early reports of commitments to cuts in defense spending were erroneous. While there will be pressure to constrain the defense budget, Congress might not move to reduce defense spending outright, but rather any increase in the defense budget could be held to less than the rate of inflation.

### Thoughts on the Fiscal Year 2024 Budget and a Potential Government Shutdown (Likely)

Following the negotiations among House Republicans last week that culminated in the election of Kevin McCarthy as Speaker of the House, there are some takeaways about what to expect in the coming months.

House Republicans have apparently committed to:

- Adopting an fiscal year 2024 Budget Resolution that balances the federal budget within ten years;
- Capping fiscal year 2024 discretionary spending at fiscal year 2022 levels or lower;
- Passing all 12 appropriations bills on time and in compliance with the Budget Resolution;
- Rejecting negotiations with the Senate unless its appropriations bills are passed, comply with the House Budget Resolution, and reduce non-defense discretionary spending; and
- Passing a Continuing Resolution (CR) before September 30 (end of the fiscal year).

There is some uncertainty about how the process will play out, but based on these principles, it seems highly likely that there will be a government shutdown on October 1. Based on recent history, it is unlikely that the Senate will meet the House's demands on passing its appropriations bill on time, so a CR will likely be necessary in order to buy the Senate more time. However, the House will probably struggle to pass a CR that can pass the Senate. According to reports, some House Republicans want a CR to be at 98 percent of fiscal year 2023 levels, which would be unacceptable to Senate Democrats (and many Republicans in both chambers). With a narrow majority in the House and a group of Members who seem to relish a fight, passing a CR to avoid a shutdown will be difficult. Our base case is a government shutdown in October, with the caveat that a painful fight during the summer over the debt ceiling might impact House Republicans' strategy as the fiscal year winds down. It is also possible that a debt ceiling fight with negative political ramifications for Republicans could cause House Republicans to rethink their fall strategy.

The first step in the budget process will be to pass a Budget Resolution (BR) which the House could consider in the spring (April?). A BR is nonbinding and is typically aspirational, although House Republicans have pledged to only pass appropriations bills that comply with the BR. The BR could also signal what policies the GOP might pursue during the debt ceiling debate as well as offer a glimpse about how the party intends to deal with the provisions of the Tax Cuts and Jobs Act (aka the Trump tax cuts) which expire after 2025.

Regarding the defense budget, a cut in defense spending seems unlikely, however a material increase in the defense budget seems unlikely as well. The narrative of the past week has been dominated by a handful of House Republicans who want to cut the defense budget. However, defense hawks still dominate the House Republican Conference, and several House Democrats support increases in defense spending. A significant block of House Democrats could join the group of Republicans who are pushing for defense spending cuts, but it is not clear that this group would constitute a majority in the House. Instead, each camp could check the other, whereby there are no defense cuts, but any increase in defense spending is minimal (i.e., below the rate of inflation). Investors could get a preview over the defense budget in April or May when the Biden administration might request additional funds for Ukraine. Such a vote could clarify the battle lines over the defense budget, especially on the Republican side.

Among the next events to watch for is the appointment of members to the House Rules Committee. The Rules Committee is the all-powerful last stop before a bill reaches the House floor. The committee's ratio is nine Republicans to four Democrats, but Speaker McCarthy apparently promised three of the Republican seats to members of the House Freedom Caucus, some of whom have been critics of defense spending and aid to Ukraine. The Rules Committee appointments could impact the upcoming budget debates in ways few people outside of Washington appreciate. As of this writing, the names of the new Rules Committee members have yet to be announced.

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