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Government Shutdown: Deadline Déjà Vu

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Summary

- Federal fiscal year (FY) 2024 begins on October 1, and as of this writing none of the 12 annual appropriation bills have been enacted into law. As a result, in the absence of Congressional action, a government shutdown will begin on October 1.
- During a government shutdown, unfunded federal agencies must discontinue non-essential functions. Essential services, such as those related to public safety or national security, continue to operate.
- A government shutdown only impacts the 25% or so of federal spending that is characterized as discretionary. Mandatory spending, such as outlays for Social Security, Medicare and Medicaid, is not part of the annual appropriations process and thus generally continues unabated.
- Earlier this year, bipartisan majorities in Congress passed the Fiscal Responsibility Act (FRA), which suspended the debt ceiling and set "topline" spending levels for defense and nondefense discretionary spending. The FRA stipulated roughly a 3% boost to defense discretionary spending and an 8% *cut* to nondefense discretionary spending for FY 2024, though our sense was that the latter number would be closer to flat after accounting for a number of adjustments and side agreements.
- However, some more-conservative House Republicans are unhappy that the trajectory for discretionary spending was not reduced even more. Given that the Republican majority in the House of Representatives is a razor-thin four seats, Speaker of the House Kevin McCarthy has faced pressure to reduce discretionary spending below the levels agreed to in the FRA. This hurdle, alongside several others, have led to gridlock in the budget process.
- There does not appear to be enough time to complete the annual appropriations process by October 1. As a result, a continuing resolution or a shutdown are the two most likely near-term outcomes. At this point, we view the chances of a shutdown starting on October 1 as more or less a coin flip.
- Past government shutdowns are instructive for assessing the potential economic impact. The *direct* hit to economic growth in the 2013 and 2018-2019 government shutdowns was a relatively modest few tenths of a percentage point. Growth rebounded by a similar amount once the shutdown ended. That said, not all the lost economic activity was recovered in full, and the *indirect* hit to the economy is more difficult to measure yet should not be ignored.
- A shutdown could delay influential economic data reports published by government agencies. Following the 16-day government shutdown in 2013, the Department of Labor's monthly Employment Situation and Consumer Price Index reports, among others, were delayed by about two weeks. Collection, processing and publication delays stretched into the following month as well.
- Determining the correct monetary policy setting in real-time is never easy, and it would be made all the more difficult by a lack of timely economic data. A government shutdown that leads to economic data blind-spots could raise the risk of a policy misstep by the Federal Reserve.

Shutdown Showdown

Fears about a federal government shutdown are on the rise as a looming October 1 deadline to fund the U.S. government draws closer. In this report, we first explain what a shutdown is and how it differs from other key budget pressure points, such as the debt ceiling. We then discuss the outlook for a legislative resolution as well as the economic implications of a potential government shutdown.

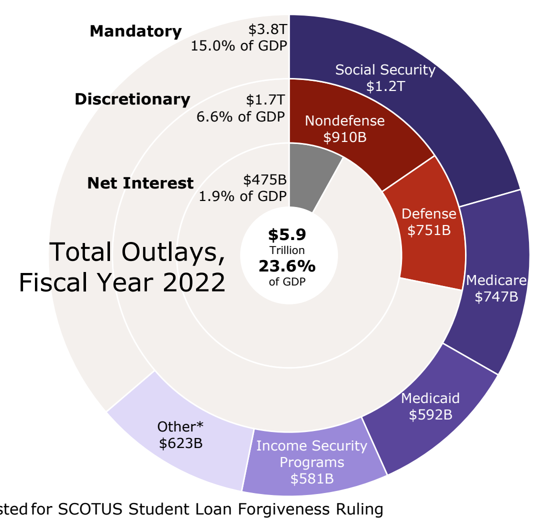
If it feels like Congress and the president just went through a bruising budget battle, you may be asking yourself how a government shutdown could follow so quickly on the heels of the debt ceiling fight that occurred earlier this year. In the spring, fiscal policymakers were at odds over increasing the nation's debt limit, which is a statutory limit on how much money the federal government can borrow. Eventually, the debt limit was suspended until January 1, 2025, as part of the Fiscal Responsibility Act (FRA), which became law on June 3. The FRA also provided "topline" spending levels for the discretionary parts of the federal budget that are set annually. As we wrote at the time, the FRA stipulated roughly a 3% boost to defense discretionary spending and an 8% *cut* to nondefense discretionary spending for FY 2024, though our sense was that the latter number would be closer to flat after accounting for a number of adjustments and side agreements.

If the fiscal year ends and appropriations are allowed to lapse, a government shutdown will commence and any unfunded federal agencies will discontinue non-essential functions.

However, simply raising the debt ceiling and agreeing to topline spending levels does not complete the federal budget process. Once spending levels have been set, Congress must pass the 12 annual appropriation bills before the start of the next fiscal year on October 1. The appropriations process involves allocating the pot of money to all the various programs and activities funded by the federal government through annual appropriations. To better understand the process, imagine a household that has developed a high-level budget for its major spending categories such as rent, groceries, etc., but still has to choose a place to live or which individual items to purchase at the grocery store. It is the second step of the process that remains incomplete. If the fiscal year ends and appropriations are allowed to lapse, a government shutdown will commence and any unfunded federal agencies will discontinue non-essential functions. Essential services, such as those related to public safety or national security, continue to operate.

It is also important to note that the appropriations process only impacts the 25% or so of federal spending that is characterized as discretionary (Figure 1). Mandatory spending, such as outlays for Social Security, Medicare and Medicaid, is not part of the annual appropriations process.[1] Unlike discretionary spending, mandatory spending is primarily determined by eligibility rules and benefit formulas that have been set in previously enacted laws. As a result, this spending continues on autopilot unless Congress acts to change the laws that dictate spending on these programs.

Figure 1



Source: Congressional Budget Office and Wells Fargo Economics

So what is the hold up? An exhaustive overview of all the disagreements over this year's budget process is beyond the purview of this report. Two of the bigger roadblocks are the topline spending levels set in the FRA as well as a supplemental spending request from the Biden administration. The

FRA was passed on a biparistan basis in both chambers of Congress, but some more-conservative House Republicans are unhappy that the trajectory for discretionary spending was not reduced even more. Given that the Republican majority in the House of Representatives is a razor-thin four seats, Speaker of the House Kevin McCarthy has faced pressure to reduce discretionary spending below the levels agreed to in the FRA. In addition, the White House has requested roughly $40 billion of additional funding, primarily to support Ukraine and areas that have been hit by natural disasters, such as the wildfires in Maui or the recent hurricane to hit Florida. Some House Republicans have expressed skepticism about enacting this supplemental funding request, while others have embraced it. In the Senate, our sense is that the fissures between the two parties on these topics are not as large. All 12 Senate appropriation bills were advanced out of committee by the end of July with sizable bipartisan majorities.[2]

There does not appear to be enough time to complete the annual appropriations process by the end of September. As a result, a continuing resolution (CR) or a shutdown are the two most likely near-term outcomes. For those unfamiliar, a CR is a temporary funding measure that continues existing appropriations until some specified date in the future. Congress often turns to CRs for a few weeks or months at a time in order to avert a shutdown and buy more time to complete the appropriations process.

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In our view, the probability of a government shutdown has increased in recent weeks as the outlook for a CR before October 1 looks increasingly precarious. At this point, we view the chances of a shutdown starting on October 1 as more or less a coin flip. If a shutdown does occur, either in October or at a later date this year, what would be the potential economic implications?

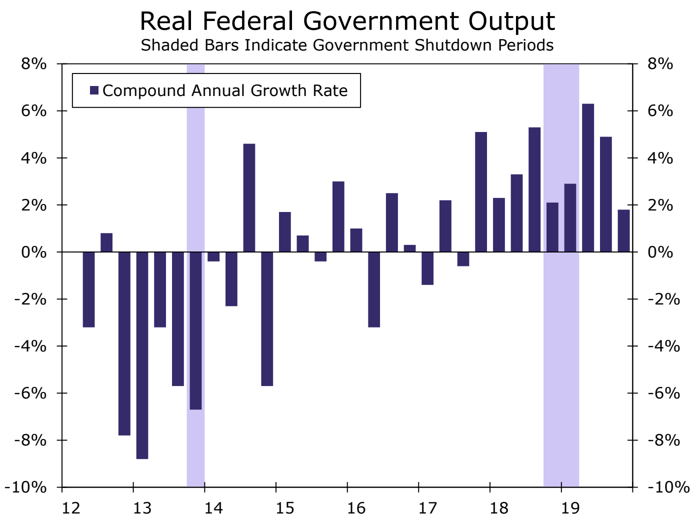
A Dent to Economic Growth, but Not a Derailment

The direct effects of both the 2013 and 2018-19 shutdowns on economic growth were relatively small and short-lived.

Government shutdowns have become all too familiar in recent years and thus are not uncharted territory for the U.S. economy. Since the 1980s when shutdowns started to occur under the modern budget process, most have been relatively short, spanning just a few days and not having a discernable impact on the economy. But over the past decade, there have been two lengthy shutdowns that have proved more disruptive. From October 1-16, 2013, all federal government agencies ceased non-essential operations. The most recent shutdown (December 22, 2018 - January 25, 2019) was only "partial", with impacted agencies only accounting for about 25% of discretionary federal spending. Yet while narrower in scope, the 2018-2019 shutdown became the longest on record at 35 days.

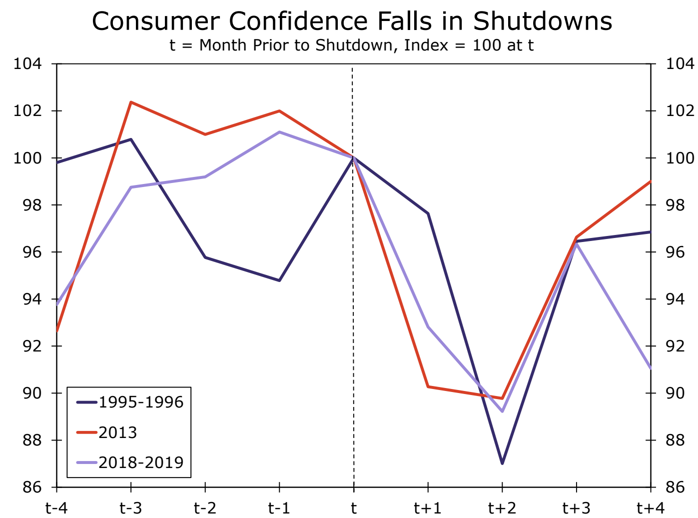
The *direct* effects of both the 2013 and 2018-19 shutdowns on economic growth were relatively small and short-lived. The Bureau of Economic Analysis (BEA) estimated that the 2013 shutdown directly reduced real GDP growth in the fourth quarter of that year by 0.3 percentage points.[3] For the five-week partial shutdown ending in January 2019, the BEA estimated the shutdown reduced real GDP growth by 0.1 percentage points in Q4-2018 and 0.3 percentage points in Q1-2019 (the shutdown spanned both quarters).[4] The hit to real GDP growth stemmed from the reduction in hours worked by federal government employees, as hours worked are used as a measure of government output. Yet the direct hit to real GDP growth soon washed out. In the first quarter after each shutdown, the federal government component of real GDP growth rebounded when hours worked returned to normal (Figure 2).

Figure 2



Source: U.S. Department of Commerce and Wells Fargo Economics

Figure 3



Source: The Conference Board and Wells Fargo Economics

That said, not all lost economic activity is recovered in full. The Congressional Budget Office (CBO) estimated a small (<0.1%), yet nonzero reduction in projected annual GDP in 2019 as a result of the partial government shutdown.[5] Furthermore, these estimates only attempt to account for the *direct* hit to economic growth from the shutdown.

The indirect hits to the economy are more difficult to measure yet should not be ignored

The *indirect* hits to the economy are more difficult to measure yet should not be ignored. Federal workers are now required by law to receive backpay for the shutdown period.[6] As a result, furloughed workers would still be counted as employed in the establishment survey of payroll employment (although classified as "unemployed on temporary layoff" in the household survey). However, both furloughed and employees working through the shutdown are not paid until *after* the shutdown has ended. This often extends to private sector workers as well, such as government contractors. Amid the delayed pay and uncertainty over how long savings need to stretch, affected workers are likely to reduce discretionary spending on the margin. Some of that spending may be merely delayed, but some, such as dining out, may be not be, leading to a permanent loss of economic activity.

While these secondary, indirect effects are largely localized to areas with a high share of federal government employment, like the D.C. metro area, the general mood of the U.S. consumer has typically soured amid the heightened discord in Washington. As illustrated in Figure 3, the Consumer Confidence Index lurched lower during previous government shutdowns. Therefore, we see the direct effect estimates by the BEA and CBO as likely lower bounds to the total impact.

Reduced Visibility at an Inopportune Time

While there is never a good time for the federal government to shut down, the potential for one in the current economic environment is more concerning. Not only would a shutdown reduce economic growth modestly, but it would create a data vacuum at a time when the path ahead for the economy is highly uncertain. A shutdown could delay influential economic data reports published by government agencies, as employees involved in collecting and processing the information are deemed non-essential.

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In the 2018-19 partial government shutdown, data blind-spots were largely limited to reports published by the Department of Commerce (DoC), such as personal income & spending and GDP. The first look at GDP growth for Q4-2018 was delayed about a month, as was December 2018 data on retail sales and personal income & spending. Data collection at other agencies, most notably the Department of Labor (DoL), continued during that period because the DoL was an agency that was funded by Congress in advance of the shutdown.

Today, none of the 12 appropriation bills have become law as of this writing. Thus, a full government shutdown, should it come to pass, would leave more holes in the picture by also impacting key DoL releases on inflation and the labor market, as was the case in the wider 2013 shutdown. Following that 16-day closure, the Department of Labor's monthly Employment Situation, Consumer Price Index and

Producer Price Index reports, among others, were delayed by about two weeks. Collection, processing and publication delays stretched into the following month as well. The disruptions spilled over into other economic indictors which use government data as input sources, such as the Federal Reserve's industrial production report. While releases were delayed, data quality for the period reflecting the shutdown was largely unaffected, with the BLS reporting normal-range response rates for the October 2013 employment and producer price index reports. However, the sample of prices used to calculate the CPI for October that year was about 75% of the usual amount.

Recent data point to economic activity in the United States continuing to hold up surprisingly well in the face of the FOMC's aggressive policy tightening cycle. Real GDP looks set to have grown at more than a three percent annualized pace in Q3, businesses are still adding 100-200K jobs per month, and layoffs are trending sideways at relatively low levels. Taken together, a recession does not appear imminent, but it is unclear whether economic growth has slowed sufficiently to put inflation back in the bottle. Monetary policy is at a crossroads as a result.

The lack of economic data could raise the risk of a policy mistake in the form of inflation being allowed to fester or a sharper-than-expected slowdown in economic growth.

Having raised the fed funds rate 525 bps over the past 18 months, the FOMC has signaled the need to move cautiously ahead and carefully assess incoming data to determine if policy is best positioned to return inflation back to target without inflicting unnecessary damage on the economy. An extended delay of key government data releases stands to hamper this stage of the tightening cycle. The lack of data could raise the risk of a policy mistake in the form of inflation being allowed to fester or a sharper-than-expected slowdown in economic growth. Determining the correct policy setting in real-time is never easy, and it would be made all the more difficult by a lack of timely economic data. These data blind-spots could come at a time when student loan payments are restarting, United Auto Workers are striking, and energy prices are rebounding, making the potential loss of visibility into the current state of the economy even more concerning.

Endnotes

1 - For further reading, see the Congressional Budget Office's glossary for key budget terms. (Return)

2 - Committee for a Responsible Federal Budget. Appropriations Watch: FY 2024. September 19, 2023. (Return)

3 - U.S. Department of Commerce: Bureau of Economic Analysis. Technical Note on Gross Domestic Product, Fourth Quarter of 2013 (Advance). January 30, 2014. (Return)

4 - U.S. Department of Commerce: Bureau of Economic Analysis. Technical Note on Gross Domestic Product, First Quarter of 2019 (Advance Estimate). April 26, 2019. (Return)

5 - Congressional Budget Office. The Effects of the Partial Shutdown Ending in January 2019. January 2019. (Return)

6 - Government Employee Fair Treatment Act of 2019, Public Law No. 116-1. 2019. (Return)

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