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How Debt Fight Could Play Out

By **JIM MCTAGUE**

Each side would make some concessions, with GOP acceding on raising tax rates.

Let fly the black swans! Every last one of them! This bull market appears capable of absorbing any shock, even headlines straight from the Old Testament: tsunamis, twisters, blizzards, revolutions, droughts, sovereign bankruptcies—you name it. All are met with the cockeyed optimism of nurse Nellie Forbush.

This is not to say the market is completely jitter-free. A scary clown doll lurks under the bed, and it looks an awful lot like the U.S. Congress, which has proved quite capable of distressing the market: Witness the dramatic, albeit ephemeral, plunge in the major averages on April 18, when S&P issued a credit warning outlook on U.S. debt, changing its rating to "negative" from "stable" owing to the government's fiscal fecklessness.

Congress will dominate the news cycle again on May 2, when the House ends its current recess and Republicans and Democrats resume their vituperative clash over whether to increase the nation's \$14.3 trillion debt ceiling. Republicans, in an effort to rebrand themselves as the fiscally responsible party, are opposing an increase unless Democrats first agree to meaningful budget cuts. Their knock is that the Democrats are addicted to big, wasteful government programs. The Democrats retort that the Republicans are scheming to take milk from babies and drip-bottles from old folks to provide tax breaks for plutocrats, pushing the government toward a general default on its debt obligations in the process. The consequence of default, they argue, would be soaring interest rates followed by another recession.

No doubt, this face-off will have all the attributes of a cliffhanger. The Hill newspaper last week had Republican Sen. Bob Corker of Tennessee promising a fight that would make the heated debate earlier this month over the 2011 fiscal-year budget look like a powder-puff game. The GOP had threatened to shut down the government if the Democrats did not accede to cuts in that spending plan. But will the intense game of chicken prove frightening enough to unnerve Wall Street?

"The fact is, we've always resolved debt-ceiling conflicts in the past," says Rob Shapiro, a former Clinton advisor who now is chairman of Sonecon, an economic consulting firm in Washington, D.C. Investors, says the Democrat, expect this will happen again: "We always start where we are now, with both parties refusing to accept the bottom line of the other side. The Republicans say they never will accept a tax increase. The Democrats say they never will accept any significant change in entitlements, especially Social Security."

They debate it, he says, so that each party can convince its political base that it has done all that it is capable of doing to protect what is dear to its heart. And then both sides accede to reality.

Shapiro says in the end the Republicans will wring some minor concessions from the administration in return for an increase in the debt ceiling. They can't expect more, he argues, because President Obama has all the leverage. If the GOP is so intransigent that investors doubt the ability of the Congress to resolve the nation's fiscal problems, Shapiro believes, the immediate consequence will be a rise in rates, which could damage the recovery. The GOP would be blamed by the voters come 2012, he says.

Ike Brannon, director of economic policy for the American Action Forum, which is populated by Republicans, also sees the GOP walking away from the debt-ceiling fight with some short-term budget reductions, but nothing to write home to the tea party about. "I think that most members of the GOP want to make sure the debt-ceiling legislation passes," he says. "This is not a great vehicle for obtaining a whole lot of changes. The real fight is in trying to pass the Ryan budget," he says, referring to the dramatic proposal by Republican Rep. Paul Ryan of Wisconsin to cut spending by \$6 trillion over 10 years and roll back the Nanny State.

Brannon was chief economist for the House Energy and Commerce Committee, and he also was an economic advisor to John McCain in the Arizona Republican's run for the White House.

THE ESTIMATED DEADLINE FOR LIFTING the debt ceiling is some time prior to May 31. The actual date depends on the pace of tax collections this year. Brannon believes that the Treasury could muddle through under the current ceiling until July. If the GOP accepts his assessment, its House members might organize themselves for a protracted fight into June in an attempt to squeeze extra concessions from the Democrats.

The White House might benefit from a protracted debt-ceiling fight, as well, surmises Brannon. "President Obama probably feels that the fight will make him look like the responsible adult and make the tea-party people look like they don't understand the economic implications of failing to raise the limit," he says.

Because the GOP would be blamed for any economic consequences resulting from failure to lift the ceiling, at the end of the day the party will take the best deal available and move on to the fight over the fiscal 2012 budget, Brannon predicts.

Democrat Shapiro believes—the GOP's antitax-hike rhetoric notwithstanding—that investors expect Congress at some point to follow the pattern of the 1980s and 1990s and accede to higher taxes to help narrow the deficit.

"President Ronald Reagan acceded very quickly," says Shapiro. The Republican president signed tax increases into law in 1982, 1983, 1984 and 1985. The hikes had been passed by a Democratic-controlled congress. Even the Tax Reform Act of 1986, which was championed by Reagan because it reduced the top rate on individual income taxes from 50% to 28%, resulted in a net tax increase during its first two years.

How would the market react if Republicans broke the pattern of the past?

In Shapiro's view, long-term interest rates suggest that the market simply does not expect this outcome. Investors might want to hedge themselves come May in case the GOP breaks with tradition.

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