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Economics Group

Special Commentary

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Five Key Issues to Watch in the 114th Congress

Executive Summary

As the 114th Congress ramps up over the coming weeks, we wanted to take a moment to point out five of the key policy issues that we will be watching in the 114th Congress. There are several crucial deadlines over the course of the next year ranging from the need to pass legislation to keep the Department of Homeland Security operating beyond the end of February, to the need to address the impending exhaustion of the Highway Trust Fund, to increasing the nation's borrowing limit. While there are a number of issues that will likely be debated or discussed in the 114th Congress, we focus on five of these issues that we see as having the greatest potential investor impact and point out the specific sectors we feel would likely be affected by each of these five pieces of legislation.

Federal Budget for Fiscal Year 2016

One of the essential policy debates to take place this spring will be over the budget for federal fiscal year 2016. The House and Senate leadership have indicated that they would like to return to normal order in the budget process, which includes passing a budget resolution by mid-April and passing all 12 appropriation bills. Returning to the normal order in the budget process should help wrap up the FY 2016 budget ahead of the Sept. 30 deadline and avoid the last minute budget drama that has plagued the process for the past several years. Beginning with the 2016 fiscal year, the full set of discretionary budget cuts, known as sequestration, enacted by the Budget Control Act of 2011 will go into effect. The magnitude of the across-the-board sequestration cuts was rolled back under the Ryan-Murray agreement that was forged back in 2013. In Figure 1, we highlight the federal discretionary spending levels projected through 2021 that were originally enacted from the Budget Control Act, and the revised caps established by the Ryan-Murray agreement over the last two fiscal years.[1] Existing cuts to federal spending were rolled back by $63 billion over fiscal years 2014 and 2015. Should Congress enact spending levels consistent with the existing Budget Control Act caps, defense discretionary spending authority would decline 10.7 percent over last year's levels, while nondefense discretionary spending would decline 4.1 percent.

Beginning with the 2016 fiscal year, the full set of discretionary budget cuts will go into effect.

Greater Flexibility?

Should some or all of the sequestration cuts go into effect beginning in October of this year, it is possible that Congress restructures the across-the-board cuts to provide more flexibility to agencies in how to implement the spending reductions. The first key signal of how the remainder of the FY 2016 budget process will shake out will take place by April 15 when Congress is expected to complete and pass a budget resolution that establishes the funding levels for the fiscal year. We expect the FY 2016 budget resolution to go through the parliamentary process known as Budget

[1] The original sequestration cuts were enacted in the Budget Control Act of 2011 (P.L.112-25). The discretionary budget caps were amended in the Bipartisan Budget Act of 2013 (P.L. 113-67).

Reconciliation, which would allow the budget resolution, along with key policy provisions attached to it, to pass in the Senate with a simple majority. Some of the potential policy provisions that have been discussed for usage in the reconciliation process are corporate tax reform and changes to or a repeal of the Affordable Care Act.

Figure 1

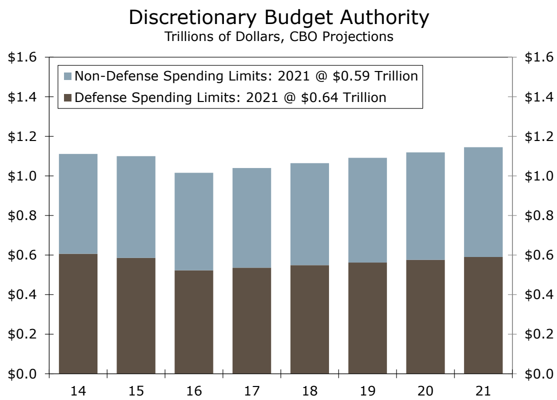
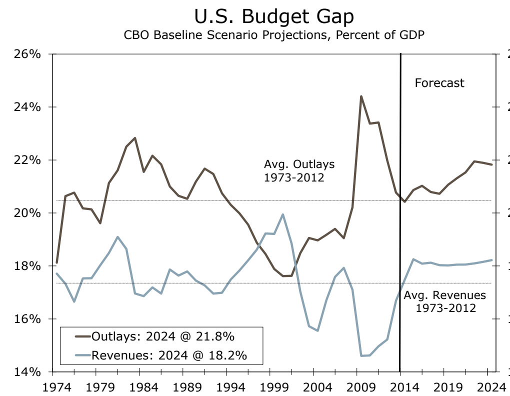


Figure 2



Source: Congressional Budget Office and Wells Fargo Securities, LLC

Another issue to watch related to the budget process is the exhaustion of the Disability Insurance Trust Fund within Social Security in 2016.

Another issue to watch related to the budget process is the exhaustion of the Disability Insurance Trust Fund within Social Security in 2016. The House passed a rule at the beginning of the current session that forces any bill related to Social Security to have an actuarial balance or the bill could be blocked from passage. The rule would remove one of the potential policy options of transferring funds from the larger Old-Age and Survivors Insurance Fund to the Disability Insurance Trust Fund as Congress has done in the past to address shortfalls in the Disability program.

Sectors potentially affected: While there are several industry sectors that could be affected by changes in federal outlay levels, we see the greatest risks to those in the defense and professional services, namely government service contractors.

Debt Ceiling Increase: Possible Brinkmanship This Summer

On March 15, the nation's debt ceiling will be re-established.

On March 15, the nation's debt ceiling will be re-established and set to the level of borrowing that took place since the debt ceiling was suspended in February of last year.[2] After the debt ceiling is re-established, the Treasury Department can begin using "extraordinary" measures to stay under the debt ceiling. We estimate that these "extraordinary" measures would keep the nation under the borrowing limit until May or perhaps June of this year. The exact date of when these measures would be exhausted will depend on tax collections during the spring tax season. The big question is how Congress will go about increasing the borrowing limit. In the past, the House has passed "clean" debt ceiling increases without any policy riders/requirements. There is some (small) possibility that the so called "Boehner Rule" could be resurrected, which would require budget cuts to increase the nation's borrowing limit. Given how contentious the debt ceiling debates have been in the past, we expect that there will be some political brinkmanship early this summer as the debate unfolds.

Sectors potentially affected: Given that Congress will increase the debt ceiling in time to avoid a default situation, the effects will largely be driven by the debate leading up to an increase in the borrowing limit. Thus, we expect the effects to be confined to financial markets, namely

[2] The debt ceiling has been suspended since February 15, 2014 under the Temporary Debt Limit Extension Act (P.L. 113-83).

Treasuries and equities. The magnitude of the effect will likely be determined by how close the nation comes to running out of options by using extraordinary measures.

Transportation Funding Bill: Addressing the Shortfall

The current funding for the Highway Trust Fund is set to expire on May 31.

The current funding for the Highway Trust Fund is set to expire on May 31. The fund has been patched since August of last year when it received a $10.8 billion infusion to keep from running out of money and halting construction projects around the country. The point of contention remains around how to fund the Trust Fund going forward. Analysis by the Congressional Budget Office (CBO) last summer showed that over the past 10 years, outlays from the trust fund have exceeded revenues by more than $52 billion, a trend they project will only get worse over the next 10 years.[3]

There are four basic approaches to addressing the shortfall in the fund: increase revenues into the trust fund, reduce spending on surface transportation programs, authorize additional transfers from the general fund of the Treasury or choose to adopt some combination of these options. If Congress chose to address the Highway Trust Fund through increases in revenues only, the CBO estimates that the current 18.4 cents/gallon tax would need to be increased between 10 and 15 cents starting this fiscal year.[4] Alternatively, a mileage-based user fee or some other form of tax policy changes could be used to raise revenues going into the fund. Should Congress choose to enact spending cuts alone, the CBO estimates that from 2015-2024, $164 billion in funding cuts would be needed to close the gap between the revenues and projected outlays from the Trust Fund. Early signs from House leadership indicate that an increase in the gasoline tax is not likely, although not all members of the House leadership have closed the door on the issue. Politically, it would be difficult to find enough cuts to completely close the gap in the trust fund; however, some cuts may be likely. Our baseline case is for Congress to once again pass another stop gap measure to transfer funds from the general fund of the Treasury to keep the fund solvent. However, we expect the debate around corporate tax reform to be tied to additional funding for the Highway Trust Fund.

Sectors potentially affected: The main sectors that could be affected by funding cuts or tax increases are transportation, heavy equipment manufacturers, along with federal, state and local highway contractors.

Corporate Tax Reform: How to Broaden the Base?

There is a somewhat greater chance that corporate tax reform takes place in the 114th Congress.

Corporate tax reform has been on the Congressional agenda for quite some time, but key policy differences continue to plague progress. In our view, there is a somewhat greater chance that corporate tax reform takes place in the 114th Congress. That said, there remain a number of issues that need to be addressed for tax reform to be enacted. There is broad agreement that something needs to be done to lower the U.S. corporate tax rate, which now ranks as the highest in the industrialized world (Figure 3).[5] Both parties more or less agree that the tax rate should be lowered and the tax base broadened. One of the key points of contention is which tax breaks to eliminate and how to broaden the tax base.

Further complicating the discussion is how to address the repatriation of corporate profits from companies with overseas operations. Foreign income earned by company operations abroad is not taxed by the IRS until the profits are returned to the United States. Thus, one option is to allow firms to repatriate these profits at a reduced tax rate to encourage firms to take advantage of the lower tax rate. Members on both sides of the aisle have suggested that some of the tax revenues

[3] **Congressional Budget Office. (2014). The Highway Trust Fund and the Treatment of Surface Transportation Programs in the Federal Budget.**
[4] **Ibid**
[5] **Organisation for Economic Co-operation and Development. (2014). Part II. Taxation of Corporate and Capital Income (2014). OECD Tax Database.**

earned through the repatriation process could be used to help address some of the issues with the Highway Trust Fund. As part of the new rules established by the House of Representatives, the CBO would be required to score tax policy legislation using a dynamic scoring method that accounts for the economic feedback effects of tax policy changes. In essence, dynamic scoring should make tax reform easier given the assumed positive feedback effects of tax cuts on economic activity. At this writing, the Senate has yet to pass a similar rule requiring the dynamic scoring.[6]

Also in the category of tax reform is how Congress will address a series of "tax extenders" that are set to expire this year. Part of the legislative push at the end of the 113th Congress included the retroactive extension of a number of business tax provisions including the research and development tax credit and the accelerated, or "bonus," deprecation tax credit for the 2014 tax year. In order for businesses to claim these tax breaks on their 2015 taxes, Congress would need to pass another extension or, as some have proposed, make these breaks permanent as part of a tax reform package. Regardless of whether or not corporate tax reform is enacted this year, we expect most of the business tax extenders to be extended for the 2015 tax year.

Given the scope of tax reform, we see exposure for the financial and non-financial corporate sectors.

Sectors potentially affected: Given the scope of tax reform, we see exposure for the financial and non-financial corporate sectors. With regard to repatriation of corporate profits, firms with large global footprints may realize higher tax liabilities should a tax break be signed into law to allow these firms to bring profits back at a reduced tax rate. Finally, firms with large research and development operations could see higher tax liabilities in 2015 if Congress fails to pass another extension of this tax credit.

Figure 3

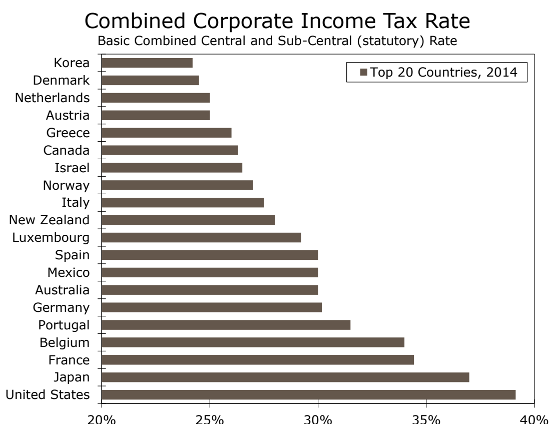
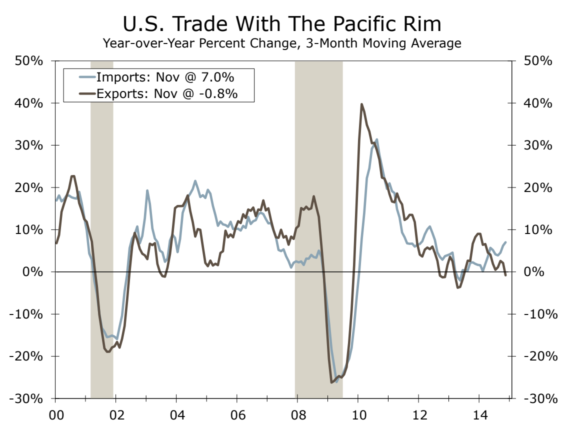


Figure 4



Source: OECD, U.S. Department of Commerce and Wells Fargo Securities, LLC

International Trade Agreements

[6] The Congressional Budget Office is responsible for "scoring" or determining the effect on the federal budget of proposed legislation. Currently, the CBO uses a static scoring technique that determines the direct effect on revenues and/or outlays based on the proposed legislation. For example, if a cut to the corporate tax rate was enacted, the CBO would score the bill by showing a negative effect on federal revenues. Conversely, under dynamic scoring, the positive/negative economic growth effects are accounted for and in turn, the positive/negative feedback effects on the federal budget are modeled. Using our corporate tax cut example, the lower corporate tax rate would promote greater economic activity and in turn would boost federal revenues growth. Thus, the total negative hit to federal revenues from a tax cut would not be as large once the positive economic feedback effects of stronger revenues from faster economic growth were accounted for in the scoring process.

There are currently two main trade agreements under negotiation: the Transatlantic Trade and Investment Partnership (TTIP) and the Trans-Pacific Partnership (TPP). The TTIP, a trade agreement with the European Union, has gone through seven rounds of negotiations, but the end does not appear to be in sight. We do not expect the TTIP to be completed this year, but the agreement may come up in the second session of the 114th Congress.

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The TPP, a trade agreement with 11 other Asian-Pacific countries, is also still under negotiation but is much closer to completion.[7] Indications from Capitol Hill and the administration suggest that the TTIP could be wrapped up in the current session of Congress. The first order of business for the Republican Congress would likely be to extend the President's Trade Promotion Authority (TPA), which would establish trade policy priorities and negotiating objectives. Once negotiated, Congress would hold an up or down vote on the agreement without amendments to the terms of the trade agreement. Besides "fast-tracking" both trade negotiations, the TPA would provide assurance to negotiating partners that the agreements could not be amended by Congress.

Sectors potentially affected: Most industry sectors would be affected by one or both of these trade agreements. Those industries with the highest exposure to Asia (in the case of the TPP) and the European Union (in the case of the TTIP) would stand to benefit the most. Among the key sectors that would benefit given what we already know about the TPP are the small business, manufacturing and agricultural sectors.

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[7] **China is not included as one of the nations in the Trans-Pacific Partnership (TPP).**

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