

The Debt-Limit Crisis

A Modern Mexican Standoff

Jeff Rohlf's¹

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In the Old West a Mexican standoff occurred when two gunmen pointed revolvers at each other at close range. In Washington DC, in 2011, the Mexican standoff took a different form: politicians of both parties threatened to cause the federal government to default on its debt if they did not get their way.

The Mexican standoff is certainly not new in American politics. It can happen whenever control of the government is divided. The Founding Fathers deliberately provided great scope for divided government by having two separate legislative bodies (the House and Senate) and additionally giving the president a role in passing legislation (through his veto power).

In the Old West, the disagreement leading to a Mexican standoff might have centered on a young lady (of which there were relatively few in the Old West). Or it might have followed from a disputed hand of poker. In 2011, the disagreement centered on the federal debt limit.

A possible outcome of a Mexican standoff is that one of the two contestants backs off. For example, he might forego his interest in the young lady or his winnings on the poker hand. In 2011, backing off meant acceding to the other party's terms with regard to the debt limit.

Another possible outcome of a Mexican standoff is a shootout. That is, one of the contestants pulls the trigger and hopes for the best. In the Old West, both contestants might end up dead, but it is also possible that one or both might live to fight another day.

In 2011, a shootout would have led to the government's defaulting on its debt. Both contestants might end up dead, as in the Old West. That is, disgusted voters might say, "A plague on both your houses" and throw the rascals out of Congress. But a more usual outcome of a shootout is that one political party is blamed, and the other party gains politically.

¹ The author has also written *Boss or Dupe: The Voter in American Politics* (free download from <http://www.jeffrohlf.com>) and *Bandwagon Effects in High Technology Industries* (MIT Press, 2001). The author gratefully acknowledges helpful comments from Chris Rohlf's.

To understand a Mexican standoff, one must know which party will gain and which will lose in the event of a shootout. The key principle is:

If the shootout leads to a serious crisis, the party that appears to be more reasonable will gain politically at the expense of the other party.

Before we apply this principle to the events of 2011, we examine an earlier Mexican standoff – that of 1995-1996. In that standoff, the federal government was shut down for a brief period of time.²

The Mexican Standoff in 1995-1996

The federal elections of November 1994 completely changed the complexion of Congress. The House of Representative, which had been controlled by the Democrats for 40 consecutive years, fell to the Republicans. The Republicans also gained control of the Senate. The Republicans had a comprehensive agenda, which they called “The Contract with America.”

1994 was not a presidential election year; so Bill Clinton remained president – notwithstanding the large Republican gains in Congress. Although the Republicans controlled both houses of Congress, they did not have nearly enough votes to override a presidential veto. The result was divided government, setting the stage for a Mexican standoff.

The standoff occurred in November. The Republicans passed a budget bill that embodied the principles of their Contract with America. Clinton objected to many aspects of the bill and vetoed it. The Republicans did not have enough votes to override the veto. Having no budget funds going forward, the government shut down (for non-essential services) on November 14.

The Republicans could have stuck to their guns. That is, they could have left the government shut down and waited for Clinton to blink. But that strategy would have been political suicide. Clinton was proposing making small changes to the status quo; the Republicans were seeking many large changes. The Republicans would have appeared unreasonable if they shut down the government because Clinton was unwilling to go along with all those changes. Consequently, the Democrats would have won big-time if the government remained shut down for a long time.

What the Republicans actually did was present Clinton with a stopgap bill to allow government operations to continue until December 15. That bill, like the previous one that Clinton had

² Divided government does not necessarily lead to Mexican standoffs. A good counterexample is the issue of defense spending during the Reagan years – both total spending and spending for the Strategic Defense Initiative. President Reagan and the Democratic Congress were in constant disagreement over these expenditures. The disagreements reflected deep-seated differences in values. Nevertheless, the issues were always resolved without resorting to a Mexican standoff. This point is discussed in more detail in *Boss or Dupe*, Chapter 8.

vetoed, contained many provisions to which Clinton objected. But politically, the shoe was now on the other foot. Since the stopgap bill had such a short duration, any harm from the objectionable provisions would be commensurately small. Clinton would therefore appear unreasonable if he did not allow the government to reopen. Clinton did sign the bill. The government then resumed operations from November 20 to December 15.

During that period, Congress passed another budget bill, and Clinton vetoed it. The government shut down again on December 16.

Congress then passed another stopgap bill, which Clinton signed. The government was able to reopen on January 6. Several other stopgap measures followed. Finally, on April 26, a budget bill was passed and signed by President Clinton.

The Republicans advanced their agenda in the various stopgap measures. In addition, the final budget bill made many changes consistent with the Contract with America. But it also included significant concessions to assuage Clinton's concerns.

The political effect of all this brouhaha was relatively minor. In the 1996 elections:

- President Clinton was re-elected in a landslide, but that would probably have happened in any event. He was a charismatic candidate, the economy was strong, and he was the incumbent.³
- There was little change in the make-up of Congress. The Republicans lost two seats in the House and gained two seats in the Senate. They retained control of both houses, but they continued not to have nearly enough votes to override a presidential veto.

Voters apparently do not regard shutting down the government for a brief period (say, a few weeks) as a serious crisis. The short shutdowns in 1995-1996 appear to have had little political impact.

The Mexican standoff served an important function in this conflict. It allowed each side to test the nerve of the other. Each side then demonstrated that it had the courage to shut down the government rather than give in to the other side. (A cynic might note that when politicians display "courage," it is the public that bears the risk.)

Once the government shut down, the onus was on the Republicans. They had to come up with stopgap measures for the government to reopen. They did come up with a series of measures that advanced their agenda but were acceptable (though disagreeable) to Clinton.

³ See the author's article "Predicting Presidential Elections" for further discussion of this point.

The ultimate outcome of this long process was the final budget bill. The final bill was a compromise. It could theoretically have been agreed upon at the start, without the delays and government shutdowns. But at the start, neither side knew how strongly it could bargain without suffering political losses. By the time of the final budget bill, both sides knew and they reached an agreement.

The process of the temporary government shutdowns and the stopgap measures can be thought of as a war. In general, if the two contesting sides know and agree on how a war will turn out, they can reach a settlement in advance. Both sides might prefer that settlement rather than a war and the settlement after the war.

Alternatively, the two sides may not know how a war will turn out or disagree on how it will turn out. In that case, they can find out for sure only by actually fighting the war.

That was the case here (though political wars involve far less human and monetary costs than shooting wars). In this political battle, the two sides, to their credit, reached a peace agreement when they found out how strongly they could negotiate without suffering political losses.

The Debt-Limit Crisis

The Republicans made big gains in the 2010 elections. They won control of the House and gained seats in (but not control of) the Senate. Since 2010 was not an election year, President Obama remained in office. Thus, as in 1995, there was divided government, setting the stage for a Mexican standoff.

There were actually three major Mexican standoffs in 2011. The most dramatic revolved around the statutory limit for federal debt and is the topic of this article.⁴

The federal debt reached the statutory limit in April. Secretary of the Treasury Geithner said that he had measures at his disposal to delay default for a few months. But he warned that legislation increasing the debt limit had to be passed by August 2, or the government would default on its debt. The time bomb then started ticking.

Default on the debt would have immediately led to a serious crisis. Investors would then have regarded U.S. Government's debt significantly less favorably for the foreseeable future. The government would inevitably have had to pay a higher interest rate on all its borrowing. Even a slightly higher interest rate, applied to \$13 trillion (and rising) of debt, could have amounted to tens of billions of dollars every year.

⁴ An earlier standoff involved the Federal budget. A later standoff was over the extension of the payroll-tax cut.

Failing to increase the debt limit in 2011 would have been a much more drastic step than shutting down the government was in 1995. Default on the debt would have caused immediate and irreparable harm to the credit of the federal government. The damage could not have been contained after the fact with stopgap measures.

The Democrats wanted to increase the debt limit without conditions. But the Republicans were unwilling to increase the debt limit unless government spending was cut back to reduce the budget deficit.

President Obama (who was leading the Democrats on this issue) could have stonewalled. That is, he could have gotten the (Democratic-controlled) Senate to pass a bill increasing the debt limit with no conditions. He could then have left it to the Republicans in the House either to support that bill or cause the government to default on its debt.

That strategy would not, however, have been prudent for two reasons:

1. The public would probably have regarded Obama's stonewalling as unreasonable; and
2. John Boehner, Speaker of the House, was having trouble holding the Republicans together on this issue. If he acceded to Obama's stonewalling, he would have lost credibility with the Republican members. He would then almost surely have lost his political power. If he wished to retain his power (and what politician does not?) he would have had to let the government default on its debt.

In default occurred under these circumstances, politicians of both parties would be subject to grave political risk. The outcome might be good or bad for Republicans or Democrats, but it would surely be bad for incumbent politicians. Who could blame the voters for saying, "A plague on both your houses."?

In actuality, Obama did not stonewall. In a meeting around July 1, he and Boehner worked out "The Grand Bargain." Under that agreement federal spending would decline by somewhat more than \$3 trillion over 10 years, and federal revenues would increase, possibly by as much as \$1 trillion.⁵

Boehner was not, however, able to sell this plan to his Republican colleagues. Instead, the House Republicans continued to propose plans with many provisions that the Democrats were sure to find unacceptable.

⁵ See Michael D. Shear, "A Debt Ceiling Cheat Sheet: 8 Possible Plans," *New York Times*, July 15, 2011.

At this point the political process had gone into Never Never Land. Obama had made quite significant concessions. It would have been political suicide for the Republicans to cause the government to default on its debt because they wanted more. The Republicans might have hoped that Obama would have a failure of nerve and make further concessions. But why would Obama make concessions to prevent the Republicans from committing political suicide?

The Republicans certainly did not need to accept the Grand Bargain. But if they did not, they needed to bargain with Obama. The bargaining could deal with additional things that Republicans wanted. But it would also have to include things that they were willing to give up that were in the Grand Bargain.

At the eleventh hours, a lot of Republicans apparently finally realized their predicament. The Republicans then began negotiations with Obama. But time was short, and the public and the financial community were getting anxious.

The final agreement involved no additional government revenues – an important plus for the Republicans. The Republicans also got a provision that required Congress to vote on a balanced-budget amendment to the Constitution. But that provision turned out to have no value. Congress did vote on the amendment in November but voted it down.

The final plan embodied smaller cuts in spending than did the Grand Bargain. Instead of over \$3 trillion, the cuts were only \$2.5 trillion.⁶ The trade-off of lesser spending cuts in exchange for no revenue increases had been on the table for some time. Eric Cantor (The House majority leader) had earlier proposed spending cuts of \$2.4 trillion with no revenue increases.⁷

A big gain for the Democrats is that the spending cuts are back-loaded. Of the \$2.5 billion in planned cuts, only \$22 billion (less than one-tenth of one percent) occur in 2011.⁸

The Democrats also gained by getting a debt-limit increase that did not need to be renegotiated later in 2011 or in 2012. In particular, Congress's failure to pass the balanced-budget amendment did not trigger the need for renegotiation.

The New York Times, on August 1, 2011, published an editorial entitled, "To Escape Chaos, A Terrible Deal." The editorial argued that the Democrats got very little in the final deal. I disagree. I believe that the Democrats got a reasonable deal. They had to give up something. The Republicans controlled one house of Congress, and stonewalling was not a viable option for the Democrats, as explained above. What the Democrats gave up was not excessive, when one considers that the agreed-upon revenue cuts were substantially back-loaded and will have little

⁶ See Nate Silver, "The Fine Print on the Debt Deal," *New York Times*, August 1, 2011.

⁷ Shear, *op. cit.*

⁸ Silver, *op. cit.*

short-run impact. Furthermore, future Congresses can rescind the bulk of the cuts if they choose to do so. The devil (or for the Democrats, the salvation) is in the details of the deal – or the “fine print,” in the terms of the *Times’s* own columnist, Nate Silver.

The final outcome of the political process was reasonable. A default on the government’s debt was avoided.

The brinkmanship leading up to that outcome was quite harmful, however. It alarmed the investment community, which does not soon forget crises. The bond-rating agency S&P was sufficiently alarmed to downgrade the debt of the federal government.

The inexperience of many House Republicans contributed to the brinkmanship. Many were serving their first term. It took them time to work out what to needed to do, and meanwhile, the time bomb was ticking away. To their credit, they ultimately got it right and did so in time to avoid disaster.

Summary

The Mexican standoff is a possible outcome whenever control of the government is divided. The key principle is that if a standoff leads to a serious crisis, the political party that appears more reasonable wins at the expense of the other. Because of this principle, (political) Mexican standoffs usually do not end in shootouts, leading to serious crises. Rather, both sides strive to appear reasonable (at least at the critical point in time), and no one pulls the trigger.

In particular, the debt-limit crisis of 2011 ultimately led to a reasonable outcome. So did the earlier Mexican standoff in 1995-1996. But there were some tense moments along the way.