

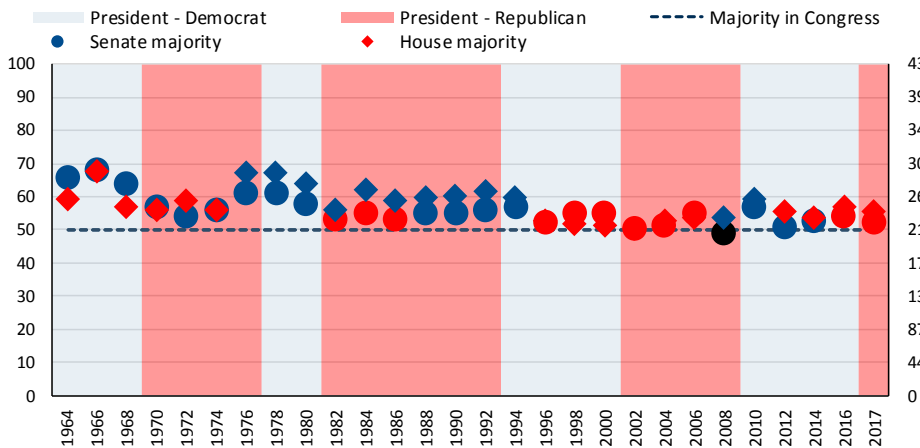
Polarisation in US Politics is Leading to Policy Inaction and Uncertainty



On 29 September 2017, Scope affirmed the United States' AA sovereign rating with a Stable Outlook. Among the identified factors constraining the rating, Scope noted that the divisions between political parties, and the ensuing lack of bipartisan collaboration, are preventing the implementation of solutions to the country's underlying structural challenges over the medium term. This special comment explores this credit constraint in greater detail.

President Donald Trump took office in January 2017. Despite enjoying a Republican majority in both the House and the Senate, the President has faced difficulties implementing his policy agenda due to divisions between Republicans, but also an ideological gap with the Democrats. Scope believes such political polarisation adversely affects the institutional framework of the United States, undermining the system of checks and balances enshrined in the US Constitution which, to avoid impasse, requires cooperation between the legislative and executive branches of government.

Figure 1: President, Senate (LHS) and House (RHS), party affiliation and seats



Source: <http://history.house.gov/Institution/Party-Divisions/Party-Divisions/> and <https://www.senate.gov/history/partydiv.htm>

In Scope's assessment, the polarised political environment is neither unprecedented nor transitory. It is, however, obstructing the federal government's ability to address, in a bipartisan way, the country's structural weaknesses, including: i) low productivity growth and labour force participation; ii) a high and rising federal government debt level; and iii) elevated contingent liabilities due to Social Security and health-care programmes.

In addition, Scope notes the emergence of significant policy swings, away from the ideological centre, whenever party control of the Congress or the presidency changes. Most recently, this trend has been demonstrated by: i) the discussion of repealing and replacing the Affordable Care Act ('Obamacare'), ii) the new administration's inward-looking approach to trade and investment, including the withdrawal from the Trans-Pacific Partnership and the announced renegotiation of the North American Free Trade Agreement (NAFTA), and iii) the withdrawal from the Paris Climate Change Agreement, all of which stand in stark contrast to the positions of the previous administration.

The lack of bipartisan collaboration and the heightened policy variation between ideological extremes result in costly policy inaction and uncertainty. In Scope's view, this situation impedes Congress from tackling the elevated public debt burden and implementing needed structural reforms. This, in turn, adversely impacts the medium-term economic and fiscal outlook for the United States.

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Polarised electorate and policy elite

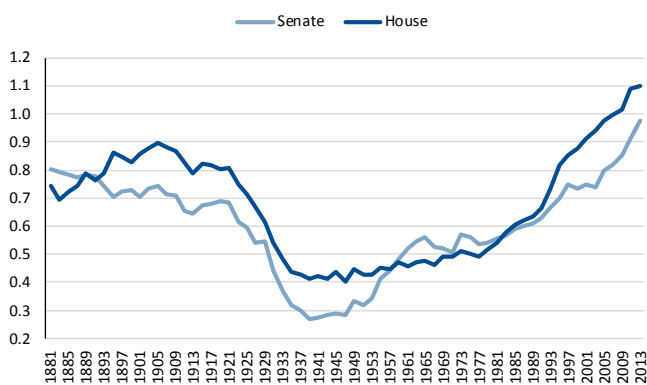
Political polarisation at historical highs

America's political landscape has become ever-more divided over the past few decades, leading to the de facto polarisation of the country's electorate and the two major parties, the Democrats and the Republicans. Polarisation in the United States has numerous causes, including the political rise and partisan realignment of the south¹, the growth in income and wealth inequality, religious and residential segregation, greater ethnic and ideological diversity, the increasing role and bias of the mass media, and the rise of new interest groups².

Scope notes that while this is not the first time that polarisation has permeated American politics³, a Pew Research Center study found that as of 2016, more than half of Americans who identify as Republicans or Democrats had a 'very unfavourable' view of the opposing party, up from around 20% in the early 1990s. Furthermore, while it is typical for partisan views of the country's direction to shift following a change in party control of the presidency, the size of the shift between both Democrats and Republicans is more pronounced today than it was in either 2001 (when Republican views grew more positive and Democrat views more negative after the transition from the Clinton to the Bush administration) or in 2008 (when Democrat views became more positive and Republican views more negative in the transition to the Obama administration)⁴.

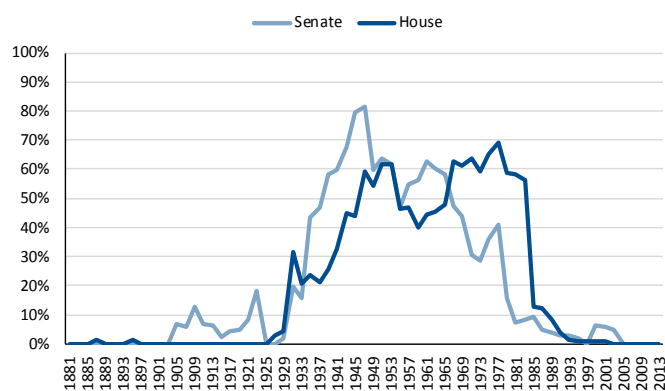
In addition, the rise in the ideological distance between both parties has also been driven by the polarisation within each party, whereby the most extreme members exert great influence on their party's policy positions. The resulting separation between parties has led to an increase in members of Congress voting along party lines. The divisions both within and between the political parties in Congress are reinforcing the schism on most domestic issues since the 1970s, at the expense of moderates who bridge the parties to broker crucial compromises⁵.

Figure 2: Political polarisation, distance between parties



Source: https://legacy.voteview.com/Political_Polarization_2014.htm
 NB: Distance between parties refers to ideological distance between moderates of each party.

Figure 3: Political polarisation, % of overlapping members



Source: https://legacy.voteview.com/Political_Polarization_2014.htm
 NB: Overlapping members refer to members of both parties that have overcome traditional party discipline by voting with the other party.

¹ The roots of greater polarisation can in part be found in the passage of the 1964 Civil Rights Act and the 1965 Voting Rights Act. Southern whites began voting for Republican candidates as the process of issues over race played out. The old Southern Democratic Party has, in effect, disintegrated. The exodus of conservative southerners from the Democratic Party at both the elite and mass levels has created a more liberal party.

² Michael Barber and Nolan McCarty, 'Causes and Consequences of Polarization'
http://www.andre-baechtger.ch/tl_files/baechtger/pdf/Negotiating%20Agreement%20in%20Politics.pdf#page=29

³ It would be inaccurate to suggest that today's polarisation is unprecedented as the parties were likely even further apart in the late 19th century, following the American Civil War.

⁴ <http://www.people-press.org/2017/05/03/public-trust-in-government-remains-near-historic-lows-as-partisan-attitudes-shift/>

⁵ <http://www.pewresearch.org/fact-tank/2014/06/12/polarized-politics-in-congress-began-in-the-1970s-and-has-been-getting-worse-ever-since/>
<http://www.people-press.org/2014/06/12/political-polarization-in-the-american-public/>

Polarisation presents voters with opposing options and may increase public participation...

... but also leads to legislative inaction and policy uncertainty...

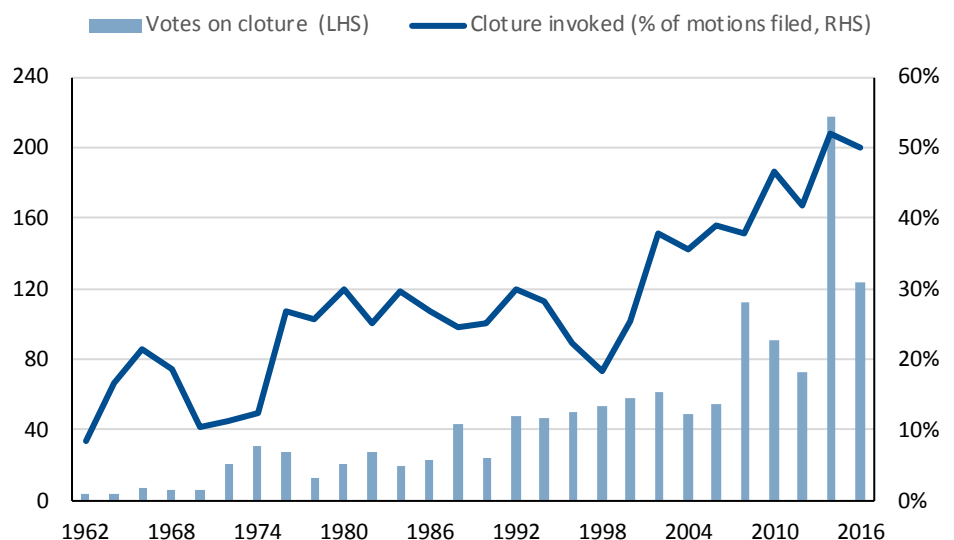
The pros and cons of political polarisation

From a sovereign rating perspective, the question arises whether polarisation affects the ability of the United States to effectively formulate and implement policies to address the country's underlying structural challenges, including the need to enhance growth prospects and improve public finances. On the one hand, strong, distinct parties present clear options to voters, which may encourage citizens to participate in the democratic process by voting, working on campaigns, voicing opinions and electing officials. In fact, there is evidence that public participation in American politics has increased with heightened polarisation⁶. As such, polarisation may have the advantage of clarifying political mandates and rewarding (or punishing) leaders who deliver (or fail to deliver) on these mandates, leading to a political system with greater accountability⁷.

On the other hand, polarisation has been identified as a root cause of current legislative inaction, leading to missed deadlines, unproductive legislative sessions, greater incentives to engage in political brinkmanship and policy uncertainty. The indicators of legislative dysfunction include declining legislative output, an appropriations process that increasingly fails to conclude prior to the beginning of the new fiscal year, and growing delays in the confirmation processes, which have enlarged the number of vacancies in the executive and judicial branches.

The possibility that the quality of law-making is being damaged by partisan politics is a more troubling issue. There is clear evidence that the polarisation in Congress has been accompanied by procedural changes in how Congress works, with greater use of closed rules on floor votes (in which few or no amendments are permitted), the exclusion of the minority party from committee-level deliberations and widespread use of the filibuster threat⁸ in the Senate on ordinary policy matters⁹. In this strained environment, politicians have increased incentives to engage in strategic disagreement in an attempt to gain an electoral advantage by transferring blame for the stalemate to the other side.

Figure 4: Increasing use of the filibuster in the Senate



Source: https://www.senate.gov/pagelayout/reference/cloture_motions/clotureCounts.htm
 NB. Cloture refers to the rule whereby a three-fifths majority can end a debate in the Senate that is filibustered by the opposition. 'Cloture invoked' displayed as a % of total motions filed on a 3-Congress (6-year) moving average.

⁶ https://www.rand.org/content/dam/rand/pubs/occasional_papers/2007/RAND_OP197.pdf

⁷ <http://www.dtic.mil/dtic/tr/fulltext/u2/a473435.pdf>

⁸ The practice of holding the Senate floor to prevent a vote on a bill. The Senate can end a debate with a three-fifths majority (60 votes of the 100 senators).

⁹ https://www.rand.org/content/dam/rand/pubs/occasional_papers/2007/RAND_OP197.pdf

While it may be reasonable to assume that a less deliberative process weakens the quality of law-making, Scope acknowledges that this hypothesis has yet to be formally tested. In addition, while it is not yet clear whether polarisation per se is eroding the substantive quality of decisions by federal judges, studies suggest that partisan polarisation has led to a politicisation of the courts, thus adversely affecting the independence of the federal judiciary¹⁰. As presidents of both parties nominate what the opposing party believes to be more ideologically extreme candidates for judicial posts, the resulting controversy over the role of ideology in the judicial process may adversely affect the credibility and perceived neutrality of the US judicial system.

... and the politicisation of appointments to the Supreme Court

In this context, Scope adds that the current Supreme Court composition would be subject to change during Trump's administration upon retirement or death of current members. The court is led by conservative Chief Justice John Roberts with four judges (Roberts, Clarence Thomas, Samuel Alito and Neil Gorsuch) who have a conservative philosophy on law, four judges (Stephen Breyer, Ruth Bader Ginsburg, Elena Kagan and Sonia Sotomayor) who have a liberal judicial interpretation and one swing-voter (Anthony Kennedy). Once appointed, Supreme Court judges have a lifetime tenure unless they resign, retire or are removed following impeachment. Given their respective ages, the potential retirements of judges Kennedy (81) and Ginsburg (84) could present the President with the opportunity to shape the institutional direction of the judiciary for a long time, decisions that could further amplify divisions in the US government.

Political brinkmanship and the economic policy framework

Scope believes that political polarisation exposes the limits of the current economic policy framework in the United States, including the abuse of the US debt ceiling, the partisan approach to fiscal legislation and, possibly, the politicisation of appointments to the Federal Reserve Board.

Abuse of the debt ceiling leads to a rating-relevant inconsistency

The Public Debt Act of 1941 set an overall limit of USD 65bn on permissible outstanding Treasury debt obligations. Since 1960, Congress has acted 78 times to permanently raise, temporarily extend, or revise the definition of the debt limit. Increasing or suspending the debt limit was not done to increase spending or authorise new spending; rather, it was done to permit the Treasury to continue to honour pre-existing commitments to citizens, businesses and investors domestically and around the world¹¹.

As detailed in our affirmation of the United States' rating in September, Scope believes that the US debt ceiling rule has led to a rating-relevant inconsistency: Lawmakers first approve spending but, once the outstanding debt approaches the statutory limit, they do not automatically allow the US Treasury to borrow the additional funds needed to honour its obligations. Scope recalls that in 1979, the US Treasury was unable to repay investors around USD 120m in Treasury bills on April 26, May 3 and May 10, owing to a failure of Congress to act in a timely fashion to lift the debt ceiling rule¹². More recently, over the past few years, this situation has led to several instances in which the US Treasury was weeks or even days away from reaching or nearly crossing the debt limit, requiring the Treasury to take extraordinary measures in order to honour US debt. This represents a unique situation among Scope's highly rated sovereigns and constitutes a meaningful operational risk to the United States' means to repay, which, in Scope's opinion, creates a tail-risk for investors in US debt once the Treasury nears the debt limit.

While under Scope's sovereign rating methodology failure to honour non-debt service obligations is not a default, it does indicate payment distress and policy dysfunction,

¹⁰ <https://www.stanfordlawreview.org/online/politicizing-the-supreme-court/>

¹¹ <https://www.treasury.gov/initiatives/Pages/debtlimit.aspx>

¹² Zivney, T., Marcus, R. 'The Day the United States Defaulted on Treasury Bills', *The Financial Review*, Volume 24, Issue 3 August 1989 Pages 475–489.

which could have a damaging impact on the economy and the sovereign's financing. As highlighted in Scope's rating action, a replacement of the debt limit rule that would ensure fiscal discipline and avoid political brinkmanship would be credit positive. Conversely, keeping the rule, in combination with members of Congress opportunistically using the debt limit as a tool to extract policy concessions, is credit negative. Similarly, repealing the rule without an adequate replacement would also be credit negative, and could lead to a review of the US sovereign rating.

As of Q2 2017, debt subject to the statutory limit totalled USD 19.8trn, a mere USD 25m under this limit¹³. On 8 September, Congress passed a bill to temporarily suspend the statutory debt limit until 8 December 2017. While this removed the immediate pressure to conform to the limit (debt outstanding increased by USD 317bn in the week after September's agreement to just above USD 20trn¹⁴), it only deferred the problem by three months. The central issue of ensuring fiscal discipline while avoiding political brinkmanship still needs to be addressed – and, probably, in a bipartisan way.

A budget process that is likely to further divide Congress

The political divide is also reflected in the substance of and approach to implementing the upcoming fiscal legislation. Highlighting the bipartisan divide, the Senate has set terms to overhaul the tax system through budget reconciliation allowing for passage of a tax bill with a simple majority vote, rather than the 60 votes normally required. However, given the divide amongst Republicans, numerous compromises will need to be struck between objectives as diverse as reducing the overall deficit, ensuring benefits to the middle class (as opposed to the top-income earners) and addressing lawmakers' concerns from high-tax states worried about the repeal of state and local tax deductions.

Fiscal uncertainty is further amplified as many details of the proposed budget and tax reforms remain unspecified and must be reconciled by the appropriate committees in Congress. For example, the latest proposal¹⁵, the 'Unified Framework for Fixing Our Broken Tax Code', released by the White House and Congressional Republican leadership, does not specify income brackets for which new individual tax rates would apply. It also does not provide details about taxes on foreign profits, that would apply once transition from a worldwide to a territorial tax system is completed. The Tax Policy Center estimates that the proposed framework would reduce federal revenues by USD 2.4 trillion over the first ten years and USD 3.2 trillion over the subsequent decade¹⁶. In addition, income inequalities would further increase as taxpayers in the bottom 95% of the income distribution would see average after-tax income increases of between 0.5% and 1.2% whereas taxpayers in the top 1% (with incomes above USD 730,000) would receive about 50% of the total tax benefit with after-tax incomes increasing an average of 8.5%.

A likely deficit-enhancing budget

However, given the political pressure on the Trump administration to score a legislative victory in 2017 following failed attempts to repeal and replace the Affordable Care Act, Scope expects that fiscal legislation will ultimately be approved by the end of the year. As the Senate's budget resolution allows for reductions in revenues and changes in outlays to increase the deficit by USD 1.5trn over the next 10 years, Scope expects that the final law President Trump will sign is likely to include significant tax cuts that will not be fully

¹³ <https://www.treasury.gov/initiatives/Pages/debtlimit.aspx>

¹⁴ <https://www.fms.treas.gov/fmsweb/viewDTSFiles?dir=w&fname=17090800.pdf>

¹⁵ To date, six documents inform Scope's views on the possible forthcoming legislation: i) the President's Budget 'America First: A budget blueprint to make America Great Again' (13 March 2017), ii) the Congressional Budget Office's 'Analysis of the President's 2018 Budget' (13 July 2017), iii) the House Budget Committee's 'Building a better America: A Plan for Fiscal Responsibility' (19 July 2017), iv) the Senate Budget Committee's 'FY 2018 Budget Resolution' (29 September 2017), v) the President's 'Unified Framework for Fixing Our Broken Tax Code', 27 September 2017 and vi) the Tax Policy Center's 'Preliminary Analysis of the United Framework', 29 September 2017.

¹⁶ The tax framework proposes to collapse the seven individual income tax rates to three (12, 25 and 35 percent), increase the standard deduction, eliminate personal exemptions, increase the child tax credit, eliminate most itemized deductions, repeal the individual and corporate alternative minimum taxes, repeal the estate tax, reduce the corporate tax rate from 35 to 20 percent, tax pass-through business income at a top rate of 25%, allow businesses to fully expense investment in equipment and machinery for at least five years, and adopt a territorial tax system that would exempt the foreign earnings of US corporations from US tax. <http://www.taxpolicycenter.org/publications/preliminary-analysis-unified-framework>.



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offset by cuts in discretionary spending. In fact, the CBO's July analysis of the President's budget proposal, which did not specify tax cuts to the extent of the subsequently released framework, estimated that federal budget deficits would range between 2.6% and 3.3% of GDP over the coming decade. Thus, based on the current state of the debate, and mindful of significant uncertainty surrounding the upcoming legislative discussions, Scope expects any final fiscal legislation to be deficit enhancing as well as further polarising the electorate and Congress.

Nominations for the Federal Reserve Board

A final aspect of the US economic policy framework that could be adversely affected by the current political divide is the composition of the Federal Reserve Board. Specifically, there are four upcoming appointments by the Trump administration for the seven-person Federal Reserve Board, even before Chair Janet Yellen's term ends in February 2018. The potential politicisation of future appointments represents an important risk in Scope's assessment of the independence of the Federal Reserve – a key pillar in Scope's evaluation of the US economic policy framework.



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