



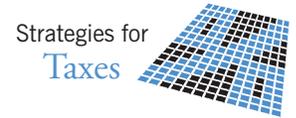
# EATON VANCE

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## ON WASHINGTON



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## Unresolved Issues Dominate as Washington Enters 2014

The compromise Congress reached to reopen the federal government and permit the United States to borrow funds kicked the can down a very short road. It set up a bipartisan committee to agree on an appropriations plan to finance government operations through 2014. If that committee fails to agree, then on January 15, 2014, Congress can agree to permit the next round of across-the-board spending cuts (known as “sequestration”) to take effect. If Congress fails to agree on the implementation of these cuts, then the government will shut down again.

More important, if the bipartisan committee fails to reach agreement on an appropriations plan, then United States borrowing authority will again cease on February 7, 2014. The government will limp along without borrowing for a number of months using tax receipts and other funds, but at some point in 2014—presumably prior to the mid-term elections—Congress will have to agree to raise the borrowing limit to prevent a default on United States debt outstanding.

The sequestration cuts—which proportionally reduce spending for defense and other government functions, but not for entitlements such as Social Security and Medicare—are not particularly popular with either party. The bipartisan committee hopes to devise an appropriations plan that

replaces the sequestration cuts with other spending cuts and/or tax increases.

The Republicans will seek to replace the defense cuts with deeper cuts to social programs and cuts to entitlements. At the top of their list are changes to slow the rate of growth of Social Security cost-of-living increases through the use of “chained CPI,” and requiring affluent recipients to pay more for Medicare coverage.

Democrats will seek to offset the sequestration cuts at least in part with new taxes. Broad tax changes, such as an increase in tax rates or a restriction on widely used tax deductions or exemptions—have no prospect of getting through the committee. But targeted tax provisions that curb perceived abuses might have a chance. Toward that end, the Democrats have proposed a list of “loophole closers” that include: (1) eliminating the ability of someone who inherits an IRA or 401(k) to “stretch” the payments over his or her lifetime; (2) curtailing the availability of sophisticated wealth transfer techniques such as grantor retained annuity trusts (“GRATs”), intentionally defective grantor trusts and dynasty trusts; and (3) precluding shareholder-employees of S corporations from treating a portion of earnings as dividends not subject to employment taxes.

At this point, I would place the odds of the committee reaching agreement at somewhat less than fifty percent. If the committee fails to agree, I believe Congress is more likely to accept the next round of sequestration cuts than to shut down the government again in January. That will set up another intense debate later in 2014 about raising the debt limit. As I have said all along, we will not default on the national debt, but the negotiations to get to that point can be harrowing.

If we approach a debt limit deadline in 2014, investors should look for potential buying opportunities. As I had predicted early this year, the market suffered a temporary downturn in September 2013 as we approached the twin

deadlines for funding the government and raising the debt ceiling. Because I knew Congress would not allow the nation to default, I suggested that this downturn would be a buying opportunity, as the markets would rebound once an agreement was in sight. This is exactly what transpired. Investors who missed that market inflection should look for similar opportunities if we approach similar deadlines in 2014.



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Andrew H. Friedman is the Principal of The Washington Update LLC and a former senior partner in a Washington, D.C. law firm. He speaks regularly on legislative and regulatory developments and trends affecting investment, insurance, and retirement products. He may be reached at [www.TheWashingtonUpdate.com](http://www.TheWashingtonUpdate.com).

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