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ML Strategies, LLC
701 Pennsylvania Avenue, N.W.
Washington, D.C. 20004 USA
202 434 7300
202 434 7400 fax
www.mlstrategies.com

FEDERAL DEFICIT, TAX & BUDGET UPDATE

YEAR END CONGRESSIONAL OUTLOOK

December 5, 2011

Super Committee Update

On November 21 the Joint Select Committee on Deficit Reduction, the super committee, announced that they were unable to reach agreement on the spending cuts required by the *Budget Control Act* (BCA) of 2011.

The twelve member super committee, comprised of equal numbers of Democrats and Republicans from the House and Senate, was required to make its recommendations for deficit reduction by November 23 with final approval by the Congress by December 23 – otherwise the BCA requires mandatory spending cuts totaling $1.2 trillion beginning in 2013. Those mandatory cuts are evenly divided between defense and non-defense spending and, when adjusted for reduced interest payments, come to $54.6 billion annually for the next decade for each category. Spending cuts in defense will not include financing of war activities, military pay, or TRICARE (which provides health care to active duty service members, National Guard and Reserve members, retirees, their families, and survivors). Non-defense spending cuts will not include the Children's Health Insurance Plan, child nutrition, food stamps, Federal employee retirement, Medicaid, Pell Grants, Supplemental Social Security Income, or veterans benefits.

Even before the announcement from the super committee some in congress were already talking about how to get around the mandatory cuts if the super committee failed, and those voices are growing now that the super committee did not act. In fact, some of the calls for changing the distribution of mandatory spending cuts in the BCA are coming from members of the super committee. Senator Pat Toomey (R-PA) has called for more defense-favorable allocation of spending cuts since the BCA divided the cuts evenly between defense and domestic spending; as have Senator McCain (R-AZ), Ranking Member of the Senate Armed

Services Committee, and Representative Buck McKeon (R-CA), Chairman of the House Armed Services Committee. They are adamantly opposed to the significant defense and security spending cuts and were bolstered by comments from Defense Secretary Panetta that the cuts would be “devastating” to the Pentagon. However, the Secretary has, since the announcement of the super committee’s failure, walked back his comments and said that Congress should approve deficit reductions of $1.2 trillion as a means of getting the nation’s fiscal house in order.

Some in Congress are advocating for a return to the proposal put forward by the *National Commission on Fiscal Responsibility and Reform* – generally known as the Simpson-Bowles plan. That proposal would have reduced the deficit by $3.8 trillion but was not advanced when it did not receive a supermajority endorsement from 14 of its 18 members.

With all of that said, President Obama has said that he will veto any effort to undo or alter the allocation of spending cuts called for by the BCA.

Outlook for December Congressional Agenda

Although the super committee was unable to reach a compromise, there remain a number of opportunities for congress to advance several pieces of legislation, including spending bills and the annual defense authorization bill, as well as an extension of the payroll tax holiday, the “doc fix,” and an extension of unemployment insurance.

With less than three weeks before the Christmas and New Year’s holidays, this is an ambitious agenda – and Speaker Boehner told his caucus this week that he would like to see the House finish its business for the year by December 16, putting further pressure on congress to move expeditiously.

<u>Year-End Package</u>

Nearly 70 tax provisions are set to expire at the end of December. A full list, prepared by the Joint Committee on Taxation can be found here. Given the high-profile failure of the super committee to offer a recommendation on reducing the nation’s deficit, it is difficult to see how Congress will find the wherewithal to enact a comprehensive tax extenders package this year.

However, while it is unclear what the legislation may look like, both the House and Senate are working on a more limited year-end bill that will likely address at least the following three items:

- <u>Extension of 2011 payroll tax cut</u>

  Enacted late last year as part of President Obama’s agreement with Republicans to extend the “Bush tax cuts,” a one-year payroll tax cut reduced payroll taxes from 6.2% to 4.2%. The tax cut is set to expire on December 31.

  Last week the Senate rejected a Democratic proposal to extend the tax cut for another year, and further reduce it to 3.1%, as well as a Republican proposal that extended the cut at the current rate for another year. The Democratic proposal would have been paid for by a 3.25% tax on income exceeding $1 million; and the GOP proposal would have been paid for by a extending the two year freeze on salaries of federal employees for an additional three years and reducing the federal work force by 10% by attrition.

Today, Senate Democrats introduced a new proposal to extend the payroll tax cut that they say will be fully paid for. The proposal is one-third smaller than the previous proposal which included an extension of the payroll tax cut to employers. This new legislation only gives the cut to employees and the self-employed. To pay for an extension of the tax cut, the bill increases the fees that Fannie Mae and Freddie Mac charge mortgage lenders to guarantee repayment of loans. The proposal does retain the "millionaire's surtax" but at a smaller rate – 1.9% versus the 3.25% in the proposal that was defeated last week. It is also temporary, and only extends for ten years. In an effort to gain GOP support, the bill includes a proposal made earlier by Minority Leader McConnell to make millionaires ineligible for unemployment compensation or food stamps. Finally, the proposal would seek to make the Social Security Trust Fund whole by transfers from the General Fund.

In the House, Speaker Boehner is working on a proposal that would extend the payroll tax cut, but also address several policy matters important to his caucus, including an auction of broadband spectrum, easing the Boiler MACT regulations from EPA, and expediting consideration of the Keystone Pipeline while moving the decision from the State Department to the Federal Energy Regulatory Commission (FERC).

- <u>Sustainable Growth Rate ("Doc Fix")</u>

The most recent "doc fix" – calculating the value of medical services provided to Medicare patients – was passed last December at a cost of $19 billion and is set to expire on December 31. The doc fix is a result of a 1997 law that mandated that reimbursements to doctors could not increase faster than the rate of inflation. If allowed to expire, doctors will see a 27.4% reduction in payments from their Medicare patients, and there is concern that many doctors would not be able to continue treating Medicare patients. There is bipartisan support for addressing this issue, but the debate will focus on how to finance it. There have been discussions about doing a one year fix, which would cost approximately $22 billion, or a two year fix, which would cost approximately $35 billion. In years past, this cost was simply added to the deficit, but as with so many issues, the nation's fiscal house and the failure of the super committee to reach a compromise mean that any doc fix this December will need to be paid for. While the medical community, along with the nation's senior citizens, is concerned about Congress missing the deadline, Senate Finance Chairman Baucus and House Ways and Means Chairman Camp have both stated that they will not allow this to happen, and the White House has also weighed in to say that failure on this issue is not an option.

- <u>Unemployment Insurance</u>

Despite the welcome news last week that the national unemployment rate has fallen to 8.6% – the lowest since 2009 – many in Congress, along with President Obama, are pushing for an extension of federal unemployment benefits for the long-term employed which are set to expire at the end of the year. The federal benefit is paid to the long-term unemployed after their state unemployment benefits expire – typically after 26 weeks in most states. Current federal law allows the long-term unemployed to receive benefits for as long as 99 weeks. Without action by Congress, about 1.8 million workers would be cut off in January, and by mid-2012 about six million unemployed workers will run out of benefits.

Other legislation that Congress will need to address this month includes:

- <u>Fiscal Year 2012 Appropriations</u>

  Although the current FY12 started on October 1, Congress has so far only passed three of the twelve annual appropriations bills – Agriculture, Commerce/Justice/Science, and Transportation/HUD, which were combined together into one "Minibus" spending bill and approved on November 18. All other federal activities are currently funded via a Continuing Resolution set to expire on December 16. There are two possible legislative solutions to finalizing FY12 spending: a new "full year" CR funding the government at current levels for the remainder of the fiscal year, or an "Omnibus" spending bill that will include the remaining nine spending bills. The House and Senate Appropriations Committees are said to be working on an Omnibus with the goal of convening a conference committee to reconcile any differences by December 12 so that the bill can be approved before the CR expires. The most likely legislative vehicle for an Omnibus spending measure would be the Defense appropriations bill.

- <u>National Defense Authorization Act for Fiscal Year 2012</u>

  The Senate approved its NDAA last week, and the House NDAA was approved in May. The two bills will now be conferenced to reconcile any differences with the goal of final approval by both the House and Senate before they adjourn for Christmas and New Year's.