

Following Extension of Tax Cuts, Attention Turns to the New 112th Congress and the Federal Budget Deficit

Dana S. Wood, Maggie C. Crosswy

January 24, 2011

A major challenge for the new 112th Congress and President Obama over the coming years—and an issue that is receiving increasing attention from policymakers on both sides of the aisle as well as from the public—will be to address the nation's budget deficit and the associated longer-term debt. The new Congress will be tested in its early days as it must act on several key items, including finalizing the Fiscal Year 2011 spending bills (a continuing resolution enacted in December funds the government through March 4) and a vote in the coming months to raise the ceiling on the federal debt limit.

In the waning days of the lame duck session of the 111th Congress, President Obama and Congress came to agreement on and passed into law a significant set of tax extensions for individuals and businesses. While the President and others hope this package will stimulate economic activity in 2011 (or at least prevent further economic loss that could jeopardize a nascent recovery), deficit hawks have decried the cost of the package and the burdens it could place on an already strained federal budget.

The Current Budget Picture

Federal spending in 2010 amounted to approximately 24 percent of gross domestic product (GDP), a level not seen since World War II, in part due to the economic downturn. Even with an economic recovery and the ensuing increase in tax revenues and decrease in spending on stimulative and safety net programs, federal spending will continue to outpace revenues to government—resulting in more borrowing and increased debt levels. Servicing that debt will become exponentially more expensive, thereby limiting the policy choices of future generations.

Foreign countries now own approximately one half of the United States' publicly-held debt, which puts the country's economy at risk. Foreign nations could choose to diversify their investment portfolios, thereby reducing their investment in the United States. Additionally, strategic decisions about national security will be more difficult as U.S. indebtedness to foreign countries grows.

Deficit Reduction Recommendations

As policymakers seek to address the nation's long-term fiscal challenges, they will have several new recommendations at their disposal. In February of 2010, President Obama created the bipartisan National Commission on Fiscal Responsibility and Reform (the "President's Commission") and selected as co-chairs Senator Alan Simpson, former Republican Senator from Wyoming, and Erskine

Bowles, Chief of Staff to President Clinton. A month prior, the non-profit Bipartisan Policy Center created a Debt Reduction Task Force (the "BPC's Task Force"), co-chaired by former Senate Budget Committee Chairman Pete Domenici and former White House Budget Director Alice Rivlin. Both panels finalized their recommendations in late 2010, building off of years of scholarly research and policy analysis from other groups and think tanks representing the broad spectrum of American political philosophy.

The lawmakers, scholars, business and union leaders, and other stakeholders that comprised the recent budget panels all attempted to address the nation's long-term fiscal challenges. The challenges are multiple. One component of the current situation is the cyclical budget deficit caused by—or, at a minimum, exacerbated by—the current recession. The second component is the systemic annual deficits that, under the status quo, will only increase over time, adding to the nation's long-term debt. Cyclical budget pressures should be relieved as unemployment declines, allowing federal tax revenues to increase and substantially-expanded federal safety net benefits to shrink. It is the projected growth in future deficits that are drawing the most concern with respect to the nation's long-term fiscal health.

There is broad agreement that in order reverse the current trend and bring federal revenues in line with expenditures, policymakers must address three critical issues: (1) the tax code; (2) federal entitlement spending; and (3) federal discretionary spending.

Tax Reform

Both the President's Commission and the BPC's Task Force posited that the American tax code is broken and must be reformed. The recent two-year extension of existing tax rates and various tax credits targeted toward businesses and individuals increased calls—from both sides of the aisle—for tax reform. The ultimate goal of such an endeavor is to overhaul and streamline the existing tax code so as to reduce its complexity and the associated burdens on taxpayers and government, while ensuring that the code's progressive nature remains intact.

Fundamental reforms to the tax code that have been proposed include: (1) lowering marginal tax rates for individuals and corporations and reducing the number of tax brackets; (2) repealing the alternative minimum tax (AMT); and (3) eliminating most credits, deductions, and exemptions, while reforming others (e.g., the Child Tax Credit and the Earned Income Tax Credit would remain intact, as would the deduction for mortgage interest, perhaps with a cap). Of note, the BPC's Task Force called for a one-year payroll tax holiday, a proposal that ultimately was included in the recently-enacted tax bill¹. The BPC's Task Force also recommended institution of a national sales tax. Both panels recommended capping tax revenue at or around 21 percent of GDP.

The goal of such reform is to create greater certitude for individuals and businesses with respect to fiscal planning, while producing the revenue necessary to reduce future deficits. President Obama has directed his economic team to begin reviewing the current tax code with an eye toward reform. Additionally, a number of key Congressional leaders have indicated a willingness to look at revamping the tax code, a protracted process that will no doubt prove politically challenging.

Mandatory Spending

Healthcare. While the recently-enacted health care law did much to increase coverage for the millions of Americans currently without health insurance, most experts agree that it did little to address long-term cost concerns. The Congressional Budget Office projects that federal healthcare

spending will grow to 10 percent of GDP by 2035, up from 5.5 percent today; as a result, it is an area where both deficit-reduction groups have proposed some changes.

One recommended change is to permanently reform the Medicare Sustainable Growth Rate (SGR) formula, which was established in 1997 to stabilize the growth in payments for physicians' services. The formula has required reductions in payments every year since 2002. However, Congress has continually blocked those reductions (including, most recently, a one-year delay enacted at the end of 2010). As a result, even larger reductions have accumulated to the point that the formula could require as much as a 30 percent cutback in 2012. The President's Commission and the BPC's Task Force called for a permanent fix to the SGR mechanism.

Further, both panels called for an expansion of managed care for dual eligibles, an increase in Medicare premiums, and reform of medical malpractice laws. Both proposals also recommended capping and subsequently phasing-out the exclusion of employer-provided health benefits.

Social Security. It is estimated that 50 million people receive benefits from Social Security, which covers not only retirees, but also workers who have disabilities that prohibit them from continuing to work. At its inception, the goal of the program was to prevent workers from sliding into poverty in old age. The program has maintained a consistent ability to keep people out of poverty (as defined by the federal government): the current poverty rate for a single individual in this country is approximately \$10,000 a year, while the average social security payment is over \$13,000 per year.

The Social Security program has two problems confronting it. First, the number of active workers supporting retirees is dropping, due to declining fertility rates and the large cohort of baby boomers who are now retired or will retire in the next 10 years. This problem is compounded by the fact that people are living much longer. When Social Security was created, the average life expectancy was 64. Today, Americans on average are living 14 years longer, in addition to retiring earlier. With such demographic changes, the current system will be unable to meet its obligations by 2037 and, left unchanged, would require an across the board 22 percent reduction in benefits.

Both deficit-reduction groups recommended addressing the fiscal impact of the increase in life-expectancy. The President's Commission would increase the retirement from 67 to 68 in 2050 and 69 in 2075. A mechanism would be established to ensure that workers, who because of the nature of their work must retire earlier, would be able to receive full benefits. The BPC's Task Force did not recommend raising the retirement age, but, instead, recommended indexing the benefits formula for increases in life expectancy as well as providing for a lower monthly benefit for early retirees. Both panels recommended that benefits be reduced for wealthier beneficiaries.

In terms of raising revenue, both panels recommended that the cap on payroll taxes be lifted. Currently, the Social Security taxes are only paid on earnings up to \$106,800. The proposals, if implemented, would raise the earnings ceiling to cover 90 percent of all wages.

Other Mandatory Programs. The President's Commission and the BPC's Task Force would both reduce spending on mandatory agriculture programs and review and reform federal workforce retirement programs (for both civilian and military personnel).

Discretionary Spending

Much has been made of increases in discretionary spending in recent years, as well as the need to reduce such spending. So-called "earmarks" and foreign aid often are targeted as wasteful government spending and an abuse of taxpayer funds. That said, proposals to restrict Congressional

earmarks or to reduce foreign aid are, in reality, symbolic simplicities as such spending represents a small fraction of government outlays. Meanwhile, other discretionary spending, like defense spending, accounts for a much larger portion of the deficit, but often has been spared the attention given to earmarks.

That may be changing. Both panels recommended freezing discretionary spending—including on defense and security—for a short-time and capping it in future years. The President's Commission, in fact, recommended 4 years of *cuts* in domestic discretionary and defense spending. To do this, the U.S. government would be forced to take a detailed look at all government programs and all agencies to determine priorities and areas that could be either consolidated or cut. Policy areas such as education, housing, public health, homeland security, and defense would all be open to careful examination of related agency programs and the possibility of significant reductions in funding.

Other specific recommendations for discretionary spending reductions include changing the way the highway trust fund is managed. The President's Commission recommended phasing in a 15 cent per gallon increase in the federal gasoline tax to be dedicated to the trust fund. There are also recommendations for cutting Congressional and White House budgets and reducing the size of the federal workforce, mainly through attrition. Already, President Obama has instituted a pay freeze for federal workers and the incoming Republican majority in the House of Representatives is planning to cut that Chamber's budget.

Based on the tone and direction of these recommendations, one might infer that they are directed at modernizing the federal government and the Congressional budget process, with an eye toward making government more transparent and less susceptible to the influence of special-interest groups. This goal presents a formidable task as it flies in the face of current Congressional prerogatives. Bureaucratic turf battles will be inevitable if cuts and consolidations are made in programs that stretch across several agencies.

Conclusion

The mission of these proposals is to achieve trillions of dollars in deficit reduction in the next 10 years. Due to the sheer size and scope of the deficit reduction goals, myriad interest groups are concerned that certain programs or entitlements will be changed or eliminated. Those interest groups already are expressing concerns that they will lose funding and programs that help their constituencies. The bureaucratic establishment likewise fears losing programs that enable agencies to justify their existence. A comprehensive program to control the budget deficit would likely reach into all facets of our society.

At the end of the day, the question is not "will the budget deficit be brought under control;" rather, it is a question of when and at what cost. Delaying action now likely will only increase the need for drastic and destabilizing measures later. Alternatively, immediate action would allow for more comprehensive and thought-out policy options, time for political compromise, and gradual implementation of reforms that would allow individuals and businesses to adjust. Further, tackling the budget deficit now will likely have a positive impact on the U.S. economy in the near future. If the United States begins to get its fiscal house in order, the global markets will likely react in a positive manner.

The recommendations of the deficit reduction panels do not have to be adopted and implemented overnight; in fact, both panels recommended that spending cuts and tax increases not take place before 2012 given the fragile economic recovery. The majority of recommendations are

accompanied by phase-in periods, so as to ameliorate their immediate impacts. Such protracted implementation will require a strong commitment to carry forward with key policies once they are implemented, regardless of changes in the political or economic climate.

Notably, Members of Congress on both sides of the aisle stood up to their own constituents and endorsed these reports, and President Obama has signaled that addressing the deficit and long-term debt could be an area ripe for compromise with Congressional Republicans. The President has indicated that he will incorporate some of his Commission's recommendations in his budget proposals for fiscal year 2012, expected in February. Budget Committee Chairmen in both Chambers have made similar commitments and various Members have vowed to work toward Congressional implementation of key recommendations. The next year will reveal whether or not Americans have the collective will to move forward and take action, despite the sacrifices that will be required.

"So whether your issue is the solvency of social security, whether your issue is tax rates, whether your issue is making sure that we pass on a balance sheet to our kids and our grandkids that allow America to continue to be the economic superpower that it has been, unless we take on this issue, we won't be able to accomplish those goals. And while I believe as imperfect as this compromise between the president and others in terms of short-term stimulus, that we will vote on later tonight, we also have to demonstrate that this body can actually walk and chew gum. We can do short-term stimulus now but next year engage in meaningful tax reform and deficit reduction." Senator Mark Warner (D-VA), on the Senate floor prior to the vote on tax cut extensions legislation

Kelley Drye & Warren LLP

Kelley Drye's [Government Relations and Public Policy](#) practice includes partners and legislative advocates who have counseled companies and individuals subject to high-profile investigations. Our lawyers and government relations professionals are familiar with the unique characteristics and "unwritten rules" of congressional investigations, and we guide clients through the process which may include document production and testimony, in a way calculated to maintain our clients' reputation and minimize risk. We not only understand the intricacies of the legislative and executive branches individually, but also help clients navigate the delicate interplay between the two.

For more information about this Client Advisory, please contact:

[Dana S. Wood](#)
(202) 342-8608
dwood@kelleydrye.com

¹ As enacted, the payroll tax cut only applies to employee contributions, not employer contributions—the Bipartisan Policy Center task force recommended that it apply to both in order to get more cash flowing into the pockets of employees (i.e., consumers) *and* create an incentive for employers to hire new workers.