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Policy Alert

Preliminary Analysis and Observations Regarding the Budget Control Act of 2011

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The Budget Control Act of 2011 (BCA, or "Act") (see related policy alert for an overview of the Act) raises significant actual or potential implications for future congressional deliberations on the entire range of fiscal legislation that will be considered by Congress in the coming months. It also raises many questions, the answers to which may not be known for some time as, beginning this month, the provisions of BCA are implemented. This policy alert is intended to frame some of the key preliminary issues raised by BCA, with the understanding that many of them will not be settled until members of Congress move forward with implementation of the Act.

Effect on FY 2012 and FY 2013 Discretionary Spending

The BCA may increase the probability that Congress can pass omnibus appropriations bills (or perhaps separate appropriations bills, at least for FY 2013) over the next two years and avoid continuing appropriations resolutions by setting annual spending limits for those years. For FY 2012 and FY 2013, the statute sets the top-line spending level, also known as the "302(a)" allocation. The 302(a) allocation for FY 2012 is $1.043 trillion, with $1.047 trillion for FY 2013. These amounts represent a reduction in budget authority of $7 billion and $3 billion, respectively, when compared to the FY 2011 continuing appropriations resolution enacted in March 2011.

Budget authority savings in FY 2012 are expected to be $44 billion, rising to $62 billion in FY 2013. For the next two years, the statute establishes a firewall between security and non-security spending. In FY 2012, security-related programs (Department of Defense (DOD), Homeland Security, State Department Foreign Operations, Military Construction, Veterans Affairs, National Nuclear Security Administration and the intelligence community management account) will account for $5 billion of the $7 billion in reduced budget authority. Non-security spending reductions will make up the remaining $2 billion. In fiscal year 2013, security spending and non-security spending accounts will both increase by $2 billion. When compared to the FY12 House budget resolution, security spending will have decreased by 1.58 percent and non-security spending increased by 10.8 percent.

	FY11 Enacted	FY12 House Budget	FY12 BCA	FY12 BCA vs. FY11	Change	FY12 BCA vs. FY12 House Budget	Change	FY13 BCA
Total Discretionary	$1,050	$1,019	$1,043	-$7	-0.67%	$24	2.36%	$1,047
Security	$689	$695	$684	-$5	-0.73%	-$11	-1.58%	$686
Non-Security	$361	$324	$359	-$2	-0.55%	$35	10.80%	$361

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Issues Related to the Super Committee

Appointment of members and co-chairs to the Super Committee: Members appointed to the Super Committee (BCA requires the appointments be made by August 16) are likely to be loyal to the elected leadership of the Congress and faithful to party principles. Thus, if a majority forms within the 12-member Super Committee, it is unlikely to be a majority of seven with one "rogue" defector—instead, members are likely to be more comfortable in small-group policy alignments.

Scope of the Super Committee's work and mandate: There are no restrictions on what the Super Committee can consider in pursuit of its deficit reduction goal. Thus, all federal spending programs and tax policies are technically on the table. While Democrats can be expected to pursue a "balanced" deficit reduction package—one that includes a revenue component—just as clearly, Republicans can be expected to insist that no revenues be included. To be decided is whether "revenue loophole closers" or "enhancements" (rather than "tax increases") become anymore acceptable in the course of the Super Committee's deliberations.

Possible deficit reduction options: The Super Committee is likely to first compile an inventory of deficit reduction options before starting the decision-making process. The publicly released work of major initiatives on deficit reduction—such as the Bowles-Simpson Commission, the Senate "Gang of Six" and Vice President Biden's negotiating group—and other major deficit reduction proposals that have evidenced some measure of bipartisan support in the past are likely to be examined.

The baseline issue: Which budget baseline is used by the Super Committee to measure the fiscal impact of various options and, ultimately, the final package will be critically important and could have significant policy implications. It is within the power of the Super Committee to determine which baseline to use and whether to follow so-called "normative" scorekeeping conventions and baseline measurements. In the absence of an affirmative decision to the contrary, the Super Committee is likely to follow convention and use a "current law" baseline that assumes and reflects the operation of current law, such as the expiration of the so-called Bush tax cuts and other significant tax provisions at the end of 2012.

Interest savings: The BCA provides that the Super Committee must achieve deficit reduction savings of at least $1.2 trillion to avoid sequestration. However, significant interest savings were credited by CBO with respect to the debt ceiling proposals advanced by both Speaker Boehner and Senate Majority Leader Reid in the context of the debt ceiling debate—and in the final compromise itself. In fact, the deficit reduction savings of all three debt ceiling proposals reflected interest savings of approximately 18 percent of the total (in the case of the final enacted compromise, $156 billion of the $917 billion deficit reduction total). The statute provides that the same scorekeeping convention be applied to the eventual work product of the Super Committee. Thus, it can be anticipated that approximately 18 percent of total deficit reduction in the Super Committee's work product would be achieved through interest savings rather than substantive policy changes. A similar scorekeeping convention can be expected to apply to any sequester.

"Extraneous" matters: The eventual work product of the Super Committee is not a budget reconciliation bill, so the rules of the congressional budget process—such as the Senate's Byrd Rule, which prevents inclusion of "extraneous" matters—do not apply. Undoubtedly, the Super Committee will be under pressure to accommodate various time-sensitive issues outside its deficit-reduction focus, such as the "physician-payment fix" that is expiring at the end of 2011 as well as other expiring provisions, such as the Social Security payroll tax relief and extended unemployment compensation benefits enacted last December.

The role of the congressional committees of jurisdiction: The role of the committees of substantive jurisdiction is far more limited in the Super Committee process than in the congressional budget reconciliation process. Under BCA, committees of jurisdiction have until October 14 to make recommendations to the Super Committee, but, contrary to the case in the budget reconciliation process, the Super Committee is not required to accept those recommendations—at all or without amendment.

The role of the Administration: The role that the Administration will play in the Super Committee process is not defined and is yet to be determined. However, on August 8, 2011, President Obama indicated that the Administration intends to submit deficit reduction recommendations to the Super Committee for its consideration. Thus it is reasonable to expect the Administration to play a significant role in the course of the Super Committee's deliberations and an equally important role as a political force in the ultimate outcome

A Full or "Mini" Sequestration

The Super Committee's goal will be to produce a package that reduces the deficit by $1.5 trillion over the next 10 years. The statute also provides that savings of at least $1.2 trillion must be achieved in order to avoid sequestration. If all fails and nothing passes, a "full" sequester of $1.2 trillion will result, effective January 1, 2013, split evenly between defense and non-defense, non-exempted spending programs. Of course, if a deficit reduction package of less than $1.2 trillion is enacted, a "mini" sequester will result, measured as the difference between $1.2 trillion and the level of deficit reduction savings that are achieved and enacted through the Super Committee process.

S&P Credit Rating Downgrade

On August 5, 2011, Standard & Poor's Ratings Services (S&P) lowered its long-term sovereign credit rating for the United States to "AA+" from "AAA" and stated that the outlook on the long-term rating is "negative." The rationale cited by S&P for the rating downgrade included its opinion that the recently enacted BCA is inadequate to stabilize the government's fiscal and debt dynamics. Specifically citing the "prolonged process and controversy" surrounding the enactment of the debt ceiling increase, S&P also expressed pessimism in the "effectiveness, stability and predictability" of the government's political institutions in meeting the nation's economic and fiscal challenges.

The S&P credit rating downgrade, methodologies and rationale are not without controversy. Nevertheless, it is unknown at this time what effect, if any, the downgrade may have on the Super Committee's deliberations. As previously described, the Super Committee is tasked with the responsibility to develop additional policy initiatives that will reduce the deficit by $1.5 trillion (and a minimum of $1.2 trillion to avoid sequestration) over the next 10 years. However, by statute, the Super Committee is also given the broad responsibility to "provide recommendations that will significantly improve the short-term and long-term fiscal imbalance of the Federal Government."

In this regard, it is interesting to note the 10-year deficit reduction effects proposed by the advocates for the following prominent deficit reduction initiatives—

Bowles-Simpson Commission	$4.0 trillion
Gang of Six	$3.7 trillion
House Budget Resolution ("Ryan Budget")	$5.8 trillion
President Obama's "Grand Bargain"	$4.0 trillion

Of course, none of the specific policy proposals or the level of deficit reduction envisioned in each of these major deficit reduction plans is in any way binding on the Super Committee's deliberations. Nor is it known at this time whether, in light of the S&P downgrade, the Super Committee will attempt to devise and advance a deficit reduction initiative beyond the Budget Control Act's statutory goal of $1.5 trillion.

Implications for the Defense Industry

The discretionary spending caps enacted as part of the debt ceiling increase will result in a reduction in defense spending of $350 billion or more over the next 10 years. In spring 2011, President Obama directed the Pentagon to identify $400 billion in savings by FY 2023, prompting a comprehensive review of budget efficiencies and reductions. The debt ceiling statute will force the DOD to revisit the budget plans already submitted by the services.

The statute itself does not specify a spending level for the DOD, but, instead, targets "security spending" for roughly $420 billion in savings over the next 10 years. The Pentagon will be using a $553 billion budget baseline and will plan for cuts in excess of $400 billion once the FY 2013 top line is determined by the Office of Management and Budget. The FY 2013 top line should range between $540 billion to $546 billion, but will depend heavily on the agreed-upon FY 2012 defense budget.

Another round of multihundred-billion-dollar defense cuts could be triggered depending on actions taken later this fall by the Super Committee. If the Super Committee fails to achieve at least $1.2 trillion in deficit reduction, a budget sequestration process will begin in FY 2013. If sequestration is triggered, the defense budget will absorb 50 percent of the across-the-board cuts. In the case of a full sequester of $1.2 trillion, this could amount to another $600 billion from FY 2013-FY 2021. Defense spending accounts for approximately 20 percent of the federal budget, yet the defense budget is required to absorb roughly a third of the enacted spending reductions and roughly half of any sequester. For these reasons, many are concerned about the impact of these reductions on national security and may be determined not to allow a sequester of these magnitudes to occur.

Implications for Health Programs

The health community writ large is unlikely to reach a monolithic, consensus position on the Super Committee process—rather, divisions are likely to emerge. Medicaid and other health care stakeholders exempt from the sequestration process (such as the Medicare beneficiary community), may prefer a sequester to the Super Committee process, which creates the risk of legislated Medicaid changes by the committee. Medicare providers (doctors, hospitals and medical device manufacturers) on the other hand—not exempt from sequestration—may reach the opposite conclusion, preferring the Super Committee process to a sequester.

Sustainable growth rate (SGR): The SGR is a statutory formula that ties Medicare reimbursement for physician services to the growth rate of the national economy. The adjustment resulting from application of the SGR formula is automatically implemented through the annual physician payment rule and can only be averted by an act of Congress. In the past, Congress has consistently intervened to prevent these cuts from going into effect. Unless Congress acts to avert the cut this year, a 29.5 percent reduction will go into effect on January 1, 2012.

The BCA does not address the SGR formula. In the days following the release of the law, some physician advocates expressed their desire for the Super Committee to handle the SGR issue in its ultimate proposal. However, with cost estimates of a 10-year SGR fix somewhere between $358 billion and $400 billion, some have questioned how such a provision could be worked into a plan that is required to achieve significant spending reductions. Estimates of a one-year fix have been calculated at ranging between $12.1 billion and $26.8 billion, depending upon the analysis.

Provider cuts: Although many Medicare providers have already seen cuts or face additional cuts in the near future as a result of the Affordable Care Act (ACA), the debt ceiling statute places providers at risk for additional cuts. Because Medicare spending makes up such a large portion of the federal budget, the Super Committee is likely to consider health care cuts as part of its recommendations. In addition if sequestration goes into effect, it is important to note that the across-the-board cuts do not apply to beneficiaries, placing providers at further risk.

Potential vulnerability for the Affordable Care Act (ACA): While the debt ceiling statute does not specifically address the ACA, the ACA is potentially vulnerable in two ways. First, the Super Committee is not prevented from recommending changes to the ACA as it looks for ways to achieve the $1.2 trillion in deficit reduction. While it is hard to imagine the Super Committee embracing a full-scale overhaul of the ACA, health care's role as a federal cost driver may cause certain provisions to be examined. Second, in the event that sequestration is triggered, certain ACA programs could be impacted.

Proposals from the past: Many stakeholders anticipate that members of the Super Committee will use past deficit reduction proposals as a starting point. This may pose concerns for the health industry in a number of areas, including extending the Medicaid rebate to dual eligible populations in the Part D benefit or strengthening the mandate of the ACA's Independent Payment Advisory Board (IPAB).

Protections to low-income health programs: While the Super Committee is not restricted from looking at low-income programs in its deliberations, certain low-income health programs are protected in the event sequestration is implemented. However, note that not all low-income programs are protected from sequestration—the exemptions protected from sequestration reference existing law containing a specific set of protected programs.

Implications for Taxes and Revenue

Tax reform: There is no stated or implied assumption that revenues will be part of the Super Committee's deliberations. The statute contains no explicit mandate for tax reform, nor does it preclude its consideration. Unlike the Bowles-Simpson Commission and Gang of Six proposals, the BCA contains no stated or implied assumption that tax reform will be considered by the Super Committee or that it would make any net revenue contribution to a final deficit reduction package. Similarly, the statute does not preclude or assume inclusion of tax reform on a net revenue-neutral basis. Given the accelerated time frame for the Super Committee's deliberations and the stated preference of the two tax-writing committee chairmen to develop tax reform as a free-standing legislative initiative, it is not anticipated that tax reform will be part of the Super Committee's ultimate package.

Implications for expiring provisions and other legislative initiatives: Various provisions of current law with significant budgetary impact will be expiring at the end of 2011. These include the Social Security payroll tax cut, extended unemployment benefits, bonus depreciation, the so-called "tax extenders" and the physician-payment "fix." The debt ceiling statute makes no mention of, or accommodation for, these expiring provisions. However, there is also nothing in the statute preventing the Super Committee from dealing with any or all of these expiring issues in the context of its deliberations. Of course, an extension of any of these issues for any period of time would "score" against the current law baseline, which anticipates and reflects their expiration at the end of 2011. Thus, if the Super Committee ultimately decides to deal with any of these expiring provisions, it will have to include additional budgetary savings of a comparable amount in order to realize its ultimate deficit reduction goal. The same analysis applies to any other legislative initiative with budgetary scorekeeping impact, such as legislation that may be advanced to address job creation and economic recovery.

Of course, the expiring provisions and other legislative initiatives could be considered outside the Super Committee process, subject to the parliamentary procedures and statutory mandates of "regular order," including compliance with the budgetary offset rules of the House and Senate (CUT-GO and statutory PAYGO).

January 2013 Convergence

If sequestration occurs, it will be effective January 1, 2013. In addition, unless extended, the Bush tax cuts (lower marginal rates, marriage penalty relief, 15 percent rates on capital gains and dividends, etc.) and the current federal estate tax will all expire on December 31, 2012—as well as the individual alternative minimum tax (AMT) relief enacted in the December 2011 tax extension package. Two additional taxes enacted as part of the Affordable Health Care Act—the 3.8 percent tax on investment income and 0.9 percent HI tax on earned income above $200K for individuals and $250k for joint returns—will also take effect on January 1, 2013. In addition, a further increase in the statutory debt ceiling is likely to be required in the first quarter of 2013.

The Balanced Budget Amendment

The statute ensures a vote on a balanced budget amendment (BBA) in both the House and Senate prior to December 31, 2011, without specifying the text of the amendment. The version of the BBA envisioned by the "Cut, Cap and Balance" bill passed by the House on July 19 has three features: (i) a requirement for a balanced budget, (ii) a limitation on federal spending of 18 percent of GDP and (iii) a requirement that taxes can only be increased in the future by a two-thirds record vote of both the House and Senate. It is unclear from the debt ceiling statute whether this version or some other version of the BBA will be voted on in the fall. Congressional passage of a BBA is not a precondition to an increase in the debt ceiling.

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