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M E M O R A N D U M

FROM: MCBEE STRATEGIC

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SUBJECT: THE JOINT SELECT COMMITTEE ON DEFICIT REDUCTION, AKA "SUPER COMMITTEE"

The following memorandum consolidates and updates analysis we've previously provided on the Joint Select Committee on Deficit Reduction ("Super Committee"), including:

I. Recent Updates

– **Super Committee Kick-off**: Senator Patty Murray (D-WA) and Representative Jeb Hensarling (R-TX), the Super Committee co-chairs, announced Friday it would hold a public organizational meeting Thursday, September 8 at 10:30 AM in Room 2123 of the Rayburn House office building. Members will make opening statements and consider the proposed committee rules. The panel will hold its first public hearing the following week on September 13 in Room 216 of the Hart Senate office building. Congressional Budget Office Director Douglas Elmendorf is expected to testify at the hearing, entitled "The History and Drivers of Our Nation's Debt and Its Threats." Last week, the panel's 6 Democratic and 6 Republican members held separate informational meetings to discuss priorities/process and go over previous deficit proposals. These include measures put forward by the co-chairs of the National Commission on Fiscal Responsibility and Reform appointed last year by President Obama, and ideas discussed this summer during debt ceiling negotiations that did not make it into the Budget Control Act .

– **Initial Focus of Discussions**: While the public hearing on September 13 is a broad overview of the nation's budgetary situation, our understanding is the discussions behind the scenes may pick up where the debt ceiling discussions, initially led by Vice President Biden, left off. That means the Super Committee members are likely to first re-visit the "mandatory" portion of the budget, since roughly $750 billion in discretionary spending cuts over the next 10 years already became law in the initial phase of the Budget Control Act. Mandatory spending makes up about 60% of the federal budget over the next decade, according to Congressional Budget Office projections. Within that category, Social Security, Medicare and Medicaid make up nearly 80%, but also happen to be the most politically controversial. Therefore the initial discussions may focus on areas of common ground in the "mandatory" side of the budget outside those three programs. Likely targets include agriculture and conservation programs, student financial aid, and federal civilian and military retirement and health benefits, as well as other measures such as new/increased user fees, federal property sales and electromagnetic spectrum auctions, which resemble increased revenues but are classified in the budget as spending reductions. We do expect Social Security, Medicare and Medicaid to enter the discussions, however.

- **Role of Authorizing Committees**: Although the Super Committee is being organized as a separate entity, its staff and membership are mostly being populated from existing committees of jurisdiction. In fact, of the 12 panel members, 5 are committee chairmen and 1 is a ranking member. Thus they are expected to take their cues from the committees of jurisdiction, particularly those with much at stake including Senate Finance/House Ways and Means (taxes, healthcare/retirement/low-income entitlements) and the Armed Services Committees. For example, Senate Finance Chairman Max Baucus (D-MT), also a Super Committee member, is holding a hearing on the tax treatment of U.S. companies overseas Thursday, which he said could inform Finance's recommendations to the Super Committee. Similarly, the House and Senate Armed Services Committees may present bipartisan recommendations to the Super Committee, which we think would be given significant deference and may be difficult to overturn. The formal deadline for authorizing committee recommendations is October 14, but we expect back-channel discussions to occur almost daily.
- **New Staff Director**: The Super Committee co-chairs last week announced the hiring of Mark Prater as the panel's staff director. Prater currently serves as Deputy Chief of Staff and Chief Tax Counsel to Senate Finance Committee Republicans under Ranking member Orrin Hatch (R-UT). Prater served in the same capacity for the Finance panel's previous ranking member, Senator Chuck Grassley, and overall counts more than two decades of service to Finance Committee Republicans under his belt. An Oregon native, Prater arrived at the Finance Committee in 1990 under then-Ranking Member Bob Packwood (R-OR), who represented a moderate brand of GOP politics that runs through the Pacific Northwest. Prater is widely respected on both sides of the aisle for his good-faith negotiating stance and vast knowledge of tax and healthcare law as well as Senate procedure. Prater helped negotiate some of the landmark bipartisan budget deals of the 1990s, as well as some of the most important legislation of this past decade – including the 2001 and 2003 tax cuts under President George W. Bush and the 2006 Pension Protection Act. Prater's selection suggests the committee will take a non-ideological look at entitlements and the tax code, though as we describe in the memo we're skeptical any major reform proposals will make it out of the Super Committee in time for its Thanksgiving deadline.

II. What to Expect From the "Super Committee"

Bottom Line: We believe the most likely outcome is an agreement by a majority of the 12 Joint Select Committee on Deficit Reduction ("Super Committee") members to either cut the bare minimum ($1.2 trillion over 10 years) from the deficit required under the debt-ceiling deal, or agree on a lower figure and let across-the-board cuts ("sequestration") take care of the rest.

The legislation sets a target of $1.5 trillion in deficit reduction, though $1.2 trillion is all that's necessary to avoid sequestration. Achieving some agreeable figure would enable the Super Committee to control the nature and timing of the cuts, applying them to more areas of the federal budget than is allowed under sequestration and in a more thoughtful manner than the blunt instrument of across-the-board cuts. This would avoid some areas (defense in particular) taking a disproportionate hit, and lawmakers could also "back-load" cuts to the latter part of the decade instead of sequestration's even application (~$110 billion annually) for the 9 fiscal years beginning in 2013 in what is expected to remain a weakened economy.

- ***Success or failure has disparate implications for different sectors - where sequestration is a more adverse outcome for defense (up to $500 billion in cuts, on top of an initial $350 billion in the debt ceiling deal), a Super Committee agreement may be a greater negative for the health-care sector***. Cuts to Medicare/Medicaid could range from $200 billion to $500 billion, while under sequestration Medicaid is exempt and Medicare cuts are limited to 2% of annual program spending (~$120 billion over 9 years), with some exemptions.

Entitlement and/or Tax Reform Unlikely: We do not believe the Super Committee has the time or the inclination to tackle a fundamental overhaul of the major entitlement programs, which are the primary driver of federal spending, nor a comprehensive re-write of the tax code to raise revenues. With less than 3 months before the panel's November 23 deadline for agreement, large-scale reforms to the tax code and the major entitlement programs (Social Security, Medicare and Medicaid) are unlikely. That means panel members will be limited to nibbling around the edges on entitlement changes, such as curbs to provider reimbursements (Medicare), cost-shifting to states and/or managed care providers (Medicaid) and possibly moving to less-generous annual inflation adjustments (Social Security). On taxes, they will be limited to a noisy debate over taxing upper-income households – which will likely continue through the 2012 elections – and over closing tax "loopholes" as a precursor to a comprehensive tax reform effort we expect to get underway next year. There could in fact be a deadline for a tax-reform deal inserted into a Super Committee bill, perhaps the end of 2012.

- ***We don't expect targeted tax increases on certain industry sectors highlighted by Democrats, such as private equity/hedge funds or oil and gas, to be included in a Super Committee agreement***. If any new revenues somehow make it into the mix they will be a very small percentage of the overall product (e.g. a Democratic proposal for lengthened depreciation of private aircraft would raise an estimated $3 billion, out of a $1.5 trillion target). Another possibility raised has been legalization of online poker, which would raise about $10 billion in taxed winnings, but the odds are slim.

Jobs Package Unlikely: We do not believe there will be a significant "jobs" package that emerges from the Super Committee talks. Thus far all of the stimulus measures floated by the Obama Administration have landed with a thud among Republican leaders. More spending on transportation and education infrastructure, extended unemployment benefits, another year of payroll tax cuts, clean energy tax credits, financial aid to states and localities and tax credits for companies that hire new workers are regarded by Republicans largely as costly and failed policies. These proposals (estimated by Moody's Analytics to cost ~$250 billion) also would increase the amount of deficit reduction measures the Super Committee must develop to offset the added cost, making an already difficult job harder.

Failure to Reach Deal Possible: Failure remains a viable option given the wide gulf that remains between Democrats and Republicans over taxes/entitlements. If the debt ceiling negotiations are any indication, there remain serious reservations among Democrats about accepting any entitlement cuts if revenue increases are not also part of the deal. Republicans to date have not moved off their position opposing revenue increases, unless used to "pay for" corporate/individual tax rate reductions, the kind of tax reform effort that is unlikely to be feasible within the short timeframe. Thus the capacity for any agreement may be in doubt – however, just because the Super Committee cannot agree does not mean the end of the story. Policymakers will still have until the end of 2012 to reach a deficit-cutting agreement that could override the automatic spending cuts as well as automatic tax increases upon the expiration of the Bush-era tax cuts set to occur in 2013.

III. What Exactly is the "Super Committee"?

The Joint Select Committee on Deficit Reduction was set up by the debt ceiling law to cut another $1.5 trillion from the 10-year U.S. deficit, on top of $900 billion in initial reductions achieved mainly through caps on discretionary spending (including defense). If the Super Committee cannot agree on at least $1.2 trillion in deficit reduction measures across-the-board spending cuts of that amount, concentrated in less than half the federal budget, would be applied beginning in January 2013.

These cuts, known as a "sequester," would make up the difference between what the Super Committee agrees on and $1.2 trillion; for instance, if the Super Committee agreed to and Congress approved a $600 billion cuts package, another $600 billion in cuts would occur through the sequestration process. Alternatively, if the Super Committee failed to agree on any cuts, the entire $1.2 trillion would be achieved through sequestration. Much of the federal budget is exempt from cuts under the sequestration process, including Social Security, Medicaid, most of the subsidies provided under the new health-care law and numerous other entitlements for the poor, elderly and disabled. Federal military and civilian retirement benefits are also exempt, as is infrastructure spending financed through excise taxes. Medicare cuts would be limited to 2% of the program's annual budget, with low-income subsidies exempt.

Sequestration would fall evenly on defense and nondefense programs. Under a worst-case scenario where the Super Committee fails to secure an agreement, $1 trillion in cuts would be applied equally to defense and nondefense programs (with the remaining $200 billion in outlay cuts to occur automatically through reduced interest payments on the national debt as a result of the lower spending). Thus defense-related spending would be subject to roughly $500 billion in cuts applied evenly across 9 years (fiscal 2013-21), or about $55 billion per year, on top of about $350 billion in reductions already assumed over the fiscal 2012-21 period as a result of the initial discretionary spending caps. The remaining $500 billion would be cut from projected spending mainly on nondefense discretionary spending, although the 2% Medicare reductions make up about $120 billion of that figure and lesser amounts would be cut from non-exempt programs including portions of the Obama health-care law and agricultural subsidies.

IV. How Does the Super Committee Process Work?

The panel differs from the earlier National Commission on Fiscal Responsibility and Reform, led by former Senator Alan Simpson (R-WY) and former Clinton Administration chief of staff Erskine Bowles, in that it has fewer members (12 vs. 18); consists entirely of members of Congress, and needs only a simple majority for approval rather than 2/3 of the panel members. Thus if 7 of the 12 panel members – evenly divided between House and Senate, Democrat and Republican – vote to support an agreement, it advances to the floor of both chambers. It is then subject to procedural protections and expedited consideration; it is sent directly to the floor of each chamber, where it can't be amended and is not subject to a Senate filibuster. Thus only 51 votes in the Senate would be necessary for passage, rather than the traditional 60 votes.

Under the law President Obama would have until January 15, 2012 to sign the bill, or the automatic sequestration would begin in January 2013. That prospect is also a major difference from the earlier Simpson-Bowles Commission, which had no consequences for failure. That said a similar sequestration mechanism was ignored on two out of three occasions when the mechanism was in place in the 1980s –after an $11.7 billion cut in 1986, other triggered sequesters were overridden (1988) and substantially reduced (1990) by subsequent legislation.

V. What the Super Committee May Agree on

The 12 committee members are not expected to plow much new ground. They are basing their discussions off of proposals already included in the Simpson-Bowles plan and other bipartisan groups, as well as items discussed in the earlier debt ceiling talks led by Vice President Joseph Biden. As much as $1.8 trillion in spending cuts reportedly had been on the table with varying degrees of support during the Biden talks, including about $1 trillion in discretionary program savings (about $750 billion of which were included in the initial debt ceiling law cuts) and up to $800 billion in mandatory program savings. There also remains the option of $1 trillion in savings by capping spending on operations in Iraq and Afghanistan over 10 years at levels assumed in President Obama's troop withdrawal plans, although Republicans balked at that proposal as a "gimmick" in the earlier talks.

The numbers suggest there is additional room to cut from defense and nondefense appropriations over the fiscal 2012-21 period, and the entire mandatory side of the budget remains ripe for the picking as none of those proposals made it into the initial round of cuts. Health care entitlement programs alone are roughly equal in cost to the entire discretionary portion of the budget over the next decade (~$12.5 trillion).

Proposals discussed earlier this year would trim between $200 billion and $500 billion from mandatory health spending over the next decade, mainly in Medicare and Medicaid. These include: cuts to Medicare reimbursements for hospitals, greater cost-sharing for long-term care, home health and clinical laboratory services; mandatory pharmaceutical industry rebates to defray Medicare prescription drug spending; and a nationwide state Medicaid matching rate to limit federal government contributions.

Other savings proposals not included in the initial round of cuts, totaling roughly $200 billion to $300 billion, include: limits to federal subsidies for agriculture, student financial assistance, and federal civilian and military retirement benefits; increased government insurance premiums for defined-benefit pension plans, higher security fees for airline tickets, auctions of broadcast spectrum to wireless telecommunications firms, and higher guarantee fees for investors in Fannie Mae/Freddie Mac securities.

VI. The 12 Super Committee Members

***Senator Patty Murray (D-WA), Super Committee co-chair*:** Murray is a strong advocate for spending on defense, veterans, transportation and housing as a senior member of the Appropriations Committee. She is also chair of the Senate Democrats' campaign committee and has made the GOP stance on curbing entitlement benefits a political issue, as well as their reluctance to raise taxes on the wealthy.

Representative Jeb Hensarling (R-TX), Super Committee co-chair: Hensarling is a conservative protégé of former Senator and presidential candidate Phil Gramm (R-TX), and the fourth-ranking House Republican. He voted 'no' on the Simpson-Bowles panel recommendations because it would have raised taxes and did too little to curb entitlement spending.

Senator Max Baucus (D-MT): Baucus is chairman of the powerful Senate Finance Committee, with jurisdiction over the Internal Revenue Code and the major entitlement programs. Baucus is cautious and deliberate and opposes major entitlement changes without tax increases on the wealthy, but has been known to make deals with Republicans, including on the 2001 tax cuts and 2003 Medicare drug coverage bill enacted under President George W. Bush. Voted 'no' on the Simpson-Bowles plan because it would have cut farm subsidies and raised gasoline taxes.

Representative Dave Camp (R-MI): *Camp is* Baucus' counterpart as chairman of the House Ways and Means Committee. While interested in tax reform, Camp has said repeatedly that the Super Committee is not the right venue and that more time for debate is needed. Camp has said 2012 could be the year despite the presidential elections, noting that the 1996 welfare reforms also occurred in a presidential election year. He voted 'no' on the Simpson-Bowles plan because it would have raised taxes without doing enough to curb entitlement spending.

***Senator John Kerry (D-MA)*:** The Democrats' 2004 presidential candidate, Kerry is now chairman of the Senate Foreign Relations Committee. Kerry has said the foreign aid budget should be spared deep reductions, and is a long-time advocate for low-income housing and support programs as well as clean energy and transportation funding, including high-speed rail. Although a partisan Democrat, Kerry is seen as someone who can work with Republicans.

Representative Fred Upton (R-MI): Upton is chairman of the House Energy and Commerce Committee, which shares jurisdiction with Ways and Means over Medicare and has sole jurisdiction over Medicaid in the House. Has said current benefits for today's seniors should remain untouched but that changes are necessary to reduce future liabilities. Upton is viewed as a moderate Republican although he has tacked to the right this year in attacking environmental regulations proposed by the Obama Administration.

Senator Jon Kyl (R-AZ): Kyl is the number two Republican in the Senate and is retiring at the end of his term next year. He is a staunch foe of tax increases and a hawk when it comes to robust military funding. Has said he will work hard to prevent across-the-board defense cuts, but it's difficult to see Kyl agreeing with Democrats on the Super Committee.

Representative James Clyburn (D-SC): Clyburn is Assistant to the House Democratic Leader Nancy Pelosi, and is a strong advocate for low-income support programs hailing from a poor rural part of the country. Clyburn has said tax increases on the wealthy as well as repeal of certain business tax breaks, such as for the oil and gas industry, should be considered. He's also made clear he won't "draw any lines in the sand" when it comes to the Super Committee talks.

Senator Rob Portman (R-OH): Portman is a former George W. Bush administration trade representative and budget director, and before that was a member of the House Republican leadership. A conservative who is seen as willing to make deals with Democrats to get things done, Portman has created a Web site to solicit views from the public on how to reduce the deficit. Portman appears unlikely to support tax increases, despite his friendly relations with Democrats.

Representative Chris Van Hollen (D-MD): Van Hollen is a former chairman of the House Democrats' campaign committee who has brought a partisan edge to his new role as top Democrat on the House Budget Committee. Consistently advocates for protecting entitlement programs and securing deficit reduction instead through higher taxes on the wealthy and large multinational corporations. Was part of the Biden group earlier this summer that appeared to be making some progress, although those talks collapsed over the tax issue.

Senator Patrick Toomey (R-PA): Former president of the anti-tax Club for Growth, Toomey is a believer in deep spending cuts and has said the Pentagon should not be spared either. Toomey argues new tax revenues can be found but only through base-broadening tax reform, including lower rates and the elimination of industry-specific incentives, including for all energy sources – including wind, solar and other renewable fuels as well as oil and gas.

***Representative Xavier Becerra (D-CA*):** One of the most liberal House members and a member of the Ways and Means Committee and Democratic leadership, Becerra voted 'no' on the Simpson-Bowles plan because he thought it cut spending too much and did not raise taxes on the wealthy enough.

VII. Key Dates to Watch

- **September 16:** First official meeting of the Super Committee, as mandated by the debt-ceiling law.
- **October 14:** Congressional committees of jurisdiction must submit their recommendations.
- **November 23:** Deadline for the Super Committee to vote affirmatively on a deficit-reduction package, after which the legislation would lose its procedural protections.
- **December 23:** Deadline for final passage in both the House and Senate, after which the legislation would lose its procedural protections.
- **January 15:** Deadline for President Obama's signature.