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The Super Committee's failure to pass new deficit reduction legislation and its implications

- The US super committee, charged with finding $1.5trn of additional budgetary savings by November 23, has failed to agree on a deficit reduction plan, triggering automatic spending cuts during 2013-2021.
- Although the direct medium-term implications from the automatic spending cuts for real economic activity are minimal, the committee's failure has reduced the likelihood of an extension of the payroll tax cut and emergency unemployment benefits, set to expire at year end.
- Our 2012 GDP forecast of about 2.0% supposes the extension of those provisions through next year. However, if Congress leaves both of them to expire, this would trigger a significant tightening in fiscal policy, reducing real GDP growth to a year average of 1.4%.
- Although lawmakers may intervene to pass legislation to avoid or restrict the sequestration process, the lack of political agreement suggests that several fiscal issues are unlikely to be resolved before the November 2012 elections, elevating the amount of policy-induced uncertainty that would weigh on the US economy for the better part of 2012.

The Joint Select Committee on Deficit Reduction (the so-called Super Committee), which was created as part of the deal over the summer to raise the debt ceiling and was supposed to come up with a fix plan for federal finances and identify at least $1.5trn in additional savings and revenue increases over the next 10 fiscal years, failed to reach an agreement on any deficit reduction measures. Although recent remarks by House Speaker Boehner referred to a partial agreement of about $600bn in savings by 23 November, the super committee's failure to meet the November deadline highlights the continuant controversy between the political parties in dealing with long-term US public finances.

According to the Budget Control Act (BCA) of 2011 enacted in August, if no new deficit reduction legislation is enacted, automatic spending cuts for both discretionary and mandatory spending will be implemented over the next 9 years starting in January 2013. Those cuts will be achieved by lowering the caps on discretionary spending and by automatically canceling budgetary resources for several programs and activities financed by mandatory spending, a procedure known as sequestration. Overall, the Congressional Budget Office estimates that the automatic restrictions on federal spending would produce net budgetary savings of about $1.1trn across 2013-2021, including interest savings (Table 1). In particular, federal spending will be reduced by an average of $109bn per year, with the required reductions equally split between defense spending and nondefense domestic programs. The majority of the net savings would come from further cuts in discretionary spending (~71%), while the rest would stem from a net reduction in mandatory spending (~13%) and lower debt-service costs (~16%). Outlays to Social Security will not be affected, while Medicare spending will be reduced by 2% each year, producing savings of about $123bn.

Table 1

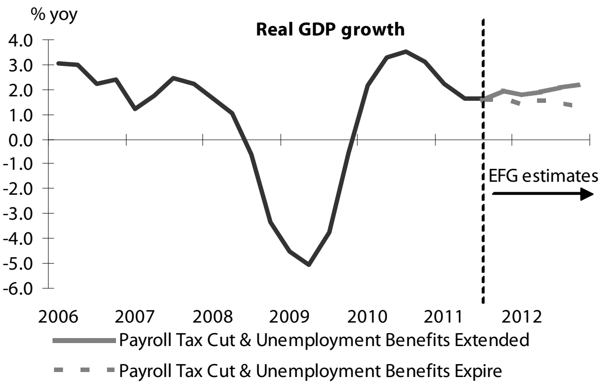
Estimated Savings from Automatic Reductions	**$bn**
Defense discretionary appropriations	-454
Nondefense discretionary appropriations	-294
Defense mandatory budgetary resources	-0.1
Medicare spending	-123
Nondefense mandatory budgetary resources	-47
Debt-service costs	-169
Boost in net spending resulted from reductions in	31
Total Impact on the Deficit	**-1,057**

Source: Congressional Budget Office (CBO)

Apart from the political uncertainty that could weigh on consumer and business sentiment in the months ahead, the direct medium-term implications from the automatic spending cuts for real economic activity are minimal; the $25bn spending reduction for FY2012 enforced by the BCA of 2011 should have very little direct effect on GDP growth (about 0.1%), and the automatic enforcement mechanisms triggered by the failure of the super committee to agree to a new deficit reduction legislation will come into effect at the beginning of 2013. However, there are two subsidiary issues relating to the fiscal dysfunction of the super committee; the payroll tax cut and emergency unemployment benefits that expire at year end. Although the fate of the above mentioned measures are not directly tied to the mission of the super committee, the most obvious way to extend them would be to include them in the super committee package. Thus, this week's failure to reach an agreement has reduced the likelihood of extension of those programs.

According to our estimates, if Congress does not act by year end to extend the payroll tax cut ($110bn per year) and emergency unemployment compensation ($50bn per year), we would expect a drag from fiscal consolidation by about 0.6% for 2012 (Figure 1). Based on the IMF calculations for the macroeconomic effects of fiscal consolidation[1], a tax-based budget deficit reduction by 1% of GDP typically reduces real economic activity by about 0.6% in the first year. Our 2012 GDP forecast of about 2.0% supposes the extension of those provisions through next year. However, if Congress leaves the payroll tax cut to expire, this would reduce real GDP growth to an average of 1.6%, while the expiration of the emergency unemployment benefits would reduce it further to about 1.4%.

Figure 1



Source: Eurobank EFG estimates

As far as ratings agencies are concerned, S&P and Moody's have announced that they will not downgrade the US sovereign rating solely based on the super committee's failure to agree, as the planned deficit reduction will materialize through the automatic enforcement procedure. However, Fitch will conclude its US rating review by the end of November, so the committee's failure would probably move Fitch's outlook on its triple-A sovereign rating from stable to negative.

The automatic spending cuts that are set to take effect in 2013 would reduce spending by about $70bn in 2013. In the meantime, lawmakers may intervene to pass legislation to avoid or restrict the sequestration process. Some Republicans have already highlighted that they will push to reverse the cuts in defense outlays, as this would weaken the military significantly. Table 2 portrays the differences in Republicans' and Democrats' plans, where defense discretionary outlays, health care spending and tax reforms (on the revenue side) are among the most controversial categories between the two political parties. On the contrary, non-defense discretionary spending and other mandatory programs have some common ground, while both

[1] *IMF (October 2010), "Will it hurt? Macroeconomic effects of fiscal consolidation", World Economic Outlook, Chapter 3, pp. 93-124.*

parties demand increases in miscellaneous revenues (such as GSE fees, spectrum sales etc). The Congress and the Administration will also have to decide if the Bush tax cuts first passed in 2001 and 2003, due to expire at the end of 2012, will be extended. However, the lack of agreement points out that these issues are unlikely to be resolved before the November 2012 elections, elevating the amount of policy-induced uncertainty that would weigh on the US economy for the better part of 2012.

Table 2

Democrats' and Republicans' plans and the Sequestration process

	Democrats	Republicans	Sequestration process
Outlays, $bn			
Nondefense discretionary appropriations	200	190	294
Defense discretionary appropriations	200	0	454
Medicare spending	400	275	123
Nondefense mandatory budgetary resources	200	285	47
Revenues, $bn			
Tax reforms	650	250	0
Miscellaneous sources	350	250	0
Debt-service costs	360	225	169
TOTAL, $bn	2,360	1,475	1,087

Source: Congressional Budget Office (CBO), Eurobank EFG

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