



# Legislative Update: November 2011



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Timely  
Thinking

## The “Super Committee” Fails: What Happens Now?

Last week, the “Super Committee” tasked with determining how to reduce the federal budget deficit by \$1.2 trillion announced that it had failed to agree on a plan before its November 23 deadline. The Committee’s failure triggers a process called “sequestration,” under which automatic spending cuts of \$1.2 trillion are implemented over ten years beginning in 2013. The sequestration cuts are to be split evenly between defense and non-defense programs. When added to cuts already agreed upon in August, total cuts in defense spending will approach \$1 trillion. Cuts to Social Security, Medicare and Medicaid benefits are not permitted in sequestration.

As predicted, differing views on the need for additional taxes contributed greatly to the Committee’s failure. Consistent with their pledge, Republicans refused to accept significant new tax revenues as part of a deficit reduction plan. That unwillingness led Democrats to reject entitlement (Social Security or Medicare) changes, asserting they will not “balance the budget on the backs of seniors when affluent Americans are not paying their fair share.” The standoff left the Committee attempting to save \$1.2 trillion through spending cuts alone. Its inability to do so forces those cuts to be implemented through the sequestration process.

The Committee’s failure to reach agreement is not surprising. A theme of my updates this year has been that Congress crosses hardened ideological lines and fashions compromise

legislation only in the presence of a “forcing event,” that is, an event that requires it to do so to avoid drastic consequences. A possible government shutdown in April was a forcing event, and Congress worked out a deal in literally the final hour to keep the government open. A default on national debt in August was another such event; again, Congress avoided draconian consequences with a deal a day before the deadline. (Early this year, I noted as other examples of forcing events a likely downgrade in the credit rating of U.S. debt and a likely severe decline in the equity markets later in the year. Both of those events happened, yet Congress did not act. I obviously underestimated Congress’s tenacity to do nothing.)

The Super Committee faced no “forcing event.” The November 23 deadline was a contrivance of the August deal that increased the nation’s borrowing limit; nothing happens as a result of the failure to meet it. The ratings agencies had made clear that the U.S. would not face further downgrades if the Super Committee did not act because the needed spending cuts would occur through the sequestration process. And those spending cuts do not begin to take effect until 2013, giving Congress another year to consider alternatives or whether to undo them entirely. Simply put, there was little need to act now.

The Super Committee’s failure, however, sets up a string of possible legislative developments for year-end 2011 and for 2012, both before and after the election.

**2011 year-end:** Under the compromise that extended the Bush tax cuts at the end of 2010, employees in 2011 are paying Social Security at a reduced rate of 4.2%. The President would like to lower the 2012 Social Security tax rate for both employers and employees to 3.1%. But if Congress does not take action by year-end, the Social Security tax rate next year reverts to the usual 6.2% for both employers and employees. Some economists are concerned that higher taxes on workers could thwart the economic recovery.

A number of other tax provisions also are set to expire at or near year-end. Of particular interest to investors is the ability to move up to \$100,000 from an IRA to a charity to satisfy their minimum distribution requirement without incurring tax. Congress also must pass legislation known as the “doc fix” to avoid a scheduled 30% reduction in reimbursements received by doctors who see Medicare patients.

Extending the lower employment tax rate and other tax breaks would be in line with Republican promises to keep taxes low. But it would not be consistent with the Republican goal to reduce the budget deficit. If Congress passes these measures, the lost revenue in 2012 will exceed the entire 2012 cost savings achieved from the debt limit deal that consumed Washington this summer. In other words, after all the rhetoric, drama and focus, the deficit actually would be slated to *increase* in 2012.

**2012 initiatives pre-election:** Some legislators—notably Senator McCain—have threatened to seek legislation in 2012 to unwind the severe cuts in defense spending imposed by sequestration. He is joined in his view by the Pentagon and many members of the Congressional committees that oversee the armed forces.

The President has said he will veto any efforts to unwind sequestration. But there is a possibility that everyone could agree on what I call an “anti-grand plan.” (“Grand plan” is the label given to a comprehensive compromise that reduces the deficit, along the lines of the Simpson-Bowles panel report last year. So,

an “anti-grand plan” would be a plan where everyone agrees to *increase* the deficit.) The Republicans want to avoid the cuts to defense. The Democrats want to avoid the cuts to staffing for social programs. And the President wants Congress to adopt his \$450 billion package to stimulate employment. The parties could simply agree to do all three.

There is precedent for this type of agreement. The deal reached at the end of 2010 gave the Republicans an extension of the Bush tax cuts, and the President and the Democrats a temporary reduction in Social Security taxes and an extension of unemployment insurance. The loser was the deficit, which increased by \$400 billion a year.

An “anti-grand plan” to avoid spending cuts similarly would meet each party’s needs—at the expense of the budget deficit. But if the August debt ceiling deal is unwound in any significant way, look for the rating agencies (including Moody’s this time) to further downgrade U.S. debt, and look for the markets to react unfavorably. We can only hope Congress resists this temptation.

**2012 post-election:** If forcing events make Congress act, there is a bounty of them coming at the end of 2012. The Bush tax cuts are scheduled to expire on December 31, 2012. The draconian defense cuts under sequestration begin to take effect the following day. And the government could hit its debt ceiling again before year-end, requiring another increase.

The President has demanded a “balanced deal” for reducing the deficit, incorporating both spending cuts *and* tax increases. Toward that end, he has threatened to veto any extension of the Bush tax cuts for families with income over \$250,000. One of the reasons the Super Committee Democrats did not feel compelled to compromise was their belief that the Republicans will be more willing to negotiate when faced with the imminent expiration of the Bush cuts.

Given the parties' competing views on taxes, Congress is unlikely to pass any tax legislation next year before the election. Congress then will have to return for a three-week lame-duck session between Thanksgiving and Christmas 2012 to address the expiration of the Bush tax cuts. The Congress that returns is the *existing* Congress—a Republican-led House and Democratic-led Senate—regardless of the election results. President Obama, too, will still be in office at the end of 2012: either he will have been re-elected—and may feel newly empowered to institute tax increases—or he will be a lame-duck president who can do what he believes is right without concern for the consequences.

But President Obama cannot simply veto the extension of the Bush tax cuts for families with income over \$250,000. If the cuts are not extended, taxes increase *across the board* in 2013. Factoring into this analysis is the silver lining that expiration of all the Bush tax cuts raises \$3.5 trillion in additional revenue, virtually eliminating budget deficit concerns and making it easier to override the sequester without concern for rating agency fallout. But that would leave a deficit program achieved more through higher taxes than reduced spending, which virtually everyone (including Democrats) agrees is counterproductive.

Although there will be plenty of forcing events at the end of next year, given the short time frame for action and the acrimonious post-election environment, an agreement may prove elusive. The President has said he will not sign a full extension of the Bush tax cuts. If he maintains that threat, then either the Republicans must accept a compromise that raises taxes only on the affluent or watch taxes go up for everyone. Under either scenario, affluent taxpayers will face higher taxes in 2013.

Fortunately, investors have a year to prepare for that scenario. In the months ahead, I will be providing planning suggestions for investors to consider to blunt the effects of an impending tax increase.

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