U.S.

Economic Watch

December 6, 2010

Economic Analysis

Jeffrey Owen Herzog
jeff.herzog@bbvacompass.com

Fiscal Commission Sets Tangible Goals

Suggestions are economically sensible, politically tough

- **The plan would reduce the debt-to-GDP ratio to 60% by 2023 and 40% by 2035**
- **Commission recommends $1.6tr in discretionary spending cuts**
- **Next major phase of political interlocution to happen during debt limit vote**

The Purpose of the Commission and Summary Reform Recommendations

The National Commission on Fiscal Responsibility and Reform ("the Commission," henceforth) on Friday failed to approve a final plan for US fiscal reform by a vote of 11 to 7. The Commission was created through an Executive Order by President Barack Obama to promulgate a systemic reform of US government finances. A vote of 14 in favor of the plan would trigger a mandatory Congressional vote. The membership of the Commission comprised six members appointed by the President (not more than four from the same political party), 3 current Senate Democrats, 3 current House Democrats, 3 current Senate Republicans and 3 current House Republicans. The purpose of the membership distribution was to create a bipartisan panel involving current political leaders. The Commission's plan would reduce the deficit by $3.9tr by 2020, reducing the debt-to-GDP ratio to 60% by 2023 and 40% by 2035. The reform blueprint would reduce discretionary spending by $1.6tr, shrink mandatory spending by $556bn, increase revenue through tax reforms and other revenue sources by $995bn and equate to $673bn in reduced interest expense. Even though the vote failed to approve the report, the Commission's work serves as a starting point.

Discretionary Spending Cuts: Government Liposuction

In the case of discretionary spending, fiscal reform encounters the unusual case of military officers actually advocating for spending cuts, which speaks to their longer-term view of the threat of unsustainable fiscal deficits to military readiness. Better to organize now a rationalized fiscal reform than face an irretrievably gutted military expenditure in the future. Nonetheless, cutting discretionary security expenditures now requires high foreknowledge of military scenarios only evolving as we speak: when can the US exit Iraq and Afghanistan? To what extent can military expenditures decrease during a time of international political fragility? These are unknown factors and thus limit the ability of any political party to quickly reduce military expenditures. However, if we can presume there will be at some point a respite for the US military, this will represent an appropriate period of rest, rearmament and cost restructuring, but only in the medium-term rather than the short-term, as the Commission presumes. Discretionary spending caps represent $1.66tr of the Commission's plan's effect on the deficit arising from reforms to outlays, almost 75% of the total $2.22tr the Commission expects to save from spending cuts. This is likely why Republicans believe more can be done with Social Security, Healthcare and other entitlements, viewing them as oranges workable for cost squeezing.

Tax Reform: More Taxpayers, Lower Rates, Higher Gasoline Taxes, Simplified Tax Code

One encouraging sign from the deliberation over the Commission's plan is common ground over attempts to eliminate "tax expenditures," which are special tax breaks for specific groups of people. Comprehensive simplification of tax reform is similarly universally regarded as positive.

However, talk of tax reform is inextricably linked with the concept of a progressive tax code, something that is not an economic decision but a political preference. Additionally, the preference between political parties for spending cuts versus tax increases comes into play. The main thrust of the Commission's plan is to close loopholes and thereby broaden the tax base. At the same time, the Commission would maintain or increase the progressivity of the tax code. While the plan would lower corporate rates due to this increased tax base and closed tax expenditures, it would also eliminate some popular tax breaks, such as enacting mortgage interest deductions only for principal residences. Under the Commission's plan, these efforts alongside a 15 cent increase in the gas tax will generate almost $1tr in increased revenues.

Entitlement Reforms: Health Care and Social Security

The basis of the Commission's planned reforms to entitlements revolve around cost savings and improved cost planning, mostly in the form of better indexation through the chain-weighted Consumer Price Index (CPI) and better cost growth adjustments. The reform package outlines various changes to physician payments, cost-sharing, malpractice law, and pharmaceutical costs. The plan also includes an increase in the retirement age and a graduate increase in the taxable minimum to cover 90% of wages by 2050. The Commission expects $341bn in savings for health care and $238bn in savings or revenue tweaks to social security. This represents $579bn over 2012-2020, which is slightly more than half of the effect of increased general revenues and about one-third of the effect of discretionary spending caps over the same time period. At the same time, the Commission's plan shows that entitlement programs like comprehensive health care and social security are consistent with a balanced budget in a world of reformed taxes and capped discretionary spending.

The Political Situation: Just the Beginning

Some of the most telling comments came from Honeywell International Chairman David Cote, who reported that considerable hyperbole occurred and words like "draconian" and "destroyed" are "applied to something like a 5 percent increase over 10 years becoming a 4 percent increase over 10 years," with Cote further commented "I really have difficulty sometimes seeing how you get your jobs done at all." This is a natural view of a businessperson in Congress. More telling is former Senator Alan Simpson's suggestion that major legislation takes a few years, commenting that "First you get the horse out on the track," he said. "Then the next year the saddle and the silks. Then next you get a jockey," and eventually a grandstand full of cheering spectators.

In retrospect, the Commission's work began at an awkward time given many important political changes this month. Not only are controversial tax cuts due for renewal or expiration, but the political party majority in Congress is shifting. Next month the political starting point for reform legislation will be different from this month due to the shift in the House majority from Democrat to Republican. Two members of the commission are leaving public office. No members of the Obama administration are part of the membership. Subgroups of like-minded commission members are designing their own deficit reduction plans, both on the left and the right with the requisite emphasis on tax increases or spending cuts. Setting a December deadline for a deficit panel allowed less focus on fiscal matters during the November elections.

A likely outcome in the near future is another political spat during this spring's upcoming vote to increase the Federal debt limit. Additionally, the President can include (or exclude) many of the Commission's recommendations in the release of next year's Federal budget. Last year's budget included a number of policy-oriented tweaks within the thick tome of the pages of the Federal budget. Overall, there appeal to be tangible areas of agreement over fiscal reform, but much deliberation must pass before a final reform event may transpire. Since this is a political process, it will never go as smooth as an expert business restructuring, but some agreements occurred. The major issues – reforms to defense and entitlement spending – will truly inform us if adequate fiscal reform will happen.