



## The Not So Super “Super Committee” — Implications for the US Deficit and the Economic Outlook

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It likely comes as no surprise that the so-called “Super Committee” – the group of 12 members of the US House of Representatives and the US Senate, split evenly along party lines – didn’t come up with an additional US \$1.5 trillion in deficit reductions over the next 10 years as mandated by the Budget Control Act of 2011. That act was enacted in August after the acrimonious debate over extending the US debt ceiling. Watching the political spectacle since the summer, I didn’t see any evidence that the two parties were negotiating in good faith to achieve the bargain that many feel will eventually be necessary, entitlement reform for tax increases.”

### Where are we now after last week’s official admission of failure?

The Budget Control Act of 2011 included automatic spending cuts that nobody wanted in order to incentivize the committee to achieve a better deficit reduction deal. It was actually quite brilliant: if you can’t get Republicans and Democrats to list which revenue increases and spending cuts they would be willing to sign off on, ask them which revenue increases and spending cuts they are most unwilling to sign off on, and make those mandatory if negotiations break down. This is indeed the fastest way to get the US budget deficit under control.

### The numbers speak for themselves

We started the year with a Congressional Budget Office (CBO) forecast (based on current law at the time) of a US \$7 trillion cumulative budget deficit over the next 10 years, or an average 3.6% of GDP. The troop withdrawal from Iraq and the drawdown in Afghanistan allowed the CBO to shave US \$1.2 trillion off that number, and the first round of spending cuts from the Budget Control Act added another US \$900 billion in deficit reductions. Add to that the further incremental savings resulting from the “Continued Resolutions” that have funded the government this year, and by the summer the deficit forecast was down to US \$4.7 trillion, or an average of 2.5% of GDP. If we believe that the automatic spending cuts that have now been triggered will actually happen, the US budget deficit will be further reduced to just US \$3.5 trillion over the next 10 years, or an average 1.8% of GDP per year. The debt-to-GDP ratio will peak at 73% next year and steadily fall back to 61% in 2021. On those metrics, no further ratings downgrades should be in the cards. In fact, the US deserves to be upgraded back to AAA. To quote one of my favorite comedians, John Hodgeman, “You’re welcome, America.” Deficit crisis averted.

### Political reality check

I am fairly confident the scenario laid out by the CBO is not going to play out. Incentives still exist for Republicans and Democrats to come up with a better deal, but I don’t underestimate their incentives to walk away from the deal completely. Republicans must by now

have realized that the numbers the CBO started with were not on their side. The CBO projections include the expiration of all the 2001-03 tax cuts in 2013, plus no further inflation adjustment for the Alternative Minimum Tax, no further “doc fix” (the annual increase in Medicare payments to doctors over and above what the law would stipulate), and the expiration of various other tax cuts. All those revenue measures together are worth more than US \$4 trillion dollars (and I am not even including the increase in debt service). Without the expiration of these tax cuts, which of course represent tax increases, the cumulative 10-year budget deficit at the start of the year would have been closer to US \$11 trillion instead of US \$7 trillion, or an average of 5.7% of GDP, everything else being equal.

### Republicans got a bad deal

To get from this US \$11 trillion to the US \$3.5 trillion the CBO currently projects by 2021, and which would represent a “successful” resolution of the deficit crisis, spending cuts account for just 46%, while tax revenue increases make up 54%. So, this is an 85 cent spending cut for every one dollar in tax revenue deals the Republicans got out of this year’s budget negotiations. A third of the reductions in expenditure are the “savings” from drawing down in Iraq and Afghanistan, which doesn’t represent real spending cuts. Take those out and the deal is closer to 50 cents for every one dollar in tax revenues. If you remove the cuts related to defense spending, which Republicans would normally oppose, it’s an even more lopsided 40 cents in spending cuts per one dollar in revenues. The Republicans were turning down three dollars in spending cuts for one dollar in tax revenue deals just to end up with 40 cents for one dollar.

## Is there a way out of the seemingly automatic deficit reduction path we are on right now?

Another way to think about the outcome I previously described, is to assume politicians in Washington allowed this to happen because they know it won't happen. However, it is hard to see how that could be achieved. If the Republicans were to win the White House next year, plus control of both Houses of Congress, the Budget Control Act of 2011 could, of course, simply be scrapped. However, it would be more than disingenuous to reverse policies that reduce the deficit when reducing the deficit was your party's main election platform. If Democrats hold on to the White House, with the President in his then second and last term, he would have no incentive to accede to Republican demands for lower taxes, lower entitlement, and more defense spending. In fact, wouldn't he want to go into history as the President who got the deficit under control? So, no significant change in this scenario either. Do the Democrats have an incentive to change the current deal? Democrats want more stimulus spending and tax cuts for middle and lower income citizens. Republicans could agree to that in exchange for smaller defense spending cuts, but they would then have to abandon efforts to prevent tax increases for higher income earners, which would deliver a political victory to the Democrats. Whichever way you turn it, it's hard to change the course we are on right now.

## Bottom line

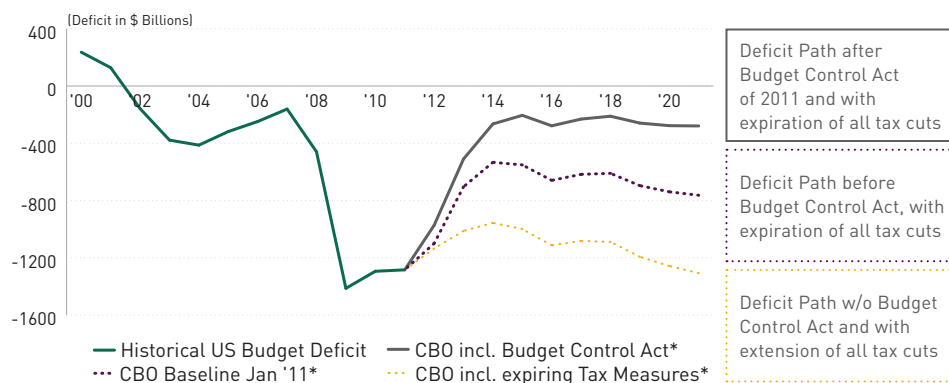
If it's hard to change the deficit reduction course we are on right now, it's time to factor this into economic forecasts. Spending will be reduced and taxes will rise in both 2012 and 2013. The fact that the Republicans' aims have not been achieved greatly reduces the probability of another fiscal stimulus package for 2012; something small may still happen, such as extending Unemployment Benefits, but we are likely to see net fiscal tightening in both 2012 and 2013. My US GDP forecast already factored in some fiscal tightening in 2012. What's new (to me anyway) is the fiscal tightening in early 2013. As a result, I am taking down my forecasts for the first half of 2013 to 1.5% and the full year numbers from 2.8% to 2.2%. ■



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FIGURE 1 *US - Budget Deficit Scenarios<sup>1</sup>*  
November 25, 2011



Source: CBO, PineBridge calculations, as of 25 November 2011.

\*Congressional Budget Office (CBO)

<sup>1</sup> There is no assurance that the forecasts or outcomes will come to pass.

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