KING & SPALDING

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The Budget Control Act of 2011--A Crisis Avoided

***"2010 changed the political landscape in dramatic fashion, and this debt deal represents a major shift to get our fiscal house in order. The terms of these cuts and of the tax and spending battles to come should have every one in America paying attention."* - Former Gov. Robert Ehrlich (R-MD)**

This Client Alert describes how Congress avoided the default of the U.S. Treasury, how it still must reduce government spending by an additional $1.5 trillion in the coming months, and what these cuts in funding can mean to industries such as healthcare, energy and defense.

On Tuesday, August 2, President Obama signed into law the Budget Control Act of 2011 (S. 365; Pub. L. No. 112-25 (2011)) (the "Act") to raise the nation's debt limit and avoid default. Two days earlier, after months of intense negotiations, the President and congressional leaders reached a final agreement on the legislation. Under its terms, the debt ceiling will be raised in tandem with reductions to federal spending. On Monday, the House passed the bill by a vote of 269-161, with 95 Democrats and 66 Republicans voting against it. The Senate approved the bill by a vote of 74-26 the next day, with six Democrats and 19 Republicans voting against it.

While enactment of the legislation prevented what many believe would have been an economic catastrophe, the compromise legislation still will require the Administration and Congress to make some extremely difficult decisions on spending and revenues in order to address the growing federal deficit.

A "Debt Limit" Primer: How Did This Become an Issue?

What is the debt limit and why does it need to be increased?

The debt limit is the legal limit on borrowing by the federal government in order to pay for obligations already incurred. The cap applies to debt owed to the public (*i.e.*, anyone who buys U.S. bonds) plus debt owed to federal government trust funds such as those for Social Security and Medicare. Before August 2, 2011, the last increase took place in February 2010. Since March 1962, the debt ceiling has been raised 74 times.[1] Ten of those instances have occurred since 2001. The debt limit went from less than

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$1 trillion in the 1980s to $6 trillion in the 1990s to the current ceiling of $15.194 trillion projected to last through February 2012.

What is often lost in the debate over increasing the debt limit is the fact that the decisions that drive the need for an increase are a direct result of already enacted legislation that increases spending or decreases revenues.

How was it done in the past?

Article I, Section 8 of the United States Constitution gives the Congress the sole power to borrow money on the credit of the United States. The modern debt limit, in which an aggregate limit was applied to nearly all federal debt, was substantially established by the Public Debt Act of 1941 (P.L.. 77-7). From 1979 through 2010, the House of Representatives, by rule (commonly referred to as The Gephardt Rule), automatically raised the debt ceiling upon passage of a budget resolution, except when the House voted to waive or repeal this rule. The Gephardt Rule was repealed in 2011.

Why was this time different?

With the national debt at its highest point in 50 years as compared to the size of the U.S. economy, the debate about the ceiling became entwined in the issue of the budget. Add to that a huge infusion of new Members of Congress elected in large part on the promise of reducing the size of the federal government and the debt limit issue became a proxy for a larger debate on the mix of methods to narrow the budget deficit over time—significant cuts to entitlement programs and major tax increases.

Legislative Background

Soon after Republicans took control of the House of Representatives in January, Speaker of the House John Boehner (R-OH) announced that passage of the Fiscal Year 2011 budget would be contingent on federal spending reductions. In April, Congress passed legislation to fund the federal government through the end of the fiscal year and avoid a government shutdown. The legislation included $38.5 billion in federal spending cuts.

Later in April, the House passed a Fiscal Year 2012 budget plan that would have reduced long-term federal spending by over $5 trillion. The plan's proposed spending reductions would have come from major changes to entitlement programs. The President released a long-term deficit reduction proposal which included $4 trillion in spending reductions, as well as revenue-raising provisions, specifically the elimination of the "Bush-era" tax cuts. Despite repeated efforts since then to craft a "grand bargain" to raise the debt ceiling and provide for significant long-term debt reduction, fundamental differences between Republicans and Democrats on tax increases and cuts to entitlement spending ultimately prevented a major, long-term debt reduction agreement.

Key Provisions of the Budget Control Act

Process to Increase the Debt Ceiling

The Budget Control Act creates a new, two-step process that allows the President to increase the statutory debt limit but also provides for congressional disapproval of those increases:

- Step One (Maximum of $900 Billion Increase in Debt Limit): By December 31, 2011, the President is authorized to submit to Congress a written certification that the debt of the United States is within $100 billion of the debt limit. Subject to the enactment of a joint congressional resolution of disapproval, the Secretary of the Treasury is authorized to borrow an additional $900 billion. Submission of this certification triggers an automatic $400 billion increase in the debt ceiling. For the remaining $500 billion, Congress is authorized to consider a joint resolution of disapproval of the increase. Rather than an up-or-down vote on raising the debt ceiling, this new process results in a vote on disapproval of the Administration's proposed increase. Failure to enact the joint resolution of disapproval results in a total debt limit increase of $900 billion.

- Step Two (Additional Debt Limit Increase of between $1.2 Trillion and $1.5 Trillion): After the debt limit is increased by $900 billion under Step One, the President is authorized to submit another written certification that the United States is within $100 billion of the debt limit, and the Secretary of the Treasury would be authorized to borrow additional amounts, ranging from:

    - $1.2 trillion, the size of automatic spending cuts if Congress fails to enact any deficit reduction measures (cuts equally divided between security and non-security accounts);

    - $1.5 trillion if Congress passes a balanced budget amendment to the Constitution and sends it to the states for ratification; or

    - if the Joint Select Committee on Deficit Reduction established under the bill achieves an amount greater than $1.2 trillion in deficit reduction, and those recommendations are enacted, the Secretary may exercise authority to increase the debt limit in an amount equal to the deficit reduction, but not greater than $1.5 trillion.

All of these options are subject to the congressional disapproval procedures outlined below.

- Expedited Congressional Procedures to Disapprove Increase in Debt Limit: The Budget Control Act specifies that any joint resolution of disapproval of the debt limit increase must be acted upon—including any veto override if necessary—within 50 calendar days of when the President submits the first certification for the initial $900 billion increase and within 15 calendar days for an additional increase in the debt limit. The expedited congressional procedures for consideration of the joint resolution of disapproval include: pre-established bill text; mandated timelines for floor consideration; a prohibition of any points of order against, or any amendments to, the joint resolution; two hours of debate prior to a vote in the House; and 10 hours for floor consideration in the Senate. Essentially, action on the joint resolution will require only majority votes in the Senate.

Caps on Discretionary Spending

- Caps on Discretionary Appropriations ($917 billion/10 years): Under the Budget Control Act, the immediate $900 billion increase in the debt ceiling would be balanced with $917 billion in savings over 10 years, primarily through the imposition of caps on discretionary spending. For the first two fiscal years of the plan (2012-2013), these caps would take the form of specific allowable dollar amounts per category of spending, divided between "security" funding—funding for the Departments of Defense, Homeland Security and Veterans Affairs, the National Nuclear Security Administration, the intelligence community management account and all budget accounts in international affairs—and "non-security" funding. For Fiscal Year 2012, the Act limits discretionary spending to $1.043 trillion in new budget authority, of which $684 billion is allocated for security spending and $359 billion in non-security spending. For Fiscal Year 2013, the limit would increase to $1.047 trillion, with $686 billion allocated for security spending and $361 billion for non-security spending.

In subsequent years, total discretionary spending would be capped as follows:

Fiscal Year	New Budget Authority (trillions)
2014	$1.066
2015	$1.086
2016	$1.107
2017	$1.131
2018	$1.156
2019	$1.182
2020	$1.208
2021	$1.234

Under the Act, neither the House nor the Senate could consider any bill, joint resolution, amendment, motion or conference report that would cause these discretionary spending caps to be exceeded. However, the Act does allow for additional spending for certain emergencies, the global war on terrorism and disaster relief. In addition, the discretionary caps could be increased to allow for additional appropriations to combat waste, fraud and abuse, on the theory that such spending would in turn save federal funding.

- Sequestration Enforcement Mechanism: In order to ensure enforcement of these discretionary caps, a mechanism termed "sequestration"[2] is included in the Act. Sequestration requires across-the-board reductions to re-balance the budget and would occur 15 days after Congress adjourned at the end of a given session. Each non-exempt account within a category would be reduced by a dollar amount calculated by multiplying the enacted level of sequestrable budgetary resources in that account by the uniform percentage necessary to eliminate a breach in the category. The President could exempt spending for military personnel from sequestration as long as sufficient savings could be achieved through cuts in other portions of the Defense Department budget.

  The Act also provides for look-back sequestration that would allow for reductions in discretionary spending caps for the next fiscal year by the amount of the breach if, after June 30, an appropriation for the fiscal year in progress were enacted that caused such a breach. Within-session sequestration would also be allowed 15 days after enactment of an appropriation for a fiscal year in progress that caused a breach for that year. Additional procedures are set forth for cases involving continuing appropriations measures.

The Congressional Budget Office (CBO) and the OMB share the responsibility for determining levels of enacted discretionary budget authority and outlays. OMB is required to account for any differences in the determinations and is authorized to carry out any sequestration actions.

Joint Select Committee on Deficit Reduction

- Duties: The Act establishes a Joint Select Committee on Deficit Reduction (Joint Committee) to provide Congress with specific legislative recommendations to reduce the federal deficit by $1.5 trillion over the next 10 years.

- Membership: Speaker Boehner, House Minority Leader Pelosi (D-CA), Senate Majority Leader Reid (D-NV) and Senate Minority Leader McConnell (R-KY) will each appoint three members to the Joint Committee within 14 calendar days of the law's enactment. While no names have been floated, Senate Majority Leader Reid has publicly stated that he would select those members "who are willing to make hard choices, but aren't locked in."[3] House Minority Leader Pelosi has indicated that her appointments would go to members who would "fight to protect Social Security, Medicare and Medicaid benefits from cuts."

- Key Dates: The Joint Committee must hold its first meeting within 45 days of the law's enactment. Standing congressional committees can file recommendations with the Joint Committee, but they must do so by October 14, 2011. The Joint Committee's final legislative recommendations are due to Congress no later than November 23, 2011, and Congress must act on them by December 23, 2011. They cannot be amended, and only a majority vote is required to pass them.

- Jurisdictional Issues: All facets of government are technically open to the Joint Committee, but there is already a serious dispute over whether it can provide for additional revenue. That outcome will be determined by the type of CBO baseline the committee decides to adopt. If it chooses the CBO's official baseline, which Republicans insist should be the case, revenue increases would effectively be off the table because that baseline assumes that all the "Bush-era" tax cuts will expire at the end of next year. Revenue increases could also result from any "tax reform" legislation, such as the elimination of a tax reduction.

- Enforcement Trigger for Committee Recommendations: The Act institutes a second sequestration mechanism in order to ensure that the second tranche of cuts occurs and totals at least $1.2 trillion. If the Joint Committee were to fail to act or Congress and the President were to fail to enact the Joint Committee's recommendations, the Act requires automatic across-the-board cuts to most federal programs, including both discretionary and most mandatory spending, including Medicare. Social Security, veterans' programs and many programs targeted to low-income Americans would be exempt from sequestration.

  For cuts to discretionary spending, the definition of "security" and "non-security" categories would be modified under this mechanism so that half of the cuts would occur in the national defense budget account (largely within the Department of Defense). The following revised annual discretionary spending caps would be used to calculate any sequestration amounts:

Fiscal Year	New Budget Authority (trillions)	Security Account Allocation (billions)	Non-Security Account Allocation (billions)
2013	$1.047	$546	$501
2014	$1.066	$556	$510
2015	$1.086	$566	$520
2016	$1.107	$577	$530
2017	$1.131	$590	$541
2018	$1.156	$603	$553
2019	$1.182	$616	$566
2020	$1.208	$630	$578
2021	$1.234	$644	$590

OMB would calculate the total amount of cuts required for each year by starting with $1.2 trillion, subtracting the amount of any deficit reduction achieved by a Joint Committee bill, reducing the difference by 18 percent to account for debt service, and dividing the result by nine.

On January 2, 2013, for Fiscal Year 2013, and in its sequestration preview report for Fiscal Years 2014 through 2021, OMB would then allocate half of the total reduction calculated for that year to discretionary appropriations and direct spending accounts within the national defense budget and half to accounts in all other non-defense functions.

In order to calculate sequestration amounts for Fiscal Years 2014-2021, OMB would reduce the discretionary spending limit for defense by taking the total reduction for defense allocated for that year, multiplying the discretionary spending limit for the revised security category for that year, and dividing by the sum of the discretionary spending limit for the security category and the OMB's baseline estimate of non-exempt outlays for direct spending programs within the defense function for that year. OMB would use a similar formula for calculating sequestration amounts for those years for non-security accounts.

For non-exempt direct spending, the Act requires OMB to follow procedures specified in the Statutory Pay-As-You-Go Act of 2010, except that the percentage reduction for Medicare programs could not exceed two percent for a fiscal year (it is estimated that other programs could see cuts of up to four percent). If the calculated amount required were to exceed two percent, OMB would be authorized to increase the reduction for all other discretionary appropriations and direct spending by a uniform percentage to a level sufficient to achieve the reduction in the non-defense budget function.

Vote on a Balanced Budget Amendment

- The Act requires the House and the Senate to vote on a balanced-budget amendment to the Constitution between October 1, 2011 and December 31, 2011. As provided in the Constitution, the amendment would have to pass each chamber by a two-thirds majority in order for the question to be sent to the states for ratification. Many commentators believe that it is unlikely that two-thirds of the House and Senate will vote for passage, nevertheless, securing guaranteed votes on a balanced-budget amendment has been a top priority for Republicans before and during the debt negotiations.

Impact of The Budget Control Act of 2011: What Does the Future Hold?

Economic Scenarios

Barring major changes to spending and tax policies, "Congress would repeatedly face demands to raise the debt limit."[4]

In June, the CBO reported two scenarios for how debt held by the public will change during the 2010-2035 time period. Neither of them is comforting. The "extended baseline scenario" assumes that the Bush tax cuts (extended by President Obama) will expire per current law in 2012, the alternative minimum tax (AMT) will be allowed to affect more middle-class families, reductions in Medicare reimbursement rates to doctors will occur, and that revenues will reach 23 percent of gross domestic product (GDP) by 2035, much higher than the historical average 18 percent. Under this scenario, government spending on everything other than the major mandatory health care programs, Social Security, and interest on federal debt (activities such as national defense and a wide variety of domestic programs) would decline to the lowest percentage of GDP since before World War II. Under this scenario, public debt rises from 69 percent GDP in 2011 to 84 percent by 2035, with interest payments absorbing four percent of GDP versus one percent in 2011.

The "alternative fiscal scenario" more closely follows what has happened in the past and what many observers expect to occur—permanently extending the Bush tax cuts, restricting the reach of the AMT, and keeping Medicare reimbursement rates at the current level (the so-called "Doc Fix" versus declining by one-third as mandated under current law). Revenues are assumed to remain around the historical average 18 percent GDP. Under this scenario, public debt rises from 69 percent GDP in 2011 to 100 percent by 2021 and approaches 190 percent by 2035.

General Impact

Some industries that could be negatively affected by the Act

- Health Care: For the already embattled health industry, the enactment of the Budget Control Act brings additional challenges. As the Joint Committee deliberates, achieving reductions in health care spending will be at or near the top of their priority list. The new law anticipates that reductions in Medicare spending will encompass a portion of the overall target of the Committee. Significantly, members of the Joint Committee will be under significant cross pressures regarding how they should deliberate, as Medicare providers will likely see an across-the-board reduction in fees of up to two percent if no law is produced and the Administration is forced to sequester funds to meet the debt reduction targets. If a law is not produced, the sequestration does not mandate that every Medicare provider have their payment reduced, but to the extent providers are subject to the sequestration, the payment reductions will be uniform, in terms of percentage reductions.

  The law overtly targets Medicare for payment reductions, but Medicaid and other health care spending are also not immune from the Joint Committee's purview. As such, modifications to Medicaid remain an option, although many Members of Congress may be reluctant to amend any Medicaid provisions of the Accountable Care Act (ACA) due to the potential of impacting ongoing challenges to the health care reform law. Either way, though, manufacturers and providers should expect that virtually all policy initiatives that save money and that were previously discussed by Vice President Biden, the Deficit Commission, MedPAC, the Office of Inspector General or Members of Congress, may be on the table for discussion.

- Energy: Lawmakers on both sides of the aisle expect energy and environment funding to be sharply reduced in the initial $917 billion in cuts. Based upon legislative work thus far in the 112th Congress, House Republican appropriators are expected to target programs related to climate change and the regulation of oil and gas, including Environmental Protection Agency emissions programs, Department of Energy clean energy research funding and State Department funding to assist foreign countries in adapting to climate change. Senate Democratic appropriators are expected to fight these efforts and seek to preserve clean energy funding.

  Once the Joint Committee begins its work to find an additional $1.5 trillion in deficit reduction, it will likely consider a wide variety of energy subsidies, including the elimination of oil and gas industry tax breaks, ending the 45-cent-per-gallon ethanol industry subsidy, and ending tax credits for mature renewable energy technologies. Accordingly, the wind and solar industries, still struggling for wide integration, could find difficult times ahead. And it remains to be seen how the electric car industry, a favorite of the Administration, will fare. The Energy Information Administration (EIA) recently released a congressionally-requested analysis of federal energy spending which may provide an additional roadmap for spending reductions. The EIA report found that, in 2010, federal energy spending totaled $37.2 billion, comprised of $14.6 billion for the renewables sector; $2.5 billion for nuclear power; $1.3 billion for coal; and $2.8 billion for natural gas and petroleum. Given the amount of deficit reduction needed, Members of Congress have come out in support of scrutinizing all energy subsidies—renewables as well as oil and gas assistance.

- Defense: According to the White House, the bill's discretionary spending caps would reduce the defense budget by an estimated $350 billion over the next 10 years. While the Department of Defense has already begun the process of identifying significant spending cuts in order to achieve the President's previous goal of reducing national security spending by $400 billion over the next 12 years, many defense officials and their congressional supporters are concerned about the possibility of additional defense-related cuts resulting from the debt bill. The Joint Committee must identify $1.5 trillion in additional spending reductions by Thanksgiving, and defense funding will almost certainly be on the table. Furthermore, if Congress fails to move the Joint Committee's recommendations, security-related spending would automatically be cut by more than $500 billion.

  Republican negotiators were able to assuage some of the concerns raised by House Armed Services Committee Chairman Buck McKeon (R-CA) and others by successfully including language in the Act that would couple initial cuts to defense spending with other security-related spending. The deeper cuts to security spending required in the second sequestration process would not provide the Department of Defense such shelter. As a result, multiple Republican members of the Senate Armed Services Committee still voted against the debt bill. Although McKeon ultimately supported the bill, he stated, "There is no scenario in the second phase of this proposal that does not turn a debt crisis into a national security crisis." Aerospace Industries Association (AIA) President Marion Blakely echoed these sentiments in her own statement, stating that the bill "dangles a Sword of Damocles over our national security later this year when further cuts would be triggered unless another compromise is reached."[5]

Conclusion

As the Joint Committee works to prepare its deficit reduction recommendations to Congress before the November 23 deadline, stakeholders should consider how they may become involved in its decision-making process. We will monitor developments in this area, and in particular, the Committee process, and report regularly.

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[1] Congressional Research Service, "The Debt Limit: History and Recent Increases" (July 20, 2011).

[2] Sequestration is an enforcement mechanism first introduced in the Balanced Budget and Emergency Deficit Control Act of 1985 (also known as the Gramm-Rudman-Hollings Act) and subsequently in the Balanced Budget and Emergency Deficit Control Reaffirmation Act of 1987 to enforce annually declining deficit targets. It was also used in the Budget Enforcement Act of 1990 and the Budget Enforcement Act of 1997 to enforce discretionary spending limits and PAYGO. Currently, sequestration is used to enforce Statutory PAYGO. Congressional Research Service, "Statutory Limits on Total Spending as a Method of Budget Control" (July 26, 2011).

[3] Politico, "Lawmakers Eye Super Committee" (August 1, 2011), *at* http://dyn.politico.com/members/forums/thread.cfm?catid=1&subcatid=1&threadid=5752159

[4] Congressional Research Service, "The Debt Limit: History and Recent Increases" (July 20, 2011).

[5] Bloomberg, "Draconian Defense Cuts in Debt Deal Tough Target for Deficit Committee" (August 2, 2011), *at* http://www.bloomberg.com/news/2011-08-02/-draconian-defense-cuts-are-tough-target-for-deficit-panel.html.