



The Budget Control Act and Debt Ceiling

Distributed by Aaron Harken and Brad Palmer

Passage of the bill

After months of political posturing and debate, it looks as if the August 2011 debt ceiling issue has finally been resolved. The Budget Control Act was passed by the U.S. House of Representatives 269 to 161, with Democrats split evenly and Republicans voting 174 in favor and 66 against. In the Senate, the bill also passed, with 74 senators in favor and 26 against. Both the president and Republican leadership in the House claimed victory, while rank and file members of Congress on both sides of the aisle maligned the bill as a betrayal of party policies.

Leading up to the deal, Republican goals broadly included no tax increases, significant spending cuts to nondefense expenditures, including entitlement programs, and a balanced budget amendment. Democrats hoped to either raise taxes or close loopholes, cut defense spending, and protect entitlements such as social security and Medicare. Leaders of both parties claimed to want to avoid government shutdown or default, as well as to avoid a downgrade of U.S. debt from AAA status.

Over the months leading up to the Treasury's debt ceiling deadline, Republican and Democrat leadership nearly came to agreement on a number of iterations of a "grand bargain," which would have potentially saved \$4 trillion over the next 10 years and included both tax increases and cuts to entitlement programs. This would likely have been the most effective long-term solution to reducing our national debt. But with pressure from extremes on both sides of the aisle, a second-best deal was agreed upon instead.

In this deal, both Democrats and Republicans had to make concessions, but both achieved some key goals. The passage of the debt ceiling may have helped avoid an immediate crisis in financial markets, but the long-term compromise that was reached lacked the level of spending cuts and/or tax increases that many had hoped for.

Details of the bill

In total, the bill is expected to raise the debt ceiling between \$2.1 and \$2.4 trillion, which should be enough to last past the 2012 elections and into 2013. Deficit reduction is expected to total at least \$2.1 trillion over the next 10 years ending in 2021.¹ Immediately following the passage of the bill, the Treasury was granted \$400 billion of new borrowing authority to raise the debt ceiling. The additional \$1.7 to \$2 trillion in debt ceiling increases will come in two stages, both of which will originate from the desk of the president and be subject to a two-thirds disapproval vote by both houses of Congress.

As for the spending cuts, these will come almost entirely from discretionary spending, meaning that entitlement programs such as social security, Medicare, and Medicaid will be left almost untouched. Initially, \$917 billion in savings from spending caps have been approved. Of these initial cuts, \$350 billion will come from defense² and the balance will come from a variety of discretionary programs, including subsidized student loans for graduate students and loan repayment incentive programs.³

A Congressional Joint Select Committee on Deficit Reduction will also be formed, whose goal it will be to identify an additional \$1.5 trillion in savings over the next five years. This Committee will be handcuffed in

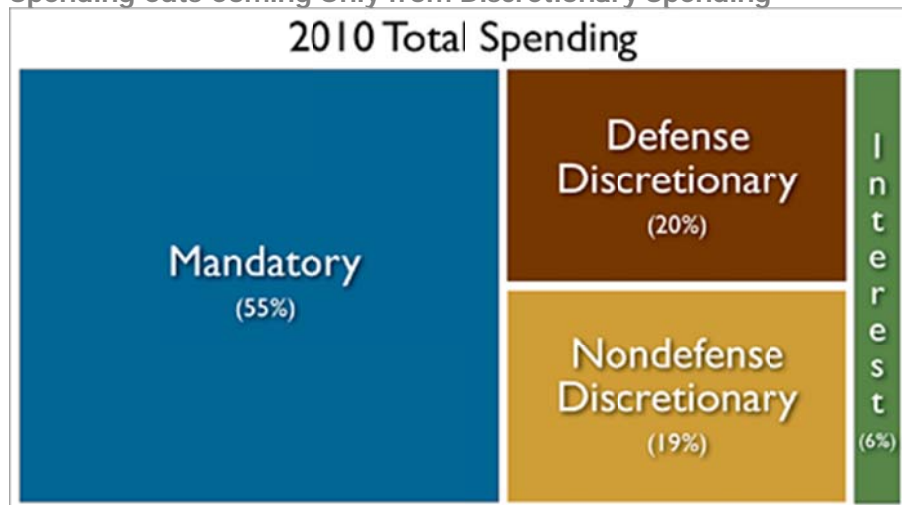
¹ Source: Congressional Budget Office

² Source: *Wall Street Journal*

³ Source: Congressional Budget Office

that it cannot cap spending on the wars in Afghanistan and Iraq and in that Medicaid and social security will be exempt from consideration. Tax increases may technically be allowed under the deal, but will likely be a hotly contested idea once again. Finally, Medicare may be subject to cuts of no more than 2 percent. If the Committee fails to come to an agreement, automatic reductions in spending will reduce deficits by \$1.2 trillion over 10 years.

Spending Cuts Coming Only from Discretionary Spending



Source: Congressional Budget Office

Implications of the bill

As investors, many of us are keenly interested in the economic impact of the passage of this bill. Given the initially poor market reaction after the bill's passage, one might conclude that the overall effect of passage was negative. But some negative market developments should be attributed to weak economic reports, including ISM Manufacturing and GDP, which were published almost concurrently with the bill's approval.

On the whole, from the perspective of the financial markets, passage of the Budget Control Act is at the very least a lesser among evils. Had a bill not been passed—forcing government officials to prioritize spending and avoid default—markets could well have reacted in a much more negative way.

Although this bill must be described as a relief from short-term crisis, its medium- and long-term implications may be less positive. With GDP growth averaging less than 1 percent annualized over the first half of the year, even the modest reductions in spending set to go into effect in 2012 could cause some drag on economic growth.

In the long run, the cuts made in the Budget Control Act may not be sufficient to turn federal budgetary habits in the right direction. In a scenario where deficit savings amount to \$2.4 trillion over the next 10 years, this averages out to a deficit reduction of just \$240 billion per year. Current Congressional Budget Office projections are for average deficits of \$947 billion per year over same time frame, based on President Obama's April 2011 budget. This means that the savings will likely not exceed continued deficit spending and that, eventually, we may face another round of budget-related debate.

Closing thoughts

It is difficult to call the Budget Control Act a clear victory for either party, but it does represent a step in the right direction. At present, the immediate concerns about debt have been alleviated. In addition, regardless of political leanings, everyone can agree that it is encouraging to see Washington addressing these issues now while the public debt is manageable.

Investors will do well to recall that the U.S. economy remains the largest—and is among the most stable—in the world. Our economy and stock market have weathered volatility in the past. Although it may not boost media ratings, there is a case for optimism. The government is under pressure to provide viable solutions for the long-term, rather than a short-term fix. So, too, should investors consider their long-term goals and

strategy when evaluating their personal financial situation. We, too, will be monitoring the activity in Washington and the markets with an eye toward the future.

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