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Federal deficits, economic concerns dominate legislative agenda

Overview

Returning this week, Congress is expected to focus primarily on efforts to reduce federal deficits and promote economic growth. The first key step in the contentious debate over federal deficits will be the deliberations of the Joint Select Committee on Deficit Reduction ("the Deficit Committee"), the 12-member panel established by Congress under the Budget Control Act of 2011. The panel is charged with recommending by November 23 at least $1.2 trillion in deficit reduction, to be followed by an up-or-down vote by Congress before the end of the year.

The Deficit Committee -- sometimes referred to as the "super committee" because of its broad authority -- will have less than 13 weeks to agree on a plan that could include a mix of spending reductions, changes to federal entitlement programs, and revenue-raising provisions. If the Deficit Committee fails to approve legislation with sufficient deficit reductions, or Congress fails to pass such legislation, the Budget Control Act triggers $1.2 trillion in automatic spending cuts beginning in 2013.

Apart from deficit reduction efforts, the Obama Administration and Congress are expected to put forth various proposals to promote jobs. The Congressional Budget Office (CBO) recently revised growth projections for the U.S. economy downward for 2011 and 2012, to 2.4 percent and 2.6 percent, respectively. CBO expects the unemployment rate (now 9.1 percent) to remain high, falling slightly to 8.9 percent by the end of 2011 and 8.5 percent by the end of 2012.

Administration, Congressional proposals

In a September 8 address to a joint session of Congress, President Barack Obama is expected to outline proposals that the Administration believes Congress "can take immediately" to promote jobs and economic growth. The President previously has called for an extension of employee payroll tax relief scheduled to expire at the end of the year and could detail additional tax proposals in his address to Congress.

The President also is expected to reaffirm his support for Congressional approval of free trade agreements with Korea, Colombia, and Panama, along with renewal of federal trade adjustment assistance programs. President Obama last week called on Congress to extend federal aviation and surface transportation programs that are set to expire before the end of September, and is expected to address these items as well in his speech.

Separately, House Republican Majority Leader Eric Cantor (R-VA) recently announced that the House will vote on a series of bills on economic growth, including measures overturning various environmental, labor, and health regulations and repealing a three-percent withholding tax on government contracts set to go into effect in 2013. Senate Democratic leaders have not detailed specific plans for economic growth legislation, but Senator Charles Schumer (D-NY), chairman of the Senate Democratic Policy Committee, recently indicated that the Senate may consider certain tax incentives for investment and job creation.

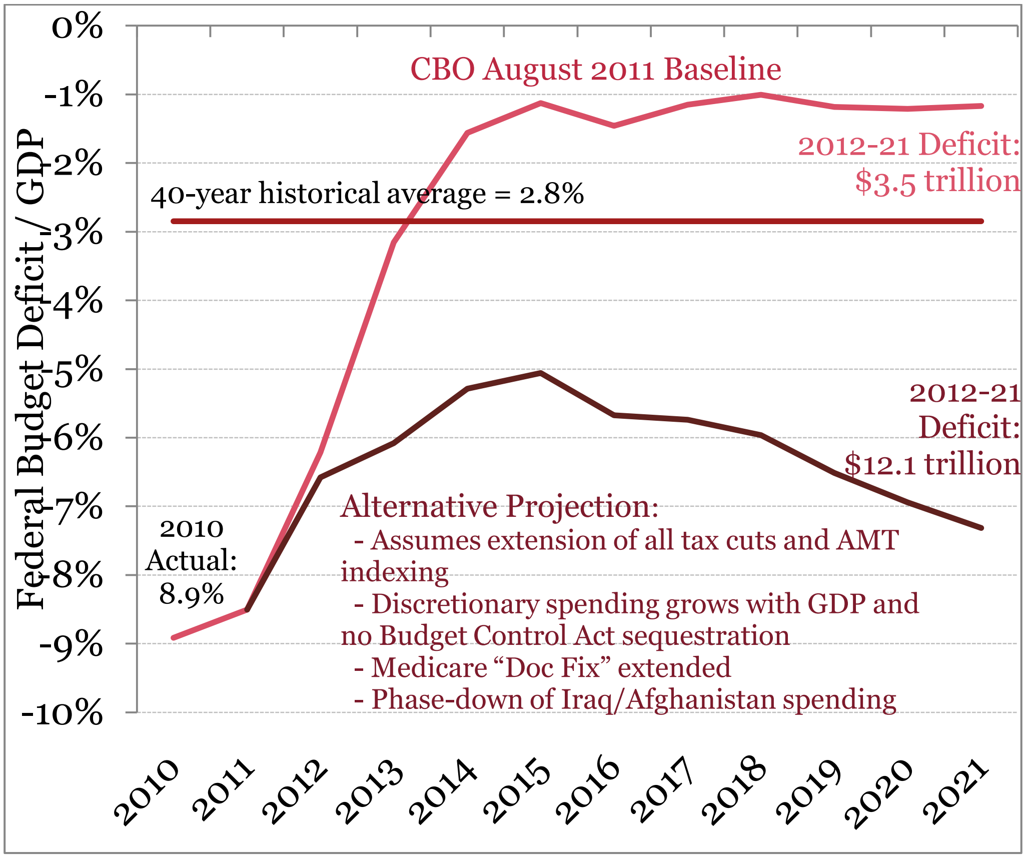
Congress will need to act this month to fund federal departments and agencies after the end of the government's current fiscal year on September 30. In light of this imminent deadline, Congress may need to pass a temporary "continuing resolution" funding some or all federal departments and agencies before October 1, since none of the 12 annual appropriations bills have been enacted to date. Noting past disagreements between the House and Senate over spending levels, Senate Republican Leader Mitch McConnell (R-KY) recently expressed the hope that spending caps agreed to as part of the Budget Control Act will help Congress reach an agreement that will avoid the threat of a federal government shutdown.

A challenge facing both the Obama Administration and Congress will be to achieve significant progress on key legislative goals given the strong policy disagreements that characterized this summer's prolonged debate over raising the federal debt limit. Standard & Poor's cited "the political brinkmanship" of the debt limit debate as a key factor in its recent decision to downgrade the U.S. government's credit rating, noting that policymaking has become "less stable, less effective, and less predictable" than previously believed. Demonstrating effective leadership on deficit and economic growth issues will be a concern for both President Obama and Members of Congress as they look ahead to the 2012 elections.

Current long-term outlook for federal deficits

CBO recently estimated that the federal deficit will reach $1.3 trillion in fiscal year 2011, or about 8.5 percent of GDP. Federal deficits over the past 40 years have averaged 2.8 percent of GDP. Beyond 2011, CBO projects a significant reduction in federal deficits on the basis of (1) the expected impact of the Budget Control Act and (2) an assumed continuation of current law, including expiration of Bush-era individual tax benefits at the end of 2012. Under these assumptions, annual deficits are projected to decline to 3.2 percent of GDP in 2013, 1.6 percent in 2014, and 1.2 percent in 2021.

By contrast, under alternative assumptions, the 10-year cumulative deficit is estimated to increase to $12.1 trillion, as shown in the chart below. CBO projects that extension of all 2001 and 2003 individual income tax reductions and indexing of the individual alternative minimum tax would increase the 10-year cumulative deficit by $4.6 trillion. Also holding federal discretionary spending constant as a share of GDP in contrast to reductions legislated as part of the Budget Control Act -- would increase the 10-year deficit by another $2.8 trillion.



(Source: Congressional Budget Office, August 2011; PwC calculations)

Joint Select Committee on Deficit Reduction

Broad authority

The Budget Control Act provides increases in the federal debt limit and requires deficit reduction. Under phase one of the law, a $900 billion increase in the debt limit is expected to cover federal borrowing costs through the end of 2011, while caps on discretionary spending and other provisions will reduce budget deficits by $917 billion between 2012 and 2021. In phase two, the law provides for a second debt limit increase of between $1.2 trillion to $1.5 trillion, which is tied to the amount of additional deficit reductions to be implemented under the legislation.

The debt limit increases are subject to a Congressional "resolution of disapproval" that the President could veto (thus leaving the debt limit in place assuming the veto is sustained). The law also provides for a vote in the House and Senate on a balanced budget amendment to the Constitution before the end of the year, but does not require passage of the amendment as a condition for increasing the debt limit.

Under the new law, a Joint Select Committee on Deficit Reduction has been organized and directed to propose at least $1.2 trillion in additional deficit reductions by November 23. If approved by the Deficit Committee, such legislation would be considered under expedited, protected procedures by the House and Senate, with an up-or-down vote in each chamber by December 23. Only a simple majority vote (rather than a 60-vote majority as often required in the Senate) would be needed for passage. If passed by Congress, such deficit-reduction legislation would have to be signed by the President to become law.

Failure to enact sufficient deficit reduction would trigger automatic spending cuts, or "sequestration," totalling at least $1.2 trillion between 2013 and 2021. Half of these automatic spending cuts would come from defense spending; the other half would come from nondefense spending, including both discretionary and direct spending. Several direct spending programs would be exempt, including Social Security and other retirement programs, Medicaid, and certain programs benefitting low-income individuals. The legislation would limit Medicare cuts under sequestration to reductions of no more than two percent in payments to providers with no reductions to beneficiaries.

In drafting legislation to achieve the specified deficit reduction savings, the Deficit Committee may consider a mix of spending reductions, changes to federal entitlement programs, and revenue raising provisions. While some recent bipartisan deficit reduction proposals featured significant tax reform proposals, it is uncertain whether the Deficit Committee will include major changes to the current tax code in its recommended legislation.

If the Deficit Committee considers any revenue provisions, the Budget Control Act requires use of the current-law CBO baseline (as discussed above), which assumes that expiring tax provisions, including the 2001/2003 individual tax cuts, will sunset as scheduled. This requirement may limit consideration of broad individual tax reform proposals since the cost of maintaining current levels of tax relief would have to be offset with other deficit reduction savings to meet the goal for overall savings set under the Budget Control Act. The legislation still could include targeted revenue-raising tax provisions affecting specific taxpayers that would count toward the committee's deficit savings goal.

Organization

House and Senate leaders in early August appointed six Democrats and six Republicans to the 12-member panel. Rep. Jeb Hensarling (R-TX) and Senator Patty Murray (D-WA) have been named co-chairs. Rep. Hensarling is Chairman of the House Republican Conference, the fourth ranking member of the House majority leadership; Senator Murray is Secretary of the Senate Democratic Conference, the fourth ranking majority leadership position in that chamber.

The panel also includes the chairmen of both the House and Senate tax committees - Rep. Dave Camp (R-MI) and Senator Max Baucus (D-MT). The House Ways and Means Committee and the Senate Finance Committee have jurisdiction over all federal revenues and major entitlement programs including Social Security, Medicare, and Medicaid.

Other Deficit Committee members with a few exceptions are senior members of the House and Senate leadership:

- Rep. James Clyburn (D-SC) is Assistant House Democratic Leader, the third ranking member of the House minority leadership.

- Rep. Xavier Becerra (D-CA) is Vice Chair of the House Democratic Caucus, and serves on the House Ways and Means Committee.

- Rep. Fred Upton (R-MI) is chairman of the House Energy and Commerce Committee, which shares jurisdiction over Medicaid programs with the Ways and Means Committee.

- Rep. Chris Van Hollen (D-MD) is Ranking Member on the House Budget Committee, and a former Ways and Means Committee member.

- Senator John Kerry (D-MA) is chairman of the Senate Foreign Relations Committee, and a former Democratic nominee for President.

- Senator Jon Kyl (R-AZ) as Senate Minority Whip is the second ranking member of the Senate Republican leadership, serves on the Finance Committee, and is the only member of the committee who has announced plans to retire at the end of the current Congress.

- Senator Rob Portman (R-OH) is a freshman member of the Senate, and has had extensive tax and budget experience as Office of Management and Budget Director for President George W. Bush, a former member of the House Ways and Means Committee, and chairman of the House Budget Committee.

- Senator Pat Toomey (R-PA), also is a freshman member of the Senate, previously served three terms in the House and led the conservative "Club for Growth" political organization before being elected to the Senate.

Rep. Hensarling and Senator Murray recently announced that Mark Prater will serve as Staff Director. Prater currently serves as deputy staff director and chief tax counsel on the Republican staff of the Senate Finance Committee. The Deficit Committee co-chairs noted that Prater has more than 20 years of service on the Finance Committee, and has "helped pass numerous pieces of bipartisan economic growth, tax, health, and employment legislation."

Some of the committee members have participated in other recent deficit reduction efforts. Reps. Hensarling, Camp, and Becerra, along with Senator Baucus, last year were members of the bipartisan President's Commission on Fiscal Responsibility and Reform, which was led by former Clinton Administration chief of Staff Erskine Bowles and former Senator Alan Simpson (R-WY). Senator Baucus also was part of the recent debt limit and deficit reduction negotiations led by Vice President Joe Biden, as were Senator Kyl and Reps. Clyburn and Van Hollen.

Next steps

The Deficit Committee will hold its organizational meeting on September 8. The panel co-chairs also have announced that the committee will hold public hearing on September 13 to hear testimony on factors driving growth in federal deficits from Congressional Budget Office Director Douglas Elmendorf.

Each House and Senate Committee (including the tax-writing committees) is entitled to transmit nonbinding recommendations to the Deficit Committee by October 14. Ways and Means Committee Chairman Camp recently stated that as a member of the Deficit Committee he does not believe the panel should attempt to overhaul the tax code, but he indicated that he is open to including language in the legislation that is reported by the committee that would require Congress to pass tax reform legislation within a specific time period. Some members of the Senate Finance Committee have suggested that additional hearings on specific tax issues should be held in coming weeks to help formulate recommendations to the Deficit Committee.

As noted above, the Deficit Committee is directed to vote on a plan to achieve at least $1.2 trillion in deficit reductions by November 23. A formal report and legislative language is to be submitted to the House and Senate by December 2. Assuming the panel reaches agreement on a deficit reduction plan, the House and Senate must hold an up-or-down simple-majority vote in each chamber by December 23.

Other legislative issues

Corporate tax reform

Since the 112th Congress commenced in January, the House Ways and Means Committee and the Senate Finance Committee have held more than 20 hearings to discuss principles and general issues of tax reform that could establish a framework for developing and analyzing specific tax reform proposals. For prior discussion of these hearings, see WNTS Insight, "Debt limit talks may affect tax reform efforts", June 9, 2011.

Several common themes have been discussed by witnesses during the hearings, including options to lower the corporate income tax rate, broaden the tax base, move toward a "competitive" territorial taxation system, and implement a consumption tax. One general concern expressed by some chief executive officers and other corporate executives testifying on behalf of major U.S. corporations is that the complexity of the U.S. tax system impedes their companies' ability to compete in the global marketplace. Several CEOs have stated that they would be willing to give up various corporate tax expenditures in exchange for a lower corporate tax rate in line with the 25-percent combined national and sub-national OECD average rate.

While it is uncertain whether the Deficit Committee will consider broad tax reform proposals, the House and Senate tax committees are expected to continue holding hearings on tax reform issues. Both Ways and Means Chairman Camp and Senate Finance Committee Chairman Baucus have expressed strong support for building the case for tax reform, but the specific timing for legislative action on this issue remains unclear.

The Senate Finance Committee has scheduled a September 8 hearing on tax reform options related to international issues. Chairman Baucus stated that the hearing would focus on "proposals to improve the tax treatment of international businesses" and would examine proposals for changing the taxation of foreign earnings, the definition of corporate residence, and the "ability to avoid U.S. taxes through tax havens."

Expiring business tax provisions

The Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010 reinstated and extended a number of business tax provisions that had expired at the end of 2009, including the research credit, CFC look-through, Subpart F exception for active financing income, and depreciation rules for certain leasehold improvements. The 2010 Act extended these provisions through the end of 2011.

While bills have been introduced to extend expiring business tax provisions, it is uncertain whether Congress will act on tax extender legislation before the end of the year. The Deficit Committee could decide to address expiring business tax provisions but the cost of such provisions would have to be offset with other deficit reduction savings to reach the goal for overall savings set under the Budget Control Act. As a result, expiring business tax provisions may have to be addressed under regular legislative procedures by the House and Senate. If Congress does not act on expiring business tax provisions before the end of the year, the House and Senate would be expected to consider such legislation in 2012, possibly on a retroactive basis.

For a comprehensive overview of the various business and individual tax provisions covered in the 2010 Tax Relief Act, see WNTS Insight, "Congress approves $858 billion tax and unemployment benefits package; President Obama set to sign legislation", December 17, 2010.

Three-percent withholding

Congress in 2005 enacted legislation requiring federal, state, and local governments to withhold federal income tax equal to three percent on gross payments to any person for property or services, subject to certain exceptions. Congress subsequently delayed the effective date of that requirement until 2012, and the IRS earlier this year issued regulations generally postponing application of the statute until January 1, 2013.

In response to concerns about the significant compliance costs and administrative burdens of this provision, there is significant support in Congress to repeal the provision. Current repeal proposals include H.R. 674, introduced by Ways and Means Committee Member Wally Herger (R-CA); S. 89, introduced by Senator David Vitter (R-LA); and S. 164, introduced by Senator Scott Brown (R-MA).

House Majority Leader Cantor recently stated that the House would vote this fall on legislation repealing the three-percent withholding provision. It is uncertain whether the cost of repeal would be offset with spending reductions or revenue-related proposals. The Joint Committee on Taxation staff previously has estimated that full repeal would cost approximately $10 billion over 10 years. Meanwhile, the IRS has scheduled a public hearing for September 12 to discuss the proposed three-percent withholding regulations.

Energy

President Obama and some Congressional Democrats have proposed repeal of several oil and gas provisions as part of deficit reduction legislation. These proposals include repeal of:

- Section 199 domestic manufacturing deduction for oil and gas companies
- Expensing for intangible drilling and development costs
- Percentage depletion for oil and natural gas companies
- Deduction for tertiary injectants.

The Senate in June voted 73 to 27 to repeal immediately a 45 cents-per gallon ethanol fuel credit (the Volumetric Ethanol Excise Tax Credit), but the House has not approved a similar proposal. This ethanol fuel credit is one of several expiring energy tax provisions that will sunset at the end of this year. As with the general business tax extenders, it is uncertain when Congress may consider expiring energy tax provisions.

Other expiring energy tax provisions include:
- Biodiesel and renewable diesel credit
- Refined coal credit
- Alternative fuel and alternative fuel mixtures credit
- Temporary rule for sales or dispositions to implement FERC or state electric restructuring policy for qualified electric utilities
- Suspension of limitation on percentage depletion for oil and gas from marginal wells.

FAA reauthorization

The House and the Senate earlier this year passed separate multi-year Federal Aviation Administration (FAA) reauthorization bills, but have not yet agreed on final legislation extending FAA programs and related aviation excise taxes in light of differing views about certain labor relations provisions and other issues. The disagreement over FAA programs predates the current Congress, with 21 short-term FAA extension bills having been enacted since 2007.

In late July, because Congress did not reach agreement on a short-term extension of FAA reauthorization, there was a partial shutdown of the FAA and aviation construction projects. On August 5, the Senate approved the House-passed Airport and Airway Extension Act of 2011 (H.R. 2553) providing for a short-term retroactive reauthorization of aviation excise taxes and construction grants. The current extension expires on September 16.

Surface transportation

Congress earlier this year passed a temporary extension of Highway Trust Fund programs that funded highway, transit, and surface transportations programs through September 30. House and Senate leaders have not agreed on the cost or duration of a new multi-year surface transportation bill, so another short-term extension measure may be needed.

Trade agreements

Senate Majority Leader Harry Reid (D-NV) and Senate Minority Leader Mitch McConnell (R-KY) announced an agreement on August 3 to move forward outstanding free trade agreements with South Korea, Colombia, and Panama. Action on these pacts, which were completed between 2006 and 2007, had been stalled as Senate Democrats and Republicans worked to find a compromise on renewal of Trade Adjustment Assistance programs.

In a joint statement by the Senate leaders, Senators Reid and McConnell indicated that the Senate plans to consider a "bipartisan compromise on the Trade Adjustment Assistance Program, followed by passage of the three FTAs" when it returns from recess. The worker assistance program is estimated to cost $640 million through 2013. Under the agreement reached by Senators Reid and McConnell, the free trade agreements and the TAA legislation will be considered separately.

The House on September 7 is scheduled to consider a trade bill (H.R. 2832) extending the generalized system of preferences (GSP), and Senate leaders have indicated that this bill may be amended in the Senate to provide for TAA renewal. Assuming Congress enacts TAA renewal as part of this GSP legislation, the Obama Administration then would formally submit the pending free trade agreements for consideration under "fast-track" Trade Promotion Authority procedures.

Tax treaties

On July 26, the Senate Foreign Relations Committee reported to the full Senate the new U.S.-Hungary tax treaty and protocols to the Luxembourg and Switzerland treaties, with the recommendation that all three pacts be approved. Consistent with other recent U.S. treaties, the U.S.-Hungary treaty, which was signed on February 4, 2010, contains a limitation on benefits article; however, unlike newer treaties with other European Union countries, it does not provide an exemption from tax for certain parent/subsidiary dividends. The Luxembourg and Swiss protocols, both signed in 2009, include updates to the exchange of information provision in the existing treaties. The Swiss protocol also includes a mandatory binding arbitration provision that will be used to address any double taxation disputes that cannot be resolved by the Competent Authorities in the two countries.

Assuming ratification by the Senate later this year, the three accords will enter into effect upon the exchange of instruments of ratification between the treaty partners.

A new U.S.-Chile tax treaty was signed on February 4, 2010, but has not yet been the subject of hearing by the Senate Foreign Relations Committee. It is understood that U.S. and Polish officials are close to completing negotiations on a new U.S.-Poland tax treaty. Tax treaty talks are expected to continue with various other countries, including Spain, the United Kingdom, Brazil, Colombia, Venezuela, Vietnam, and Malaysia, as well as possible further changes to the treaty with Switzerland.

State tax legislation

On May 12, Senate Finance Committee Member Ron Wyden (D-OR) introduced the Digital Goods and Services Tax Fairness Act of 2011 (S. 971), which would prevent states from imposing certain discriminatory and excessive taxes on providers and consumers of digital goods and services. A related bill (H.R. 1860) was introduced in the House by House Judiciary Chairman Lamar Smith (R-TX). The House Judiciary Subcommittee on Courts, Commercial and Administrative Law addressed this bill in a May 23 hearing; however, there has been no recent Congressional action.

Also in May, Representative Howard Coble (R-NC) introduced the Mobile Workforce State Income Tax Simplification Act of 2011 (H.R. 1864). The bill provides for a 30-day threshold to limit the authority of states to tax and require withholding on certain income of employees in non-resident states. The House Judiciary Subcommittee on Courts, Commercial and Administrative Law held a May 25 hearing on this bill.

On July 7, the House Judiciary Committee approved a Business Activity Tax Simplification Act (H.R. 1439). This bill would provide a codified physical presence nexus standard, and includes a 15-day de minimis period for the imposition of a business activity tax.

On July 14, the House Judiciary Committee also approved the Wireless Tax Fairness Act (H.R. 1002). This bill would bar a State or local jurisdiction from imposing a new discriminatory tax on or with respect to mobile services, mobile service providers, or mobile service property during a five-year period beginning on the date of enactment. A similar bill (S. 543) was been introduced in the Senate and referred to the Senate Finance Committee for consideration.

More recently, the Main Street Fairness Act was introduced in both the House (H.R. 2701) and the Senate (S. 1452) in late July. The Act would allow states that simplify their sales and use tax systems to impose a sales and use tax collection requirement on remote sellers, such as catalogue and Internet sellers.

Tax policy personnel changes

On August 29, President Obama nominated Alan Krueger to chair the White House Council of Economic Advisers. Dr. Krueger would replace Austan Goolsbee, who stepped down as CEA chairman in early August. Dr. Krueger, who teaches economics at Princeton University, was the Treasury Department's chief economist in 2009-2010. While at Treasury, he was involved in several stimulus initiatives, including the Build America Bonds program. Dr. Krueger's nomination is subject to confirmation by the Senate.

President Obama has not yet named a replacement for Treasury Assistant Secretary for Tax Policy Michael Mundaca, who stepped down in May. Responsibility for the Treasury tax policy office currently is being shared by Deputy Assistant Secretary for Tax Policy Emily McMahon and Deputy Assistant Secretary for Tax Analysis Mark Mazur.

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