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www.eurobank.gr/research
research@eurobank.gr

GLOBAL ECONOMIC & MARKET OUTLOOK

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FOCUS NOTES

Olga Kosma
*Economic Analyst*
*okosma@eurobank.gr*

# US Fiscal Policy: The sequestration process and its implications

- The automatic spending cuts under sequestration took effect at the beginning of March, amounting to $85bn cuts to budget authority in FY2013 and $109bn cuts through FY2014-2021.
- The bulk of sequestration concerns discretionary spending, with an "effective" reduction of 13% in defense and 9% in non-defense discretionary.
- Our baseline scenario suggests that the automatic spending cuts will finally remain in effect. Nevertheless, Congress could reformulate the cuts to provide government agencies with more flexibility in managing the budget cuts under the sequester.
- According to our estimates, the sequestration process is expected to subtract 0.5% from GDP growth in 2013. The equivalent effect on the US labor market is a reduction of about 750k in full-time jobs.
- Overall, we expect a deceleration of real GDP growth to around 1.5% y-o-y in 2013 from 2.2% in 2012, provided that the size of the fiscal restraint reaches 1.5% of GDP, i.e. 1% drag from tax increases and 0.5% from spending cuts.



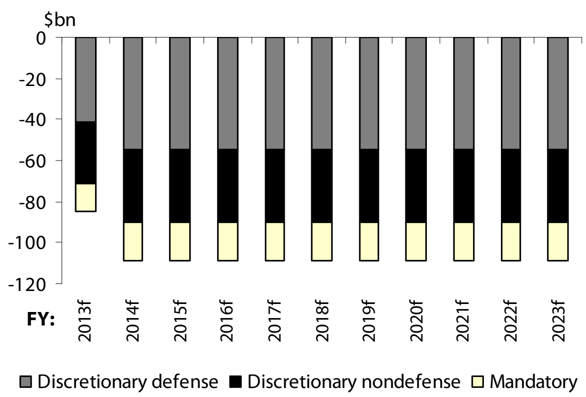
## What is sequestration and how did we get here?

As of March 1, the US federal budget is subject to sequestration, the automatic across-the-board spending cuts that amount to $1.2 trillion over the next decade. Sequestration has its origin in the Budget Control Act of 2011 (BCA), which was signed by Congress and President Obama in the summer of 2011 in exchange for a debt ceiling increase. In particular, the BCA raised the debt limit by $2.1 trillion and included $2.1 trillion in spending cuts and other savings over the following ten years. Caps on expected discretionary outlays for many agency budgets were estimated to reduce government spending by $900bn, and the remainder $1.2-1.5 trillion deficit reduction was to be achieved by the Joint Select Committee on Deficit Reduction (the so-called Super Committee). If the Super Committee failed to agree to the additional spending cuts, then automatic spending cuts worth $1.2 trillion would be enacted over a nine-period (2013-21) evenly split between defense and nondefense programs. The Super Committee actually failed to agree on a deficit reduction package, so the sequester legislation took effect. Sequester spending cuts were initially slated to begin in January 2013, but the American Taxpayer Relief Act (i.e. the new fiscal cliff deal passed on January 2) delayed the start-date for the sequestration until March 1, 2013.

**How big are the automatic spending cuts and which government functions are affected?**

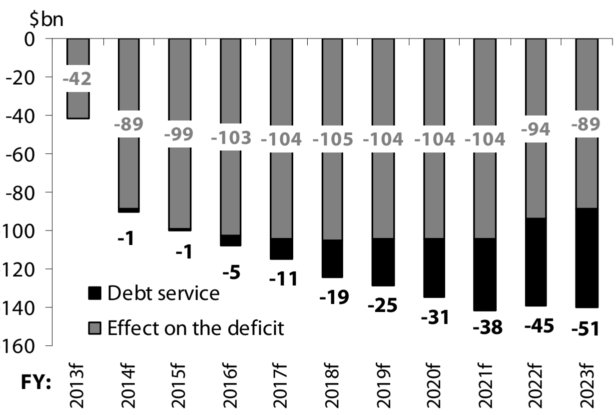
According to the latest estimates from the Congressional Budget Office (CBO)[1], the automatic budget cuts amount to \$85bn in fiscal year 2013 and to \$109bn in each of the remaining eight fiscal years of the sequestration (Figure 1). The automatic budget cuts refer to the reduction in budgetary resources available to government agencies. However, not all of that money would have been spent in a specific fiscal year if it hadn't been for the sequestration: a portion of that money would have been used for goods or services to be provided and, consequently, paid in subsequent years. For example, the acquisition of major weapons systems or the completion of large construction projects can take several years to be completed. Hence, CBO projects that sequestration will reduce cash disbursements by \$42bn in fiscal year 2013 and \$89bn in fiscal year 2014. Much of the remaining decline in outlays from the 2013 sequestration will occur in fiscal year 2014, and some will occur in the following years (Figure 2).

**Figure 1**
**Projected spending cuts to budget authority**
(Fiscal Year)




*Source: Congressional Budget Office, Eurobank Research*

**Figure 2**
**The actual outlays reduction due to sequestration**
(Fiscal Year)




*Source: Congressional Budget Office, Eurobank Research*

Many key programs of the budget are exempted from sequestration, including Social Security, all low income programs (Medicaid, Temporary Assistance for Needy Families-TANF, Supplemental Nutritional Assistance Program-SNAP), military personnel and overseas combat operations. Medicare payments to physicians and other health care providers are projected to be reduced by only 2%, representing \$11bn of the total \$85bn sequestration for this fiscal year, with no direct cuts to beneficiaries. The bulk of sequestration concerns discretionary spending, with a reduction in budgetary resources for defense (other than spending for military personnel) of about 8.0% across the board (representing \$43bn of the total \$85bn), and a reduction in budgetary resources for nondefense programs of about 5-6% (representing \$31bn of the total \$85bn). However, the spending cuts must be achieved over the next seven months as the US fiscal year ends on September 30, so the "effective" reduction in spending is about 13% for defense programs and about 9.0% for non-defense discretionary spending.

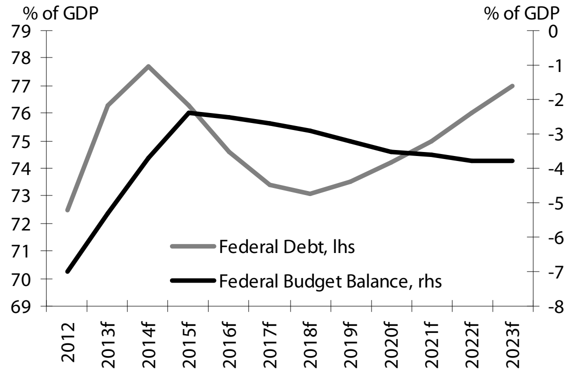
**What are the baseline budget projections, if we take into account the sequestration process?**

Figure 2 shows the effect of sequestration on the deficit broken down by fiscal year. According to the CBO's estimates, federal spending will be reduced by \$42bn in the remainder of fiscal year 2013 and by \$995bn over the 2014-2023 period, plus another \$228bn savings from lower debt service. The CBO's baseline scenario includes a federal deficit reduction to more normal levels over the next few years due to fiscal consolidation, declining from 7.0% of GDP in 2012 to -2.4% of GDP in 2015, which equals the average deficit over the last 50 years (Figure 3). The projected improvement in the federal budget deficit is attributed to tax increases and spending cuts, which have been applied at a very

[1] *Congressional Budget Office, "The Budget and Economic Outlook: Fiscal Years 2013 to 2023", February 2013.*

rapid pace, and a cyclical improvement in the US economy as well. Nevertheless, federal budget deficit is projected to increase later in the coming decade, due to the pressures of an aging population, rising health care costs, an expansion of federal subsidies for health insurance, and higher interest costs on federal debt. As a result, federal public debt is projected to remain historically high relative to the size of the economy for the next decade. CBO estimates that if current laws remain in place, public debt will generally be on an upward trend over the following years, reaching 77% of GDP by 2023.

**Figure 3**
**CBO's Baseline Budget Projections**




*Source: Congressional Budget Office, Eurobank Research*

**Will sequestration be modified, or will be rather implemented in full?**

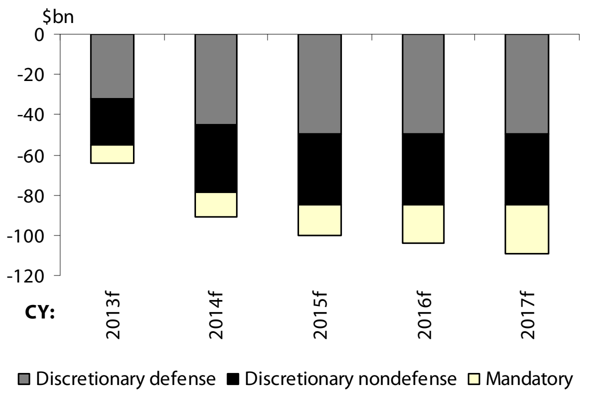
It is not the first time that a sequestration process is being implemented in the US. Automatic spending cuts under sequestration took effect in fiscal years 1986, 1988 and 1990, and Congress intervened to reduce the impending cuts two out of three times (in 1988 and 1990). This time around, the automatic spending cuts took effect at the beginning of March, so many government agencies have issued 30-day notices to their employees of potential furloughs so as to meet their reduced budgets. However, market participants had been expecting since the beginning of the year that Congress would scale back the full impact of sequestration when it extended spending authority on 27 March. Senate Democrats have proposed to replace some of the automatic spending cuts in 2013 with outlays cuts or tax increases (for personal income over $1million) over the next several years. Although we cannot rule out an agreement that reduces the short-term effect of sequestration, the latest developments increase the likelihood that a government shutdown will be avoided at the end of March, leaving in place the impacts of sequestration. The Republican House of Representatives passed a continuing resolution last week to extend spending authority from March 27 to the September 30, maintaining the lower spending levels required by sequestration. Senate Democrats will probably make some adjustments to the House-passed bill before passing it over the next few days, removing the threat of a disruptive government shutdown.

Although the replacement of the 2013 cuts under sequestration with other deficit reduction measures does not look very likely, Congress could reformulate the cuts to provide government agencies with more flexibility. Under the Budget Control Act, sequestration must be implemented by a uniform percentage at the program, project and activity level within each budget account. This rule limits the flexibility that government agencies have in managing the budget cuts under the sequester. In particular, the Department of Defense, which faces the bulk of the automatic spending cuts (half of the total $85bn), has noted that it would need more discretion to direct cuts in the correct appropriations, reducing the severity of funding cuts in specific areas like facilities, ship and aircraft maintenance. The failure to reduce or reformulate some of this year's sequester cuts during March suggests that the scheduled cuts will probably be implemented for at least a few months. The next chance for Congress to address sequestration will be in May, when the debt limit suspension ends. Given that the Treasury can take "extraordinary measures" to remain below the debt limit by about 2-3 months, the next key date for negotiations is the beginning of August.

**What are the economic effects of the sequestration process?**

The sequestration process is expected to add further pressure to the economy starting mainly from the second quarter of the year. The sequester budget cuts will reduce cash disbursements by about $42bn in fiscal year 2013, with about 80% of the cuts implemented in discretionary funding and 20% in funding for mandatory programs. Adjusting these estimates to a calendar year basis, we expect that sequestration will reduce federal spending by about $60-65bn in calendar year 2013 and about $90bn in calendar year 2014, with the level of cuts continuing to increase gradually thereafter (Figure 4). The effect of the projected spending cuts on economic growth depends on the size of the "fiscal multiplier", i.e. the ratio of a change in GDP to the change in government spending, which measures the degree to which reductions in federal outlays flow through to output. There is an extensive academic literature on fiscal multipliers, which concludes that the multiplier on government expenditures is larger than the multiplier on tax increases. This is so because public outlays reduce directly demand and feed into GDP, while households have the ability to moderate the negative effect of a tax increase on consumption and, consequently, on growth by reducing their savings. CBO's analysis gives a wide range of estimates for the government spending multiplier, with the low estimate equaling 0.5 and the high estimate equaling 2.5.

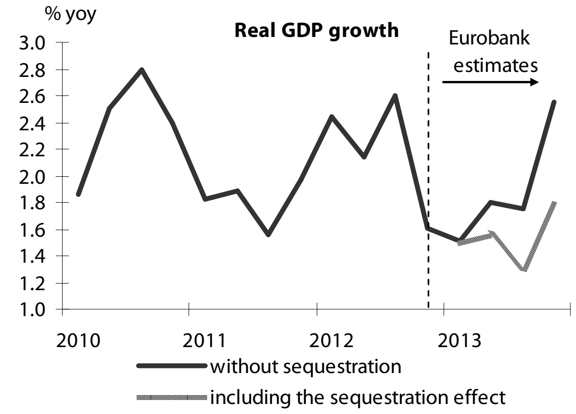
**Figure 4**
**The actual outlays reduction due to sequestration**
(Calendar Year)




*Source: Congressional Budget Office, Eurobank Research*

Our growth estimates assume a "fiscal multiplier" on government spending of about 1.2, which is near the middle of the range of estimates in the economic literature regarding public outlays. That said, a one dollar reduction in federal spending translates to a 1.2 dollar reduction in GDP. Therefore, we expect a 0.5% sequester-related drag on GDP in 2013 (Figure 5). Although the level of the automatic spending cuts under sequestration is expected to increase further in the following years (Figure 4), the rate of change will be much more gradual by then so the largest drag to GDP growth should be in 2013. The effect on Q1 GDP growth will be minor since furloughs will probably be enacted at the end of March, so the peak effects will concentrate on the remaining three quarters of the year. Meanwhile, the CBO estimates that the automatic spending reduction will have reduced employment by 750k by the end of 2013, which is equivalent with a 0.5% reduction in employment. Hence, our forecast for the unemployment rate in 2013 has moved to an annual average of 7.6%, from 7.4% a month ago. Overall, we expect a deceleration of real GDP growth to around 1.5% y-o-y in 2013 from 2.2% in 2012, provided that the sequester cuts remain in effect and the size of the fiscal restraint reaches 1.5% of GDP. The tax increases represent about two thirds of the total restraint, amounting to around $200bn. Given that tax multipliers tend to be less than 1, we estimate that the revenue side will reduce growth by about 1.0%, adding to the 0.5% drag from the spending side.

**Figure 5**
**Sequestration will further drag GDP growth**




*Source: Eurobank Research*

**Other fiscal policy issues**

Although the major fiscal policy choices that affect economic prospects in 2013 have already been made (the New Year's fiscal deal and the sequestration process), there are other fiscal policy issues that could potentially pose downside risks to the outlook.

By late March, Congress will need to extend the current "continuing resolution", which was most recently extended in September 2012 until March 27. A continuing resolution is a type of appropriations legislation used by the Congress to fund nonessential functions of government agencies, if a formal appropriations bill has not been signed into law by the end of a fiscal year. Although a partial shutdown of the federal government looked likely in the first two months of the year, this risk has actually evaporated in recent weeks. The House passed its continuing resolution last week and the Senate is currently debating the conditions under which it will temporarily extend spending authority for the remainder of the fiscal year 2013, with its passage probably coming next week.

Furthermore, Congress faces a budget resolution deadline on April 15. In exchange for suspending the debt limit, both chambers of Congress were committed to pass their budget resolutions for fiscal year 2014 by mid-April. If either body fails to adopt a budget resolution, members of that body will not receive their salary payments until that body passes a budget. Up to now, both the Senate and the House have released their budget resolutions, and will probably vote on them over the next couple of weeks. The Senate's budget would result in less fiscal restraint in fiscal year 2014 than the approach taken by House Republicans, with spending being roughly $184bn (i.e. 1.1% of GDP) higher in the Senate's proposal than in the House's plan.

Last but not least, the debt ceiling, which was temporarily suspended in early February, will be reinstated in mid-May. We expect the Treasury to be able to continue borrowing using several accounting strategies ("extraordinary measures") through August, so Congress should increase the debt limit by early August at the latest. The implementation of sequestration suggests that the next increase in the debt limit will likely be enacted more easily, as Republicans urgency to demand further cuts in exchange for a debt ceiling increase has faded. However, we cannot rule out the possibility that Congress cannot reach an agreement on a common budget plan this spring and Republicans use the debt limit debate to force a favorable budget deal.

## Research Team

**Editor,** Professor **Gikas Hardouvelis**
*Chief Economist & Director of Research Eurobank Group*

### Financial Markets Research Division

**Platon Monokroussos:** *Head of Financial Markets Research Division*
**Paraskevi Petropoulou:** *G10 Markets Analyst*
**Galatia Phoka:** *Emerging Markets Analyst*

### Economic Research & Forecasting Division

**Tasos Anastasatos:** *Senior Economist*
**Ioannis Gkionis:** *Research Economist*
**Vasilis Zarkos:** *Economic Analyst*
**Stella Kanellopoulou:** *Research Economist*
**Olga Kosma:** *Economic Analyst*
**Maria Prandeka:** *Economic Analyst*
**Theodosios Sampaniotis:** *Senior Economic Analyst*
**Theodoros Stamatiou:** *Research Economist*

Eurobank EFG, 20 Amalias Av & 5 Souri Str, 10557 Athens, tel: +30.210.333 .7365, fax: +30.210.333.7687, contact email: Research@eurobank.gr





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