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MACROCOSM

Do the Sequesters Matter?

Friday, February 8, 2013

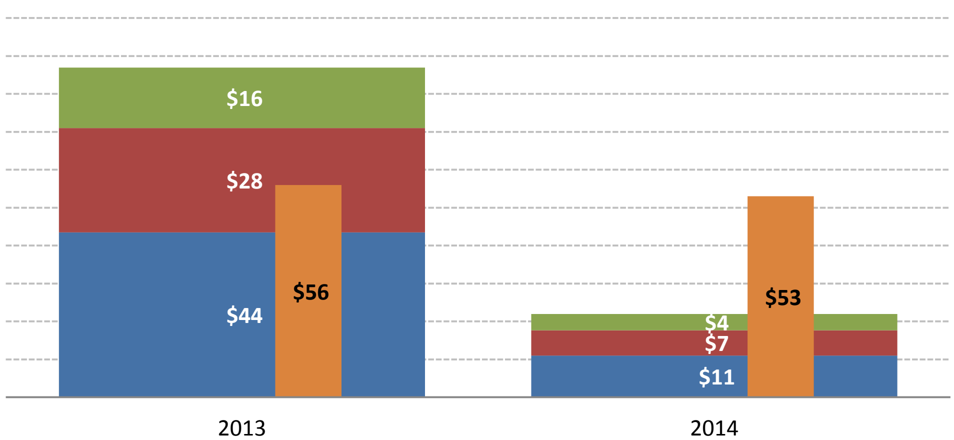
Donald Luskin

Not so much. A "trillion in deficit reduction" is really only a $109 billion one-off spending cut.

The next policy threat to the economy is the onset of the sequesters -- the automatic cuts in federal spending imposed by the Budget Control Act of 2011. Originally they were to take effect on January 1, but the American Taxpayer Relief Act of 2012 cancelled them for January and February, so they are now scheduled to take effect on March 1. It is possible they will be delayed or otherwise modified, but we don't expect that at this time. So let's look at their economic impact, assuming that they do indeed take effect on March 1.

- We estimate based on Congressional Budget Office analysis that the sequesters will reduce budget authority for the federal government by $87 billion in calendar 2013.
- Of that, about $43.5 billion will apply to defense, $27.5 billion to non-defense discretionary spending, and $16 billion to Medicare (please see the chart below).
- In calendar 2014 an additional reduction of $22 billion will kick in, divided $11 billion in defense, $6.7 billion in discretionary and $4.3 billion in Medicare.
- So in total, $109 billion in reductions will take effect over two years.
- It will take some time for this reduction in budget authority to work through the pipeline into actual reductions in outlays.

Budget authority: **Defense** **Discretionary** **Medicare**
Outlays: **Total** USD billions, calendar year



Source: Congressional Budget Office, TrendMacro calculations

Update to strategic view

US MACRO: We think the sequesters will go into effect at the end of the month. This will mean a one-time $109 billion cut in federal outlays spread across 2013 and 2014. But after that shock, federal spending will begin to grow again, and will be back to last year's level within five years (even without considering growth of entitlement spending). This will be another demand-side blow to growth this year, but hardly the catastrophe being portrayed in Washington and in the media. We estimate that, at most, it could reduce GDP by 35 bp in 2013 and 33 bp in 2014.

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- We estimate that about $56 billion will hit in calendar 2013, and the remaining $53 billion in 2014 (again, please see the chart on the previous page).
- *This is the entire effect of the sequesters. Nothing happens in subsequent years. These cuts in outlays only happen once -- they are not repeated.*
- This key fact is not widely understood. That's because the politicians always speak of the sequesters in terms of *cumulative deficit reduction*, not in terms of *spending cuts*. The *cuts* of a single 12-month period are multiplied by however many years they wish, usually ten. But the reality is that the *cuts* only happen once.
- Furthermore, the often-quoted cumulative deficit reduction figures are exaggerated by inclusion of debt service savings.
- Once the cuts have been made initially -- in 2013 and 2014 -- then budget authority rises from the lowered base.
- *We estimate that outlays will work their way back to their 2012 levels in five years, and be higher than when they started by the end of the decade of so-called deficit reduction required by the Budget Control Act* (please see the chart below).

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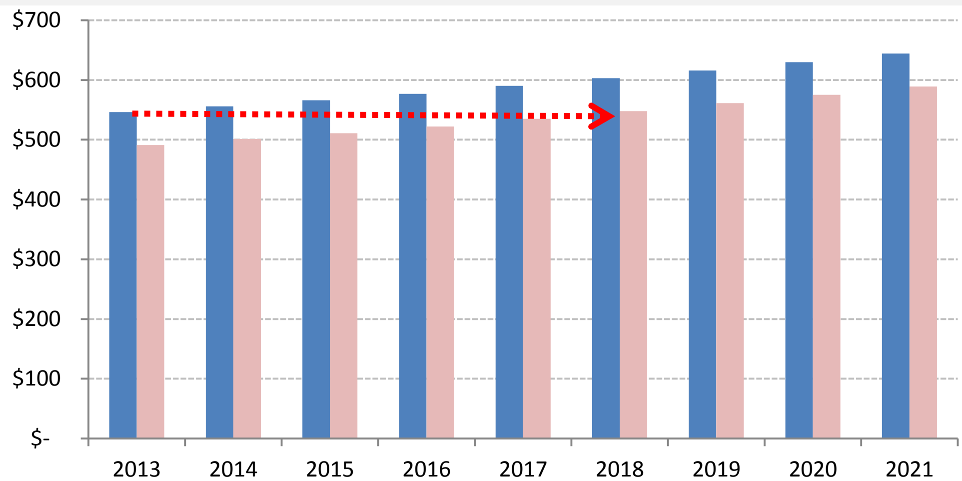
Defense budgetary resources: CBO baseline After sequester
USD billions, fiscal year



Source: Congressional Budget Office, TrendMacro calculations

So we should think about the sequesters as a one-time $109 billion shock that will hit in 2013 and 2014, and then go away. How bad a shock?

- Political utterances on the subject are exaggerated to the point of sheer nonsense. In a speech Wednesday, Defense Secretary Leon Panetta warned, "We will furlough as many as 800,000 DOD civilians." But the Department of Defense's own website admits that it employs a *total* of only "718,000 civilian personnel."
- News reports are amplifying the misinformation. A *New York Times* story this week stated as fact that the sequestrations put "at least one million jobs on the line."

- The $109 billion shock from the sequestrations is very similar in magnitude to the $120 billion shock from the expiration of the payroll tax "holiday" under ATRA (see "Tax Hikes Have Consequences" January 2, 2013).
- A simple demand-side analysis makes them both a blow to growth for 2013, and to some extent this informs our unenthusiastic outlook (see "2013 Outlook: Think Globally, Shrink Locally" January 14, 2013).
- But the payroll tax hits entirely in 2013, where it represents about 76 bp of GDP. The sequesters will be spread evenly across 2013 and 2014, representing about 35 bp and 33 bp respectively.
- And the payroll tax hike is also an important supply-side blow to labor contribution, in an economy where labor force participation has been falling for a dozen years. Such a blow further erodes the already damaged labor platform on which future growth depends.
- On the other hand, the sequesters -- while costly to growth in the short term, perhaps -- are a salutary *offset* to a decade of rapid expansion of government spending, deficits and debt which itself threatens future growth.
- We do not believe that this spending has produced a significant increment to growth, and so we don't see why a small offset to it should be especially damaging.
- The worst risk now is that congress might follow President Obama's vision of replacing the sequesters with tax hikes. That would replace a mere demand-side blow with a one-two supply-side punch.
- We believe that is very much a non-starter in the House of Representatives, with the GOP having acquiesced to tax hikes just last month. If Obama and the Democrat-controlled Senate insist on that condition, then we see little reason to think that the sequesters could be averted.

Bottom line

We think the sequesters will go into effect at the end of the month. This will mean a one-time $109 billion cut in federal outlays spread across 2013 and 2014. But after that shock, federal spending will begin to grow again, and will be back to last year's level within five years (even without considering growth of entitlement spending). This will be another demand-side blow to growth this year, but hardly the catastrophe being portrayed in Washington and in the media. We estimate that, at most, it could reduce GDP by 35 bp in 2013 and 33 bp in 2014.