Automatic Reductions in Government Spending -- aka Sequestration

posted by Wendy Edelberg on February 28, 2013

We have received many questions in recent days about the budgetary and economic implications of the automatic reductions in government spending that are scheduled to occur under current law (in technical terms, a sequestration). So, we thought it would be helpful to pull together our answers to some of those questions, incorporating information from our most recent economic and budget projections released earlier this month and from CBO's recent Congressional testimony:

How Will Budgetary Developments in 2013 Affect Economic Growth This Year?

In fiscal year 2013, by CBO's estimates, federal revenues will rise and outlays will decline as shares of gross domestic product (GDP), resulting in a federal budget deficit equal to about 5.3 percent of GDP (compared with 7.0 percent last year). The fiscal policies that reduce the deficit will lead to less demand for goods and services, thereby holding down economic growth this year, as CBO reported in *The Budget and Economic Outlook: Fiscal Years 2013 to 2023* (http://www.cbo.gov/publication/43907). If not for that fiscal tightening, CBO estimates, economic growth in 2013 would be roughly 1½ percentage points faster than the 1.4 percent real (inflation-adjusted) growth that the agency now projects, under current laws, from the fourth quarter of calendar year 2012 to the fourth quarter of 2013.

How Are Changes in Tax and Spending Policies Contributing to That Outcome?

The fiscal tightening in 2013 is mostly a result of two developments: the expiration of certain tax policies that will lead to an increase in tax revenue (relative to 2012, payroll tax rates are higher and tax rates on income above certain thresholds have increased); and the automatic spending reductions scheduled to occur under current law (the sequestration). In the absence of those policies, real GDP would grow about 1¼ percentage points faster between the fourth quarter of last year and the fourth quarter of this year, CBO estimates. (The remaining ¼ percentage point reduction in economic growth due to fiscal tightening comes from other, smaller changes in spending and taxes.) The expiration of those tax provisions and the automatic spending cuts account for about equal portions of that 1¼-percentage-point effect. The spending changes have a smaller budgetary impact than the tax changes, but they affect GDP by a larger amount per dollar of budgetary cost.

In the absence of sequestration, CBO estimates, GDP growth would be about 0.6 percentage points faster during this calendar year, and the equivalent of about 750,000 more full-time jobs would be created or retained by the fourth quarter. By CBO’s estimate, extending the tax provisions that expired would have similar positive effects on output and jobs. Those economic effects represent CBO’s central estimates, which are based on the assumption that the values for key aspects of economic behavior are the midpoints of CBO’s ranges for those values.

How Big Are the Automatic Spending Reductions in 2013 and 2014?

The economic effects of changes in federal spending in this calendar year reflect the budgetary effects of the automatic spending reductions in fiscal year 2013 (which ends in the third quarter of calendar year 2013) and in the beginning of fiscal year 2014 (which includes the fourth quarter of calendar year 2013). As reported in Table 1-7 of *The Budget and Economic Outlook,* (http://www.cbo.gov/publication/43907) CBO projects that sequestration will reduce the deficit by $42 billion in fiscal year 2013 and that this year’s sequestration and automatic spending reductions next year will reduce the deficit by $89 billion in fiscal year 2014. CBO did not attempt to project the precise timing or detailed composition of this year’s spending reductions. Instead, our estimates are based on historical observations of the timing of the broad types of spending that will be affected.

Why Does CBO Expect the Sequestration to Reduce Outlays by Just $42 Billion in Fiscal Year 2013 Even Though the Automatic Budget Cuts Total $85 Billion This Year?

The $85 billion represents the reduction in budgetary resources available to government agencies this year as a result of the sequestration. But not all of that money would have been spent in this fiscal year in the absence of the sequestration: Some would have been used to enter into contracts to buy goods or services to be provided and paid for next year or in subsequent years. Acquiring major weapons systems and completing large construction projects, for example, can take several years. The $42 billion figure is CBO's estimate of the reduction in cash disbursements in fiscal year 2013; much of the remaining outlay reductions from the 2013 sequestration will occur in fiscal year 2014, though some will occur later.

How Does CBO Estimate the Economic Effects of Changes in Fiscal Policy?

The estimated economic effects of eliminating the sequestration or extending the tax provisions that expired rely on the same methodology that CBO has used in numerous recent reports, such as *Economic Effects of Policies Contributing to Fiscal Tightening in 2013* (http://www.cbo.gov/publication/43694), *Estimated Impact of the American Recovery and Reinvestment Act on Employment and Economic Output from October 2012 Through December 2012* (http://www.cbo.gov/publication/43945), and *Policies for Increasing Economic Growth and Employment in 2012 and 2013* (http://www.cbo.gov/publication/42717). In the short term, CBO estimates that increases in government spending or decreases in taxes would lead to additional economic activity, particularly given the extent of unused resources in the economy. The basis for that view is presented in CBO's working paper, *Assessing the Short-Term Effects on Output of Changes in Federal Fiscal Policies* (http://www.cbo.gov/publication/43278). Indeed, between mid-2009 and mid-2012, a real drop in purchases of goods and services by state and local governments—along with a decline in federal purchases of goods and services after they had peaked in 2010—was a significant factor slowing the economic recovery, as CBO discussed in its report *What Accounts for the Slow Growth of the Economy After the Recession?* (http://www.cbo.gov/publication/43707)

Nevertheless, although CBO expects that reducing the amount of fiscal tightening this year would strengthen the economy in the short term, the resulting increase in federal borrowing would weaken the economy in the longer term unless other changes in spending or tax policy were made to offset that additional borrowing. That trade-off is discussed in a number of CBO's reports, including the recently issued *Macroeconomic Effects of Alternative Budgetary Paths* (http://www.cbo.gov/publication/43769). Another CBO report, *Choices for Deficit Reduction* (http://www.cbo.gov/publication/43692), discusses the criteria that might be used to evaluate proposed changes in fiscal policy, including the effects of varying how quickly policies are implemented.