The Sequester Cuts Take Effect: Now What Happens?

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On March 1, the government spending cuts known as the "sequester" took effect without any action from Congress. Below I discuss what those cuts mean and what is likely to follow as Congress wrestles with additional deadlines.

The journey to the sequester spending cuts began in August 2011. A few months earlier, the United States had hit its borrowing limit. If Congress did not approve an increase in the limit, the United States, cut off from additional borrowing, would be unable to pay interest on outstanding debt and would default. The Republicans, who had taken control of the House earlier that year, threatened to vote against a debt ceiling increase unless the President accepted substantial cuts in government spending. With the prospects of a default fast approaching, the parties agreed, among other items, to cut federal spending by $2.1 trillion over ten years beginning in 2013.

The parties could agree on only about $900 billion of actual spending cuts, however. So they delegated the burden of allocating the additional $1.2 trillion of cuts to a newly-appointed "Super Committee" comprised of members from each party. If the Super Committee could not reach agreement, then, under a process called "sequestration", the $1.2 trillion in cuts would be split evenly between defense and domestic programs and then allocated equally among projects within those two subsets. (The parties agreed there would be no cuts in Social Security, Medicare, or Medicaid benefits.)

The President believed that the threat of significant cuts to defense would prompt the Republicans on the Super Committee to agree on an alternative allocation. But it was not to be. The Super Committee failed to reach agreement and the sequestration fallback became operable, with the cuts of $600 billion in defense and $600 billion in government programs slated to begin on January 1, 2013.

That date, however, happened to coincide with the date the "Bush tax cuts" were set to expire. Economists became concerned that the combination of tax increases and spending cuts would push the United States over a "fiscal cliff" and back into recession. To avoid that result, the parties agreed on New Year's Eve 2012 to defer the commencement of the sequestration cuts to March 1, 2013. That deadline has now passed.

Neither party wanted the sequestration cuts to take effect. Most Republicans (and some Democrats) were not happy with the cuts in defense. Most Democrats were unhappy with the cuts in social programs. Economists estimate that the cuts -- $85 billion of which will hit in 2013 – will reduce GDP this year by ½ to ¾ of a percentage point.

But the real unhappiness lies in the way the sequestration process operates. The across-the-board reduction in spending is not done simply at the agency level. Rather, it goes down to departments within each agency, and to spending accounts within those departments. Thus, the process robs an agency head of the ability to reallocate funds within the agency to retain funding for crucial programs. For instance, the Secretary of Transportation cannot choose to move funds from a non-essential transportation function to keep TSA inspectors at airports.

There is hope that this problem, at least, will be resolved. March 1 is not the final deadline Congress faces this year – or even this month. Congress has funded the federal government only through March 27. If Congress does not appropriate additional amounts to run the government, then on March 28 the federal government will shut down.

To keep the government running Congress must pass a "continuing resolution." The continuing resolution would fund the government at 2012 levels, less the sequester cut amounts. The continuing resolution also could provide for a different allocation of spending cuts than the across-the-board sequester. At a minimum, it should give agency heads the ability to reallocate funds among accounts to minimize the effect of the sequester cuts.

One would think the prospect of a government shutdown – which neither party wants – would be sufficient to force Congress to reach a deal. And such a compromise is likely, if not before March 27 then shortly thereafter. But the path to a compromise will not be straight. The Republicans were stung by the fiscal cliff deal that raised taxes without reducing government spending, and are seeking additional spending cuts, this time in entitlement programs. The President has insisted that any deficit reduction plan be "balanced" to include new revenue (taxes) as well. The Republicans are steadfastly refusing to accept any tax changes, including the closing of what the President has asserted are tax "loopholes."

And looming behind the government funding date is yet another deadline – the very same one that kicked off this entire process a year and a half ago: on May 18 the United States again hits its debt limit. Presumably an agreement to keep the government running will incorporate an increase in that limit. But given that Washington is dealing with issues in bite sized portions – if it deals with them at all – that result cannot be guaranteed. Stay tuned for further updates.

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