November 22, 2011

Washington Update

SPECIAL REPORT: SEQUESTRATION UNDER THE BUDGET CONTROL ACT OF 2011

Now that the Joint Select Committee on Deficit Reduction (the Super Committee) has failed to report out a package of at least $1.2 trillion in deficit reductions through any combination of spending reductions or revenue increases, there is no *immediate* impact. With the demise of the Super Committee and on the (fairly safe) assumption that the Congress will take no independent deficit reduction action before January 15, 2012, the process of sequestration will begin. Of course the Congress can take action at any time to modify the provisions of Budget Control Act of 2011 (BCA) or repeal the provisions of BCA altogether, but the procedural protections for such action, such as not allowing amendments – an up or down majority vote in both Houses of Congress (thus dispensing with the Senate's filibuster rules) and legislative action by a date certain have all vanished with the failure of the Super Committee to take action. In broad scope, the BCA now triggers a "sequestration" of $1.2 trillion in spending reductions in three broad categories: "defense", "non-defense" and Medicare. There are broad exemptions from these spending reductions with the most notable and sizeable being Social Security, Medicaid and Overseas Contingency Operations (Iraq and Afghanistan) war funding.

Technically, sequestration is an amount of money equal to the difference between the cap set in the BCA budget baselines and the amount actually appropriated by Congress which is "sequestered" by the Treasury and not handed over to the agencies to which it was originally appropriated by Congress. With respect to the $1.2 trillion in cuts that will occur beginning in FY 2013, the BCA assumes that 18% of the savings will come from decreases in debt service costs (due to reduced deficit spending), thus $216 billion of savings is expected to come from reduced debt service costs. That leaves a total of $984 billion to come from budgetary savings over the next 9 years beginning in 2013. This $984 billion is then evenly divided over that nine year period requiring an *annual* spending reduction of $109 billion. This annual spending reduction is allocated as follows: 10% for defense programs, 8% for non-defense discretionary programs and no more than 2% reduction in Medicare programs (which amounts to an approximate $123 billion in savings over the 9 years for Medicare programs. Within the defense and non-defense categories the required spending reductions will be allocated proportionally between discretionary and mandatory programs.

Caps on Spending

Since Congress will likely fail to enact a package of $1.2 trillion in savings by January, 15 2012, the spending caps in the BCA for discretionary funds are revised as follows:

- For FY 2013, **$546 billion** for the defense category and **$501 billion** for nondefense;
- For FY 2014, **$556 billion** for the defense category and **$510 billion** for nondefense;
- For FY 2015, **$566 billion** for the defense category and **$520 billion** for nondefense;
- For FY 2016, **$577 billion** for the defense category and **$530 billion** for nondefense;
- For FY 2017, **$590 billion** for the defense category and **$541 billion** for nondefense;
- For FY 2018, **$603 billion** for the defense category and **$553 billion** for nondefense;

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- For FY 2019, **$616 billion** for the defense category and **$566 billion** for nondefense;
- For FY 2020, **$630 billion** for the defense category and **$578 billion** for nondefense; and
- For FY 2021, **$644 billion** for the defense category and **$590 billion** for nondefense.

It is important to note that the Office of Management and Budget OMB will revise its baselines over time (to adjust for legislative changes, new mandatory spending or other legislative actions that cause baseline "creep". OMB is authorized under BCA to revise these spending caps downward in order to ensure that the $1.2 billion budgetary savings are achieved over the 9 year window.

How Enforcement Works

The BCA details the formula by which the federal government's spending will be decreased. For purposes of this memorandum, the key points of this formula are that it will work to achieve $1.2 trillion in total savings (of which $948 billion will be mandatory and discretionary defense and non-defense savings). In September, 2011, the Congressional Budget Office (CBO) estimated that during FY 2013-2021 these $984 billion in cuts will entail an average *annual* $55 billion reduction in defense discretionary spending, an average *annual* $36 billion reduction to non-defense and an average *annual* $19 billion reduction to non-defense mandatory spending (including Medicare). The actual *annual* Medicare reductions will be $11 billion for FY 2013 and 2014, each; $12 billion for FY 2015; $13 billion for FY 2016 and 2017, each; $14 billion for FY 2018; $15 billion for FY 2019; $16 billion for FY 2020 ;and $17 billion for FY 2021.

None of these cuts will occur in FY 2012 and it is not until January 2, 2013 that the first of these cuts will be implemented, which is likely to compound the fiscal year impact as more than one-quarter of the fiscal year will have already passed. On that day, OMB will issue its first sequestration report, which will detail the across-the-board cuts to discretionary and mandatory funding for FY 2013 spending in order to implement the first set of cuts designed to lower government spending. Concurrent with OMB's report, the President will issue a sequestration order that implements this first round of cuts which will reduce the non-exempt programs by the uniform percentages identified above. By each January 21, the President will need to notify Congress whether military personnel accounts will be exempted from any possible cuts to defense spending. The President in his role as Commander in Chief has the option to make a determination that national security will be jeopardized by the implementation of defense personnel cuts and he can exempt those accounts from the scheduled cut. Should the President make that determination, then the percentage decrease in funding for the other defense accounts will be larger to offset the exemption of military personnel accounts from sequestration.

On the first Monday in February 2013, per tradition, the President will likely submit his FY 2014 budget request to Congress and along with it OMB will issue its first sequestration preview report for FY 2014 that will revise, if necessary, the *discretionary* spending caps for fiscal year 2014 (and the out-years). OMB will also issue a sequestration order for *mandatory* funding for FY 2014 (before any mandatory funds are expended) to meet the sequestration amount calculated by OMB. Again, with respect to discretionary funding, so long as Congress and the President agree to funding levels that do not breach the caps, then discretionary funding for a given fiscal year would not be subject to a sequestration order in the final sequestration report (which is issued 15 days after the end of a Session of Congress – usually one quarter into the fiscal year). Additionally, if the appropriations for defense and non-defense discretionary spending do not breach the caps, Congress and the President may prioritize funding within those categories as they wish without any restriction.

There are additional scenarios under which sequestration could take place. In a situation where the government is operating under a continuing resolution 15 days after the end of a Session of Congress (as was the case earlier this year), if the *annualized* level of discretionary spending is higher than either spending cap, then the President would issue a sequestration order. If after June 30 of a given year, Congress enacts a supplemental appropriations bill for the fiscal year in progress that breaches a cap for that fiscal year, then the discretionary spending limits for that category will be reduced by the amount of the breach in the *following* fiscal year. In the event that Congress passes supplemental funding that causes a breach and then adjourns by July 1 (admittedly an unlikely event) there will still be a sequestration of those funds to the extent they breach the discretionary spending caps.

There are other dates of interest in the sequestration process. On August 15 of a given year, CBO will issue its "sequestration update report" and OMB will release its version of the same report by August 20 of that given year. No later than ten days after the end of the Session of Congress, CBO will release its "final sequestration report" and OMB will do the same no later than 15 calendar days after the end of the session (usually in early January.) If Congress breached the discretionary spending caps as determined by OMB (CBO really does not have a role here), then the President will issue a sequestration order for defense and non-defense funding that will impose a percentage reduction across all the non-exempt discretionary accounts.

For more information on these issues you may call Denis J. Dwyer or Michael Kans at 202-659-8201.