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Q&A

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Federal budget cuts: impact and implications

With Darrell Spence

Economist Darrell Spence shares his view of planned reductions in federal spending and their potential impact on the U.S. economy. Across-the-board budget cuts — known in government parlance as "sequestration" — are scheduled to begin March 1. While they may be painful, Darrell says, the cuts should be offset by accelerating economic activity in the private sector and continuing monetary stimulus from the Federal Reserve.

With federal budget cuts amounting to $1.2 trillion through 2021 — $85 billion this fiscal year alone — how much of an impact do you think the sequester will have on the U.S. economy?

Any time you cut federal spending, it has an impact on the economy, but this year it will probably be less than the $85 billion that has been reported. There are ways for the government to push some of the spending cuts into next year. We think roughly half of the $85 billion in cuts will actually be made this fiscal year — amounting to about 0.3% of GDP. The payroll tax hike that occurred at the beginning of the year amounts to about $105 billion, or 0.7% of GDP. Added together, the sequestration cuts and the increased payroll taxes are expected to exert a reasonable drag on U.S. economic activity, but there are other things happening in the U.S. economy that can offset it. Overall, I expect the economy will keep growing.

The total amount of the sequestration is smaller than budget-control programs earlier proposed by the Simpson-Bowles commission and the White House. Is it enough to be meaningful?

When we talk about spending cuts beyond 2014, one thing that needs clarification is these are not cuts in the true sense of the word. They are levels of spending that are below what the government has estimated spending will be through 2021. So it is a little less Draconian than it sounds when you talk about $1.2 trillion in spending cuts. It is really $1.2 trillion less spending than we would have had under the government's baseline estimate. It doesn't mean that federal spending won't continue to grow; it just grows at a rate that is less than the current forecast.

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If we get the full $1.2 trillion over the period that the sequester mandates, it will help in terms of reducing the federal budget deficit, but it won't necessarily put us on the road to long-term fiscal solvency. The sequester does not mandate spending cuts in the areas where spending is growing most rapidly, namely Social Security and Medicare.

At this point, is there any chance of modifying or delaying the sequester?

When the sequester was first proposed and legislated, the odds were that it would never actually happen. It was just a tool for the Administration and Congress to get past an impasse. Now that the sequester is here, I think it's indicative of how rancorous the debate has become about how to reduce the size of the federal deficit. Clearly, one side wants to focus on raising revenue, while the other side wants only to cut spending. The fact that the sequester is happening now just shows how very difficult it is for the two sides to compromise and find a way to ultimately put the U.S. on a path to fiscal solvency.

How long do you think it will take for Americans to feel the effects of these cuts?

Some of the effects will be felt immediately. Certain federal employees may be furloughed in the departments that are subject to the sequester. However, most people don't expect the sequester to last all that long. In fact, when the continuing resolution to fund government operations comes up for renewal toward the end of March, that will present a good opportunity for the government to deal with the sequester and to mitigate its impact. So even though some of the effects could be felt right away, there is a strong possibility that some of it gets reversed.

What is the likelihood that private sector economic activity will offset the negative effects of higher taxes and lower government spending?

The good news is that the U.S. still has a vibrant private sector economy. Despite the fact that we have fiscal restraint this year in the form of a payroll tax hike and the sequester, there is still a very sizable share of the U.S. economy that is doing well. The housing market is recovering, and the ongoing improvement in household formation suggests that it is likely to continue. The auto sector is doing well as consumers replace ageing vehicles. Fiscal policy is a drag on growth — one that is likely to be with us for a while — but the drag is manageable considering the size and the overall growth rate of the U.S. economy.

What about the role of the Federal Reserve? Should we expect additional monetary stimulus, and perhaps a longer period of low interest rates, to offset the potential headwinds from fiscal austerity?

Federal Reserve officials view the sequestration as yet another drag on growth, and they have made it very clear that they are unlikely to change the stance of their policy until they find a good reason to do so. That good reason is going to be a better growth outlook. Fed officials have said that they won't start to raise interest rates until the unemployment rate gets down

Timeline

August 2, 2011	The Budget Control Act of 2011 (BCA) — the outcome of negotiations to raise the debt ceiling — passed by Congress and signed by President Obama. The BCA creates the bipartisan Joint Select Committee on Deficit Reduction.
November 23, 2011	The select committee fails to produce deficit reduction legislation by this deadline, triggering the sequestration provisions effective January 2, 2013.
January 1, 2013	As part of the deal to avoid the fiscal cliff, Congress passes a package of tax increases and temporarily extends the implementation of sequestration to March 1.
January 31, 2013	Congress passes legislation suspending the federal debt ceiling through mid-May. The bill also calls for Congressional pay to be withheld if budget resolutions are not passed by April 15.
March 1, 2013	Sequestration scheduled to take effect.
March 27, 2013	Stopgap measures funding the federal government expire; could force partial government shutdown.
May 19, 2013	Federal debt limit to be reinstated.

closer to 6.5%. There are other ways they could start to remove accommodation or even tighten policy through balance sheet measures and by selling some assets they have purchased. However, they don't yet view the economy as growing strongly enough to start removing some of that accommodation.

Are the critics correct when they say these spending cuts should be spread out over a longer period of time, or is it more important to quickly get the federal budget under control?

In terms of fixing the federal deficit, the U.S. has the luxury of time. The one thing you don't want to do is make very drastic cuts over a short period. Rather, it would be better to smartly solve the problem over an intermediate- to long-term time frame. The more dramatic the cuts are, the bigger the impact on the economy. It almost makes fiscal austerity self-defeating: spending cuts drag the economy down so much that it goes into recession, and that actually makes the deficit situation worse.

To see real-life examples of that, you need look no further than some of the peripheral European countries. They implemented significant fiscal austerity, and it is not necessarily working because it is having such a negative impact on their economies. But the reason they had to do it is because they ran out of time and could not borrow in the financial markets any more. The U.S. is not in a similar situation. Our debt ratios are not nearly as high as some of the peripheral European countries. We still have market access and the dollar is still the reserve currency of the world. All these things suggest we are not about to hit the wall. We do ultimately have to deal with this problem, but we have some time.

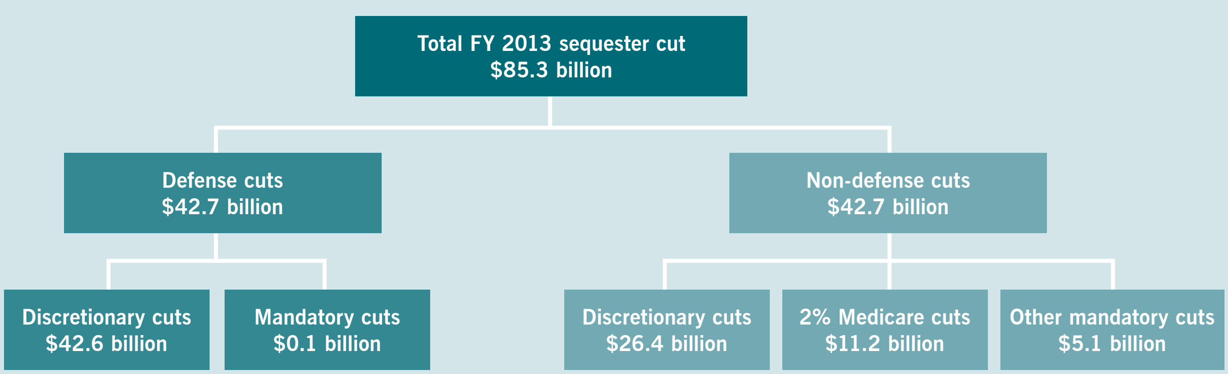
Is there still a risk of a market panic from events in the U.S. or Europe?

In any given year there is always the possibility of an unexpected risk influencing the markets. The recent election in Italy suggests that perhaps the European populace is getting tired of fiscal austerity and will decide they want their governments to move in the opposite direction. That would have a significant impact on the bond markets and the overall financial markets of the countries involved, and probably even more broadly. It remains to be seen whether similar sentiments are echoed in other areas of Europe. That said, we have seen substantial cyclical improvements in the global economy. The rebalancing and healing continue to take place, particularly in the United States, and that provides a level of support for economic activity.

Sequestration spending cuts

The Budget Control Act of 2011 requires spending cuts of $1.2 trillion over nine years beginning in 2013. Less $216 billion in assumed savings on debt service, this amounts to $984 billion in program cuts, or $109 billion in projected spending each year. Because Congress postponed implementing the cuts to March 1, the total deficit reduction for FY2013 (which ends Sept. 30) will be $85 billion. Most mandatory spending is exempt from the sequester, including Social Security, retirement benefits, veterans benefits, certain tax credits, Medicaid, the Children's Health Insurance Program, unemployment insurance, and food stamps.

Breaking down the FY 2013 sequester



Sources: Bipartisan Policy Center, Congressional Budget Office, Office of Management and Budget

What is your overall outlook for U.S. economic growth?

Growth in 2013 is likely to meet the consensus estimate of about 2.2%. This would be similar to the pace of growth last year. There are a couple of reasons for that, including positive momentum in housing and automobiles. However, you also have fiscal restraint in the form of the payroll tax increase and the sequestration, and the outlook for U.S. exports is somewhat negative because of the weak economy in Europe. But again, there is a more positive outlook for business investment. So when we start to put together all the positives and the negatives, we have an economy that is likely to continue to track along the same growth rate that it's been tracking for a couple of years.

Heading into 2014, though, as the impact of the sequester and the payroll tax hike start to moderate, it does seem reasonable to expect a slight acceleration of real GDP growth. Maybe that will be the year we finally break through the 3% mark, which is the point at which it should start to feel like we're having a self-sustaining and more durable expansion.

Relatively speaking, how does this focus on sequestration compare to other debates we've witnessed recently over the fiscal cliff, the debt ceiling, and tax increases?

I have been an economist at Capital for nearly 21 years. During most of that time, fiscal policy did not play a big role in formulating our outlook, because we didn't have federal deficits and fiscal issues of the size they are now. That has all changed. I think we as a nation are now going to have the federal government playing a much more prominent role in our lives. It doesn't mean that all of us will be directly affected by it, but we are certainly going to be exposed to it — and that includes all of the debate and drama that goes along with devising a long-term solution to our fiscal problems.

The total dollar amount of the sequester only represents about 2% to 2.5% of government spending. The cuts that the federal government is making are really not all that significant. When you look across the U.S. economy, many corporations and individuals have already made cuts of a similar magnitude. It is probably not too much to ask that the federal government do the same if it helps put us on the path to fiscal solvency. ■