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Sequestration: What Is It? And How Could It Impact California?

In August 2011, Congress passed the Budget Control Act of 2011.[1] Unless Congress elects to reverse the act, it will impose automatic spending cuts—known as sequestration—on many federal programs starting in January 2013. The automatic cuts are intended to ensure a $1.2 trillion deficit reduction through 2021, and in general are divided equally between defense and non-defense spending. Many federal programs will be subject to automatic cuts by a fixed percentage, although the Budget Control Act (BCA) explicitly exempts specific programs from the cuts.

Automatic Federal Budget Reductions—Known as Sequestration—Will Cut Many Programs and Spare Others
While some programs—such as Medicaid (Medi-Cal), Pell Grants, and Social Security benefits—are exempt from sequestration, many others—like Medicare, Workforce Investment Act, and Head Start—are not. Because California depends on billions of dollars in federal funding annually, sequestration cuts could impact the state significantly.

The process for determining the cuts is specified in the BCA, and in part depends on spending levels in the Continuing Resolution adopted by Congress in September 2012.

For non-defense programs, the federal Office of Management and Budget (OMB) estimates the act will result in automatic cuts of 7.6 percent to mandatory programs, and 8.2 percent to discretionary programs. For defense programs, the automatic cuts are estimated to be 10 percent of mandatory programs, and 9.4 percent of discretionary programs. In addition, the OMB projects the act will result in cuts of approximately 2 percent (about $11 billion) to Medicare.

"Mandatory" and "discretionary" designations are federal statutory terms that generally indicate how programs are funded.

- **Discretionary programs** are funded through federal appropriations bills; Congress sets the funding level for each program through the annual federal budget process.

- **Mandatory programs** are funded through legislation other than federal appropriations bills, and include entitlements, such as veterans' pension programs and Medicaid. Congress controls spending for these programs indirectly—that is, outside the budget process—by setting benefit rules and eligibility levels.

In addition, the federal budget divides programs into defense versus non-defense. Defense programs include those with a defense function (primarily programs under the Department of Defense); all other programs are considered non-defense.

Which Federal Programs Are Exempt From the Automatic Cuts?

The BCA explicitly protects certain federal programs from the automatic cuts scheduled to begin in January 2013. Major *non-defense programs* that are exempted include:

- Child Care Entitlement to States
- Child Nutrition programs (for example, school breakfasts and lunches)
- Children's Health Insurance Program (Healthy Families)
- Federal-Aid Highways
- Medicaid (Medi-Cal)[2]
- Pell Grants
- Social Security benefits
- Supplemental Nutrition Assistance Program (CalFresh, formerly known as food stamps)
- Supplemental Security Income
- Temporary Assistance for Needy Families (CalWORKs)

Federal *defense programs* protected from cuts include:

- Department of Veterans' Affairs programs (for example, veterans' benefits and health care)
- Military salaries

Which Federal Programs Are Not Exempt From the Automatic Cuts?

Examples of major federal *non-defense programs* that will receive automatic cuts under the BCA include:

- **Education:** Head Start, Individuals With Disabilities Education Act (IDEA), Title I funding for disadvantaged pupils and other Elementary and Secondary Education Act (ESEA) programs that fund K–12 functions (such as Title III funds for English learners)
- **Employment and Training:** Workforce Investment Act (WIA) programs
- **Health and Human Services:** Child Care and Development Block Grant; Medicare; National Institutes for Health grants; Ryan White HIV/AIDS grants; Substance Abuse Prevention and Treatment (SAPT) Block Grant; Women, Infants, and Children

Supplemental Feeding Program (WIC)

- **Housing:** HOME grants (for affordable housing development), Homeless Assistance Grants, Low-Income Home Energy Assistance Program (LIHEAP), Section 8 housing vouchers
- **Public Safety:** Byrne Justice Assistance (JAG) grants, State Criminal Alien Assistance Program (SCAAP)
- **Transportation:** General Fund transfers to the Highway Trust Fund, Transit Capital Assistance, Transportation Investment Generating Economic Recovery (TIGER) grants[3]

In addition, other *non-defense programs* in areas such as environmental protection and water quality will be cut; while cuts to individual programs may be small, the cumulative impact could be significant.

Of the federal *defense programs*, more than $50 billion will be cut from the Department of Defense (DOD). Most DOD cuts will be in procurement, which could significantly impact spending on contractors who provide scientific, engineering, and technical services, as well as the suppliers and vendors who depend on those contractors. (One-third of the aerospace and defense industry is employed in three states: California, Texas, and Washington.)

How Would Sequestration Impact California?

At the time this report was published, little information was available on exactly how sequestration would impact specific states. However, California receives large amounts of funding from the federal government: about $83 billion in federal funds will be funneled through the state budget in 2012–13. And even more federal funds flow directly to localities and entities outside the state budget, such as Medicare payments to providers and Head Start payments to locally based organizations. The federal funding cuts slated to occur under sequestration could have significant impacts on California's budget and economy, particularly if they are combined with fiscal policy changes needed to address the state's ongoing budget challenges.

How Does Sequestration Tie Into the Federal Budget Process?

The federal fiscal year is October 1 to September 30. The budget process begins when the president submits his or her budget request to Congress in February; it ends when the House and Senate approve final appropriations bills (or an omnibus bill) and send them to the president for his or her signature or veto. If Congress has not completed the appropriations process by September 30, it must either pass a continuing resolution (CR) to continue funding the federal programs, or face government shutdown.

CRs typically extend the current year's funding levels for three to six months. On September 28, 2012, President Obama signed a CR—House Joint Resolution (H.J.Res.) 117—to keep the federal government funded until March 27, 2013.[4]

H.J.Res. 117 sets spending at $1.047 trillion for fiscal year 2013—the level set by the

BCA. It also temporarily extends funding for some programs that would have expired at the end of September 2012, including the Supplemental Nutrition Assistance Program (SNAP) as well as the Temporary Assistance for Needy Families program (TANF).[5] To provide grants after March 27, 2013, when H.J.Res. 117 expires, Congress must reauthorize or extend the affected programs beyond that date.

H.J.Res. 117 does *not* amend or eliminate the BCA sequester. The BCA requires across-the-board percentage cuts to be applied to the fiscal year 2013 funding that is in place on January 2, 2013; thus, the OMB will use the annualized funding levels in the CR as the basis for implementing the sequester.

What Is the Fiscal Cliff? And How Is It Related to Sequestration?

Under current law, several fiscally related policy changes are scheduled to start in early 2013. Collectively, these events are known as the "fiscal cliff" because of their projected reduction in the federal budget deficit in 2013 and potential adverse effect on the nation's economy.

The Fiscal Cliff: Major Tax Cuts Set to Expire in 2012

According to the Urban–Brookings Tax Policy Center, federal taxes are scheduled to rise in 2013 for six main reasons:

> First, most Bush-era tax cuts enacted in 2001 and 2003, and extended for an additional two years at the end of 2010, are again set to disappear.

> Second, some of the temporary tax cuts that were part of the American Recovery and Reinvestment Act of 2009 (ARRA), and were extended at the end of 2010, will expire.

> Third, Congress has not acted on dozens of short-term tax breaks that typically are extended.

> Fourth, the payroll tax cut, always intended to be temporary, is set to expire after a two-year run at the end of 2012.

> Fifth, new taxes enacted in the 2010 Affordable Care Act (ACA) will take effect in tax year 2013.

> Sixth, the alternative minimum tax (AMT) "patch," which shields tens of millions of taxpayers from additional taxes, expired at the end of 2011. Unless Congress extends the patch retroactively, many taxpayers will owe AMT on their 2012 tax returns (the tax returns that will be filed in early 2013).

Source: Urban Institute and Urban–Brookings Tax Policy Center, October 1, 2012

The biggest components of the fiscal cliff include the expiration of various tax provisions—resulting in significant tax increases—and spending reductions due to BCA sequestration. Federal tax collections would increase by more than $500 billion in 2013, more than 20 percent above what they would be without the fiscal cliff.[6] (See "The Fiscal Cliff: Major Tax Cuts Set to Expire in 2012" on the opposite page.) Other scheduled changes include the expiration of emergency unemployment benefits and other programs, as well as a 30 percent reduction in Medicare payments to physicians.

According to the nonpartisan Congressional Budget Office (CBO), the combined economic impacts of these events would "probably lead to a recession in 2013."

As implementation dates draw near, continued uncertainty and inaction by Congress regarding the fiscal cliff also could contribute to economic volatility. The CBO warns, however, that reducing or eliminating the fiscal cliff without similarly offsetting fiscal policies in future years would weaken the economy in the long run (relative to what would occur under current law). Thus, there are significant economic challenges to addressing the more immediate and expected consequences of sequestration and other upcoming policy changes with long-term deficit reduction.

Where Do We Go From Here?

Originally, sequestration was intended to be a backup plan if a specially-designed Joint Select Committee failed to develop a

What Is the Fiscal Cliff?
Several fiscally related policy changes—including across-the-board cuts to many federal programs, known as sequestration—are scheduled to begin in January 2013. These changes, collectively referred to as the "fiscal cliff," may only be amended or stopped by Congress.

deficit-reduction plan of a similar magnitude. Because that committee failed to reach an agreement on an alternative (and thus no alternative was approved by Congress by January 2012), the automatic cuts are scheduled to go into effect beginning January 2, 2013. (Because agencies will need time to implement sequestration, administrative actions to implement the reductions may occur up to 120 days after the president issues the order on January 2.)

President Barack Obama has stated his opposition to the automatic cuts and publicly asked Congress to suspend the cuts in favor of another deficit-cutting alternative, such as his proposed fiscal year 2013 budget. In addition, many Congressional members have expressed serious reservations about allowing sequestration to go forward. However, the only way to stop the automatic cuts is through legislative action, and Congress is in recess until after the November 6 election. In the meantime, the Office of Management and Budget has instructed federal agencies to continue normal spending and operations until further notice.

Congress could take a number of actions to modify, waive, replace, or delay sequestration and other fiscal cliff issues, although the Obama Administration has indicated any legislation that simply delays implementation of sequestration will be vetoed. One alternative being discussed is to delay sequestration but provide an accompanying set of cuts as a "down payment" toward the total sequestration amount. Various sources indicate that, while a legislative response to sequestration and other components of the fiscal cliff are quite fluid, it would be extremely challenging for Congress to craft a comprehensive deficit-reduction package in the last few weeks of the 2012 session.

In the coming months, lawmakers will likely look at components of various alternative policies proposed over the past several years, such as the president's fiscal year 2013 budget (or future budget proposals), the Simpson–Bowles Commission's recommendations of 2010, and the House Republican Sequester Replacement Reconciliation Act of 2012. This means *all* programs—including those specifically exempted from the Budget Control Act's sequestration—could land on the negotiating table.

Endnotes

1 Public Law 122–25.

2 Although Medicaid grants to states are exempt from sequester, the Medicaid state Grants and Demonstrations account is not exempt. Several programs are under this account, although only the Money Follows the Person Demonstration and the Medicaid Integrity Program would be impacted, as they are the only two programs that received funding in federal fiscal year 2012 and under the current Continuing Resolution.

3 In recent years, gas-tax revenues have not been sufficient to fund federal transportation programs, so Congress has authorized transfers from the General Fund to the Highway Trust Fund to keep the fund solvent and meet program obligations. While Highway Trust Fund programs are exempt from sequestration, the General Fund transfers themselves are not exempt.

4 Public Law 112–175.

5 The current Continuing Resolution (CR) provided a short-term extension for some programs that would have expired at the end of September 2012. The CR did not include a full extension of many programs contained in the 2008 farm bill (P.L. 110–246). As a result, the authority or funding for these programs has expired.

6 Roberton Williams, Eric Toder, Donald Marron, and Hang Nguyen, "Toppling Off the Fiscal Cliff: Whose Taxes Rise and How Much?" Urban Institute and Urban–Brookings Tax Policy Center, October 1, 2012, p. 1-2.

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Federal Update is the first in a series of occasional briefs researched and written by the California Senate Office of Research (SOR) to highlight federal issues and their potential impact on California. SOR is a nonpartisan office charged with serving the research needs of the California State Senate and assisting Senate members and committees with the development of effective public policy. It was established by the Senate Rules Committee in 1969. For more information and copies of this report, please visit **www.sen.ca.gov/sor** or call **(916) 651-1500**.