Should we be fearful of the automatic federal spending cuts?

Automatic spending cuts known as the sequester, stemming from the 2011 agreement on the debt ceiling and deferred in the fiscal cliff agreement of last January, are scheduled to start on March 1. What impact will this have on the U.S. economy?

These cuts should eliminate US$1,200B of spending over 10 years. It is a consequence of the Congress committee members’ inability to find US$1,500B in deficit reduction measures back in the fall of 2011. For 2013, the cuts amount to US$109B, but the fiscal cliff agreement reduced their size by US$24B. Therefore, US$85B have to be wiped out of the federal government’s budget by the end of the fiscal year, September 30. The thorny point is the manner in which the cuts will be achieved. The sequester procedure gives no right to scrutinize exactly what is to be cut. Instead, it demands a “blind” 8% cut in military spending (apart from combatant personnel), a 5% cut in non-military spending (excluding Medicaid and social security programs) and a 2% cut in the Medicare program. Proportionally speaking, the cuts are evenly distributed between the military and non-military sectors.

These cuts could have a significant impact on growth. The White House recently warned that many government services would be directly affected. From airport security to food inspection, not to mention aid to small businesses and unemployment insurance, the automatic cuts are likely to make themselves felt.

But it is by no means certain that the macroeconomic effects will be all that severe. The US$85B cuts take a bite out of funds allocated to various programs. The Congressional Budget Office estimates that the actual effect on direct government spending will be just US$44B, i.e. US$35B for discretionary spending and US$9B for mandatory spending (Medicare and other social programs). The difference is due to the fact that the government may use funds that were previously allocated, but not yet spent, and the possibility of deferring some of the budget cuts to later years.

Implications: When the fiscal cliff agreement was adopted at the very beginning of 2013, it was estimated that all the austerity measures combined (including tax increases) would subtract, at most, 1.5 percentage points from growth. This also includes approximately 0.5 points stemming from automatic cuts. Since economic growth is still fragile, this is really not an ideal policy, but neither is it a disaster that would drive the United States back into recession. By comparison, all of the measures contained in the fiscal cliff (before the agreement) threatened to reduce growth by approximately 3.5 points.

Although there was little hope, at the time of writing, of a new agreement being reached, we cannot rule out the possibility of a last-minute agreement, as we have often seen in recent years. If not, the cuts may be re-examined when the politicians attempt to resolve the issue of the federal government’s funding between now and March 27, in order to avoid another shutdown. Obviously, as Ben Bernanke pointed out on Tuesday, more carefully targeted and gradual budget adjustments would be preferable to these blind cuts that no one wants.

Francis Généreux
Senior Economist

Sources: Bipartisan Policy Center and Desjardins, Economic Studies

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