BIPARTISAN POLICY CENTER

FACT SHEET • December 2013

What is the Impact of the Defense Sequester on the Economy?

The first punch to the economy from the defense sequester has landed and the second is in motion. If it's not blocked, these reductions will contribute to 640,000 fewer jobs in the economy and gross domestic product (GDP) will be over 0.6 percent lower by the end of 2015. Adopting the bipartisan agreement by House Budget Committee Chairman Paul Ryan (R-WI) and Senate Budget Committee Chairman Patty Murray (D-WA) would delay the worst of these macroeconomic impacts for a short time – a year to a year-and-a-half. A longer-term solution would be necessary to achieve sustained relief from the economic drag of sequestration.

Sequestration cuts approximately equally from defense and non-defense spending (including Medicare). With the first fiscal year of reductions behind us, we now know more about what parts of the budget were cut and how these cuts affect the economy. The Bipartisan Policy Center (BPC), with assistance from the economic consulting firm Macroeconomic Advisers, LLC, has developed projections of the impact of the defense sequester on federal outlays and the economy. We focus our analysis on the half of sequestration that falls on defense discretionary spending – the annually appropriated budget for the U.S. military. Detailed data about spending on activities affected by sequestration are available within this category.

Key Findings

- If fully implemented, the spending reductions from the defense sequester will grow significantly over the next two years. Because budget cuts in each fiscal year affect actual spending (outlays) for many subsequent years, the impact of the defense sequester on spending will **double** in Fiscal Year (FY) 2014 and **triple** in FY 2015, as compared to FY 2013.
- The economy has already been adversely affected by sequestration. By the end of calendar year 2013, we estimate that the defense sequester will reduce the size of the economy (GDP) by roughly **0.4 percent** and will result in the elimination of **350,000 jobs**, from what would have occurred absent these reductions.
- It will only get worse. If defense sequestration remains in effect according to current law, by the end of 2015, GDP will be around **0.6 percent** lower than if there had been no sequester. *This drop in GDP is equivalent to the New Orleans or Milwaukee metropolitan areas not existing.* The unemployment rate will be approximately **three-tenths of a percentage point** higher, and **640,000 jobs** will be lost.
- Finally, these impacts only reflect the damage from one-half of sequestration. While spending rates for the non-defense portion of the sequester are harder to estimate, if sequestration is implemented in its entirety, it will likely reduce GDP by **roughly 1 percent** and cause about **one million job losses** by the end of 2015.

Spending cuts will **TRIPLE** by FY 2015

350,000 jobs eliminated by the end of 2013

640,000 jobs eliminated by the end of 2015

1% reduction in GDP from entire sequester

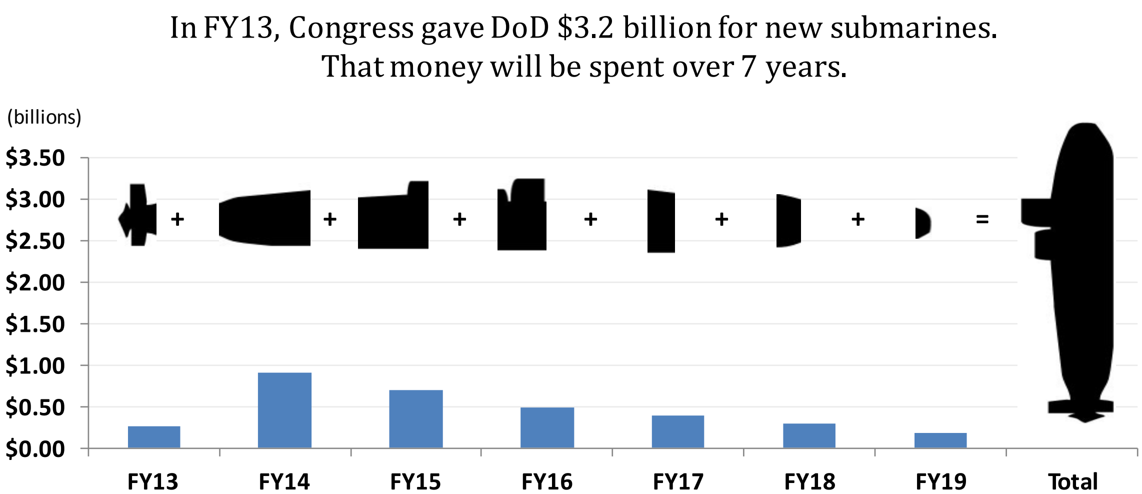
A full description of BPC's economic analysis and findings follows. Additional information about the impact of the defense sequester on military readiness is available in our recent report, *From Merely Stupid to Dangerous: The Sequester's Effects on National and Economic Security*.

How Budget Cuts Become Spending Cuts

The economy is affected by changes in actual dollars spent by the federal government. But the sequester cuts are taken from *budget authority* (BA), which is authorization (in the form of legislation passed by Congress) to federal agencies, such as the military, to spend funds on certain activities. Those budget reductions eventually affect actual spending (which is referred to as *outlays* in budget parlance). Sometimes, budget authority will translate into spending quickly, such as in the case of salaries and benefits, which are overwhelmingly budgeted and spent in the same year. However, in other areas, such as procurement, budget authority may spend out over many years. For example, in FY 2013, Congress appropriated $3.2 billion for the purchase of two new submarines. This $3.2 billion of budget authority will be spent over seven years – the time it takes to construct the submarines.

- Each year, Congress appropriates money to the Department of Defense (DoD) with authorization to spend it according to a specified budget. This is known as *budget authority* (BA), and is how the sequester cuts are measured.
- But DoD does not spend all this money in that same year. Actual spending is known as *outlays*.
- Weapons systems are effectively bought on installment.

THE TIME LAPSE BETWEEN GETTING AND SPENDING MONEY

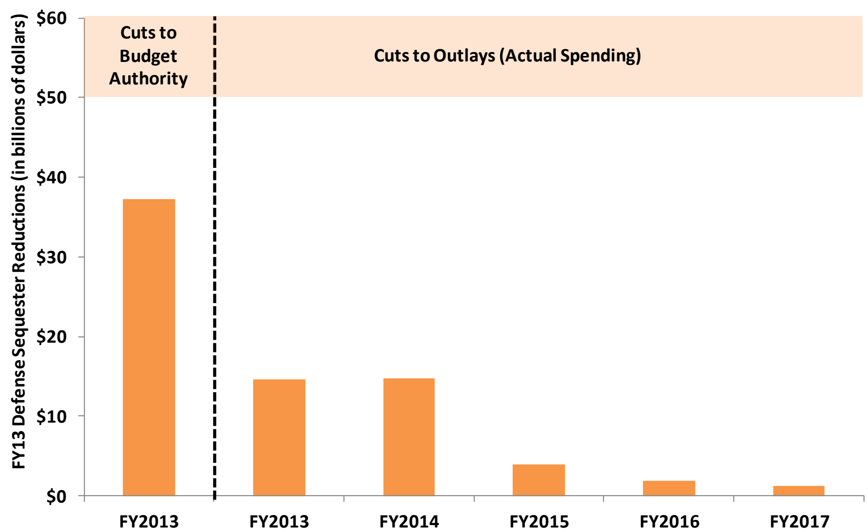


Source: Department of Defense; Bipartisan Policy Center

The Defense Department produces estimates of the spendout rate from budget authority to outlays across dozens of categories. Using this data, BPC has estimated how the budget cuts from the FY 2013 sequester will affect spending.

Since the sequester cuts to the defense budget did not apply equally to all types of spending, FY 2013 sequestration will actually have as large of an effect on spending in FY 2014 as in FY 2013. In particular, military personnel – which spends quickly – was exempt, so the cuts were concentrated on slower-spending accounts, such as operations and maintenance, R+D, and procurement.

MOST SPENDING CUTS FROM FY13 SEQUESTER WON'T OCCUR UNTIL FY14 & LATER

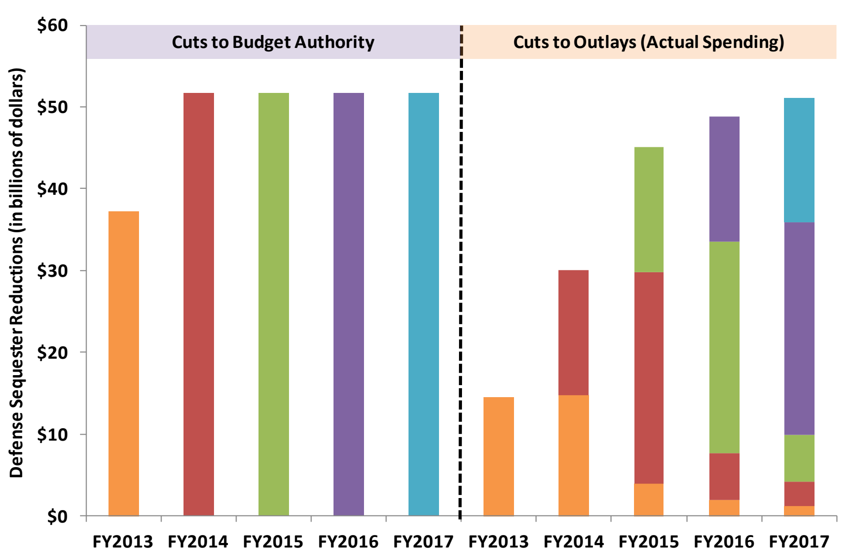


Note: Analysis includes sequestration cuts to budget authority of FY13 defense appropriated accounts and unobligated balances, assuming cuts to unobligated balances have the same effect on outlays.

Source: Department of Defense; Bipartisan Policy Center calculations

If sequestration continues according to current law, the cuts to budget authority will continue and the effect on outlays will multiply in the coming years, as shown by the following chart:*

PROJECTED SPENDING REDUCTIONS FROM DEFENSE SEQUESTER THROUGH FY2017



Note: Analysis includes sequestration cuts to budget authority of FY13-17 defense appropriated accounts and unobligated balances, assuming cuts to unobligated balances have the same effect on outlays.

Source: Department of Defense; Bipartisan Policy Center calculations

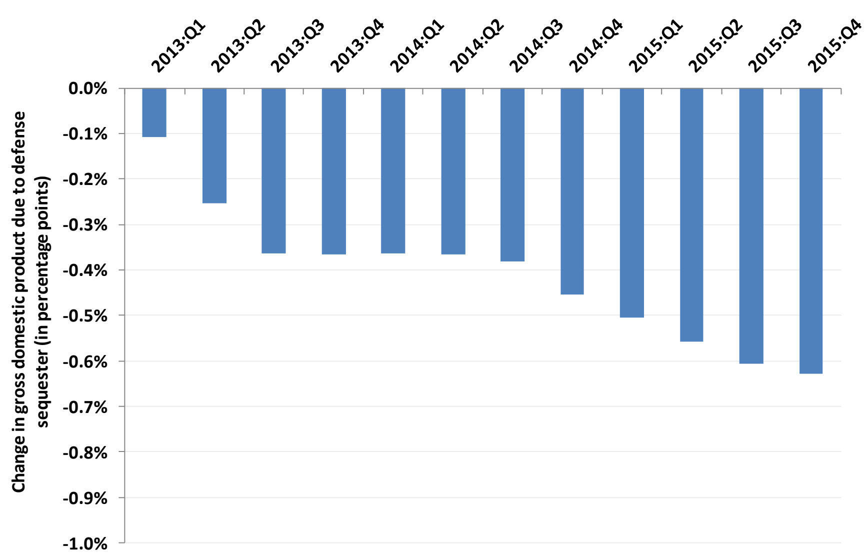
*Due to the American Taxpayer Relief Act of 2012 (the "fiscal cliff" deal) and other legislative changes, the FY 2013 sequester on the Department of Defense (DoD) required a cut of $37 billion. For the remaining years of sequestration, those reductions to budget authority are scheduled to be $52 billion below the original defense spending levels specified by the Budget Control Act of 2011.

While the defense sequester cuts to budget authority will stabilize at just over $50 billion in FY 2014, the effect on outlays will still be ramping up, doubling in FY 2014 and tripling in FY 2015, as compared to FY 2013. Since the outlay reduction is what affects the economy, the worst of sequestration's economic impacts are yet to come.

Sequestration and the Economy

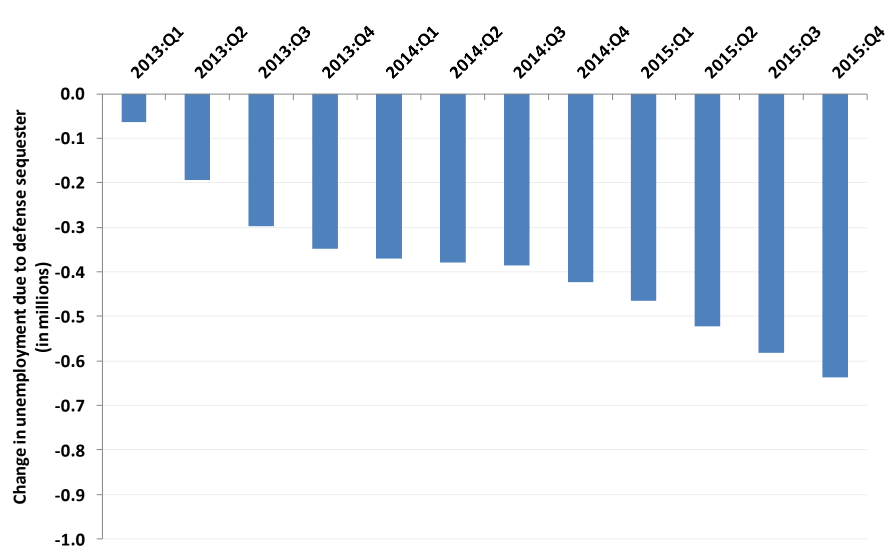
Macroeconomic Advisers, LLC, used these outlay projections to estimate the impact of the defense sequester on the size of the economy and employment. Those effects are well underway. By the end of calendar year 2013, the size of the economy is estimated to be nearly 0.4 percent smaller than if the sequester cuts had not happened; if sequestration continues as planned, by the fourth quarter of 2015, GDP will be more than 0.6 percent lower. Thus, the sequester impact is as if a metropolitan area the size of New Orleans or Milwaukee didn't exist.

DEFENSE SEQUESTER WILL REDUCE GDP BY OVER 0.6% AT CLOSE OF 2015



Source: Bipartisan Policy Center; Macroeconomic Advisers, LLC

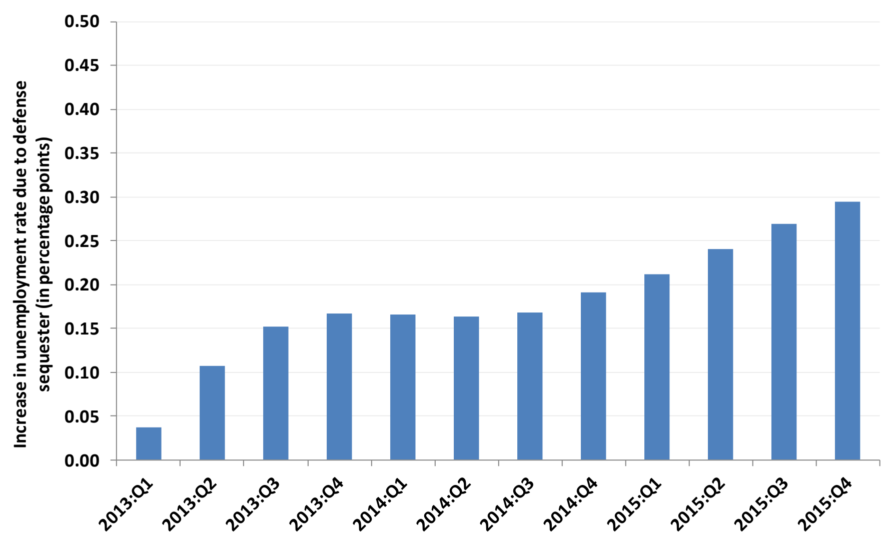
DEFENSE SEQUESTER WILL REDUCE CIVILIAN EMPLOYMENT BY 600K AT CLOSE OF 2015



Source: Bipartisan Policy Center; Macroeconomic Advisers, LLC

The hit to GDP coincides with lower employment. BPC estimates that the defense sequester will result in 350,000 fewer jobs by the end of calendar year 2013. By the end of 2015, 640,000 jobs will be eliminated if the defense sequester continues according to current law, and the unemployment rate will increase by three-tenths of a percentage point, relative to a scenario in which sequestration did not exist.

DEFENSE SEQUESTER WILL INCREASE UNEMPLOYMENT RATE BY 0.3% AT CLOSE OF 2015



Source: Bipartisan Policy Center; Macroeconomic Advisers, LLC

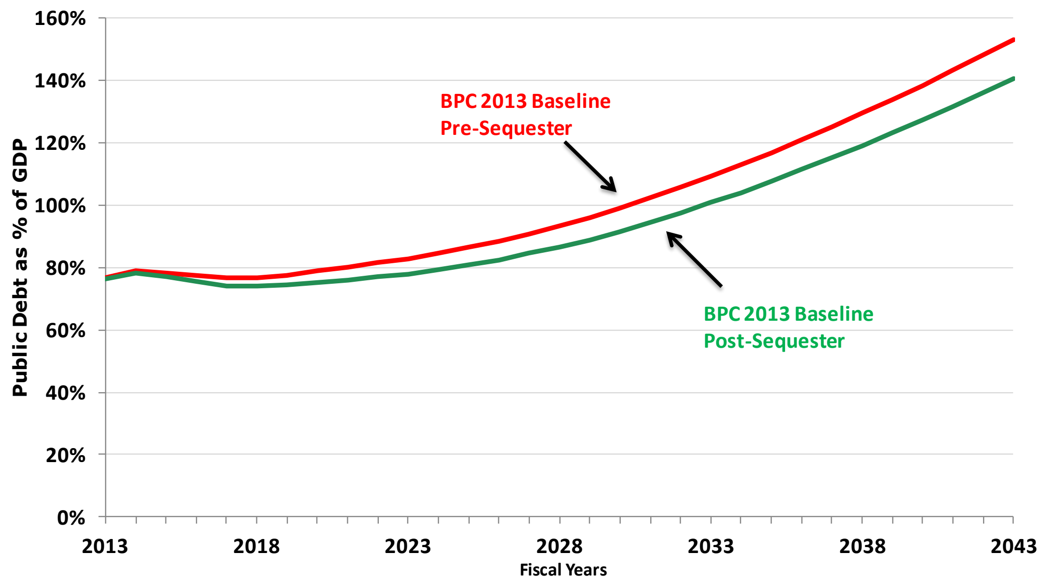
Importantly, these estimates only reflect the impact of about half of the sequestration cuts. While there is less information available about the rate at which the non-defense sequester has affected outlays, it is likely of a similar magnitude. If the entire sequester continues unchanged through the end of 2015, GDP would likely be around 1 percent lower and about one million jobs would be lost, compared to a scenario in which sequestration did not exist.

If the bipartisan agreement between Congressman Ryan and Senator Murray is adopted, some of the sequester's near-term economic drag would be delayed. In particular, restoring some of the funds to defense and non-defense discretionary spending during FY 2014 and FY 2015 would mean that the economic damage from the sequester would likely not worsen significantly over the next one to one-and-a-half years. This would allow additional time for the economic recovery to pick up speed before more deficit reduction is implemented. However, a longer-term agreement would be necessary to permanently reduce the negative economic impact of the sequester.

Where Do We Go from Here

The clock can't be turned back and the effects so far cannot be fully undone, but as the charts above show, the nation is on course for additional economic damage that could be avoided. Replacing the sequester with the Ryan-Murray budget agreement would alleviate some of these impacts. Ultimately, sequestration will not fundamentally change the nation's debt trajectory, only delaying by two years the date at which point debt exceeds 100 percent of GDP:

SEQUESTER DELAYS FEDERAL DEBT REACHING 100% OF GDP BY ONLY 2 YEARS



Note: The BPC Alternative Baseline assumes current law, except that: 1) funding for combat operations overseas winds down; 2) Medicare physician payments are frozen at 2013 levels ("doc fix"); 3) the sequester is waived; 4) expiring tax provisions are extended as they have been in the past; and 5) aid for Hurricane Sandy is not extrapolated for future years.

Source: Congressional Budget Office (February 2013) and Bipartisan Policy Center extrapolations

The best approach would address the true drivers of the nation's long-term debt challenge – the growing cost of entitlements, especially those related to health care, and an inefficient tax code that raises too little revenue. Furthermore, reductions to defense spending would be made through gradual reforms that make the Department of Defense more efficient and effective in its mission. These changes are politically challenging, but would address the nation's fiscal imbalance and would likely enhance economic growth over the long run.

For more information about the defense sequester, see BPC's reports:
Indefensible: The Sequester's Mechanics and Adverse Effects on National and Economic Security
From Merely Stupid to Dangerous: The Sequester's Effects on National and Economic Security