February 2013

Sequestration (a.k.a. – Automatic Spending Cuts)

The automatic government spending cuts, set to take place on March 1st, are extremely intertwined with the debt ceiling. Some of the background bullet points of this article were also mentioned in our prior article on the debt ceiling.

Background:

- The U.S. debt has grown from $8.9 trillion at the end of 2007 to $16.4 trillion at the end of 2012.
- In 2011, the debt ceiling became the central battle theme between Republicans, who had taken control of the House in the 2010 elections, and President Obama. Republicans refused to raise the debt ceiling limit without a deficit-reduction package as part of the deal.
- The impasse was resolved in July 2011 when both parties agreed to the Budget Control Act, which forces broad spending cuts if no deal could be worked out by the end of 2012.
- These automatic cuts, known as "sequestration" cuts, were supposed to take place on January 1, 2013. However, they were pushed back until March 1, 2013 by the American Taxpayer Relief Act of 2012, passed on New Year's Day to head off the so-called "fiscal cliff."

The Issue At Hand:

The biggest issue, as I see it, is the dramatic shift in the demographics of our country. Our population is aging, people are living longer, and retirees are more reliant on government programs to supplement a large percentage of their retirement income needs. Of the $3.793 trillion that our government spent last year, $2.25 trillion was on mandatory programs, like social security, Medicare, Medicaid, and pensions. In fact, social security, Medicare, and Medicaid account for more than two-thirds of this mandatory spending. With government income at only $2.469 trillion in 2012, that doesn't afford us much to spend on discretionary government departments, like Health & Human Services, Education, Housing & Urban Development, or our military without going into a deficit. The 2012 Tax Payer Relief Act is estimated to raise an additional $364 billion in 2013. This still places us with a $960 billion deficit without some sort of government spending cuts.

The fear of the "sequestration" cuts is that the $85 billion in automatic government spending cuts, set to take place on March 1, 2013, could put the United States back into a recession. In my opinion, this is a very real possibility. Our GDP dropped 0.1% for the 4th quarter of 2012. Cuts in government spending coupled with increasing taxes at the beginning of the year, could easily shrink the economy further. If no agreement occurs, $1.2 trillion in automatic government spending cuts will occur over the next 10 years. The hardest hit will be military spending, cut by 11%. The Department of Education will experience a 7.8% cut to its budget this year (reduced to 5.5% in 2021). On February 13th, the nonpartisan Congressional Budget Office has estimated that 750,000 jobs will be lost in 2013 if the "sequestration" occurs in its present, pre-agreed upon form.

The solution is not an easy one. Increase taxes on individuals too much, and you will hurt the discretionary spending. Increase taxes on corporations, and they will be forced to cut back on discretionary spending, including hiring more employees. Cutting too deeply into government spending hurts GDP growth and increases unemployment. Cutting retirement benefits of the elderly through austerity measures is clearly a less than desirable solution. Ultimately, the long-term solution is to grow our economy and our tax bases while controlling our expenses. Lack of fiscal responsibility by our political leaders will come with dire consequences.

As mentioned before, the "sequestration" is set to take place on March 1st, unless both parties negotiate a new deal. Given the historic lack of cooperation between the Democrats and Republicans, I am not counting on a negotiated deal. The closer that we come to the automatic spending cuts without any type of resolution, the higher the likelihood the markets will become more volatile.

As always, we are monitoring the situation closely and will make appropriate changes if necessary to your portfolios. If you have any questions, please feel free to call or write.

Sincerely,
Jeff