# WHAT THE FISCAL CLIFF DEAL MEANS FOR DEFENSE

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Backgrounder

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The American Taxpayer Relief Act (ATRA) of 2012, signed into law on January 2, 2013, averted much of what has become known as the "fiscal cliff." While the bill mostly deals with automatic changes scheduled to take effect for tax rates and programs such as Medicare and unemployment insurance, it also makes several important changes to sequestration that affect the Department of Defense (DoD). Specifically, it delays sequestration by two months, reduces the amount of cuts in proportion to the delay, and alters the way the budget caps are applied in Fiscal Year (FY) 2013. This backgrounder details how the new law alters sequestration and what it means for defense.

## What Changed

The ATRA makes three major changes to sequestration from what was originally specified in the Budget Control Act (BCA) of 2011. First, it changes the implementation date for the "penalty" sequester—the initial cut that is a direct result of the failure of the Super Committee to reach its deficit reduction target—from January 2 to March 1.[1] It also moves the date of the "after-session" sequester—the second phase of sequestration that eliminates any remaining budget authority in excess of the budget cap—from January 15 to March 27.[2,3]

The second major change is that it reduces the amount of the penalty sequester for FY 2013. In the original BCA, the penalty sequester for FY 2013 was $54.7 billion for national defense (the 050 budget function). The new law reduces that by $12 billion to $42.7 billion.[4] This reduction is roughly in proportion to the two-month delay: instead of cutting $54.7B over the remaining nine months of the fiscal year, $42.7 billion will be cut over seven months.

The third major change in the law is a reduction and change in definition of the budget caps. Under the original BCA, the initial budget caps for national defense were set at $546 billion in FY 2013 and $556 billion in FY 2014. These initial caps are then reduced by the amount of the penalty sequester, and any remaining budget authority in excess of the revised caps is eliminated in the after-session sequester. The new law reduces the FY 2013 cap by $2 billion and the FY 2014 cap by $4 billion.[5] For the purposes of the FY 2013 after-session sequester only, the new law uses the broader security category for the

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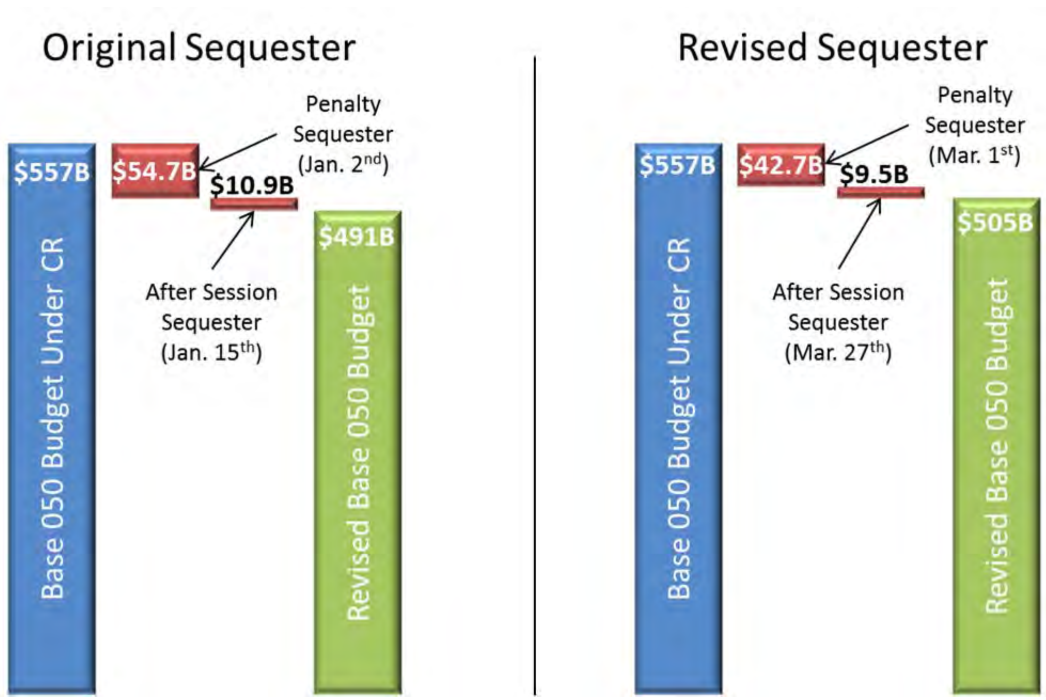
[1] H.R. 8, 112th Congress, §901(c).
[2] H.R. 8, 112th Congress, §901(b).
[3] In FY 2014 and beyond, only the "after-session" sequestration will occur. The "penalty" sequester, also referred to as the Joint Committee sequester, is unique to FY 2013 and is a direct result of the Super Committee's failure to achieve the required deficit reduction.
[4] H.R. 8, 112th Congress, §901(a).
[5] H.R. 8, 112th Congress, §901(d) and (e).

budget cap, which includes the budgets for the Departments of Defense, Homeland Security, Veterans Affairs, and the National Nuclear Security Administration. The initial budget cap for the security category in FY 2013 is $684 billion, including the $2 billion reduction. As before, this initial cap is further reduced by the amount of the penalty sequester, which is $42.7 billion for FY 2013. All accounts within the broader security category must be reduced by a uniform percentage to bring their total below the revised cap. In FY 2014 and beyond the budget cap reverts to the more narrowly defined 050 budget function, which includes DoD and roughly $24 billion in defense-related spending in other agencies. In FY 2014, the initial 050 cap is $552 billion, taking into account the $4 billion reduction from the ATRA. This cap is further reduced by the original $54.7 billion penalty sequester, and all accounts within the 050 budget function must be reduced by a uniform percentage to bring their total below the revised cap.

Figure 1 summarizes the changes for overall national defense funding (the 050 budget function), comparing the original sequester under the BCA (left) to the amended sequester under the ATRA (right). The net effect for national defense is that the total level of funding for FY 2013 will be $505 billion, some $14 billion higher than the $491 billion in funding allowed under the original BCA.

*Figure 1: Changes to Sequestration for Overall National Defense Funding (050) in FY 2013*




DoD funding comprises 95.8 percent of overall national defense funding, or $534 billion, in the continuing resolution currently in effect. Because sequestration requires uniform cuts across all accounts, DoD will receive 95.8 percent of the cuts allocated to national defense under the penalty sequester. DoD is 75.6 percent of the broader security category, and thus will receive 75.6 percent of the cuts to this category under the after-session sequester in FY 2013. Figure 2 details how the changes from ATRA affect the

DoD portion of sequestration. The net effect for DoD is that its FY 2013 budget will be cut to approximately $486 billion instead of $471 billion. Table 1 details the annual caps on the base discretionary DoD budget for years FY 2013 to FY 2021, comparing the president's request to the original BCA sequester and the revised ATRA sequester.

*Figure 2: Changes to Sequestration for DoD Funding in FY 2013*

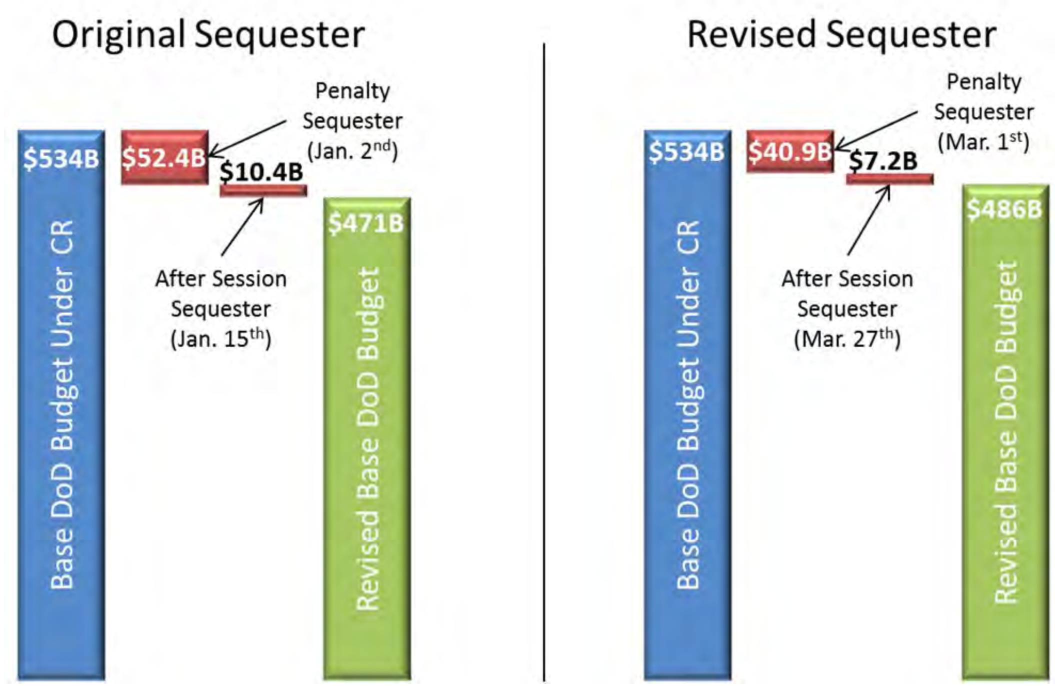



*Table 1: Comparison of DoD Base Discretionary Budget Authority for FY 2013 to FY 2021*
*(in billions of then-year dollars)*

| | FY13 | FY14 | FY15 | FY16 | FY17 | FY18 | FY19 | FY20 | FY21 |
|---|---|---|---|---|---|---|---|---|---|
| President's FY13 DoD Budget Request | $525.4 | $533.6 | $545.9 | $555.9 | $567.3 | $579.3 | $592.4 | $605.4 | $617.9 |
| DoD Budget Under Original Sequester | $470.9 | $479.0 | $488.7 | $499.2 | $511.6 | $524.0 | $536.5 | $549.8 | $563.2 |
| DoD Budget Under Revised Sequester | $485.7 | $475.2 | $488.7 | $499.2 | $511.6 | $524.0 | $536.5 | $549.8 | $563.2 |

## What Did Not Change

The law did not alter the way the cuts must be administered. It still requires a uniform percentage reduction across all applicable accounts at the program, project, and activity level. Under the original sequester (using annualized funding levels enacted in the continuing resolution), the penalty sequester would have cut 9.6 percent and the after-session sequester would have cut an additional 2.1 percent across all applicable DoD accounts, for a total reduction of 11.5 percent.[6,7] Under the amended law, the penalty sequester will cut 7.5 percent and the after-session sequester will cut an additional 1.5 percent, for a total reduction of 8.8 percent.[8]

The law also did not alter the way military personnel and Overseas Contingency Operations (OCO) funding is handled. Military personnel funding counts against the budget caps but is exempt from the across-the-board cuts. OCO funding, in contrast, does not count against the budget caps but is subject to the across-the-board cuts. For example, each additional dollar of military personnel funding pushes the level of total funding over the budget caps by another dollar and thus triggers another dollar of cuts. These additional cuts, however, are taken from other accounts since military personnel accounts are exempt from the across-the-board cuts. In contrast, each additional dollar of funding designated as OCO does not change the amount of funding that must be sequestered because it does not count against the budget cap. OCO funding does not affect the dollar amount of the cut, but, because OCO funding is intermingled in the same accounts as base funding, it is cut by the same percentage as all other non-exempt funds.[9]

## March Madness

The two-month delay in sequestration has created a confluence of three critical fiscal events scheduled to occur in or around the month of March. First, the Treasury will begin to run out of options to avoid breaching the debt ceiling in late February or early March.[10] If Congress does not take action to raise the debt ceiling, the Treasury will not be able to pay all of the nation's legal obligations, which include payments to military personnel, DoD civilian personnel, and defense contractors. Moreover, a government default on its legal obligations (even if it continues to make interest and principal payments) could have broader economic effects that ultimately worsen the nation's debt situation.[11] It could put at risk the "full faith and credit" of the United States government

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[6] The two percentages do not add to 11.5 percent because the cuts are applied on top of one another, i.e. (1-0.096) x (1-0.021) = 0.885.

[7] This figure differs from the 10.3 percent cut estimated by the author in August (see "Analysis of the FY2013 Defense Budget and Sequestration" accessed at http://www.csbaonline.org/publications/2012/08/analysis-of-the-fy2013-defense-budget-and-sequestration/) because the prior analysis used the requested level of funding for FY 2013 rather than the higher level of funding enacted in September under the continuing resolution. It also differs from the 9.4 percent reduction in the OMB Sequestration Transparence Act Report because that report only included the penalty sequester and used the FY 2012 level of funding (see "OMB Report Pursuant to the Sequestration Transparency Act of 2012," accessed on January 7, 2013, available at http://www.whitehouse.gov/sites/default/files/omb/assets/legislative_reports/stareport.pdf). The continuing resolution currently in effect provides $3.1 billion more for DoD than the FY 2012 level of funding and $8.3 billion more than the FY 2013 request.

[8] These calculations must assume a level of unobligated balances and therefore are not intended to be exact. The exact percentage will not be known until the amount of unobligated balances in all applicable defense accounts is determined in March.

[9] DoD can prioritize funding within accounts and has indicated that it will preserve funding for OCO activities at the expense of other activities within the same accounts.

[10] Timothy Geithner, Secretary of the Treasury, to Senator Harry Reid et al., December 26, 2012, accessed on January 5, 2013, available at http://www.treasury.gov/connect/blog/Documents/Sec%20Geithner%20LETTER%2012-26-2012%20Debt%20Limit.pdf

[11] Department of the Treasury, "Debit Limit: Myth v. Fact," accessed on January 7, 2013, available at http://www.treasury.gov/initiatives/Documents/Debt%20Limit%20Myth%20v%20Fact%20FINAL.pdf.

and potentially affect the nation's ability to borrow in times of crisis, such as a major war or national disaster.[12] All major wars the United States has fought, from the Revolutionary War to the most recent wars in Iraq and Afghanistan, have been financed in part through borrowing.

The second critical fiscal event is sequestration, which will occur on March 1 (the penalty sequester) and again on March 27 (the after-session sequester). The third critical fiscal event also occurs on March 27 when the current continuing resolution expires. If Congress has not passed an appropriations bill or continuing resolution by that date, the federal government will have to shut down all non-essential activities. The potential for a government default, sequestration, and a government shutdown all occurring in the month of March can be fairly called "March Madness."

## Conclusion

The fiscal cliff debate and the way the ATRA was ultimately crafted provide some insight into what the coming months may mean for defense funding. Throughout the fiscal cliff debate, sequestration appeared to be a relatively lower priority for political leaders on both sides of the aisle in comparison to the other major issues involved in deficit reduction, such as tax rates and changes to programs like Social Security and Medicare. The decision to delay sequestration by two months implicitly links it to the upcoming debt ceiling debate, which may again make sequestration a relatively lower priority. The debt ceiling debate is likely to be focused on identifying spending cuts in entitlement programs and broad reform of the tax code. Reaching an agreement on these difficult issues will itself be challenging. Attempting at the same time to find an additional $1 trillion in spending cuts or revenue increases to offset sequestration may be unrealistic. For these reasons, the fiscal cliff deal's two-month delay in sequestration may ultimately increase the odds of sequestration—or some variant of it—going into effect.



[12] Ibid.