CORNERSTONE
GOVERNMENT AFFAIRS

MEMORANDUM

TO: RICE UNIVERSITY

FROM: CORNERSTONE GOVERNMENT AFFAIRS

SUBJECT: SEQUESTRATION OUTLOOK

DATE: DEC. 2, 2011

The Budget Control Act of 2011 (BCA) enacted in August after heated negotiations established the Joint Select Committee on Deficit Reduction — the Super Committee — and requires a series of automatic spending cuts, known as sequestration, in the event the Super Committee fails to produce a bill to reduce the deficit. Just before Thanksgiving, the Super Committee announced it was not able to reach an agreement on deficit reduction. Therefore, as required under BCA, an automatic sequestration of $1.2 trillion will be triggered on Jan. 2, 2013. The BCA does not lay out any specific program funding cuts but does require cuts among large categories of spending.

Federal government spending is divided into two broad categories:

(1) **Mandatory** or entitlement programs, such as Social Security, Medicare, Medicaid and certain other programs -- including but not limited to food stamps, federal civilian and military retirement benefits, veterans' disability benefits and unemployment insurance -- that are not controlled by the annual appropriations or budget process. Instead, the eligibility for these programs is set in law and funding is provided by the Treasury as needed. Mandatory programs account for more than 60 percent of federal spending, and the cost of these programs is expected to rise dramatically in the coming years as more people become eligible for benefits.

(2) **Discretionary** programs must have their funding renewed each year by Congress in order to continue operating. The annual budget process, including the 12 annual appropriations bills, determines the discretionary funding necessary to administer most government agencies and programs. Almost all defense spending is discretionary, as are the budgets for basic research, housing and K-12 education, to name just a few examples. Altogether, discretionary programs make up about one-third of all federal spending.

BCA treatment of mandatory spending - sequestration

The BCA requires cuts to mandatory spending amounting to approximately 29 percent of the $1.2 trillion in reductions. Of this, 16 percent of savings will be due to lower debt service and 13 percent will come from an automatic sequestration of mandatory spending for fiscal years 2013-2021. Several mandatory programs, and portions of programs, are exempt from the sequestration process, including Social Security benefits and Medicaid. There also is a limit of 2 percent on cuts to Medicare.

BCA treatment of discretionary spending – caps and sequestration

The BCA limits discretionary spending by establishing specific caps for fiscal years 2012-2021. The Appropriations Committees maintain jurisdiction over funding levels for specific programs, projects and activities but, as in the past, the cumulative total of the appropriations bills may not exceed the caps established in the BCA. Absent an agreement by the Super Committee, the BCA also sets in motion the sequestration process, where cuts are automatic and spending caps are reduced. Approximately $109 billion will be sequestered from discretionary programs in FY13, half from defense accounts and half from non-defense accounts.

For FY12 and FY13, the BCA created two caps on discretionary spending, a "security" spending cap and a "non-security" spending cap. For FY12, the security category included funding for the Departments of Defense, Homeland Security, VA and State. For FY13, the security category is mostly limited to the Defense, meaning that spending cuts will fall more heavily on those programs in 2013. After FY13, there is just one overall cap.

The Congressional Budget Office (CBO) estimates that sequestration will likely reduce security/Defense discretionary funding by 10 percent and non-security discretionary funding by 7.8 percent in FY13. The caps on spending for FY14-FY21, after the initial FY13 sequestration cuts, will achieve the balance of the savings – resulting in cuts (below the previously projected spending levels) of 8.5 percent for security programs and 5.5 percent for non-security programs in FY21. If Congress adheres to the caps for the entire 10 years, it will appropriate about $825 billion less than if it appropriated the same level of resources, adjusted for inflation, as in FY11.

Discretionary programs likely affected by sequestration

Though the estimate of sequestration cuts to non-security discretionary programs in 2013 is 7.8 percent, this does not mean that all programs will be treated equally. The BCA included sequestration exemptions for several programs, accounts and activities within discretionary spending. This could mean that some programs may suffer significantly higher cuts, while others are left untouched. Under the BCA, the White House Office of Management and Budget (OMB) is tasked with calculating the sequestration and annual spending cap targets. Therefore, OMB will have some responsibility in interpreting which programs and portions of programs are exempt from sequestration – unless Congress intervenes.

In previous years, Congress has included sequestration instructions, at much lower levels, in annual appropriations bills funding discretionary programs. Since sequestration is not scheduled to begin until January 2013, Congress may still pass legislation to adjust sequestration levels or redefine sequestration categories or exemptions.

Members of Congress strongly supportive of defense spending have announced plans to protect the Pentagon's budget from the nearly $500 billion in estimated cuts over the FY13-21 window. However, President Obama has announced he will veto any legislation that unilaterally prevents defense cuts.

At this point, we do not know if or how Congress will intervene in the sequestration process. If Congress passes a budget resolution (which is usually a short bill setting an overall spending target to base the annual appropriations bills on) in the Spring, it is likely that it will be the vehicle for changes to the sequestration process. Indeed, House Republicans have already announced plans to use the budget resolution to replace the sequester with an alternative fiscal fix.

Should OMB retain control over defining and calculating the sequestration categories, the president's FY13 budget request to Congress, to be released in February 2012, will provide a good indication of which programs are likely to suffer most heavily under sequestration and which programs OMB is most likely to protect through their interpretation of the BCA exemption categories. For instance, in the FY12 budget request, the administration suggested an $8 billion funding level for NSF and assumed that that amount would be reduced to between $7.8 billion and $7.9 billion over the next four years.

It is safe to assume that under the current scenario, NIH, NSF and other research grant-making agencies will receive at least a 7.8 percent in funding. Some in Congress suggest that such a cut at NIH would result in 2,500 to 2,700 fewer research grants per year. It also would mean a per-year cut of $530 million at NSF, which would translate to a cut of $430 million for research grants. At that level, NSF would be able to fund around 1,500 fewer research and education grants. It is likely that if sequestration moves forward, a disproportionate amount of cuts will come to DOD research programs. The Pentagon leadership will be extremely reluctant to cut weapons system acquisition, and OMB will likely protect military personnel from cuts as well. **Therefore, it is reasonable to expect that cuts much greater than 10 percent will be levied on DOD extramural research programs.**

While it is unlikely that these cuts will result in reductions to existing grants, it is highly probable that renewals could be canceled and future awards drastically reduced. In addition, research centers enjoying annual appropriations support could see their funding eliminated as well. It is our recommendation at this time that Rice prepare for <u>at least</u> proportional cuts of 8 percent for NIH- and NSF-supported research and 10 percent to DoD-supported research to its federal portfolio.

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As always, please do not hesitate to contact us with questions or concerns.