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STRATEGIES

Sequestration under the Budget Control Act

Background on the Budget Control Act

On August 2, 2011, the Budget Control Act of 2011 (BCA) (P.L. 112-25) became public law. While the bill allowed the debt ceiling to be increased up to $2.8 trillion, it also include provisions to reduce the deficit by $2.3 trillion over 10 years. The BCA aims to reduce the deficit by $2.3 trillion over 10 years through two main vehicles:

- **Caps on discretionary spending**: BCA limits – or "caps" – overall discretionary spending for the next ten years. If implemented as enacted, these caps will reduce spending by $841 billion over the next decade. Under BCA, discretionary spending will be cut by $841 billion over 10 years, with $44 billion (4 percent) in cuts in FY 2012, accelerating over 10 years to $119 billion (9 percent) in FY 2021. The new caps do not constrain spending for the war in Afghanistan or similar activities or for designated emergencies. Given the emphasis on discretionary spending, the caps would not affect Medicare or Medicaid, which are mandatory entitlement programs.

- **"Super Committee" Sequestration**: BCA also created a new, special joint committee of Congress charged with finding at least $1.2 trillion in deficit reduction. If this "Super Committee" failed to reach a consensus, then additional sequestration (related to both discretionary and mandatory spending) would go into effect. On November 21, 2011, the Super Committee members acknowledged that they could not come to an agreement, defaulting to the separate sequestration process.

This paper will summarize the sequestration processes for both the caps on discretionary spending, as well as the Super Committee sequestration process. For each of these summaries, this paper will examine the BCA *as it was enacted*. As with all actions of Congress, Congress may opt to revisit some of the key components of the BCA in 2012, since the Super Committee sequestration cuts do not go into effect until 2013. Given that potential, this paper further summarizes previous Congressional sequestration processes and provides an outlook for what Congress may consider in its further deliberations regarding deficit reduction.

Sequestration

Sequestration is a mechanism through which automatic, across-the-board spending cuts are made. The BCA will initiate a sequestration if (1) Congress approves spending higher than caps set forth in the law or (2) if a separate plan supported by the Super Committee is not accepted by Congress. The BCA creates two slightly different sequestration procedures for each scenario.

Sequestration and the Discretionary Spending Caps

The BCA sets out discretionary spending limits through FY 2021, starting with FY 2012. These caps represent spending cuts relative to current spending levels (or baseline). The first two fiscal years, FY 2012 and 2013, have caps for both security[1] and non-security discretionary spending; FY 2014 through FY 2021 have only one overall cap for all discretionary spending.

[1] For purposes of the discretionary spending caps, security funding is defined as the Department of Defense, the Department of Homeland Security (DHS), the Department of Veterans Affairs (VA), the National Nuclear Security Administration, "intelligence community management," and international affairs.

When Sequestration Occurs. Within 15 days of Congress ending a session (typically at the end of a calendar year, so each Congress has two sessions), the Office of Management and Budget (OMB) is required to produce a report estimating spending for that fiscal year. If Congress has appropriated spending levels above the caps set forth in the debt agreement, then the president orders a sequestration. In addition, if, at any time after the initial sequestration, Congress passes a law increasing spending above any of the spending caps, there is another sequestration fifteen days after the passage of the law. If the law is passed before July 1, the sequester occurs for that fiscal year; if the law is passed on or after July 1, the relevant cap for the next fiscal year is lowered by the amount of the breach.

How Sequestration Occurs. Each nonexempt account is reduced by an equal amount to bring the spending level to the cap. For instance, if security spending ends up above the FY 2012 cap, all security accounts will be reduced by the same amount until overall security spending is below the cap; non-security spending would not be affected if it was under its cap.

Exempt Accounts. Congress outlined a whole series of exempt accounts.[2] Health-related accounts include:

- All programs administered by the Department of Veterans Affairs,
- Grants to States for Medicaid (75–0512–0–1–551),
- Children's Health Insurance Fund (75–0515–0–1–551),
- Non-defense unobligated balances,
- Black Lung Disability Trust Fund Refinancing (16–0329–0–1–601),
- Medical Facilities Guarantee and Loan Fund (75–9931–0–3–551),
- Payment to Department of Defense Medicare-Eligible Retiree Health Care Fund (97–0850–0–1–054),
- Payments to Health Care Trust Funds (75–0580–0–1–571),
- Payment to Radiation Exposure Compensation Trust Fund (15–0333–0–1–054),
- Radiation Exposure Compensation Trust Fund (15–8116–0–1–054),
- Vaccine Injury Compensation (75–0320–0–1–551),
- Vaccine Injury Compensation Program Trust Fund (20–8175–0–7–551),
- Black Lung Disability Trust Fund (20–8144–0–7–601),
- Department of Defense Medicare-Eligible Retiree Health Care Fund (97–5472–0–2–551),
- Energy Employees Occupational Illness Compensation Fund (16–1523–0–1–053),
- Postal Service Retiree Health Benefits Fund (24–5391–0–2–551), and the
- Retirement Pay and Medical Benefits for Commissioned Officers, Public Health Service (75–0379–0–1–551).

Sequestration and the Super Committee

When Sequestration Occurs. Given the recent acknowledgement by the Super Committee, a separate sequestration process will be initiated on January 2, 2013 (second quarter of FY 2013).

How Sequestration Occurs. Spending will be lowered by $1.2 trillion, with $109.3 billion in cuts per year (beginning in FY 2013), half of which ($54.7 billion) comes from security spending [3] and the other half from the rest of the budget. These cuts affect both mandatory and discretionary spending with proportionate cuts to both.

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[2] See http://www.law.cornell.edu/uscode/html/uscode02/usc_sec_02_00000905----000-.html for a full listing.

[3] For purposes of the Super Committee sequestration process, "security spending" is defined primarily as Department of Defense funding (Budget Function 050).

Exempt Accounts. With respect to exempt accounts, the Super Committee sequestration process is identical to that of the discretionary caps sequestration process, except that Congress further specified that only Medicare payments to providers (e.g., physicians, hospitals, Medicare Advantage plans, Part D prescription drug plans, etc.) would be cut, and these cuts would be limited to 2% per fiscal year. According to the Kaiser Family Foundation[4] and Avalere Health, [5] the sequestration would not affect:

- Premiums under Parts B and D (including the Qualified Individual program)[6],
- Cost-sharing for Medicare-covered services,
- Medicare premium and cost-sharing subsidies under Part D (including low-income and catastrophic coverage subsidies), and
- Revenues to the Medicare Part A trust fund.

Further, while sequestration would not directly raise beneficiaries' premiums and cost-sharing, it is possible that reductions in payments to plans and providers could indirectly affect beneficiaries' out-of-pocket costs, if, for example, Medicare Advantage plans shift costs to beneficiaries by raising premiums or cost-sharing. Once the 2.0 percent limit was reached for Medicare, spending cuts for all other nondefense discretionary and mandatory programs would be increased by a uniform percentage to achieve the required deficit reduction.

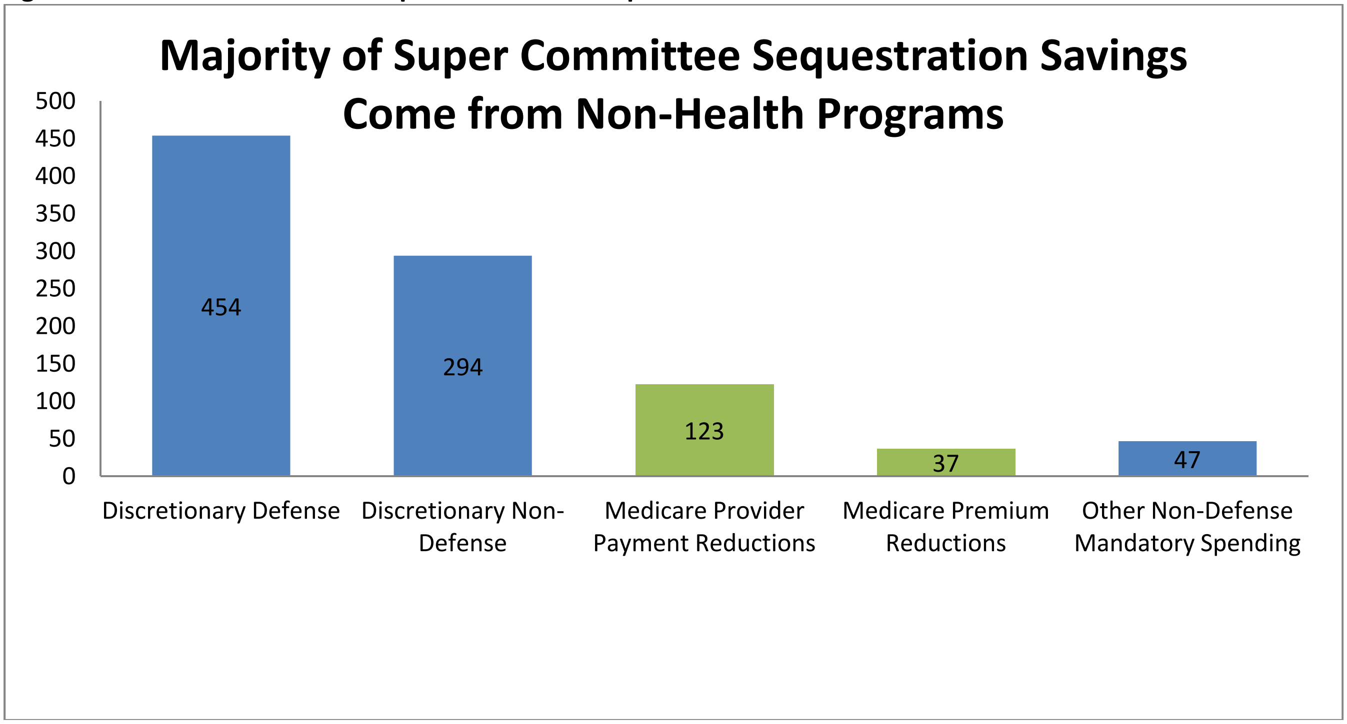
CBO Estimate. The Congressional Budget Office (CBO) has estimated the changes in discretionary and mandatory spending that would occur if the sequestration process was triggered because no new deficit reduction legislation was enacted.[7] CBO's analysis can only approximate the ultimate results; the Office of Management and Budget (OMB) would be responsible for implementing any such automatic reductions on the basis of its own estimates

CBO estimates that, if no legislation originating from the deficit reduction committee was enacted, the automatic enforcement process specified in the BCA would produce the following results between 2013 and 2021:

- Reductions ranging from 10.0 percent (in 2013) to 8.5 percent (in 2021) in the caps on new discretionary appropriations for defense programs, yielding total outlay savings of $454 billion.
- Reductions ranging from 7.8 percent (in 2013) to 5.5 percent (in 2021) in the caps on new discretionary appropriations for nondefense programs, resulting in outlay savings of $294 billion.
- Reductions ranging from 10.0 percent (in 2013) to 8.5 percent (in 2021) in mandatory budgetary resources for nonexempt defense programs, generating savings of about $0.1 billion.
- Reductions of 2.0 percent each year (*emphasis added*) in most Medicare spending because of the application of a special rule that applies to that program, producing savings of $123 billion, and
- Reductions ranging from 7.8 percent (in 2013) to 5.5 percent (in 2021) in mandatory budgetary resources for other nonexempt nondefense programs and activities, yielding savings of $47 billion. Thus, savings in nondefense mandatory spending would total $170 billion.
- About $31 billion in outlays stemming from the reductions in premiums for Part B of Medicare and other changes in spending that would result from the sequestration actions.
- An estimated reduction of $169 billion in debt-service costs.

[4] http://www.kff.org/medicare/upload/8216.pdf
[5] http://www.avalerehealth.net/attachments/Budget_Control_Act_and_Impact_of_Sequestration.pdf
[6] According to the Kaiser Family Foundation, in 2007, Part D benefit payments consisted of about 7% of the total going to drug plans, with 4% for low-income subsidy payments, and 1% for payments to union and employer-sponsored plans. See www.kff.org/medicare/upload/7305_03.pdf for more information.
[7] http://www.cbo.gov/doc.cfm?index=12414&zzz=42045

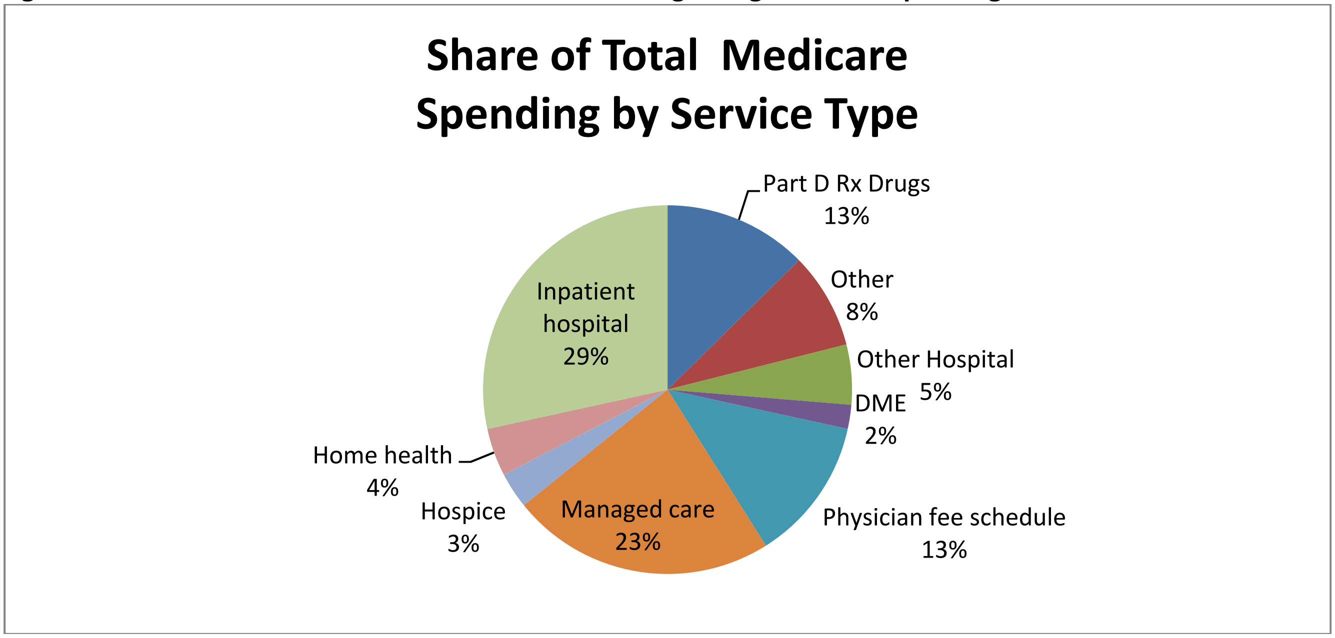
Figure 1. CBO estimate of the Super Committee Sequestration Process.



Note: The Medicare premium reductions are a result of provider payment reductions which would automatically reduce Medicare premium payments.

CBO and Medicare. Given the separate "savings clause" for Medicare, CBO also provided further estimates regarding the impact of that clause on future spending. CBO estimates that mandatory spending will account for roughly 58 percent of all nondefense spending that would be subject to enforcement procedures under the BCA from fiscal years 2013 and 2021. Of that nonexempt mandatory spending, the vast majority is for Medicare programs and activities that would be subject to the 2.0 percent limit. In the absence of such a limit, reductions in budgetary resources for Medicare would total $256 billion between 2013 and 2021. With the 2.0 percent ceiling, however, such reductions would be less than half that – a total of $123 billion over that period. The other $133 billion in required reductions that could not be accomplished because of the 2.0 percent limit would be reallocated proportionally among the remaining nonexempt mandatory programs and discretionary programs in the nondefense category (e.g., NIH funding).

Figure 2. MedPAC June 2011[8] Databook information regarding Medicare spending for 2010.



Total Effect of Sequestration Cuts. In examining the initial discretionary budget cap sequestration and the Super Committee sequestration process, FY 2013 is a special case. In 2013, discretionary spending caps are not lowered, but cuts are made from whatever discretionary and mandatory spending Congress approves for FY 2013, regardless of whether the level is at the spending caps or not (in other words, discretionary spending that year may be cut below the cap already instituted). For the other years, FY 2014 through FY 2021, the discretionary caps are lowered and mandatory spending is reduced by their respective calculated amounts. See the chart below for more information regarding the total effect of both sequestration processes.

Table 1. Total Effect of the BCA – Caps on Discretionary Spending and Super Committee Sequestration Processes

	BCA Caps on Discretionary Spending	Super Committee Sequestration	Total Effect
Effect on Medicaid, CHIP, Social Security benefits, TANF, etc.	No reductions, mandatory spending programs	No reductions, exempted programs	0% reductions
Effect on Medicare provider payments	No reductions, mandatory spending programs	Limited to 2% per year (special rule)	2% in 2013; 16.6% in 2021
Effect on discretionary public health programs (NIH, FDA, CDC)	4% in 2012; 9% in 2021	8.5% in 2013; 10% in 2021	4% in 2012; 19% in 2021
Effect on SGR	No reductions, mandatory spending programs	No changes without separate Congressional action	Not addressed; separate action required

[8] http://www.medpac.gov/documents/Jun11DataBookEntireReport.pdf

Previous Congressional Sequestrations and the Congressional Outlook

Previous Congressional Sequestrations. The BCA is not the first law to include a sequestration mechanism to constrain federal spending. Therefore, to better understand potential Congressional actions related to the BCA, it is best to also examine Congress's previous reactions to similar sequestration mechanisms, including the Balanced Budget and Emergency Deficit Control Act of 1985 (Gramm-Rudman Hollings Act), the Budget Enforcement Act of 1990 (BEA), and the Statutory Pay as You Go Act.[9]

Gramm-Rudman Hollings Act. The Gramm-Rudman Hollings Act established declining deficit targets, with the hope of achieving a balanced budget by FY1991. If Congress did not meet one of the targets, the law required a sequestration for both mandatory and discretionary spending. Similar to the BCA, Medicare reductions were capped annually at 2 percent of Medicare payments to providers, while Medicaid, Social Security, and other low-income programs were exempt from sequestration. In fact, a sequestration occurred in FY1986 and FY1990, but Congress avoided sequestration from FY1987 and FY1989, and reduced the sequestration in FY1990, through various means. For example, in 1987, Congress revised the Gramm-Rudman-Hollings Act by raising the deficit targets and setting FY1993 as the new target date for achieving a balanced budget. Some have criticized the Act for requiring Congress to take responsibility for deficits outside of its control, such as those due to poor economic conditions, rather than applying spending restrictions only to new legislation under the control of Congress.

Budget Enforcement Act. The BEA, which enacted as part of the Omnibus Budget Reconciliation Act of 1990, effectively replaced the Gramm-Rudman-Hollings Act. It included a pay-as-you-go (PAYGO) rule, which required all new mandatory spending and revenue legislation in a given fiscal year to be offset and not increase the deficit, or reduce the surplus, for that year, and the OMB tracked spending and revenues on a scorecard. If Congress violated the PAYGO rule (i.e., the scorecard amount was greater than zero), sequestration of mandatory spending, including Medicare, would be triggered. In addition, the BEA raised the limits on sequestration of Medicare spending from 2 percent to 4 percent of payments to providers, while continuing to exempt Medicaid, Social Security, and other low-income programs. In addition, the BEA included a separate process that set caps on discretionary spending, which were enforced by sequestration.

From FY1991 to FY1999, mandatory and discretionary spending mostly complied with the PAYGO rule and discretionary spending limits. However, beginning in FY2000, spending began to deviate substantially from these limits, and Congress used a variety of techniques to prevent large sequesters from occurring. For instance, Congress enacted the Defense Appropriations Act in FY2002, which required OMB to zero-out the PAYGO scorecard for FY2001 to FY2002 in order to avoid a sequestration of $130 billion. Although Congress extended the BEA in 1993 and 1997, the law effectively expired in 2002 when Congress set the OMB scorecards for the remaining years of the law to zero.

Statutory Pay-As-You-Go Act. The Statutory Pay-As-You-Go Act of 2010, established in February 2010, uses the same general PAYGO mechanism as the BEA, with some important differences. For example, the 2010 law allows Congress, until the end of 2011, to exclude the costs through December 31, 2014 of reforming the sustainable growth rate (SGR) formula to prevent automatic reductions in Medicare payments to physicians and does not require offsets for revenue loss associated with extending some tax cuts. The Act continues to exempt Medicaid, Social Security, and other low income programs, but has a higher threshold (4%) for the reduction in Medicare provider payments.

[9] http://www.kff.org/medicare/upload/8216.pdf

Congress complied with the PAYGO requirement in the first year of this Act, although about $1 trillion over ten years was excluded because it was designated as emergency spending or adjustments to current policy. This PAYGO mechanism is still in effect and is permanent unless overridden.

Congressional Outlook. Despite the inability of the Super Committee to develop a deficit reduction plan, Congress may opt to revisit the BCA and its two sequestration processes if such sequestration processes become politically unpalatable. Given that the Super Committee sequestration process does not go into effect until after the next election cycle (during the second quarter of fiscal year 2013 in early January 2013), Congress may opt to address potential deficiencies during the lame duck session of 2012 or when the new Congress reconvenes in January 2013.

Some Republicans already have expressed their intent to introduce legislation and work to protect defense spending from a sequester. For example, House Armed Services Chairman Buck McKeon (R-CA) has announced his intent to introduce legislation to prevent the cuts from taking effect in their current form. Also, Senators John McCain (R-AZ) and Lindsey Graham (R-SC) have expressed their intent to block defense spending and are working on a plan to minimize the impact of the sequester on the Department of Defense (DoD).

However, after the announcement that the Super Committee failed to reach agreement, President Obama stated he will veto any effort to alter the sequestration process: "My message to them is simple: No," he said, "There will be no easy off-ramps on this one." President Obama argued that Congress still has one year to achieve the required $1.2 trillion in deficit reduction, but acknowledges that it will be tougher to do now that Congress does not have the fast-track protections afforded to the Super Committee to vote on a plan.

Senate Majority Leader Harry Reid (D-NV) does not support altering the sequester ratio of cuts, but Minority Leader Mitch McConnell (R-KY) supports altering the sequester rule. In the House, Speaker John Boehner (R-OH) has said he feels obligated to honor the $1.2 trillion cuts, but has not committed to maintain the current ratio of cuts.