What We Hope to See from the Government Funding Negotiations
September 10, 2013

Only three weeks remain for Congress to agree on a plan to fund the federal government for FY2014. Absent appropriations bills or a so-called continuing resolution (CR), the government will "shut down" on October 1. A shutdown means that non-essential services would be discontinued due to lack of funding. The sequestration currently in place, born out of the Budget Control Act and failure of the Super Committee in 2011, adds an additional wrinkle to the debate. The sequestration cuts in 2014 will cause discretionary spending levels to be $91 billion below what was previously agreed to, with cuts to both defense and non-defense programs that neither side supports in full. Both the House and the Senate have called for violating the lower sequestration caps – the former on the defense side and the latter on both sides of the discretionary budget.

Ideally, lawmakers should use the sequestration as it was originally intended – to spur a bipartisan agreement on politically sensitive tax and entitlement reforms. Absent a comprehensive agreement, they should at the very least pursue either a partial replacement or a spending agreement which offsets any spending above the caps imposed by sequestration to avoid adding to the debt.

Absent offsets or a broader budget agreement that controls the long-term debt, appropriating funds above the sequestration levels should not be allowed. Canceling any savings from the sequester without replacing them with reforms elsewhere would be incredibly irresponsible and send a message that Washington is unable or unwilling to maintain the deficit reduction they have already agreed to, let alone tackle the long-term challenges that remain.

In the case of a short-term continuing resolution, they **must at a minimum set appropriations at FY 2014 *post-sequester* levels for defense and non-defense appropriations – the amount mandated by law – or else fully offset any higher funding levels with other reforms.** A short-term CR can buy time for a more permanent solution, but even short-term solutions should at least adhere to basic principles of fiscal responsibility.

CRFB's Grading System for Potential Appropriations Outcomes	
A	*Replace sequester-level caps with **a comprehensive plan to fix the debt***
B	*Replace sequester-level caps with permanent policies **at least as large***
C	*Enact **a multi-year partial replacement** or **year-long appropriations at sequester levels**, or above them with offsets to avoid adding to the debt*
F	*Enact funding **above sequester levels without offsets**, **cancel enforcement**, or use **budget gimmicks***
Incomplete	*Enact **a short-term fix** in the form of a temporary Continuing Resolution*

The State of Play for the FY2014 Appropriations

Under current law, FY2014 appropriations levels are set by the sequestration, which went into effect this year due to the failure of the Super Committee in 2011. Although the FY2013 sequestration cut spending levels across the board, for FY2014 and beyond the sequestration sets lower spending caps for appropriators to meet on discretionary funding (mandatory cuts remain across-the-board). Specifically, appropriators are required to appropriate no more than $967 billion in new discretionary funds for FY2014, which is roughly $20 billion lower than what was appropriated after sequestration for FY2013 (almost entirely on the defense side), and more than $90 billion lower than the intended caps for 2014 established in the January fiscal cliff legislation.

Fig. 1: Base Discretionary Funding under FY2014 Budget Proposals (Billions)

	Fiscal Year 2013		Fiscal Year 2014		
	Pre-Sequester	**Post-Sequester**	**Current Law**	**House Budget**	**Senate Budget**
Defense	$544	$518	$498	$552	$552
Non-Defense	$499	$469	$469	$415	$506
Total Base Funding	**$1,043**	**$988**	**$967**	**$967**	**$1,058**

Note: Figures reflect budget authority excluding disaster, war, and program integrity adjustments.

Neither the House nor the Senate currently intends to fully abide by the sequestration cuts. Senate appropriators have been marking up their funding bills at pre-sequester levels that are $91 billion higher than what current law allows. House appropriators, on the other hand, have attempted to pass appropriation bills that place all the sequester cuts onto non-defense programs in order to blow through the defense cap by more than $50 billion. So far, neither chamber of Congress has been able to pass legislation reflecting these goals. Of the 12 bills that need to pass, only four have made it out of the House, and none have made it out of the Senate, with the three bills that passed the House actually increasing spending above FY2013 levels.

Fig. 2: Status of Appropriations Bills (Billions)

Appropriations Bill	House		Senate		FY 2013
	Passed By:	**Level**	**Passed By:**	**Level**	**Level**
Agriculture	Committee	$19.5	Committee	$20.9	$19.5
Commerce-Justice-Science	Committee	$47.4	Committee	$50.3	$47.0
Defense	House	$512.5	Committee	$516.6	$486.3
Energy-Water	House	$30.4	Committee	$34.8	$33.8
Financial Services	Committee	$17.0	Committee	$23.0	$21.6
Homeland Security	House	$39.0	Committee	$39.1	$38.0
Interior-Environment	No Action	$24.3	No Action	$30.1	$28.2
Labor-HHS-Education	No Action	$121.8	Committee	$164.3	$149.6
Legislative Branch	Committee	$4.1	Committee	$4.4	$4.1
Military Construction-VA	House	$73.3	Committee	$74.4	$70.8
State-Foreign Ops	Committee	$34.1	Committee	$44.1	$39.8
Transportation-HUD	Committee	$44.1	Committee	$54.0	~$48.5*
Total		**$967**		**$1,058**	**~$988**

Source: House and Senate Appropriation Committees and the Center on Budget and Policy Priorities.
*Figure adjusted to remove one-time offsetting collections from the Federal Housing Administration (FHA) and Government National Mortgage Association (GNMA).

In July, the House had begun consideration of the Transportation-HUD appropriations bill in an effort to comply with their spending targets. However consideration was suspended, with reports suggesting that there were not enough votes to pass. Similarly, the Senate's efforts to pass a T-HUD bill at their own higher levels was unable to make it through that chamber.

Given this impasse, the most responsible and in some ways most achievable long-term solution would be to replace some of the steep and abrupt sequester cuts with a broader deficit reduction package that focuses on all parts of the budget. Yet, with only three weeks until current government funding expires, policymakers appear to be headed toward a temporary "Continuing Resolution" to buy more time to find agreement on a longer-term solution.

What We Hope to See from the Funding Negotiations

With the Senate and House so far apart on FY 2014 spending levels, replacing at least some of the discretionary sequester cuts with more permanent and intelligent deficit-reduction would not only be good policy going forward, but might in some ways be politically easier than fully abiding by the sequester or fully ignoring it.

CRFB has written many times before about the many drawbacks of sequestration, including that it is poorly targeted, imposes unnecessary burdens on the economy, is too small to control growing debt (even this decade), does nothing to address tax or entitlement reform, ends in 2021 and thus does little for controlling long-term debt, and its political sustainability is questionable.

Given these facts, the sequestration should be permanently replaced with more credible and sustainable discretionary caps and a comprehensive mix of measures to cut low-priority spending, slow entitlement growth, and reform the tax code. That package could be enacted all at once or in part through a process, but it would ideally be large enough to put the debt on a clear downward path relative to the economy over the next decade and beyond – in other words, bigger than the sequester.

Absent such a package, policymakers should at least pursue changes that move in the right direction. If policymakers cannot **go big, go smart, and go long** – as we continue to call for – they should at least aim to achieve some savings that are larger, better targeted, and more long-term than what the sequester savings produce. At minimum, policymakers should **do no harm** by abiding by pay-as-you-go principles and ensuring ten-year deficits do not increase as a result of their actions.

In the case of a CR, this would mean ultimately **spending at FY 2014 post-sequester levels or offsetting any increase from those levels with savings elsewhere.** A temporary CR, though far from ideal, would be preferable to a plan that deficit-finances spending above the post-sequester caps or uses gimmicks to pay for the difference. Such a short-term measure could provide additional time to negotiate and put in place a sensible plan.

Evaluating Scenarios for Funding the Government

Policymakers have a wide number of choices for addressing government funding levels, which will have varying fiscal consequences. CRFB will ultimately evaluate proposals based on the totality of what they include. However, below are various scenarios to which CRFB has assigned letter grades based on their level of fiscal responsibility.

In broad terms, a passing grade requires a funding solution of at least a year and preferably longer, and which does not add to the medium- or long-term debt relative to sequestration. A failing grade, on the other hand, would go to any plan that spends above sequester levels without tangible and credible offsetting savings.

The most likely option for the upcoming budget battle appears to be a grade of 'incomplete', which would be awarded in the case of a temporary CR. Although this scenario allows policymakers more time to find a permanent solution, the level at which the CR is set and any related offsets is important for determining Washington's fiscal credibility going forward. In the case of an incomplete grade, policymakers should spend the subsequent weeks and months working toward a permanent solution. Below is CRFB's grading system on appropriations for the upcoming negotiations:

Fig. 3: CRFB's Grading System for Appropriation Scenarios

A	Replace sequester-level caps with new caps and **a comprehensive plan to put the debt on a clear downward path** relative to the economy over this decade and the long term
B	Replace sequester-level caps with permanent policies that generate **at least equal savings over a decade** and **more over the long-term**
C	Enact **a multi-year partial replacement** of sequester that does not add to the debt, or enact **year-long appropriations at sequester levels**, or above them with offsets
F	Enact appropriations **above sequester levels without offsets**, **cancel enforcement**, or use **budget gimmicks** to replace the sequester
Incomplete	Enact **a short-term fix**, either a CR at sequester levels or above them, fully offset; or worse, a short-term CR above sequester levels (i.e. at FY 2013 levels)

Passing Grades

Sequestration was designed to encourage Congress to agree to a mix of spending cuts, tax changes, and entitlement reforms that would address our growing debt levels. Ideally, either before October 1 or later in the year, policymakers will agree to just that. The core elements of any new deficit reduction framework should be comprehensive tax reform and structural entitlement reforms – though other spending cuts and a set of achievable discretionary caps below pre-sequester levels could also contribute to the solution. A permanent SGR fix could also be included as a part of this broader fiscal package.

Such a plan could be implemented all at once or in part through some type of process – backed either with new triggers or the temporary retention of sequestration – to allow the Committees of jurisdiction to achieve savings targets on a fast-tracked basis (see CRFB's December 2012 analysis for what a credible process and enforcement mechanisms could look like: http://crfb.org/document/report-what-we-hope-see-fiscal-cliff-negotiations).

An **A** grade would come from a plan large enough to put the debt on a clear downward path relative to the economy. We previously estimated that this would require $2.2 trillion of savings relative to the CRFB Realistic Baseline, though that number could be lower depending on the specifics as well as the impact of revised GDP numbers.[1] Obviously, this approach would be optimal for long-term sustainability, hence the A grade.

To receive a **B,** policymakers would have to replace sequestration with a package at least as large over ten years - at least **$1.15 trillion** in deficit reduction, including interest, based on CBO's methodology (part of the savings could come from retaining part of the sequester; for discretionary spending would mean replacing the sequester with caps higher than sequester but lower than pre-sequester levels in the BCA). Such a package might not be large enough to put the debt on a clear and robust downward path, but any package to replace the temporary sequester cuts with permanent tax or entitlement changes will offer substantially more deficit reduction in the second and third decades when our challenges become more severe.

To earn a passing grade overall, policymakers would at least need to agree not to make the fiscal situation worse. A higher **C** grade would be awarded to a multi-year sequester solution, for example replacing five years of sequestration with caps both sides agree to and permanent spending and/or tax changes would improve the situation.

Recently, the *New York Times* reported on an option being floated to pay for two-years of sequester repeal, half with pure spending cuts and half with user fees that Republicans could claim as cuts and Democrats as revenue. The table below outlines what a deal like that might look like, assuming one third of the sequestration cuts were retained:

Fig. 4: Savings in an Illustrative "Mini Deal"

Budget Option	Current Law	CRFB Realistic
Repeal Two Thirds of Sequester (including mandatory portion)	**-$140**	**$70**
Spending Cuts	**$70**	**$70**
Reduce and Reform Farm Subsidies	$35	$35
Increase Contributions to Federal Retirement	$20	$20
Enact Modest Medicaid and Post-Acute Care Payment Reforms	$15	$15
User Fees	**$70**	**$70**
Allow PBGC to Increase Premiums	$15	$15
Increase Spectrum User Fees and Allow New Auctions	$5	$5
Increase Aviation Security User Fee and Establish Air Traffic Surcharge	$30	$30
Establish Fees for Abandoned Mines, Inland Waterways, and Nuclear Utilities	$5	$5
Make Current Fannie/Freddie and Customs Fees Permanent	$15	$15
Total Deficit Reduction	**$0**	**$210**

[1] Committee for a Responsible Federal Budget. "Our Debt Problems Are Still Far from Solved." Policy Paper, May 15, 2013. http://crfb.org/document/report-our-debt-problems-are-still-far-solved.

Such a deal would be worse than a permanent or five-year replacement, as it would be unlikely to include any of the structural reforms necessary to alter the nation's fiscal trajectory. But, by our estimates, these changes *would* offset a two-year partial sequester repeal over ten years and would reduce deficits in the second decade by about $250 billion before interest.

The lowest C grade would be reserved for a one-year solution which did not increase the debt. This would be awarded if policymakers agreed to spending at post-sequester levels for FY 2014 or else offset any spending above those levels. Because this solution would do nothing to improve the fiscal situation over any time period but would also not make it worse, it merits the lowest passing grade that lawmakers could receive.

Failing Grades

As policymakers solve 2014 funding levels and beyond, the worst thing they could do from a fiscal perspective is add to the overall debt this decade. The sequestration cuts are mindless, abrupt, anti-growth, narrowly focused, and fail to address the long term. However, **canceling any savings from the sequester without replacing them with reforms elsewhere would not only add to the debt and defeat the purpose of the sequester, but would send a message that leaders in Washington are unable to maintain even the deficit reduction they have agreed to.**

Using gimmicks to offset the cost of sequester reversal would be equally troubling. Among many potential gimmicks to avoid in upcoming negotiations are:

- **Phony savings:** Phony savings such as those from counting a war drawdown that has long been in place, or taking out the assumption in current law projections that the one-time Hurricane Sandy funding will happen again and again, represent the types of gimmicks that lawmakers must avoid.

- **Timing shifts:** Tax cuts or spending increases that temporarily reduce short-term deficits only to balloon long-term deficits – such as the Roth IRA conversion provision in the fiscal cliff deal – represent another gimmick that must be avoided.

- **Excessively back-loading savings:** Rational fiscal policy may want to push off the majority of savings until the economy has fully recovered. However, delaying too long to begin savings at all, or allowing savings to balloon beyond what is achievable, would not and should not be viewed as credible.

- **Arbitrarily redistributing non-credible cuts:** When policymakers were first faced with automatic physician cuts under the Sustainable Growth Rate (SGR), they reversed those cuts by calling for larger automatic cuts in the future. Yet if abrupt cuts of a certain size or not politically achievable now, there is no reason to think even larger cuts will be achievable later. Policymakers should avoid this gimmick, and specifically should not reverse the sequestration in early years paid for by increasing the size of it in later years.

- **Relying on Emergency Supplemental Funding:** The prospects of the use of force in Syria opens a potential opportunity for a supplemental funding bill. Although current cost estimates suggest such a bill shouldn't be necessary, it may ultimately make sense as a means for funding a one-time operation. In that event, policymakers must avoid the temptation to use this supplemental to backfill any of the defense (or non-defense) cuts from the sequester. Any supplemental funding should also be fully offset.

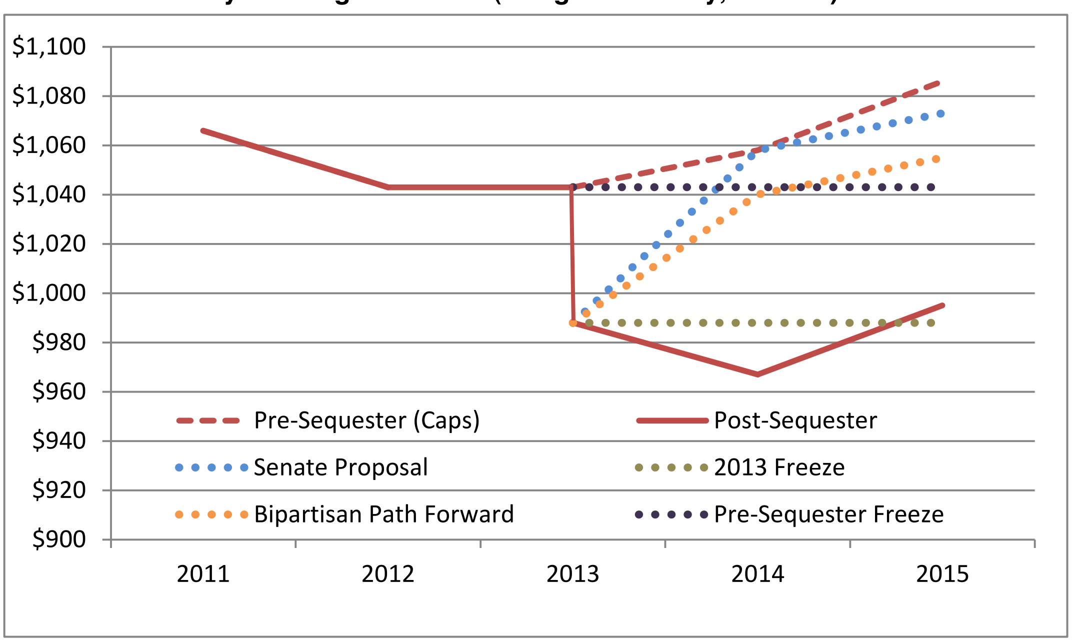
Incomplete Grades

Although policymakers must ultimately decide how to deal with the sequester and FY2014 spending levels, they may very well punt on these decisions in the short term to give themselves more time to come to a resolution and possibly to align the expiration of government funding with the drop-dead date for raising the debt ceiling.

A CR to fund the government for several days, weeks, or even months is a sensible alternative to a government shutdown if a broader deal cannot be reached. However, it matters what such a CR looks like.

Policymakers have a number of options for where to set FY2014 levels as they continue to negotiate. They could set funding at pre-sequester BCA levels, at the post-sequester levels they are required to spend at under statute, or somewhere in between – for example a freeze at 2013 levels (about $20 billion above the required cuts for 2014).

Fig. 5: Base Discretionary Funding Scenarios (Budget Authority, Billions)



Notes: Figures exclude funding for overseas contingency operations, disasters, and program integrity initiatives.

The responsible course of action – particularly for any extended CR – would be for policymakers to set funding levels at FY2014 post-sequester levels or else offset the fiscal impact of any departure from those levels through alternative savings. Doing so would earn policymakers an **incomplete** grade, but with a **positive outlook**. It is true that sequestration is a poor policy choice, and it is also true that levels set in a short-term CR do not definitively set spending levels for an entire year. However, spending above current law levels without providing offsets sends the wrong message about Washington's commitment to fiscal responsibility and in doing so undermines their fiscal credibility. Going this route would earn lawmakers an **incomplete** grade with a **negative outlook**.

The longer the CR, the more important it is that the resolution does not add to the debt relative to current law. And importantly, spending above sequester levels and waiving the enforcement of it, which would otherwise hit in January 2014, would turn an incomplete score into a **failing** grade.

In the process of negotiating FY2014 funding levels, policymakers must agree to at least **do no fiscal harm**. The temptation to allow 2013 levels to continue – at a small cost of $20 billion – will certainly be there. Given that this $20 billion difference falls almost entirely on the defense side, there may be further temptation to plus-up the non-defense side in response. Without offsets, this would be a huge mistake and represent a failure in Washington.

Conclusion

The need to avoid a shutdown and fund the government by October 1 represents the first in what may be a series of opportunities this upcoming fall and winter to discuss and ultimately address the nation's long-term fiscal picture. Given the purpose of the sequester – to encourage the enactment of a bipartisan agreement to control the debt – policymakers would ideally use this moment to replace at least a portion of the sequester with a comprehensive plan to reform the tax code, slow entitlement growth, reduce or reprioritize other spending, and put the debt on a clear downward path over the long-term.

At a minimum, however, policymakers must **do no fiscal harm.** If they agree to a one-year or multi-year reduction in sequestration cuts, such reductions should be fully financed through mandatory spending cuts or new revenue. If they agree to a temporary CR, they should do so at post-sequester levels or else fully offset any departure from those levels.

Sequestration is not the smart way to reduce the deficit. But repealing it without replacing the savings would represent a step in the wrong direction.