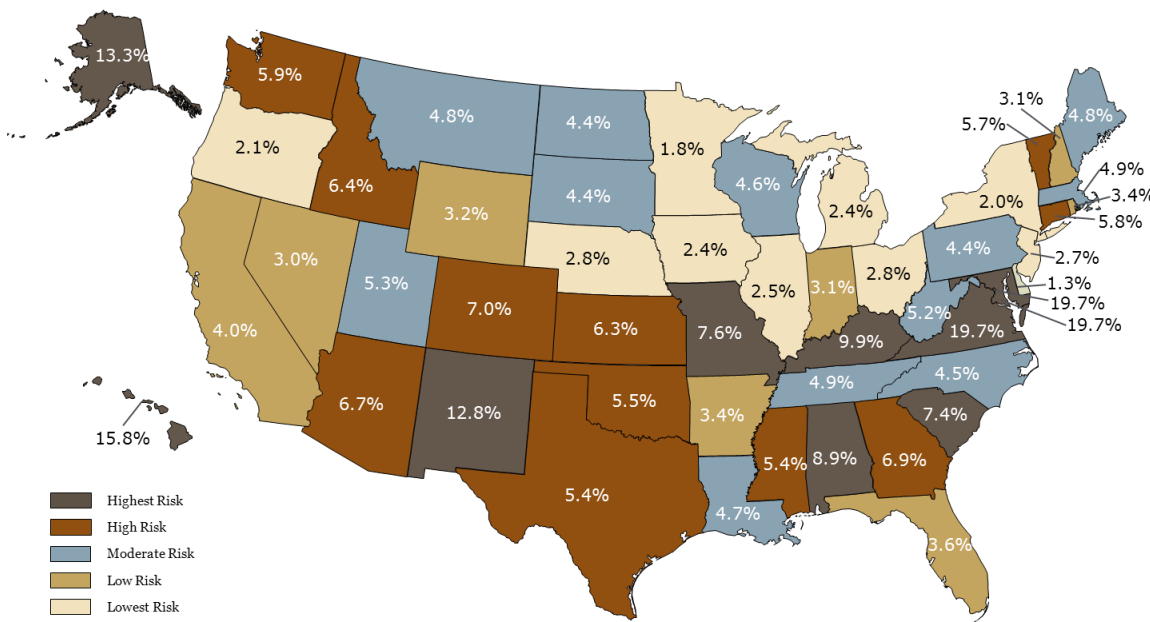


Economics Group**Special Commentary****Mark Vitner, Senior Economist**mark.vitner@wellsfargo.com • (704) 410-3277**Michael A. Brown, Economist**michael.a.brown@wellsfargo.com • (704) 410-3278**Sequestration: Which States Are Most Vulnerable?**

Over the course of the past few weeks, it has become more and more likely that the sweeping set of automatic federal spending cuts known inside the D.C. Beltway as “Budget Sequestration” will take place as scheduled beginning on March 1. In order to assess the potential regional impact of these budget cuts, we have identified those states that have the greatest exposure to federal funding cuts. We utilize the metrics calculated by the Pew Center on the States for federal spending as a percentage of state GDP.¹ We then identify those states that are most susceptible to defense and those most susceptible to nondefense spending cuts. Even a cursory review of the data shows that the process of budget sequestration will harm certain states disproportionately. In general, the greater Washington, D.C. area and southern states will be the hardest hit, while states in the Midwest and along the West Coast will likely be impacted to a lesser extent. While the impact of budget sequestration could be severe, there is some reason to believe that at least some of the cuts may be partially reversed in the months ahead.

The process of budget sequestration will harm certain states disproportionately.

Federal Spending as a Percent of State GDP

¹ Pew Center on the States. (2012). The Impact of the Fiscal Cliff on the States.



What Is Federal Budget Sequestration?

The process of budget sequestration is not new, in fact, the mechanism as we know it today has been in place since 1985.² One of the first steps in the budget process is for Congress to establish an annual Budget Resolution that caps the amount of total government spending for the fiscal year. In a typical budget process, Congress begins work on separate appropriation bills in the spring of each year. In some cases, the amount of federal funds appropriated in these bills exceeds the established annual Budget Resolution amount and, therefore, the Treasury Department is forced to “sequester” or not distribute funds to the agencies for the amount of spending above the annual limit. The amount of budget sequestration is determined by the difference between the cap set by Congress in the annual Budget Resolution and the excess amount appropriated by Congress beyond the annual cap.

The annual sequestration process was brought into the public spotlight back in 2011 when the Budget Control Act of 2011 established automatic budget cuts, a sequestration of spending authority, if a designated deficit reduction committee failed to arrive at a long-term deficit reduction plan. By late December 2012, the committee failed to reach an agreement on deficit reduction, therefore triggering an automatic set of budget cuts to designated sequesterable items beginning on Jan. 2, 2013.³ In the final showdown in December of last year over the “fiscal cliff,” Congress delayed the implementation of the sequestration process until March 1 and reduced the amount of budget cuts to be implemented this fiscal year to around \$85 billion.⁴

Even with the reduction in cuts for this fiscal year ending in September, there is still an estimated \$1 trillion in total cuts expected over the next 10 years, which will affect state economies on two fronts, defense cuts and nondefense cuts. The adverse economic effects from defense cutbacks will potentially reduce wages and employment in areas with a defense presence and regions with large defense contractors. Cuts in nondefense programs will affect a large number of hospitals, government contractors and research institutions.

States with a High Degree of Exposure to Defense Spending Cuts

The impending defense cuts will likely have a greater immediate impact effect on state economies due to the fact that these cuts are concentrated in a specific industry, which itself is concentrated in a handful of areas, as opposed to the nondefense cuts that are spread across a wider number of industries and geographic areas. Thus, we expect those states listed in Table 1 below to be disproportionately affected by the sequestration process. The potential effects on these states include military layoffs, cuts in defense contracts, reductions in military personnel and may result in another round of base closures. Moreover, these states would also face spill-over effects stemming from slower income growth and higher unemployment, which will cut into state and local tax receipts and increase demand for social services.

The regional impact of defense cuts is primarily concentrated in the Pacific West and the areas in and around Washington, D.C. Among the states most likely to be impacted is Hawaii, home to the U.S. Navy’s Pacific Fleet, which could see layoffs and reduced income growth, which in turn would weigh on economic growth. In addition, Alaska with its Air Force, Army and Naval operations would also be disproportionately impacted from defense cuts. Another key region of the country that would face difficulty is the area around Washington, D.C. The District of Columbia along with its neighboring suburbs in Northern Virginia and suburban Maryland are particularly vulnerable due to the multitude of defense agencies and contractors located in the region. Defense outlays are estimated to have accounted for 9.8 percent of the combined D.C., Virginia and Maryland

The impending defense cuts will likely have a greater immediate impact effect on state economies.

² The process of budget sequestration as it is used today was established by the Gramm-Rudman-Hollings Deficit Reduction Act of 1985 (P.L. 100-119) which served as a mechanism for formally establishing the amount of total government spending as opposed to simply aggregating total spending contained within several individual appropriation bills.

³ A sequesterable item as defined by the Budget Control Act (P.L. 112-25) consists of across the board mandatory and discretionary defense and nondefense items including a 2 percent reduction in Medicare benefits. Excluded from the sequestration process are Social Security, Medicaid, civil and military employee pay or veteran benefits.

⁴ American Taxpayer Relief Act of 2012. (P.L. 112-240, Jan. 2, 2013).

economies in 2010. The impact on the greater Washington, D.C., area is even more significant, however, and the prospect of drastic cuts has been a weight on economic growth this past year.

Washington, D.C., had been one of the economy's bright spots during the early days of the economic recovery, with job growth outpacing the rest of the economy and residential and commercial real estate markets turning around ahead of most other areas. Conditions began to slow following the botched negotiations over raising the debt ceiling back in 2011 and the prospect of significant cuts in defense spending began to send shudders through the real estate community in Northern Virginia, which was already reeling from cutbacks from the last round of base closures from the Base Realignment and Closure Commission (BRAC). Expectations slipped further following the presidential election, which appears to have made implementing the budget sequestration, particularly as it relates to defense spending, that much more likely.

Employment growth in the Washington, D.C., metro area has slowed this past year, as defense spending has wound down and agencies and contractors have pulled back on discretionary purchases. Overall, job growth remains solidly in positive territory, however, as growth has picked up in other areas, including residential construction, retail trade and travel and leisure. While growth has held up, the mix of jobs has changed and is now more heavily weighted toward lower paying occupations in retailing and tourism. As a result, income growth will likely slow.

Other areas vulnerable to defense cuts include Huntsville, Alabama and St. Louis, Missouri. Both have outsized exposure to the aerospace industry and will see growth slow if the military purchases fewer fighter jets, missiles and helicopters. Huntsville is likely more vulnerable due to its smaller size. Smaller towns that host large military bases are probably the most vulnerable areas in the sequestration battle because so much of their economic wellbeing is tied to the continued flow of defense dollars. Georgia is home to three such areas: Columbus, Warner Robbins and Hinesville. In Texas, El Paso and Waco, home to Fort Bliss, and Fort Hood, may also be vulnerable. All have seen growth slow ahead of the sequestration, as businesses have become more tentative about expanding and hiring workers. Following years of strong growth, Fayetteville and Jacksonville, North Carolina have seen their economic fortunes turn. Growth had previously been fueled by troops relocating from other bases after the last round of base closings and an influx of earnings that flowed in from the surge of troops fighting in Afghanistan.

Among larger metro areas, the greatest potential impact is in large Navy towns such as San Diego and Norfolk-Virginia Beach. The Norfolk area has already seen the deployment of the USS Harry Truman to the Persian Gulf delayed and a popular air show has also been canceled. Shipbuilding and major overhauls will also be impacted and some projects are already being delayed.

Smaller towns that host large military bases are probably the most vulnerable areas in the sequestration battle.

Table 1

Top 10 States with Exposure to Defense Cuts		
State	Federal Defense Spending as a % of 2010 GDP	Total Federal Spending as a % of 2010 GDP
Hawaii	14.6	15.8
Alaska	10.5	13.3
District of Columbia	9.8	19.8
Maryland	9.8	19.8
Virginia	9.8	19.8
Kentucky	8.0	9.9
Alabama	7.0	8.9
Missouri	5.9	7.6
Connecticut	5.3	5.8
Arizona	5.2	6.6

Source: Pew Center On The States and Wells Fargo Securities, LLC

States with a High Degree of Exposure to Nondefense Spending Cuts

Table 2 below shows the states that are most susceptible to nondefense spending cuts. As can be seen, the impact of nondefense cuts is less regionally concentrated. The Washington, D.C., Maryland and Virginia regions will again face sizable impacts from budget sequestration. Other states that rely on federal grant and procurement programs such as New Mexico and Idaho will also likely face headwinds to economic growth over the next 10 years if the full set of budget cuts are allowed to go into effect.

The effect from these cuts would likely fall heaviest on smaller states that have relatively few alternative funding sources.

The Washington, D.C., area is once again the most vulnerable region for nondefense procurement contracts along with salaries and wages. The potential impact from reduced federal outlays could affect everything from biomedical research to homeland security. Cuts in nondefense outlays would likely trigger significant furloughs, layoffs at civilian contractors and generally less business for supporting services, including law firms, caterers, airlines and hotels. New Mexico, which is home to the Los Alamos National Laboratory, is another area where cuts in federal spending will be hard to offset. Much of the cuts in nondefense spending will be spread across the country, however. In addition, smaller Medicare reimbursements and a reduction in research grants to major universities are likely to be prime targets for budget cuts. Federal spending for education and agriculture would also likely be reduced. The effect from these cuts would likely fall heaviest on smaller states that have relatively few alternative funding sources to make up for any shortfalls in federal funding.

Table 2

Top 10 States with Exposure to Nondefense Cuts		
State	Federal Nondefense Spending as a % of 2010 GDP	Total Federal Spending as a % of 2010 GDP
District of Columbia	10.0	19.8
Maryland	10.0	19.8
Virginia	10.0	19.8
New Mexico	9.2	12.8
Idaho	4.9	6.3
West Virginia	3.8	5.3
Tennessee	3.1	4.9
Alaska	2.8	13.3
Montana	2.7	4.8
South Carolina	2.6	7.4

Source: Pew Center On The States and Wells Fargo Securities, LLC

Our Outlook for Fiscal Policy and the Potential Economic Impact

Given the partisan gridlock over the past year, it is unlikely that a prompt solution to avoiding the impending sequestration process will transpire quickly. Our expectation is that Congress will allow the sequestration process to begin, while it completes work on a continuing resolution for the remainder of the fiscal year, which is required to be completed prior to March 27 or the nation will face a government shutdown. While a government shutdown will likely be avoided, the debate over taxes and spending policy will likely take place in the first half of March. It is likely that a deal will be reached to offset some spending cuts with tax increases or closing loopholes but, in general, we do not expect the magnitude of spending cuts to be significantly reduced. One possible option is to spread the budget cuts over a longer period of time, which would still allow for longer-term deficit reduction but at a more gradual pace. Regardless of the political outcome, we still expect some moderate impact on state economies from the pullback in government spending in the short term, as agencies hold off on major spending commitments and put hiring on hold. The magnitude of the impact will be left to policymakers.

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