



Hampton Roads Economic Quarterly

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About this Document

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Sequestration and the Economy

By James Clary

The Sequester is a group of cuts to federal spending that took effect on March 1st. Originally passed as part of the Budget Control Act of 2011, sequester was intended to force the Joint Select Committee of Deficit Reduction to agree to reduce the budget by \$1.5 trillion over 10 years. The potential of sequester, across-the-board cuts with no discretion, was considered so undesirable that it would force a bipartisan agreement on deficit reduction.

Unfortunately, no agreement was reached, and sequester went into effect March 1, 2013 (it had been scheduled to begin January 1, but had been delayed as part of the fiscal cliff deal). **The March 27th expiration of the continuing resolution is critical in determining the path of future federal expenditures.**

Sequester has already had, and will continue to have, large and significant impacts on the national economy. With this region's reliance on the federal government, particularly the Department of Defense (DoD), the impact will be even greater here. Hampton Roads derived 46% of it's total economic output from the DoD in 2012, and that share had been poised to increase in 2013.

Summary Impacts

- Hampton Roads to lose 20,650 jobs (11,750 of which are related to DoD)
- Hampton Roads gross regional product to be reduced by \$1.96 billion
- Loss of \$1.26 million in regional education funding (DoD related Federal Impact Aid)
- Furloughs for federal workers located in Hampton Roads
- Sequestration is currently delaying significant shipbuilding and repair contracts

What will Sequester do

Sequester will cut \$85.3B from the federal budget in FY2013 (the federal fiscal year goes from October 1 to September 30). Cuts this year are lower than the \$109.3B cut in FY2014-FY2021 as a result of money allocated by the American Taxpayer Relief Act (the fiscal cliff deal). The lower level of cuts this year are balanced by the shorter time frame over which they will be spread.

Half the cuts enacted are from the DoD, with the next largest share coming from other federal discretionary programs. There

FY 2013 Cut Analysis (In Billions of Dollars)	
Joint Committee required savings	1,200.0
Deduct debt service savings	-216.0
Net programmatic reductions	984.0
Divide by 9 to calculate annual reduction	109.3
Reduction for FY13 resulting from Cliff Deal	-24.0
Net remaining programmatic reduction for FY13	85.3
Split 50/50 between defense and nondefense functions	42.7

Source: Office of Management and Budget

are also cuts to mandatory programs: a 2% (\$9.9 billion) cut to Medicare as well as \$4B in cuts to other mandatory programs, though many of the mandatory programs were held harmless.

Sequester cuts are damaging in two distinct ways. First, they weakened the national economy during a period of weak growth following a large recession. The Congressional Budget Office estimates that GDP will shrink by 0.635% as a result of fiscal tightening related to sequestration. Macroeconomic advisors forecast that sequestration will increase the unemployment rate by 0.25%, which is the equivalent of 389,000 more individuals unemployed. U.S. payroll employment lingers at 3.2 million jobs below the January 2008 peak.

Programs Held Harmless:

- Military Pay
- Medicaid
- Social Security
- Temporary Assistance to Needy Families (Welfare)
- Supplemental Nutritional Assistance Program (Food Stamps)

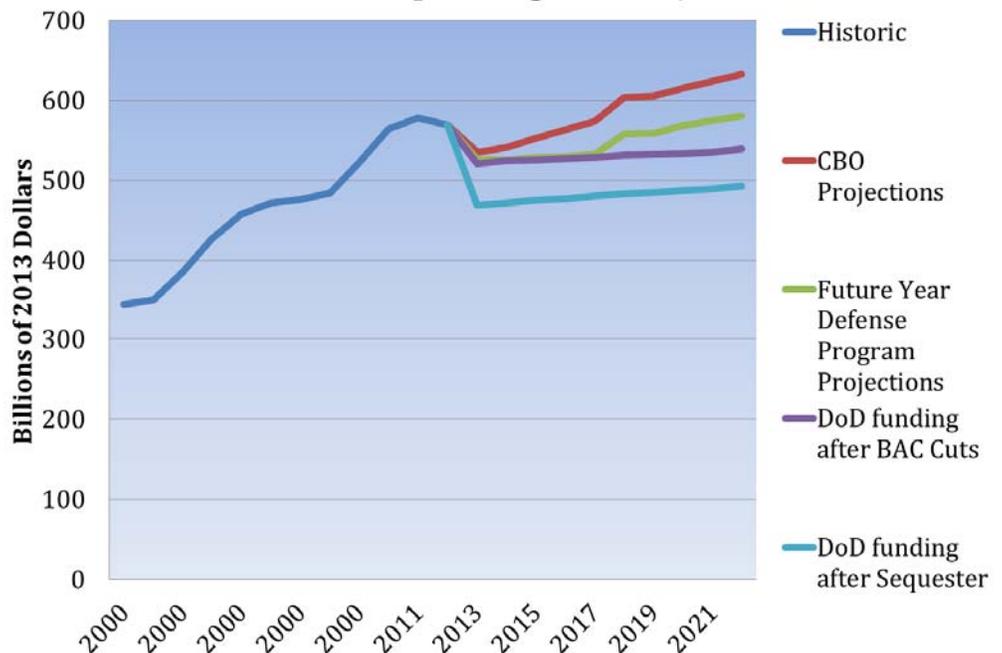
Second, the indiscriminate nature of the cuts results in a minimum amount of flexibility by department and administrators to make sensible cuts or allow for new strategic directions. This forces cut backs in maintenance and training programs, which could have a large impact on effectiveness of current operations and increase costs in the future. This is comparable to putting off your vehicle's oil change in the current month to save money and being forced to replace the car's engine next year.

Impact on Healthcare

One of the least analyzed pieces of sequestration is with regards to the 2% reimbursement cut to Medicare providers, a \$9.9 billion cut in FY2013. This cut goes into effect on April 1st and will have significant employment impacts both nationally and regionally, as Moody's also indicated that most hospitals will focus on cutting staff. Moody's indicated that it has a negative outlook for non-profit hospitals across the nation as a result of these Medicare cuts. HRPDC estimates these cuts alone will cause regional employment to decline by 1,600.

Additionally, the budget of the National Institute of Health will be cut by \$1.5B, halting scientific research and new grants for research & development. Current grant holders received notice indicating current grants might not be renewed, their scope restricted, or even be canceled if work had not yet begun. This will have a long term impact on both national and international health outcomes, as well as economic development within the United States. Medical technology and services are a significant export of the U.S. and the entrepreneurial opportunities that result from technology transfer are a major boon to communities. It is difficult to model the

CBO Defense Spending and Projections



Source: Congressional Budget Office

Navy's Response to Sequestration as Related to Hampton Roads

- Furloughs for Civilian Personnel
- Deferral of Maintenance for the USS Abraham Lincoln, deferral of repair work on 11 ships scheduled here
- Affecting construction of the new class of Aircraft Carriers (Ford CVN78)
- Negotiating modifications of Advanced Procurement of Virginia-Class SSN
- Cancel the deployment USNS Comfort
- Stop New Tuition Assistance Enrollments
- End of Support to Non-DoD organizations
- Delayed the Deployment of USS Truman
- End of bonuses for Civilians

impacts of possible changes to grants on local research institutions, but this presents a significant concern as sequester continues to be national policy.

Defense Cuts

Defense cuts are significant for the nation and especially the Hampton Roads region, both from a national security and an economic perspective. Overseas contingency operations are impacted by sequestration cuts in 2013, affecting the military's ability to carry out those operations. Also, training has taken a significant hit as travel, training operations, and flight time have taken a large percentage of the decline in spending. This was a consequence of holding military pay constant as greater cuts are then required in other functions.

Local impacts with the Navy have already manifested, with delayed deployment of the USS Harry S. Truman and the delayed repair work on numerous ships, including the USS Abraham Lincoln overhaul. DoD Civilian employees in the region have already been warned of furloughs and contractors have either warned staff of layoffs or have already begun that process.

In this region, ship building and repair work has been particularly impacted by projects delayed as a result of sequester. This has a long term impact on the ability of this industry to support the Navy because of the high degree of training required to conduct this extremely technical work.

HRPDC updated estimates using recently released data from the military branches, and these indicate that DoD cuts will cost the region 11,750 jobs in 2013, with that number potentially rising as currently delayed repair and construction projects are canceled. **These changes would reduce regional personal income by approximately \$1 billion.**

Federal Impact Aid

While technically part of the Department of Education, cuts to Federal Impact Aid affect this DoD-reliant region. The United States has recognized since 1940 that military installations have the potential to remove a significant portion of a school district's tax-base, while simultaneously enrolling the dependents of DoD personnel.

Federal Impact Aid & Sequester	
Locality	Estimated Cuts
Chesapeake	-\$101,703
Gloucester	-\$2,048
Hampton	-\$28,922
Isle of Wight	-\$950
Newport News	-\$145,236
Norfolk	-\$213,041
Poquoson	-\$5,697
Portsmouth	-\$16,805
Suffolk	-\$18,885
Virginia Beach	-\$373,178
Williamsburg/James City	-\$2,577
York County	-\$349,946
	-\$1,258,989

Source: National Association of Federally Impacted Schools

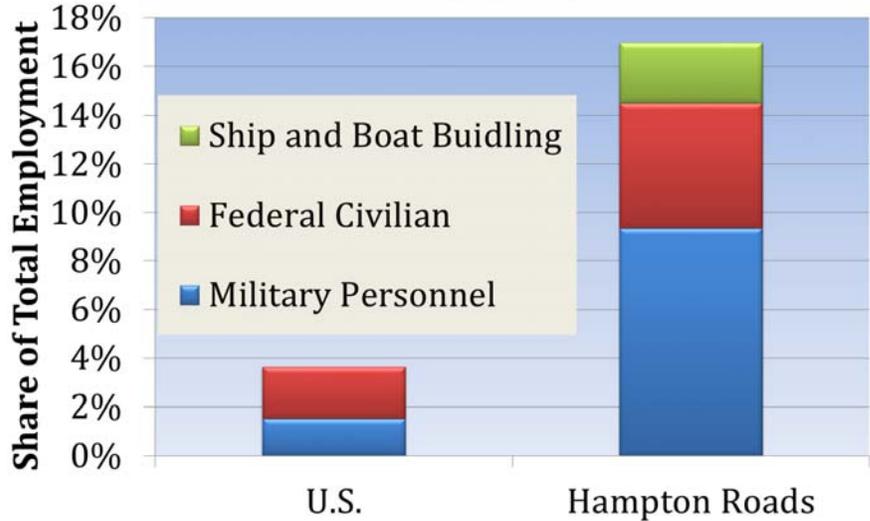
The two most significant Federal Aid programs in Hampton Roads are the Payments for Federal Property (which contributes only to York County), and the Payments for Federally Connected Children. **The Department of Education indicates it will cut all programs by 5%, which would remove \$1.25 million annually from Hampton Roads school districts.**

Non-Defense Discretionary Cuts

While cuts to the military are a primary concern for this region, civilian cuts will also affect Virginia and this region significantly. Economist Stephen Fuller at George Mason University estimated that **Virginia** was second only to California in the employment consequences from cuts, and **would endure the largest per capita consequences of these cuts.**

The Non-Defense Sequestration cuts will cost the region 7,200 jobs, and almost \$921million in gross regional product.

Hampton Roads and U.S. Federal Employment as a Share of Total Employment, 2011



Source: Bureau of Economic Analysis, Bureau of Labor Statistics, HRPDC

Total Impact to Hampton Roads

Sequester would cause the second largest economic downturn in Hampton Roads since World War II. The impact would be magnified since this region has yet to fully recover from the great recession. **The region would lose 20,650 jobs and \$1.96B in annual gross regional product (over a 12 month period).**

Analysis of the federal budget indicates that a decline in real defense spending will likely be required because of the long term budget outlook, but there exists no consensus on how to manage the effects of a defense spending build-down. Research indicates that defense industrial facilities like shipyards have a larger economic multiplier than other defense contractor spending, which explains the large employment impact of defense cuts in the region despite military pay being held constant. While a strong economic environment would typically allow personnel to transition from government oriented positions to private sector ones, the region’s impaired economy will make it more difficult to find equivalent employment in the near future.

The impact on schools because of less federal aid through traditional programs as well as through the decline in Federal Impact Aid will provide a significant challenge to local educators as they grapple with budget issues and declining local revenue.

Total Annual Hampton Roads Economic Impact		
<u>Sequester Cut</u>	<u>Employment</u>	<u>Gross Product (M)</u>
Defense Cuts	-11,750	-\$930
Non-Defense Cuts (Discretionary)	-7,300	-\$920
Healthcare/Medicare Reimbursement	-1,600	-\$110
Total-	-20,650	-\$1,960

Hampton Roads Economic Outlook: by Greg Grootendorst

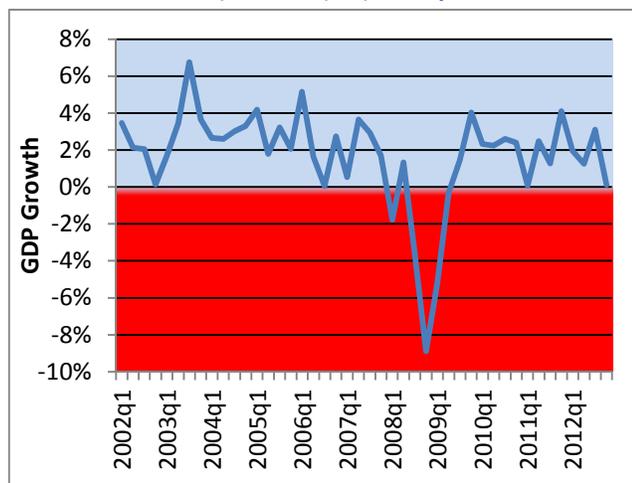
Federal Expenditures Cloud Regional Outlook

Hampton Roads' economic future continues to be shrouded in a cloak of uncertainty. Looming cuts in federal expenditures, coupled with a generalized uncertainty regarding the outcome of the sequester, has weighed heavily on the Hampton Roads economy. Households and businesses facing an unclear future struggle to make economic decisions and hold tightly to their purse strings. With DoD expenditures responsible for 46% of the region's gross product, each cut in expenditures slices deep into the region's economic fabric.

While the nation continues to slowly pull out of the "great recession", Hampton Roads faces a continuing uphill battle. The region has finally begun to show some sustained signs of economic progress, following four years of decline and 50,000 jobs lost. In the past fifteen months, the region has managed to reclaim 14,000 jobs, bounce off the bottom of the housing market, and reduce the region's unemployment rate by an entire percentage point. Unfortunately, if no action is taken to prevent the full effect of the sequester, the Hampton Roads economy will lose the progress that it has made and will be pushed back into recession. The expiration of the continuing resolution on March 27th could result in a government shut-down. Negotiations to avoid such a shut-down provide an opportunity to address the issue of the sequester and the future path of federal funding.

Hampton Roads Economic Indicators

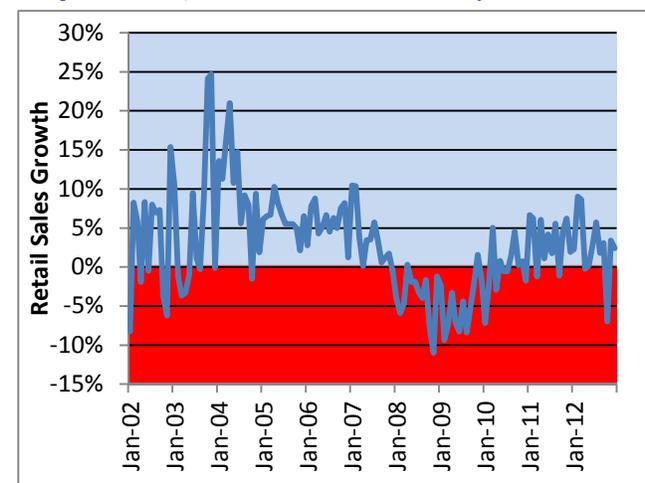
GDP, Annualized Growth Rate
United States, 2002Q1 - 2012Q4, Quarterly



Source: Bureau of Economic Analysis, HRPDC

GDP: Gross Domestic Product combines consumption, investment, net exports, and government spending to determine the size and general health of the economy. U.S. gross product increased at a 0.1% annualized rate for the fourth quarter of 2012, the lowest growth rate since the first quarter of 2011. On a positive note, personal consumption expenditures and nonresidential fixed investment both experienced increases from the prior quarter. These gains were somewhat offset, however, by significant cuts in government spending and a downturn in private inventory investment.

Retail Sales, Year over Year Growth
Hampton Roads, Jan 2002 - Dec 2012, Monthly



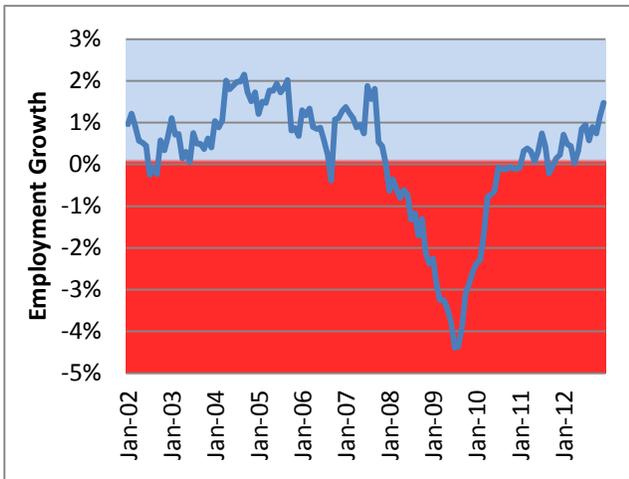
Source: Virginia Department of Taxation, HRPDC

Retail Sales: Hampton Roads' retail sales, as measured by the 1% local option sales tax, serve as an indicator for consumption in the region. Since consumption composes 70% of economic activity in the US, the growth or decline of retail sales gives a strong indication of the direction of the local economy. Retail sales were up 2.8% between December 2011 and December 2012. The region has been experiencing very modest growth since the summer of 2010, but remains 1.6% below retail levels prior to the recession. Retail sales for both the Commonwealth and the Nation have returned to pre-recession levels.

Hampton Roads Economic Indicators

Employment, Year over Year Growth

Hampton Roads, Jan 2002 – Dec 2012, Monthly

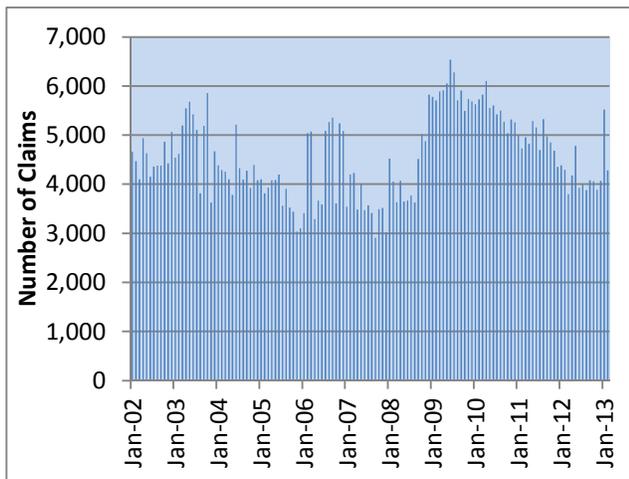


Source: Bureau of Labor Statistics, HRPDC

Employment: Non-agricultural civilian employment figures are considered the best estimate of labor market activity by the National Bureau of Economic Research. Year-over-year employment has experienced 14 months of positive growth, establishing a strong trend towards recovery. Seasonally adjusted employment totaled 749,000 in December of 2012, up 4,400 from November and up 11,400 from a year earlier. In spite of the recent growth trend, Hampton Roads' BLS employment figures remain 32,700 below the pre-recession high.

Initial Unemployment Claims, Seasonally Adj.

Hampton Roads, Jan 2002 – Feb 2013, Monthly

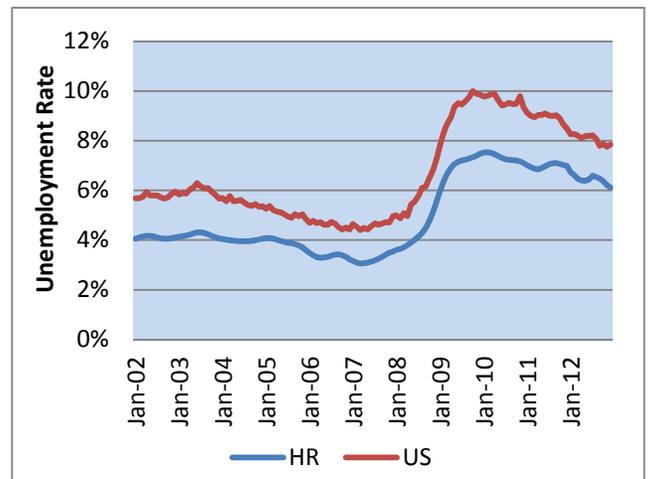


Source: Virginia Department of Labor, HRPDC

Initial Unemployment Claims: The number of Initial Unemployment Claims is a leading economic indicator, reflecting those who are forced to leave work unexpectedly and thus revealing the strength of the job market with little lag time. Initial claims have declined off the peak in the recession, and have trended towards the region's long-term average. There was a significant spike in regional claims during the month of January where claims jumped to recession high levels. Elevated claims will likely result as the region begins to feel the impact of the sequester.

Unemployment Rate, Seasonally Adj.

U.S. & Hampton Roads, Jan 2002 – Dec 2012, Monthly

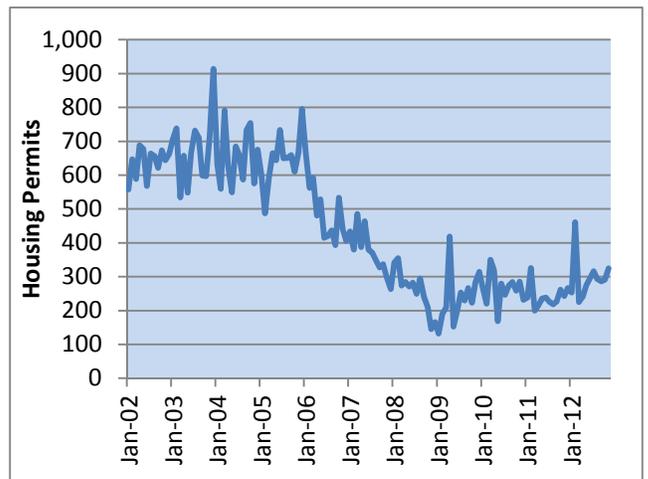


Source: Bureau of Labor Statistics, HRPDC

Unemployment Rate: The unemployment rate is the percentage of the population which is actively seeking work, but is unable to obtain a position. Hampton Roads' unemployment rate was 6.1% in December of 2012, the lowest level since January 2009 when unemployment was growing rapidly with the recession. The region's unemployment rate remains well below the national average which was 7.9% in December.

Single Family Housing Permits, Seasonally Adj.

Hampton Roads, Jan 2002 – Nov 2012, Monthly



Source: U.S. Census Bureau, HRPDC

Single Family Housing Permits: Permit data indicates the level of construction employment and confidence regarding the future trajectory of the local economy. Regional housing permits fell for a period of 3 years following the housing boom. Since 2009, permit activity has been struggling to gain traction. Over the past year, it appears that permit activity has finally begun to develop a sustained trend towards recovery; however, the most recent data reveals that housing permit activity is still only at 60% of the region's long-term average.