

THE BROOKINGS INSTITUTION

SEQUESTRATION AND THE NATION'S DEFENSE:
PROSPECTS AND PERILS

Washington, D.C.
Tuesday, June 26, 2012

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Introduction:

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Keynote Speaker:

THE HONORABLE KELLY AYOTTE (R-NH)
United States Senate

PANEL 1:

Moderator:

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Panelists:

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PANEL 2:

Moderator:

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Panelists:

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P R O C E E D I N G S

MR. O'HANLON: Good afternoon, everyone. Welcome to Brookings.

On behalf of myself, Michael O'Hanlon, as well as Peter Singer, and all of us at the 21st Century Defense Initiative, we're very happy to have you here today for our event on the prospects and perils of sequestration. And for those of you who think that's a funny Washington word that you can ignore if you don't live inside the Beltway, think again because sequestration could be coming come January, and it could mean 15 percent budget cuts in much of the federal budget starting with, but hardly ending with defense. And that's what we're here to talk about today.

We will convene two panels to talk about this subject. But before doing so, I have the great honor of welcoming to Brookings Senator Kelly Ayotte of New Hampshire. Senator Ayotte was elected to the U.S. Senate in 2010. So she joined the Tea Party, in one sense, probably a term that she deserves more than most because she's from New Hampshire and could claim a little New England prerogative over that term. But I think as you'll find today, her thinking is unpredictable in many ways, except that it's centered on trying to resolve our current fiscal plight and the challenges of sequestration.

She has important committee assignments on Armed Services as well as Budget, which are both directly applicable, of course, to the defense budget, but also on Small Business and Commerce, which make her acutely aware of the challenges facing American business, which is a big part of the theme of our discussion today as well, because of the consequences that sequestration would cause to American business and the economy.

Senator Ayotte has already become a major voice in our country's debate over fiscal policy, over national security policy, and how to make Washington

work better. And I'll think you'll get a lot of insight and inspiration from hearing her this afternoon.

Her background is in law and law enforcement. She was born in Nashua, New Hampshire. That's where she still lives. That's where her family lives all the time. Prior to becoming a U.S. Senator, she was the attorney general in New Hampshire under both Democratic and Republican governors. And prior to that, had built a reputation as a formidable prosecutor, helping New Hampshire to its enviable status as the "safest state in the country."

And before giving her the podium, and she'll make remarks and then take a couple of questions before we convene our first panel at 2:00, I want to also extend a word of thanks to your family, Senator, because as much as I admire your sacrifice, I also admire theirs. I know that your husband, Joe Daley, up in New Hampshire with your two children are sharing their wife and mother with the rest of us. And we need her, so thank you. And thank you very much, Senator, for being here. We look forward to your comments.

SENATOR AYOTTE: Oh, thank you. Thanks. Let me just -- thank you so much, Michael. I deeply appreciate being invited here today to be in front of the Brookings Institute [sic] and I appreciate all of you who have come to participate in this. And I'm really thrilled to see the two panels that are following me on this because it's a great array of national security experts, Department of Defense officials, and members of our defense industrial base that I'm sure will give you even greater insight than I'll provide today.

But what I'd like to do is provide the context of where we are with respect to this issue of sequestration because our country is facing a grave threat to our national security, and the grave threat was created by Congress in the debt ceiling deal that we

did last summer. I am one who voted against that deal because, frankly, I didn't like the way this was set up from the beginning in terms of where it put our national security.

And also, I would have liked to have seen us just do what we should do in terms of the fiscal state of the country, and put together a strong responsible fiscal plan for our country that takes into account the big picture, which obviously is not just defense spending, not just non-defense discretionary spending, but also the 60 percent plus of our budget that includes mandatory spending. And until we do that, we're not going to get our fiscal house in order in the way that we need to get our country on the right track.

But today, we're here to talk about this threat to our national security. And I want to put it in perspective because I'm not someone -- I serve on the Senate Armed Services Committee and also I'm the ranking Republican on the Readiness Subcommittee. And I'm not someone who says that we shouldn't cut anything from our Department of Defense, but we have to put into perspective where we are with our Department of Defense right now, because in addition to this issue of sequestration, the President's proposed 2013 budget that has come forward has already been taken up by the Senate Armed Services Committee and the House Committee as well in terms of the authorizing committees.

That will be a cut of \$487 billion of spending reductions over the next 10 years. And there are some pretty tough choices in those initial spending reductions. But our defense leaders and Secretary Panetta have testified before the Senate Armed Services Committee about the choices made in those reductions, and they're difficult but doable. What we're here talking about today is an additional \$500- to \$600 billion in across-the-board fashion that will come in January of 2013 because of the Super Committee's failure to come up with savings. And it hits both defense and non-defense. My focus today will be on the defense end.

But that additional \$500 billion -- it gets close to \$600 billion when you include interest -- it's done in across-the-board fashion, so essentially everything gets cut. There's no strategic thinking to the way it would be implemented, and, therefore, we do everything insufficiently. And if you listen to what our military leaders say about it, starting with Secretary Panetta, he has said we would be shooting ourselves in the head to allow sequestration to go forward in January. He's described it as devastating, catastrophic; it would inflict severe damage to our national security for generations.

And to understand why our military leaders are so concerned about this, again, I said I'm the ranking Republican on the Readiness Subcommittee, and I've been particularly focused on making sure that we maintain the readiness of our forces to prevail in the conflicts that we're involved in today. We still remain in a conflict in Afghanistan, and to deter tomorrow's conflicts. And when that deterrence fails to defeat our enemies decisively, that's why our national security exists.

And we now have one of the most competent and battle-hardened military forces in the history of our country. I know many in this room have met our men and women who are serving right now. The training that they have, the courage that they've shown is phenomenal, and they are the very, very best. And we cannot at this time, in this moment in the history of our country, gut our first-class forces or break faith with our troops. If you hear what our Chairman of the Joint Chiefs of Staff has said recently, it's pretty shocking. Chairman Dempsey has said that if sequestration goes forward, that our advantages over potential adversaries will diminish, it will diminish deterrence, and "increase the likelihood of conflict," and none of us wants to see that happen.

And if you look at other times in the history of our country where we have reduced defense spending, let's go back to the early '90s. At that point, we had ended a

conflict, we had thought that we were going to take a peace dividend at that point, and, of course, coming from -- we eventually had 9-11. But at that point, there was a feeling in the country that we could scale back on defense spending, and here's where we are today. We're not in the same position at all. We are in a position where according to Secretary Panetta, just last month, he said that the threats to our country have not receded.

Our troops remain engaged in the conflict in Afghanistan. We continue to confront a real terrorist threat emanating from Somalia, Yemen, Pakistan, and North Africa. And as Secretary Panetta has said, we continue to see the proliferation of weapons of mass destruction, threats from Iran and North Korea, and turmoil in the Middle East. We also see what is happening, the rising power of China and the investment they're making in their military in the Asia-Pacific region. And of course, we have other conflicts, like the conflict happening right now in Syria.

The course of where we are right now in our national security, this is not a time for us to make decisions that will undermine our ability to confront these challenges that we face right now. And let me talk briefly what this means and what we know so far will be the impact of sequestration on our various forces.

With respect to the Army, I told you that the initial \$487 billion in reductions, that's going to result in approximately a 72,000 reduction in our Army. Now everyone who's looked at this would agree with getting out of Iraq and a gradual decline in the level of forces in Afghanistan that we were going to do some downsizing of our ground forces. So the initial reduction of 72,000 to our Army is happening. But with sequestration, General Odierno has testified that we would be facing an additional 100,000 reduction in our army if we allowed sequestration to go forward, with 50 percent of that reduction coming from the Guard and Reserve. And I think this is an issue that

governors aren't aware of fully yet, although elected officials at all levels in this country are becoming aware of it. In fact, the Council of Mayors recently issued a resolution on the effects of sequestration, urging Congress to come to an agreement on it. But think about; 100,000 -- 50,000 from the Guard and Reserve -- and the function that our Guard and Reserve play. We couldn't have fought in Iraq or Afghanistan without the Guard or Reserve, and they also play a very important Homeland function for our security as well as responding to natural disasters for our governors.

Now let's talk about the Marine Corps. Under the initial reductions that are likely to happen, the Marine Corps is going to be reduced at this point by 20,000. If sequestration goes forward, the Marine Corps will face, according to the Assistant Commandant, an additional 18,000 in reduction in our Marine Corps. But here's the thing that keeps me up at night. The Assistant Commandant for the Marine Corps came before the Readiness Subcommittee. I asked him about the impacts of sequestration, and he said this; sequestration would render the Marines incapable of conducting a single major contingency operation. Think about it -- our Marine Corps. That to me is a shocking statement and one that cries out for us on a bipartisan basis to resolve this issue. And if the Department of Defense chooses to protect manpower accounts, when the Army and Marine Corps would have to cut even more deeply than into training, maintenance, and modernization funds which, of course, would have a negative impact on industry, which we're going to talk about in a minute.

Secretary Panetta has said that sequestration would result in us having a Navy bringing us back to 1915, ground forces back to 1940 where we were before World War II, and the smallest Air Force in the history of our country. We would have to potentially undermine contracts and agreements that we have, including the Joint Strike Fighter, the KC-46A Supertanker, and many of our modernization efforts that are

underway right now that are very, very important to making sure that our men and women in uniform have the very best equipment to protect our country.

But in conjunction with this, no one would say that the Department of Defense is an area where it's a jobs program. But the reality is that sequestration not only undermines our national security, it will hurt our economy, and it could fundamentally tear our defense industrial base. And that is of deep concern not only to my membership on the Senate Armed Services Committee, but as a member of the Small Business Committee.

Often with our essential weapons system, it's not just the large defense contractors that will certainly be impacted by the sequestration cuts, but they rely many times on very small contractors. And in some areas, there's one contractor, a small company who's producing the component where you have a sole supplier. And when these businesses go out of business or they decide to do something else because they cannot deal with the uncertainty of where we are right now or they cannot address or keep their bottom line in a sustainable way because of the cuts that are coming, they go out of business and they don't come back. And it's not easy for us to recreate that capacity so quickly if we suddenly find ourselves in a situation where we need that type of equipment, when we need that part. And that just doesn't happen overnight and that's of deep concern, not only for our large defense contractors, but for many small businesses throughout this country that serve those contractors.

So we're not just talking about the jobs issue, which is, of course, of concern to anyone who serves in Congress. We're talking about lost lives if we don't give our men and women the equipment that they need, the very best, and we don't stay on the cutting edge of technology when it comes to areas like ISR and other areas where we need valuable information to protect America.

There have been several reports about this, which I think will probably be talked about today with the Panel. The National Association of Manufacturers issued a report last week that studied the impacts of sequestration. The Bipartisan Policy Center and the Center for Security Policy have also looked at this issue. The George Mason University has done a study to look state by state to see what the impacts on jobs are if we go forward with sequestration. And here's what the NAM Report says: "More than a million private-sector jobs, including 130,000 manufacturing jobs, will be lost in 2014 if we just continue to sit on our hands in Congress. Total job losses will increase unemployment by .7 percent, and GDP could be impacted by almost 1 percent lower in 2014." Think about it. Where are we nationally with our unemployment? Over 40 weeks plus of over 8 percent unemployment. And so not only do we undermine our national security, but a lot of people will be out of work if we continue on this path. Just a couple of numbers: The neighboring state of Virginia is estimated to lose approximately 123,000 jobs; Ohio, 18,000 jobs; Connecticut, 34,000 jobs. I could go through every state in the nation. My own home state of New Hampshire: 3,300 jobs. We're a small state. I can tell you 3,300 jobs matter very, very much to our state, but we're one of the smaller impacts if you look around the country.

And some people may believe around here in Congress -- when I say here, not here in this room -- but collectively in Congress that this is an issue that we can wait until the lame duck session to address. But the problem is this: The Department of Defense and the Pentagon, they're already paralyzed by sequestration. They don't know if it's coming. They worry that we have the political will to resolve this. And so they're holding on right now in terms of action or inaction, and our contractors are already feeling the impact of it. In fact, Bob Stevens, as CEO of Lockheed Martin, talked about this paralyzing effect of where we are right now with sequestration. And he said, "The very

prospect of sequestration is already having a chilling effect on the industry. We're not going to hire. We're not going to make speculative investments. We're not going to invest in incremental training because the uncertainties associated with \$53 billion of reductions in the first fiscal quarter of next year are a huge disruption to our business." And yesterday Bob Stevens came forward and talked about the fact that they are likely -- Lockheed Martin is going to have to issue what's called the WARN Act notice. Our large defense contractors have a duty under federal law prior, before 60 to 90 days, before a potential layoff occurs. They have to notify their employees that they may be laid off. And so there are potentially hundreds of thousands of WARN Act notices that could be issued before the November election, which I don't know if that's not a wakeup to members of Congress that this is an issue that needs to be addressed now, I don't know what is. And the bottom line is that our defense industrial base, they report to their Boards of Directors. They have responsibilities to their employees. They can't wait until December to take the actions that need to be taken. And so we will feel the impacts of sequestration before the lame duck session. And it's one of the compelling reasons why this is an issue that I hope will be addressed on a bipartisan basis before the election. We owe that to the American people because our foremost responsibility in this government is to make sure that they're safe and protected. And let's not forget that without protection and safety, our economy cannot thrive and grow. We all saw what happened on September 11. Not only the loss of human life, but also the devastating impact on our economy of an event like that. And so there is a relationship not only in keeping us safe, but in making sure that we can continue to prosper as a nation.

So where are we and what's next? There are three proposals that have been out on the table. They are Republican proposals mainly. And one is one that I'm cosponsoring along with Senator Kyl, Senator McCain, and several other Republicans in

the Senate that would deal with the first year of sequestration. To deal with year one, it's about \$109 billion. And it addresses both defense and nondefense sequestration because we appreciate that members may come to this to resolve it for different reasons, some may come because they're concerned about the nondefense reductions, and some may come, like me, because we're concerned about the impact on our security.

In order to do that, basically what we did was Simpson-Bowles recommended for our federal workforce for every three positions that came open, that you would only fill one. Our bill would say for every three positions that come open, you can fill two out of three, and we would keep a federal pay freeze in through 2014. That covers us for year one of sequestration.

The House -- Chairman McKeon in the House has a similar proposal. His is just implementing the Simpson-Bowles for every three positions that come open, that you can only fill one. And then, of course, Congressman Ryan and the House have actually passed a reconciliation; have passed a bill that would address sequestration. And what I would say is my hope is what will happen is that we will see a bipartisan group get together before this election, because this is too important to kick the can down the road to the lame duck session for the reasons I just described. And I also don't believe that this should be used as some kind of chip in the lame duck session where we have the tax rates, we have the "doc fix," we have -- you name it, it's going to be up in the lame duck session, and our national security should not be put at risk with that.

Now, here's the issue of where we are. You know, some have said that they would not -- I think on the Democratic end particularly Harry Reid has said without tax increases to our tax rates, then we're not going to resolve sequestration. And I think that's a false choice. There are those of us that have already said on the Republican end we're willing to work with you on revenue, but we're not going to further hurt our economy

by increasing tax rates, but there were areas of revenue that the Super Committee came up with that we're willing to sit down and talk with you about to resolve this issue before the election. And so I would hope that members of both sides of the aisle would see this is an area where we need to find common ground on behalf of our national security, and not only about that but this is not a time to further hurt our economy by devastating our defense industrial base. And that's pretty much where we are.

I appreciate all of you being here today. And the reason that I became so incensed about this issue is because I don't know how we can look the American people in the eye and say we are not going to put that foremost responsibility of protecting our country and making sure that we fulfill that responsibility, and we should not allow our lack of courage on the big picture fiscal issues to stop us. And that's what worries me around here -- that we all have to show some courage and make sure that we look and address the debt. There's no question that it has to be addressed. But we also shouldn't create the national security crisis on top of our current fiscal crisis to do that.

So, I appreciate you all being here today and look forward to answering your questions. Thanks.

MR. O'HANLON: Thank you, Senator, very much. We'll take just a couple of questions, and I'll free to recognize anybody who has one, and then please wait for a microphone, because you're speaking in front of the whole audience and the whole country via C-SPAN. Please identify yourself and ask a question, one question, please, for the Senator.

So, we'll start here in the fourth row.

MR. MEYER: Ken Meyer, Court World Docs. I'm just confused by all the talk of austerity and sequestration and reduction in defense spending and what I see our military doing around the world. We opened a new base in Australia. We're talking about

returning to our bases in Thailand and the Philippines even, Vietnam. We're still in Central Asia. Talking about stationing 13,000 troops in Kuwait. We're beefing up our forces in the Persian Gulf in anticipation of contention with Iran. We're talking about possibly intervening in Syria. We've already intervened in Libya. We have Special Forces all over East and West Africa. We're talking about opening missile bases in Eastern Europe. In Latin America we've reactivated the Fourth Fleet. We're talking about opening new bases in Panama, Colombia, and Peru. It just seems like a disconnect between this talk of military spending reduction and what I see as an expansion of the American military presence around the world, which I'm tempted to add -- which is in line with the increase in our national debt -- but I'll resist that temptation. Is my perception wrong?

SENATOR AYOTTE: I think I would respectfully disagree with your perception in this sense -- let's start with the administration's new national security strategy, which is a shift in focus to the Asia-Pacific region because of the investment that China is certainly making in its navy and its military and that being a very important part of the world in terms of our economy and the entire world's economy. In conjunction with that, the administration has said that they are going to keep the focus also on the Middle East, and rightly so. If you look at what's happening right now with Iran making efforts to acquire the capability of producing a nuclear weapon, the presence we have right now in the Straits of Hormuz is very, very important in terms of our protection, the protection of our allies. So, if we want -- and I think we need to do -- have the presence we have, we also see other areas in the world where we have dealt great blows to al Qaeda, but they're also continuing to thrive in areas of Africa, and to me there are grave risks that exist around the world that need to be addressed. And I think the one premise that I would disagree with the terms of how you framed it is defense spending is being reduced.

I think there's bipartisan agreement, although difficult choices, on the rough number of the initial reductions. What we're talking about is let's not be irresponsible given the risks that exist around the world of the additional cuts that are coming across in a meat-ax approach coming in January between 500 and 600 billion. I agree with the administration's shift of focus to the Asia-Pacific region, so long as we keep our eye, importantly, on the Middle East. And I don't think the world is any safer that we should suddenly be withdrawing from it and/or significantly diminishing our capability. And let's not forget that the strength of the world economy -- there is a direct relationship between not only the thriving economy of America, our relationship with economies around the world, and our strength and keeping security for our country.

MR. O'HANLON: Let's see, one more question.

SENATOR AYOTTE: Yes, ma'am.

MS. RAFFEL: Helen Raffel, Resources for the Future. If you flatly reject any kind of tax revenue increases, what kinds of revenue increases do you have in mind that you would be happy to talk about?

SENATOR AYOTTE: Here's what I flatly reject. I think we have a broken -- now, these are two separate policy areas, but I think we have a broken tax code. I don't think that you should, that there's no question that on a bipartisan basis we have to do a large fiscal agreement for the country that would not only include a tax reform -- I think there's some bipartisan support around here for simplifying our code -- and also eliminating loopholes, deductions, how you want to look at it, and making it a simpler, fairer code. I think that in the context of that, we can look at -- the Super Committee, in fact, did some examination of areas of revenue that aren't adding -- increasing our tax rates but areas where we could find revenue whether it's eliminating loopholes or whether it's other areas of revenue that don't further hurt our economy.

That's something I think Republicans would be willing to talk about. What we aren't willing to talk about is to take our broken tax code and say we're going to just increase tax rates on individuals to do this, because I think that's the wrong way for us to go for America.

SPEAKER: (off mic)

SENATOR AYOTTE: I can't hear in this setting. I mean, the Super Committee did look at a whole host of revenue raisers. I'll give you an example. I'll give you an example that wouldn't apply in this context, but last year I voted to eliminate the ethanol subsidy, for example. It expired on its own, even though the Senate had voted to eliminate it. But that's an example where maybe could find some common ground within the tax code of loop holes, that perhaps we could apply that to deal with sequestration. And the Super Committee looked at a whole host of issues like that. We're saying let's bring that back up. Let's sit around the table. You didn't do the job the first time. Let's get it resolved on behalf of our country. And there is some common ground there that I think we could see a way forward with. But to take our broken tax code to increase tax rates, that's not something I see a core group of Republicans willing to do when the road forward to tax reform is going to be to simplify our broken tax code, and that -- no question -- needs to be done in, hopefully, a big deal where we also deal with entitlements, which, if you look at where we're spending our money in federal spending, the growth of the mandatory spending programs is going up dramatically. And so we could cut defense spending to the bone, to the absolute bone, and we will not get a hold of the fiscal crisis unless we take on the big picture of how we are -- what -- where our money is going and how we are handling things within our government.

MR. O'HANLON: Were going to go seamlessly into Panel 1, but as we do that, please join me in thanking Senator Ayotte.

SENATOR AYOTTE: Thank you.

(Recess)

MR. O'HANLON: Thank you, everyone, for staying with us, and we'd like now to begin our first panel. I have the pleasure and honor of moderating this panel as well as having introduced Senator Ayotte, and I've got a great group here discussing things. After our panel, we'll have a brief break, and then Peter Singer will convene our second panel.

So, here to my left, Ron Haskins is a Senior Fellow in Economic Studies at Brookings. Many of you who know his distinguished career will know about his role in welfare reform when he worked on Capitol Hill in the 1990s, but he's always been balancing, just as the Welfare Reform Bill attempted to do, his concern for fiscal restraint and care with his concern for our nation's neediest and for its economic future, and that continues to be the theme of much of his work recently.

To my right is David Worn of Palantir, which is, as many of you know, one of the most innovative and dynamic defense companies in the country today. David's been good enough to join us on previous Brookings events, especially related to our ongoing working group on the future of the defense industrial base, and his perspective is extremely informative, because, for one thing, he works for a company that has been innovative and trying to help protect our country with more economical means in many cases. So, he's a voice that's willing to consider various kinds of fiscal restraint, but still I'll let him speak for himself but put that in perspective in terms of how to make sure our country stays strong in the process.

And, finally, to my right, to the far right, is Steve Bell, who is -- for those of you who have been in Washington for a while or those of you who are new, you will know him nonetheless, either way, as Senator Domenici's right-hand man, a man who is

just one of those powerful inside-Washington people that we all read about, and they really exist not just in Tom Clancy novels and other dramas, but in real life, and he's one of them. And for those of you who know Senator Domenici's career, he has been one of the most effective American statesmen at trying to ensure our nation's fiscal solvency and economic future for many decades. And of course we had some success in that endeavor back when Steve and Senator Domenici were in charge. But, again, we sort of need to turn to them for advice now. Steve's also been central in the new Bipartisan Policy Center Report on sequestration.

So I'm going to begin with him and then just work this way, and each person's just going to give a few opening thoughts as I ask them a broad question, then we'll go to some discussion and then to you.

And, Steve, we just had this excellent presentation from Senator Ayotte talking about the broad challenges of how the Defense Department would be affected by a possible sequestration scenario, and we all know that sequestration, just to review the basic point, would be about \$500 billion in additional cuts over the next decade on top of \$500 billion that are already happening on top of additional reductions in war spending, which of course were always intended to be temporary. But, nonetheless, it's worth putting this in context. And so I just wanted to ask you to summarize three or four of the main findings, if you could, of the Bipartisan Policy Center Report what you are most concerned about concerning sequestration. And I don't want to pre-judge the conversation. Not everyone is as adamantly opposed to a sequestration-like scenario as everyone else. I think we all have our concerns.

And I think probably most of us, at least speaking for myself, are against it, but I'll let Steve speak for himself and highlight what the Bipartisan Policy Center Report indicated about this potential scenario that, again, could kick in, in January if

nothing happens on Capitol Hill in the meantime.

MR. BELL: Well, it's always a pleasure to be here, especially with a former CBO analyst of high repute and who had an opportunity in the '90s to go through some of this.

In 1985 we had something called the Graham-Ripper-Hollings Act. I was Dtaff Director of the Budget Committee at the time, Mr. Domenici was Chairman, Mr. Hogan -- Bill Hogan -- was my deputy; and it fell to us to have to write that language. That was the first time that we had sequester, as far as I know, as a legal term in the budget lexicon. I didn't approve of it then; I don't approve of it now. I don't think Congress needs a (inaudible) coming down because it can't do its work. We give them -- been 11 campaigns, in addition to doing work on budgets. We elect them for a reason. We elect them to vote, and we elect them to get things done. And when someone says and is willing to say publicly as a United States Senator or a United States Congressman we can't do this, we need something to force us to do this or to do it for us, then you know something really important has gone wrong.

Our report is very simple. We have Jim Jones -- he used to be NSA director; Pete Dominici; Dan Glickman, who among other things was the Chairman of the House Intel Committee. The White Paper says three things: (1) A stupid fiscal policy; (2) a stupid defense policy; (3) a stupid economic policy.

Why? If the sequester goes through, both on defense and non-defense, it doesn't change our approaching 100 to 200 percent of GDP debt to GDP ratio except for two years. So, instead of 2032, we'll be at 200 percent, we'll be at 2030 with a hundred percent of those cuts taken from the smallest part of the budgets, about 35 percent, and the largest and growing part untouched. So, it's stupid fiscal policy.

Economic policy. I have the misfortune of having spent 10 years on Wall

Street at a defunct firm called Solomon Brothers, now defunct, and I cannot imagine a more fragile time to be doing silly things with serious subjects. And I think this is a silly thing with serious subjects. We are approximately one million lost jobs in civilian and non-civilian areas over about a two-year period. There are people who have bigger numbers. But the fact is they're starting this August when the unions and the companies are going to start talking about more notices. They're earlier in New York than the Federal Bill, so we'll start there. People are going to be scared, and the economy is going to continue to slow down. As someone who collaborated with us on our report said, the sequester has already started. They're already starting to feel it. That's why CBO reduced its growth estimate for the second half of this year. It's why the Fed Board of Governors came out with its unusual reforecast down.

And, finally, as defense policy, can you imagine anything dumber than taking all programs, regardless of merit, and just cutting them across the board by, in our case, 15 percent over the last three quarters of the fiscal year '13? So, you've got a program that's seven years old and you're funding it out. It's going down; it's going to get out by the eighth year. You have another program, brand new, in cyber that's two years into its ten-year course, and you're going to cut both by 15 percent? That's not good defense policy, and I think it was unanimous in our group -- and we did have a variety of people -- that there are lots of ways to cut defense. This is the worst.

MR. O'HANLON: Very provocative and helpful opening.

David, let me turn the same broad question to you. Again, I know you're not unafraid to consider defense budget changes -- even reductions. Personally, as the person who began the Palantir office and also maybe even corporately, but I'll let you speak for yourself, but how do you situate sequestration within the context of overall defense budget reductions? Is it a bridge too far? Is it doable? Could you just speak to

the general subject of where we are in the defense budget reduction process and what the sequestration possibility means to you?

MR. WORN: Sure, sure. First of all, thank you for having us back. We're always pleasantly surprised as a bunch of Silicon Valley nerds to get invited back to the party.

I will beg your forgiveness again, as I did last time, in advance that if I say something that sounds crazy it's because I'm from California. (Laughter)

It was difficult, quite frankly, for me to begin to engage in sort of thinking about this, because it just seems so crazy when you kind of dig into the details. So, you know, I will try to, I think, parse out some of the craziness from, I think, some of the underlying issues that are meaty that are involved in this conversation.

First of all, on sequestration, we certainly will and are willing to add our voice to those saying as currently proposed; this thing is crazy and will have very, very bad impacts across the board. You know, it's our hope that something rational will happen. As an engineer, my mind immediately jumps to the classic game theory, the game of chicken problem where you're driving down the road and you find yourself in a game of chicken and the correct strategy is for you to very visibly rip your steering wheel off of the column and be seen to throw it out the window. This is clearly the approach that the Department of Defense is taking when they're going around town saying things like we're not even going to think about this. The concern, of course, with that strategy is that if your counterparty has taken the same approach, you've perhaps put yourself in a position where even two rational parties are unable to afford an inevitable catastrophe. We certainly hope that that's not the case with this. If it is, bad things are going to happen certainly.

But we do think that there are actually some interesting and more logical

elements of this conversation to be discussed. Implicit in a lot of people's responses to the sequestration question is this underlying belief that lower defense budgets inevitably lead to lessened capability and a diminished industrial base. I've spoken at this group before about our thoughts on both of these points, and, in summary, we don't necessarily think that either follows. And certainly in this environment it would be silly for us not to acknowledge that deleveraging needs to happen. The government needs to figure out how it's going to spend less money on these things. Defense will inevitably suffer somehow, even if it's just the 10 percent on top of the 8 percent on top of the 20 percent that Mike already discussed. If we actually care about these outcomes and we care about the industrial base, then we should be talking about those questions as well, not just the insanity of the proposed approach to sequestration.

So, I do have some thoughts about all of those things. The main sort of underlying perhaps three-layers deep meaning that's very prevalent in the valley these days actually goes, again, perhaps one layer deeper to ask the question: Is there actually something even more fundamental that we're overlooking right now?

You know, the reality is that absent economic growth, arguing about whether we're going to spend 3 percent or 4 percent of GDP misses the point. The pie is getting smaller. Your percent of it doesn't matter. So, are there actually some tie-ins to this conversation largely surrounding our views on technological innovation and the rate of innovation in this country that perhaps educate this at an even more fundamental level.

So, things that we're concerned about but certainly some opportunities here for interesting discussion as well.

MR. O'HANLON: Good. We'll come back to that.

And, Ron, if you could please frame for us -- a lot of people in this group are defense specialists first and foremost, and we often talk about sequestration as the

ax hanging over -- the guillotine hanging over the Department of Defense's head. But you study a lot of parts of the federal government that could be affected comparably, and I wondered if you could, also as an economist who looks at macroeconomic issues, talk about sequestration from your vantage point. There's been discussion that the discretionary accounts on the domestic side actually grew too much in the last 10 years and maybe a little of belt tightening's not such a bad thing, but maybe this is the wrong way to do it, maybe it's the right way to do it. Could you just help us begin to frame that conversation, then we'll go back to a couple of the --

MR. HASKINS: Well, let me first observe that I've never been on a panel at Brookings or anywhere else where Steve Bell is on the far right. From an audience perspective, he's on the far left, which I think might be the worst. So, you should sit in the middle, Steve. (Laughter)

The biggest problem with sequestration is its way too small, which is a way of saying we're going to eat ourselves in little bites. I mean, the problem with the comments that the Senator made is we're going to have to do six, eight times as much as we've already done, and if we do it in little bites like this, especially if we cut defense contractors, and if you start with defense, to me that's probably the worst thing to do, because defense is very powerful in PR terms. As well, they can appeal to the safety of the country, as the Senator did and as everybody on a defense committee does. We ought to have across-the-board cuts. We ought to go bat, as Steve and colleagues have been saying for years now and as we've been saying here at Brookings for years. So, the whole approach is just flawed.

The second thing is, as both of the previous panelists pointed out, across-the-board cuts are truly insane. I mean, that is really a crazy way to do things. I spend a lot of my time studying the Obama Administration's emphasis on evidence-

based policy that's sweeping the country now, not just in the Administration but in the scholarly world, that why don't we pay more attention to evidence about what really works and, as the President said, and it's an ongoing process since we ought to cut things that don't work and spend more money on things that do work. And so across-the-board cuts is absolutely the opposite of that, so that's a crazy thing to do.

The next point is that we're in the soup now on sequestration. We made a promise, and I would slightly disagree about -- I do agree with, you know, we ought to make decisions and we elect people to make wise decisions and so forth, but if we get sequestration, that'll be \$2.1 trillion, including \$900 billion that we got last year, and that's a good down payment. It's only a down payment, but -- so there is some progress. So, at least let's give a little credit, even though they backed off and want someone else's fingerprints on it rather than the committee's. It still is a move in the right direction.

So, all things considered, it's a lousy way to do things, but we have to do it; and, not only that, we have to do a lot more of it and there'll be big political repercussions either way. In the long run, if we don't do something and continue to kick the can down the road, then there'll be repercussions down the road. If we take big steps now, there'll be repercussions now. And the worst thing about the way we're doing it now is we're going to take a big hit on public dissatisfaction on defense contractors and so forth, and then we're going to have to come back and do it again, come back and do it again, come back and do it again. So, the politics of it is very rugged. We need a big agreement. And to the extent that this takes any of the steam out of a big agreement is a big mistake.

MR. O'HANLON: Let me press you, though, on something I think was implicit in what your remarks just were, but in the interest of having a good, full discussion here today where there's obviously some people adamantly against sequestration, let me

make sure I heard you right. It sounded like you are not in that group, because it sounded like for you the bigger problem is we haven't gone far enough, we haven't brought in entitlements. Perhaps you didn't use that word, but I'm assuming that's one of your concerns. Maybe tax reform, as the Senator mentioned, but it doesn't sound like you are unduly worried about cuts in the discretionary budget, either defense or nondefense, because it sounded like your concern about the budget deficit is so great that it trumps whatever ugliness you might forecast in the way the sequestration axe is going to hit.

MR. HASKINS: Yes. I completely agree with that. I would -- I think we do need defense cuts. I'm not sure exactly what the level is. I'm not an expert in defense. But we need defense cuts. We need cuts in domestic discretionary. And you were exactly right, they've been increasing quite rapidly, and I think we could figure out a way to make cuts in discretionary -- nondefense discretionary -- that would be okay. They wouldn't be great but they'd be okay. But everybody knows that we're not going to make serious progress until we do something about revenues, until we do something about entitlements. There's a little teeny piece of entitlements in here. I think it's about \$16 billion, something like that. So, it relieves the pressure a little bit. But that's nothing compared to what we could get. So, we need reform in entitlements. We need more revenues. Republicans are going to have to come to the table. I just don't see how they can continue to avoid it

So, yes, I'm guilty as charged.

MR. O'HANLON: Interesting. And waiting for our conversation, because we don't just want to be obviously preaching a single message. That's not in the Brookings spirit, and I'm sure it's not reflective of everybody on Panel 2 either.

So, let me press the same point first, David, with you. You talked about

and you summarized the different kinds of cuts we're seeing -- first of all in war spending, which is going to be, in annual terms, more than a hundred billion dollars a year, because it had gone as high as 170 or 180, and it's already down now to about half that, and it's headed down to 40, 50 in the next couple of years. So, that's already a big chunk of more than a hundred billion out of the annual defense budget, although it's never supposed to stay that way indefinitely, obviously.

And there's sort of an annual term. It's about a \$50 billion chunk that's coming from the first (inaudible) of the Budget Control Act, the \$487 billion divided by 10. And now there's this additional roughly \$500 billion cut that would happen to DoD under sequestration.

How much of that can you live with? Or is it not so much the numbers as I've put them but more the time sequencing and, as Steve was discussing earlier, the, you know, sort of blind way in which they apply to all accounts? What troubles you the most? At what point do you want to -- if you could rewrite sequestration, how would you do it?

MR. WORN: Was that one question?

MR. O'HANLON: Yeah.

MR. WORN: Okay.

MR. O'HANLON: The last part. Well, then, you can focus on the last part.

MR. WORN: Okay.

I mean, obviously implicit in that statement again, I think, are those two points that I started with. There's an assumption that less money being spent on defense implies less capability and a diminished industrial base. Certainly, if we just do what we're doing right now and spend less money on it, I think it reasonably follows that we'll

have less capability and a less responsive industrial base. The point that I believe I've tried to consistently make and the point that I saw MacKenzie -- I don't know if she's here yet today -- making an op-ed just a day or two ago is that there are perhaps opportunities now to look at less money, to create a different pattern of spending the same way perhaps that -- you know, I oftentimes get chided by my peers in the Valley, that somehow we in D.C. are living in this capitalism exclusion bubble, that somehow when there's less money to spend, that doesn't immediately mean that capitalism will respond and look for market-based solutions to those new challenges. Why does it always mean that we have to pay more to get less? That doesn't follow to me -- or pay less to get less perhaps.

So, I do believe that more innovative spending within the government, more opportunities to look for ways -- for example, to open up government programs of record as one possible example, to disruptive innovation from other areas of the market.

Certainly, we've seen just recently with our friend Elon and SpaceX this works -- even in areas that I think historically would have thought, space launch? No way can the commercial market come and do something. That's something that the defense industrial base must do itself. Maybe. Maybe. But the market will find a way. I think that's largely what this country is premised upon. So, that's the kind of capability side from the -- you know, what will the impact on the industrial base be? Again, if you believe that the total defense spend is being efficiently allocated across the market currently, then certainly spending less will give you less capability across that base.

Certainly, I don't think it's a contentious point to make that there are dislocations. There are inefficiencies in the allocation of the defense spend. Whether you can cut that fat without cutting into the muscle is perhaps where the debate is occurring, but certainly my experience over the seven years trying to bring disruptive

innovation into the government shows that it is possible to do more for less within the government and not sort of where the government is traditionally chided for doing less or more or the same for more.

MR. O'HANLON: So, Steve, let me turn to you, please, before we open it up, and I'd like to just ask you to sort of respond to where we are in the conversation, because you made very punchy, pithy, eloquent statements earlier expressing your disdain for sequestration -- I think is a fair word --

MR. BELL: Yes.

MR. O'HANLON: -- and what we're hearing from our colleagues on the panel is a little less stridency in their objections to at least some aspects of sequestration, at least a dollar magnitude of what's being proposed that sounds like both these gentlemen can live with. They may not prefer it but they can live with it. What bothers you most about sequestration? You already mentioned the way in which it would affect good programs as well as bad, but if you could rewrite sequestration, how would you do it? How much cutting is actually okay? You know, how much do we need to mitigate this to have a good bill?

MR. BELL: This sounds like a chicken answer, but I think we all know from Ron over to here that the defense budget is suffering from the same thing the federal budget is suffering from. Payment for personnel, benefits for personnel, retiree benefits, retiree health benefits consume larger and larger proportions of the budget. So, when someone says to you oh, well, we've spent 4 percent of the budget as a percentage of GDP on defense, it's an irrelevancy, because before 1975 we didn't have an all-volunteer Army. We didn't have to increase benefits to entice enrollment. We didn't have to give people 20 and out. And just so everybody will know, I have a 100 percent disabled brother from the war and 100 percent disabled stepfather, so I'm

not speaking -- I'm speaking from -- our family has always been in the military. So, I asked my stepfather would you be willing to pay \$20 a month more for Tricare for Life? He said sure, \$20, of course. We're talking about that kind of thing. We have a federal budget that is being eaten up by Medicare and Medicaid retirement programs. We have a defense budget that's being eaten up. And if you look at the lines across -- this is what we spend for personnel, this is what we spend for everything else -- they're about ready to cross. We're going to spend more money for personnel and benefits than we're going to spend on all the rest of the stuff we do, including the stuff we spend overseas more.

That's the real problem that people don't want to wrestle with.

When we started this thing, General Wald -- Chuck Wald -- said you know they're going to burn this building down, don't you? That's the building where we are. I said who? He said oh, the VFW. And he meant it, but those are the people that are going to be upset, the people who get the benefits now and have promised to get benefits forever and oppose any benefits change. So, I think it's -- I think you really have to look at the budget in little, kind of discreet pieces and say what are you going to do about the hollowing out that's already occurring because of all the money we have to spend on benefits?

And so I really think it's a little more complicated subject, and I don't think it's one sequester's going to solve. I think it's one maybe that's going to take a couple of years to solve until people like Wald and Jones and other people like that stand up and say hey, you know, we're spending too much money on benefits.

MR. HASKINS: Mike, let me make a quick point here as background to sequestration, and that is why we are here and have sequestration? I mean, think of the logic of it. Thirty or forty years ago we spend something like 55 percent of our budget on programs we now appropriate. Now we're down to something like 35 percent. So,

there's been a huge shift in federal spending to the entitlements, and we're not willing to do anything about entitlements. We're not willing to increase revenues, so what do we do? We screw defense and come up with some idiot thing like sequestration. Now, the money's good. We've got to do this. We're going to have to do it even broader. But the focus on this one area because politicians are reluctant to really tackle the heart of the problem -- it just -- it doesn't make sense.

Now, one thing about the psychology of this that we ought to ponder is meetings like this and comments like the Senator made show that people are aware wow, if we cut defense this much we could be jeopardizing our national security. Secretary of Defense, various generals have made all kinds of powerful statements. I'll bet Americans are listening to that. And that's exactly what Steve wanted to happen when he invented sequestration. You're supposed to so much pain on people and the threat is so great that they'll do the right thing, because otherwise they won't do the right thing. So, hopefully, meetings like this will convince Republicans that we need more revenues and Democrats that we need to change entitlements, and we can get a big deal that will relieve the pressure from this, you know, 35 percent of the budget that we're now trying to balance a budget on that little teeny share of our total spending, which makes no sense.

MR. O'HANLON: So, just a last clarifying question.

Steve, if I understood you right, it sounded like you were saying that you might or might not be able to live with the additional \$500 billion in 10-year defense cuts as long as you could have some control over where they were applied and over what period of time they were phased in. Is that a fair summary?

MR. BELL: It is, because, as I say, you go down one level and you see where the money is really being spent, and you have to make -- by the way, this is not a

call for the draft, okay, please, no one take this as a call for reinstatement of the draft
(laughter) -- you take a look at where the money's being spent, you take a look at
somebody who's in for 20 years, he gets out at 39 and he lives to 79. So, he's worked 20
and gets 40 years plus a COLA plus Tricare for Life. And you have to ask yourself as
well, very many communities are asking themselves around the country right now --

MR. HASKINS: Yes, they are.

MR. BELL: -- can we afford, even for good work -- policemen, firemen,
those kinds of important people -- can we afford to do this while we're not getting new
ambulances or new fire trucks or the most modern IT equipment? And I really believe
that the money that needs to be found in defense, by and large, is money that we're
unwilling to touch because it benefits people to whom we have made promises, and
those promises we probably can't keep in their entirety, and nobody wants to say that.

MR. O'HANLON: Fascinating.

I'm going to just make one comment myself as, I guess, the token hawk
on the panel. I didn't realize I was going to be that when the conversation began. While I
agree --

MR. BELL: Another token hawk. We've got a bad panel here.

(Laughter)

MR. O'HANLON: I'm going to make just one comment, which is that
there have been a lot of very rich and provocative, I think, important statements that
we're going to have to be living with the need to do a lot of what you three have been
talking about whether we like it or not for the reasons you've mentioned. My own
assessment is that there isn't enough savings, even in the ideas that you're talking about,
to realistically get that additional \$500 billion in sequestration out of the Department of
Defense budget. I think it actually would cut substantially into muscle and it would make

it unrealistic that we could rebalance, keeping our focus on the broader Middle East and also staying strong in the East Asia-Pacific region. I tend to think -- and I've suggested some programmatic cuts that go beyond the Obama Administration's current thinking, but even if we do that, partly because the Obama Administration's hoping for efficiencies and reforms that may or may not generate the savings that they're planning on. But we're going to do very well to actually even add another hundred billion over 10 years to what's currently in the books. Sequestration would add another \$500 billion in cuts. So, for me the arithmetic doesn't add up. I'm not saying there's any bottom line objective answer, but I just wanted to add that to the mix as we now go to all of you.

So, with that, again, the same ground rules as before. We'll start with Harlan in the back, but even though I mentioned your mentioned your name, please identify yourself and pose a question. If you could choose to whom you're addressing the question that would be helpful, too.

MR. ULLMAN: I'm Harlan Ullman.

First, thanks to the panel, because this is a very stimulating and provocative session. But I think you guys are wildly optimistic, because I think it's going to be a lot worse case. The world economic situation is dicey at best. If the euro collapses, the pressure that's going to put on us is going to be huge. You have a political system that is broken, that unless one party wins both ends of Pennsylvania Avenue and 60 votes in the Senate, I think there's very little chance of anything rationally being done.

And even worse than that, no matter who wins the election, you're probably going to have a real change in the leadership with all the departments, and so it's going to be five or six months after the election or more until you have a chance for people to be in position to actually talk about reprogramming and the like.

Now, I think you're absolutely right that we have to make far greater cuts

to our overall spending. There's probably not going to be any agreement between the differences over taxation and spending. So, give me a couple of big ideas how you deal with a system that's broken where we really have to accommodate by cutting trillions and trillions of dollars, doing it in a sensible way, and who do we get to lead the charge?

Mr. Obama's not going to do that unless he's reelected and maybe not then, and Mr. Romney's not going to do that unless he's elected and maybe not then. So, as an American citizen, please tell me how we deal with this looming catastrophe that everybody recognizes as coming but nobody really wants to stand up and take the really tough choices that will be needed.

MR. HASKINS: Let me say one thing as a background here. In this room five or six years ago, Alice Rivlin, sitting right about where you are, stood up in front of the audience and said during a debate like this that she was afraid that we would not solve this crisis until a disaster occurred, until there was a crisis -- she was referring to some kind of financial crisis -- and I think that's still a realistic possibility, and to the extent you're right we're going to have to have some kind of disaster even worse than our recent financial disaster before politicians will face what they have to face.

Having said that, I think the revenue side ironically, for all the sturm and drang about it, is the easiest in many ways, because our tax code is so bad -- in fact, I'll tell you how you might even get Republicans to do it -- our tax code is so bad that everybody agrees, I think, that you ought to broaden the base and reduce the rates. That's the classic way to reform the tax code. You should have a broad base and the lowest rates possible. And you can do that by getting rid of a lot of loopholes.

Now, that's where politics comes in. There's going to be a lot of objection to that. So, you've got to wound a lot of people I think. You can't just do it for a few people. It's got to be a lot of sacrifice and then a lot of sacrifice on the spending side.

And the way you do it is you do it in a way that might be revenue neutral, and CBO will score it that way so Republicans will say oh, yeah, we've fixed the tax code, but we're not raising taxes -- not just rates, but we're not raising additional revenue. And then you put a provision in there, just like we do for premium support, where if you don't get a certain amount of revenue, then you have -- there's some failsafe procedure where you do raise rates or do something to raise the revenue you need. I think that's doable. It would give Republicans cover. And, in fact, I think eventually we'll do something like that.

On the spending side, I remain convinced there's lots of spending that would be a lot safer for the country than defense spending. We spend a lot of federal dollars in education. I can't see that it's done a lot of good, and, you know, we could save \$20, \$30 billion on education spending. So, you get several places like that, and I think that, you know, it adds up.

Alice and I wrote a chapter five years ago where we proposed all kinds of cuts like that that added up to a very substantial amount of money on the spending side. So, I think it could be done. It could be done in a way that would do the least damage to the country.

But we're always going to face the kind of risk that the Senator talked about and that's been talked about on this panel that the less government money you spend, it could have an impact on the economy; it's going to increase unemployment. It's inevitable. But let's do it all at once so we can survive for two years and then things will return to normal.

MR. BELL: If I might (off mic)

MR. WORN: I'm glad you asked that question. I am kind of surprised, too, to be characterized as an optimistic perspective. (Laughter) You know, I certainly never cast that way when I'm back in the Valley.

But, you know, when I look at the data and the data shows, you know, median household incomes stagnant for the last 30 years, the mean may be rising slowly but largely because of the top end, you know, my concern -- and I alluded to this at the start -- is that we have an economic growth problem here. And when we have an economic growth problem here, everything becomes zero sum and we're sitting around trying to figure out which Paul we're going to rob to pay which Peter.

MR. HASKINS: Right.

MR. WORN: That is not an encouraging conversation for anybody to be a part of I don't think.

The perspective that has increasing resonance out in the Valley is that there is a technological innovation component of this that we really need to refocus on. We have perhaps all been blinded by the computer age or perhaps high finance and thought that we're actually living through an age of technological innovation here. I think if you sat for a few moments and thought about other areas or other sectors -- perhaps transportation where arguably we're moving slower today than we did 30 years ago, or energy where we're still burning oil -- are we still innovating? Is that still the engine of growth in this country? Absent economic growth again, we're having this conversation of 3 or 4 percent of an ever decreasing pie. I think this is a particularly relevant conversation for this group, because the Department of Defense clearly has a history, a robust history of helping this technological innovation in this country. Unfortunately, it is a rather, now, aged pedigree in helping out with innovation in this country. There's no reason that that necessarily has to be true. Mackenzie, again, in her article yesterday proposed any number of areas where the Department could clearly, if it set its mind to it, really fire up technological innovation in this country and solve, again, what I would argue is the root cause of us having these conversations, which is that absent growth we're

having zero sum conversations and everybody's unhappy. So, I do think there's a way out of this, but it's going to be hard.

MR. O'HANLON: Go ahead, speak.

MR. BELL: Let me speak very briefly about something extremely complicated but which I've been speaking about on the Hill for the last two or three weeks.

Can we avoid as much damage as possible in the lame duck session? You notice I'm talking about big, big, huge things. I'm talking about one specific thing: How do we pass a continuing resolution by October 1st, get through the elections, and then minimize the damage the lame duck will do while maximizing the opportunity in the 113th Congress that we actually might be able to go toward the big deal that Ron has mentioned?

Believe or not, there is a way to do that. As someone I briefed yesterday on said to me, Steve, that's great, that's rational, that's really intelligent, kind of like a mechanical engineer, but you don't have any votes for it, because we're not rational up here. This is a person who's been up there 20 years, and she is a very smart person. There is a way to compel behavior short of sequestration. Because we have so many members of Congress who are new -- just to be blunt with you -- it is going to be very difficult to tell them how to do this without them saying oh, my God, more Washington, D.C., gobbledegook.

But I think, using the powers that the Senate and House has, using something along the lines of enhanced reconciliation instruction -- and I hate to say that again, but, you know, that's where I come from -- I think there's a way to get us into next year with minimal damage and the best chance to get the big deal, which is taxes and entitlements. So, I know there are some senators and congressmen thinking about it

now. They don't dare, before the election, say it out loud, and I don't blame them. But there are some people thinking about it. And I want to say that there are some very good members on both sides of the aisle who, you know, were briefed by Mr. Dudley, who is the Chairman of the Federal Reserve Bank of New York, and other people over the last two weeks who understand what's coming out, thinking very actively about minimizing the damage, get a big deal, even with this Congress, after the lame duck so, I still, for this one time, am going to think about a happy outcome.

MR. HASKINS: Can I --

MR. O'HANLON: What we'll do is we'll come back it, because -- yeah.

I'm going to take two questions before we go to the panel, so both these two gentlemen across from each other.

MR. NICHOLSON: George Nicholson from Stratton Corp.

Steve, you talked about sequestering. Congressman Adam Smith, Ranking Member of the House Armed Services Committee -- he's been on a couple of panels, and he's made the point that by jawboning this whole things -- don't worry, we don't have to worry about the initial intent by Senator Graham and others, just, okay, this is a (inaudible), people say I don't need to worry about it. He says -- the other point is he says his biggest supporter, the military as he is, Fort Lewis in his district or court -- he goes back to his district -- they're not interested about worrying about the defense budget. They're worrying about what's happening to their 401(k) -- their, you know, retirement incomes.

And then when the Senator was talking, the issue she brought up about, you know, the Guard and everything else, the Chief of Staff of the Air Force, the Secretary of the Air Force made difficult decisions on cuts and active duty. Both the House and the Senate -- you can't touch the National Guard, so, again, everything is

going to have to be put on the table. You know, how do you convince the American people how serious this is?

MR. O'HANLON: Let's take this other question, too, and then we'll just go down the panel.

MR. KEENE: Hello, I'm Mitt Keene from the Observatory Group, but this is a question for Steve Bell.

Let's suppose, for the sake of argument, that an agreement is not possible in the lame duck session on the sequestration to avoid the automatic cuts. To what extent does the administration have discretion in terms of the timing of how soon it implements the automatic cuts, because I've read that they may have some discretion in terms of how much they appropriate to the various agencies?

MR. BELL: Well --

MR. KEENE: And then also if you maybe could flesh out a little bit about this idea that you have to avoid it.

MR. BELL: This crazy idea, yeah.

There are two acts you have to keep -- there are two things you have to keep in mind. One is the Antideficiency Act, and one is something called the Empowerment Control Act. In between those two things which say you can't spend money you don't have appropriated to you -- it's a felony -- and you cannot impound money except through certain specific processes -- most agencies are going to have to spend some money in the upcoming fiscal year. Okay, it sounds very arcane, but it's very important. Some people say there will be no obligations in the first quarter of this coming fiscal year. That seems highly improbable, to put it mildly.

The only question is how much will be spent by the agencies in the first quarter? Our estimate is about 22 percent. Not 25, which is what you might think at first,

but about 22. How many games can be played by OMB within that 22? In 2013, almost none. Why? Because this is a program project activity level. Very granular-level gut. You are going to have to reach it if you're the Department of Treasury, for example, by making some very hard decisions since you don't make anything. You know, you've got 5 percent of your -- you know 5 percent contracting out for such things and 95 percent of your people. And just today -- I mean, this week we're going to turn over \$150 billion worth of national debt run by, you know, 10 or 15 people in the basement of Treasury. They're going to have to, at some point, lay off people. That's what it's going to come down to, either through attrition; furlough, which is a real pain to do; or, worse, trying to lay off people permanently. So, there are not as many games that can be played as people fear.

Now, Democrats think the games will be played in defense, and they've come to me and said how can we stop these games. And Republicans think they'll be played in a non-defense. How can we stop these games? And I try to tell them well, you know, really, OMB is going to make the final calculation, and if they do what they did in '85, they are going to go down to the lowest level enumerated specifically in an appropriation bill or a report accompanying that appropriation bill, which means fuel purchases -- Air Force, fuel, right? I mean, you know, you know the categories better than anybody. And at some point, you know, 15 percent of an M16 magazine is not a really great thing to have if you need the full mag.

MR. O'HANLON: Ron, do you want to comment?

MR. HASKINS: I would say -- I would -- my response would be what the article in the *New York Times* this morning -- once people see what the cuts are going to be down to the granular level, all hell's going to break loose --

MR. BELL: Yes, sir.

MR. HASKINS: -- and Congress will have an opportunity to mess around. I don't think they have the option of not coming at least close to \$1.2 trillion, because I think -- especially for Republicans -- the Tea Party would completely revolt. It would be a huge problem. People would lose elections over this. So, I think they're going to get there somehow, but almost any way would be more rational than, you know, across-the-board cuts of the kind you are describing now. And when people -- people haven't seen them yet. There's a huge problem of ignorance out there. People don't know exactly -- they're speculating what's going to happen. 26,000 teachers, I saw somewhere this morning -- well, maybe that's true, but we need to see the OMB. Until we know exactly what they're going to be, and then we'll see who's really going to get gored, and they're going to be mad, and they're going to do something.

MR. BELL: Now, Adam Smith -- just talk about Fort -- his military base out there in Washington state. I guarantee you that -- and my brother used to live right outside of there -- I guarantee you when those folks see what the impact's going to be on small businesses that service the personnel on that base to housing, to all of that, at some point -- and I think it's going to be in September after the August recess -- they will start caring about something other than just their 401(k)s. They're going to start worrying about the grocery people with 10 people that's all of a sudden going to go to 5. And that is starting now. There are people in this audience -- I guess I can quote Stevens from Lockheed Martin -- they've already started slowing down what they're doing. And so guys, at some point, are going to go back to their banks where they've had lines of credit for 20 years and this guy's got 150 people in a tool-and-die shop, Akron, Ohio, and he's going to say okay, I'm going to re-up my line of credit. The bank's going to say do you have that contract signed? No, don't worry, you know, you've only had it for 20 years. Why don't we wait -- because he's got the OCC and FDIC looking over his shoulder, right

-- why don't we just wait till you get the contract signed. I can't wait that long. Now, that's not an exaggeration. That slowdown is starting now, and I don't think it's -- I don't think it's an exaggeration. It's not something the defense industry made up. It's not something that Secretary Panetta made up. If you go out to New Mexico where defense spending is really, really important, you're starting to see the slowdown there. And it's not all just because we're laying off 400 people in Los Alamos. It's bit by bit by bit. You're seeing people scared and not doing anything. You're going to worry about your 401(k)s. You're also going to worry when your wife or your husband loses his or her job.

MR. O'HANLON: Let me ask one clarifying question on that, then we'll one final round for our panel before our break.

Could I ask, is this more right than wrong? I realize that sequestration is very complicated and it's going to vary, you know, and have some discretion, and that's a lot of what you're driving at. Is the following statement at least mostly right, that next year the typical federal agency, if sequestration occurs, is going to have to find 15 percent reductions -- 12 to 15 percent reductions -- in its workforce expenditure, meaning that since you're usually not going to fire people --

MR. BELL: You can't. It's very hard.

MR. O'HANLON: Since you can't, and since you can only slow hiring so much because it's only a certain percentage, what this basically means for the typical federal worker is up to two months of furlough. Isn't that one way to understand the likely implications of sequestration?

MR. BELL: Yes, and you can't reduce people's pay in the federal government, okay? That's against the law. So, where you are, GS-14, level 3, let's say, that's where you stay. And at some point you're the manager of an agency, and you're going to have to say to people look, I don't know how we're going to be able to keep

doing this. I've saved some money, I'm doing everything I can, but you all ought to know that probably we're not going to hire a replacement for Jeannie when she leaves. And I need three more of you probably by the end of this year.

In an economy which is weak where people are slowing up their retirement plans anyway because of the last three and a half years, this is not -- this does not hold good tidings I don't think.

MR. O'HANLON: Let's take two more questions, and then we'll have a final round of responses. We'll go over here and then -- where else did I have a hand? Okay, and then here on the aisle to finish. She's coming. We want to make you famous, so wait for the mic.

MR. BAGLEY: Jack Bagley. I have no dog in this fight. But I have not heard yet any discussion about a government shutdown. What do you think of the possibility of a government shutdown like we had in the Clinton administration that forced people to act?

MR. O'HANLON: Great, and then over here on the aisle, if we could, please.

JORDAN: My name's Jordan. This question is probably mostly for David.

I know that there's been a lot of talk about the defense industrial base, and there's two things going on right now -- one geared by them and one geared by the government -- that are supposed to help them survive these budget cuts: the government with Export Control Reform trying to move stuff from State to Commerce so that the defense industrial base can sell stuff abroad more easily, and then also this idea that defense contractors are trying to transition from manufacturing to service and stuff -- services things -- because, as I think the Senator even said, services don't get cut as

hard when the defense budget and the hammer comes down. Could you speak to how the defense industry is thinking about these things and whether or not, you know, these transitions are actually going to help them stay afloat?

MR. O'HANLON: You want to start? Then I'll go to Steve and Ron.

MR. WORN: Sure, I can try. I mean, I think the -- you know, the overarching theme of just listening to Steve and Ron talk and try to answer this question is the depths to which you two have probed kind of the insanity of a lot of this is something that I can't come close to touching.

The Export Control Reform is certainly something that even as a smaller business has benefited us tremendously. I know that for larger companies that will hold true as well. As for the transition from service to manufacturing, I think I mirror a lot of the commercial industry in harboring some deep skepticism about sort of the cost-plus model inherent in a lot of the services work provided to the government and the incentives that that generates. So, I don't know that I'm as bullish, although that may actually end up being great for the industry. But when it applies to sort of outcomes for the government meeting industry, I don't know that I'm as bullish about that particular aspect as I am about the export reform.

MR. O'HANLON: Steve, any final comments?

MR. BELL: No, just that I hope that everybody will -- you know, they talk about contacting your congressman and your senator. This decision's going to be made by about six or seven people. It's going to be made at the leadership level in the House and Senate, and it's going to be, I think, very, very difficult.

Will we have a government shutdown? I was involved in the last one when I was told by a very smart Republican leader, "Don't worry, Clinton will get the blame." And I was very lucky, because in 1997 January, I got to stand out in frozen west

front watching Mr. Clinton be reinaugurated as President of the United States. I think -- and I'm not speaking for him, but my sense is the House Republican leadership more than almost anything in the world hopes they can avoid even the hint of a government shutdown in the October Continuing Resolution period, because they're not suicidal. I mean, they would want to -- they want to stay in the majority. I don't know whether they have the votes to do a semi-claim CR. I just don't know. I don't think anybody knows. But when we get to the debt ceiling, which is not a government shutdown, which is much more interesting if you can look at it from far away, like if you lived in China and you could look and see us not pay our debts, for example. I think that's going to come the moment of real truth.

If we go through what we did last August, acting really like we were children and did not understand that we were dealing with the global financial infrastructure, at some point, friends of mine that used to work with me in the bond market, but especially equity market are going to run. They panic, by the way. One of my best friends runs a mutual fund. He said to me oh, don't worry. He said if a panic starts, I'll be the first out the door. (Laughter)

MR. O'HANLON: I'm going to ask you one final question before we go to Ron for the ultimate wrap-up here for the panel, because I want to make sure that, again with your expertise on the Hill, Steve that we give people as clear a sense of what really is at issue here. We talked a bit ago about furloughs and the possibility of that as one necessary response because of the way in which the sequestration language has been written that it has to apply in all these different accounts.

Let me just imagine a big ship being built by one of our friends in industry for the U.S. Navy, and let's say it's a ship that takes four or five years to build and it's already one or two years into construction. And obviously Congress has the right every

year to look at the shipbuilding process, decide if it's going well, decide if we still need the ship, but usually Congress is going to keep funding it, because there are huge inefficiencies in deciding halfway through the construction of a ship you don't need it anymore. So, we don't usually do that. What's going to happen to that ship in sequestration, because the company building it is presumably going to have, let's say, 80 percent of the funds that they would have needed to do the construction at the pace that was intended. Does that mean they go at that pace and they fire 20 percent of their workforce and maybe drive up the unit cost of the ship because of the inefficiency they've introduced? Or is there some other mechanism?

MR. BELL: Well, I don't know if there are any contract officers here. I hope there are, because what will probably happen is the government will say termination at the convenience of the government. That's in every contract clause. And they will go and say well, remember, we told you subject to appropriations, we don't have it. And then the contractor -- let's say General Dynamics -- will say well, you know, we have a contract here that says if you do this to us halfway through this, you owe us a billion-two in damages. So, at some point, you have to say well, how much is it we're going to save over here by cutting this and how much are we going to pay in damages because of the contract?

We're trying to do some of that now. It's extremely complicated. But the fact of the matter is to find \$500 billion in defense spending over the next 10 years beyond where we are -- you're going to have to cut more than \$500. There's just no doubt about that, because you are going to pay substantial penalties for weapon systems that are halfway through or two-thirds of the way through plus the unit cost. It's really kind of silly.

MR. O'HANLON: So, Ron, if you could please sum up. Anything that's

on your mind about the shutdown question or anything else that you'd like to finish with.

MR. HASKINS: Yup, yeah.

Well, I agree with Steve that the government's not going to shut down, and if I didn't agree with you I would not say so out loud. (Laughter) But I would add a different reason to it. I went through two government shutdowns the Republicans perpetrated on the nation back in '95 and '96, and they did say the country will blame Clinton for it. But the other thing they said -- and this comes straight out of Republican philosophy -- is no one cares; they're not even going to notice. So, I would say within about 8 nanoseconds of the government shutdown, the *Washington Post* featured stories about these government employees who worked so hard all year long and now they're not going to get their check, they can't buy presents for their kids at Christmas. They had great stories about families that drove all the way across the country, they had their dog and everything, and they couldn't get in a national park. That's what's going to happen, okay? So, Republicans -- and, you're right, I mean, Boehner remembers that, so do other members of the Republican -- they're not going to let that happen. They'll do everything they can to keep it from happening.

But it might be a good thing. It's not unlike -- I thought about this several times during this conversation -- we need an outraged public that we've got to do something about our situation. This is only like a footnote to what's coming if we don't address our problem. Polls show that Americans say that they understand that we have to do something about the deficit.

The final thing I would say is that sequester is a horrible idea. You called it stupid -- at least three different ways it's stupid. I completely agree. But it's better than nothing.

MR. O'HANLON: Fascinating. Well, let's --

MR. WORN: Mike, I don't want my wrap-up thoughts to be about export control. Can I just say one thing, please?

MR. O'HANLON: Yes, please.

MR. WORN: (Laughter) Not that they're not wonderful.

You know, I am constantly, in these conversations, reminded of that great Jean Monnet quote -- French political philosopher -- that people see change only in necessity and necessity only in crisis. I would feel bad if I walked out of this room without saying we are clearly the most innovative country in the world, still, and if we're not seeing this as an opportunity, as this debt crisis as an opportunity, as this deleveraging crisis as an opportunity to think about how we as a nation are thinking about these bigger picture items and ought to start thinking about how do we efficiently cancel ship programs, we're missing a real opportunity. We have to refocus on growing this pie.

That's the solution. That's the solution.

MR. O'HANLON: Okay, go ahead.

MR. HASKINS: I've just got to add one thing to that. (Laughter) I agree. Philosophically you're right, but in order to see those opportunities and make them work, you need leadership, and that's the main ingredient that we lack right now. We do not have great leaders either in the Administration or on the Hill.

MR. O'HANLON: So, we'll take now about a 10-minute break and then reconvene. Please join me in thanking the panel.

(Recess)

MR. SINGER: Let me convene us back into order here. I'm Peter Singer. I direct the 21st Century Defense Initiative here at Brookings. I'm very excited to welcome you all back to this discussion on "Sequestration and the Nation's Defense." As I wrote about in a recent article in *Politico*, I'm a bit frustrated by a strange thing that's

happening in defense politics today.

Now, rather than focusing on the very compromise of both, and I'll say the word, tax rather than revenue, and entitlement reform that the congressional Super Committee was intended to force, the discourse out there in defense discussions seems to be a cross between two strategies. One is a deliberate strategy to maximize the level of panic over what it might mean for the U.S. military national security.

I can't resist, but throwing across the idea that having more than 150,000 Marines, but that they would still somehow not be able to carry out a single contingency, or the idea that the Navy would be the size it was in 1915, but the equal amount of effectiveness as it was in 1915. I, for example, would much prefer to have a Virginia class submarine of today than one of the submarines back then, even two, three of the submarines back then.

But while we've got that going on on one side, we also have a second strategy, to deliberately not plan or prepare for the very nightmare contingency that we're laying out there. If this was the movie *Spinal Tap*, the volume would be set to 11 while Pentagon planners are being told to wear earmuffs.

Unfortunately, Operation Hysterical Ostrich, as I jokingly call it, may make for good politics and punditry, but it's a really poor way to approach national security discussions and planning. And so today this panel is very much intended to get our way past that, to bring together a group of some of the nation's top experts and really dig deep into what the potential implication the sequestration might mean specifically for the industry and for national security, as well as talk about alternatives and solutions, to treat it seriously rather than just turning the volume up to 11 and hoping something good happens out of that.

So the panel today features first Dr. Rebecca Grant. She earned her

Ph.D. in International Relations from the London School of Economics. Afterwards, she worked for the RAND Corporation, the Offices of the Secretary of Air Force and Air Force Chief of Staff.

She's presently the Director of the General Billy Mitchell Institute for Airpower Studies, which is an Air Force Association nonprofit dedicated to studying all forms of air power. As well, she's president of IRIS Independent Research, performing strategic planning for both aerospace and government clients, including the Air Force and the Navy.

Then we'll hear from Mackenzie Eaglen. She received her Master's from Georgetown University. She served as the Presidential Management Fellow in the Office of the Secretary of Defense and Joint Staff. Then she served as a Research Fellow over national security at the Heritage Foundation, as well as a staff member on the 2010 Quadrennial Defense Review Independent Panel. And she's currently a Fellow in the Marilyn Ware Center for Security at the American Enterprise Institute.

And finally, we're welcoming back to Brookings Tom Davis, who is notably a former Brookings Federal Executive Fellow. But behind that, he was a graduate of the U.S. Military Academy, has a Master's in International Security and Economics from Harvard University.

As an Army officer, he was program analyst for the Army, Military Assistant for the Secretary of the Army. He also commanded an artillery battalion in 3rd Armor Division, the First Gulf War, as well as was an Assistant Professor at West Point. Currently he's Vice President for Strategic Planning at General Dynamics, where he assists senior corporate executives in evaluating defense market opportunities, as well as emerging global opportunities.

So a set of really great experts to dig into an important issue. So first

we'll hear from Rebecca, then Mackenzie, and then Tom.

MS. GRANT: Thank you, Peter. It's really great to be here today and to be on the panel with Mackenzie and Tom. So we're going to have a lot to talk about with the defense sequestration possibilities. I want to review two things very quickly which you probably all know. One is I think that we probably all share an assumption that it's time for the defense budget to come down.

As you know, we have been spending at historical highs. You've probably all seen the chart that looks at the DOD top line. What always strikes me is that our spending in recent years has been higher than it was during the Korean War. If you're like me, you pinch yourself and say, how did we get into this situation?

But the fact about sequestration itself is really a frightening one. You talked about *Spinal Tap*, Peter, but I was trying to think about a movie that would somehow give us a sense of what this is like. The only one for me that came to mind is that old James Dean movie *Rebel Without a Cause*, where at the final moment in the drag race, the losing driver catches the sleeve of his jacket on the car and it's fatal for him. There's simply no way to bail out of this.

In fact, what we've seen is DOD starting to try to bail out by throwing some programs over the side, by making some cuts. The hard thing about sequestration is that we have come off a period of three rounds of budget-driven cuts. Again, we may all agree that cuts are in order. The problem here is that we don't see these tied to a national strategy, to strategic decisions about how we will direct these cuts. So sequestration is tough then and it's tough in its mechanics.

As the first panel mentioned, sequestration needs quite simply a cut, probably about 10 percent, to each account. That means that if it's 06028675309 spending \$51 million in basic R&D on Air Force high-energy lasers, take out 10 percent.

It's such a difficult way to go about cutting the defense budget, but it's simply, I think most of us would agree, a non-starter in terms of sound fiscal management.

So I want to talk about two ways that we might see this unfold and tell you why we really need to avoid sequestration and get to the place we need to go, which is a strategy driven hard set of choices about our future defense budget.

When we think about the worse case of sequestration, the image, for me, that comes to mind is a fire base in Afghanistan, a FOB in Uruzgan Province or anyplace else that's not able to get its C17 or its C130 air drop of water, wood, blood, ammunition, whatever those troops have asked for.

But there are other parts of the defense budget that are also likely to suffer. And what I want to talk about here is the R&D accounts, RDT&E, research, development, test, and evaluation. You all know what those accounts are about. Put together for FY 2013, they comprise about \$70 billion. So even if we have a stay of execution on program line sequestration, one possibility is for Congress to go back to DOD and say, all right, we're not going to make you cut 10 percent out of every one of these thousands and thousands of programs, we'll give you a bogey of about \$50 billion for purposes of discussion and let you find a way to go at it.

Well, when you've got \$70 billion in R&D, maybe that's a tempting target. Let's talk first about the basic part of that, the science and technology piece, 6.1 and 6.2 money, for those of you who are into that sort of thing.

These are perhaps the little billions of dollars, but they compromise some of the most essential money for innovation. They include basic research carried out at universities, and applied research that attempts to take new developments in nanotechnology or in cyber and convert them into something with a useful military application.

These little cuts can be quite important. And if we have a case where we see them simply go away, we pay the price as a lost technology opportunity. But there's another problem and that's in the remaining \$50 or so billion left in the R&D account. This is money that goes into what the military likes to call demonstration and development, 6.4, 6.5, 6.6, 6.7 for the technocrats among us. What sort of things are in those programs? Well, they're pretty important. The Army has some work on Patriots and on MEADS, its follow-on air defense system. The Navy has big accounts in its JSF program and in JTRS, its Joint Tactical Radio System. The Air Force, which has about \$25 billion of that, covers some classified programs in that category. I think those are usually a lot of space programs, and also things like high energy laser and GPS control.

Then defense-wide there's another \$17 billion in that part of the R&D budget. It includes things that we really like, things like cyber, things like Homeland Security crossover initiatives, and also ballistic missile defense initiatives.

In short, these are not the kind of things that we can afford to blindly slash either through programs, program level sequestration, or through attempting to direct a big \$50 billion bogey in one year into the R&D accounts.

Here's the reason we shouldn't do it. Take something like the F35 program. That's a program that, along with many other major systems, still has some R&D money, although it's also largely a production program. And what we learn about other programs going forward -- for example, to use another Air Force one, Long Range Strike -- is pretty compelling about the costs of doing insufficient R&D. A RAND study that was completed in 2011 found that insufficient R&D was a major cost driver in four major programs. Those included F35; the Navy has now cancelled DDG-1000 Destroyer; the Wideband Gapfiller satellite; and the Army Apache Helicopter. Take money out of R&D in the wrong place and you'll essentially bank on more cost to that program when

and if you restart it again.

We could talk more about O&M and some of the other things. I think sequestration also could mean attempting the desire to take a lot of money out of that operations and maintenance account to essentially bench portions of the military, stand down the aircraft, bring the ships back to port, and do things like that.

But I think what we can see as soon as we look at concrete examples is that we agree the defense budget needs to come down. We need to look at what goes on after Iraq and Afghanistan. But slashing through the R&D accounts is not the way to do it. Time to get to a strategy discussion and make those hard choices.

MR. SINGER: Mackenzie.

MS. EAGLEN: Thank you, Peter and Michael, for having me on the panel. And thanks to Rebecca and Tom for letting me sit up here with you guys. I'm going to take a little different angle. Now, Rebecca is a good friend, and we've even published together on -- we agree on a lot of things in national security. I would just caveat not everyone in the room agrees the defense budget has to come down, or debt reduction, if that were even the case. Unfortunately, the defense budget cuts have not been allocated towards debt reduction, and that's the big elephant in the room. We're cutting defense and the military is owning up to it, and they're patriotic, and the chiefs are standing behind it saying, but we're doing it for debt reduction, actually that's not the case.

The President's budget that's sitting on the Hill right now proposes a generous net increase for every other federal agency and one and a half trillion in taxes. So DOD is the only federal agency taking any sort of cuts, spending cuts that were supposedly applied to debt reduction, but, as you know, the debt is not coming down.

And I agree with her broad points. You know, I was just at a meeting

with a senior Air Force official and that came up in one of the questions earlier, and the discussion was about the active component cuts and the reserve component cuts in the Air Force. And it just serves as a great anecdote and an example of what a knife's edge the U.S. military is operating under.

High budgets aside, most of those budgets go to people, so let's just talk about -- Michael has had me here talking about that other times before and that's not what I want to talk about. But, you know, this delta of 1,500 people in the active Air Force and reserve component Air Force and could they have done that any other way and sliced that any other way, it's driven by force structure reduction, so A-10s, for example. You're familiar with the debate and the family feud that has spilled out into the public. Literally, it can't be done any other way because they're on a knife's edge. So to think that there's all this more money that could possibly be absorbed aside from sequestration, because that's really what I want to talk about.

The (inaudible) panel here is solutions. And one of the favored solutions I hear around town, it's nothing new, but it's any deal to fix sequestration is going to have more defense cuts, which just kind of baffles the mind since we're already talking about the four hundred eighty seven and how difficult that has been to absorb under the BCA Tranche One.

So sequestration is going to get bought down, but it's not going away, and that's unfortunate, because I think that should be the discussion. You know, how ultimately in the end, even if Congress backs into sequestration, the Pentagon will get flexibility. It will never come down to this program project activity level because of the damage and eloquent destruction that's been described up here on the stage today.

So I've been thinking a lot about, so what are the solutions, let's get aside from how awful it is, because I do think there is consensus that it's pretty ridiculous,

and it was a silly bill that passed, and it was an awful "Sophie's Choice" that was put into place for many members of Congress that is the sequester. So the solution set, well, I was at the Bloomberg News Conference last week, and I heard a lot of members of Congress talking about sequestration, like Senator McCain, Senator Levin, Norm Dicks, Congressman Welch, a bunch of others, and so I thought I might hear something new. I wasn't surprised that I didn't hear much new.

But a couple of things, Washington loves to dust off the old plan that died before there was the new plan and recycle old ideas, and we have to come up with a new solution, so I just figured I'd tell you what was going on before. So you know where everyone is going to go, all the things are going to go -- turn back to, and we have to have this conversation in lame duck. It may or may not be the right solution, but we're not going to resurrect big, bold, new ideas, although I think Steve made a great point on the last panel about the grand bargain.

I've met with Senator Warner's staff, Senator Murray's staff; a lot of members on the Hill do want that grand bargain. They aren't talking about it publicly, but there is the will there. It's not all gloom and doom.

But nonetheless, what are the old plans that died before we had the BCA and that are going to get resurrected in terms of any new conversations about a tax deal that ultimately allows people to have the conversation about sequestration? Because don't fool yourself, tax increases aren't going to pay down sequestration. That's just to get everyone at the table to talk about sequestration. There's no dollar-for-dollar offset here. Same thing with Obamacare. Potentially money's freeing up from the Supreme Court, for example, depending on how they rule.

Well, let's dust off Simpson-Bowles, the President's Commission, because that's become a favorite position for a lot of members, because there was a lot

of work and thought that went into it. And what it gives us on the defense side is the exact recipe that Senator Levin has outlined and that we've all already known, which is there are significantly more defense budget reductions beyond the \$487 billion as part of the Budget Control Act.

If you break down just the defense side, and I think there's -- it's always great to look at these en masse, and it's important because Simpson-Bowles looks at the whole budget, just like Rivlin-Domenici, and other plans. And that's key one and I'm glad that if we're going to dust off any plans, it's a plan that looks across the whole government and federal spending writ large.

But if I'm just breaking down the defense piece, this plan centered around roughly \$860 billion in total over a decade in defense spending reduction. Now, the baselines have changed, so all the numbers are different, but you get the rough idea. Focus primarily on modernization, you know, F35, V22, pick your program, it's probably in there for a reduction or a cancellation altogether.

But there were some groundbreaking changes on a bipartisan level to talk about defense entitlements, and it's something, you know, a lot of our colleagues up here at Brookings and around town are thinking about and have looked at about the way you pay those in uniform. Not today's force, I don't even want to go there. It's now the conversation we're going to have about how you pay tomorrow's force. And changes to TRICARE, changes to should DOD operate commissaries, for example, or should we let the private sector do that? Should they have to control base exchanges and things like that?

Interesting ideas up for debate. This doesn't mean we're just going to take this plan and enact it whole cloth, but it's an interesting idea. Very quickly, Rivlin-Domenici, their proposal, a slightly different defense number. It came in at around

roughly the same amount, however, basically would freeze the defense budget for five years and then only grow it at the rate of inflation. Seems reasonable if you do it the right way, of course, but still a pretty big bogey. So when you're looking at doubling the four hundred eighty seven roughly. And, you know, Senator McCain referenced one other plan that we're all going to dust off, or at least they, those policymakers and politicians, they're going to dust off as they think about how to come up with a deal, big or small, and then lame duck and beyond for figuring this out.

And the other one is the Super Committee. Yes, it failed, but there was a lot of work done on the staff and a member level on the Super Committee, and there were a lot of negotiations. And a lot of these numbers have already sort of come to agreement in theory, they just haven't taken that vote. And that's why we're waiting on the lame duck, right; it's just about taking a vote. People's hearts and minds are already there in large part. There is a large center already there to do any number of these kinds of things.

So Senator McCain referenced, for example, the proposal put forward by Senator Toomey as part of the Super Committee internal negotiation for tax reform at various sorts. It's a big, vague phrase, and I understand it means a lot of different things to a lot of different people, but -- and as Senator McCain said, a tax increase is in the eye of the beholder. So, for example, eliminating ethanol subsidies, which Congress is doing anyway right now, but some people consider that tax reform, closing a loophole, generates additional revenue by default. Things like that border tax reform. Those are the things that were on the table. I think the Super Committee is -- deliberations of various packages they had put together for big proposals is also a place to look. The Super Committee was looking at more defense budget cuts, don't fool yourself, it was not we'll take the four hundred eighty seven and go home. They were looking at, as a

starting point, \$200 billion to \$250 billion.

But there was a special emphasis on trying to protect the short term acquisition cycle, not to break the program to end up costing more money in the long run, not to break R&D, that ultimately breaks programs in the future, and not to increase the unemployment benefit requests as a direct result in the next quarter based on basically layoffs. So there are times that you would see in sequestration, you could see in more defense budget cuts if they're not done the right way. And if you have a net increase in unemployment benefit requests, have you saved a dollar?

So there was a lot of work in the Super Committee, and this is where Congress is going to start from when they have these conversations in the lame duck.

MR. SINGER: Thanks. Tom.

MR. DAVIS: Thanks, Peter. As Peter mentioned, I was a battalion commander in Desert Storm in the 3rd Armor Division and our 3rd Brigade executive officer was this little-known Lieutenant Colonel named Marty Dempsey. So we had him to a dinner not too long ago in his new esteemed post, the Chairman of the Joint Chiefs of Staff. And he looked out over all of us and he said it's just a great thrill to be here with all these old familiar faces. I know why you're old and I'm trying to figure out why you're familiar. So I feel very much in Marty's shoes on that.

I'm also thinking I'm at a point right now batting cleanup on this, where I get to practice that old Washington adage that nobody says anything new, but everybody has to be allowed to say it. So I'm going to -- I had a whole bunch of very pithy comments here, but I think I'm going to restrict it down to just a couple.

I saw a comment in the *Economist* magazine not too long ago, interesting that this would be coming out of Europe, where the editorial page had a comment that said it would be an extraordinary event if America sacrificed its position as

the world's leading military power as the result of a legislative accident, and this would be an accident. Nobody intended the provisions of the Budget Control Act to actually be enacted, and I think that's really where we are.

We are looking at a very catastrophic, as Secretary Panetta has said, legislative accident that will happen unless there's a great degree of leadership and a great degree of attention paid to this sometime between now and January 2nd. Everybody needs to recognize, and I think everyone does, you've heard it on the panel time and time again, and I have to tell you, those of us in the defense industry certainly do, that the looming problem with deficit and debt has got to be addressed. And it's going to have to be an addressment that comes in a multidimensional, detailed, and in no small order time-phased approach, and that's not what we're looking at right now. And I think Mackenzie has laid out several reasons why that's a major challenge, as has Rebecca with her focus on the RDT&E accounts.

There's two ways to get an airplane on the runway, a landing or a crash landing, and this one is going to be a crash landing unless something is done about it. I get asked all the time, you're the strategic planner for General Dynamics, but what are you guys planning to do to get ready for sequestration should it happen? And my boss has made the comment a couple times, I don't know, what do you do to get ready when you hear an asteroid is hitting the planet?

It's a tough thing to do, and one of the reasons it's going to be hard to do is, despite the length of legislation, there are an awful lot of unknowns out there that make planning rather difficult.

Just for example, you know, what's the baseline that's going to be used for this? Is it going to be a continuing revolution of FY '12 or will be some sort of enactment of an FY '13 budget? Will military personnel be exempted? One must

assume that they will be, because not doing so has the effect of essentially firing people as they're returning for multiple tours overseas and an economy that's perhaps not prepared to take them. And I think all of you have seen the statistics that unemployment figures among people who were former veterans are higher than the general population.

Will overseas continue to see operations be exempted? It's not in FY '13, but will it be politically prudent not to fund that full account? I think it probably would not be a very popular thing.

How will they be treated in the following years? Michael mentioned when he was up here, there is a bit of a placeholder going out in the out years, but will that be rolled into anything that would happen in the future or not, and how would that be scored?

Unobligated balances, how much are the unobligated balances? One report says \$65 billion, one says \$85 billion. That's a \$20 billion swing, which is about 40 percent of the amount of the sequester impact on the defense budget. If these accounts are exempted, and many of them would have to be, then that puts a bigger burden on the modernization and investment accounts that, of course, people in my industry are most concerned about and the accounts that are associated with those projects, programs, activities. And despite Steve Bell's comment earlier, you know, what are projects, programs, and activities anyway? There's not a uniform view on that.

OMB has the responsibility of coming out with the rules on enacting this, and so far they have not done that. So we can just assume that after you make some prudent assumptions on how this thing would go, that we're looking somewhere between about a 12 and 15 percent cut.

Now, some have argued that even if sequester happens in its full flower, that that's just going to return top-line defense spending back to essentially where it was

in 2006, and that's basically true, but that's not really the problem.

The industry, the defense industry has shown over the years that given time, given guidance, and given the ability to do so, you know, we can adjust to new circumstances. The problem here is the rapidity of the descent, doing so in one year, because the one year timeframe basically prevents the Department of Defense from doing a few managerial things that it would otherwise want to do involving floor structure, benefits, and many other things you've heard mentioned before.

Let me talk just a little bit about the WARN Act to make sure everybody understands this. You've heard it mentioned two or three times up here. It stands for the Worker Adjustment and Retraining Notification Act. That requires by federal law those of us who have people working for us on our workforce, if they're going to lose their job, that they have to be notified 60 days out where employees may reasonably be expected to be terminated. Interesting wording here, "may reasonably be expected to be terminated."

The federal requirement is 60 days. There are some states that have 90-day requirements, California and New York among them. There are some labor agreements that have a date that pushes out even further. This gets you out into the timeframe of potentially mid-September for when WARN Act notifications will have to go out.

The only thing that's really known about sequestration right now is that something happens to January. What does that mean for specific contracts, specific programs, specific locations, specific facilities? That's not known. But we do know this from past practices; the government tends to be rather broad in its interpretation of what the words "may reasonably be expected to lose their job" means. And if they believe we reasonably, as employers, should have seen this coming, then we have certain obligations and wind up with certain financial burdens if those warning notices don't go

out.

So my supposition is that a lot of these warning notices will go out, they will go out in advance of November 2nd, some of them will go out about that date, and I think that they will, no doubt, get somehow or another into the political dialogue, and we may be seeing a little bit about that right now. This is simply compliance with federal and state and sometimes labor agreements.

It was mentioned up here, and it went by quickly and I wanted to mention it one more time, and that is, when it comes -- in fact, General Dynamics was mentioned specifically in the case of a submarine -- that when it comes to meeting a certain objective in terms of savings, inevitably, because of termination costs and other fees that are associated with contracts, you may wind up, you probably almost certainly will wind up terminating more than a dollar a program to get a dollar of savings. In other words, even though you cancel this and it's \$1, yes, but you owe me 20 cents back or whatever it is. So this compounds the implications of terminating contracts.

Prime contractors will have to make adjustments to the contracts that they have with the government based upon economic adjustment rates, and we will also have to redo contracts with our suppliers. A lot of us are still trying to find out what exactly the dimension of that readjustment is going to be both with the government and with our own suppliers. I'd have to tell you at General Dynamics we don't quite yet have a grasp on what that number is, but Bob Stevens at Lockheed Martin has mentioned the number; 40,000 contracts that would have to be dealt with by him. And again, as was mentioned before, a lot of the reductions that happened on the non-defense side will have to be applied in some form or another against personnel, and that presents a real serious challenge.

I want to take just a minute here to drag you all into the weeds, as if you

haven't been there long enough already. I, for many years, as Peter mentioned, was a program budget official for the Army and the Pentagon, and there are a few things that come down to the practicalities of how the Pentagon is going to have to deal with this, and I wanted to just share with you a few of them.

I've had some discussions with my old community over there. Most of those discussions were reasonably brief and sometimes rather harsh on their part and generally end with somebody throwing their hands up and running for the door. But here are a couple of things that you need to keep in mind.

First of all, none of the offices that work within the empire of the OSD Comptroller over in the Defense Department, going down to the service reflections that they have, have any experience in doing this. They don't have established SOPs, they don't have what we in the Army would call TTPs -- tactics, techniques, and procedures -- for actually implementing something like a sequester.

Second, compounding this issue over the past several years, these offices have been managed and have been run by people who are accustomed to taking big infusions of budget authority and distributing it around to meet immediate requirements and needs. This is the opposite of that. This is taking money away. This is establishing priorities. This is saying you're the winner and you're the loser.

I first went to the Pentagon in this capacity in 1986 as a young major, and we didn't know it at the time, but we were just then on the cusp of the Reagan build-up, and we were just then having to change how we actually handed out money and how we actually managed it as we went through our programming and budgeting processes, and it was a long, at least two year, learning process.

Third, many assume this is a relatively easy issue. One just takes every line item in the Pentagon, multiplies it by whatever percentage is determined to be

allocated to the various accounts, pushes the sort button, and you get new numbers and you're done.

The Pentagon database, so far as I'm aware, unless there's been some major change, is not configured by PPAs. On the programming side, it's built around things called programming elements which contain all colors of money. Each service has its own versions of this. In the Army in my day, they were called PDIPs, which stood for Program Development Incremental Package. I have no idea who came up with that acronym or what they were thinking because it in no way describes what it is. But a PDIP basically for something like an Apache helicopter has procurement money in it, it has RDT&E money in it, it has military personnel money in it, it has O&M money in it, it may even have construction money in it.

Digging all that out and sorting all of that out is no small task, and it will take the Pentagon a long time to do it. So however the sequester cut is mechanically applied, some programs are going to be cut that should otherwise increase, because that was what the plan would be, and some will have to be cut that would otherwise be cut further. So you're going to wind up in some cases, after you've managed to sort through all this, with a situation where some programs actually, if this is built off the continuing resolution from FY '12, will have more money in them than they would have otherwise had had FY '13 gone forward.

All this is going to take a lot of time, and depending upon the timeframes, depending upon the congressional action or inaction, I think the probability is quite high after you've done all the data sorting that has to be done, the department will be faced with the prospect of producing the mother of all reprogramming requests, followed by the mother of all Nunn-McCurdy reports. This is going to completely paralyze the system for some amount of time.

So I think, as Harlan Omen said back there, this is not going to be dealt with very quickly. It's going to take a long time, it's going to drag into the middle of next year, and meanwhile, all of us are going to be sitting around wondering exactly what programs are going to be adjusted and which ones we're going to have to adjust.

I wanted to pick up just two things, Peter. The question came up by a young gentleman sitting here about exports and moving into services. I think the question was, you know, if all this happens and if you have a diminishment in the buying power, won't you guys just go and do overseas sales and that will pick up some of the difference or move into services because services should be a growth industry.

Well, the answer to both those questions is probably not. If you take a look around the world and the condition of the world currently, you're going to have to look pretty hard to find a place where there is a great passion and a great amount of money for buying the type of equipment that this country produces.

The market internationally for selling the things that are produced on the manufacturing side of the fence industry is a very challenged market right now. We heard a comment here a few moments ago about euro and Europe and the euro zone. Nobody in the euro zone except for one country spends anywhere near what the agreement is supposed to be that they're supposed to be meeting on the defense allocation percentage of GDP, not much do there. Some money to be spent in the Middle East, some capability there. We have, for many years, had a co-production contract with the Egyptians for M1 tanks. The announcement yesterday about the results of the Egyptian presidential election creates a high degree of uncertainty. We'll have to see how that all plays out.

And in terms of services, many of us have already moved into services. We have one major component of GD -- in fact, it's our biggest component. Most people

think we still build F16 fighters and all that, but we actually exited that market. Our biggest group is the Information Systems and Technology Group, which has a major part of it that does government services.

So a lot of that business is very mature. And I would suggest to you, a lot of people are probably going to be pulling back from government services because those are also government expenditures. Peter, I think that that, with that cheery assessment, I'll pass it over to you.

MR. SINGER: All right. So it seems both generally from the past panel and this panel, there's a fair amount of consensus that sequestration is not the smartest thing to do. Tom, I was waiting for your movie reference because the movies that have been thrown out there have been *Spinal Tap*, *Rebel Without a Cause*, *Sophie's Choice*. These are not situations you want to be in, but that's where we're at. Okay. So we have consensus around this, don't do it, it cuts muscle and fat by the same percentages, it cuts the innovative and the wasteful, it doesn't reflect a strategy. Okay, we enter that amount of consensus.

I seem to hear general discussion around some kind of support for a grand bargain that doesn't just focus on defense, but brings in these other elements of other parts of discretionary spending, but most importantly, the bigger parts that are eating up the budget. I hear that kind of consensus.

My concern is this, we're in the realm of thinking about national security and thinking about it with a realistic lens, and we do things like contingency planning. We plan in our realm for things that are not only extremely likely, but sometimes not all that likely.

For example, the U.S. military maintained a plan to invade Canada all the way up prior to World War II. In turn, Canada maintained a plan to invade the United

States all the way up to World War II. They sent a spy mission to the United States in the 1920s to figure out invasion routes, so we do contingency planning for things that aren't likely.

I will put sequestration not in the category of invasion of Canada, but in the potential likelihood, because the other thing that we've heard consensus is dysfunctional leadership. So let's just say we go down this path, we agree we don't like it, as Tom put out really effectively, he said, okay, didn't we get to this point, and your quote was something happens, what should happen? We've talked about our worries in this contingency, but what are -- if we get to this dangerous period that we all agree we don't want to happen, what are the things we should be doing if we're stuck in that dark alleyway? I'll try to give a long -- we'll go to Rebecca, and I'd love to hear from each of you on it.

MS. GRANT: I'm sure we all have a lot to say on what should happen. Sequestration is causing us to admit the problem and to avoid the strategy discussion we really must have. We are the richest nation on earth; we can pay for what we need in defense. What we haven't done is decide what that is.

We had a lot of things we had to do in the last decade. Some of it was spending on new programs, and a lot of clandestine stuff, and a lot of it was building up the ground forces for the wars we're in. We have not really collectively decided what's next, and what's too bad is that countries like China have.

You know, the People's Liberation Army helped put the Chinese government in power back in 1949. But quite a few years ago, they said in their document, we're done with the ground force stuff because our strategy is going to be X, Y, and Z. We need to do something like that. We either need to say, you know, we are going to follow our January 2012 strategy and invest more in sea power and in air power,

or we need to say, you know what, we are really a land power, let's take the money there, take it out of something else. I know where I come down on that, but the main point is, we need to have that discussion.

We've had some -- the good draw-downs that we've had, the steep ones, including the one after Korea, was done thoughtfully. The Eisenhower Administration had a plan. It sad that I have to use an example that old, I think there was a plan after the end of the Cold War. Maybe it wasn't what we all thought was perfect, but there was a pretty coherent Bottom Up Review, it gave a pretty steep plan, and it said here's what we're going to do. That's what's missing right now. The more time we waste discussing sequestration, the less energy we have to get to those hard strategic choices that we must make.

MS. EAGLEN: And I would add to your consensus list, Peter, emerging consensus, another one, which is that sequestration could ultimately cost more than you say. So the \$55 billion for defense or to get to the total \$1.2 trillion, and not just the termination for convenience and the contract breaking and the subcontracts doing their time passing the bill back to DOD and all of those inefficiencies, the lawsuits from the civilian work force and others, but then also just the general process and the nature of it, I think we can agree. The unemployment request benefits, if you do have the scenario where you have -- if DOD is America's largest employer in any form of sequestration, even when you exempt certain accounts for people, you're still going to see an uptake in unemployment if it happens as it's structured. So there's emerging consensus, but it just doesn't save much money, so why would you do it on that, in my opinion.

So I think Rebecca laid out a really good first answer and I'll try and back it up on what should happen. So back to some of the three bigger plans that I referenced, like Simpson-Bowles or Super Committee or Rivlin-Domenici or others, Gang

of Six. Senator Conrad had a draft budget. We never saw it, but it had a lot of things in there. Senator Coburn had a back-to-black budget. Senator Mike Lee has a new budget to restore the American dream. There are lots of debt reduction plans out there.

Since we all know any debt reduction plan is going to have to tackle something to do with taxes, however it turns out. It doesn't matter what it does, but it's going to address tax reform broadly, presumably. All of that work has to get done now. So what should we be doing? We should be doing that work on the committee level in the U.S. Congress now. Other smart people on other panels when I've talked have talked about their experience on domestic spending, tax and policy issues in the '80s, when President Reagan and Congress made multiple deals, one to include major tax overhaul, but it doesn't happen overnight. There have been four years of groundwork that have been laid before the final deal was done. The staff has to know what's going on. The members have to have been talking and thinking about this. There has to be oversight hearings. There has to be hearings of inquiry. There has to be so much legwork done to just say we're going to reform the tax code because it's a lame duck and now we're ready, it just doesn't happen like that.

Sometimes you can muscle through something major, like a new START Treaty, but it's very rare. And in this case, I just don't see that it can happen. So what should they do? If they want the grand bargain, they've got to do the legwork now.

And I would argue it's not as politically hot potato as many members think that it is. Senator McCain, I referenced his comments last week, he's already said we're there, the Republicans are taking the vote, we're just not taking it to the lame duck. Speaker Boehner has said before the final deal with Harry Reid, Barack Obama, and John Boehner, just the three of us in a room before everything collapsed, and then ultimately 24 hours later we had a -- the BCA.

They had a deal that wasn't the BCA. And what the Speaker has said, after the *Washington Post* reported on it -- and he said it was an accurate article, and the White House didn't comment, so I take that to mean it was accurate -- is that the Speaker signed up to \$800 billion in tax increases, and that he was going to get the House to vote with him on that, this House, the Tea Party House or whatever you want to call it. So the Republicans are there. So when I hear members like Carl Levin say, you know, and Harry Reid say we're going to break the backs of the ideologues, the rigid ideologues on taxes, it's already happening, but the groundwork isn't getting done. All of the work that has to be done on a staff and member level and the Committees of Jurisdiction, Ways and Means, and all the other ones, overlaps in so many areas and places. So what should get done is, fine, you're not going to take the votes now, but do the work now.

MR. SINGER: I'm going to press you, though. You still avoided the contingency I laid out, which was let's just say this group of leaders is not able to come to the agreement that we think is potential, and the sword of Damocles falls, we do get sequestration. As Tom laid out, we enter a world of something happened.

MS. EAGLEN: Right.

MR. SINGER: What happens then? Rebecca laid out the idea of potentially shifting strategy, maybe a shift in emphasis of -- I'm going to put words that you said -- leaning more air towards ground or the like, okay. But in this contingency, in that contingency, which I would argue is not in the extremely, extremely unlikely, but maybe it's in the unlikely, what then?

MS. EAGLEN: Okay. I'll just quickly say what I think how that would play out. First, not to avoid the question, but Congress will not -- it wouldn't be an overnight thing. I think Tom eloquently laid out how this would happen over many months, and that is exactly right. This is not a midnight, like a government shutdown kind

of thing that would happen. Congress would back into this.

One, there's probably going to be CR that runs through mid-February anyway. So January 2nd is now February 14th for purposes of a sequester in theory, if that's how they do it, and that's the rumor on the street.

Congress, running through the Hill right now, the newest consensus for how to fix sequestration is a three-month delay. So now you're talking May, mid-May, they're going to try and do all those things like the legwork that they haven't been doing, whether that's DOD actually building out these expensive tables and scenarios, a new strategy perhaps, but the tax and the entitlement work, as well.

A one-year delay is also a very popular fix right now. I've heard the Speaker, I've heard James Clyburn and I've heard Chris Van Hollen all reference specifically a one-year delay. So unfortunately, well, the right answer is Rebecca's, and I completely agree. It's not how the town works and that wouldn't be how we would back into sequestration.

And frankly, we're in now year four of DOD's endless state of debilitating strategic review, and the strategy is changing. I don't like it and there hasn't been a consensus strategy, but it's been changing so quickly that the budgets can't keep up, overlaid with the budget-driven decisions by Congress and the White House. So that would be the thing that should happen, and unless you're having a sweep of Congress and the White House, it wouldn't. I agree that that would be the right thing to do.

MR. SINGER: Tom.

MR. DAVIS: Robert Kennedy once commented that Americans are not well informed, but they're highly entertained. And I think one of the reasons we're here right now is to try to help the process of getting Americans well informed. And what they need to be informed about is that, through some mechanism or another, this whole

process has got to be, at the very minimum delayed, long enough to make it informed.

Right now it's not. I mean, it's implicitly uninformed because it's got the automatic dimension that goes into it.

What I would like to see in only semi-facetious, but I guess mostly facetious way is I think every Republican on the Hill ought to walk around with a red lapel pen that has a blue 20 in it, and every Democrat should have a blue lapel pen with a red 20 in it. And 20 is the percent of GDP that we have to get to in both federal expenditures and revenue.

Right now, federal expenditures, including defense, are 24 percent of GDP, which is an all-time high since we have been keeping reliable records. We are 15 percent on revenue, which is an all-time low since we have been keeping reliable records. Those two numbers have traditionally been about 21 percent on expenditures and about 19, 19-1/2 on revenue. That gap is quite clearly unsustainable.

So at some point there has to be a serious, informed, realistic discussion about what the options are that are going to move you back in the direction of those two metrics, which basically is the number 20.

I haven't really seen that yet, and I haven't seen too much indication that people are willing to get there. But if you begin to focus on the problem, then one of the first steps you're going to have to take is take a deep breath, and I think Senator Ayotte was very clear about it, get this moved back to where we can deal with it in a constructive and not destructive manner.

I've just tried to lay out the paralysis that is going to hit the United States Government, and particularly the defense side of it. And I'll tell you, when I was here with Mike back at the federal -- Army Federal Executive Fellow back, I won't say how long ago, but I did a report about how the Defense Department does its planning and

programming and budgeting process, with the intent of going to gather best practices from other agencies of government and applying those to how the Defense Department does it. But much to my surprise, what I discovered is, nobody does this as well as the Defense Department. I talked to the fellow at the State Department who would be the counterpart of I guess David Chu in those days, the PA&E, and he said, you know, I've only got to deal with three things: people, telephones, and buildings. And I have a hard time coordinating and laying that out, and I only try to do it one year at a time.

It's a very complicated thing. But we've got to step forward and we've got to recognize that the objective is a long term objective, it's an objective that's going to take work, and honest reflection, and informed decision on both sides of this equation that Mackenzie has laid out, and we've got to move there without penalizing ourselves severely in the near term.

If this goes forward, if we are forced in the defense industry to have to reconsider, renegotiate, reevaluate 40,000 contracts in just Lockheed Martin, the only thing that's going to come out of this is positive employment for at least one generation of lawyers. And talking to Dino Alavez a little while ago, you know, for those at General Dynamics, the A12 story, which has now gone on for the better part of 20 years, should be somewhat instructive.

MR. SINGER: All right. There's been so much positive news from this panel; I want to open it up to the floor here for questions. So again, please wait for the microphone to come to you and stand and introduce yourself. I think we have a question right here.

MR. MARQUEZ: Ricardo Marquez. Thinking about the long-term objective, if we can get past sequestration and think constructively about reforms, is there something that would be in terms of moving beyond perhaps service-centric force

structure, something that would re-jigger the way we have our forces postured around the world?

And in addition to that, is there something we can do on the management side, which is perhaps move past long-term budgeting, restructure the work on the PPBS programs, two sides that helps make it more agile and nimble on the other side of this issue? So, Heaven forbid, sequestration is on the horizon again, something about the organization has prepared to move and move agilely.

MR. DAVIS: Can I try that one first? Good question, thanks very much. And, of course, I just want to wrestle with it a long time. Rebecca is much more attuned to the contemporary thoughts on strategy, particularly as it pertains to airpower, which has been her expertise for a while, and Mackenzie has invested a lot of time on the maritime side. I've got my own views about that. Of course, I'm the Army guy up here, I've got my own views about that, as well, but let's set those aside for right now.

There's a couple things that we're going to have to come to grips with in a serious way. What we're seeing right now is an accumulation of effects over a lot of discreet decisions and policies that have just built up to where we are.

You heard Senator Ayotte talking about the tax exemptions, the loopholes, as she described it. Those are commonly called tax expenditures and exemptions. One of them that's in Bowles-Simpson I believe is eliminating the home mortgage exclusion. Well, you know, that's something that affects 67 percent of American households, it's a big thing. I don't recall the loophole, but why do we have that? Well, we had that years ago to encourage something.

What we've got to start encouraging now are outcomes on a much more holistic way than we have done in a very systemic way over the course of time. Now, in my industry, despite what you may believe, you know, we're quite reactive. There are

those that like to think that, you know, we rush up to the Army and say, my goodness, we were in the lab the other day and we came up with this thing there and it walks, it flies, it shoots guns, it goes under water, it'll leap over tall buildings, the truth to the matter is that we're quiet reactive, you know.

The Army comes and says here's what we'd like to have and what would that cost, and usually by the time we're done crossing it out, they go, my God, I never thought it would cost that, so that's the situation we're in.

But we have to recognize a couple things. It was said up here that you'd much rather have the United States Navy of today with 284 ships than you'd want to have the one in 1915. I don't think anybody here is going to dispute that. We also have to come to grips with another dimension of the all volunteer Army.

You heard Steve Bell and others talking about the implicit expense that has accumulated over that for a long time. I'll plead guilty. I'm an Army retiree, I made the decision a year ago to drop my company's health care insurance and just go with TRICARE. I'm sorry, Bob Gates, I mean, I hung -- I went the other way for 15 years. As Milton Friedman once said in his book, *Free to Choose*, you know, it's a rational decision on my part which is taking advantage of the circumstances that exist. We've got to come to grip with the fact that we have a volunteer armed force. We have a much more capital intensive force than we've ever had. We're never again going to mobilize like we did for Korea, where we wind up bringing 3 million people on board, that's just not going to happen. This country does not mobilize anymore.

In fact, if you look at the 10-year period of this conflict, even though the budget has gone up like 60 percent in real terms, we've actually only gone up 2 percent in military manpower. The Army and Marine Corps went up, the Navy and the Air Force actually went down. We have 8 percent fewer airplanes; we have 8 percent fewer ships.

It's a capital intensive service, that's just the way it is. So we're going to have to, as Rebecca has suggested, take a deep breath, take a step back, holistically look at what we need to do and how we need to do it. Find every way we possibly can to apply technology to it as opposed to manpower, and hope that we can capture the benefits that you get from that.

So just one small thing, you're seeing it right now. Predators that are -- it's in the language now. My son, who is an English professor at Northwestern, even knows the word, and, you know, he's an English professor and he could care less about what goes on in the military for the most part. But we're at a point right now, there should never again be another John McCain story. We've got the technology, you know, we can do this, and we're going to have to make the decision to move forward and do it in a cost-effective way.

MR. SINGER: Steven, you want --

SPEAKER: I can't resist. I mean, my frustration with the discussions on sequestration and turning the volume up to 11 on the national security implications is all of those senior leaders that speak with such urgency on that don't speak with the same amount of urgency on the fact that the defense budget is being eaten from within; that regardless of what happens to the budget, whether it goes slightly up, whether it stays flat, whether it goes slightly down, or even significantly down, until you deal with the fact of the escalating costs and personnel and the lack of acquisitions reform, you end up in the same place, just by a matter of a couple of years.

I mean, there's a recent study that found, you know, effectively, if we don't change it, escalating personnel costs, meaning that around 2030, 2035, that's it that the Pentagon is paying for, nothing else.

And yet how did we deal with them? You know, we have sequestration

discussions, and yet what happened? We decided to potentially create a commission with no power, a commission to be ignored later. And so I think there's a significant amount of real action that can take place in those areas, be it dealing with the escalating health care costs, catching up a personnel system that, you know, was designed in the 1940s, it doesn't match millennial troops' needs. It was mentioned, acquisitions, in terms of the shift in the industry has been towards services. More than 50 percent of what the Pentagon buys from industry is services, and yet we've had no significant reform on the Pentagon side to figure out how to buy services smarter and better. So, to me, that's the real part of the, you know, the equation that needs the volume raised, and that's the solution of maintaining our national security strength rather than just these numbers.

So my soapbox off, let's give someone else a chance to ask a question.

MR. DAVIS: Yeah, but let me throw one more thing in for the colonel here since he brought it up, you know, on the personnel costs. You know, those people in the Pentagon, Peter is absolutely right, have got to have a more open mind on dealing with a lot of the stuff we've had.

Back 20 years ago, we were doing a study on adjusting the military medical establishment, and I was on the program budget staff, an officer on the program budget staff in the Army, and it was obvious to my little group that this was going to be a cost driver that was going to really hurt us in the future. No one could see it at the time because the costs were not obvious if you just looked at the first layer, but when you adjusted for the fact that we were taking out major medical facilities, we were taking out of doctors, we were eliminating bases and all that, costs were going up. I came out with this radical idea I just read about, I didn't know anything about this, I just read about it in the newspaper, that, you know, a lot of places do this thing called a co-pay.

So I proposed, why don't we just set it up so that when a soldier takes

his daughter, because she's got a small cold, to the clinic, and he's generally gone all day, let's just have a little \$2 co-pay, which will make him do the rational decision about, do I spend all day doing this or do I take my \$2 and I go by the drug store and get some aspirin and give her some orange juice and put her to bed.

You would have thought that I was -- I mean, I thought I was going to be court-martialed. How can you possibly believe that a soldier ought to have to pay \$2 to see a doctor? That was a radical idea, but, you know, other people do it. So I think Peter's point, if I'm reading you correctly, is that in so many ways, the military is an isolated insular group and it really has to be brought forward less isolated and I think more consistent with how practices really go on in other places where you're not seeing the personnel.

I mean, nationally, you're not seeing this increase in employment cost and training cost and so forth, so we've got to get in step.

MR. SINGER: Because there's no sexier topic than military health care. I mean, you focused on active duty troops, but the reality is that most of the cost is on the other side. So it's not the idea of this active-duty soldier getting the co-pay, but studies have found that the lowest per capita cost user of military is active duty.

Or pharmaceutical costs have gone up by 500 percent, mainly because it's retiree sourcing through retail rather than mail order. And frankly, mail order is a little bit more convenient because it comes to your home rather than going out.

But the point -- what we're getting at here is, there's a lot of smart things that could be on the table that aren't because of, I would argue, a lack of leadership and an unwillingness to pay some political pain. But let's go to something far less sexy than military health care. Other questions. Right here.

MR. GIOQUINTO: Hi there, Nick Gioquinto with the American Institute of

Contemporary German Studies. So I've heard a lot of focus on the domestic repercussions of the sequestration, but coming from I guess my perspective, we had leaders from and strategists from German political parties come to our institute last week, and there was some concern about, you know, funding in context of the European partnership and the transatlantic partnership. And they kind of referenced a lot of the demilitarization of Europe by Europeans themselves, and then also them looking at the United States to pick up kind of the slack.

In the meanwhile, we have the United States saying that we can't also spend all that money, and that's in kind of the sense of the assumptions that, you know, on one hand, we can't do the sequestration, but, on the other hand, we also need to cut defense to some extent. So I guess what would you say the repercussions are for the transatlantic partnership and international security cooperation?

MS. GRANT: I'll take that. You know, as you know, some of our key allies, I'm thinking particularly of Britain, of the UK, have already been through a fairly wrenching process of cuts. I spent some time last week with a group of 12 one- and two-stars from various international air forces, and all of them, nearly all of them were deep into a series of cuts.

And, you know, one fellow said, and I think it's really key, that this is no time to turn our backs on each other, and he meant it as a group of airmen, that being the context. So we certainly need to find and try to protect those things that will help. And sequestration is hard, because one thing that I think would be cut pretty quickly are those partnership and cooperation activities. I think of exercises. All the services, Marines, Army, Navy, Air, do all sorts of exercises with international partners on a regular basis. I would expect to see some of that go away, and that would be a real loss. Those are things that have great value and help bond the coalitions that we all now rely on. We

fight in coalitions. It would be hard to see that go away.

I think that would be a source of tension. I think, though, there are other -- there are probably larger issues in the transatlantic dialogue, but the budget thing is there really on both sides, so we will all be working through that almost regardless of which direction sequestration goes. Good question.

MR. SINGER: Okay. We've got time for one last question, if anyone would like to ask it.

Well, okay, so with that, actually I want to offer each of you the opportunity for closing remarks, and why don't we just go in the order before?

MS. GRANT: Great. I just wanted to do one wrap up to emphasize the need for strategy forces. But I think there are things we should not do, and the number one thing we should not do is chase windmills and chase after the things, you know, go on a wild goose chase essentially. Let's not just cut programs because we've heard of them, you know. We need the F35, we need *Virginia* class submarines, we need some of the big programs. Yes, they're big dollars, yes, we all know what they are, but cutting those alone are not the solutions that we're looking for. And I say a little bit the same with TriCare. I don't think TriCare is the number one hidden source of all evil in the defense budget. We have to come to grips with the larger issues, but let's not let ourselves get distracted looking for the one magic thing that will solve it, because these are not it. Let's not run in the wrong direction as we all work hard on the choices ahead.

MS. EAGLEN: I would similarly echo that and say that, you know, the defense capabilities and budget cuts have been underway now for three years. The Budget Control Act is not the first round of cuts, and so that makes it a lot harder, talking free sequestration, sequestration, and after, and all the cuts that will come after it even if it doesn't happen.

And, you know, so Secretary Gates started this under President Obama's leadership with the program cuts. So he just went right after modernization accounts, primarily procurement, killed or canceled 50 -- 40 to 50, depending on how he calculated it, major programs are delayed, meaning reduced by; extended the period over which you buy them, and 240 major and minor ones. This wasn't just the big ones you know about, like F22, it's all the way down to like the radio, some new radio for a certain unit, for an Army unit. Okay, so that's the easy stuff. You kill programs, it's a big win, although, again, the savings here is a really big, squishy number that isn't ever as big as you think it is.

Then the next year started more program cuts, kills, delays, cancellations, again, low-hanging fruit, because it's easy, it wins you a headline, it wins you a bumper sticker, you can show immediate savings. But actually when it comes to termination costs and everything else, the number falls slightly.

Then Secretary Gates tried to get in front of Congress and the President seeing the debt reduction snowball coming at the Department, his own Chairman of the Joint Chiefs saying we've got to cut the defense budget to pay down the debt, so Secretary Gates launched an efficiencies initiative. The first year he said we're going to save \$100 billion over 5 years, everything from closing joint forces to command to cutting (inaudible) general officer staffs, everything, you name it, it's a much bigger enterprise. The efficiency drills continued into 2012, as well. Unclear what it meant for 2012, just that they had a bogey that they had to reach. It's not going to change and so it'll probably come out of modernization account. But nonetheless, you see the drills that have been underway now.

And then here we are. So today you can say, oh, well, we're going to cut the, you know, 30 major programs left. Okay, that's great, then what, you know? So I

agree with Rebecca, that you can't simply just pull a string here and pull a string here and pull a string here. That's the kind of defense reforms or cuts that have been underway. It's going to take a whole enterprise-wide effort.

And it sounds so easy so say, you know, at the think tank, but it's genuinely true, and you can't do it in the last year of any administration. It's going to have to start next year, because you're going to need a secretary of either political party who's got time to do this, to learn how to figure out how to tackle it all at once, the kinds of things like acquisition reform on the services side to get zero attention; and Peter is 100 percent correct, the DOD civilian workforce, which is exceptionally large and in dire need of a review and downsizing significantly.

So pretty quickly, military compensation, not just TriCare, the entire whole thing -- because, you know, you start plugging that retirement, well, what about education? What about health care? So, you know, there isn't one easy way to just to nibble away at compensation. It requires a whole new system for a whole new group of people probably dual-tracked in the future that has nothing to do with what we're doing today. All of that has to happen at once. And it's not easy to do, but it actually can be done.

We're at the point where any other cuts aren't going to either save you money or just hurt your national security. It's not sexy, that's the problem. Everybody wants to just go for the program kill, great, but you're tough on the contractors or whatever, but the kinds of things that have to happen now are the slow bureaucratic boring things behind the scenes over multiple years of leadership at the secretary of defense level who can see those through.

MR. SINGER: Tom.

MR. DAVIS: I'm just going to take this little conclusion thing, since I'm

the industry representative up here, and I appreciate what Rebecca and Mackenzie said about strategy and so forth. It was 51 years ago last January that Dwight Eisenhower delivered his farewell address from the Oval Office. I got some wonderful insight to it when I was the Army Fellow at the Atlantic Council, because my boss there, guide I think I'd probably better call him, General Andy Goodpaster, he gave me a few thoughts about crafting that thing.

Mackenzie's old colleague at the Heritage Foundation, Jim Carafano, describes that speech as one destined to be frequently cited and seldom read. But it coins the phrase "military-industrial complex." And there is this enduring image that the industry that I'm up here representing is a large falling thing with smokestacks and smoke coming out and long assembly lines, and, in fact, that's not at all what we are.

When Dwight Eisenhower gave that speech, the defense industry was the largest manufacturing industry in the country. It was larger than cars, it was larger than steel, it was larger than oil and gas. It had grown up to meet an immediate need that was quite stark and quite challenging, and he references that. This is new in the American experience, are his words.

Right now, the top five of us in the defense industry, the top tier companies -- Boeing, Lockheed Martin, General Dynamics, Northrop Grumman, and Raytheon -- combined annual income is half that of Exxon. It's also half that of Walmart. So if we had a complex out there, it exists in some other sector.

David Berteau at CSIS did a study that since the defense consolidation and the downturn of 1991, 150 companies have left this industry either through consolidation or through an outright exit. This is a rather tightly compact, very efficient business right now.

Norm Augustine likes to say -- and, of course, he was one of the

architects as the CEO of Lockheed Martin during the 1991 period -- that we have gone from having a large number of unhealthy companies to a small number of healthy companies, and you're better having that because unhealthy companies do desperate things.

The sequestration discussion we're having right now, you know, is basically a meat axe approach to the defense budget, the defense establishment, the military establishment, and the defense industry that Secretary Carter recently called the sixth leg of service and part of our force structure. This is an effort and a circumstance that we're in, deficit and debt reduction that has to have a very serious, calculated, planned, and programmed approach to it, and that is not sequestration.

We have to do this in a mindful, thoughtful way, because the room for error in the defense industry is actually much smaller than many people a few years ago would have told you.

MR. SINGER: Great. Well, I'll end on three quick points. The first is I think despite a real diversity in terms of the folks on the different panels, there has been a fair amount of consensus around a couple core points, the main one being the insanity of the predicament that we have placed ourselves into, placed ourselves into in the long term, but also placed ourselves into in the short term. We may have disagreement on what to do next, but I think that's a big takeaway for me, is that no one supporting this meat axe-like approach.

The second is the notion that these lean times will force politically painful choices, but not necessary strategically painful, and that's why they call for leadership, because the leadership, which we've heard, has been lacking in this context is about two things, leadership is not only about making smart strategic decisions, but also it's at its essence about making tough choices, and so it remains to be seen whether we're going

to have that combination. And I certainly hope we see that combination emerge in the next few weeks and months, because we definitely need that true kind of leadership.

And then third is just to thank you, a thank you to the fellow panelists and those who spoke on the prior panels. It's been a really great, in-depth discussion of an important topic. And a thank you to all of you for joining us here. So please join me in applause. (Applause)

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