

THE BROOKINGS INSTITUTION

SEQUESTRATION AND THE NATION'S DEFENSE:  
PROSPECTS AND PERILS

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PANEL 1

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**Panelists:**

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## PROCEEDINGS

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-Rippen-Hollings Act. I was Staff 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., gobbledygook.

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 understanding 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)

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