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SEQUESTRATION IMPLEMENTATION OPTIONS AND THE EFFECTS ON NATIONAL DEFENSE: ADMINISTRATION PERSPECTIVES

COMMITTEE ON ARMED SERVICES
HOUSE OF REPRESENTATIVES

ONE HUNDRED TWELFTH CONGRESS

SECOND SESSION

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SEQUESTRATION IMPLEMENTATION OPTIONS AND THE EFFECTS ON NATIONAL DEFENSE: ADMINISTRATION PERSPECTIVES

HOUSE OF REPRESENTATIVES,
COMMITTEE ON ARMED SERVICES,
Washington, DC, Wednesday, August 1, 2012.

The committee met, pursuant to call, at 10:05 a.m. in room 2118, Rayburn House Office Building, Hon. Howard P. "Buck" McKeon (chairman of the committee) presiding.

OPENING STATEMENT OF HON. HOWARD P. "BUCK" MCKEON, A REPRESENTATIVE FROM CALIFORNIA, CHAIRMAN, COMMITTEE ON ARMED SERVICES

The CHAIRMAN. The committee will come to order. Good morning, ladies and gentlemen.

The House Armed Services Committee meets today to receive testimony on the Administration's implementation options for sequestration. Joining us today is the Honorable Jeffrey Zients, the Acting Director of the Office of Management and Budget, and the Honorable Ashton Carter, the Deputy Secretary of Defense.

Although this is the first day of August, when you look at the calendar there are only a handful of legislative days left to resolve the devastating across-the-board cuts to our military known as "sequestration." The House has already passed a measure that would achieve the necessary deficit reduction to resolve sequestration for a year. However, the Senate has yet to consider any solution other than the President's proposal, which was defeated unanimously. And since he offered that failed proposal 6 months ago, the President has been virtually silent on the issue.

This impasse and lack of a clear way forward has created a chaotic and uncertain budget environment for industry and defense planners. In part because of this rising tide of uncertainty and in part to help build the political will to resolve sequestration, this Congress has repeatedly requested information from the President and the Office of Management and Budget on exactly how sequestration will be implemented. We understand that planning for sequestration won't lessen the damage, but failing to plan for it will make a terrible situation worse.

In fact, this hearing appears to have prompted a flurry of activity within the Administration. On Monday, the Department of Labor issued guidance on the applicability of the WARN [Worker Adjustment and Retraining Notification] Act, urging employers not to notify employees regarding potential job losses before the elections. Just yesterday, the President made the long-awaited determination that military personnel accounts will be exempted from sequestration. And, Director Zients, yesterday you issued a memo to Federal agencies that is a small step in the right direction. So there is even more to discuss.

I also know we will hear a lot today about balanced deficit reduction, so I want to address the issue briefly. Despite claims that the President's budget request reduces the deficit by $4 trillion by proposing $2.50 in spending cuts for every $1 in new revenue, these claims are off the mark by nearly 90 percent. The savings are propped up by a series of budget gimmicks, claiming spending reductions that are actually tax increases and counting spending reductions that are already in law. It claims $848 billion in savings from ending the wars in Iraq and Afghanistan by counting funds that all would admit would not be requested in the first place.

But even if that is the foundation for the President's solution, let the Senate bring some version of it to a vote. Then we will have a conference and sort out our differences. Until that happens, it is my sincere hope that we can each end much of this uncertainty here today.

As one senior military official recently told me, America's inability to govern ourselves past sequestration plays directly into the hands of those who spread the narrative of American decline and will ultimately thrust us into a more dangerous world. If this is not enough to compel action and straightforward talk on the part of the Administration, I do not know what is.

Thank you for being here, and I look forward to your testimony this morning.

I also request that my full remarks be submitted for the record.

Mr. Smith.

[The prepared statement of Mr. McKeon can be found in the Appendix on page 57.]

STATEMENT OF HON. ADAM SMITH, A REPRESENTATIVE FROM WASHINGTON, RANKING MEMBER, COMMITTEE ON ARMED SERVICES

Mr. SMITH. Thank you, Mr. Chairman.

I, too, thank our witnesses for being here today.

And I completely agree with the chairman that sequestration is a problem right now. I think this committee has done an excellent job of bringing attention to that reality. Folks who think that because sequestration doesn't actually kick in until January that we have until then are completely wrong. The impacts of the uncertainty of whether or not sequestration is going to happen are having a definite impact on our economy and not just defense. Remember, sequestration hits the entire discretionary budget, not just the defense budget. It actually hits a little bit of the mandatory spending, as well, and has a profound impact on private employers' decisions going forward about what to invest in.

It is impacting the economy right now. The best thing Congress could do would be to find a solution right now to that. Also, the uncertainty of what is going to happen with the tax cuts that are set to expire at the end of this year is also a major problem for the economy. Delaying on all this is a huge, huge challenge. And that uncertainty is having as big an impact as anything right now on our inability to get our economy moving again. So I agree with the chairman completely that we need to focus attention, that this is a problem right now that needs to be addressed as soon as possible.

It is also worth noting that sequestration was a bad idea in the first place. It was based off of the Gramm-Rudman-Hollings bill back in the 1980s. Both of those plans, the architects of which have said we never meant for it to be implemented. It is a terrible idea; it is horrible policy. It was only meant as a forcing mechanism. It was going to be so awful, so hideous, that everyone would have to get together and agree to prevent it.

But we now have seen what was, I think, obvious even before we passed the Budget Control Act and the reason that I didn't vote for it, the problems of determining how to deal with our deficit—you know, how to address it, what to cut, what revenue to raise—are so serious, and there is so much difference that we can, in fact, go through even something as bad as sequestration rather than find the solution.

So, you know, putting a gun to the head of the economy as a so-called forcing mechanism to deal with the deficit was a bad idea from the very beginning and one that I hope we never try again. But, again, the chairman is right—a problem right now that we have to address.

I really want to thank our witnesses for being here, Mr. Zients in particular, and also for offering a solution. The White House has put out a variety of different solutions. The Democrats in the House have. Every time the Republicans in the House have put up a bill to deal with sequestration, there has been an alternative offered by the Democrats.

Now, the Senate is, regrettably, a different story, because right now the difference is, Democrats and Republicans have a different approach to this. And in the Senate, nobody actually controls the Senate because it takes 60 votes to do anything. So you would have to, in the Senate, have the Democrats and the Republicans agree to get anything out of the Senate.

So I think the solution here isn't, you know, hoping that at some point the Senate acts. The solution is to get all Democrats and all Republicans to come together and try to figure out what a reasonable approach to this is. Really, the problem is there is just a fundamental disagreement on that. And we have had that debate; we will have it again today.

Personally, I think revenue has to be part of the equation. As I have said before, if you look at the Republican proposal that says we shouldn't cut defense, we should cut taxes by even more, and we should balance the budget, the math simply doesn't add up unless you cut everything else in our budget—Medicare, transportation, education, health care, everything else—by 50 percent. Nobody supports that. The Republicans don't even support that. They haven't proposed it.

So let's be realistic about the choices we face and realistic about the fact that revenue has to be a piece of the equation. Again, as I have said before, if you are absolutely committed, as this committee is—and I do not doubt that—to providing for the common defense, to make sure that our service men and women have the support that they need to defend this country, then you ought to be willing to raise the money necessary to pay for it. I think that has to be on the table.

But I do agree with the chairman that it is time for all parties concerned to come together and try to find a solution to this very damaging problem. And I think this hearing is helpful in that. Again, I thank Mr. Zients, Mr. Carter for being here to have that discussion.

And I hope we can begin to make some progress toward a solution. It is great that this committee is shining a light on how big the problem is. I think we all get that now. We now have to move past that to finding some way to solve the problem so the sequestration does not happen.

And, with that, I yield back, and I look forward to the testimony and the questions and answers.

[The prepared statement of Mr. Smith can be found in the Appendix on page 60.]

The CHAIRMAN. Thank you.

Mr. Zients.

STATEMENT OF HON. JEFFREY ZIENTS, ACTING DIRECTOR, OFFICE OF MANAGEMENT AND BUDGET

Mr. ZIENTS. Mr. Chairman, Ranking Member Smith, and members of the committee, good morning, and thank you for having me here. I am here to discuss the Joint Committee sequestration. These are the automatic spending reductions for fiscal year 2013 required by the Budget Control Act.

I want to start by reiterating a point made when the President signed the Budget Control Act last August. Sequestration, by design, is bad policy, and Congress should pass balanced deficit reduction to avoid it.

The intent of the sequester was to use the threat of mutually disagreeable cuts to both defense and nondefense programs to force Congress to enact a compromise deficit-reduction plan. If allowed to occur, sequestration would be destructive to domestic investments, national security, and core Government operations.

A CBO [Congressional Budget Office] report estimated that on an annual basis defense spending would be cut by approximately 10 percent, while nondefense funding would be cut by almost 8 percent. The actual percent cuts would be even greater, given that one-fourth of the fiscal year will already have elapsed by January 2nd. These cuts would be across the board and indiscriminate.

There has been a lot of focus on the defense cuts, which Deputy Secretary Carter will address in a moment. But we would face equally harmful domestic cuts, with sequestration causing severe harm to many of the investments most critical to our country's long-term economic growth.

More than 16,000 teachers and aides would lose their jobs. Close to 700,000 young children and mothers would lose nutrition assistance. A hundred thousand kids would lose their places in Head Start. The FAA [Federal Aviation Administration] would face significant cuts in operations. Food safety and workplace safety inspections would be cut back. The number of FBI [Federal Bureau of Investigation] agents, Border Patrol agents, and transportation safety staff would decline. And the NIH [National Institutes of

Health] would have to halt or curtail vital scientific research, such as research into cancer and childhood diseases.

The President's detailed submission to the Joint Committee last September and his February budget both included a plan to responsibly avoid these cuts, making tough choices to reduce the deficit with a balanced package of spending cuts and revenue increases. The President's plan included $2.50 in spending cuts for every dollar in revenue and, overall, over $4 trillion in deficit reduction, far exceeding the amount that was required by the Joint Committee to avoid sequestration.

Recently, attention in Congress has focused on seeking information from the Administration on planning and preparing for sequestration. I want to stress that in the very unfortunate event that Congress fails to pass a balanced deficit-reduction package and avoid sequestration, the Administration will indeed be prepared to issue the sequestration order on January 2nd and to manage its implementation. But let me be very clear: No amount of planning—no amount of planning—will mitigate the damaging effects of sequestration.

Moreover, our planning must be deliberate so that we avoid inadvertently triggering some of the negative effects of sequestration. We do not want to waste scarce resources or disrupt critical Government operations. To make this vivid, the right course is not to spend time moving around rocks at the bottom of the cliff to make for a less painful landing. The right course is to avoid driving off the cliff altogether.

Implementation of sequestration would be governed by the procedures set forth in the law. And I want to emphasize that the law provides OMB [Office of Management and Budget] and agencies with very little flexibility or discretion in implementing sequestration. It would be a uniform percentage reduction at the account level, which would apply evenly, equally, across programs, projects, and activities.

Because Congress has not yet made progress toward enacting balanced deficit reduction, the Administration is taking a number of actions to prepare for a possible sequestration. Earlier this week, OMB issued guidance to agencies and will engage with agencies on matters necessary for issuing the sequestration order. I have also notified Congress of the President's intent to exercise his authority to exempt all military personnel accounts from sequestration if it were to occur.

And regarding Federal contractors, earlier this week the Department of Labor issued guidance on the WARN Act, clarifying that contractors are not required to issue WARN Act notices to their workers in advance of January 2nd and that doing so would actually be inappropriate in light of the underlying purposes of the act.

So we are taking the necessary steps, but, as I stated, no amount of planning will mitigate the damaging effects of sequestration. Sequestration is a blunt, indiscriminate instrument designed to force action—force Congress to act.

It is August 1st. Five months remain for Congress to work together to pass balanced deficit reduction and avoid the sequester. The Administration stands ready to work with Congress to get the job done.

Thank you, and I look forward to taking any questions.

[The prepared statement of Mr. Zients can be found in the Appendix on page 62.]

The CHAIRMAN. Thank you.

Dr. Carter.

STATEMENT OF HON. ASHTON B. CARTER, DEPUTY SECRETARY OF DEFENSE, U.S. DEPARTMENT OF DEFENSE

Secretary CARTER. Thank you, Mr. Chairman, Ranking Member Smith, members of the committee. Thanks for the opportunity to be here with you today. I am pleased to join my colleague, Mr. Zients. And I will focus, of course, on the impacts of sequestration on the operations of the Department of Defense.

Let me begin, though, if I may, by thanking you all for your continuing support to our Department and our service members and military families, not only in Afghanistan but everywhere around the world. It is much appreciated.

I just returned on Friday from a 10-day trip around the Pacific theater, where I had the opportunity to meet with our troops stationed in Hawaii and Guam, the Republic of Korea, Japan. For over 70 years, the presence of our service men and women has been a critical guarantor of peace and prosperity in the Asia–Pacific region. In the climate of peace and stability created by the U.S. military presence, first Japan rose and prospered, then South Korea, then Southeast Asia, and now China and India. We intend to remain a Pacific power for decades to come because we believe this region is one where an important part of our future lies. Our new defense strategy calls for exactly that. And that is one of many reasons why the subject of this hearing is so important to all of us.

Mr. Chairman, if it is acceptable to the committee, I would like to ask that my full statement be submitted for the record, and I will just continue with some——

The CHAIRMAN. With no objection, so ordered.

Secretary CARTER. Secretary Panetta and I have been emphasizing for many months that sequestration, if it is allowed to happen, would have a devastating effect on defense. While I will focus on the impact on the Department of Defense, Acting Director Zients' testimony makes it clear that the effects on the operations of nondefense agencies would be equally devastating.

He has already described the mechanics by which sequestration would work, and I would refer you to my prepared statement for a more detailed treatment of the mechanics of sequestration as they would apply particularly to the Department of Defense.

I will briefly highlight some of the impacts of sequestration that are specific to DOD [Department of Defense], but much of what I say could be echoed by nondefense Government managers and also by industry managers who furnish critical goods and services to the Federal Government. While I can describe many of sequestration's impacts on DOD, it is not possible to devise a plan to implement it that somehow eliminates these consequences or even mitigates them substantially.

The intent of sequester was to use the threat of mutually agreeable cuts to both defense and nondefense programs, implemented inflexibly and mindlessly, to force Congress to enact a compromise deficit reduction plan. It was never designed to be implemented. Sequestration, therefore, if it were allowed to happen, would introduce senseless chaos into the management of every single one of more than 2,500 defense investment programs, waste into defense spending at the very time we need to be especially careful with the taxpayers' dollar, inefficiency into the defense industry that supports us, and would cause lasting disruptions even if it only extended for 1 year.

Sequestration in fiscal year 2013 would seriously disrupt our forces and our programs. Over the longer term, the lower spending caps in fiscal 2014 through fiscal 2021 would require that we substantially modify and scale back the new defense strategy that the DOD leadership, working under the guidance of the President, so carefully developed just a few months ago.

If sequestration is triggered, its impacts would be, as I said, devastating for defense. Given the recent announcement that the President will exempt military personnel funding from sequestration, the cuts in the rest of DOD funding will be about 10 percent. Under sequestration rules, moreover, this same percentage cut must apply individually to literally thousands of defense programs, one by one.

Overseas contingency operations, or OCO, funding would be subject to sequestration. That is, of course, wartime war support funding. Supporting our warfighters in combat is obviously our highest priority; we would therefore endeavor to protect wartime operating budgets as much as possible, including the key operation and maintenance accounts. This is possible to do in part because the O&M [Operation and Maintenance] accounts contain OCO as well as base budget funding, and these two categories of O&M funding merge together during execution of the DOD budget. We could therefore reduce the base budget portions of O&M disproportionately and spare the OCO portions. We could take similar steps, as needed, in other accounts that include OCO funding.

However, especially in the Army and the Marine Corps, this action would lead to a correspondingly much larger impact on base budget O&M and, hence, on readiness of those Services. We would seek to minimize effects on readiness of units deploying in the near term, but we could probably not do so fully. As a result, some later-deploying units, including some deploying to Afghanistan, could receive less training, again, especially in the Army and the Marine Corps. Under certain circumstances, reduced training could also impact the readiness of other units to respond to new contingencies should they occur. Obviously, sequestration would also affect training in the other Services, the Navy and the Air Force, as well.

Next, sequestration would force DOD and, for that matter, other Government agencies to reduce funding for civilian personnel. We would probably have to release temporary employees and impose at least a partial hiring freeze. We might also have to impose unpaid furloughs on our civilian personnel. You can imagine the effect on the output, not to mention the morale, of these defense employees who conduct so many of the Department's essential support functions, from repairing weapons to conducting needed oversight and audits.

Military families and retirees would be adversely affected by sequestration. For example, we could be forced to cut back on base support services, facility maintenance, and maintenance of Government-owned family housing. Commissary hours might have to be reduced. Funds for the Defense Health Program, which provides health care for retirees and military dependents, would be sequestered, resulting in delays in payments to service providers and potentially some denial of medical services.

These various sequestration actions, taken together, would represent a major step toward the creation of an unready, hollow military force. Military readiness would therefore be added to the list of programs and other departments harmed by sequestration, as has been described by Mr. Zients.

Sequestration would also inevitably lead to universal disruption of DOD's investment programs. As I noted, under current rules that govern the sequestration process, every one of our more than 2,500 procurement programs, research and development projects, and military construction projects would each be indiscriminately reduced, each by exactly the same percentage.

Some managers would be forced to buy fewer articles, fewer weapons. Reductions in buy sizes will cause unit costs of weapons to rise, which will in turn result in further cuts in buy sizes. In cases where we cannot feasibly reduce the quantity of items bought, we would have to delay projects, which is also economically inefficient. Many military construction projects could be rendered unexecutable by sequestration. We would be forced to delay fixing schools, defer construction of new medical facilities, delay environmental cleanup, and so forth.

While we can foresee the harmful effects of sequestration, as I explained earlier, the nature of the sequestration mechanism makes it impossible to devise a plan that eliminates or substantially mitigates them. We are working with OMB to understand this complex legislation, and we are, as I have described, assessing impacts. But we are still 5 months from January. I am hoping, to quote Secretary Panetta, that Congress, both Republicans and Democrats, will exercise the necessary leadership to make sure that sequestration is detriggered. In the unfortunate event that sequestration is actually triggered, we will work with OMB, and like all the Federal agencies affected by this law, we will be ready to implement it.

While we will not fail to prepare for sequestration, we are equally worried about a different type of error. This would occur if sequestration does not happen but we end up triggering some of its bad effects anyway. For example, we do not want to unnecessarily alarm employees by announcing adverse personnel actions by suggesting that such actions are likely. For efficiency reasons, we do not want to hold back on the obligation of funds, either for weapons projects or operating programs, that would have been obligated in the absence of a possible sequestration. Nor do we want to cut back on training, which would harm military readiness in a period when we face a complex array of national security challenges.

Finally, we understand that private companies that serve the Department of Defense and constitute important members of our national security team will be making decisions on issues related to sequestration. They face many of the same dilemmas we do, and a number of them have expressed to me their alarm at such a wasteful and disruptive way of managing the taxpayers' money and the talents of their employees. We will continue to consult closely with them, along with OMB and other Government departments. The best thing that can happen for our industry partners, as well as the Department, is for the Congress to enact a balanced deficit-reduction plan that halts implementation of this inflexible law.

I believe that what I have just outlined makes clear that sequestration would be devastating to DOD, just as it would be to every other affected Federal agency. Secretary Panetta and I strongly believe that we need to deal with the debt and deficit problems in a balanced way and avoid sequestration and that this will require legislation that both Houses of Congress can approve and the President can sign.

The men and women of our Department and their families need to know with certainty that we will meet our commitments to them. Our partners in the defense industry and their employees need to know that we are going to have the resources to procure the world-class capabilities they can provide and that we can do so efficiently. The American people, our allies, partners, friends, and potential foes the world over need to know that we have the political will to implement the defense strategy that we have put forward. And that is why Secretary Panetta and I urge action now.

Thank you again for all you do to support our men and women in uniform here at home and around the world. Thank you, and I would be happy to take your questions.

[The prepared statement of Secretary Carter can be found in the Appendix on page 68.]

The CHAIRMAN. Thank you very much.

The Department of Labor's guidance notwithstanding, each company must decide for themselves if and when they are obligated to provide advance notices to their employees of impending layoffs. The criteria established by the WARN Act is that such layoffs be reasonably foreseeable.

Two weeks ago, I asked the CEO of Lockheed Martin; the CEO of EADS North America, who is the chairman of the National Defense Industrial Association and the former Deputy Director of OMB; the president of Pratt & Whitney, who is the chair of Aerospace Industries Association; and a small-business owner who is on the board of the National Association of Manufacturers, I asked these four people the following question: Can you each confirm at this time that layoffs are reasonably foreseeable? Their unanimous answers were "yes."

I also asked each of them if they believed they were obligated by the spirit of the letter of the WARN Act to give conditional notices to employees that may be laid off as a result of sequestration in advance of making a final determination regarding which specific employees will be let go. None of them disagreed.

Finally, I asked them if any of the exemptions to the 60-day notice WARN Act requirements are applicable in this situation. For example, could the companies they represent claim that layoffs from sequestration were sudden, dramatic, and unexpected? Here is what they said:

"We don't believe so."

"No, they are well forecasted and anticipated."

"We knew months in advance and could see it coming."

"I would agree with my colleagues. The law on the books today says that sequestration will occur on January 2nd, not conditional or contingent on anything. That is the law of the land, and we are obligated to plan on it. We have a fiduciary responsibility to our boards, to our shareholders, and our employees to plan based on the laws that are on the books today."

Director Zients and Secretary Carter, if the largest defense contractor and senior elected representatives of the National Defense Industrial Association, the Aerospace Industries Association, and the National Association of Manufacturers all believe that layoffs are, and I quote, "reasonably foreseeable," and the WARN Act applies, why do you disagree with them?

Mr. ZIENTS. Well, I think the important thing here is that it is the Department of Labor that issued guidance. They oversee the WARN Act. That happened earlier this week, so subsequent to the hearing that you are describing. And they did that in response to questions that had been raised by contractors in the defense industry and contractors who do business with other Government agencies.

And DOL [Department of Labor], as that agency that is responsible for implementing the WARN Act, provided the guidance. And the guidance makes clear that contractors are not required to issue WARN Act notices 60 days in advance of January 2nd. And they go on to say: And to do so would be inconsistent with the purpose of the WARN Act. These potential plant closings or layoffs are speculative and unforeseeable, so to give blanket notices both wastes taxpayer resources and creates unnecessary uncertainty.

So, clearly, the companies that you just talked about need to absorb this guidance from the Department of Labor, which is very clear, and they need to make their own decisions, but I think the Department of Labor has responded to questions from contractors with the guidance that they gave earlier this week.

Secretary CARTER. Mr. Chairman, I can't add anything on the legal side. That is the interpretation of the Department of Labor.

I will say, I mean, I sympathize with my colleagues in the defense industry, in the sense that they, like we, are on the horns of this dilemma. On the one hand, this should not happen, and nobody wants it to happen. And we don't want to begin taking actions now to tear ourselves to pieces in the expectation of something that is really stupid if it happens 5 months from now. On the other hand, we don't want to be in a position where we are completely flatfooted 5 months from now either.

So that is where we are. And I sympathize very much with them. And this gives them, as they discuss with their boards and their counsels, as they make their own decisions, this is legal guidance that they can take as input.

But the underlying issue here is that we have a lot of people who depend on us to behave in a more or less predictable and responsible way. And this puts them in a lousy position, this prospect of sequestration, which is why, as I said, the Secretary and I—and Mr. Zients has said the same thing—Secretary Panetta and I have been saying for months, we've got to head this off. It is very damaging. Just having the shadow over us is damaging, as this discussion illustrates.

The CHAIRMAN. I think we already, as Mr. Smith pointed out and I have said repeatedly, we are already in sequestration. They are already making decisions, they are already doing things, because it is the law of the land.

Let me ask, did either the OMB or DOD provide input into the Department of Labor's opinion?

Mr. ZIENTS. OMB plays a role, as you probably know, in clearing guidance from all agencies. So OMB played its normal role of clearing interagency guidance.

Secretary CARTER. Mr. Chair, we did not, no. The Department of Defense didn't, though the—as I said, there is a sensible result here of not having people tear themselves apart about something that I hope doesn't happen. But we don't have a role in making the legal determination, no.

The CHAIRMAN. Hope really probably isn't good enough to build a strategy on. They are going by based on what the law of the land is.

Have you or anyone else in your organization given any guidance to industry, either verbal or written, not to issue conditional WARN Act notices to employees before the election?

Secretary CARTER. Speaking of Defense?

The CHAIRMAN. Both of you.

Secretary CARTER. No, we have not given separate guidance from the Department of Labor. We have made available to our contractors, as I assume everyone does to all Government contractors, the Department of Labor's guidance on the WARN Act.

Mr. ZIENTS. The Department of Labor's guidance issued earlier this week is the only guidance that has been given out.

The CHAIRMAN. Let me ask that question again. Have you or anyone else in your organization given any guidance to industry, either verbal or written, not to issue conditional WARN Act notices to employees before the election? Yes or no?

Secretary CARTER. No. No. No.

Mr. ZIENTS. No.

The CHAIRMAN. Thank you.

Director Zients, in your testimony you stated that you cannot estimate the percentage reduction and the amount of the reduction by program, project, and activity until Congress enacts all fiscal year 2013 appropriations.

Can you explain, please, why the OMB couldn't make certain reasonable assumptions, like the DOD appears to have done, to begin its analysis?

For example, why couldn't you use the President's budget request as a baseline, or the House-passed appropriations, or a continuing resolution funding level? After all, in the case of the Department of Defense, the difference between the House-passed appropriation and the President's request is 1 percent. I think most analysts would like those odds, 99 percent certainty of what the funding will ultimately be.

Mr. ZIENTS. I would say that the CBO estimates have a decent methodology, but the problem with CBO's estimates or anyone's estimates at this point is you have to make a series of assumptions. You have to understand what the appropriation level is going to be. One has to understand unobligated balances on the defense side and what they are going to be. One has to understand mandatory spending for those programs that are going to be subject on the mandatory side to sequestration. Furthermore, you then have to understand how that spending is going to interact with PPAs [Program, Project, or Activity].

So it is a very complex exercise. I think the estimates that Dr. Carter provided of 10 percent on an annual basis in DOD and 8 percent for the domestic programs are likely in the range.

I would suggest that our energy, our time is much better spent avoiding sequestration through balanced deficit reduction rather than trying to massage numbers that we all agree will have a devastating impact on both defense and domestic programs.

The CHAIRMAN. However, you cannot spend your time doing that and Dr. Carter can't spend his time doing that. We, the Members of Congress, have to spend our time doing that.

Mr. ZIENTS. Absolutely.

The CHAIRMAN. So what you are saying is you basically will implement the law as written, and it will be a straight, across-the-board cut of roughly 10 percent to every single program, every single line item.

Mr. ZIENTS. Well, the guidance that we gave yesterday——

The CHAIRMAN. I mean, this is what——

Mr. ZIENTS [continuing]. Has us working with agencies to understand which programs are exempt and which programs are not exempt. So, clearly, if a program is exempt from sequestration, it will not be subject to such a cut.

The CHAIRMAN. Right.

Mr. ZIENTS. And that is the kind of work——

The CHAIRMAN. And that is the personnel.

Mr. ZIENTS. It is not only personnel. There are other accounts that we would have to go through by looking at the Budget Act of 1985, looking at the BCA [Budget Control Act], how programs have changed, what new statutes have come in place. It is a complex exercise to understand which accounts are exempt and which ones are not.

The CHAIRMAN. But you have given——

Mr. ZIENTS. That is obviously an important part of the across-the-board cut, because if an account is exempt, it is no longer in the denominator, if you will, and therefore——

The CHAIRMAN. Right. So you have listed what accounts will be exempt. And then everything else will be cut line item by line item, across the board, evenly?

Mr. ZIENTS. That is what the law says.

The CHAIRMAN. Thank you very much.

Mr. Smith.

Mr. SMITH. Thank you, Mr. Chairman.

Just to be clear—and I think you were very clear in your opening statement, but to follow up—you are looking at the options for if, you know, God forbid, this comes to pass, we have to implement it. You are not completely ignoring it and just waiting.

Mr. ZIENTS. Well, I mean, fortunately or unfortunately, OMB has experience working with agencies to plan for contingencies—Government shutdown, possible debt ceiling. We know how do this.

Mr. SMITH. Right. You went through it, like, four times just——

Mr. ZIENTS. And so we know how do this. And as Dr. Carter said, we will be ready. We will be ready at DOD; we will be ready across the Government if, unfortunately, Congress doesn't do its job and pass balanced deficit reduction.

At the same time, we want to do it in an efficient way. There are 5 months between today and January 2nd. That is plenty of time for Congress to pass balanced deficit reduction. And at the same time, it is more than enough time for us to be ready for the unfortunate possibility of January 2nd coming to be and we have to implement the sequester.

We will be ready. But, really, that is not where the energy should be spent. The energy should be spent on passing balanced deficit reduction to avoid what everybody agrees is bad policy.

Mr. SMITH. Right. And there is no question, I think your testimony has been clear, that you both think sequestration is completely awful and should be avoided in any way possible at this point.

Mr. ZIENTS. Absolutely.

Mr. SMITH. And then on the WARN Act, that is a legal question, and we will skip the legal. But neither one of you is suggesting that defense contractors or, you know, people in the transportation industry or any of those, you know, shouldn't be concerned. I mean, there is clearly an impact on jobs. We don't know what specific jobs, and that is what makes the WARN Act difficult, because you don't know specifically who is going to be laid off at this point. But, clearly, there is a lot to be concerned about if you are a defense contractor or a defense worker, and neither of you would dispute that, I assume.

Secretary CARTER. No.

Mr. ZIENTS. Absolutely. I mean, if we have an across-the-board $109 billion cut indiscriminately done, there will be bad consequences, no doubt. And the sequester was designed to be a forcing function, not to be a policy that was going to be implemented.

Mr. SMITH. Absolutely. And the WARN Act is a very narrow question of whether or not you know specifically who is going to be laid off. And, you know, part of the legal obligation that the Budget Control Act puts you all under is to issue guidance on how should we implement this. But, clearly, there is a lot to be concerned about if you are a worker under any Government contract.

Mr. ZIENTS. Yes.

Mr. SMITH. I mean, that is an interesting thing about these hearings, as has been pointed out by some of my colleagues, that, you know, we have had hearings about the devastating impacts of cutting Federal Government spending on defense workers at the same time we have complained that somehow cutting Federal Government spending on other workers doesn't have any impact on the economy. It does, whether it is just defense or not.

And as you both have said, it is a matter of finding the balanced approach to solve this problem. And there is a clear gulf between the two parties on what the best solution to that is. But I don't think there is any gulf between us on how devastating sequestration would be and on how important it is that we work to prevent it.

Thank you. I yield back.

The CHAIRMAN. Thank you.

Mr. Bartlett.

Mr. BARTLETT. Thank you.

I have four quick questions for Director Zients. With succinct answers, hopefully we can get through all of them.

Sequestration, depending on how it is administered, it could be truly catastrophic. As our witnesses acknowledged in their opening statements, the Budget Control Act specifies that sequestration be implemented in accordance with section 256(k) of the Balanced Budget and Emergency Deficit Control Act, which states that, "except as otherwise provided, the same percentage sequestration shall apply to all programs, projects, and activities, or PPAs, within a budget account. Defense programs, projects, and activities have been defined in the past as the most specific level of budget items identified for defense appropriations, the related classified annexes and explanatory statements, and the budget justification documents as subsequently modified by congressional action."

This level of application may render some programs unexecutable based on resulting order quantities that are not economical or efficient to manufacture or produce. Additionally, some investments for low-quantity orders may not be able to be fully funded even with reduced quantities.

Director Zients, how do you define PPAs for the purpose of sequestration of defense accounts?

Mr. ZIENTS. Well, I think Dr. Carter said there are about 2,500 PPAs across the Defense Department. Across the Government, there are tens of thousands of PPAs. And as you said, each one of those will receive an across-the-board cut.

Mr. BARTLETT. Will sequestration be implemented at the individual program, project, and activity, or at a higher aggregate level to afford agencies some amount of discretion and flexibility?

Mr. ZIENTS. The law is clear: It needs to be implemented at the PPA level.

Mr. BARTLETT. What accounts will comprise the basis of available funds subject to sequestration on January 2, 2013?

Mr. ZIENTS. It will be those accounts that are determined to not be exempt. And it will also include unobligated balances on the defense side and the mandatory programs that are subject to sequestration.

Mr. BARTLETT. Which exact spending accounts will or will not be subject to sequestration?

Mr. ZIENTS. Those that are not exempt will be subject to sequestration, as I just described. Also, unobligated balances on the defense side are subject to sequestration, as are the mandatory spending programs that are not exempt from sequestration.

Mr. BARTLETT. Can you provide us with a list of the exempt accounts?

Mr. ZIENTS. That is the exercise that we launched yesterday. And we will be developing that list.

Mr. BARTLETT. Will the authorities provided in section 258(b) of the Balanced Budget and Emergency Deficit Control Act of 1985, providing flexibility among defense programs, projects, and activities, be used?

Mr. ZIENTS. We are analyzing how the 1985 act interacts with the BCA. And that is central to determining what accounts will be exempt and which ones will not be exempt.

Mr. BARTLETT. Will the Department of Defense be granted any flexibility to apply sequestration in order to adjust programs and ensure continuation of critical investments?

Mr. ZIENTS. The Department of Defense will do what the law says. It will apply across-the-board cuts at the PPA level and then make decisions within PPAs, the most rational decisions possible.

Mr. BARTLETT. On what basis and at what level will that authority be given?

Mr. ZIENTS. According to the law.

Mr. BARTLETT. In my prepared question here, it states that "except as otherwise provided." How do you interpret that?

Mr. ZIENTS. I need more context in order to understand what your question is.

Mr. BARTLETT. If you could take a look, please, at 256(k) and for the record tell us what you think "except as otherwise provided" means.

Mr. ZIENTS. We will do so.

[The information referred to can be found in the Appendix on page 105.]

Mr. BARTLETT. Thank you.

The President's budget request for fiscal year 2013 for national defense exceeded the revised discretionary spending limits by approximately $5 billion. Should such a funding level be appropriated for fiscal year 2013, would the additional $5 billion be subject to sequester and included in the calculation of the available funds?

Mr. ZIENTS. Well, that depends on whether Congress does what we all agree needs to be done, which is, if balanced deficit reduction is enacted and the sequester is avoided, then, no, we return to the security/nonsecurity caps.

If under the very unfortunate situation where sequester kicks in on January 2nd and the caps are defense and nondefense, that $5 billion would be subject to a different sequester, not the Joint Committee sequester but the cap violation sequester.

Mr. BARTLETT. Thank you very much for your succinct answers. We got through five questions, not just four. Thank you very much.

Mr. ZIENTS. Thank you.

The CHAIRMAN. Thank you.

And just to follow up, the section that he was referring to, number four, that you will be giving him the information on says, "Except as otherwise provided, obligations in sequestered accounts shall be reduced only in the fiscal year in which a sequester occurs."

Yesterday, the Secretary of the Department of Education said if sequestration kicks in and education will be affected, as you pointed out—and I am glad to hear somebody talking about—I have only been talking about the defense side. We understand that that is half of the equation. But he said any cuts to education would be put off until the next year, the next education year. By what authority will he be doing that?

Mr. ZIENTS. That is not the case. The way——

The CHAIRMAN. Okay. That is what he——

Mr. ZIENTS. As we all know, the school year starts in September——

The CHAIRMAN. Right.

Mr. ZIENTS [continuing]. So the 2012–2013 school year——

The CHAIRMAN. Well, actually, I was on a school board, and the board I was on, the school year started in June. Their fiscal year ran June to June.

Mr. ZIENTS. Well, in terms of how we fund.

The CHAIRMAN. Right.

Mr. ZIENTS. So September through early summer. So the, what the Secretary clarified was that the 2012–2013 school year would not be impacted by sequester. However, there would be very devastating consequences to the 2013 through 2014——

The CHAIRMAN. They will have 2 years?

Mr. ZIENTS. No. That money would have to be taken out within the fiscal year, which as you all know ends September 30th. So there would be devastating cuts to the next school year. So Education, like all departments, would have to live under the law and do their fair share of these devastating across-the-board cuts.

The CHAIRMAN. Thank you very much.

Mr. Reyes.

Mr. REYES. Thank you, Mr. Chairman.

Gentlemen, welcome.

GAO [Government Accountability Office] has stated that, regardless of the possible effects of any sequestration, agencies must continue to comply with the requirements of the Impoundment Control Act, with "impoundment" defined as any action or inaction by an officer or employee of the Federal Government that precludes obligation or expenditure of budget authority.

Our committee has received testimony that indicates that there is an observable slowdown and reduction in contracts and orders. Questions this morning for you are: What is OMB's position on contracts funded with fiscal year 2012 appropriations but executed in fiscal year 2013? Will agencies be allowed to delay contracts to preserve flexibility or accelerate contracts prior to January 2nd to protect programs? What is your guidance?

Mr. ZIENTS. We have been very clear in yesterday's guidance that we expect agencies to continue normal business operations and to not slow down in any way.

Mr. REYES. And have you noticed the same thing that we have noticed? Is there any indication from your perspective that these things are occurring?

Mr. ZIENTS. Well, I will defer to Dr. Carter, because two-thirds of contracting is at DOD, and I know he has been tracking the obligation level there.

Dr. Carter.

Secretary CARTER. I have been concerned about exactly the phenomenon you are raising that Mr. Zients addressed, which is that we begin to experience the deleterious effects of sequestration even if sequestration, which we all hope, doesn't take place.

I don't see that in the obligation rate statistics yet. I have some anecdotal evidence to that effect from our contracting officers and procurement officials. We are not seeing it show up in the numbers yet.

And, of course, as I said, the guidance that we were given yesterday, which I think is very sensible, which is, let's not self-sequester before we have to, if we end up having to, which of course we don't want, and our program managers to keep operating in the most efficient manner that they had planned to, so they are giving good defense value for the taxpayer dollar. We want them to keep on keeping on, if they are managing well, doing it the sensible way, not starting to do it in a nonsensical way.

Mr. REYES. And I was interested in your response about not providing guidance to industry leaders. But what about providing guidance within the Government? As it pertains to violations of the Antideficiency Act, if a director or program leader would—you know, they have to plan long-term—and sequestration kicks in, what guidance are you providing managers about not being in violation of the Antideficiency Act?

Mr. ZIENTS. Well, I think agencies are well aware of the Antideficiency Act. Sequester has not taken place at this point. Hopefully it never will. Agencies are instructed, as I said, to continue their normal business operation, which means to continue to spend at the appropriate level. Obviously, not to in any way violate the Antideficiency Act, at the same time not to slow down spending.

Mr. REYES. Well, it seems to me like that puts them in a catch-22 situation. They need to plan ahead. For instance, you mentioned the cutbacks that would affect Customs and Border Protection. They have to make those kinds of—as a chief, you have to make those kinds of plans.

Mr. ZIENTS. Those cuts do not occur until the sequestration order is issued on January 2nd. And again, I think the job of everybody here is to ensure that we never get to that point, that Congress passes a balanced deficit reduction that avoids the sequester, and agency operations continue.

Mr. REYES. Well, I agree with you, but our track record isn't that good here in Congress.

Mr. ZIENTS. We will be ready, if Congress fails——

Mr. REYES. So there are managers out there that could conceivably, you know, from my experience, could conceivably be in violation. And I am just wondering, is somebody taking that into account, and giving that kind of guidance——

Mr. ZIENTS. They cannot be in violation.

Mr. REYES [continuing]. And that kind of cover?

Mr. ZIENTS. They have their appropriations level, and they are spending that appropriation level prudently. If on January 2nd, the level of spending is reduced by $55 billion on the defense side and $55 billion on the domestic side, agency managers will be ready to implement that. So we will be ready. Again, I think that we have prepared for these types of contingencies before. OMB knows how to do it. DOD knows how to do it. Agencies know how to do it. The thing that we have to focus on right now is avoiding this situation altogether.

Mr. REYES. Thank you, Mr. Chairman.

Secretary CARTER. May I just add to that if I may, for clarification that you all may not need, but to make sure all of our program managers understand. The key point is that funds they obligate between now and when sequester hits, if it hits, will not be subject to sequester. So they are not going to have to retroactively adjust activities they put on contract during this period, those activities, per se. I mean, we are going to make sure all of our program managers, I think most of them do understand that, but that is where the guidance is helpful because it makes clear to everybody: Go ahead and obligate the funds that you have appropriated to you in the way that is appropriate. Do your defense mission or whatever your other mission is in an efficient way, and sequester isn't going to retroactively apply to what you do now.

The CHAIRMAN. Thank you.

Mr. Thornberry.

Mr. THORNBERRY. Thank you, Mr. Chairman.

Mr. Zients, part of what you have got to do at OMB is to provide economic forecasts, employment forecasts, whether there will be more or fewer people unemployed in the future. As you know, there has been several studies about the economic consequences of sequestration. Do you have any doubts that if sequestration were to take effect that there would be substantial numbers of people lose their jobs, and that it would be detrimental to the economy?

Mr. ZIENTS. I think that is absolutely is case. As I said earlier, if you take $55 billion out of the defense budget and an equal amount out of the domestic side, teachers will lose their jobs, people that work at the FAA will be furloughed or potentially laid off, same situation with Border Patrol. So it has a significant impact across the board.

Mr. THORNBERRY. As you know, some studies have estimated 1 to 2 million people in the defense industry could lose their job. Do you think that is about right?

Mr. ZIENTS. I don't have any basis for evaluating that estimate, but clearly the impact both in the defense industry and in other industries would be significant.

Mr. THORNBERRY. Okay, I want to go back to the Department of Labor guidance for just a second. Would the Department of Labor guidance that says it would be inappropriate to send out WARN Act notices be any sort of immunity for a contractor who would get sued later by employees who were laid off?

Mr. ZIENTS. You know, I am not a lawyer, and I am certainly not a labor lawyer. I think the DOL guidance is very direct. Clearly, companies need to work with their legal counsel to interpret that guidance.

Mr. THORNBERRY. Well, and I would assume you would say they ought to learn from their experience, too. If they have been sued in the past over these issues and it takes years to resolve those lawsuits, then that would factor in at least because they send out the notices.

Mr. ZIENTS. Yeah, I would assume that each situation, having spent time in the private sector 20 odd years, each situation is different and has to be evaluated. I think we have pretty clear guidance from the Department of Labor as to the current situation with sequestration, and clearly company leadership needs to work with their legal counsel to interpret it.

Mr. THORNBERRY. Sure. Can I get back to the Department of Education issue for just a second? I don't fully understand that. Is it the fact that all of the Education money is sent out to the school districts before January 2nd?

Mr. ZIENTS. No.

Mr. THORNBERRY. Then how can it be that some of the money that would be—well, here is what is going on in my mind. You said sequestration will apply to unobligated balances of the Department of Defense. If a school district has not spent all of their school funds why is that not an unobligated balance?

Mr. ZIENTS. Well, first of all, the way the law works, unobligated balances outside the Department of Defense are not subject to sequestration. So let me clarify that. It is only unobligated balances at the Defense Department that are subject to sequestration. But at the end of the day, the Department of Education has the same across-the-board cut. It is X billions of dollars. It has to reduce its spending in fiscal year 2013 by that amount. So by funding the school year that is about to begin, it will have a big impact on the school year, the following school year, because the Department of Education has to hit that number of taking that money out. It would have a devastating impact on kids and education across the country.

Mr. THORNBERRY. Yeah. Now, you made that clear and I understand that part. What I don't understand completely is whether OMB has discretion to determine when those across-the-board cuts will occur. Can they occur on February 2nd, or September 2nd, depending on OMB's discretion? Why is it——

Mr. ZIENTS. Well, you know there is——

Mr. THORNBERRY [continuing]. In the case of schools it will be several months after——

Mr. ZIENTS. There are so many different types of programs, and PPAs across the Federal Government. As you know, some programs are seasonal, so more spending might be up front, in which case you need to save up front. Some might be back-end loaded, in which case the money is going to come out of the later months of the fiscal year.

By the end of fiscal year 2013, each agency has to achieve that across-the-board cut in each one of those PPAs. There is a lot of complexity. There is a lot of nuance. I think it is hard to generalize about how that will be achieved.

Mr. THORNBERRY. Well, do you have discretion at the OMB to determine when those across-the-board cuts will occur within the time period from January 2nd to September 30th?

Mr. ZIENTS. Well, the sequestration order is issued January 2nd. That means that $55 billion has to come out on each side. That means that agencies need to think through how they are going to end their fiscal year with the savings achieved. And in every situation it is different, and in every situation it is going to be very difficult. And remember, if these 8 to 10 percent numbers had been cited up front based on the CBO estimates, 8 percent on the domestic side, 10 percent on the defense side, they are actually skipping higher than that, because on January 2nd we are actually a quarter into the fiscal year. So those are more like 10, 11, 13, 14 percent cuts.

The CHAIRMAN. Thank you very much.

Ms. Sanchez.

Ms. SANCHEZ. Thank you, Mr. Chairman. Thank you, gentlemen, for being before us. My first question is for Director Zients. Did you have a vote on the Sequestration Act?

Mr. ZIENTS. On the Budget Control Act?

Ms. SANCHEZ. Yes.

Mr. ZIENTS. No, I am not a Member of Congress.

Ms. SANCHEZ. Thank you. And Secretary Carter, I would ask you the same question. Did you get a vote on that?

Secretary CARTER. I did not.

Ms. SANCHEZ. Thank you. So, Mr. Chairman, the Budget Control Act was neither authored nor passed by the Administration. The enactment of the Budget Control Act is really the responsibility of this body, the United States Congress. And as our witnesses stated in their testimony, the only body that can turn the course of this policy is us, not them. So everybody here wants to discuss the negative impacts of sequestration. I think, you know, there is probably other committees that have been doing this.

Mr. TURNER. Excuse me, will the gentlewoman yield? Will the gentlelady yield for just a moment?

Mr. TURNER. I mean, the President did sign it. It's not a vote——

Ms. SANCHEZ. But the gentlemen in front of us——

Mr. TURNER. It wouldn't have become law if the President hadn't signed it. I voted no, by the way.

Ms. SANCHEZ. Taking back my time. We know the impacts of the sequestration law, loss of jobs, cancelation of programs across the board, less teachers, less programs to support our children, less programs for our senior citizens. However, I don't think that the solution is to exempt the Department of Defense. I think that we need to sit down and in a logical manner go through and figure out what we need to cut. And this is the law as it is right now. It will go, I think it is a—it is wrong to go percentage by percentage across the line, but I think that we need to, as leaders in this country, sit down. I know that I talked to a number of my leaders from both major and small businesses, and in, you know, in my conversations with—I had a CEO express to me that the impact of sequestration, the uncertainty is weighing down the company. He said to me, I can't even make decisions for my company, Loretta, because really it is making me crazy not to be able to lead my company.

I know that with this sequestration California is due to lose something like 150,000 jobs. I mean, we are really on the line for this. And I don't want to see sequestration triggered, but I do think that we all need to sit down in a very calm manner and look through and figure out where we are going to make cuts, both in the Department of Defense and in all of the other places of our budget.

So I would just urge my colleagues to sit down in a constructive way and work through this and stop this whole uncertainty that is going on.

And I yield back, Mr. Chairman.

The CHAIRMAN. Thank you. Mr. Jones.

Mr. JONES. Mr. Chairman, thank you very much. And I was listening very carefully to Ms. Sanchez, and for me personally, I have Camp Lejeune Marine Base down in the district and the depot down in the district, and the anxiety of the sequestration is mounting each and every day. And one of my biggest concerns is, quite frankly, and Mr. Director, probably you or Dr. Carter could answer this for me. But if we do go into sequestration, the mental health programs within the Department of Defense, which I think now are very much stressed with the PTSD [Post Traumatic Stress Disorder] and the TBI [Traumatic Brain Injury], at what point do we go to within the 5 months that you get to a point that everyone that is going to be on any type of list to be advised that you will not continue in this position; if we cannot come to a resolution in the House, which I think both parties want to try to do that, at what point are you in that 5-month period of time that you have to start notifying? I know that is based on the labor laws or whatever, but give me an idea of that element. And also, if you would, how do you anticipate the best you can the threat to the mental health programs within the Department of Defense?

Secretary CARTER. Well, thanks for asking that question, because I absolutely share your concern. We have of necessity, and sadly, learned a lot about the mental health consequences of combat over the last decade and have really tried to advance the art with which we service our wounded warriors. And there is no question about it, this is caught up like everything else we do in sequester. Obviously, we try, as we are going to try everywhere we can, within the pretty brutal constraints of the law as it is written, to protect the most essential parts of our caregiving for PTSD, traumatic brain injury, and so forth.

And obviously, we are not in a position to say we are going to be perfectly successful in doing that because we do have these big cuts indiscriminately applied. But we will certainly try.

And just in closing, I just appreciate the community support of Lejeune. I was just down in Lejeune a few weeks ago and you are great to our people down there and we are grateful for it.

Mr. JONES. Doctor, thank you very much, and Mr. Director, if we get into December and there has been no resolution by Congress, then the process starts. So does it start before December if there is no resolution by Congress to stop sequestration?

Mr. ZIENTS. Well, we are going to be very mindful of being ready, and at the same time not doing things that are wasteful and disruptive. But if we are in that very unfortunate situation where the sequestration order needs to be issued on January 2nd, we will be ready to do so.

Mr. JONES. Okay. Mr. Chairman, I yield back my time.

The CHAIRMAN. Thank you.

Mr. Andrews.

Mr. ANDREWS. Thank you, Mr. Chairman. I would like to thank the witnesses. I think we can stipulate that just about everybody on this committee thinks sequestration is a bad idea. I do. And we don't want to see it happen. I don't. I think we can also stipulate that it is bad for the economy for civilian workers in the Defense Department, and people who work for contractors and DOD contracts get laid off. I think it is equally bad for the economy, by the way, for teachers and firefighters, and people who work for highway contractors to get laid off, too.

And I want to apologize to the witnesses. I think you have done a very good job explaining an indefensible problem that they have been saddled with. Normally I like to ask the witnesses questions, but I think that that is probably not the right thing to do this morning because the answer to the sequestration problem lies on our side of the table, not yours.

And I would just say with great respect and affection for all of my colleagues, I think it is time for us to start to say what we are for and not what we are against to fix this problem. Understand that repealing sequestration increases the national debt by a trillion dollars. That is what it does. So if we repeal this, we have to take responsibility for what we would do instead. I, by the way, think that replacing that trillion dollars is not nearly enough. I think we need a $4 trillion deficit reduction plan. I would stick with the trillion dollars that most of us voted for last August 2nd, and I would do the following on top of it: In Medicare, I would say that people have to wait a little longer before they can get their Medicare benefits. I personally support a plan that would say for each year that you are under 55 years of age you have to wait a month to get your Medicare benefits to vest beyond 65. So I would say to a person 45 years old, you get Medicare when you are 65 years and 10 months old. I would do the same thing with Social Security. The roof did not cave in on my head when I said those things. I know that there are sacred things you can't say in American politics. We need to start to say them.

I would favor some reductions in domestic areas of the budget. I am from New Jersey. I would favor reductions in beach erosion funds from the Federal Government if we also had reductions in crop subsidies and other funds that benefit other areas of the country. I think it is time we have to do those kind of things. I don't think that every housing authority should have a job training program, and the Department of Labor has many job training programs. I think we can do that.

I think that the wealthiest 2 or 3 percent of Americans should pay slightly higher income tax in order to reduce the deficit, and I think every dollar they pay should go to our deficit reduction.

And I also think that we can reduce defense spending, personally, below the level that is in the sequester. I wouldn't go to the $495 billion, but I think we could do a bit beyond the 495 that is already in the bill. But the way we ought to do it, is have statutory caps on defense appropriations where each year this committee and our younger cousin, the Defense Appropriation Subcommittee, would make decisions about rational and intelligent ways to allocate those reductions. I think, for example, that our footprint in Asia and Europe is a bit too large and could be reduced. I think that a nuclear arsenal that can blow up the world 24 times is quite sufficient and it could modernized and reduced in cost.

I frankly think that changes in the military healthcare system, which would be painful and politically unpopular, we have an obligation to discuss them and consider them in a fair and balanced way.

Now, I do not expect any of my colleagues to agree with all or any of what I have said. If you agree with it, fine. If you disagree with it, fine. But I do think it is fair to expect each of our colleagues on and off this committee, if they want to say they are against sequester to say what they would do instead. If you are not prepared to say how you would replace that trillion dollars of addition to the national deficit, then I think that that is kind of unfair to the witnesses here.

Look, I hope and pray that on January 2nd that sequester order is never issued. It is very bad for the country and for this economy. But the power to stop that is with us, ladies and gentlemen, not with the gentlemen here testifying this morning. And the way to stop it, and I think the chairman of the committee deserves great credit for a long time, really for 10 or 11 months, at educating the Congress and the country on the consequences of sequester. I commend him for that. But we as a group have to move to the next step. Okay, we can stipulate to the fact that we all don't like this. Now, what are we going to do about it? And I have put forward some ideas. I know they are quite controversial. I think others should put their ideas forth and then let's go about our business, do our job, pass a law, put it on the President's desk, and repeal sequester that way.

I yield back the balance of my time.

The CHAIRMAN. I thank the gentleman, and I mentioned earlier that we had passed legislation not to get rid of the trillion dollars, not to eliminate that, merely to pay for the first year of it, to move it out of—you have presented some items which I applaud your doing that, however, many who are facing election in November who are in tighter races are not going to step up and do that.

Mr. ANDREWS. Well, if the chair will yield, my race may have just gotten a lot tighter. But, and I say it with great respect for the chairman because he has not practiced this sin in my opinion. We have been pushing things out to the future around here for 40 years. We keep having commissions and delays, and that is what got us into this problem. I think the time is for us to make some decisions.

The CHAIRMAN. I am in agreement with you on that. The gentleman talked about we have 5 months left. We have 2 legislative weeks left before we leave for the election to go home and tell people what a great job we are doing. And then we come back after the election and you know what the environment here will be like. People that have lost their elections that are given a desk down in the basement, saying don't miss any votes, to try to solve something that is very, very important that we haven't been able to solve for a year-and-a-half. And so I am frustrated with that, and I think that it is very important that we do that. In the meantime, though, they do have a responsibility to let the people know what they can expect. We have a responsibility to fix this. I am just not very optimistic at how we are going to go about that.

Mr. Forbes.

Mr. FORBES. Thank you, Mr. Chairman. Mr. Zients, you opened the door to my questions when you were willing to speak for the entire Administration and say that the Administration stands ready to work for Congress and also, you were very freely willing to opine as to which actions of the Administration, or which actions of Congress you thought were responsible or not responsible, and also, which ones you thought were realistic or not realistic.

So my first question to you, you have heard Mr. Carter's testimony today about how devastating and horrible the atrocities that are going to come from sequestration. You also heard the ranking member say that he voted against that. I voted against that. Do you believe that it was reasonable to use a draconian method such as sequestration to force Congress to do anything?

Mr. ZIENTS. Let's go back and review the history here.

Mr. FORBES. No, sir, I am just asking. I only have 5 minutes. I just want you to tell me whether you think it is responsible or not responsible.

Mr. ZIENTS. The majority——

Mr. FORBES [continuing]. Not responsible. Pardon me?

Mr. ZIENTS. The vast majority of members of this committee, both Democrats and Republicans, voted for the Budget Control Act. The decision was made——

Mr. FORBES. Mr. Zients, you stated in your testimony that you thought certain actions by Members of Congress were irresponsible. I am asking you, do you think it was responsible to use an action as draconian as sequestration to force Congress to——

Mr. ZIENTS. The Budget Control Act said the sequestration was law and order to force balanced deficit reductions.

Mr. FORBES. Mr. Zients, are you willing to just say what is responsible when it is to your favor? Are you willing to tell us? If you don't have an opinion whether it is responsible——

Mr. ZIENTS. Did I think that it would be responsible to implement the sequester? Absolutely not. But a balanced deficit reduction——

Mr. FORBES. Do you think it was responsible to use that as a forcing mechanism?

Mr. ZIENTS. It was—you all wrote the law.

Mr. FORBES. Mr. Zients, I am just asking you if you thought it was responsible.

Mr. ZIENTS. I think it was responsible to implement balanced deficit reduction.

Mr. FORBES. Did you think it was responsible to use a draconian method such as sequestration——

Mr. ZIENTS. I think whatever it takes to get balanced deficit reduction.

Mr. FORBES. Do you think it was responsible for the President to sign that measure into law?

Mr. ZIENTS. I think given the situation with the debt ceiling, I think the President was presented that bill. It passed both Houses of Congress, and the President signed the bill.

Mr. FORBES. And you testified before the Senate on February 14th, and this was a quote, you told the Senate, "The President is not proposing that the sequester go away. The sequester is a very important force and function for us to do deficit reduction."

So is it your thought that sequestration with all its atrocities, even though it may be, in effect, holding national defense blackmail, is a proper tool if it forces deficit reduction?

Mr. ZIENTS. There are 5 months remaining for Congress to act. What is holding us up right now is the Republican refusal to have the top 2 percent pay their fair share.

Mr. FORBES. Okay, Mr. Zients, and let's go to——

Mr. ZIENTS. The balanced deficit reduction to replace sequester——

Mr. FORBES. Mr. Zients, let's go to your partisan statement that you just made about Republicans and Democrats and say this: You mentioned the fact that the President has put forward a realistic alternative to this. You also come in here and state it is Congress' job to fix this. Do you acknowledge that the President has at least some responsibility to come in and stop sequestration from happening?

Mr. ZIENTS. The President has put forward on two occasions——

Mr. FORBES. I am just asking you——

Mr. ZIENTS. In September of 2011 a balanced deficit reduction plan to avoid sequester.

Mr. FORBES. Mr. Zients, do you feel that he has some responsibility to put forward a realistic proposal?

Mr. ZIENTS. He has done so on two occasions.

Mr. FORBES. All right, now, the one occasion that you mentioned in here was his budget. This is a copy of his budget. Do you know how many votes this budget got in the Senate of the United States Congress?

Mr. ZIENTS. That budget was not voted on in the Senate.

Mr. FORBES. It was voted down 99——

Mr. ZIENTS. It was a Republican gimmick called the Mulvaney Amendment which did not have the President's policies included in it.

Mr. FORBES. It was voted down, 99 to nothing. Mr. Zients, do you know how many votes that budget got in the House of Representatives?

Mr. ZIENTS. That budget was not voted on.

Mr. FORBES. It was voted down by every single Member of Congress. Mr. Zients, don't you think a realistic proposal should have a single vote from at least 1 out of 535 Members of Congress in some committee or some forum and can you tell me a single proposal that the President of the United States has put forward to stop sequestration that has gotten a single vote out of the Senate or the House of Representatives?

Mr. ZIENTS. What you are referring to was not the President's budget. It was a gimmick.

Mr. FORBES. Mr. Zients, I am just asking——

Mr. ZIENTS. Again, the root cause of the problem——

Mr. FORBES [continuing]. For you tell me if there is any proposal that you can put forward today, any proposal that the President has put forward to stop sequestration that has gotten a single vote in a Senate committee, on the Senate floor, a House committee, or the House floor.

Mr. ZIENTS. The root cause of the problem here is the Republicans refusal to ask the top 2 percent to pay their fair share.

Mr. FORBES. Mr. Zients, I understand your partisanship. I am just asking you if you can tell me that that proposal—can you point to such a proposal? Then your answer is no.

And then my second question is this: If you can't point to any such proposal that has gotten a single vote, can you honestly sit there and say that the President has a realistic proposal if it can't garner a single vote in the Senate or the House, and with that, Mr. Chairman, I yield back.

The CHAIRMAN. Thank you, Mrs. Davis.

Mrs. DAVIS. Thank you, Mr. Chairman. And I appreciate the opportunity for the hearing today. And I just want to share with my colleague that he was asking about the Administration, but in actuality before the Rules Committee recently the Democrats did put forth a proposal to offset sequestration, and that didn't go very far. And so there are opportunities to do that. And unfortunately, as it was just mentioned, if we don't address the top 2 percent paying their fair share, then we are not going to get where we need to go.

One of the things that you brought forth today is really the impact on our military families. And I know that everybody on this committee has consistently been very, very strong when it comes to our military families. But in addition to the problems that we would see as a result of sequestration, we also have tax cuts that will go away for our military families that would mean significant, significant problems to them, whether it is the child tax credit, a number of other opportunities that they have had over the last number of years, and I wonder if you could comment on that? Because we would have a real impact on our families if we are not able to move forward.

One of the things that struck me the other day when we had the defense industry here is they were suggesting in order so solve this problem, and we know this is true, everything has to be on the table.

Mr. ZIENTS. That is right.

Mrs. DAVIS. We have to be willing to look at a debt deficit reduction package——

Mr. ZIENTS. I think you bring up a good point.

Mrs. DAVIS [continuing]. That is going to make a difference. Please.

Mr. ZIENTS. My understanding is both the House and the Senate Republicans and Democrats agree that middle-class families should not experience a tax increase at the end of this year. My understanding is there is a consensus around that. The Senate has passed a bill which will ensure that middle-class families, families earning under $250,000—and in fact all Americans under their first $250,000 of income would have no tax increase. And I would encourage the House to pass that bill so we can take away that uncertainty for all middle-class Americans that their taxes will indeed not go up on January 1st.

So why not where there is an area of agreement go ahead and provide certainty to those families and those individuals and to our economy that taxes will not go up on middle-class families.

Mrs. DAVIS. Thank you, I appreciate that. And I would challenge my colleagues on that as well because that is the one way that we can begin to give some certainty, I think, to the economy as a whole.

Mr. ZIENTS. Absolutely.

Mrs. DAVIS. Could you comment, further, though, on additional cuts that would occur under sequestration for our military families? How would those be felt? And I guess going to Secretary Carter as well, you have a lot of contact with the industries that support our defense, and what have you heard from them in terms of what they really feel Congress should be focusing on right now?

Secretary CARTER. I think you captured it just a moment ago. My colleagues in the defense industry are beholding this situation unfold with the same kind of alarm that we are expressing in the departments and agencies that have to manage things. It is no way to do business and you know the best of them have very carefully tried to give us good value and manage their facilities and their programs and their technology and their people in an optimal way for us, and this just throws everything they are trying to do in a cocked hat, so I think they are hoping for the same thing that everybody here has been talking about, which is that we can find a way not to do this to ourselves. And so I just associate myself with them in every way. They are trying to manage on our behalf a situation that is really untenable.

Mrs. DAVIS. Thank you. Thank you, Mr. Chairman, I yield back.

The CHAIRMAN. Thank you.

Mr. Miller.

Mr. MILLER. I think my colleagues will find consolation in the fact that we will be given the opportunity to vote on the floor tomorrow to extend all of the Bush era tax cuts, including those for the middle class as well.

Mr. Zients, as the Director of OMB, Acting Director, I guess, of OMB, what is the law today regarding the Bush tax cuts, what is called tax cuts? How do you interpret the law today?

Mr. ZIENTS. They are set to expire.

Mr. MILLER. When?

Mr. ZIENTS. At the end of the year.

Mr. MILLER. And do you make any plans in regards to that in your forecasting of your budgeting that there will be more revenue brought into the Government because they expire?

Mr. ZIENTS. Well, the President's plan assumes that there will be no tax increases on families earning less than $250,000.

Mr. MILLER. No, that is not my question. My question is, as the Bush tax cuts are today, what is the law? The law is they will expire at the end of the year. So at the end of the year what type of forecasting do you do to prepare for that?

Mr. ZIENTS. Well, the President's plan has the tax cuts not expire for families under $250,000. I don't think all of that——

Mr. MILLER. But that is not the law.

Mr. ZIENTS. Let me finish.

Mr. MILLER. No, sir. What is the law? They expire, correct? What do you have to do? If it is the law, you have to prepare for those tax cuts expiring, correct?

Mr. ZIENTS. I don't really understand the intent. What type of preparations are you talking about? I think we all agree that it is——

Mr. MILLER. Do you forecast having additional revenue coming into the Government?

Mr. ZIENTS. I am sorry?

Mr. MILLER. Do you forecast additional revenue coming into the Government?

Mr. ZIENTS. The policy is protect those families——

Mr. MILLER. From any of the tax cuts. No, sir.

Mr. ZIENTS. Yes, we do. We have money coming into the Government under the assumption that the top 2 percent will not have——

Mr. MILLER. And how much money will that be?

Mr. ZIENTS. Over a decade it is about a trillion dollars, $850 billion in the expiration of the tax cuts and the estate tax.

Mr. MILLER. So he plans on part of the law not expiring, but sequestration you are not planning on any of it because somebody has made the statement, and Mr. Carter, I would like for you to tell me who made the statement that sequestration was never intended to happen, but——

Mr. ZIENTS. I don't think anyone would debate whether sequestration was intended to happen.

Mr. MILLER. But it is the law.

Mr. ZIENTS. Sequestration was the forcing function to balance the deficit reduction.

Mr. MILLER. But it is the law.

Mr. ZIENTS. The root cause problem here——

Mr. MILLER. Is the law.

Mr. ZIENTS [continuing]. Is the refusal of Republicans to acknowledge the top 2 percent have to pay their fair share. And we do have that trillion dollars.

Mr. MILLER. Mr. Zients, was the President's budget ever voted on in the Senate?

Mr. ZIENTS. The President's budget itself was not voted on in the Senate.

Mr. MILLER. The President's budget, was it ever voted on in the Senate?

Mr. ZIENTS. No.

Mr. MILLER. Does it concern you that in a Democratic-controlled Senate by Harry Reid, that Harry Reid would not even bring up the President's budget for a vote?

Mr. ZIENTS. What concerns me is that we have 5 months to do balanced deficit reduction——

Mr. MILLER. No, that is not—my question is regarding the President's——

Mr. ZIENTS. And that the refusal to acknowledge that the top 2 percent have to pay their fair share——

Mr. MILLER. Sir. Sir, it is my time. Sir, it is my time. Does it concern you and the President that the Democrat-controlled Senate would not, in your words, vote on the proposal that the President of the United States gave to this Congress?

Mr. ZIENTS. What concerns me is we have 5 months to enact balanced deficit reduction to avoid sequester.

Mr. MILLER. Sir, I have a minute-and-a-half left and I am going to ask you again, and I will ask you until the time runs out. Does it concern the President that Harry Reid and the Democrat Senate would not bring up the President's proposed budget?

Mr. ZIENTS. What concerns me is that the vast majority of Democrats and Republicans in this committee voted in favor of BCA, which has as a forcing function sequestration and there has been no progress by Republicans to acknowledge that we need a balanced package that includes further spending cuts and requires the top 2 percent to pay their fair share.

Mr. MILLER. I would expect you to be political in your comments today, but you have not answered my question. Does it concern you or the President that the President's budget was not voted on in the Democrat-controlled United States Senate?

Mr. ZIENTS. My energy and my concern is how we use the next 5 months to balance deficit reduction and try to avoid the sequester.

Mr. MILLER. Can you explain to me then, sir, why you waited until yesterday to put out any type of discussion in regards to what was going to be exempt from what agency? I mean, now you are saying—we have actually had 6 months prior to that.

Mr. ZIENTS. Well, let's assume that all of us agree that the energy should be put against avoiding the sequester. No one thinks it is good policy. As I said on multiple occasions, OMB and agencies will be ready in the very unfortunate situation if January 2nd comes and the sequester order needs to be issued.

The CHAIRMAN. Thank you. Mr. Courtney.

Mr. COURTNEY. Thank you, Mr. Chairman, and I thank you for conducting this hearing. I would just like to again walk through a few points with the witnesses. It was almost exactly a year ago that the Budget Control Act was passed. In fact, the Administration had initially asked for just a clean bill in terms of avoiding default on the full faith and credit of this country. They were not the ones who were insisting on a sequestration-backed mechanism for deficit reductions, isn't that correct?

Mr. ZIENTS. That is right. I mean, the history here is that Republicans refused to do balanced deficit reduction last summer, and the threat of default led to the Budget Control Act.

Mr. COURTNEY. Thank you, and Mr. Carter, in your testimony, you mentioned the fact that the design of the Budget Control Act actually incorporated the Gramm-Rudman Sequestration 1985 Act, which is sort of the basic structure of how sequestration would take place.

Again, you have been through a few rodeos in terms of past budgets. I mean, the fact is that Gramm-Rudman was on the books for a number of years. I mean, it was a bumpy ride before finally Congress reached a point where we balanced the budget actually in the early 1990s. You know, I would just note that when it passed, Congressman Gramm was on the record saying it was never the objective of Gramm-Rudman to trigger sequester. The objective of Gramm-Rudman was to have the threat of the sequester force compromise and action. And that is precisely the thinking with the Budget Control Act, that again was enacted just about almost exactly a year ago, isn't that correct?

Secretary CARTER. That is my understanding as well, yes, both of the past and the recent past.

Mr. COURTNEY. And at the time the Speaker was actually boasting in public that he got 98 percent of what he wanted in terms of negotiations with the White House. Again, this was certainly something that had more than bipartisan participation. In fact, the

Speaker claimed he got 98 percent with the deal that was finally voted on and sent to the President a year ago.

I would like to just also go to one point which my good friend Mr. Forbes was trying to claim that there was not a single proposal that the White House has offered that has been voted on and approved by either the Senate or the House in terms of deficit reduction. And I would actually point out that in the 2011 Republican budget plan, where they claimed $5.7 trillion in savings, $1 trillion of those savings was war savings in the OCO account. And I realize, you know, today the chairman, who is also someone I have a great deal of respect for, now claims that that is a gimmick. But the fact of the matter is we are going to spend $98 billion in Afghanistan this year, isn't that correct?

Mr. ZIENTS. That is right. And CBO scores those savings, the OCO savings, and importantly, by capping OCO, we are closing the backdoor on discretionary spending.

Mr. COURTNEY. Right.

Mr. ZIENTS. So those are real savings as determined by CBO, and importantly, closes the backdoor so that we cannot in any way increase the cap.

Mr. COURTNEY. And I want to be clear. I am not doing this as a gotcha point. I mean, the fact of the matter is there actually is some overlap between budget documents that have been voted on by the vast majority of the Republicans in the House and what the President actually put forward. And I think we should go back to Mr. Gramm's admonition when the Gramm-Rudman sequestration was first passed that really it is really a mechanism to force compromise and action. And there really are some working parts that we can begin to get to that point and avoid the cataclysmic results.

Mr. ZIENTS. And we are where we are, but 5 months remain, and there is plenty of time to do balanced deficit reduction and avoid the sequester.

Mr. COURTNEY. I would just note that, back in eastern Connecticut where I come from, people get it, we have fought two wars on a credit card, and that post-2014 it is not going to be down to zero, but we are going to be bringing down that process of pouring money into Afghanistan. And those are real savings. That is real money that this Government is not going to be expending. And to me, you know, for the Administration to offer that as a way of reducing the budget and hitting the Budget Control Act targets, which again the Republican budget in 2011 used precisely the same measure, is at least one piece of how we can solve this problem. And again, I don't know if you want to comment on that.

Mr. ZIENTS. It is driven by the policies of ending the war in Iraq and drawing down in Afghanistan.

Mr. COURTNEY. Thank you. I yield back, Mr. Chairman.

The CHAIRMAN. You know, I would think that the gentleman would know, serving on this committee, that whether a Republican or a Democrat proposes using OCO funding that we are carrying out into the future for 10 years a trillion dollars knows that it is not going to be spent because we know that we have pulled the troops out of Iraq and we will pull all of the troops out of Afghanistan by 2014. And so we don't need to carry that into the future.

And I have said it is a gimmick whether a Republican or a Democrat proposed it.

Mr. COURTNEY. Well, I respect that. I would just note, though, that certainly your caucus is on record supporting that type of approach. And I would yield back.

The CHAIRMAN. Mr. Turner.

Mr. TURNER. Thank you, Mr. Chairman.

Mr. Zients, it has been a pleasure having you here in front of the Armed Services Committee. We are not usually of the habit of hearing such partisan statements in what is really a bipartisan committee. We don't usually hear people throw around Republican and Democrat, but you have very, very well. I want to commend you on your broken record of your partisanship with respect to the fiction of the fact that this Administration has a budget or a plan.

We have already established, although you have tried to denie it over and over again, that there has been not one single vote in the Senate, not one single vote of support in the House or one Member of the House or one Member of the Senate who supports the President's so-called budget.

The lack of that support means you have no plan. We are in August, August. There is not one thing on the table that we could pick up that has the support of the House or the Senate that would solve this problem that comes from the President. I can't imagine what it would be like to have the title of Director of Office of Management and Budget and to have had no support in Congress for a budget. I would probably, if I was you, would want to stand in front of Congress and blame Congress instead of blaming the fact that you have no plan. You keep saying Congress should act. Congress should act. You are absolutely right, but you know, Congress by the Constitution, we can't do it alone. We have to have the President. Just as the President signed the act that causes sequestration, again, a bill I pointed out that I voted against, the President has full responsibility for sequestration, having voted for it, having endorsed it coming out of the House and the Senate, and then signed it himself, and also his responsibility for having essentially pulled out of the "super committee" [Joint Select Committee on Deficit Reduction], having provided no plan for the supercommittee to have an action that would have then, in effect, avoided sequestration.

What we are dealing with now, though, is two things. One, your statements on the WARN Act, and I want to ask you a couple of questions about that. We have people who are faced with the effects that sequestration might be coming. We have contractors that are concerned that they are going to have civil penalties and additional actions against them as a result of failure to notify employees that they might be laid off as a result of the threat of sequestration. You said the Department of Labor has issued a guidance so that no one need provide those notices.

So let me ask you first. You have said you weren't a lawyer, but you might not be a lawyer, but you might, I know, have an understanding of the authority of the position you sit in, so let's start with your position. Do you have any legal authority or ability to waive the penalties in the WARN Act for noncompliance under the threat of sequestration?

Mr. ZIENTS. No, I do not believe so.

Mr. TURNER. Okay, let me go then to the Department of Labor's own guidances. Here we have the U.S. Department of Labor's fact sheet with respect to the WARN Act, and they expressly state, an employer who violates the WARN Act provisions by ordering a plant closing or mass layoff without providing appropriate notice is liable for, boom, boom, boom. And it lists all of these things that they are liable for. And then it says, the Department of Labor—this is their document—since it has no administrative or enforcement responsibility under WARN, cannot provide specific advice or guidance with respect to individual situations. This is their document. I am assuming you don't disagree with it?

Mr. ZIENTS. I think the Department of Labor is the expert here.

Mr. TURNER. Did you disagree with their document?

Mr. ZIENTS. They are the experts.

Mr. TURNER. Right. Their document goes on to say: Enforcement of WARN requirements is through the United States District Court. Then you go to the actual regs that are with respect to the WARN Act, and it says: The Department of Labor—these are the actual Federal regulations—the Department of Labor has no legal standing in any enforcement action and therefore will not be in a position to issue advisory opinions of specific cases.

So, although you won't acknowledge it, their documents acknowledge it, the statement by the Department of Labor that people need not provide WARN Act, warning notices under the threat of sequestration has no effect. It is not worth the paper it is printed on. It may be the desire of the Administration that no one do that, but it certainly isn't reality. It is a fiction. And now then to reality. The reason why people——

Mr. ZIENTS. May I respond?

Mr. TURNER. The reason why people have to do that is in addition to no plan from this Administration, we also have no detailed understanding from the Administration what the effects of sequestration would be. You can't provide us one document that shows what is going to happen if sequestration hits, correct? Do you have one for us today?

Mr. ZIENTS. In our testimony, both Dr. Carter and I illustrated——

Mr. TURNER. Specifically. Do you have documents that specifically show who gets cut, who loses jobs, what programs stopped?

Mr. ZIENTS. One can't do that at this point.

Mr. TURNER. The answer is no, right.

Mr. ZIENTS. The answer is——

Mr. TURNER. You just haven't done it. You are before us with no ability to provide us any of that.

Mr. ZIENTS. The answer is——

Mr. SMITH. I am sorry, if you want to give a speech, give a speech. The witness has to get more than 2 sentences out of his mouth if you are asking him a question. It has to be said, if you just want to badger the witnesses, you know, you can do that and not put it in the form of the question.

Mr. TURNER. I have the answer. The answer is no.

The CHAIRMAN. The gentleman's time has expired. Mr. Johnson.

Mr. JOHNSON. Thank you, Mr. Chairman. Just a few questions, or just a couple of statements, I am sorry, that I would like to make. I want to thank you all for joining us, and I am sorry that we have dragged you from your actual governing responsibilities to attend this spectacle, this attempt by House Republicans to wash their hands of their own mess and lay the blame on the President. It is an election year, after all. The responsibility to govern is something I know both of you take seriously, which is more than I can say about this Tea Party Republican House of Representatives, which brings me to an important point.

Why exactly are we here? I will answer that question. We are here because last summer the House Republicans, bowing down to their Tea Party base, refused to honor the financial commitments of the United States Government and threatened to undermine the full faith and credit of their own country. Scrambling to deal with that manufactured crisis, Congress broke through the gridlock and enacted legislation that would impose sequestration unless we agreed on a balanced approach to meeting our budget targets. And now instead of working on that balanced approach, the approach every serious economist says is necessary, what do the House Republicans do? They passed the Ryan budget. They cut unemployment. Excuse me, they cut employment and training programs. They cut food stamps, low-income home energy assistance. They cut healthcare for children, the sick, and the poor. They cut foreclosure prevention. They cut taxes for the rich. And they loaded up the defense authorization with pork, an East Coast missile shield, nuclear facilities no one wants, and billions of dollars of waste far in excess of the caps under the Budget Control Act.

They want to have their pie sisters' cherry pie and eat it too. This hearing is not about the Obama administration and sequestration. It is about the Republican Party's abdication of its responsibility to govern and the terrible results.

Now, the Tea Party Republicans during the debt ceiling negotiations insisted on sequestration as a part of the deal to keep America from defaulting on its debt for the very first time in our history.

Mr. Zients, what would have happened if we had not broken that gridlock and which branch of Government was responsible for this sequestration policy? And last but not least, Mr. Zients, I would like to ask you whether or not the Administration is willing to meet our budget targets by adopting a balanced approach that involves a measure of spending reductions and a measure of revenue increases.

Mr. ZIENTS. In terms of the debt ceiling negotiation, I think it had a bad impact on the economy during that period of time. I cannot imagine and don't even want to think about the impact that it would have had on the economy if we had not—if we had actually defaulted.

Mr. JOHNSON. And in fact, just the threat of it——

Mr. ZIENTS. It is unimaginable. The threat of it alone had a bad impact on the economy at a period of time when we could hardly afford further bad news.

You know, I think balanced deficit reduction is the key here. Further spending cuts, and revenue with the top 2 percent paying its fair share. You are right, independent economists, Bowles-Simpson, Rivlin, all of them have at the center of their plan balance, spending cuts, and revenue. It is the lack of balance, it is the insistence that we can do spending cuts only that is the root cause problem here that has us in a situation where we are 5 months out and we have not yet replaced the sequester. Balanced plan is the key to moving forward and making sure that we do not have to implement what we all would agree is a bad policy of sequester.

Mr. JOHNSON. So what you are suggesting is that it is this very Congress who has compelled your attendance today that is the very problem that they have called you here from——

Mr. ZIENTS. Congress needs to pass a balanced deficit reduction that the President can sign into law and avoid the sequester.

Mr. JOHNSON. I thank you, Mr. Zients, and I yield back.

The CHAIRMAN. Thank you.

Mr. Shuster.

Mr. SHUSTER. Thank you, Mr. Chairman, and thank the witnesses for being here today. I would like to remind everybody that the House Republicans have acted. We passed a budget. The Senate has not acted. If you would go back to the White House and I would ask you to encourage the President to do like he did on the cyber bill and show some leadership. He wrote an op ed, and all of a sudden the Senate starts to take up a cyber bill. He needs to maybe write another op ed and insist that the Senate draw up a budget, whatever their budget is, pass something. Let's get into conference. Let's talk about it. But to sit here and say we have done nothing is just not accurate. We have passed a budget. In fact, we have passed one for the past 2 years. So that is something that needs to be corrected in the record here today.

My question, though, goes to Dr. Carter, concerning multiyear procurement authority, the multiyear contracts. What percentage of what we procure today are in those types of multiyear contracts?

Secretary CARTER. I can't give you an exact percentage. I can actually find it out for you, but it is fairly small. But they are very important, because multiyear contracts can be much more efficient. Because you lengthen the horizon of the manufacturing——

Mr. SHUSTER. Savings?

Secretary CARTER [continuing]. Base. So it is much more efficient, and sequester, if it occurs, would affect the payment on those contracts in the future. So it is a partial exception to the thing I was describing earlier about obligated funds not being——

Mr. SHUSTER. And it will expose us to Federal Government to termination liability considerations, is that correct?

Secretary CARTER. In general for changes, adjustments of the kind that would be called for in sequestration, when you negotiate a multiyear contract, you negotiate variable numbers because we actually never know what our appropriation is going to be year by year.

Mr. SHUSTER. But my question is, there is liability there for us if we break this contract?

Secretary CARTER. There is. It is less efficient if the quantities go down.

Mr. SHUSTER. So has the Department of Defense or OMB taken into consideration what kind of dollars we are talking about, because if we cut those contracts and we cut them down, there is still going to be a cost somewhere there. So has there been an analysis done on any of those multiyear contracts?

Mr. ZIENTS. Contract by contract, and you are right there will be tremendous inefficiencies both in terms of quantities having to be decreased which loses economies of scale, delaying things.

Mr. SHUSTER. I understand, but have you done any analysis on that?

Mr. ZIENTS. No specific analysis on that at this point.

Mr. SHUSTER. Is that something you can shield so that, for instance, I guess the F–35 [Lightning II fifth-generation stealth fighter jet] would be one of those multiyear contracts. Can we shield those? Is that something that——

Secretary CARTER. The F–35 is not yet at this point in its lifetime subject to multiyear contracts. But we can, and all of our program managers know how to make those adjustments. They are just, as Mr. Zients said, grossly inefficient.

Mr. SHUSTER. But under the BCA will you be able to exempt those? Have you done an analysis into that?

Mr. ZIENTS. As we have talked about, it is across the board at the PPA level. You have got to go PPA by PPA. Some PPAs might have one contract in them in which case that has to be cut. Others might have multiple contracts in which——

Mr. SHUSTER. So there is some ability to do that.

Mr. ZIENTS. Sorry?

Mr. SHUSTER. There is some ability to shield some of those multiyear contracts?

Mr. ZIENTS. Yeah. It really has to go PPA by PPA. It is going to be different at the Defense Department than it is going to be at Education, than it is going to be at Agriculture. It is a very——

Mr. SHUSTER. So that begs the question. Are you considering that?

Secretary CARTER. Yeah, but we would certainly take advantage—we are going to take advantage of any flexibility that we can find.

Mr. SHUSTER. That is something you should be doing, right? Because you will be standing——

Secretary CARTER. Absolutely. But unfortunately, there is just so little flexibility in sequester. It is not much help, but we will take advantage of every bit of flexibility we can, if this happens to us, to continue to try to deliver best value we can for the taxpayers' defense dollars. And I am sure all of the other managers around the Government will try to do the same.

Mr. SHUSTER. I appreciate that, but again it brings me back to what I started. The House Republicans have acted and again, I would urge you to go talk to the President to have him show some leadership on this to get the Democratic-controlled Senate—as I last knew, the Democrats control the Senate so to sit here and say that we haven't acted is just not true.

Mr. ZIENTS. In 20 odd years in the private sector inevitably you do a lot of negotiations. In order to come to the table, you have to have two reasonable parties in order to get something done.

Mr. SHUSTER. Propose something. Propose something. Get it passed in the Senate.

Mr. ZIENTS. Spending-only approach, 2 percent aren't paying their fair share. It is not a starting base for a balanced budget.

Mr. SHUSTER. Again, what 2 percent is that, to make sure that I am clear on that. Is that people, single folks that earn over $200,000 and a couple over $250,000? Is that the correct number?

Mr. ZIENTS. It is the package that is coming before you which ensures there is no tax cuts for 98 percent of Americans families who are——

Mr. SHUSTER. So that means as a former small business owner and you have been in the private sector, if I am a Subchapter S Corporation, sometimes my tax return would show over $250, $300,000, but I don't take that money home.

Mr. ZIENTS. The President's plan protects 97 percent of small businesses.

Mr. SHUSTER. I take that money and invest it back in my business.

The CHAIRMAN. The gentleman's time has expired.

Mr. SHUSTER. It is going to hurt the job creators.

The CHAIRMAN. The gentleman's time has expired. Mr. Barber.

Mr. BARBER. Thank you, Mr. Chairman. And thanks to our witnesses for testifying here today. As the newest Member of Congress, I was not here to vote on sequestration. Thank goodness. Had I been here, I would not have voted for this irresponsible plan. This is an irrational way to deal with the budget deficit and our national debt. Sequestration represents a failure of leadership in Congress and is absolutely the wrong approach to getting our fiscal house in order. It would have a devastating impact on the two military installations, the service members, the civilian personnel, and defense contractors that are the major economic drivers in my district. And it would bring serious harm to funding for border security, a priority for me and for my district, to education, to public safety, disability services, and essential services for the most vulnerable members of my district.

If a family took an approach like sequestration to manage its budget, it would cut mortgage payments, utility bills, food, clothing purchases, child care, and all of the rest by the same amount across the board. Obviously, no family would or could do this. And while I was not here to vote against sequestration last fall, I am here to help stop it. I came here with the full intention of working across the aisle to solve problems, and I have been told countless times that this is a pretty naive proposition. But I remain hopeful that common sense and bipartisanship will yet prevail.

My question is for you, Dr. Carter. I am very concerned about all of these potential cuts across the board to both military and to domestic spending. But I would like to focus, with your help, on the Department of Defense, since that is such a critical area in my district and, of course, in many others.

Could you please help us by identifying three critical national security priorities that absolutely must be protected whether we have deep cuts under sequestration or some other formulation?

You know, Congressman Jones spoke to one that is of grave concern to me, how we treat our military members for Post Traumatic Stress Disorder and for TBI. And there are others, I am sure. But could we have your view on what are the three most critical national security priorities that must be protected?

Secretary CARTER. Well, the first one that obviously comes to mind is our wartime spending and support to the forces that are engaged in the fight in Afghanistan. As I indicated in the opening, that is largely but not exclusively OCO funding. And the bad news is that OCO is subject to sequestration.

The only slight silver lining on that cloud is that the operations and maintenance part of OCO and the base part of OCO become one account in the year of execution, which, said differently, without all the gobbledygook, is that we can take money from ordinary O&M, training, readiness here at home in order to keep the troops in the field funded in a way that we really owe them. But that makes the hit on the readiness here back at home even harder. So you are shifting the pain away from the theater, which is the responsible thing to do, but you make it even heavier.

Second thing I would say is, that is not entirely possible for the other parts of OCO that are not operations and maintenance. And we are going to have to find other ways there to provide the materiel and so forth that the troops need in the field.

Otherwise, I could go on and on, but let me just take a few. I think military medical care was cited already. Obviously, that is an area where we will work very hard, within the limits of this very rigid law, to do everything we can to make sure that there is no impact on the care we give wounded warriors, families, and so forth.

And, of course, the exemption of military personnel is one way of signifying our faith in the importance of ordinary soldiers, sailors, airmen, and marines.

So those are four or five responses to your question. There are many.

Mr. BARBER. Thank you, Dr. Carter.

The CHAIRMAN. Thank you.

Mr. Conaway.

Mr. CONAWAY. Thank you, Mr. Chairman.

Gentlemen, thank you for being here.

Mr. Carter, Secretary Carter, if sequestration happens—and none of us want it to, and we are going to work real hard, and yada, yada, to not allow that to happen, but it is the law of the land. And it looks to me like there are an awful lot of contracts that will either be terminated or rescoped at a point in time as a part of the sequestration. Have you got any sense yet as to what the associated costs will be with terminating and rescoping these contracts?

Secretary CARTER. The contract termination per se is not required, in the sense that if you have already obligated money—that is, it is on contract—that obligated fund is not subject to sequestration. So this would be—the extant contracts would not be affected.

Mr. CONAWAY. So you are not anticipating terminating any contracts that haven't yet been funded?

Secretary CARTER. They do not have to be terminated on account of sequestration.

Mr. CONAWAY. Yeah.

Director Zients, Government-wide, this problem is going to be thousands and thousands of contracts and obligations. Would you anticipate that you have the authority to do some sort of a class waiver, class deviation? Or would you have to go at it contract by contract, task order by task order?

Mr. ZIENTS. As you point out, there are hundreds of thousands of contracts Government-wide. About two-thirds of the $535 billion of contracting we do is at DOD. On the other third, I think you have to go contract by contract, understand where we are not going to exercise options, where are we going to make modifications, where do you need to consider terminations. It is a very inefficient, as we talked about, very labor-intensive exercise.

Mr. CONAWAY. Right. Well, as a predicate to all that, have you given guidance to all of the executive branch agencies and everyone that—I mean, this falls under your umbrella of responsibility. Have you started to give them that guidance? Is there going to be a training and everything else go on? Are you giving any guidance whatsoever on this?

Mr. ZIENTS. The guidance we gave yesterday, as you know, was focused on exempt and nonexempt accounts and, importantly, instructed agencies to continue business as usual, their normal operations. If we get to a point where January 2nd and the sequestration order is kicking in, we will have prepared agencies on contracting and other issues.

Mr. CONAWAY. So they will have enough workforce in place, trained and ready to go, to do it——

Mr. ZIENTS. As you know, the acquisition workforce is stretched——

Mr. CONAWAY [continuing]. With the same efficiencies that the——

Mr. ZIENTS. As you know, the acquisition workforce is stretched to ensure that we are moving from——

Mr. CONAWAY. All right.

Mr. ZIENTS [continuing]. No-bid contracts to competition, from cost-plus contracts to——

Mr. CONAWAY. Right.

Mr. ZIENTS [continuing]. Fixed-price contracts. So this is——

Mr. CONAWAY. Well, reclaiming my time, the effect on the Department of Defense is about, we think, $55 billion the first year. That is net. Either one of you have an estimate as to—once you start doing these adjustments, terminations, whatever it is, it triggers penalty payments and other kinds of things, as well as the costs of defending and all this kind of stuff. Do we know what the gross is going to be in order to net back down to 55?

Mr. ZIENTS. Well, the $55 billion is the money that would be, unfortunately, taken away. You are right that spending underneath that $55 billion would be inefficient.

Mr. CONAWAY. Okay. But doesn't that add to the problem? And then you have to——

Mr. ZIENTS. It means the money that you have left will be less efficiently spent, yes.

Mr. CONAWAY. So can you give us a guess yet as to what the gross expenditure is going to be at to be cut in order to make up for that inefficiency?

Mr. ZIENTS. Again, you are cutting $55 billion. The remaining money will not be as well-spent because of the inefficiencies we have described.

Mr. CONAWAY. All right.

Let me ask you this question. Dr. Carter, you said earlier that if, during the first quarter, all these agencies get their money obligated and pushed out, then it is not subject to sequestration at that point in time.

Mechanically, how does that work? Are we going to have some sort of a mass rush across Government to get everything spent and done during that first quarter and pushed out to the recipients so that—how do you cut, at that point in time, if everything has been spent?

Secretary CARTER. Well, it is what it is. If they have obligated funds——

Mr. CONAWAY. So how do they comply with the law, though, Dr. Carter if——

Secretary CARTER. They have to meet their sequestration target with the amount of funds that are not obligated at that date. So this is a subject that we will go through with all of our program managers one by one.

Mr. CONAWAY. So this is just the Department of Defense. The rest of Government——

Secretary CARTER. No, the same principle would apply to any agency that is doing contracting.

Mr. CONAWAY. All right.

Secretary CARTER. Just the way the law works.

Mr. CONAWAY. All right.

We collectively and, in particular, the Administration seems to be taking the attitude with respect to sequestration of the fellow who fell off the 10-story building. As he is passing the fifth floor, he is saying, "So far, so good. So far, so good." We have five floors left, we have 5 months left. And I am not sensing a lot of leadership.

And I understand the macho, that you have to pound away, Mr. Zients, about the balanced—and all those kinds of things. But there are those of us who have similar opinions, held just as strongly, that we have a spending problem, not a revenue problem. In 2005, 2006, and 2007, the rates currently in place, these horrible rates that this President extended, raised money the old-fashioned way, it increased Federal revenues the old-fashioned way: more people working and growing the economy. And that would be a balanced approach.

And I yield back.

The CHAIRMAN. Mr. Critz.

Mr. CRITZ. Thank you, Mr. Chairman.

Thank you, Mr. Zients, Dr. Carter, for being here.

Mr. Zients, my questions are more about clarification. You had mentioned the tax, or not extending the tax cuts for the top 2 percent. Now, are you talking about on income that is earned over $200,000 or anyone who earns over $200,000?

Mr. ZIENTS. Yes, the first $250,000 for a family or $200,000 for the individual——

Mr. CRITZ. Would still receive the tax cut.

Mr. ZIENTS. Yeah. So it is income above that.

Mr. CRITZ. Okay. So——

Mr. ZIENTS. And it is that group that we need to have pay their fair share so we have a balanced approach here.

Mr. CRITZ. Now, what is the estimate of how much money that would raise over the next—I think the estimate is over 9 years, right, not over 10? Or is it over 10?

Mr. ZIENTS. I think it is 10. It is about $850 billion.

Mr. CRITZ. Eight hundred and fifty billion. And sequestration is $1.2 trillion, but I guess with interest savings it is really like $984 billion or something like that?

Mr. ZIENTS. That is correct. That is correct.

Mr. CRITZ. So that leaves a gap of, by my estimate, $134 billion that would then still have to come through cuts if we used all of the income or revenue from the elimination of those tax cuts to go definitely toward—or strictly toward sequestration.

Mr. ZIENTS. The President's plan actually has about $1.2 trillion of revenue, so revenue that goes beyond just the expiration of the 2001–2003. But you are right, there also are further spending cuts. So the balance here is not simply the 2 percent paying their fair share; it also is further spending cuts in health care and other non-mandatory programs—I am sorry, other mandatory non-healthcare programs.

Mr. CRITZ. So if we have $134 billion over 9 years to cut, then that works out to be, what, $10 billion, $15 billion per year, $7.5 billion defense, $7.5 billion domestic programs. Is that close estimates?

Mr. ZIENTS. Well, there is also—your $10 billion to $15 billion sounds correct. But discretionary, let's remember that as part of BCA we have already saved a trillion dollars.

Mr. CRITZ. Yeah.

Mr. ZIENTS. So there are mandatory programs, as I just mentioned, both on the healthcare side and non-healthcare side, that the President's budget and his submission to the Joint Committee last September articulate savings in those areas.

Mr. CRITZ. And just to clarify, as well, the bill that I believe we are going to vote on tomorrow that has come over from the Senate, will that have that $850 billion in revenue?

Mr. ZIENTS. The Senate bill ensures that no family with less than $250,000 has any tax increase. And as you point out, for families with more than $250,000, that first $250,000 is also protected. It extends that middle-class tax cut for 1 year, while not extending the tax cuts for the wealthiest 2 percent, consistent with the wealthiest 2 percent need to pay their fair share.

Mr. CRITZ. And that will raise the $850 billion?

Mr. ZIENTS. In essence, yes.

Mr. CRITZ. In essence. Okay.

And just to clarify, too, because you both have said it, that sequestration takes effect January 2nd——

Mr. ZIENTS. Yes.

Mr. CRITZ [continuing]. And becomes law—or is law, but it becomes effective January 2nd, but it is really until the end of the fiscal year that each agency has to show the savings. Because, like, at Education, their money is already spent for that school year, so they have to take it out of the next. And the same with Defense.

If they have already obligated money through the end of this year, then whatever is left in their pot is where they have to——

Mr. ZIENTS. On January 2nd, we will be a quarter of the way through the fiscal year, so the 8 and 10 percent cuts that we cited on the domestic and defense side actually are higher percentages, because they have to be applied to that 9-month period of time.

Mr. CRITZ. Right. Right.

Okay. I just wanted some clarification. I appreciate your indulgence. Thanks for being here.

I yield back.

The CHAIRMAN. Thank you.

Mr. Wilson.

Mr. WILSON. Thank you both for being here today.

And I want to thank Chairman McKeon for his leadership. I think it has been very revealing, Mr. Chairman, the information that the American people are receiving today. Very important for the American people. It has direct impact on the citizens I represent.

I am very grateful I represent Fort Jackson, the initial Army training facility. I represent Parris Island. We are very proud of the Marines that are trained there. Marine Corps Air Station, Beaufort Naval Hospital. I represent North Airfield. And in the new district I represent of Aiken County, I now will be in the neighborhood of Fort Gordon and the Eisenhower Medical Center. So I've got wonderful people, military families.

And as chairman of the Military Personnel Subcommittee, I am very, very concerned about what I have heard today.

And, in particular, Dr. Carter, yesterday, in advance of this hearing, the President announced that he would exempt military personnel accounts from sequestration. Can you please describe in more detail whether these accounts will be exempted in whole or in part, or to what extent?

Secretary CARTER. The law gave the President until early August to make that determination. He did decide to exempt military personnel in toto. So it is, that part of our budget will be exempt from sequestration. That means that the rest of the budget, of course, has to bear a larger share of the cuts, but we certainly think that is a fair and a practical thing to do.

It is fair because it is the right thing to do by our troops in a time of war. It is a practical thing to do because, the way the military personnel regulations and laws work, it would be very difficult to take that much money out of the military personnel account if it weren't exempted. For example, we cannot furlough military personnel. We can furlough civilian personnel and, sadly, might have to do that if sequester happens. We can't do that with military personnel. The only way we could accommodate a cut of that size would be to do things like stop accessions, which is very unhealthy for the force; stop bringing in new people; stop permanent change-of-station moves, which means everybody freezes in place and we can't move anybody around.

So as you thought about applying sequester to the military personnel account, it is particularly unpleasant. As I have said, sequester is very unpleasant in general to everything we do. It would be particularly unpleasant to that. So it is in a bad situation; this is making the best of a bad situation, to exempt military personnel.

Mr. WILSON. And, actually, you said it was stupid. And that is just unfortunate for our country.

And as you mention about furloughs and accession, related to that is something else, and that is, does the exemption of military personnel accounts from sequester mean that even more military personnel will have to be separated to offset the loss of savings from pay and benefits?

Secretary CARTER. No, because the entire military personnel account is protected in this way. What will suffer disproportionately as a consequence is readiness of the force that exists, modernization, research and development, test and evaluation. All of the other major accounts will suffer as a consequence.

Mr. WILSON. Additionally, in your testimony you indicated this will affect our service members who are serving overseas, actually in the line of fire. In June, the Commandant of the Marine Corps expressed concerns about, quote, "a hollow force," the same statement of Secretary Panetta, if the President exempts military personnel accounts.

Do you agree with the Commandant? If the O&M accounts are sequestered, how will the Department ensure that service members are properly trained and equipped?

Secretary CARTER. Well, this is the kind of tradeoff one doesn't want to have to make but is made under sequester.

Past 2013, when these very mechanical cuts are imposed, I think that the entire leadership of the Department has made clear and the President made clear in the budget that we submitted for fiscal 2013, which of course didn't presume sequestration but did contain his intent on this matter, we do understand that military personnel are going to have to be part of meeting our budget target in the future.

Remember, we already have in our 2013 budget $489 billion of cuts. We have already taken that in Defense. We did include military personnel in that, because to do otherwise would, as you suggest, be unbalanced and would mean that we would have a hollow force of the same size.

Mr. WILSON. Thank you very much.

The CHAIRMAN. Thank you.

Mr. Wittman.

Mr. WITTMAN. Thank you, Mr. Chairman.

Secretary Carter, Honorable Administrator Zients, thank you so much for joining us today. We appreciate you taking the time.

Secretary Carter, let me ask you, you had previously testified before us that sequestration would affect CVN–78 [*Gerald R. Ford* class supercarriers], our LCS [Littoral Combat Ship] programs, our DDG–51 [*Arleigh Burke* class guided missile destroyer] programs. Can you elaborate a little bit more on that in looking at how it will affect the different shipbuilding accounts? Specifically, how is it going to affect the *Ohio* class replacement submarine? We know one of the models for procurement and construction has been the *Virginia* class submarine, and it is critical to our force projection there in the Asia Pacific. We know how important that is.

And can you also comment, too, on how sequestration would affect our shipbuilding industrial base and, specifically, the suppliers and vendors that support that industrial base?

Secretary CARTER. Excellent question. And I share all the concerns that are implied there.

Sequester does apply to each and every program line item. And some programs have both an R&D [research and development] line and also a procurement line, and sequester applies separately to the R&D line and the—so this is a detailed pain for each and every management of each and every one of our programs, which leads to inefficiency.

And to get to your shipyards, you know, our shipyards plan out their work years in advance so that they operate in the most efficient way. And this will cause us to make very inefficient adjustments in each and every one of them. So it is a sad waste of the taxpayers' procurement dollar to run things this way.

Mr. WITTMAN. Sure.

How would it affect the *Ohio* class replacement? Would it delay that? How would it affect that program, in your estimation?

Secretary CARTER. I will get back to you with a more detailed answer.

Mr. WITTMAN. Okay.

Secretary CARTER. But at this point in the *Ohio* class replacement program, that is going to be largely R&D money.

Mr. WITTMAN. Sure.

Secretary CARTER. So it will affect the rate at which we accumulate the design content of the *Ohio* class replacement. And, obviously, we will work as hard as we can to make sure we don't slow the overall project down as a consequence, but there will definitely be a risk of that.

Mr. WITTMAN. Let me ask you, in your understanding of the shipbuilding supplier industrial base, do you think that with this uncertainty that is building with sequestration, do you think there is a possibility that any of those small businesses would go out of business in the interim?

Secretary CARTER. Yeah, I do. The bottom of the supply chain is particularly vulnerable in times of economic inefficiency, which this would engender.

We work very hard to protect particularly the small businesses that supply Defense. And the reason for that is that small businesses are particularly vibrant, they are good sources of technology, they breathe new life and new talent into the defense sector, which we need. So we are always concerned about the small businesses, and we will work hard to keep them in the game.

Mr. WITTMAN. Sure.

How difficult and costly would it be to reconstitute that small-business supplier industrial base for our shipbuilding if it were unfortunately to be affected by sequestration?

Secretary CARTER. Well, we worry all the time about exactly that, not, by the way, just in the context of sequestration, but budget cuts in general and just management day to day. It is very hard once you lose a specialized supply chain contributor to regain that specialized expertise. So once you lose it, it is very expensive to regain. So, better to keep it in the business in the long run, which is why our whole industrial base policy is such an important part of what we do in defense.

Mr. WITTMAN. Let me ask you, I want to point to some comments that have been made about BRAC [Base Closure and Realignment]. You know, there has been a lot of back and forth about BRAC. And when Secretary Panetta came and testified before us February 15th, 2012, he said very specifically that, in looking at the total context of defense spending, is that the Administration's policy was to pursue a BRAC in 2013 and 2015. And, as you know, I put an amendment in both the appropriations side and the authorization side to set aside BRAC in 2013.

I was surprised when President Obama, though, visited Richmond, Virginia, and he did a sit-down interview, and his quote on BRAC was this. He says, "You know, I don't think now is the time for BRAC." He said that on July 15th. He went on further to say, "We just went through some base closings, and the strategy that we have does not call for that."

And I am just wondering, was the President misspeaking there? Because it was very clear to me that Secretary Panetta said that it was this Administration's policy to pursue BRAC in 2013, and then his comment on July 15th just seemed to be counter to that. So I just wanted to get some clarification from you.

Secretary CARTER. No, the President is right; we did not build into our 2013 budget submission any savings or any presumption about BRAC for the very simple reason that that is not an authority we have. That is an authority only Congress has. And so there was never any prospect and is no prospect of any BRAC in 2013.

Down the road, if we continue to have reductions in overall defense spending, it will be a necessary corollary of that, that we will have to revisit BRAC. But that is obviously not going to happen in 2013.

Mr. ZIENTS. I want to be clear that it is not only no savings in 2013, there were no savings in the 5-year window——

Secretary CARTER. Yes. I am sorry.

Mr. ZIENTS [continuing]. Of the defense budget. And I think the President has been very clear, this is not the economic time, given the fragility of the economy, for doing BRAC.

Secretary CARTER. So we didn't build that into our budget submission.

Mr. WITTMAN. Okay. Very good.

The CHAIRMAN. The gentleman's time has expired.

Mr. WITTMAN. Thank you, Mr. Chairman.

The CHAIRMAN. Mr. Scott.

Mr. SCOTT. Thank you, Mr. Chairman.

And, gentlemen, thank you for being here.

And I did not vote for sequestration. I know that commitments were made at the highest level in both parties that this would never happen and we wouldn't be sitting here today, but we are. And, unfortunately, for me, as a man with a wife and a soon-to-be 13-year-old boy, I am quite honestly tired of the blame game. I am going to live under whatever we do for a long time in this country, and I and the rest of the freshman class want to get this resolved.

But I would like to, if I could, Mr. Zients, talk with you about a couple of things. If you listen to the President, he has essentially said, well, if you all would just pass my budget, everything would be okay. Well, he didn't get a single vote for his budget from Democrats or Republicans. So that is not my fault, that it didn't pass. I mean, it wasn't supported by his own party. Same with his jobs bill.

And as I have listened to the President come out and talk, he has talked more about the Buffett rule than he has anything else. And I understand you have said, and I take you at your word, that he is going to be—that his tax bill is coming to the House. I assume we will have his total language. And you said it would generate somewhere in the range of $850 billion over 10 years. Is that——

Mr. ZIENTS. That is right.

Mr. SCOTT. Okay. We spend approximately $10 billion a day in this country. Is that fair enough, give or take a—okay.

The Buffett rule generated $47 billion over the course of 10 years. So, over the last 18 months that I have been here, as an American I have listened to my President present a proposal for corporate-jet tax increases that would fund the Government for 45 minutes and a Buffett rule that funds the Government for 10 or 11 hours.

The bottom line is this: This Tax Code that we are living under today, the one that we are living under today, generated $2.567 trillion in 2007. It generates less than that today. Part of it is the global recession, but part of it, with due respect to the President, part of it is the class warfare that he is perpetuating. And with due respect, there is a difference in taxing schedule S income and taxing W–2 income.

Why would—now, you are obviously a smart guy. But if you are a schedule S business owner and you are going to pay schedule S taxes at approximately 40 percent under the President's proposal or you could convert to a schedule C and pay them at what he says should be a lower rate than we even have today, why wouldn't you convert your schedule S to a schedule C and pay at the lower tax rate?

Mr. ZIENTS. Well, a couple things here. First of all, the President presented a very detailed plan to the Joint Committee that had $4 trillion——

Mr. SCOTT. But would you answer the schedule S versus schedule C?

Mr. ZIENTS. I operated in the economy——

Mr. SCOTT. Sure. I did, too.

Mr. ZIENTS [continuing]. During the Clinton administration, which is the level of taxation that we are talking about returning to. I can say personally that there was plenty of incentive to grow my businesses. My businesses when I started were about——

Mr. SCOTT. The budget was balanced.

Mr. ZIENTS [continuing]. One hundred people; today they employ about 4,000 people.

Mr. SCOTT. The budget was balanced.

Mr. ZIENTS. Plenty of incentive to grow businesses in the type of tax economy that we are going to—or tax regime that the President recommends that—or proposes that we return to so that the top 2 percent are paying their fair share.

The President is also in favor of tax reform——

Mr. SCOTT. Are those that are paying nothing paying their fair share, according to the President?

Mr. ZIENTS [continuing]. The top 2 percent are paying their fair share. No one with incomes under—no family with income under $250,000 is paying any more.

Mr. SCOTT. Let's go back to——

Mr. ZIENTS. But the President also is, to your point, the President is very much in favor of tax reform so we have a simpler system, lower rates.

Mr. SCOTT. Has he presented a proposal?

Mr. ZIENTS. He has set forward principles and looks forward to working with Congress.

Mr. SCOTT. He has not presented a proposal, with all due respect.

Mr. ZIENTS. Tax reform is a very complex terrain, but the principles are——

Mr. SCOTT. Absolutely.

Mr. ZIENTS [continuing]. There, and the President looks forward to engaging——

Mr. SCOTT. And he has been President for 4 years, and it is time for him and the Administration to stop blaming George Bush.

The bottom line is—the bottom line is we are spending $10 billion a day in this country. Your revenue estimate—and I asked this of another member of the Administration, the only member of the Administration that the President has allowed to meet with the freshman class, which represents about 20 percent of Congress now—the revenue estimate that you have, how is that derived?

Mr. ZIENTS. The revenue estimate in the President's proposal of $1.6 trillion?

Mr. SCOTT. The budget for fiscal year 2013——

Mr. ZIENTS. Right.

Mr. SCOTT [continuing]. How—the total receipts——

Mr. ZIENTS. It is derived by having the top 2 percent pay its fair share, by us returning to the Clinton-era tax rates, and by ensuring that deductions are limited to 28 percent for the wealthiest 2 percent. That creates about $1.6 trillion. As you said, there are some other specific proposals, like the corporate tax piece. That is how we get there.

And, again, the President would love to do tax reform in order to simplify and lower rates.

Mr. SCOTT. You are the director of the budget office. And with due respect, the President's assumptions, what you all have given us in your assumptions assumes that the revenue from corporate taxes doubles over the 24 months between 2011 and 2013.

Mr. ZIENTS. I don't believe that to be the case. The President's tax reform proposal on corporate is tax-neutral. Now, you have the economy growing and picking up pace. We are not where we need to be——

Mr. SCOTT. I think that is part of the problem, is that the President's definition of growth and his Administration's definition of growth is 1.5 to 2 percent. And, quite honestly, it just doesn't get us there.

Mr. ZIENTS. Well, if Congress would enact the American Jobs Act, we would have better growth.

Mr. SCOTT. And the President was asked——

Mr. ZIENTS. And if we got rid of——

Mr. SCOTT [continuing]. On four separate occasions by my office specifically to give us an——

The CHAIRMAN. The gentleman's time has expired.

Mr. SCOTT [continuing]. Outline of where the money would go, and he refused.

The CHAIRMAN. Just to clarify something that Mr. Wittman brought up, I remember in a meeting with Secretary Panetta in my office—I don't know if you were there, Dr. Carter—but the request of us was that we have two BRACs going forward in the strategy. Is that correct?

Secretary CARTER. Yes. He has asked for authority to begin BRAC in 2013. That would not have led to any BRAC activity, obviously. In the process, there is a commission and so forth.

The CHAIRMAN. But it was the Administration request of us. We didn't put it in our bill, but it was his request at that time.

Secretary CARTER. That was.

The CHAIRMAN. Thank you.

Mr. Palazzo.

Mr. PALAZZO. Thank you, Mr. Chairman.

Also, I would like unanimous consent to introduce a report by Ernst & Young titled "Long-Run Macroeconomic Impact of Increasing Tax Rates on High-Income Taxpayers in 2013." Can I enter that for the record?

The CHAIRMAN. No objection, so ordered.

[The information referred to can be found in the Appendix on page 79.]

Mr. PALAZZO. Okay. I am going to quote from it in a second. But, first of all, you know, we ask ourselves why we are here. And if we are honest with ourselves, we can just look back over decades of fiscal mismanagement of this country by both parties, both Republican and Democrat, and maybe one or two independents if they were out there at the time. But, you know, we have just made some poor fiscal choices year after year after year.

And, you know, we—pointing fingers at this time is not going to resolve sequestration. You have mentioned over and over, both of you on this panel, that we have 5 months to avert sequestration. And we need to be working together. We don't need to be engaging in, you know, partisanship or playing the blame game. Whether you voted for the bill or whether you didn't vote for the bill, it is facing us. It is coming at us very quick, like a fast-moving train.

And if sequestration is allowed to take effect, we know it is irresponsible, and we know the damage that it is going to do is irreversible. But you did mention some things on the President's plan to raise the revenue through taxing the 2 percent that you say don't pay their fair share. I think 5 percent of the top earners pay almost 40 percent of our total revenues.

But that report I just mentioned actually kind of analyzes, I think, what the President's plan is. And those businesses that you are talking about employ 54 percent of the private-sector workforce and pay 44 percent of Federal business income taxes. The number of workers employed by large flow-through businesses is also significant. More than 20 million workers are employed by flow-through businesses with more than 100 employees.

The report—and this is from the executive summary, and the report goes on to pretty much say that these higher marginal tax rates result in a smaller economy, fewer jobs, less investment, and lower wages. Specifically, this report finds that the higher tax rates will have significant adverse economic effects in the long run, lowering output, employment, investment, the capital stock, and real after-tax wages when the resulting revenue is used to finance additional Government spending.

You know, that is food for thought. But I would like to ask some questions. We are here to talk about—this is the House Armed Services Committee, and I want to get some more questions from Mr. Carter, or Secretary Carter, on how sequestration is going to affect our military personnel.

You testified that if the President elects to exempt military personnel funding in fiscal year 2013, the out-year cuts would force the Department to make substantial reductions in military personnel in units in the years beyond fiscal year 2013.

With the President having just recently announced that military personnel accounts are exempted, could you please clarify when additional reductions in military personnel would commence? Would it not occur until after fiscal year 2014 or later, or would the Department have to start taking steps in fiscal year 2013 to responsibly draw down the force beginning at a later date?

Secretary CARTER. What the President did was exempt from sequestration in fiscal year 2013 military personnel. As I said, that was both a decision made on principle and one that was practical, given the limitations on how we could have—the draconian way in which such cuts would have had to be taken.

In the longer run, over the course of the next 10 years, particularly as we absorb the $489 billion worth of cuts we have already absorbed, military personnel, that part of our budget will be taken into consideration in those cuts, as it was in the 2013 budget that we submitted. Because to do otherwise would be to unbalance.

But what the President was doing was avoiding something associated with sequester in 2013, which is a particularly absurd—given that all of sequester is absurd—a particularly absurd impact on that account in 2013. And that was absolutely the right thing to do, because, otherwise, we would have had to have done some very drastic things to——

Mr. PALAZZO. Thank you——

Secretary CARTER [continuing]. Accommodate the sequester.

Mr. PALAZZO [continuing]. Secretary Carter.

Would any of these reductions rely heavily on involuntary separations?

Secretary CARTER. We are trying, in the plan that we submitted for 2013 and the out-years, which, again, is the first $489 billion, and we would endeavor to do that in whatever circumstances that we found ourselves, to avoid or at least minimize involuntary separations. In fact, we have built our whole drawdown, particularly in the Army and the Marine Corps, on the principle of minimizing—we can't eliminate entirely—minimizing involuntary separations.

Mr. PALAZZO. Thank you.

The CHAIRMAN. Thank you.

Director Zients, I know you were planning on leaving at 12:30, but we do have one more Member. I understand you have agreed to stay for that.

Mr. ZIENTS. Absolutely.

The CHAIRMAN. And I thank you for that.

Mr. Lamborn.

Mr. LAMBORN. Thank you, Mr. Chairman.

Thank you both for being here and staying a few minutes longer. I appreciate that.

Mr. ZIENTS. Please.

Mr. LAMBORN. Director Zients, what is the OMB position on contracts funded with fiscal year 2012 appropriations but executed in fiscal year 2013? In other words, will agencies be allowed to delay contracts to preserve flexibility or accelerate contracts prior to January 2nd in order to protect programs?

Mr. ZIENTS. We assume, or we are instructing agencies to continue their normal business operations. That was central to yesterday's guidance. Agencies that have—or, sorry, contracts that are fully obligated will not be impacted. Unobligated balances, as we have talked about, are subject to sequester. So contracts that are not obligated would be subject to sequester, or to the ramifications of sequester.

Mr. LAMBORN. Okay. Thank you.

And for either one of you, in the event that fiscal year 2013 begins under a continuing resolution, which is looking more and more likely, how will sequestration calculations be applied?

I will restate that. If fiscal year 2013 begins under a continuing resolution, will OMB consider apportioning based on post-sequestration estimates or based on fiscal year 2012 levels?

Mr. ZIENTS. We will assume business as usual. And, obviously, if unfortunately we are in an event where, January 2nd, the sequestration order is implemented, we will be ready to implement.

Mr. LAMBORN. Okay.

Mr. Carter, do you have anything to add to that?

Secretary CARTER. I don't, no. That is accurate.

Mr. LAMBORN. And as a follow-up, in that event will changes be retroactive to the beginning of the fiscal year once the appropriations bills are passed?

Mr. ZIENTS. No.

Mr. LAMBORN. Okay.

Mr. Carter.

Secretary CARTER. Same answer.

Mr. LAMBORN. Okay. I appreciate your both being here. Thank you.

Mr. Chairman, I yield back.

The CHAIRMAN. Thank you.

Mr. Smith.

Mr. SMITH. Thank you.

Just quickly, I want to thank both of our witnesses for being here and the discussion. About half the discussion I think was a useful discussion about how do we get out of this problem, and the other half of this discussion was simply, you know, the majority's attempt to try to blame the Administration for the entire problem.

Mr. Turner observed that, you know, you were being partisan. I think, just for your explanation, normally on the Armed Services Committee the members of the committee are very partisan, but our witnesses are from the DOD and they don't really fight back. And today we finally had someone who was willing to punch back. So that was about the only thing that was different.

I think that, you know, was not the most useful exchange that we have had. And I would ask that if we are going to have witnesses up from the White House, you know, don't cut them off every 2 seconds. I mean, if you are not getting the answer you want after a sentence, that is fine. But, otherwise, it is just embarrassing to the committee to not give the witnesses a chance to at least get two words out of their mouth in between questions.

But, again, I think the chairman's intentions were very good in this hearing: to finally, you know, start having the discussion about how we get out of this. Not all Members lived up to your intentions, but the discussion at least is moving forward. And I think it was very useful to have, you know, people from the White House and the committee have the discussion about how we can get out of what we all agree is, you know, a problem that we must avoid. And the sooner, the better. Not a January 2nd problem. The sooner we can come up with a solution, the more certainty we can have in the economy and the better we can help turn things around.

So I thank the chairman for attempting that and succeeding in part, at least.

I yield back.

The CHAIRMAN. Thank you.

I think that this is a bipartisan committee. And I think this is probably, in my time, the first time that we have had a witness come that has actually told us what Republicans should do and what Democrats should do. And I think that got us off on a track that I was uncomfortable with, and I wish it hadn't happened.

But for you to state your position, that the worst thing that could happen is Republicans are not willing to raise revenue, as I said in our earlier meeting and at my opening statement, we have taken action. And this isn't private industry; we talked a little bit about how that works. This is the Congress of the United States, and we are directed by the Constitution. And the Constitution lays out a framework where we resolve problems, and that is, one body passes legislation, the other body passes legislation, and then you have a conference and try to resolve the differences. And we find ourselves hung up because the Senate hasn't taken action.

Director Zients, one final follow-up question. Is it the case that the President's negotiators first raised the sequester mechanism during the debt-ceiling negotiations with the House?

Mr. ZIENTS. I don't know the history of that negotiation.

The CHAIRMAN. Okay. That has been my understanding, that that is where it came from. And is there a way that you could find out and get back to us for the record?

Mr. ZIENTS. I was not part of those negotiations. We can——

The CHAIRMAN. Do you know anybody that was in there that you could ask?

Mr. ZIENTS. Let me see what kind of follow-up we can do.

[The information referred to can be found in the Appendix on page 105.]

Mr. ZIENTS. At the end of the day, the vast majority of members of this very committee, Democrats and Republicans, voted in favor of the BCA.

Mr. SMITH. Mr. Chairman, could I just throw something in there that I meant to say earlier?

You know, I didn't vote for the BCA. I completely understand the Members who did. Because the other piece of it is, nobody likes sequestration, but no one wanted the debt ceiling to be breached either. That was, you know, the complete, terrible choice that we faced. So the Members who voted for it, the President who signed it, it wasn't, "Yay, sequestration." It was, "We have to stop the debt ceiling from being breached." And that was the only option on the table, D or R. I totally understand the Members who said, I don't like sequestration, but——

Mr. ZIENTS. Furthermore, we are where we are, as you have pointed out. It is the law. We have 5 months. We all agree we need to avoid it. Let's focus our energy forward to do balanced deficit reduction to avoid the sequestration.

The CHAIRMAN. Thank you very much.

This hearing is adjourned.

[Whereupon, at 12:41 p.m., the committee was adjourned.]

APPENDIX

AUGUST 1, 2012

PREPARED STATEMENTS SUBMITTED FOR THE RECORD

AUGUST 1, 2012

Statement of Hon. Howard P. "Buck" McKeon

Chairman, House Committee on Armed Services

Hearing on

Sequestration Implementation Options and the

Effects on National Defense: Administration Perspectives

August 1, 2012

Good morning ladies and gentlemen. The House Armed Services Committee meets today to receive testimony on the Administration's implementation options for sequestration. Joining us today is the Honorable Jeffrey Zients, the Acting Director of the Office of Management and Budget, and the Honorable Ashton Carter, the Deputy Secretary of Defense. Gentlemen, thank you for joining us.

Although this is the first day of August, when you look at the calendar there are only a handful of legislative days left to resolve the devastating across-the-board cuts to our military known as sequestration. The House has already passed a measure that would achieve the necessary deficit reduction to resolve sequestration for a year—however, the Senate has yet to consider any solution, other than the President's proposal, which was defeated unanimously. And since he offered that failed proposal 6 months ago, the President has been virtually silent on the issue. This impasse, and lack of a clear way forward, has created a chaotic and uncertain budget environment for industry and defense planners. We heard from some of those leaders 2 weeks ago that even though cuts are scheduled for implementation January 2nd, companies are required to assess and start planning now, in accordance with the law—and, sequestration is the law right now. Just because there is bipartisan consensus that sequestration is bad and should be replaced, it doesn't mean that we can wish away the law. The President wanted sequestration in the Budget Control Act and he got it. Let us also not forget that it was the President who put defense "squarely on the table" last spring. Until the President and the Senate come to the table with a proposal to resolve the cuts, we have no choice but to proceed as if sequestration will happen.

In part because of this rising tide of uncertainty and in part to help build the political will to resolve sequestration, this Congress has repeatedly requested information from the President and Office of Management and Budget on exactly how sequestration will be implemented. With two million Active Duty, civilian, and private sector jobs at stake it is unconscionable this information has been denied to Congress, the Department of Defense and our industry partners. Make no mistake, we understand—planning for sequestration won't lessen the damage. But failing to plan for it will make a terrible situation worse.

One bright light of bipartisanship in this impasse was the overwhelming House and unanimous Senate passage of the Sequestration Transparency Act—legislation requiring the President to submit a report to Congress detailing how the Administration plans to implement the budget sequestration cuts. So this hearing is very timely, and seeing as the President already has that legislation on his desk, gentlemen, I think it's time to cut to the chase and start talking.

In fact, this hearing appears to have prompted a flurry of activity within the Administration. On Monday, the Department of Labor issued guidance on the applicability of the WARN Act, which requires notification to employees in advance of massive layoffs. Just yesterday, the President made the long-awaited determination that military personnel accounts will be exempted from sequestration. And Director Zients, yesterday you issued a memo to Federal agencies that was a small step in the right direction. So there is even more to discuss.

The panel of defense industry leaders testified before this Committee that barring any additional guidance, they must proceed as if sequestration will become a reality, and under the requirements of the WARN Act notify their employees that they may well be laid off in the coming months. As one CEO put it, the Administration's failure to issue any guidance on sequestration has completed obscured the industry's near-term horizon with a "fog of uncertainty." We asked them for the specific guidance they needed. They've responded and I have to say, input from the Department of Labor wasn't on their list.

That's because the Department of Labor's own fact sheet on the WARN Act says it is inappropriate for the Department to issue guidance on the applicability of WARN Act. Nevertheless, on Monday night the Department of Labor urged employers not to follow the requirements of the WARN Act before the election. So instead of bringing his party in the Senate to the negotiating table to resolve sequestration, the President has focused on preventing advance notice to American workers that their jobs are at risk.

Despite the fact that we can all agree that sequestration will cause job losses and that is the law of the land, the President's Labor Secretary found a lot of excuses to explain why layoffs aren't foreseeable. I guess the conclusion is that the Administration doesn't believe Americans deserve the common courtesy of being given a couple of months notice before they lose their jobs. In the end, it doesn't matter. Each company will have to make its own conclusion as to whether or not the layoffs are "foreseeable." But I don't want to dwell on that ill-conceived guidance. Business leaders will do what they think is in the best interests of their employees and shareholders, and we are here today to talk about OMB's planning.

Director Zients, you have argued that no amount of planning or reports will turn the sequester into anything other than the devastating cut in defense and non-defense programs that it was meant to be. I fear this means many of our questions will go unanswered and our hearing will be used solely as an opportunity to push for the wholesale adoption of President Obama's budget plan.

I know we'll hear a lot today about "balanced deficit reduction," so I want to address the issue briefly. While the President's so-called "balanced" plan may sound fair, it quickly collapses under scrutiny. In a recent op-ed, Director Zients, you argue this "balanced" approach finds $1.2 trillion in savings, and reduces the deficit by $4 trillion by proposing $2.50 in spending cuts for every $1 in new revenue. But the numbers simply do not add up.

The $2.50-to-$1 ratio was arrived at by a series of budget gimmicks, claiming spending reductions that are actually tax increases and counting spending reductions that are already in law. It claims $848 billion in "savings" from ending the wars in Iraq and Afghanistan by counting funds that we all would admit will not be requested in the first place. And most troubling, it raises taxes on hard-working Americans and threatens an already weak economy. But even if that's the foundation for the President's solution, let the Senate bring some version of it to a vote. Then we'll have a conference and sort out our differences.

Until that happens, it is my sincere hope that we can end much of this uncertainty here today. Our allies are getting anxious and our adversaries emboldened. As one senior military official recently told me, America's inability to govern ourselves past sequestration plays directly into the hands of those who spread a narrative of American decline and will ultimately thrust us into a more dangerous world.

If this is not enough to compel action and straightforward talk on the part of the Administration, I do not know what it is. I look forward to your testimony this morning.

Statement of Hon. Adam Smith

Ranking Member, House Committee on Armed Services

Hearing on

Sequestration Implementation Options and the

Effects on National Defense: Administration Perspectives

August 1, 2012

Thank you, Mr. Chairman. I, too, thank our witnesses for being here today. And I completely agree with the chairman that sequestration is a problem right now. I think this committee has done an excellent job of bringing attention to that reality. Folks who think that because sequestration doesn't actually kick in until January that we have until then are completely wrong. The impacts of the uncertainty of whether or not sequestration is going to happen are having a definite impact on our economy and not just defense. Remember, sequestration hits the entire discretionary budget, not just the defense budget. It actually hits a little bit of the mandatory spending, as well, and has a profound impact on private employers' decisions going forward about what to invest in.

It is impacting the economy right now. The best thing Congress could do would be to find a solution right now to that. Also, the uncertainty of what is going to happen with the tax cuts that are set to expire at the end of this year is also a major problem for the economy. Delaying on all this is a huge, huge challenge. And that uncertainty is having as big an impact as anything right now on our inability to get our economy moving again. So I agree with the chairman completely that we need to focus attention, that this is a problem right now that needs to be addressed as soon as possible.

It is also worth noting that sequestration was a bad idea in the first place. It was based off of the Gramm-Rudman-Hollings bill back in the 1980s. Both of those plans, the architects of which have said we never meant for it to be implemented. It is a terrible idea; it is horrible policy. It was only meant as a forcing mechanism. It was going to be so awful, so hideous, that everyone would have to get together and agree to prevent it.

But we now have seen what was, I think, obvious even before we passed the Budget Control Act and the reason that I didn't vote for it, the problems of determining how to deal with our deficit—how to address it, what to cut, what revenue to raise—are so serious, and there is so much difference that we can, in fact, go through even something as bad as sequestration rather than find the solution.

So, putting a gun to the head of the economy as a so-called forcing mechanism to deal with the deficit was a bad idea from the very beginning and one that I hope we never try again. But, again, the chairman is right—a problem right now that we have to address.

I really want to thank our witnesses for being here, Mr. Zients in particular, and also for offering a solution. The White House has put out a variety of different solutions. The Democrats in the

House have. Every time the Republicans in the House have put up a bill to deal with sequestration, there has been an alternative offered by the Democrats.

Now, the Senate is, regrettably, a different story, because right now the difference is, Democrats and Republicans have a different approach to this. And in the Senate, nobody actually controls the Senate because it takes 60 votes to do anything. So you would have to, in the Senate, have the Democrats and the Republicans agree to get anything out of the Senate.

So I think the solution here isn't hoping that at some point the Senate acts. The solution is to get all Democrats and all Republicans to come together and try to figure out what a reasonable approach to this is. Really, the problem is there is just a fundamental disagreement on that. And we have had that debate; we will have it again today.

Personally, I think revenue has to be part of the equation. As I have said before, if you look at the Republican proposal that says we shouldn't cut defense, we should cut taxes by even more, and we should balance the budget, the math simply doesn't add up unless you cut everything else in our budget—Medicare, transportation, education, health care, everything else—by 50 percent. Nobody supports that. The Republicans don't even support that. They haven't proposed it.

So let's be realistic about the choices we face and realistic about the fact that revenue has to be a piece of the equation. Again, as I have said before, if you are absolutely committed, as this committee is—and I do not doubt that—to providing for the common defense, to make sure that our service men and women have the support that they need to defend this country, then you ought to be willing to raise the money necessary to pay for it. I think that has to be on the table.

But I do agree with the chairman that it is time for all parties concerned to come together and try to find a solution to this very damaging problem. And I think this hearing is helpful in that. Again, I thank Mr. Zients, Mr. Carter for being here to have that discussion.

And I hope we can begin to make some progress toward a solution. It is great that this committee is shining a light on how big the problem is. I think we all get that now. We now have to move past that to finding some way to solve the problem so the sequestration does not happen.

[EMBARGOED UNTIL 10:00 AM, AUGUST 1]

EXECUTIVE OFFICE OF THE PRESIDENT
OFFICE OF MANAGEMENT AND BUDGET
WASHINGTON, D.C. 20503

TESTIMONY OF
JEFF ZIENTS
ACTING DIRECTOR AND DEPUTY DIRECTOR OF MANAGEMENT
OFFICE OF MANAGEMENT AND BUDGET
BEFORE
HOUSE ARMED SERVICES COMMITTEE

August 1, 2012

Mr. Chairman, Ranking Member Smith, members of the Committee, good morning.

I am here today to discuss the automatic spending reductions for fiscal year (FY) 2013 required by section 251A of the Balanced Budget and Emergency Deficit Control Act of 1985 (BBEDCA), as amended by the Budget Control Act of 2011 (BCA), commonly referred to as "the Joint Committee sequestration," as well as the impacts of these reductions and the actions the Administration is taking to prepare to implement the sequestration, should it be necessary, on January 2nd, 2013.

I want to start today by reiterating a point the Administration first made when the President signed the BCA last August: the Joint Committee sequestration, by design, is bad policy, and Congress should pass balanced, bipartisan deficit reduction to avoid it. The intent of including the sequestration in the BCA was to encourage Congress to enact a compromise deficit reduction plan through the threat of mutually disagreeable cuts to both defense and non-defense programs. If allowed to occur, the sequestration would be highly destructive to domestic investments, national security, and core government functions.

The BCA, which passed both chambers of Congress with bipartisan majorities, reduces the deficit through two mechanisms. First, it established binding discretionary caps that reduce the deficit by almost one trillion dollars over the next decade and reduce non-security discretionary spending to the lowest level as a share of the economy since the Eisenhower Administration. These cuts are divided between non-security and security agencies, with the Department of Defense (DOD) included as a security agency. It included a firewall between the two sides in the first two years to ensure that neither side bore the full brunt of these reductions. This commitment to shared burden is a principle that is consistent throughout the BCA deficit reduction framework. The President's FY 2013 Budget complied with these caps as originally defined, making difficult choices across all discretionary programs.

Second, the BCA established a congressional Joint Committee charged with the task of developing a proposal that would achieve at least $1.2 trillion in deficit reduction and provided for expedited consideration of a deficit reduction package if it received a majority of votes on the Joint Committee. However, last November the Joint Committee announced that it could not reach agreement on a balanced, comprehensive deficit reduction plan. This failure triggered an enforcement mechanism of automatic funding cuts, known as sequestration, beginning on January 2, 2013, to achieve the required deficit reduction. These cuts total approximately $109 billion a year from FY 2013 through FY 2021, split evenly between defense and non-defense programs. In FY 2013, savings would be achieved through a blunt, across-the-board cut to Federal funding, with the bulk of the reductions coming from discretionary programs. From FY 2014 through FY 2021, the reductions in discretionary funding would be implemented by reducing the discretionary caps, and non-exempt mandatory programs would be sequestered each year.

Specific details about percentage reductions and the amount of the reduction by program, project, and activity (PPA) cannot be known at least until Congress enacts appropriations for FY 2013 and finalizes any legislation affecting mandatory programs, as both types of legislation could affect the allocation of the reduction. However, a CBO report released last September estimated that base defense discretionary funding would be cut by approximately 10 percent, while non-defense discretionary spending would be cut by almost 8 percent. In practical effect, the percentage cut would be even greater given that one-fourth of the fiscal year will have already elapsed by the date of any sequestration order on January 2, 2013.

As prescribed by the BCA, these cuts would indiscriminately impact all programs without regard to priorities or function, except for programs that Congress exempted in law. A great deal has been written about the devastating effects the sequester will have on defense programs, and I am sure that Deputy Secretary Carter will provide additional details on those impacts. But less attention has been paid to the equally destructive effects sequestration will have on non-defense programs.

An eight percent reduction in non-defense discretionary funding would cause severe harm to many of the investments most critical to our country's long term economic growth. More than 16,000 teachers and aides responsible for educating thousands of children would lose their jobs. In addition, 700,000 women and children would lose the nutrition assistance they need to remain healthy. 100,000 kids would lose places in Head Start, which helps them begin school ready to learn. The National Institutes of Health would have to halt or curtail vital science, such as research on cancer and childhood diseases. Let me underscore this point -- the across-the-board cut required by the BCA would jeopardize critical programs that improve children's health and education, adversely impacting future generations.

Beyond these sharp reductions in critical investments for children, the sequestration would also undermine basic services that Americans expect from their government. The Federal Aviation

Administration, which ensures that air travel is safe, would face significant cuts in operations. Food safety and workplace safety inspections would be slashed. The number of FBI agents, Border Patrol agents and transportation safety staff would decline — making the country less safe and secure. Numerous national parks would have to close in whole or in part. And, our nation's ability to forecast severe weather, such as drought events, hurricane, and tornadoes could be seriously undermined. The National Weather Service could face system outages at critical times, leading to reduced data availability for forecasters, and delayed upgrades in critical weather forecasting systems. These cuts — and the thousands of others that sequestration would compel — would be devastating. That is why the President believes that enacting a balanced deficit reduction package that would avoid sequestration should be the focus of Congress's efforts.

To this end, the President has put forward legislative proposals on two separate occasions to responsibly avoid these cuts: first, in the President's Plan for Economic Growth and Deficit Reduction that was presented to the Joint Committee in September, and second, in the President's FY 2013 Budget. Both of these plans made tough choices to reduce the deficit with a balanced package of spending cuts and revenue increases. Both plans included over $4 trillion in deficit reduction (including the deficit reduction in the BCA itself), far exceeding the amount that would have been required of the Joint Committee to avoid sequestration.

Instead of working to enact a balanced deficit reduction package to avoid the threat of sequestration, some members of Congress have focused on unbalanced solutions that rely solely on spending cuts or try to alter only part of the Joint Committee sequestration. These proposals do not represent realistic ways to advance the conversation and avoid sequestration. Unlike the President's Budget, they are inconsistent with the conclusions of numerous independent and bipartisan groups that recommend a comprehensive, balanced deficit reduction package comprised of both spending cuts and revenue increases.

More recently, attention in Congress has focused on seeking information from the Administration on planning and preparing for sequestration. I want to stress that if required, OMB will be prepared to implement sequestration on January 2, 2013. However, we believe the right course of action is for Congress to act to avoid sequestration well in advance of that date.

In the unfortunate event that Congress fails to pass a balanced deficit reduction package to avoid sequestration in advance of January 2, OMB's implementation of sequestration will be governed by the procedures set forth in BBEDCA, as amended by the BCA. Under that law, OMB has very little flexibility or discretion in implementing sequestration. Due to the failure of the Joint Committee established by the BCA, annual savings of approximately $109 billion will be required, split evenly between non-exempt defense programs, as designated by budget function 050, and all other non-exempt programs.

As I noted before, it is impossible at this time to determine the exact amount of the reductions that will be required in any given account or program. First and foremost, we do not yet know the FY 2013 funding levels, which represent the base to which the automatic reductions to discretionary spending will apply, and which must therefore be known in order to calculate the across-the-board percentage reduction. In addition, the FY 2013 appropriations will govern how the cuts will be applied within each account. BBEDCA requires that the same percentage reduction apply equally to all PPAs within a budget account. These PPAs can change from year to year and differ substantially in their level of specificity between budget accounts. In executing the sequestration, OMB would apply a uniform percentage reduction at the account level, which would apply equally across PPAs within an account as identified by agencies. The reductions required by sequestration at the PPA level cannot be fully known at least until the FY 2013 appropriations are enacted.

Beyond the FY 2013 appropriations, BBEDCA requires that unobligated balances be factored into the sequestration calculation for defense programs. The level of unobligated balances will not be known for some time. Further, baseline mandatory outlays may need to be adjusted based on legislation enacted over the coming months, which will impact the calculation of the sequestration percentage. In addition, under BBEDCA, the President may exempt all or parts of military personnel funding from sequestration, provided he notifies Congress of the manner in which he will exercise such authority on or before August 10. All of these may affect the allocation of the reductions required by sequestration.

Once the uniform percentage reduction is determined, the cut will apply to all non-exempt accounts in equal measure. In this respect, the Joint Committee sequestration would operate like other sequestrations that are used for budget enforcement purposes, such as a sequestration of discretionary funding pursuant to section 251(a) of BBEDCA to enforce the discretionary caps or a PAYGO sequestration pursuant to the Statutory Pay-As-You-Go Act of 2010. However, unlike other experiences with sequestration mechanisms, the magnitude of the Joint Committee sequestration will present unique challenges that cannot be mitigated by planning or using existing authorities to reallocate funding among accounts.

The President remains confident that Congress will act to avoid the sequestration through a balanced deficit reduction package—the very task the BCA charged Congress with accomplishing. But because Congress has not yet made progress towards enacting sufficient deficit reduction, OMB is beginning the analysis necessary to issue a potential a sequestration order on January 2, 2013. The implementation of that order will bring a host of other challenges—most prominently, the need to revise plans for agency operations during the remainder of FY 2013 in order to comply with the substantially reduced funding levels to be specified in the January 2, 2013 sequestration order. The preparation for such a devastating contingency, once undertaken, would necessarily divert scarce resources from providing other important agency services and meeting other priorities—to say nothing of the disruptive effects this exercise would have on the Federal workplace, Federal employees and contractors, and their families. Instructing the government to prepare for significant sequestration-induced disruptions—including potentially widespread furloughs or even reductions in force—could inadvertently trigger some of the negative effects of sequestration even if sequestration never happens (as it was never intended to do). This is why it is particularly critical for Congress to take prompt action to avoid the sequestration through a balanced deficit reduction package.

Of course, OMB's preparations to issue a sequestration order on January 2, 2013 do not change the fact that the Joint Committee sequestration is bad policy, was never meant to be implemented, and should be avoided through the enactment of bipartisan balanced deficit legislation. Let me be clear: the impact of sequestration cannot be lessened with advance planning and executive action. Sequestration is a blunt, indiscriminate instrument designed to force Congressional action on achieving a balanced deficit reduction plan. It is not the responsible way for our nation to achieve deficit reduction. It is not a credible substitute for a responsible deficit reduction plan. Time remains for Members of Congress to work together to produce a balanced, bipartisan deficit reduction plan that achieves at least the level of deficit reduction agreed to in the BCA that the President can sign to avoid the sequestration. The Administration stands ready to work with Congress towards this type of plan.

Thank you. I am happy to answer your questions.

Jeffrey Zients

Acting Director

Office of Management and Budget

Jeffrey Zients was confirmed by the Senate on June 19, 2009 as the Deputy Director for Management of the Office of Management and Budget and the nation's first Federal Chief Performance Officer, and served as OMB's acting director from July-November 2010. He has twenty years of business experience as a CEO, management consultant and entrepreneur with a deep understanding of business strategy, process reengineering and financial management. His expertise extends across a broad range of industries and geographies. Zients served as CEO and Chairman of The Advisory Board Company and Chairman of the Corporate Executive Board, firms that are leading providers of performance benchmarking and best practices across a wide range of industries, assisting senior executives at over 5,000 businesses to improve the efficiency of their operations. Zients began his career in management consulting at Bain & Company and Mercer Management Consulting, where he focused on developing strategies and improving operations of Fortune 1000 companies. Immediately prior to his Senate confirmation Zients founded an investment firm focused primarily on growth companies in the business and healthcare services sectors. He also co-founded The Urban Alliance Foundation, a non-profit organization that partners with corporations to provide economically disadvantaged youth with year-round paid internships, adult mentors and job training. Zients graduated summa cum laude from Duke University with a degree in Political Science. He and his wife Mary live in Washington, D.C. and have four children.

DEPUTY SECRETARY OF DEFENSE ASHTON B. CARTER
PREPARED TESTIMONY
HOUSE ARMED SERVICES COMMITTEE
WEDNESDAY AUGUST 1, 2012

EMBARGOED UNTIL RELEASED BY THE COMMITTEE

DEPUTY SECRETARY OF DEFENSE ASHTON B. CARTER PREPARED TESTIMONY HOUSE ARMED SERVICES COMMITTEE WEDNESDAY AUGUST 1, 2012

I appreciate the opportunity to join with the Acting Director of the Office of Management and Budget (OMB) in testifying today regarding the effects of sequestration.

Secretary Panetta and I have been emphasizing for many months that sequester would have devastating effects. While I will focus on the impact on the Department of Defense (DoD), Acting Director Zients' testimony makes clear that the effects on non-defense agencies would be equally devastating. We urge Congress to avoid sequestration by devising a comprehensive and balanced deficit reduction package that both the House and Senate can pass, and that the President can sign. Back in February, the President's Budget for FY 2013 in fact contained a proposal for such a balanced reduction. Secretary Panetta and I strongly urge that the Congress enact a balanced deficit reduction plan to avoid sequestration.

Acting Director Zients already described the mechanism by which sequester would work. In my statement today, I describe some impacts specific to DoD. But much of what I say would be echoed by managers in other federal agencies and by industry leaders who furnish critical goods and services to the federal government. And, while I can describe many of sequester's impacts on DoD, I cannot describe a "plan" that somehow eliminates these consequences, or even mitigates them substantially. The reason for this is that sequester was designed to be an inflexible and mindless policy. It was never designed to be implemented. Instead, it was enacted as a prod to Congress to devise a comprehensive package to reduce the federal deficit.

As I illustrate some of the impacts of sequester, it will be clear that it is a policy that should never be implemented. It introduces senseless chaos into the management of more than 2,500 defense investment programs, waste into defense spending at the very time we need to be careful with the taxpayer's dollar, inefficiency into the defense industry that supports us, and causes lasting disruptions even if it only extends for one year. Sequester in FY 2013 would seriously disrupt our forces and programs. Over the longer term, the lower caps in FY 2014 through FY 2021 would require that we substantially modify and scale back the new defense strategy that the DoD leadership, working under the guidance of the President, so carefully developed just a few months ago.

How Sequester Would Work in DoD

If sequestration occurs, it would be governed by the Balanced Budget and Emergency Deficit Control Act (BBEDCA) of 1985, as amended by the Budget Control Act (BCA) of 2011. Congressional report language also specifies some of the detailed procedures for DoD.

Sequestration requires that national defense programs be reduced by almost $55 billion in FY 2013, and the lowering of the discretionary caps would result in reductions of the same amount in each year from FY 2014 through FY 2021. The DoD budget would bear more than 95 percent of this reduction.

While sequestration and lowering of the discretionary caps could have important effects for each of the next nine years, I will focus today mostly on the effects in FY 2013. In FY 2013 special rules govern the sequester and require an across-the-board application of the cuts that is designed to be inflexible. To determine the size of the sequester by project and account, a percentage will be calculated based on the prescribed dollar cut (almost $55 billion) and the total of the FY 2013 appropriation and unobligated balances from prior years. Obviously, that percentage cut cannot be estimated precisely until we know the level of FY 2013 appropriated funds and the level of prior-year unobligated funds.

Sequester would apply to all of the DoD budget, including the wartime or Overseas Contingency Operations (OCO) portions of the budget – with only one potential exception that is significant. Under the 1985 Act, the President has the authority to exempt all or parts of military personnel funding from sequestration. If the President chooses to utilize this authority for FY 2013, he must notify the Congress by August 10, 2012, about the manner in which he will exercise the authority. If the President exempts military personnel funding from sequester in FY 2013, then other DoD budget accounts must be cut by larger amounts to offset the military personnel exemption. DoD estimates that the percentage reductions under sequester could range from 8 percent for all DoD accounts (if military personnel funding is fully sequestered) to 10 percent for accounts other than military personnel (if "milpers" funding is fully exempt from sequestration). These estimates assume that Congress provides funds for FY 2013 equal to the President's request and reflects DoD's best estimate of unobligated balances from prior years.

OMB will eventually calculate the sequester percentage and will use the percentage to calculate reductions in dollar terms for each budget account. How these reductions are applied in DoD varies between the operating and investment portions of the budget, as specified in law and applicable Congressional report language. Cuts to the operating portions of the DoD budget must be equal in percentage terms at the level of budget accounts. (Examples of budget accounts in the operating budget include Army active operation and maintenance, Navy reserve operation and maintenance, and Air Force Guard operation and maintenance.) Within each budget account in the operating portion of the budget, DoD can determine how best to allocate the reductions based on management judgments. For the investment portions of the budget, the dollar cuts must be allocated proportionally at a lower level of detail identified as "program, project, and activity (PPA)". More than 2,500 programs or projects are separately identified and must be reduced by the same percentage. Absent a reprogramming action, the inflexible nature of the sequester law means that DoD would have no authority to vary the amount of the reduction. Within a PPA, however, managers can decide how best to allocate the reductions.

It is important to note that reprogramming – a method used by DoD to shift funding from lower to higher-priority projects during the year when funds are being executed – would at most offer a limited ability to modify the effects of sequester. Under current law, the amount of funds that can be transferred is limited. Moreover, any reprogramming that adds funds to a program or project must be offset by a cut to another program or project, which may be difficult because, as a matter of policy, we seek Congressional approval of reprogramming actions. Reprogramming might be used to offset some effects of sequester but, realistically, it would not offer a means for making wholesale revisions.

To close this description of sequestration, let me say what sequestration would NOT do. Sequestration would generally not affect funds already obligated as of the date the sequester cuts are calculated.

Impacts of Sequester

Acting Director Zients discussed some of the potential effects of the sequester on non-defense programs. Just as in non-defense agencies, sequestration would have devastating effects on DoD and its personnel both because of the size of the sequester cuts and because of the mindless way the law requires that they be allocated. Although we strongly believe that Congress should enact a balanced deficit reduction package and avoid sequestration, we have reviewed the law and identified some of the key impacts sequestration would have on the Department.

As noted earlier, OCO funding – which pays for the added costs of wartime activities – is subject to sequester. Supporting our warfighters in combat is DoD's highest priority. We would therefore endeavor to protect wartime operating budgets as much as possible, including the key operation and maintenance (O&M) accounts. The O&M accounts contain OCO as well as base-budget funding, and these two categories of O&M funding merge together during execution of DoD budgets. We could reduce the base-budget portions of O&M disproportionately and spare the OCO portions. We could take similar steps as needed in other accounts that include OCO funding.

However, especially in the Army and the Marine Corps, this action would lead to large cuts in base-budget O&M. We would seek to minimize effects on training and readiness of units deploying, but we could probably not do so fully. As a result, some later-deploying units (including some deploying to Afghanistan) could receive less training, especially in the Army and Marine Corps. Under some circumstances, this reduced training could impact their ability to respond to a new contingency, should one occur.

Sequestration could also affect training in the other military services. We will seek to minimize effects on readiness. However, Air Force flying hours for pilots could be reduced by several hours a month and Navy steaming days could decline by several days a quarter. The result will be reduced training and lower readiness.

The sequester would force us to reduce funding for civilian personnel, and I would join other senior federal managers in making difficult personnel decisions that will harm all of our departments. Although it is premature to describe in detail how sequester would impact the DoD civilian workforce, it might be necessary to impose a partial hiring freeze or unpaid furloughs. These actions would reduce our capability in important ways: fewer people to fix our weapons including those damaged in war, less expert time and attention available to enter into well-crafted contracts and handle financial transactions, and less support for other critical day-to-day operations.

Military families and retirees would be adversely affected by sequestration. For example, we could be forced to cut back on base support services, facility maintenance, and maintenance of government owned family housing. Commissary hours might have to be reduced. Funds for the Defense Health Program, which provides health care for retirees and military dependents, would be sequestered, resulting in delays in payments to service providers and, potentially, some denial of service.

These various sequestration actions, taken together, would represent a major step toward creation of an unready, "hollow" military force. Military readiness would be added to the list of programs in other departments harmed by sequestration including nutrition assistance for low-income women, education for young students, and research projects designed to improve American lives.

Sequestration would also inevitably lead to universal disruption of DoD's investment programs. Under current rules that govern the sequester process, every one of our more than 2,500 procurement programs, research projects, and military construction projects would each be indiscriminately reduced. Those who manage these programs would be forced to join many other acquisition managers in non-defense agencies as they seek to accommodate the reduced funding for FY 2013, three months after the fiscal year starts.

Some military managers would be forced to buy fewer weapons. For example, assuming proportional cuts and DoD's current estimate of the size of the sequester, we would buy four fewer F-35 aircraft, one less P-8 aircraft, 12 fewer Stryker vehicles, and 300 fewer Army medium and heavy tactical vehicles compared with the requests in the President's Budget for FY 2013. Reductions in buy sizes will cause unit costs of weapons to rise, which will in turn demand further cuts in buy sizes. In cases where we cannot feasibly reduce the quantity of items bought – ships come immediately to mind – we would have to delay projects. There could be a delay of several months in the new CVN-78 carrier along with delays in the Littoral Combat Ship program and DDG-51 destroyer procurement. Some military construction projects could be rendered unexecutable by sequester. We could be forced to delay fixing schools, defer construction of new medical facilities, and delay environmental cleanup.

I have focused on the effects of sequestration on DoD. But much of the Intelligence Community's funding is within the DoD budget and is also subject to sequestration. As it would in DoD, sequestration would have devastating effects on the Intelligence Community. If sequestration occurs, senior managers in the Intelligence Community would join me and leaders in all affected non-defense agencies as we strive to meet the needs of American citizens while operating under a law that was purposely designed to be inflexible.

While I have focused on effects in FY 2013, sequestration and lowering of the discretionary caps reduces DoD budgets by $50 to $55 billion in each year from FY 2013 through FY 2021. The cuts beyond FY 2013 would not have to be implemented in the across-the-board manner that I have just described. But the cuts are still large. Even if the President elects to exempt military personnel funding in FY 2013, the outyear cuts would force the Department to make substantial reductions in military personnel and units in the years beyond FY 2013. Otherwise we will end up with too many units and not enough funds to train and equip them. Significant cuts in military units would, in turn, require that we revisit the national security strategy that the President put in place last January. While it is premature to outline specifics, sequestration would force DoD to revise a strategy that was carefully crafted and designed to meet current national security needs.

Next Steps on Sequester

While we can foresee the harmful impacts of sequester, as I have described, we cannot devise a "plan" that eliminates, or even substantially mitigates them. Sequester defies rational "planning." It was designed to be irrational. We are working with OMB to understand this complex legislation, and we are assessing impacts. Because we are still five months from implementation, Congress has the time to enact a balanced deficit reduction plan and halt implementation of this inflexible law. In the unfortunate event that sequestration is actually triggered, we will work with OMB and – like all the federal agencies affected by this law – we will be ready to implement.

But we are equally worried about a different type of error. This would occur if sequestration does not happen but we end up triggering some of its bad effects anyway. For example, we do not want to unnecessarily alarm our employees by announcing adverse personnel actions or by suggesting that such actions are likely. We do not want to hold back on the obligation of funds – either for weapon projects or operating programs – that would have been obligated in the absence of a possible sequester, since this would introduce inefficiency and waste. Nor do we want to cut back on training, which would harm military readiness in a period when we face a complex array of national security challenges. In the charged budgetary environment in which we are operating, this type of error is very real.

Finally, we understand that private companies that serve the Department of Defense and constitute important members of our national security team will be making decisions on issues related to sequester. They face many of the same dilemmas we do, and a number of them have expressed to me their alarm at such a wasteful and disruptive way of managing the taxpayers' money and the talents of their employees. The best thing that can happen for private companies is for Congress to enact a balanced deficit reduction plan that halts implementation of this inflexible law.

Summary

I believe that my testimony today makes clear that sequester would be devastating to DoD, just as it would to every other affected federal agency. It is important to remember that sequester was not a policy designed to be implemented. It was enacted as a prod to Congress to act on the federal deficit.

Congress needs to deal with the debt and deficit problems in a balanced way and avoid sequestration. The men and women of this Department and their families need to know with certainty that we will meet our commitments to them. Our partners in the defense industry, and their employees, need to know that we are going to have the resources to procure the world class capabilities they can provide, and that we can do so efficiently. Allies, partners, friends, and potential foes the world over need to know that we have the political will to implement the defense strategy we have put forward.

Ashton B. Carter

Deputy Secretary of Defense

Ashton B. Carter is the Deputy Secretary of Defense.

Previously, Dr. Carter served as Under Secretary of Defense for Acquisition, Technology and Logistics from April 2009 until October 2011. As Under Secretary, Dr. Carter led the Department's efforts to accelerate the fulfillment of urgent operational needs; increase the Department's buying power; and strengthen the nation's defenses against weapons of mass destruction and other emerging threats.

Over the course of his career in public service, Dr. Carter has three times been awarded the Department of Defense Distinguished Service Medal. For his contributions to intelligence, Dr. Carter was awarded the Defense Intelligence Medal.

Dr. Carter earned bachelor's degrees in physics and in medieval history from Yale University, summa cum laude, Phi Beta Kappa, and was awarded his doctorate in theoretical physics from Oxford University, where he was a Rhodes Scholar.

Prior to his most recent government service, Dr. Carter was chair of the International and Global Affairs faculty at Harvard University's John F. Kennedy School of Government and Co-Director of the Preventive Defense Project. Dr. Carter was also Senior Partner at Global Technology Partners, a member of the Aspen Strategy Group, a member of the Board of Trustees of the MITRE Corporation and the Advisory Boards of MIT's Lincoln Laboratories and the Draper Laboratory, and an advisor to Goldman Sachs.

During the Clinton Administration, Dr. Carter was Assistant Secretary of Defense for International Security Policy. From 1990 until 1993, Dr. Carter was Director of the Center for Science and International Affairs at Harvard University's John F. Kennedy School of Government, and Chairman of the Editorial Board of International Security. Previously, he held positions at the Massachusetts Institute of Technology, the Congressional Office of Technology Assessment, and Rockefeller University.

Dr. Carter has served on the Defense Science Board, the Defense Policy Board, the Secretary of State's International Security Advisory Board, and the Congressional Commission on the Strategic Posture of the United States. He is a member of President Obama's Government Accountability and Transparency Board.

Dr. Carter is a Fellow of the American Academy of Arts and Sciences and the American Academy of Diplomacy and is a member of the Council on Foreign Relations and the American Physical Society.

In addition to authoring articles, scientific publications, government studies, and Congressional testimonies, Dr. Carter has co-edited and co-authored eleven books.

Dr. Carter is married to Stephanie Carter and has two grown children.

DOCUMENTS SUBMITTED FOR THE RECORD

AUGUST 1, 2012

Long-run macroeconomic impact of increasing tax rates on high-income taxpayers in 2013

Prepared on behalf of the Independent Community Bankers of America, the National Federation of Independent Business, the S Corporation Association, and the United States Chamber of Commerce

Drs. Robert Carroll and Gerald Prante
Ernst & Young LLP

July 2012

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Executive Summary

The confluence of fiscal policy changes scheduled to occur at the end of 2012 – sometimes referred to as the "fiscal cliff" – poses serious challenges for policy makers. One area of disagreement is the increase in tax rates for high-income taxpayers resulting in part due to the sunset of elements of the 2001 and 2003 tax cuts. President Obama has called for the reinstatement of the higher top tax rates in his budget submission to the Congress, while key Republican members of Congress have called for their extension. The increase in the Medicare tax and its expansion to unearned income for high-income earners under the Patient Protection and Affordable Care Act of 2010 (PPACA) further contributes to the increase in top tax rates.

The concern over the top individual tax rates has been a focus, in part, because of the prominent role played by flow-through businesses – S corporations, partnerships, limited liability companies, and sole proprietorships – in the US economy and the large fraction of flow-through income that is subject to the top two individual income tax rates. These businesses employ 54% of the private sector work force and pay 44% of federal business income taxes.[1] The number of workers employed by large flow-through businesses is also significant: more than 20 million workers are employed by flow-through businesses with more than 100 employees.

This report uses the EY General Equilibrium Model of the US Economy to examine the impact of the increase in the top tax rates in the long-run. While a recent Congressional Budget Office (CBO) report examined the near-term effects of all of the federal government fiscal policies under scrutiny at the end of 2012 and found them to be of sufficient size to push the economy into recession at the beginning of 2013, this report focuses on the long-run effects of the increase in the top tax rates. This report examines four sets of provisions that will increase the top tax rates:

- The increase in the top two tax rates from 33% to 36% and 35% to 39.6%.
- The reinstatement of the limitation on itemized deductions for high-income taxpayers (the "Pease" provision).
- The taxation of dividends as ordinary income and at a top income tax rate of 39.6% and increase in the top tax rate applied to capital gains to 20%.
- The increase in the 2.9% Medicare tax to 3.8% for high-income taxpayers and the application of the new 3.8 percent tax on investment income including flow-through business income, interest, dividends and capital gains.

With the combination of these tax changes at the beginning of 2013 the top tax rate on ordinary income will rise from 35% in 2012 to 40.9%, the top tax rate on dividends will rise from 15% to 44.7% and the top tax rate on capital gains will rise from 15% to 24.7%.

These higher tax rates result in a significant increase in the average marginal tax rates (AMTR) on business, wage, and investment income, as well as the marginal effective tax rate (METR) on new business investment. This report finds that the AMTR increases significantly for wages (5.0%), flow-through business income (6.4%), interest (16.5%), dividends (157.1%) and capital gains (39.3%). The METR on new business investment increases by 15.8% for the corporate sector and 15.6% for flow-through businesses.

This report finds that these higher marginal tax rates result in a smaller economy, fewer jobs, less investment, and lower wages. Specifically, this report finds that the higher tax rates will have significant adverse economic effects in the long-run: lowering output, employment, investment, the capital stock, and real after-tax wages when the resulting revenue is used to finance additional government spending.

Through lower after-tax rewards to work, the higher tax rates on wages reduce work effort and labor force participation. The higher tax rates on capital gains and dividend increase the cost of equity capital, which discourages savings and reduces investment. Capital investment falls, which reduces labor productivity and means lower output and living standards in the long-run.

- Output in the long-run would fall by 1.3%, or $200 billion, in today's economy.
- Employment in the long-run would fall by 0.5% or, roughly 710,000 fewer jobs, in today's economy.
- Capital stock and investment in the long-run would fall by 1.4% and 2.4%, respectively.
- Real after-tax wages would fall by 1.8%, reflecting a decline in workers' living standards relative to what would have occurred otherwise.

These results suggest real long-run economic consequences for allowing the top two ordinary tax rates and investment tax rates to rise in 2013. This policy path can be expected to reduce long-run output, investment and net worth.

Long-run macroeconomic impact of increasing tax rates on high-income taxpayers in 2013

I. Introduction

At the end of 2012, a substantial shift in fiscal policy is currently scheduled to occur. The 2001 and 2003 tax cuts, various other expiring provisions, and the extensions of the reduction in the payroll tax enacted earlier this year are all set to sunset. Major elements of the Patient Protection and Affordable Care Act of 2010 (PPACA) are scheduled to take effect beginning in 2013. The sequestration enacted as part of the Budget Control Act of 2011 is scheduled to begin in early 2013. In addition, the AMT patch that sunset at the end of 2011 will greatly expand the reach of the AMT beginning with the 2013 spring filing season.

Notwithstanding this enormous near-term uncertainty in fiscal policy, there are areas of apparent agreement, such as the permanent extension of many of the provisions of the 2001 and 2003 tax cuts that affect low- and moderate-income taxpayers, supported by many prominent members of Congress and included in each of President Obama's annual budget submissions. An area of disagreement is whether the reductions in the top two individual income tax rates and the top tax rates on dividends and capital gains enacted in 2001 and 2003, should be extended or allowed to sunset.

These tax rates, however, may be of particular economic importance. The reported income of high-income taxpayers has been found to be more sensitive to tax rates than that of low- and moderate-income taxpayers. Thus, increasing tax rates on high-income taxpayers may have larger effects on the size of the tax base than among other taxpayer groups. The high income tax brackets have also been found to be important to flow-through businesses because a disproportionate share of this income is subject to the top income tax rates. Finally, the taxation of dividends and capital gains results in the double taxation of corporate profits and higher tax rates amplify the distortive effects of the double tax for a number of economically important decisions.

This study considers the long-run macroeconomic impact of the increase in the top individual tax rates to better understand their effects and help inform the policy debate.[2] These long-run effects of these higher tax rates on major macroeconomic variables – output, employment, investment, capital stock and after-tax wages – are estimated using the Ernst & Young LLP General Equilibrium Model of the US Economy. This model distinguishes between taxpayers facing the top tax rates and other households, and allows investment and the capital stock in the United States to adjust to differences in after-tax returns in the United States and abroad.

Alternative assumptions are made regarding how the revenue from the higher tax rates could be used – to finance a higher level of government spending versus a return of the revenue to households through an across-the-board reduction in tax rates. These two financing assumptions reflect alternative uses of the additional revenue.[3] The analysis also considers the sensitivity of the results to alternative sets of behavioral assumptions to reflect the uncertainty in how households and firms might respond to changes in tax policy.

This report finds that the increase in the top tax rates would reduce long-run output by 1.3% when the resulting revenue is used to finance additional government spending. Employment is found to fall by 0.5%. In today's economy, these results would translate into a reduction of gross domestic product (GDP) of $200 billion and employment by 710,000 jobs. Investment and the capital stock (net worth) would fall in the long-run by 2.4% and 1.4%, respectively. Real (non-inflationary) after-tax wages would fall by 1.8%, indicative of the decline in living standards relative to what would have occurred otherwise.

If the higher tax rates are instead used to finance an across-the-board reduction in tax rates, long-run output instead falls by 0.4% with more modest declines in investment and the capital stock. The sensitivity analysis shows a range in the reduction of long-run output of between 1.0% and 1.7% when the resulting revenue is used to finance higher government spending and a range of between 0.3% and 0.6% when used to finance an across-the-board reduction in tax rates.

These results suggest real long-run economic consequences for allowing the top two ordinary tax rates and dividend and capital gains tax rates to rise in 2013. This policy path can be expected to reduce long-run output, investment and net worth. If the revenue is used to finance higher spending -- a policy consistent with financing the growth in entitlement programs – employment and livings standards would also be adversely affected.

II. The effect of higher tax rates on economic decision making

The confluence of fiscal policy changes scheduled to occur at the end of 2012 – sometimes referred to as the "fiscal cliff" – poses serious challenges for policy makers. One area of disagreement is the increase in the top tax rates due to the sunset of elements of the 2001 and 2003 tax cuts. These higher tax rates are embodied in several provisions:

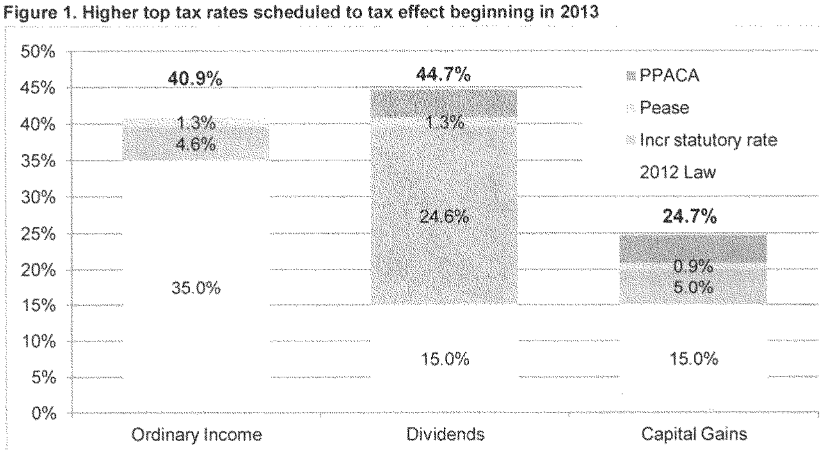
1. the increase in the top two statutory tax rates from 33% and 35% to 36% and 39.6%, respectively;

2. the increase in the top statutory tax rate on dividends from 15% to 39.6% (i.e., top ordinary income tax rate) and capital gains from 15% to 20%; and,

3. the reinstatement of the limitation on itemized deductions for high-income taxpayers, which further increases the effective marginal tax rate on ordinary income, dividends and capital gains.

In addition, the health insurance reform legislation (PPACA) enacted in 2010 further adds to the tax increases high-income taxpayers will face beginning in 2013 due to the increase in the Medicare tax from 2.9% to 3.8% and the extension of this tax to unearned income (e.g., interest, dividends and capital gains).[4]

Figure 1. Higher top tax rates scheduled to tax effect beginning in 2013



Source: Ernst & Young LLP.

These higher tax rates, as depicted in Figure 1, will result in an increase in the top federal effective marginal tax rate on ordinary income from 35% to 40.9%. The top effective tax rate on dividend income received by individuals will rise from 15% to 44.7%, but this calculation excludes the previously paid tax on this income at the corporate level.[5] The top effective tax rate on capital gains received by individuals will rise from 15% to 24.7%.[6] Including state tax rates would increase these tax rates further.

Economists have long recognized the role tax rates play in the decision making of households and firms. Resources transferred from the private economy to the public sector to finance government spending through taxes, not only reduce disposable incomes but also have important economic consequences depending on how those revenues are raised and spent. The more households and firms base their decisions on tax considerations, rather than economic merit, the more economic resources are generally wasted.

The concern over higher individual tax rates has also been a focus because of the prominent role played by flow-through businesses – S corporations, partnerships, limited liability companies, and sole proprietorships – in the US economy and that a large fraction of flow-through income is subject to the top two individual income tax rates. These businesses employ 54% of the private sector work force and pay 44% of federal business income taxes.[7] The number of workers employed by large flow-through businesses is also significant: more than 20 million workers are employed by flow-through businesses with more than 100 employees. Tabulations of the effect of the increase in the top two individual tax rates on flow-through business taxpayers is provided in Appendix D.

Flow-through employment varies considerably within different industries with significantly greater representation in the services and construction industries, with C corporation employment more dominant in the manufacturing, wholesale and retail trade, and transportation industries. Large employers likely skew these statistics. For example as while only 7% of flow-through employment is within the manufacturing sector, more than 81% of manufacturing firms are organized as flow-through businesses.[8] The flow-through form is also important to financial services sector as nearly one-third of all banks -- mostly community banks -- in the United States are organized as S corporations.

Economic research has generally indicated that high tax rates on these firms' owners may result in less hiring and capital investment of businesses, and the slower growth of firms within this sector. Higher tax rates on dividends and capital gains can also have pronounced effects on economic decisions. High taxes on dividends and capital gains serve to increase the double tax on corporate profits and amplify the distorting effect that the double tax has on the overall level of investment, the allocation of investment within the economy, debt versus equity financing, and corporate governance through its effect on firm dividend policy.

Impact of high tax rates on the tax base and revenues

High tax rates in particular can be especially harmful. High tax rates can affect the amount of labor workers supply, especially for secondary workers among married couples. High tax rates can also discourage saving, affect how investors allocate their investments and households' consumption patterns. High tax rates can also affect taxpayer compliance. All of these ways in which taxpayers respond generally reduce the amount of revenue the government can expect to collect from higher tax rates.

These behavioral responses are not inconsequential. Research on the major changes in tax rates over the past nearly thirty years has generally found that these responses can have a sizable impact on the size of the tax base, especially for higher income taxpayers. For example, a recent study of the lower tax rates enacted in 2001 and 2003 reported that the reduction in the top two tax rates led to an increase in reported taxable income for those affected by roughly three percent and may have lowered the cost of the tax cuts by as much as 40 percent.[9] Similar effects have been found for the lower tax rates enacted in 1981 and 1986, while the higher tax rates enacted in 1993 have been found to reduce the size of the tax base.[10]

Importance of higher income tax rates to owners of flow-through businesses

In addition, the top two tax rates are particularly important to flow-through businesses because of the high concentration of flow-through income reported by taxpayers in these tax brackets. Research has found that flow-through business owners may be particularly sensitive to individual income tax rates when making a number of economic decisions.

For example, tax rates have been found to affect the entry and exit from flow-through form as individuals decide whether to open up their own business or work for another firm.[11] Higher tax rates have also been found to deter these businesses from hiring workers and investing, and higher tax rates also affect the rate at which flow-through businesses grow.[12] The effect of the individual tax rates on these types of economic decisions is one reason the tax treatment of flow-through businesses has figured prominently in recent discussions of changes to these tax rates.

Increases in the cost of capital resulting from higher individual income tax rates was found to reduce the investment spending of entrepreneurs and the probability that they invested at all.[13] A 5-percentage point increase in the individual marginal tax rate was found to reduce the percentage of entrepreneurs who made new capital investments by 10.4 percent and the mean amount of investment by 9.9 percent.

Lower individual tax rates were found to increase the probability of entrepreneurs hiring workers and, for those with employees, the total amount of a firm's wages.[14] A 10-percent increase in the net-of-tax share (i.e., 1 minus the marginal tax rate) was found to increase the mean probability of hiring workers by 12 percent, and for those firms with employees, increase the median wage bill by 3.7 percent. Finally, a 10-percent increase in the net-of-tax share was found to increase business receipts by 8.4 percent.[15]

Importance of dividend and capital gains taxation

The double tax on corporate profits can also distort a number of business decisions.[16] The double tax creates a differential in the taxation of business income earned by C corporations and flow-through businesses. One important distortion arises because the double tax mainly affects business income generated by activities financed through equity capital within the C corporation form. The double tax thus raises the cost of equity financed investment by C corporations relative to debt financed investment, providing an incentive for leverage and borrowing rather than for equity financing. Accordingly, the double tax contributes to the tax bias for higher leverage. Greater leverage can make corporations more susceptible to financial distress during times of economic weakness.

The double tax also increases the cost of investment in the corporate sector relative to the rest of the economy. This tax bias against investment in the corporate sector leads to a misallocation of capital throughout the economy. That is, capital is not allocated to its best and highest use based on economic considerations. This reduces the productive capacity of the capital stock and dampens economic growth. As noted before, the diversity of organizational forms can be seen as a useful choice for businesses to make in organizing themselves, but the impact of differential treatment should be recognized. Finally, the double tax raises the overall cost of capital in the economy, which reduces capital formation and, ultimately, living standards.[17]

III. Methodology

The EY General Equilibrium Model of the US Economy (the "EY GE Model") is used to estimate the economic impact of the increase in the top individual tax rates in the long-run. This model has been designed to reflect the major features of the US economy and capture the key economic decisions of firms and households affected by the tax changes. Households adjust their labor-leisure choice to maximize their utility in the face of a lower after-tax reward from work. Firms adjust their use of labor and capital inputs in production to maximize firm value in response to reductions in the after-tax return from saving and investment. Investment flows shift between major sectors of the US economy, as well as between the United States and the rest of the world, in response to the higher US tax rates until after-tax returns are equalized. A more detailed description of the EY GE Model is provided in Appendix A.

The model is initially calibrated to the US economy in 2011. The model is calibrated to match the size of each sector and its use of capital and labor under current law average marginal tax rates by income source. Policy changes, however, are assumed to be financed by an exactly offsetting change in fiscal policy, either through a change in government spending/transfers or through a change in tax policies.

In the context of evaluating the economic effects of the increase in the top tax rates, two alternative financing assumptions are considered. First, the additional revenue is assumed to finance a higher level of government spending. In the current policy environment, this assumption is broadly consistent with the higher taxes funding a portion of the growth in government spending associated with the growth in entitlement programs. Second, the additional revenue is assumed to be returned to households through an across-the-board reduction in individual income tax rates. This assumption, in effect, alters the distribution of the tax burden by exchanging a tax increase on high-income taxpayers for a tax reduction for all taxpayers. This policy also involves, to some extent, a substitution of higher taxes on capital for generally lower taxes on labor.

The impact of four sets of tax increases are estimated:

- The increase in the top two tax rates from 33% to 36% and 35% to 39.6%.
- The reinstatement of the limitation on itemized deductions for high-income taxpayers (the "Pease" provision)
- The taxation of dividends as ordinary income and at a top income tax rate of 39.6% and the increase in the top tax rate applied to capital gains to 20%.
- The increase in the 2.9% Medicare tax to 3.8% for high-income taxpayers and the application of this tax to unearned income including interest, dividends and capital gains.

These policies encompass changes that both reduce the after-tax reward from work and the after-tax return from saving and investment. Table 1 shows the increase in the average marginal tax rates (AMTR) for various income sources and the marginal effective tax rate (METR) for new investment associated with these tax changes. These measures indicate the extent by which the increase in the top tax rates affects the overall tax burden by income source within the US economy.

The AMTR on overall wages increases by 5%, while the AMTR for noncorporate business income increases by 6.4% reflecting the greater concentration of noncorporate business income within the top two tax brackets. The AMTR on dividend income increases by more than one and one-half times (157%) reflecting the very large increase in the effective statutory tax rate on this income (i.e., from 15% to 44.7%) and the concentration of this income in the top tax brackets. The AMTR on capital gains increases by 39.4% reflecting the significant increase in the effective statutory tax rate (i.e., from 15% to 24.7%) and the concentration of this income in the top tax brackets.

The marginal effective tax rate (METR) on new investment is a more detailed calculation that indicates the additional economic income an investment would need to earn to cover taxes over the life of an investment after taking into account the major features of the tax code: corporate and noncorporate tax rates, depreciation schedules and investor level taxes on interest, dividends and capital gains. The METR can be thought of as a measure of the "tax wedge" between the pre- and after-tax return and reflects the distorting effect of the tax system on investment decisions. The increase in the top tax rates described above results in the METR rising by over 15% in both the corporate and noncorporate sectors. Investment in the corporate sector is affected by the increase in investor level taxes, while investment in the noncorporate sector is affected by the higher taxes on ordinary income.

Table 1. Effect of higher tax rates on the average marginal effective tax rate, various income sources and new investment

	2012 Law	2013 Law	Percent Increase
Average marginal tax rates			
Wages	31.3%	32.8%	5.0%
Noncorporate business income 1/	30.6%	32.6%	6.4%
Interest	26.6%	31.0%	16.5%
Dividends	9.1%	23.4%	157.1%
Capital gains	11.2%	15.6%	39.3%
Marginal effective tax rate on new investment			
Corporate sector	25.9%	30.0%	15.8%
Noncorporate sector	19.9%	23.0%	15.6%

Notes: The average marginal tax rates are income weighted averages calculated from the EY Individual Income Tax Microsimulation Model after adding $100 to each taxpayer's income (by source). The marginal effective tax rate on new investment is calculated from the EY Cost of Capital Model. The METR reflects the additional economic income an investment in a competitive market would need to earn to cover taxes over its life.
1/ Includes income from flow-through businesses (S corporations, partnerships, sole proprietorships and farm proprietorships).
Source: Ernst & Young LLP.

The increase in the AMTRs and the METRs depicted in Table 1 indicate the overall increase in the tax burden on labor and saving/investment throughout the economy. Additional adjustments are made to reflect the extent by which some of these income sources are held within taxpreferred accounts, tax-exempt non-profit organizations or by lightly taxed foreigners and then used as inputs into the EY GE Model to simulate the macroeconomic impact of increase in tax rates.

In addition to modeling the impact of the higher tax rates under different uses of the resulting revenue, this study also considers the sensitivity of the results to the responsiveness of households and firms to changes in taxes. Ultimately, the estimated impacts will depend on a combination of the structure of the model and how responsive households and firms are to changes in after-tax rewards, such as the wage rate and the after-tax returns. In the baseline simulations, this study uses parameter values reflecting key household and firm behaviors that approximate central tendency estimates from prior research. However, uncertainty underlies the exact magnitude of these parameters and this study presents results assuming sets of "low" and "high" values for these parameters.[18] This approach provides a general sense for the potential variability in estimated results that could result from alternative views on how responsive households and firms might be to changes in tax policy. The key parameter values under the baseline specification and their low and high value specifications are provided in Appendix B.

IV. Estimated impacts of the higher tax rates on high-income taxpayers

In this section, the impact of the higher top tax rates on key macroeconomic variables in the long-run are presented. Results are presented assuming two different uses of the revenue and. additional estimates are also presented assuming a low and high responsiveness of households and firms to taxes.

Potential short-run effects of higher tax rates

While the EY GE model is used to estimate economic impacts in the long-run, the higher tax rates can be expected to have a short-run impact as well, although through a different channel. During periods when the economy is performing below full employment, changes in fiscal policy can be expected to have significant effects on economic performance. During such periods, there is often a strong case for fiscal stimulus provided other avenues for stimulating the economy, such as monetary policy, are not available or have been exhausted.

The Congressional Budget Office (CBO) recently analyzed the effects of the sunset of the 2001 and 2003 tax cuts, as well as a number of other policies that sunset or go into effect beginning in 2013 – the so-called Fiscal Cliff.[19] The CBO analysis found that the increase in taxes and reduction in spending would significantly hinder the economic recovery by serving as a temporary negative shock to the total demand for goods and services in the economy, and, thus, result in significantly lower output and higher unemployment.

In total, the fiscal changes scheduled to occur in 2013 will reduce the federal budget deficit by $774 billion (or 5.1% of GDP) in calendar year 2013. This fiscal shock is projected to result in 2013 real GDP growth of 0.5%, whereas in the absence of this fiscal shock, real GDP growth is estimated at 4.4%. CBO projects that under current law policies, the economy will contract by 1.3% in the first half of 2013 before growing by 2.3% in the second half of 2013, meeting the standard textbook definition of a recession of two consecutive quarters of negative economic growth. The CBO also projects that employment would increase by 2 million more jobs under the scenario where the budget deficit is not reduced.

While CBO did not separately analyze the near-term effects of the provisions affecting high-income taxpayers, the deficit impact of the higher tax rates is nearly $70 billion or 10% of the total fiscal cliff in calendar year 2013, and totals nearly $1.1 trillion over the ten year budget window. Although a disproportionate share of the tax change is likely to be channeled through savings for taxpayers facing the top tax rates as compared to other taxpayers, these policies can still be expected to have significant effects on output and employment in the near term.

Revenues used to finance higher government spending

The baseline results for the impact of the higher top tax rates when the revenue is used to finance higher government spending is shown in Table 2. Output falls in the long-run by 1.3% and is accompanied by a reduction in employment of 0.5%. In today's $15.7 trillion economy with total employment of 142.2 million, these reductions would be a roughly $200 billion reduction in output and a loss of roughly 710,000 jobs. Investment falls by 2.4% and the size of the capital stock (or net worth) by 1.4% in the long-run. The reduction in the size of the capital stock means workers are less productive as they have less capital to work with and new technologies are incorporated into production more slowly. Workers' real after-tax wages ultimately fall by 1.8% in the long-run.

Table 2. Baseline estimates of the long-run impact of higher top tax rates

	Revenue used to finance higher government spending	Revenue used to finance across-the-board reduction in tax rates
Output (GNP)	-1.3%	-0.4%
Employment	-0.5%	+0.4%
Investment	-2.4%	-1.4%
Capital Stock	-1.4%	-0.6%
Real after-tax wages	-1.8%	+0.3%

1/ Higher tax rates include the increase in the top dividends tax rate to 39.6%, the top capital gains tax rate to 20%, the increase in the top two ordinary tax rates to 36% and 39.6%, and the increase in the Medicare tax from 2.9% to 3.8% and its application to unearned income (e.g., dividends, capital gains and interest income) for high-income taxpayers.
Source: Ernst & Young LLP.

These results can best be understood by considering how the higher tax rates affect the after-tax reward to work and the after-tax return to savings and investment and the disposable incomes of households. The higher tax rates make work less attractive as compared to leisure, thereby reducing labor supply. At the same time, the lower after-tax returns to saving and investment make current consumption more attractive and make investment in the United States less attractive. The increase in taxes also reduces disposable incomes, which reduces households' desire to consume more leisure.

Additionally, the higher tax rates on dividends and capital gains through the sunset of the 2001 and 2003 tax cuts and the extension of the Medicare tax to investment income raises the cost of equity investment in the corporate sector. This causes a shift of investment from the corporate to the noncorporate and housing sectors due to the lower after-tax returns to corporate investment. A similar shift of investment abroad can also be expected to occur until after-tax returns equalize. These changes in investment reduce the capital stock and also result in a less economically efficient allocation of capital across sectors, both of which reduce output.

The higher taxes on dividends and capital gains also cause producers to reduce their capital-labor ratio and become more labor intensive. The decrease in capital intensity offsets some of the reduced labor supply associated with the higher taxes on wages through the higher ordinary tax rates and the increase in the Medicare tax. This explains why investment and the capital stock decline more sharply than labor supply. Real after-tax wages, however, fall due to the reduction in the size of the capital stock and its less productive deployment in the economy. The reduction in real after-tax wages is reflective of a reduction in living standards relative to what would have occurred otherwise.

Comparison to other studies that have examined the long-run macroeconomic effects of other tax policy changes helps put the results reported in Table 2 into context. At the upper end of reported estimates, one study estimates that long-run output would increase by 6% to 9% from complete replacement of the income tax with a flat rate consumption tax (Altig et al, 2001).[20] Replacement of the current income tax by a progressive consumption tax was estimated to increase long-run output by roughly 2.8% (2005 Tax Panel).[21] Replacing the corporate income tax with a consumption tax/value-added tax was estimated by the Treasury Department to increase long-run output by 2.0% to 2.5% (Treasury 2007).[22]

While large is in the eye of the beholder, comparison to other tax policy changes that many would regard as significantly more far reaching suggest that the higher tax rates on high-income taxpayers scheduled can be expected to have significant economic consequences for the size of the economy in the long-run.

<u>Revenues used to finance an across-the-board reduction in tax rates</u>

As an alternative use of the revenue from the higher top tax rates, this study also considers returning the revenue to taxpayers through an across-the-board reduction in individual income tax rates. The combination of higher top tax rates and the across-the-board reduction both increases the progressivity of the tax code and generally reduces taxes on labor taxation in favor of higher taxes on capital.

The results for this simulation (Table 2) indicate that output, investment and the capital stock would still all decline in the long-run, but by smaller amounts. In the long-run, output would fall by 0.4%, investment by 1.4% and the capital stock (net worth) by 0.6 percent. Employment and real after-tax wages would both increase somewhat (0.4 percent and 0.3 percent, respectively).

The major difference between these estimates and the results shown for when revenue is used to finance higher government spending is that the lower tax rates on low- and moderate-income taxpayers serve to increase the after-tax reward from work for low- and moderate-income taxpayers, resulting in greater labor supply.

<u>Sensitivity of results</u>

The sensitivity results for "low" and "high" responsiveness of households and firms to tax policy changes are provided in Table 3. These results bound the baseline results reported in Table 2 above. For the policy scenario where the revenue from the higher tax rates is used to finance additional government spending, output declines by between 1.0% and 1.7% in the long-run.

Similarly, capital stock falls by between 1.0% and 2.2% and real after-tax wages, reflecting the decline in living standards, fall by between 1.6% and 3.1%.

More modest results are estimated for the policy scenario where the resulting revenue is instead used to finance an across-the-board reduction in tax rates. Long-run output falls by between 0.3% and 0.6%. The capital stock falls by between 0.3% and 1.0%, while real after-tax wages rise by between rise by 0.5% and 0.0%.

Table 3. Sensitivity of results to "low" and "high" responsiveness of household and firm behavior

	Revenue used to finance higher government spending	Revenue used to finance across-the-board reduction in tax rates
Low responsiveness		
Output (GNP)	-1.0%	-0.3%
Employment	-0.5%	+0.3%
Investment	-2.0%	-0.9%
Capital Stock	-1.0%	-0.3%
After-tax wage	-1.6%	0.5%
High responsiveness		
Output (GNP)	-1.7%	-0.6%
Employment	-0.5%	+0.5%
Investment	-3.1%	-1.6%
Capital Stock	-2.2%	-1.0%
After-tax wage	-3.1%	-0.0%

1/ Higher tax rates include the increase in the top dividends tax rate to 39.6%, the top capital gains tax rate to 20%, the increase in the top two ordinary tax rates to 36% and 39.6%, and the increase in the Medicare tax from 2.9% to 3.8% and its application to unearned income (e.g., dividends, capital gains and interest income) for high-income taxpayers.
Source: Ernst & Young LLP.

V. Summary

The confluence of fiscal policy changes scheduled to occur at the end of 2012 – sometimes referred to as the "fiscal cliff" – poses serious challenges for policy makers. One area of disagreement is whether the increase in the top tax rates due to the sunset of elements of the 2001 and 2003 tax cuts, as well as the increase and expansion of the Medicare tax to unearned income for high-income taxpayers, should be allowed to occur.

This study examines the impact of these higher top tax rates for the US economy in the long-run. Some of these provisions, particularly the increase in tax rates on dividends and capital gains, can be expected to adversely affect investment and the capital stock by reducing the after-tax return to investment. Other provisions, such as the increase in the top two ordinary tax rates and the increase in the Medicare tax on labor income of high-income taxpayers can be expected to both reduce disposable incomes and reduce labor supply by reducing the price of leisure.

Overall, this study finds that the higher tax rates would reduce output in the long-run by 1.3% when the proceeds are used to finance additional government spending. Employment would fall by 0.5%. In today's economy these changes would translate into a decline in GDP of $200 billion and employment by roughly 710,000 jobs. Investment, the capital stock (net worth) and real after-tax wages would also fall. Under the alternative assumption that resulting revenues are used to finance an across-the-board tax cut, output would only fall by 0.4% and real after-tax wages would rise. A sensitivity analysis using "low" and "high" responsiveness of household and firm behavior bounds these results, but does not appreciably change the qualitative results.

These results may suggest to policy makers that allowing the top tax rates to increase comes with economic consequences. Long-run output can be expected to fall, and, depending on the use of the revenues, living standards, as reflected by workers' real after-tax wages, may also be lower.

Appendix A – EY General Equilibrium Model of the US Economy

The EY general equilibrium model of the US economy was used to estimate the macroeconomic impacts associated with the tax rate increases in the long-run. In this model, tax policy affects the incentives to work, to save and invest, and to allocate capital and labor among competing uses. Representative consumers and firms incorporate the after-tax reward from work and savings into their decisions of how much to save, work, and produce. Output is generated by four production sectors, and individual level decisions of two consumer groups determine the aggregate level of labor supply and savings.

An overview of the model follows:

Firms

Firm behavior is modeled for four production sectors – corporate-manufacturing, corporate-nonmanufacturing, noncorporate, and housing. Production is represented by the standard Cobb-Douglas functional form with differing elasticities of factor substitution, factor-intensities and scale parameters.

Firms choose the optimal level of labor and capital to maximize firm value. Investment in each sector is determined so as to equalize the after-tax return to investment. Firms will add to investment so long as the increase in firm value resulting from additional investment exceeds the after-tax cost of additional investment. In this way, investment is reallocated throughout the economy (i.e., across the four production sectors) until after-tax returns are equalized. A similar investment allocation mechanism is included to account for the flow of investment between the United States and the rest of the world (as discussed below).

The value of the firm reflects all tax characteristics including the corporate tax rate, depreciation schedules, economic depreciation, and investor level taxes on firm earnings/distributions. The model assumes that firms respond to the traditional view of dividends taxes whereby such taxes influence investment decisions.

Households

The model includes two consumer groups – the top 2 percent of taxpayers and all other households. These two groups allow the tax changes described above for high-income taxpayers to be analyzed. Household utility is represented by a CES function of leisure and consumption goods from the four production sectors.

Each household's labor supply is determined using the aforementioned CES function along with a labor supply elasticity and initial leisure preference endowment for each household. Households respond to the after-tax return to labor (one minus the marginal tax rate), as well as their overall income levels, in determining whether to work and thereby earn income that is used to purchase consumption goods or to simply consume leisure by not working. Households also receive transfers from government, which are not contingent upon their own work effort.

Government

The model includes a simple characterization of the government. Government is assumed to impose taxes and redistribute income to households, thereby increasing households' ability to consume products.

The government finances its expenditures by collecting taxes – individual income, corporate income, payroll taxes – and issuing government debt. The model includes a representation of the graduated tax rates schedule together with the various exclusions, exemptions, deduction and credits, and investor level taxes on dividends, capital gains, and interest. The corporate tax includes the corporate tax rate and the system for depreciating investment in tangible property. The noncorporate tax rate and the tax depreciation system are includes in the modeling of the noncorporate sector. The model incorporates both average and marginal tax rates, thereby taking into account both the income effect of higher taxes and the marginal incentive effect that tax rates have on labor/investment decisions.

In this model, tax policy changes are assumed to be offset by a contemporaneous and offsetting change in government spending or taxes. This structure illustrates the effect of the financing assumption on the estimated impacts.

International Capital Flows

The model includes a representation of international capital flows, which are assumed to respond to differences in after-tax rates of return in the United States and the "rest of the world" through a constant elasticity expression. This approach represents a compromise between the standard closed economy approach and the alternative of a completely open economy in which capital is perfectly mobile and the international return to capital is fixed.

The United States is assumed to be large enough to affect the rate of return in the rest of the world. The model is initially calibrated to the current capital flows of Americans and foreigners and their holdings in the United States and the rest of the world. Changes to these initial capital holdings are then estimated, whereby the percent change in capital in the United States is equal to an assumed semi-log elasticity multiplied by the change in the difference between the US after-tax rate of return and the rest of the world after-tax rate of return.

Appendix B – Key model parameters under baseline specification and "low" and high" responsiveness of households and firms

	Baseline	Low Responsiveness	High Responsiveness
Constant elasticity of substitution parameter	1.0	0.9	1.1
Labor supply elasticity	0.4	0.3	0.5
Leisure share of time endowment	0.38	0.38	0.38
Nominal interest rate	5.5%	5.5%	5.5%
Elasticity of substitution in production (Manufacturing)	2.3	2.1	2.5
Elasticity of substitution in production (Non-manufacturing)	2.0	1.9	2.1
Elasticity of substitution in production (Housing)	0.4	0.3	0.5
Labor intensity (Manufacturing)	0.6	0.6	0.6
Labor intensity (Non-manufacturing)	0.7	0.7	0.7
Labor intensity (Housing)	0.3	0.3	0.3
International capital flow elasticity (semi-log)	0.05	0.03	0.08
Capital income share	0.29	0.29	0.29
Transfer income share (Low- and Moderate-Income)	0.8	0.8	0.8
Definition of "High-Income"	Top 2%	Top 2%	Top 2%

Source: Ernst & Young LLP.

Appendix C – State-by-state effects on output and employment from increasing tax rates on high-income taxpayers

	Output ($ in billions)	*Employment*
United States	-$200.9	-710,000
Alabama	-$2.3	-10,100
Alaska	-$0.7	-1,800
Arizona	-$3.5	-13,000
Arkansas	-$1.4	-6,300
California	-$26.3	-76,400
Colorado	-$3.5	-12,200
Connecticut	-$3.1	-8,800
Delaware	-$0.9	-2,300
District of Columbia	-$1.4	-3,900
Florida	-$10.1	-39,400
Georgia	-$5.6	-20,900
Hawaii	-$0.9	-3,200
Idaho	-$0.8	-3,300
Illinois	-$9.0	-30,700
Indiana	-$3.7	-15,400
Iowa	-$2.0	-8,000
Kansas	-$1.8	-7,300
Kentucky	-$2.2	-9,700
Louisiana	-$3.3	-10,200
Maine	-$0.7	-3,200
Maryland	-$4.0	-13,800
Massachusetts	-$5.3	-17,400
Michigan	-$5.2	-21,300
Minnesota	-$3.8	-14,500
Mississippi	-$1.3	-5,900
Missouri	-$3.3	-14,500
Montana	-$0.5	-2,300
Nebraska	-$1.3	-5,100
Nevada	-$1.7	-6,100
New Hampshire	-$0.9	-3,400
New Jersey	-$6.5	-20,900
New Mexico	-$1.1	-4,300
New York	-$15.5	-46,900
North Carolina	-$5.9	-21,200
North Dakota	-$0.5	-2,100
Ohio	-$6.5	-27,500
Oklahoma	-$2.1	-8,400
Oregon	-$2.6	-8,800
Pennsylvania	-$7.8	-30,800
Rhode Island	-$0.7	-2,500
South Carolina	-$2.2	-9,900
South Dakota	-$0.5	-2,200
Tennessee	-$3.6	-14,300
Texas	-$17.5	-56,800
Utah	-$1.7	-6,500
Vermont	-$0.3	-1,600
Virginia	-$5.8	-19,900
Washington	-$4.8	-15,300
West Virginia	-$0.9	-4,100
Wisconsin	-$3.4	-14,900
Wyoming	-$0.5	-1,500

Source: Ernst & Young LLP.

Appendix D – Individual tax returns affected by the expiration of the top two tax rates in 2013

		"At-Risk" Returns		Returns in top two tax brackets with higher tax liability	
Type of Return	All returns	Total	% of all returns	Total	% of all returns
All returns	146.2	3.8	2.6%	1.5	1.0%
Adjusted Gross Income (AGI)	$9,362	$2,860	30.6%	$1,687	18.0%
Total business income (less losses)	$922	$653	70.8%	$560	60.7%
Returns w/ positive business income	25.5	2.1	8.2%	0.9	3.6%
AGI	$3,090	$1,667	53.9%	$1,120	36.3%
Total business income	$1,189	$723	60.8%	$576	48.5%
Returns w/ positive S corporation income	3.8	0.9	23.2%	0.5	12.6%
AGI	$1,187	$913	76.9%	$688	58.0%
Total business income (less losses)	$561	$467	83.2%	$412	73.4%
S corp income	$492	$404	82.0%	$354	71.9%
Returns w/ positive partnership income	3.9	1.0	25.7%	0.5	11.9%
AGI	$1,226	$964	78.6%	$656	53.5%
Total business income (less losses)	$455	$387	85.0%	$320	70.3%
Partnership income	$272	$215	79.1%	$165	60.9%
Returns w/ positive sole proprietorship income	17.2	0.8	4.5%	0.3	1.7%
AGI	$1,395	$535	38.3%	$311	22.3%
Total business income (less losses)	$460	$169	36.8%	$122	26.4%
Sole prop income	$382	$90	23.6%	$51	13.4%
Returns w/ positive other* business income	5.8	0.6	9.7%	0.2	3.9%
AGI	$838	$493	58.8%	$303	36.1%
Total business income (less losses)	$260	$180	69.3%	$146	56.4%
Other business income	$102	$42	41.6%	$20	20.0%

Note: "At-risk" returns includes single returns with AGI > $200,000 and joint returns with AGI > $250,000. The AGI thresholds are at 2009 levels and would be indexed for inflation thereafter. Most returns that are "at risk" who are not in the top two brackets are AMT returns. Returns with business income includes returns that report sole proprietorship, farm proprietorship, partnership, S corporation or rental income or losses. Other business income includes rental income reported on schedule E and farm income on schedule F. Returns are in millions, incomes are in billions of dollars.
Source: Ernst & Young LLP Individual Tax Microsimulation Model.

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[1] See, for example, Robert Carroll and Gerald Prante, "The Flow-Through Business Sector and Tax Reform: The economic footprint of the flow-through sector and the potential impact of tax reform," An Ernst & Young LLP report prepared for the S Corporation Association, April 2011.
[2] For models of this type, roughly two-third to three-quarters of the long-run effect is reached within a decade.
[3] Using the additional revenue to reduce the deficit is not modeled.
[4] While the Medicare tax is applied to investment income for high-income taxpayers, the associated revenue is not transferred to the Medicare trust fund.
[5] The top integrated dividend tax rate that includes both the corporate and individual level taxes on corporate earnings paid out to shareholders as dividends will be 68.5% in 2013 (including both federal and state taxes). See Robert Carroll and Thomas Neubig, "Business Tax Reform and the Tax Treatment of Debt: Revenue neutral rate reduction financed by an across-the-board interest deduction limit would deter investment," An Ernst & Young LLP Report prepared for the Private Equity Growth Capital Council, May 2012, p.4.
[6] The top integrated capital gains tax rate will be 43.3% in 2013 after taking into account the tax benefits of deferral and both federal and state taxes. Ibid, p.4.
[7] See, for example, Robert Carroll and Gerald Prante, "The Flow-Through Business Sector and Tax Reform: The economic footprint of the flow-through sector and the potential impact of tax reform," An Ernst & Young LLP report prepared for the S Corporation Association, April 2011.
[8] Ibid.
[9] For example, see Gerald Auten, Robert Carroll and Geoffrey Gee, (2008), "The 2001 and 2003 Tax Rate Reductions: An Overview and Estimate of the Taxable Income Response," *National Tax Journal*, Vol. 61(3), (September 2008), pp. 345-364.
[10] A series of studies have examined the responsiveness of reported taxable income to changes in tax rates. For example, Feldstein (1995) and Auten and Carroll (1999) examined the 1986 tax reform. Carroll (1998) and Heim (2009) examined the 1993 tax rates increases. For an extensive review of this literature see Saez, Slemrod and Gertz (2009).
[11] Donald Bruce and Tami Gurley-Calvez, "Federal Tax Policy and Small Business," In Overcoming Barriers to Entrepreneurship, Rowan and Littlefield Publishers, forthcoming; William M. Gentry and R. Glenn Hubbard, "'Success Taxes, Entrepreneurial Entry, and Innovation," Working Paper No. 10551, National Bureau of Economic Research, June 2004.
[12] Robert Carroll, Douglas Holtz-Eakin, Mark Rider and Harvey Rosen, "Income Taxes and Entrepreneurs' Use of Labor," *Journal of Labor Economics,* April 2000, 18(2), pp. 324-351; Robert Carroll, Douglas Holtz-Eakin, Mark Rider and Harvey Rosen, "Personal Income Taxes and the Growth of Small Firms," *Tax Policy and the Economy*, NBER, Vol. 15, 2001, pp. 121-147; and Robert Carroll, Douglas Holtz-Eakin, Mark Rider and Harvey Rosen, "Entrepreneurs, Income Taxes, and Investment," In *Does Atlas Shrug? The Economic Consequences of Taxing the Rich*, Joel Slemrod, ed., Russell Sage Foundation and Harvard University Press, NY, 2002, pp. 427-455.
[13] Robert Carroll, Douglas Holtz-Eakin, Mark Rider and Harvey Rosen, "Entrepreneurs, Income Taxes, and Investment," In *Does Atlas Shrug? The Economic Consequences of Taxing the Rich*, Joel Slemrod, ed., Russell Sage Foundation and Harvard University Press, NY, 2002, pp. 427-455.
[14] Robert Carroll, Douglas Holtz-Eakin, Mark Rider and Harvey Rosen, "Income Taxes and Entrepreneurs' Use of Labor," *Journal of Labor Economics,* April 2000, 18(2), pp. 324-351.
[15] Robert Carroll, Douglas Holtz-Eakin, Mark Rider and Harvey Rosen, "Personal Income Taxes and the Growth of Small Firms," *Tax Policy and the Economy*, NBER, Vol. 15, 2001, pp. 121-147.
[16] See Robert Carroll and Gerald Prante, "Corporate Dividend and Capital Gains Taxation: A comparison of the United States to other developed nations, An Ernst & Young LLP report prepared for the Alliance for Savings and Investment, February 2012.
[17] For example, a dynamic analysis of the lower tax rates on dividends and capital gains enacted in 2003 found that they would increase gross domestic product in the long-run by 0.4 percent and the capital stock by 1.2 percent if made permanent. See US Department of the Treasury, *A Dynamic Analysis of Permanent Extension of the President's Tax Relief*, July 25, 2006.
[18] The Frisch labor supply elasticity equals 0.18 under the low response parameters and 0.75 under the high response
parameters. This is consistent with the results surveyed by Browning, Hansen and Heckman (1999), and recent papers by Ziliak and Kniesner (1999, 2005) and Lee (2001), which estimate the Frisch labor supply elasticity for men ranges between 0.0 and 0.5. The econometric literature has generally found larger labor supply responses for women compared to men, but there are few studies that measure the Frisch labor supply elasticity for women. Aaronson and French (2002) suggest this value is believed to be around 1.
[19] See Congressional Budget Office, *Economic Effects of Reducing the Fiscal Constraint That Is Scheduled to Occur in 2013,* May 2012.
[20] See David Altig, Alan Auerbach, Laurence Kotlikoff, Kent Smetters and Jan Walliser, (2001), "Simulating Fundamental Tax Reform in the United States." *American Economic Review,* Vol. 91, pp. 574-595.

Long-run macroeconomic impact of increasing tax rates on high-income taxpayers in 2013

[21] Robert Carroll, John Diamond, Craig Johnson and James Mackie III, "A Summary of the Dynamic Analysis of the Tax Reform Options Prepared for the President's Advisory Panel on Federal Tax Reform," Office of Tax Analysis, US Department of the Treasury, May 25, 2006.
[22] US Department of the Treasury, *Approaches to Improve the Competitiveness of the US Business Tax System for the 21st Century*, December 20, 2007.

WITNESS RESPONSES TO QUESTIONS ASKED DURING THE HEARING

AUGUST 1, 2012

RESPONSE TO QUESTION SUBMITTED BY MR. MCKEON

Mr. ZIENTS. As I stated at the hearing, I was not part of the debt ceiling negotiations in 2011 and I do not know who first raised the sequester mechanism in those negotiations. However, it is clear that the sequester mechanism had bipartisan support, as evidenced by the fact that the Budget Control Act of 2011 was passed by both houses of Congress with bipartisan majorities. Rather than focusing on past negotiations, Congress should work together to enact bipartisan, balanced deficit reduction to avoid the sequestration. [See page 51.]

RESPONSE TO QUESTION SUBMITTED BY MR. BARTLETT

Mr. ZIENTS. Section 256(k)(2) of the Balanced Budget and Emergency Deficit Control Act of 1985, as amended (BBEDCA), states that, "[e]xcept as otherwise provided, the same percentage sequestration shall apply to all programs, projects, and activities within a budget account." Pursuant to this provision, the same percentage reduction will be applied equally at the program, project, and activity level within each sequestrable account, unless another provision of law expressly directs that sequestration be implemented differently. [See page 15.]

QUESTIONS SUBMITTED BY MEMBERS POST HEARING

AUGUST 1, 2012

QUESTIONS SUBMITTED BY MR. MCKEON

Mr. MCKEON. Do you agree that sequestration is now the law and that barring the passage of further legislation, signed by the President, it will have to be implemented?

Mr. ZIENTS. The Balanced Budget and Emergency Deficit Control Act of 1985, as amended, is law and, barring enactment of bipartisan deficit reduction that allows us to avoid sequestration, it will have to be implemented. I urge the Congress to avoid sequestration by enacting bipartisan balanced deficit reduction that the President can sign. Since Congress has not made progress on enacting balanced deficit reduction, in July, OMB issued a memo to agencies that outlines the initial steps to prepare for the possibility that OMB will issue a Joint Committee sequestration order on Jan. 2, 2013. The memo also notes that additional steps would need to be taken over the longer-term. Should Congress fail to act, OMB will be ready to issue the sequestration order on January 2, 2013, as required by law.

Mr. MCKEON. Whose responsibility is it within the Executive Branch to interpret the Budget Control Act and issue guidance on its application? Can this responsibility be delegated? Has it been delegated?

Mr. ZIENTS. The Budget Control Act of 2011 (BCA) assigns various responsibilities to the Office of Management and Budget (OMB). OMB interprets the relevant provisions of the BCA to carry out the responsibilities assigned to it by law, and it has not delegated this function.

Mr. MCKEON. What is OMB's estimate of the percentage reductions by agency and account, after exemptions have been fully considered?

Mr. ZIENTS. As set forth in the Sequestration Transparency Act of 2012 (STA) Report submitted to the Congress, the estimated percentage reductions range from 7.6 to 10.0 percent. However, these estimates are preliminary and are dependent on a number of assumptions required by the STA. If the sequestration were to occur, the actual results would differ based on changes in law and ongoing legal, budgetary, and technical analysis.

Mr. MCKEON. Will unobligated prior-year funds be subject to sequestration cuts? Will there be any special considerations for unobligated funds that are intended for multiyear contracts?

Mr. ZIENTS. Section 255(e) of the Balanced Budget and Emergency Deficit Control Act of 1985, as amended, provides that: "Unobligated balances of budget authority carried over from prior fiscal years, except balances in the defense category, shall be exempt from reduction under any order issued under this part." Therefore, only unobligated balances in the defense category are subject to sequestration. At the appropriate time, OMB will work with the Department of Defense (DOD) and other agencies to determine how to address key questions affecting contracting and other areas.

Mr. MCKEON. Current law provides that, 20 days after the final sequester order, either house of Congress may proceed to consider a joint resolution that can "modify" or "provide an alternative" to the sequester order. Does the President intend to propose a resolution to Congress that would reorder the Department of Defense sequester to shift reductions among defense accounts?

Mr. ZIENTS. The sequestration modification provision referenced in your question is section 258A of the Balanced Budget and Emergency Deficit Control Act of 1985, as amended (BBEDCA). On August 2, 2012, the Senate Parliamentarian ruled that section 258A does not apply to the Joint Committee sequestration. Consistent with the Senate Parliamentarian's ruling, OMB has independently concluded that, based on the statutory text of BBEDCA, the sequestration modification provision in section 258A is not applicable to the Joint Committee sequestration.

Mr. MCKEON. What guidance will be issued to Federal departments and agencies regarding the obligation and expenditure of funds during the first quarter of FY13?

Mr. ZIENTS. In July, OMB issued a guidance memorandum to agencies concerning the potential Joint Committee sequestration. That memorandum stated that agencies should continue normal spending and operations. In the event a continuing resolution for FY 2013 is enacted, OMB would issue guidance to agencies on the apportionment of funds available under the continuing resolution, as is OMB's ordinary practice whenever there is a continuing resolution.

Mr. MCKEON. Sequestration may cause the Government to make unilateral changes to tens of thousands, if not hundreds of thousands, of Government contracts and task orders. How will the Government manage this level of contract dislocation?

Mr. ZIENTS. Sequestration would impose a significant acquisition management burden on the agencies. If sequestration occurs, it will be a difficult and time-intensive process to determine how individual contracts should be modified, terminated, or otherwise impacted by the reduction in funding. This work would be highly disruptive and would need to be handled on a case-by-case basis to ensure that both the contractor and the taxpayer are treated fairly. Conducting these planning activities prematurely could have adverse effects on the contracting community and on taxpayers. That is why it is imperative that Congress acts to avoid sequestration by enacting balanced deficit reduction.

Mr. MCKEON. When will OMB provide the federal agencies guidance on how to handle this volume of work?

Mr. ZIENTS. In July, OMB issued a guidance memorandum to agencies concerning the potential Joint Committee sequestration. That memorandum stated that agencies should continue normal spending and operations. Until Congress acts, the Administration will continue to work, as necessary, on issues related to the sequestration and its implementation. OMB will issue additional guidance regarding sequestration in the months ahead as necessary.

Mr. MCKEON. Clarity and assurances by the Government during this period of uncertainty can be of significant help to industry as they carry out their own planning and preparation for the period ahead. Will OMB provide clarification and assurances that programs with fully funded contracts awarded prior to October 1, 2012, will not be subject to sequestration?

Mr. ZIENTS. Contracts fully-funded with prior year money will not be subject to sequestration in FY 2013. We will work with agencies, often on a case-by-case basis, in order to determine how sequestration would affect different contracts. It is important to note, however, that conducting these planning activities prematurely could have adverse effects on the contracting community and on taxpayers. That is why it is imperative that Congress promptly acts to avoid sequestration by enacting balanced deficit reduction.

Mr. MCKEON. Typically, OMB would have issued initial guidance to Federal agencies regarding the preparation of their FY14 budget requests by now. How does your guidance address sequestration? What assumptions are you making about sequestration as you currently build the FY14 budget?

Mr. ZIENTS. OMB issued guidance to agencies on preparing their 2014 Budget submissions on May 18, 2012. That guidance makes clear that the Congress can and must act to avoid sequestration. The 2014 Budget will need to make hard choices: the discretionary caps put in place by the BCA continue to sharply constrain discretionary spending. Accordingly, the 2014 Budget will build upon the BCA and the 2013 Budget's framework, which called for over $4 trillion in deficit reduction that would far exceed the amount required to avoid sequestration. The 2014 Budget will continue to cut lower-priority spending in order to create room for the most effective investments in areas critical to economic growth and job creation, including education, innovation, infrastructure, and research and development.

Mr. MCKEON. What information can you provide regarding the impact that sequester would have on essential public safety responsibilities such as homeland security, food safety, and air traffic control activities?

Mr. ZIENTS. Sequestration would have significant negative effects on a variety of important Government activities, including public safety. For example, sequestration would likely force the Federal Government to significantly reduce the total number of active law enforcement agents. The Federal Aviation Administration, which ensures air traffic is safe, would face significant cuts in operations. The Department of Agriculture's efforts to inspect food processing plants would be curtailed.

Mr. MCKEON. Given that the FY13 sequestration requires a specified amount of reductions, the longer that sequestration actions are delayed past January 2, 2013, the larger the cut that would need be applied over the remaining period of FY13. Will the Administration be ready to execute sequestration on January 2, 2013, and, if not, why not?

Mr. ZIENTS. The Administration firmly believes that the Congress should take action to enact a balanced deficit reduction plan in order to avoid sequestration. That said, given the Congress's lack of progress on enacting balanced deficit reduction, beginning work on what needs to be done in advance of issuing a Joint Committee sequestration order is both responsible and necessary. Until Congress acts, the Administration will continue to work, as necessary, on issues related to the sequestration and its implementation. The Administration will be ready, if necessary, to issue a Joint Committee sequestration order on January 2, 2013.

Mr. MCKEON. Will agencies be allowed to adjust programs through major reprogramming actions? Will the Administration seek an increase in the General and Special Transfer Authority caps for FY13 and, if so, by how much?

Mr. ZIENTS. Many agencies, particularly small agencies, do not have any existing transfer authority. Even for those that do, however, no amount of transfer authority is enough to mitigate a sequestration of this magnitude. Our focus should not be on trying to mitigate the impacts of sequestration. It is bad policy by design, and no amount of shifting funds around will change that or mitigate its impacts. That is why the Congress must act to pass a balanced deficit reduction package and avoid sequestration.

Mr. MCKEON. If military personnel accounts are exempt, how will sequestration cuts be applied to the Services? Will military personnel account totals be included or excluded in Service totals when the percentage distribution to PPAs is calculated?

Mr. ZIENTS. On July 31, OMB notified Congress of the President's intent to exercise his authority under section 255(f) of the Balanced Budget and Emergency Deficit Control Act of 1985, as amended, to exempt all military personnel accounts from sequestration. Exempting these accounts does not affect the total amount of the Joint Committee sequestration, but it excludes the funding in these accounts from calculations of the uniform percentage reduction required in non-exempt accounts. The same uniform percentage reduction would be applied to each non-exempt PPA in the defense category.

Mr. MCKEON. If military personnel accounts are exempt, what are the consequences for other Departmental PPAs?

Mr. ZIENTS. On July 31, OMB notified Congress of the President's intent to exercise his authority under section 255(f) of the Balanced Budget and Emergency Deficit Control Act of 1985, as amended (BBEDCA), to exempt all military personnel accounts from sequestration. Exempting these accounts does not affect the total amount of the Joint Committee sequestration, but it excludes the funding in these accounts from calculations of the uniform percentage reduction required in non-exempt accounts. Therefore, exempting military personnel accounts would increase the uniform percentage reduction required in non-exempt accounts in order to achieve the total amount of the Joint Committee sequestration. The same uniform percentage reduction would be applied to each PPA within a non-exempt account.

Mr. MCKEON. What steps, if any, will the Administration take to ameliorate WARN Act requirements in advance of sequestration's January 2, 2013, effective date? Would this guidance be issued over 90 days prior to the execution of sequestration?

Mr. ZIENTS. The Department of Labor (DOL), the agency charged with implementing the WARN Act, released guidance on the WARN Act on July 30, 2012. The DOL guidance explained that, in the context of the prospective across-the-board budget cuts that may occur on January 2, 2013, WARN Act notice to employees of Federal contractors is not required 60 days before that date, and in fact would be inappropriate, given the lack of certainty about how the budget cuts will be implemented and the possibility that sequestration will be avoided before January.

Mr. MCKEON. The Committee received testimony from industry witnesses, including the former Deputy Director of OMB, that the actual budget impact of sequestration will go far beyond the Budget Control Act requirement of a $55 billion FY13 topline reduction when the costs of contract cancellations, claims, personnel severances and other related actions are factored in. Do you agree or disagree with this observation and why? Do you have an estimate of how much in additional cuts could be required to achieve the BCA net FY13 topline reductions?

Mr. ZIENTS. The Joint Committee sequestration will have far-reaching consequences for a wide range of Government programs, including national security and critical investments necessary to foster economic growth. It is impossible to quantify the full impact that these arbitrary, across the board reductions can have. That is why the Administration firmly believes that the Congress should take action to enact a balanced deficit reduction plan in order to avoid sequestration.

Mr. MCKEON. The volume and magnitude of contract modifications and contract terminations will cause price changes for both prime and sub-contractors. Under current Government contracting rules, contractors will likely submit requests for equitable adjustments. What actions will OMB and the DOD, particularly DCAA and DCMA, need to take to respond to this volume of work?

Mr. ZIENTS. If sequestration were to occur, some contract modifications would be required, and contractors would likely submit equitable adjustment requests as a result. Responding to these adjustments would be costly and time consuming for the

Government's contracting professionals in order to ensure that both the contractor and the taxpayer would be treated fairly. With respect to DCAA (Defense Contract Audit Agency) and DCMA (Defense Contract Management Agency) in particular, I defer to the Department of Defense as to how this would be managed at the appropriate time.

Mr. MCKEON. Does the Department plan to use transfer authority after a possible sequester to avoid the impact on certain PPAs, including OCO? On what transfer authority will the Department rely?

Secretary CARTER. [The information was not available at the time of printing.]

Mr. MCKEON. In advance of sequestration, does the Department plan to adjust its recruiting goals or place any freezes on separations, including retirements?

Secretary CARTER. [The information was not available at the time of printing.]

Mr. MCKEON. What is the requirement for providing advance notification to service members prior to making involuntary separations?

Secretary CARTER. [The information was not available at the time of printing.]

Mr. MCKEON. If FY13 funding is sequestered, will the DOD have to implement a reduction in force (RIF) within its civilian workforce?

Secretary CARTER. [The information was not available at the time of printing.]

Mr. MCKEON. If civilian reductions are planned and a RIF is implemented, how many civilians will be let go to achieve the savings necessary to comply with funding reductions? Will civilian jobs be eliminated on the basis of tenure or on the basis of critical skill sets?

Secretary CARTER. [The information was not available at the time of printing.]

Mr. MCKEON. What are the costs associated with a RIF, and would those additional costs be recovered through higher civilian reductions?

Secretary CARTER. [The information was not available at the time of printing.]

Mr. MCKEON. In compliance with 10 U.S.C. 1597, the DOD has established guidelines for the manner in which reductions in the number of civilian positions within the Department are made. The DOD is required to notify employees 60 days prior to the effective date of any civilian reduction or furlough action. In addition, 10 U.S.C. 1597 also states that the DOD may not implement any involuntary reduction or furlough of civilian positions until the expiration of the 45-day period beginning on the date on which the Secretary submits to Congress a report setting forth the reasons why such reductions or furloughs are required. Does the DOD intend to submit this report to Congress? If so, when?

Secretary CARTER. [The information was not available at the time of printing.]

Mr. MCKEON. Has a plan for the reduction of civilian personnel been initiated? What is the communication plan to provide information to civilian employees? If no plan has been initiated, why not? Has any guidance been issued to prevent such planning?

Secretary CARTER. [The information was not available at the time of printing.]

Mr. MCKEON. Do you intend to take a balanced approach to civilian and military personnel reductions, or will military or civilian end strength be disproportionately impacted by sequester?

Secretary CARTER. [The information was not available at the time of printing.]

Mr. MCKEON. What is the position of the Department of Defense on the allowability of any WARN Act compliance costs that result from sequestration? Is the Department prepared to accept financial responsibility for any and all costs incurred from compliance by contractors with the requirements of the WARN Act through advance agreements or other established mechanisms?

Secretary CARTER. [The information was not available at the time of printing.]

Mr. MCKEON. Absent the passage of legislation, signed into law by the President, that modifies sequestration, do you agree that layoffs are reasonably foreseeable?

Secretary CARTER. [The information was not available at the time of printing.]

Mr. MCKEON. Do you agree that Federal law requires contractors to provide notice of mass layoffs or plant closings at least 60 days prior to implementing such actions?

Secretary CARTER. [The information was not available at the time of printing.]

Mr. MCKEON. Do you believe that any of the exceptions of the WARN Act apply? For example, are layoffs under sequestration "sudden, dramatic, or unexpected"?

Secretary CARTER. [The information was not available at the time of printing.]

Mr. MCKEON. What is your position on the assessment of many in industry that, barring additional guidance, WARN Act notices will have to be sent out before January 2nd?

Secretary CARTER. [The information was not available at the time of printing.]

Mr. MCKEON. Sequestration may cause the Government to make unilateral changes to tens of thousands, if not hundreds of thousands, of Government contracts and task orders. How will the Department manage this level of contract dislocation?

Secretary CARTER. [The information was not available at the time of printing.]

Mr. MCKEON. What methodology will you use to determine if contracts will be terminated or modified? How will you determine estimated costs associated with contract modifications?

Secretary CARTER. [The information was not available at the time of printing.]

Mr. MCKEON. Do you have a preliminary estimate of the potential termination costs and increased contract costs due to renegotiation and reinstatement of contracts? If not, how do you know how much you will have to cut in order to generate $55 billion in net savings?

Secretary CARTER. [The information was not available at the time of printing.]

Mr. MCKEON. Would any resultant terminations be characterized as terminations for convenience? Why or why not?

Secretary CARTER. [The information was not available at the time of printing.]

Mr. MCKEON. Is it possible that major defense acquisition programs could be terminated due to sequestration?

Secretary CARTER. [The information was not available at the time of printing.]

Mr. MCKEON. Have you issued Department-wide guidance regarding the awarding of new FY12 fourth-quarter or FY13 first-quarter contracts, as well as whether to exercise options on existing contracts? If not, when will you issue guidance? What criteria will you offer contracting officers who must make these decisions?

Secretary CARTER. [The information was not available at the time of printing.]

Mr. MCKEON. Modifications to contracts pursuant to sequestration may cause major defense acquisition programs to reach either a significant or critical cost breach under Nunn-McCurdy. How will the DOD handle such occurrences? To limit disruption to major defense acquisition programs, will the Administration seek Congressional relief for Nunn-McCurdy breaches solely caused by sequestration?

Secretary CARTER. [The information was not available at the time of printing.]

Mr. MCKEON. Have any major defense acquisition programs started to plan for sequestration? For example, have any programs delayed contract awards planned for fiscal year 2012 or slowed spending plans so that they can carry over additional funds to fiscal year 2013?

Secretary CARTER. [The information was not available at the time of printing.]

Mr. MCKEON. The Department of Defense is typically reluctant to use "re-opener" clauses in its contracts. In light of the numerous unknowns attached to sequestration, will the DOD include "re-opener" clauses in contracts awarded after October 1, 2012?

Secretary CARTER. [The information was not available at the time of printing.]

Mr. MCKEON. Sequestration would potentially take effect while you were in the final stages of constructing the FY14 request. What impact would this have on your budget building process?

Secretary CARTER. [The information was not available at the time of printing.]

Mr. MCKEON. What steps has the Department taken to assess the risks and identify potential implications to missions and critical skills and competencies?

Secretary CARTER. [The information was not available at the time of printing.]

Mr. MCKEON. Given that OCO funds are subject to sequestration, how will the Department continue to support ongoing operations in Afghanistan?

Secretary CARTER. [The information was not available at the time of printing.]

Mr. MCKEON. Can you please provide an assessment of the impact on ongoing operations and the safety of United States military and civilian personnel?

Secretary CARTER. [The information was not available at the time of printing.]

Mr. MCKEON. Can you please provide an assessment of the impact on the readiness of the Armed Forces, including impacts to steaming hours, flying hours, and full spectrum training miles, and an estimate of the increase or decrease in readiness (as defined in the C status C–1 through C–5)?

Secretary CARTER. [The information was not available at the time of printing.]

Mr. MCKEON. If OCO accounts are sequestered and money is pulled from the base budget to cover the costs of war, as General Dempsey has suggested, what will be the impact to the Army and Marine Corps procurement and O&M accounts?

Secretary CARTER. [The information was not available at the time of printing.]

Mr. MCKEON. Have you started to revise the current strategic guidance? The Department has previously stated that the current strategy will have to be revisited in the event of sequestration. The last guidance took nearly a year to develop. What will you do in the absence of a defense strategy when sequestration takes effect?

Secretary CARTER. [The information was not available at the time of printing.]

Mr. MCKEON. Given that the FY13 sequestration requires a specified amount of reductions, the longer that sequestration actions are delayed past January 2, 2013, the larger the cut that would need be applied over the remaining period of FY13. Will the Administration be ready to execute sequestration on January 2, 2013, and, if not, why not?

Secretary CARTER. [The information was not available at the time of printing.]

Mr. MCKEON. Will agencies be allowed to adjust programs through major reprogramming actions? Will the Administration seek an increase in the General and Special Transfer Authority caps for FY13 and, if so, by how much?

Secretary CARTER. [The information was not available at the time of printing.]

Mr. MCKEON. If military personnel accounts are exempt, how will sequestration cuts be applied to the Services? Will military personnel account totals be included or excluded in Service totals when the percentage distribution to PPAs is calculated?

Secretary CARTER. [The information was not available at the time of printing.]

Mr. MCKEON. If military personnel accounts are exempt, what are the consequences for other Departmental PPAs?

Secretary CARTER. [The information was not available at the time of printing.]

Mr. MCKEON. What steps, if any, will the Administration take to ameliorate WARN Act requirements in advance of sequestration's January 2, 2013, effective date? Would this guidance be issued over 90 days prior to the execution of sequestration?

Secretary CARTER. [The information was not available at the time of printing.]

Mr. MCKEON. The Committee received testimony from industry witnesses, including the former Deputy Director of OMB, that the actual budget impact of sequestration will go far beyond the Budget Control Act requirement of a $55 billion FY13 topline reduction when the costs of contract cancellations, claims, personnel severances and other related actions are factored in. Do you agree or disagree with this observation and why? Do you have an estimate of how much in additional cuts could be required to achieve the BCA net FY13 topline reductions?

Secretary CARTER. [The information was not available at the time of printing.]

Mr. MCKEON. The volume and magnitude of contract modifications and contract terminations will cause price changes for both prime and sub-contractors. Under current Government contracting rules, contractors will likely submit requests for equitable adjustments. What actions will OMB and the DOD, particularly DCAA and DCMA, need to take to respond to this volume of work?

Secretary CARTER. [The information was not available at the time of printing.]

QUESTIONS SUBMITTED BY MR. LANGEVIN

Mr. LANGEVIN. In the event that FY13 begins under a continuing resolution, how will sequestration calculations be applied?

Mr. ZIENTS. Pursuant to sections 251A(7) and 253(f)(2) of BBEDCA, the sequestration would be applied against the annualized amount available under the Continuing Resolution.

Mr. LANGEVIN. You note in your testimony that the Department cannot even substantially mitigate the effects of sequester and that there are significant risks of triggering adverse consequences even if sequester does not happen. When must Congress act in order to forestall this possibility?

Secretary CARTER. [The information was not available at the time of printing.]

Mr. LANGEVIN. Sequestration would potentially take effect while you were in the final stages of constructing the FY14 request. What impact would this have on your budget building process?

Secretary CARTER. [The information was not available at the time of printing.]

Mr. LANGEVIN. Given that, per the Budget Control Act, Congress determined that OCO funds are subject to sequestration, how will the Department continue to support ongoing operations in Afghanistan?

Secretary CARTER. [The information was not available at the time of printing.]

QUESTIONS SUBMITTED BY MR. COURTNEY

Mr. COURTNEY. Please describe any impact of sequestration on existing multiyear procurement contracts. For example, FY13 is the last year of a five-year block buy of *Virginia* class submarines—how would sequester impact the last year of that contract and, specifically, impact the two submarines set to begin construction in FY13?

Mr. ZIENTS. Sequestration would impose a significant acquisition management burden on the agencies, and it would adversely affect nearly every multiyear procurement contract. However, any effects on specific contracts depend on decisions by agencies that have not yet been made.

Mr. COURTNEY. Please describe any impact of sequestration on existing multiyear procurement contracts. For example, FY13 is the last year of a five-year block buy of *Virginia* class submarines—how would sequester impact the last year of that contract and, specifically, impact the two submarines set to begin construction in FY13?

Secretary CARTER. [The information was not available at the time of printing.]

QUESTIONS SUBMITTED BY MR. SCHILLING

Mr. SCHILLING. Do you believe that the President took into account single points of failure in our national security and industrial base when making these "difficult choices" in his budget?

Mr. ZIENTS. Although many difficult choices had to be made in its development, the President's FY 2013 Budget fully supports the defense strategy announced in January 2012, which was the product of several months of deliberation among DOD's most senior leaders as well as extensive engagement by the National Security Staff and the President. The Administration is committed to maintaining a healthy industrial base and always considers effects on the industrial base in its planning.

Mr. SCHILLING. Because the Senate has not yet passed a budget or any appropriations bills, Congress is very likely headed towards a Continuing Resolution (CR). How will a CR change the calculations you will do for sequestration?

Mr. ZIENTS. Pursuant to sections 251A(7) and 253(f)(2) of BBEDCA, the sequestration would be applied against the annualized amount available under the Continuing Resolution.

Mr. SCHILLING. If you already know how you must implement sequestration by law and the high likelihood of a CR being the base from which you take your numbers off of, why do you not already have fair estimates of the cuts to departments, agencies and programs?

Mr. ZIENTS. The Sequestration Transparency Act of 2012 Report submitted to Congress last week contains preliminary estimates of the required cuts based on FY 2012 funding levels. However, appropriations legislation that is actually enacted for the fiscal year beginning on October 1, 2012 will change the estimates provided in the report. Other legislation, including any enacted changes to direct spending levels between now and January 2, 2013, as well as changes in the level of unobligated balances in the defense function, could also affect these estimates. Depending on the timing of the discretionary Final Sequestration Report for FY 2013, the discretionary spending limits could be adjusted as provided by section 251(b)(2) of BBEDCA, which would change the allocation of the Joint Committee reductions between the defense and nondefense functions. In addition, OMB continues to review the application of various provisions of BBEDCA to specific programs and accounts. For all of these reasons, it is impossible to calculate the exact amount of reductions that will be required in any given account at this time.

Mr. SCHILLING. How long will it take you to make the necessary calculations for sequestration and how much time will agencies and programs have to prepare for those cuts—ie, your implementation time?

Mr. ZIENTS. OMB has experience in executing budget enforcement provisions and will be ready, if necessary, to issue the Joint Committee sequestration order on January 2, 2013.

Mr. SCHILLING. Director Zients stated that obligated balances would be factored into the cuts. How will this affect the industrial base—both organic and private?

Secretary CARTER. [The information was not available at the time of printing.]

Mr. SCHILLING. What precisely does the personnel funding exception from Sequestration entail?

Secretary CARTER. [The information was not available at the time of printing.]

Mr. SCHILLING. You pointed out that our Intelligence Community gets much of its funding from the DOD budget. Can you expand on the exact impacts to our ability to react and respond to threats this would cause? Can you also talk about the trickle-down effect to how this will affect our homeland security forces?

Secretary CARTER. [The information was not available at the time of printing.]

QUESTION SUBMITTED BY MR. WEST

Mr. WEST. Should the sequester take effect, how do you feel the monetary and military aid given to Israel, with respect to the Arrow Weapons System and David's Sling Weapons System, be affected.

Secretary CARTER. [The information was not available at the time of printing.]

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