



BIPARTISAN POLICY CENTER

From Merely Stupid to Dangerous: The Sequester's Effects on National and Economic Security

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- Because of the structure of defense spending, our national security forces and defense industry have been able to continue operating under sequestration, but not without damage.
- The full brunt of the cuts hasn't hit yet, and if we go down the sequester path for too long, we won't be able to reverse the devastating impacts.
- It isn't primarily the size of either the federal budget or the defense budget that poses problems; it is the dramatic change in the composition of those budgets over the decade—entitlements are pushing out investments. And sequester worsens that trend.
- Essential government services, especially in defense, are not being performed, and will not be if sequester continues.
- The combination of sequester cuts and unaddressed cost increases will erode force readiness, stall modernization, and reduce the fighting forces by at least 50% by 2021.
- The impact of the defense sequester on spending, which drives the economic impact, will double in Fiscal Year (FY) 14 and triple in FY 15, compared to FY 13.

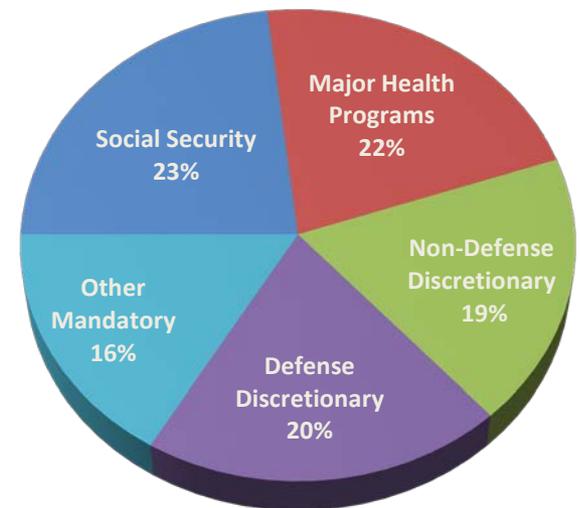
- Over the past few years, the financial crisis and the federal government's response have driven debt to historically high levels as a percentage of gross domestic product (GDP).
- Absent reforms, within a decade, the debt will resume its steady march upward as the Baby Boom generation ages, health care costs continue to rise, and the inefficient federal tax code provides insufficient revenue to keep pace.

- Spending on entitlement programs will soon consume more than half of the federal budget, squeezing funds available for national security and domestic spending.

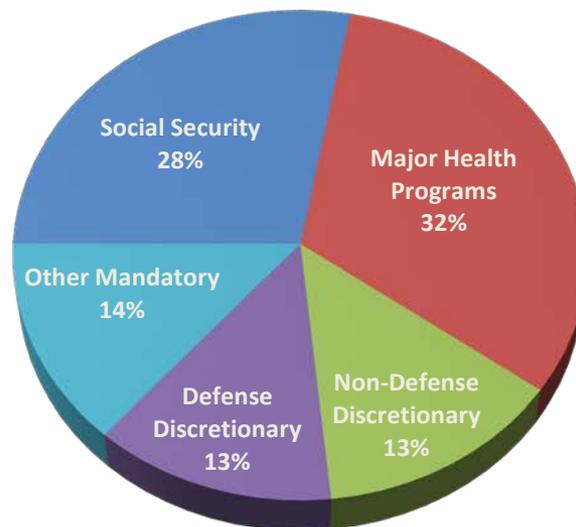
1992



2012



2022 (projected)



Sources: President's Fiscal Year 2014 Budget, Congressional Budget Office historical spending data, Bipartisan Policy Center calculations

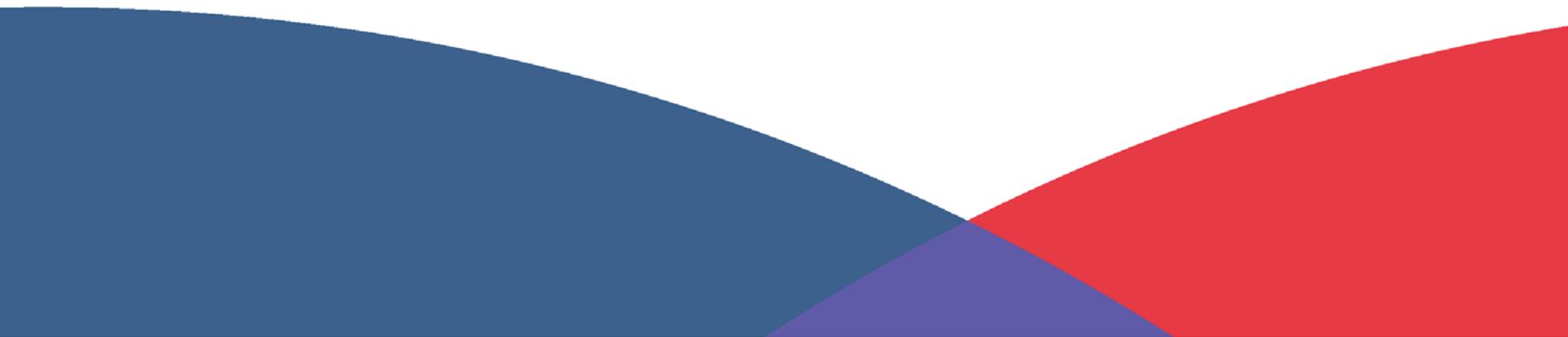
- In 2011, Congress passed and the President signed the Budget Control Act, which imposed caps on domestic and defense discretionary spending. The law also established a congressional “supercommittee,” charged with finding a long-term fiscal plan. The supercommittee failed, which triggered the across-the-board cuts, called the sequester.
- In other words, without political consensus on how to change how we spend money, the sequester is *arbitrarily* and *automatically* cutting *how much* we spend.
- Sequestration exacerbates the trend portrayed in the pie charts on the previous slide.

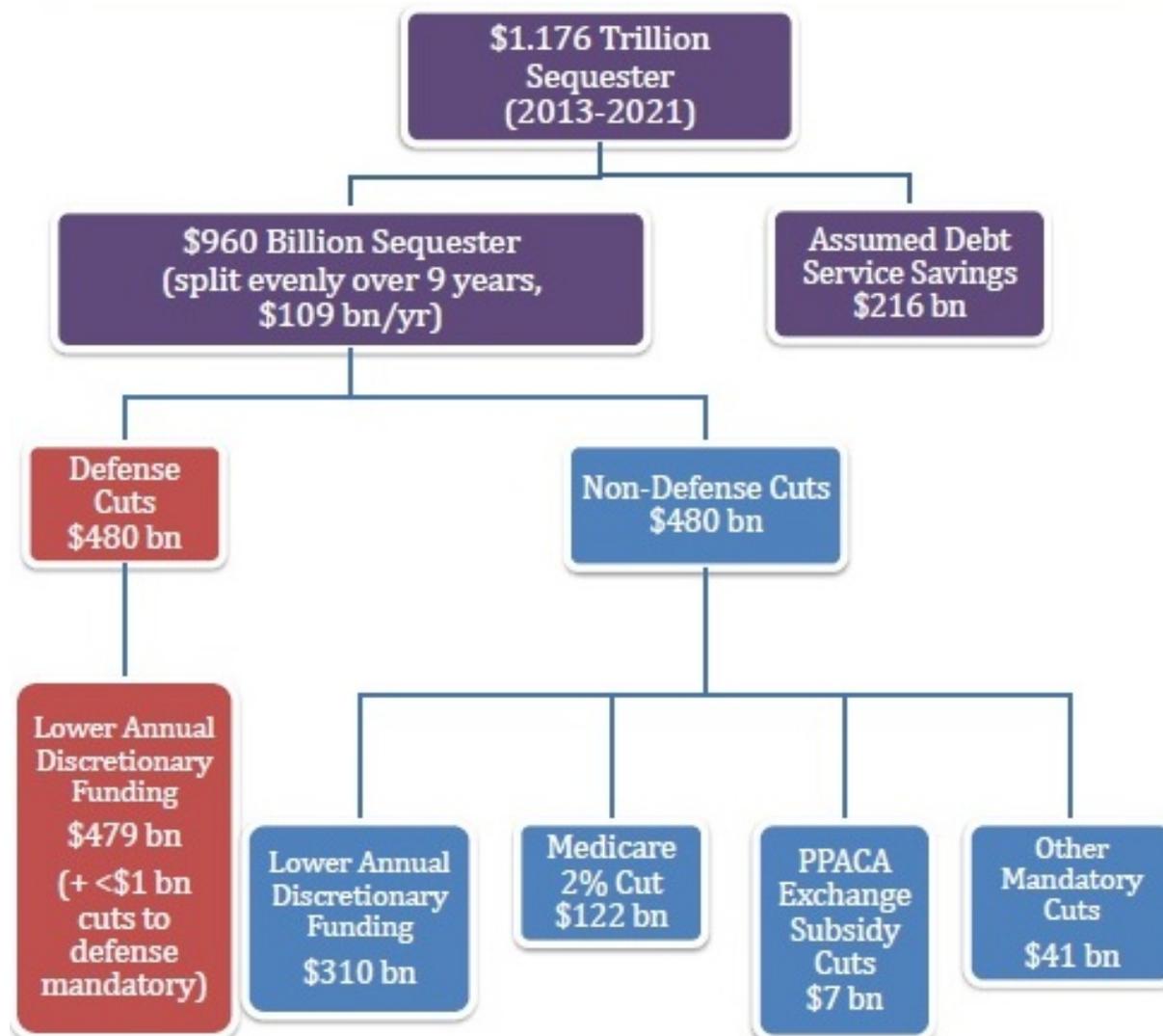
- **Some prominent individuals believe that the sequester is a successful, harmless deficit-reduction tool:**
 - “The sequester cuts in annual budgets for the military, education, transportation and other discretionary programs have also been an underappreciated success, with none of the anticipated negative consequences.”
 - Stephen Moore, *The Wall Street Journal*
- **Data cited by “sequester boosters”:**
 - Our military is still the strongest in the world and it was prepared to engage in Syria, if necessary
 - Major defense contractor stocks are on the rise
 - The economy is still growing, if slowly
 - Spending and the deficit are down, both in real terms and as a percentage of GDP

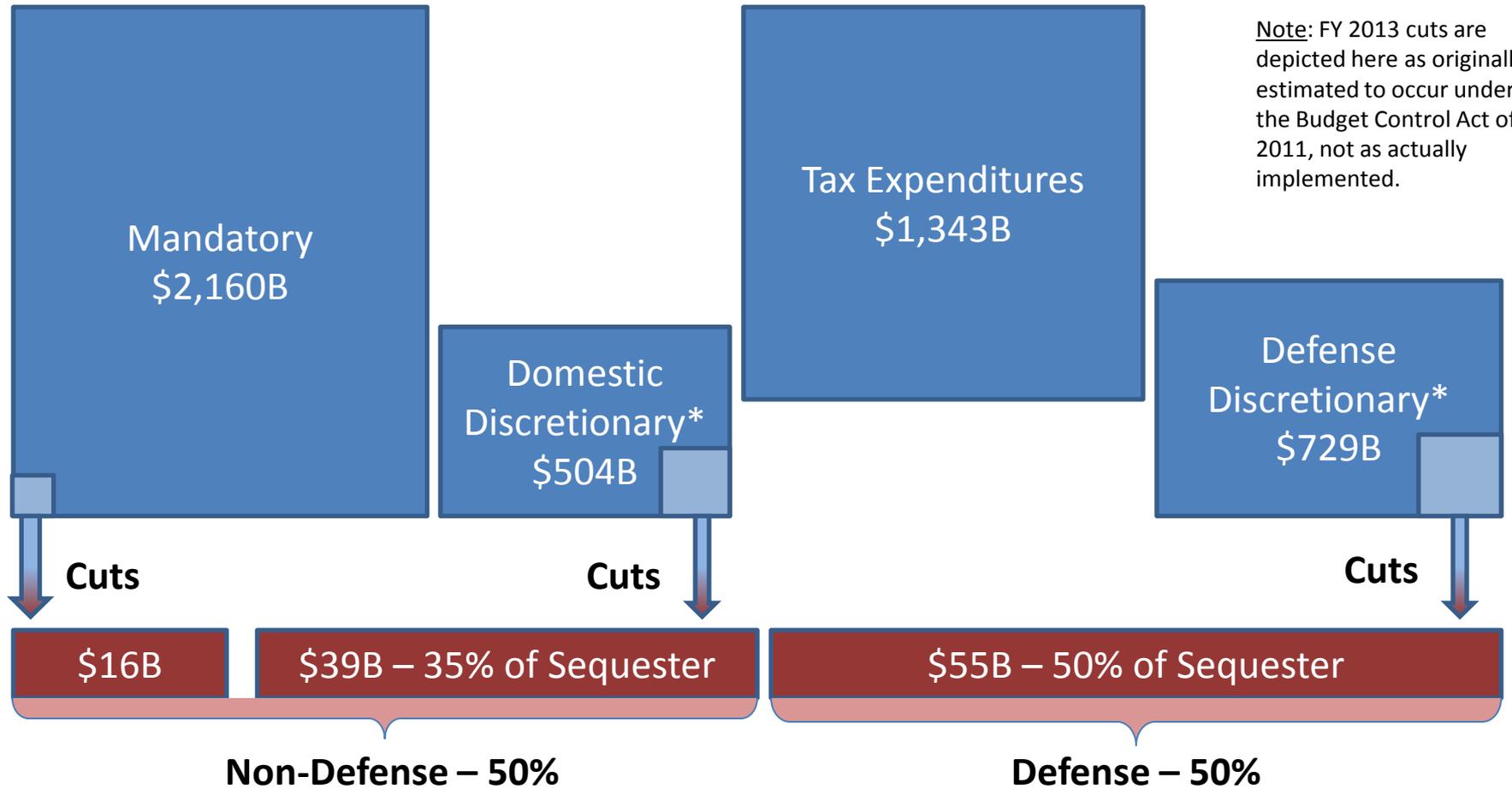
- **Our analysis and the facts indicate that this is NOT TRUE.**
- **Sequester is causing lasting, long-term harm:**
 - Exacerbates the budget's structural problems;
 - Corrodes national security;
 - Hampers the economic recovery.
- **These impacts will become more visible and grow in magnitude in FY 2014.**



Fiscal Year 2013 Sequester Implementation







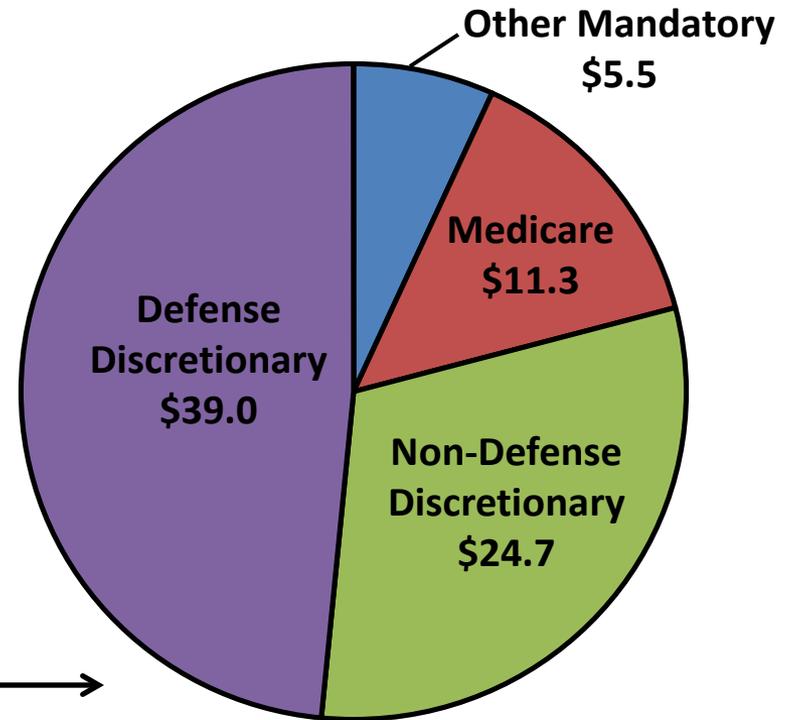
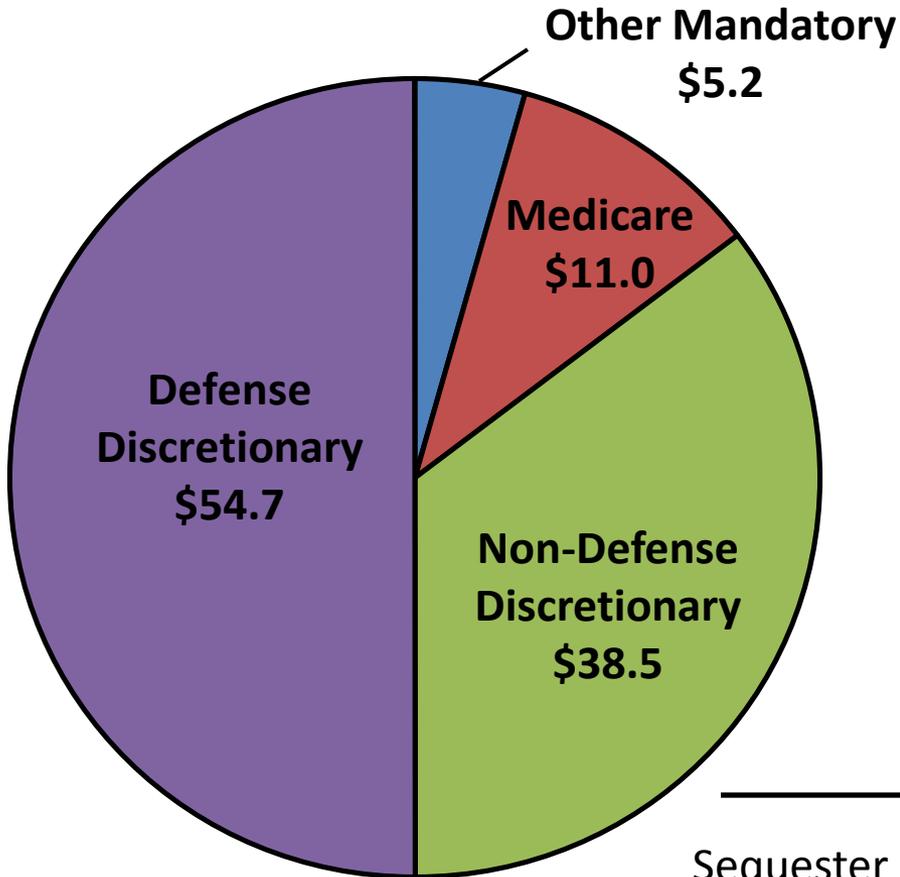
* These amounts include all discretionary budgetary resources for the duration of FY 2013, not solely the non-exempt monies that are subject to sequester. Additionally, the figures assume that a continuing resolution at FY 2012 levels is enacted for FY 2013, that war funding (Overseas Contingency Operations funds) is provided at the level requested by the president. Defense discretionary funds include unobligated balances from prior years, which are subject to sequester.

Sources: Congressional Budget Office, Donald Marron and Tax Policy Center using data from the Office of Management and Budget and Treasury

HOW THE FISCAL YEAR 2013 SEQUESTER CUTS HAVE CHANGED

**Original Estimated FY 2013 Cut:
\$109.3 Billion**

**Final Total FY 2013 Cut:
\$80.5 Billion**



Sequester reduced by
~\$29 billion

- In many ways, the FY 2013 sequester ended up being different than expected, mitigating the pain being felt in 2013:
 - Timing: Cuts started to take effect in June, not January
 - Reduced Reductions: \$37B cut from DoD, not \$52B
 - Additional Defense Appropriations: Defense spending was bumped up (at the expense of domestic spending) in the March funding bill, offsetting some of the FY 2013 sequester cuts
 - Exemptions of funds: Cuts were heavily focused on readiness & investment pieces of the defense budget

Original FY13 Sequester to Defense Spending (050) = \$54.7 billion



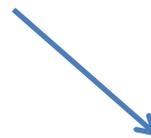
“Fiscal Cliff” Deal (-\$12 billion)

\$42.7 billion



“Credits” for cutting accounts below sequester-levels in March appropriations bill (-\$3.7 billion)

\$39.0 billion

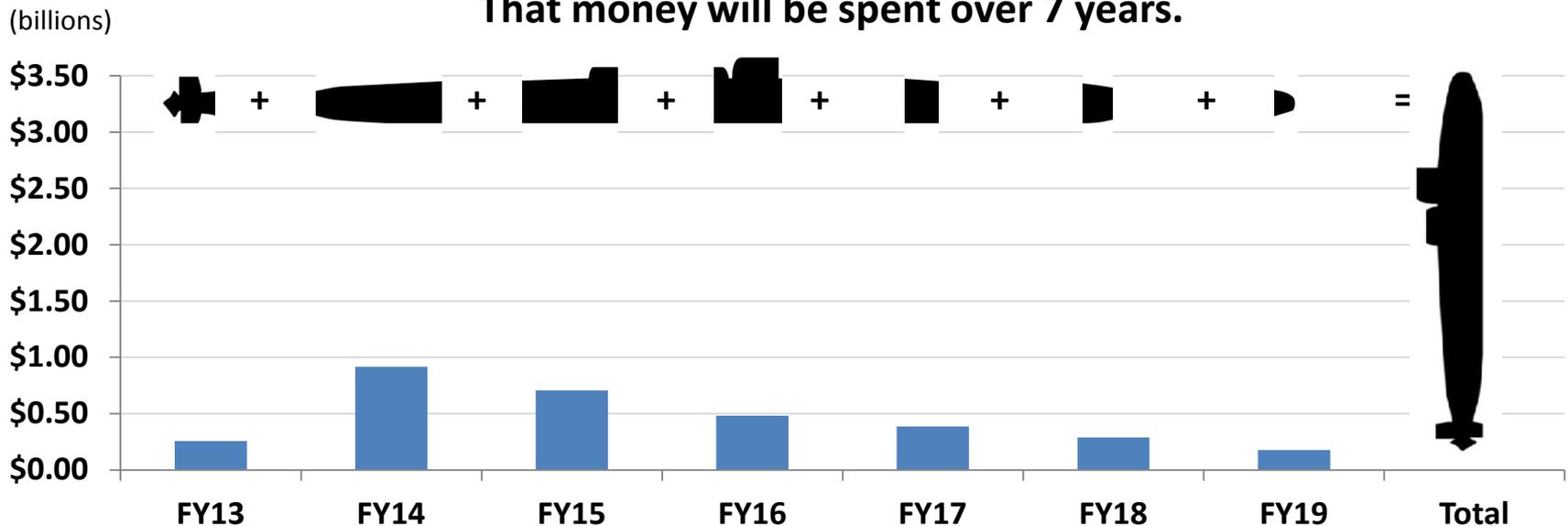


Sequester Cuts to Department of Defense (051) Discretionary Spending = \$37.2 billion

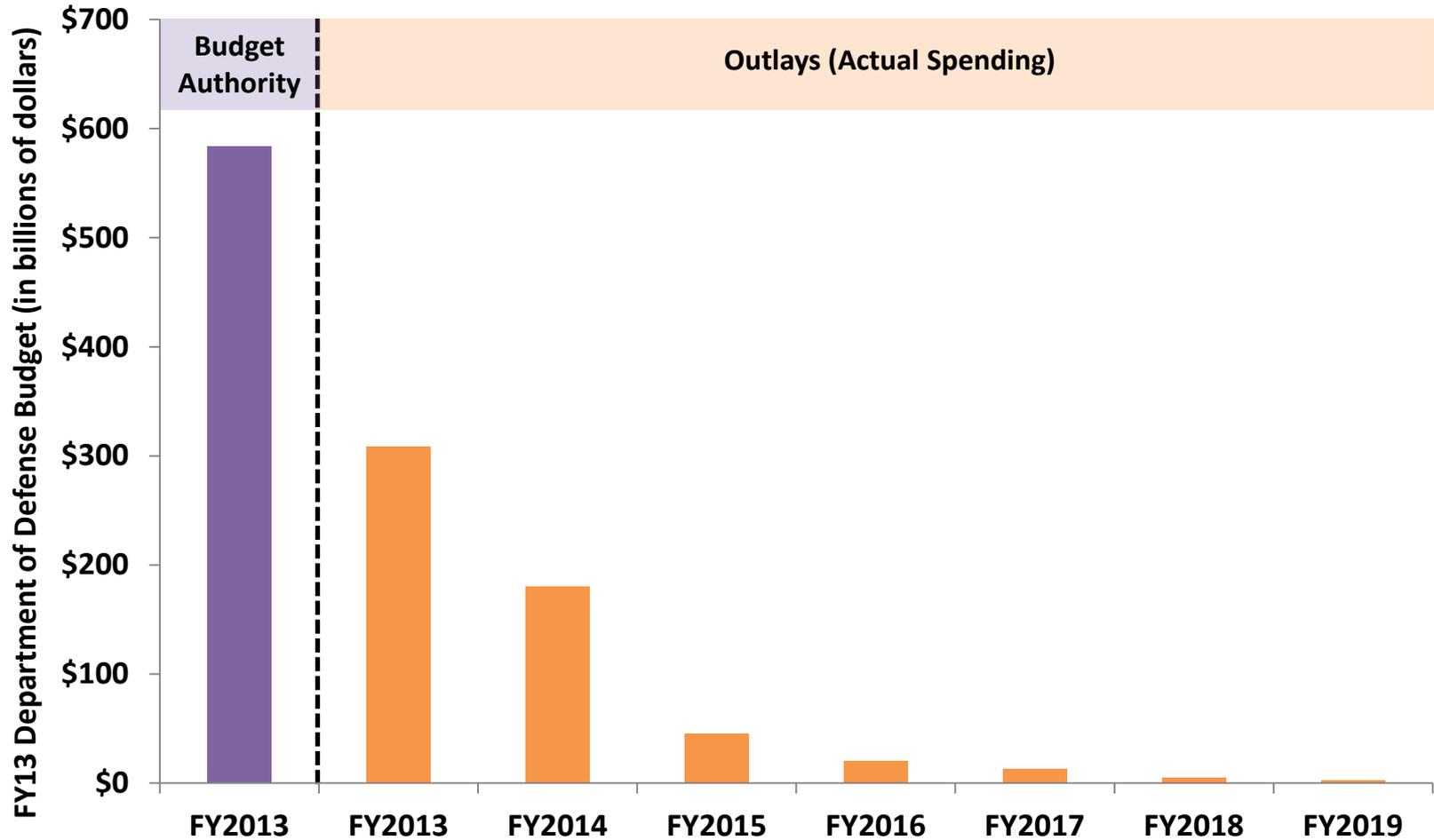
Sequester Cuts to Other Defense-Related Spending (053/054) = \$1.8 billion

- Each year, Congress appropriates money to the Department of Defense (DoD) with authorization to spend it according to a specified budget. This is known as *budget authority (BA)*, and is how the sequester cuts are measured.
- But DoD does not spend all this money in that same year. Actual spending is known as *outlays*.
- Weapons systems are effectively bought on installment.

**In FY13, Congress gave DoD \$3.2 billion for new submarines.
That money will be spent over 7 years.**

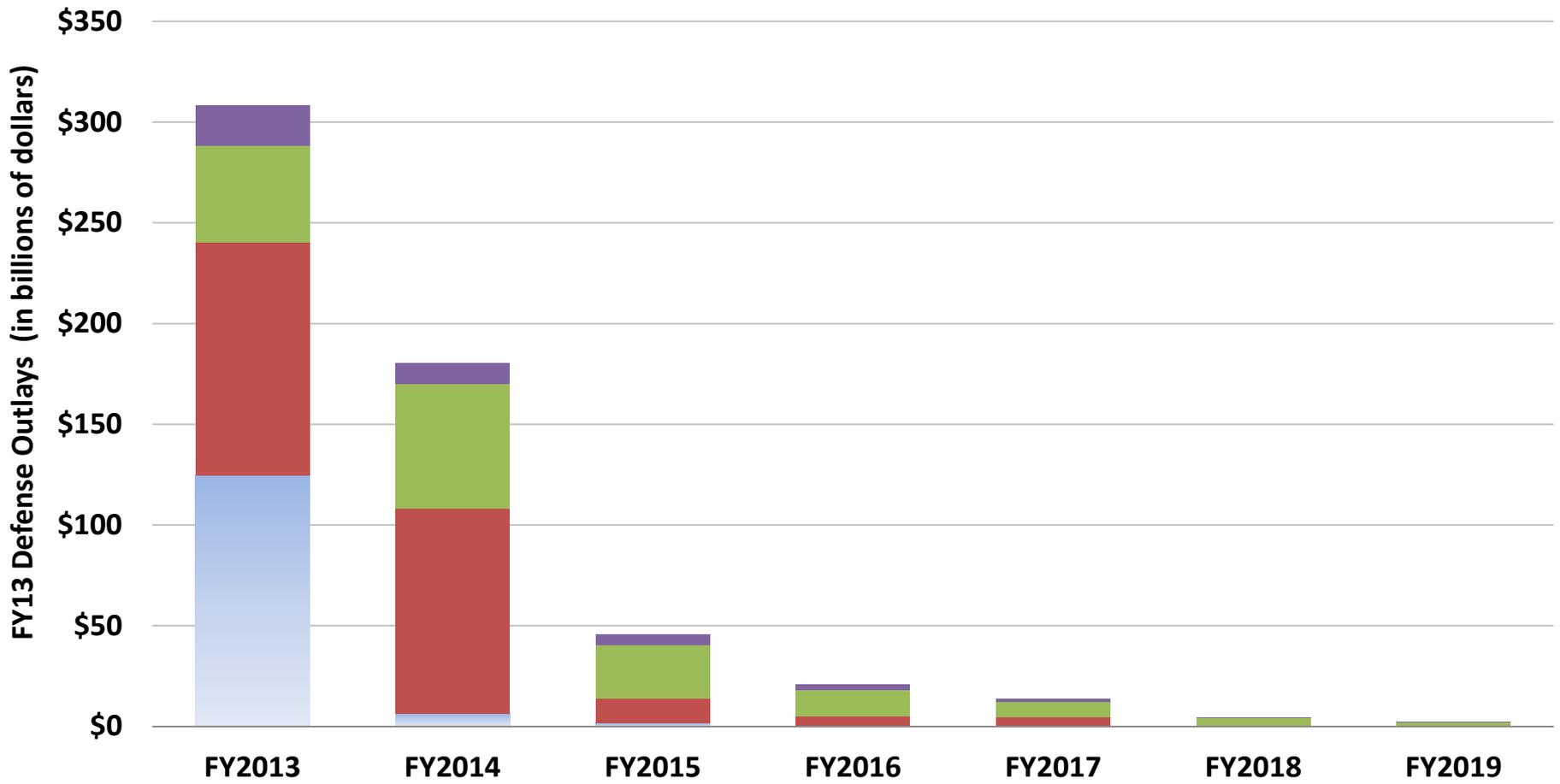


THE FY13 DEFENSE BUDGET WILL BE SPENT OVER MANY YEARS



Sources: Department of Defense; Bipartisan Policy Center calculations

FY13 DEFENSE OUTLAYS BY CATEGORY



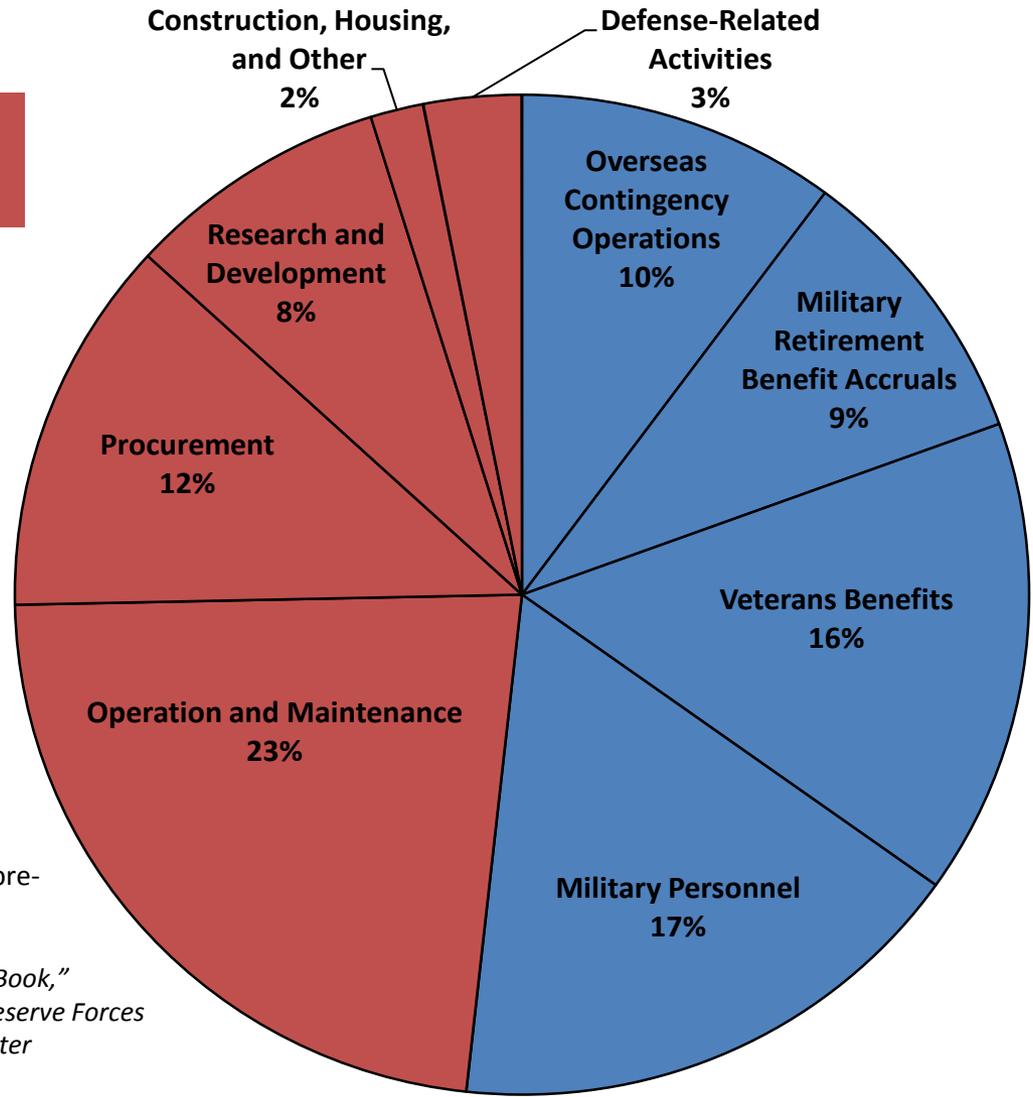
■ Military Personnel (exempt) ■ Operations and Maintenance ■ Procurement and R+D ■ Other

Sources: Department of Defense; Bipartisan Policy Center calculations

- **Much defense-related spending is not subject to sequester.**
- **Exempt spending includes:**
 - Military Personnel
 - War-fighting costs (known as Overseas Contingency Operations)
 - Military retiree benefits, including some that are not paid out of the Department of Defense budget
 - Veterans Benefits
- **Some (but not all) exempt categories spend out particularly quickly, delaying sequester's impact.**
- **Exemptions mean cuts fall more heavily on certain areas:**
 - Operations and maintenance
 - Procurement
 - Research and development

Areas subject to sequester cuts

Areas exempt from sequester cuts



Note: Figures based on FY 2013 pre-sequester appropriations.

Sources: DoD Comptroller "Green Book," Congressional Research Service, Reserve Forces Policy Board, Bipartisan Policy Center calculations



What are the short- and long-term impacts of the sequester on **National Security?**

- Force readiness deteriorating: Military is approaching post-Vietnam hollow force—most non-deploying units are not combat ready.
- Modernization stalled: Research and procurement of weapons systems critical for future missions has been significantly cut, leading to unit cost increases and schedule delays.
- Decision process broken: The proven method of linking vital interests, threats, military strategy, requirements, and resources has been broken by sequester's automatic cuts.
- Structural problems exacerbated: The combination of sequester and unaddressed structural problems in the defense budget—growing spending on personnel, massive overhead, and inefficient acquisition—will reduce the fighting forces by at least 50% by 2021.

Sequester is driving all key elements of force readiness downwards:



- the number of personnel in their units against the number required;

- the individual skill training of personnel in their military occupational specialty;

- the unit training in its mission (both as individuals and as a maneuver unit);

- the equipment the unit is required to have;

- and whether that equipment is operational.

- **Readiness of the units not currently deployed or about to be deployed has gone from combat-ready to not combat-ready:**
 - Army: "...we will have significantly degraded readiness in which 85% of our active and reserve brigade combat teams will not be prepared for contingency requirements; flying and training has been curtailed or cancelled."
 - Navy: "...we will have only one non-deployed carrier strike group and one amphibious ready group trained and ready....maintenance and overhaul has been severely cut."
 - Air Force: "...over 30 squadrons have been grounded, pilot flying hours have been cut by 18%, workload at depots has been cut by over 30%."
 - Marines: "...units not slated for Afghanistan are at the lowest readiness level and is driving the USMC to a one-to-two dwell – gone 6 months, home 12 months, gone 6 months."

Source: Armed Services Committee Hearings, Sept. 18, 2013

SEQUESTER CUT TO PROCUREMENT OF TOP-TEN PROGRAMS (\$M)

Program	FY 2013 Enacted	FY 2013 Sequester	Prior Year Obligations	Prior FY Cut	Total Cuts
F-35s	\$5,240.0	-\$814.9	\$4,652.6	-\$0.7	-\$815.5
DDG-51	\$3,035.3	-\$502.7	\$2,855.1	\$0.0	-\$502.7
Virginia Class Submarine	\$3,213.4	-\$353.9	\$1,619.5	-\$138.4	-\$492.3
P-8 Poseidon Aircraft	\$2,382.1	-\$122.1	\$422.5	-\$112.0	-\$234.2
F/A-18E/F Hornet	\$2,578.2	\$0.0	\$325.3	-\$221.3	-\$221.3
Littoral Combat Ship	\$1,782.6	-\$43.6	\$671.9	-\$140.6	-\$184.2
CVN Refueling Overhauls	\$1,746.1	-\$93.3	\$282.0	-\$83.0	-\$176.3
UH-60 Blackhawk	\$1,304.4	-\$8.4	\$334.8	-\$120.0	-\$128.3
Trident II Modifications	\$1,198.3	-\$100.3	\$195.0	-\$11.8	-\$112.1
CH-47 Helicopter	\$1,184.5	-\$110.0	\$78.6	-\$1.8	-\$111.8
Totals	\$23,664.9	-\$2,149.2	\$11,437.3	-\$829.6	-\$2,978.8

- Almost every essential program is at risk, either through program reductions or termination.
- Prospective result: Unit cost increases, schedule delays, adverse effects on industrial base.

- **Army**

- “...will end, restructure or delay over 100 acquisition programs, putting at risk the ground combat vehicle program, the armed aerial scout, the production and modernization of our other aviation programs, system upgrades for unmanned aerial vehicles and the modernization of our air defense command-and-control systems...”

- **Navy**

- “...will lose at least a Virginia-class submarine, a littoral combat ship and a float-forward staging base. We will be forced to delay the delivery of the next aircraft carrier, the Ford, and will delay the midlife overhaul of the George Washington aircraft carrier. Also, we'll cancel procurement of 11 tactical aircraft...”

- **Air Force**

- “We are looking at cutting as many as 50 percent of our modernization programs. We will favor recapitalization over modernization whenever that decision is required. That's why our top three acquisition priorities will remain the KC-46, the F-35 and the long-range strike bomber.”

- **Marine Corps**

- “We will be forced to reduce or cancel modernization programs and infrastructure investments in order to maintain readiness for those deployed and next-to-deploy units. Money that should be available for procuring new equipment will be rerouted into maintenance and spare accounts for our legacy equipment. This includes our 42-year-old Nixon era amphibious assault vehicle.”

Source: Armed Services Committee Hearings, Sept. 18, 2013

- The technology seed-corn for future capabilities has been adversely impacted.
- \$6B cut from 738 of 764 research and development programs in FY 2013.
- Programs impacted include:
 - Electronic warfare technology
 - Medical technology
 - Night vision technology
 - Intelligence technology
 - Cryptologic gear and rapid cyber technology
 - Air operations command and control
 - Undersea warfare technology
 - Nuclear arms control monitoring and nuclear detection
- Average cut to RDT&E programs was 8% of total funding (when including prior year balances).

Source: Department of Defense

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THE RIGHT WAY



- DoD excels at long-term planning, programming, budgeting, and execution processes.
- This is a multi-year approach that proceeds from threats to strategy to resources resulting in a budget recommendation to Congress.
- Congress undertakes authorization and appropriation process with extensive hearings and oversight resulting in approval or disapproval of DoD recommendations at all levels.

THE WRONG WAY



- Sequester breaks these links and replaces thoughtful prioritization and decision-making with mindless cuts.

- Sequester does not curtail the dramatic growth in per-capita cost of military and civilian personnel.
- The cost of personnel has almost doubled since 2000.
 - DoD is spending \$110B more for a force that is almost 10% smaller (1.5M active duty at the time vs. 1.4M today).
- Fully-Burdened costs of active duty:
 - FY 2013 = \$384K

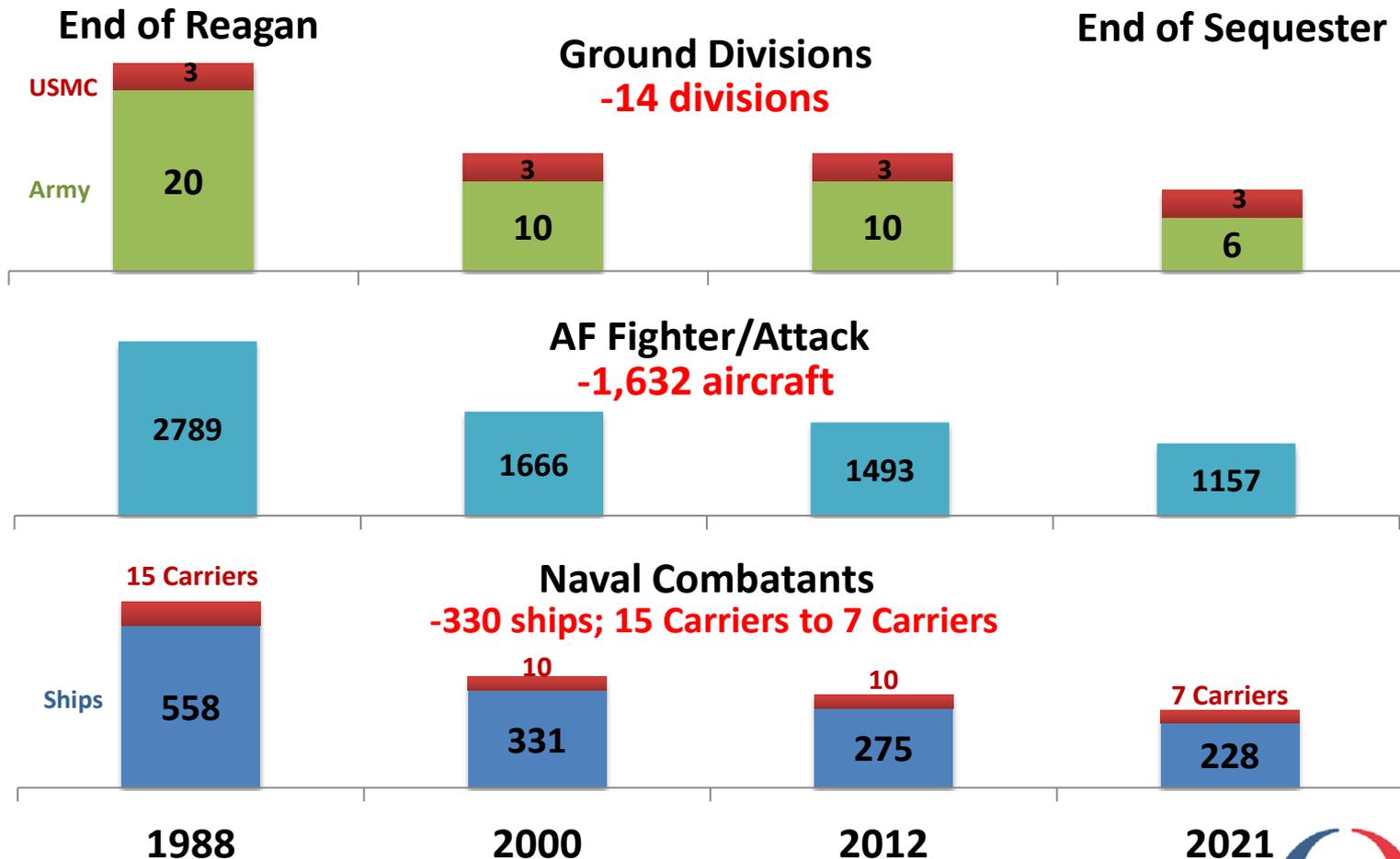
- Combination of sequester cuts with internal cost growth in personnel and overhead and inefficient acquisition will halve combat forces by 2021.

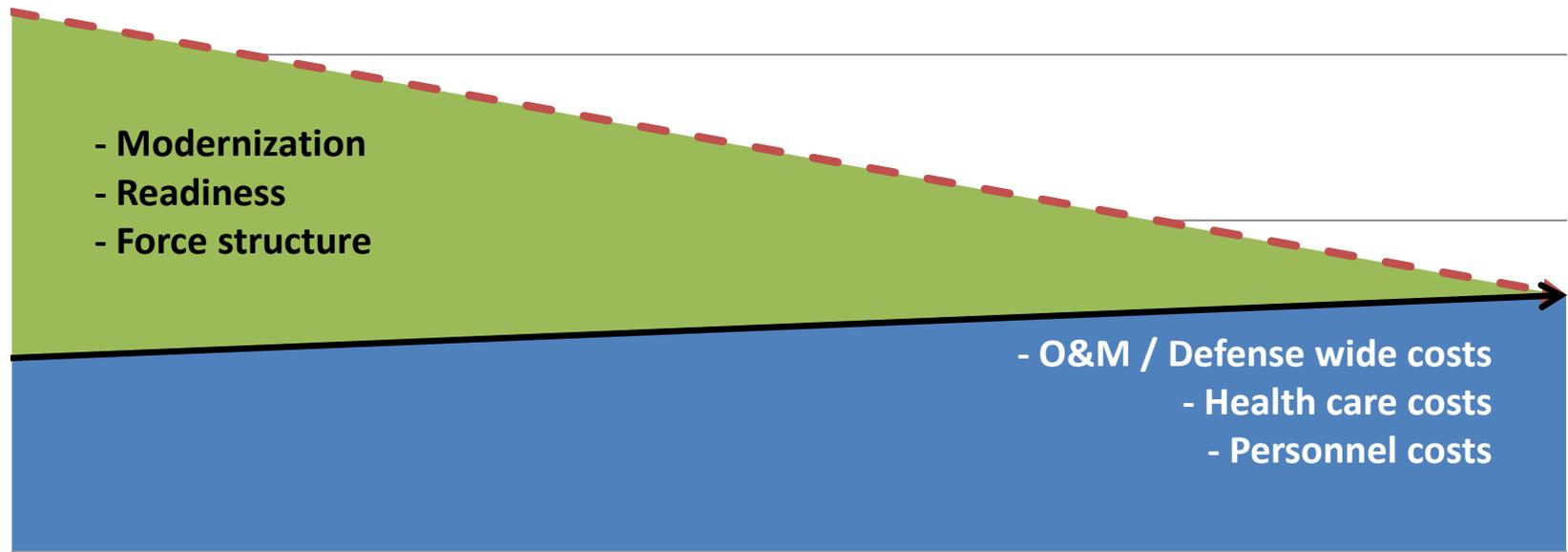
	End of Reagan (1988)	End of Bush (1992)	End of Clinton (2000)	End of GW Bush (2008)	Middle of Obama (2012)	2021 (projected)*	Change (1988-2021)
Total Base Budget Authority - No Sequester (billions of constant \$)	\$553	\$483	\$418	\$545	\$561	\$487	-11.9%
Active Duty Personnel (K)	2,209	1,880	1,449	1,474	1,481	1,280	-42%
Reserve and Guard Personnel (K)	1,158	1,135	865	843	846	803	-30.7%
DoD Civilian Personnel (K)	1,090	1,006	698	707	800	766	-30%
Active Commissioned Ships	573	471	341	282	285	235	-59.0%
Carriers	15	15	10	10	10	7	-53.3%
Army Divisions (active)	20	20	10	10	10	6	-70.0%
AF Fighter/Attack (total active inventory)	3,027	2,000	1,666	1,521	1,493	1,157	-61.8%

*Assumptions based on similar #/% reductions as prior periods combined with public statements by service chiefs

Sources: FY 2014 President's budget (adjusted to remove OCO), future year projections adjusted into constant dollars, DMRR, Air Force Magazine, Service Testimony, USAF and USN FY 2014 Long Range Inventory and Funding Plans

- The combination of sequester cuts and unaddressed cost increases will erode force readiness, stall modernization, and reduce the fighting forces by at least 50% by 2021.





FY2012

FY2021

- By 2021, the personnel, health care, and defense-wide costs will consume 100% of the budget without reform to current cost trend.
- O&M costs per active-duty:

1980 = \$55K

2001 = \$105K

2010 = \$211K



What is the impact of the sequester on **the Economy?**

- **Lower GDP growth**
 - Reduced spending results in lower output
- **Lower employment**
 - Directly, through defense civilian furloughs (today) and reduced active force levels and reduced civilian workforce (in the future)
 - Indirectly, through lower private-sector employment (defense contractors, service businesses)
- **Erosion of the industrial base**
 - Fewer suppliers, especially negative impact on smaller contractors
- **Effects are only beginning to be felt.**

- **Many anecdotal/localized impacts from the sequestration of domestic programs have already begun to materialize:**
 - Impact aid schooling for military and Native American children
 - Local Head Start programs: both on students and teachers
 - Public Defenders offices – layoffs, not trying cases on Fridays
 - Fewer grants to scientific and medical research
 - Cuts of 10% or more to extended unemployment insurance benefits for millions of long-term unemployed

- **Beige Book Notes Sequester**

- The Fed's Beige Book noted for the first time this year the impact of the FY 2013 sequester: "The defense industry experienced weakening in the Cleveland District, and... the Richmond District reported orders being cancelled or delayed."

- **It's Finally Dinging the Economy**

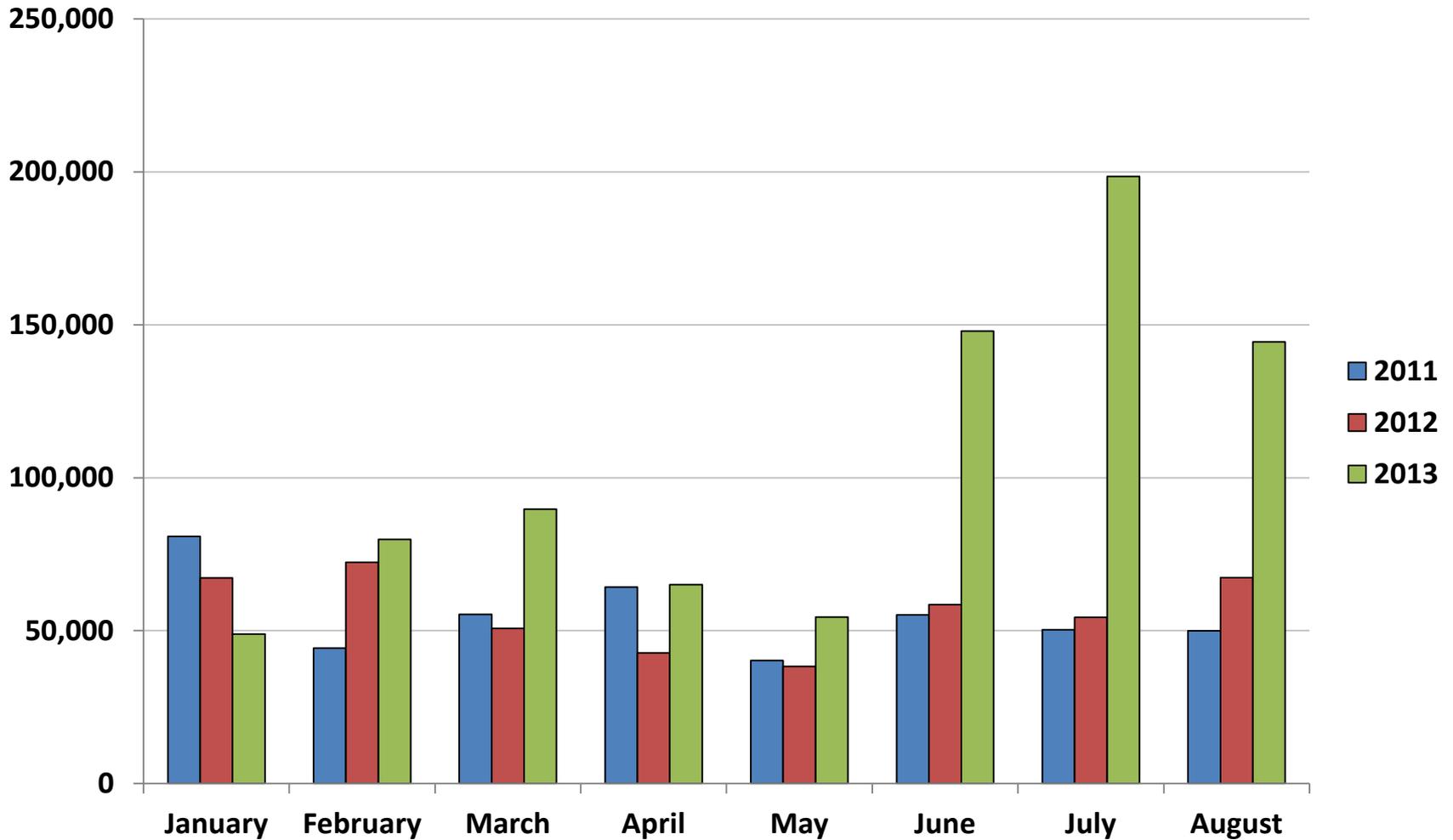
- Macroeconomic Advisers' report on the sequester and the economy noted: "The sequester is expected to slow growth this year, and largely accounts for the weak second-quarter growth and lackluster third-quarter growth."

- **IMF Urges Fewer Cuts**

- "The United States could spur growth by adopting a more balanced and gradual pace of fiscal consolidation," the IMF noted in its annual World Economic Review. "U.S. growth is expected to slow to 1.9 percent in 2013... growth could pick up to 2.7 percent with more moderate fiscal adjustment."

- **Spring 2013: DoD announced 11 days of furloughs for civilian employees**
 - Affected over 600,000 civilian employees
 - Massive negative reaction from employees, Congress
 - Furloughs cut back to 6 days
 - Congress threatens to prohibit furloughs for FY 2014

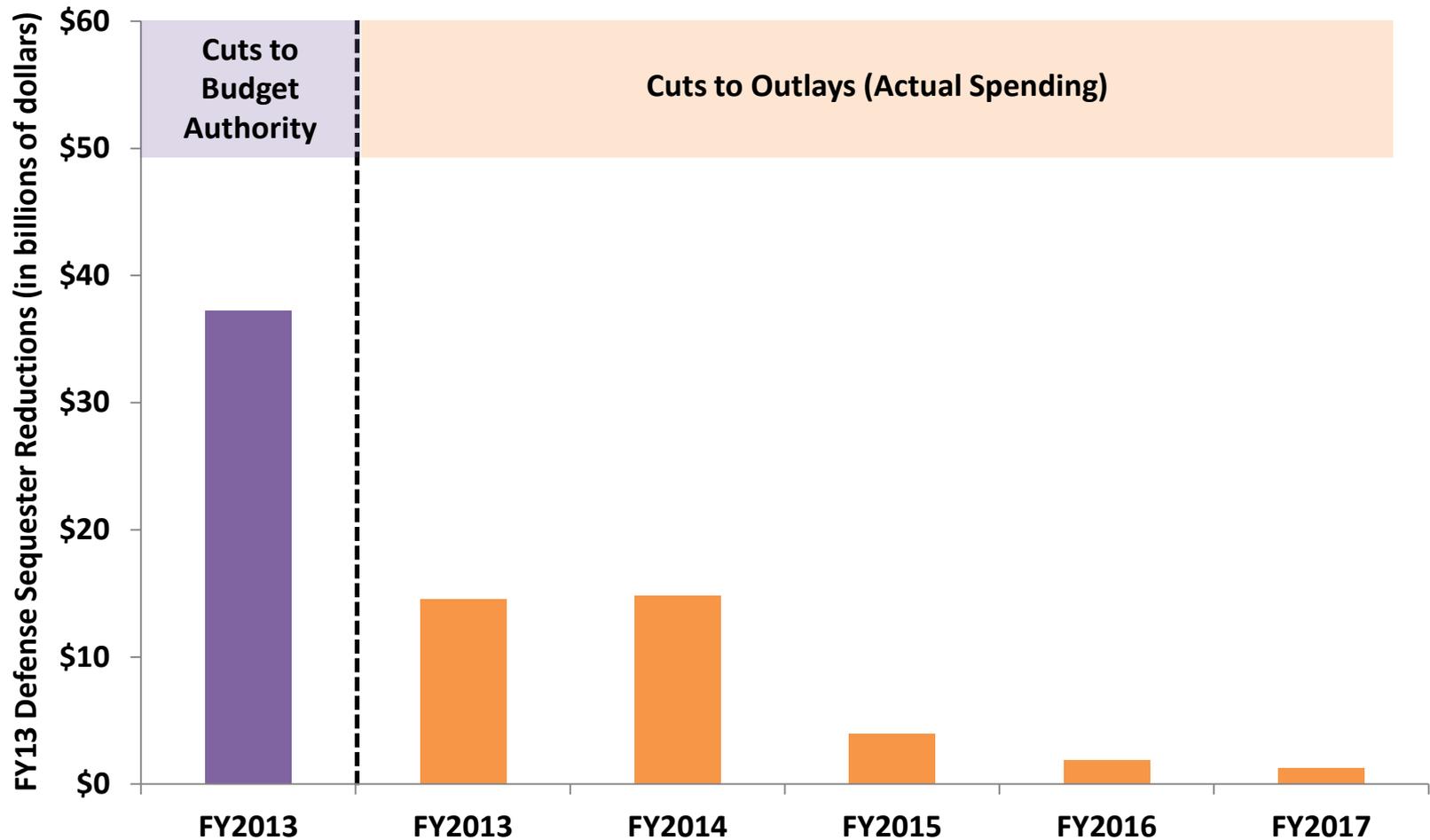
- **Effect of furloughs beginning to show in economic data**
 - Example of what happens when fast-spending accounts (e.g., payroll) are cut
 - But many of the affected accounts **are not** fast-spending



Source: Bureau of Labor Statistics

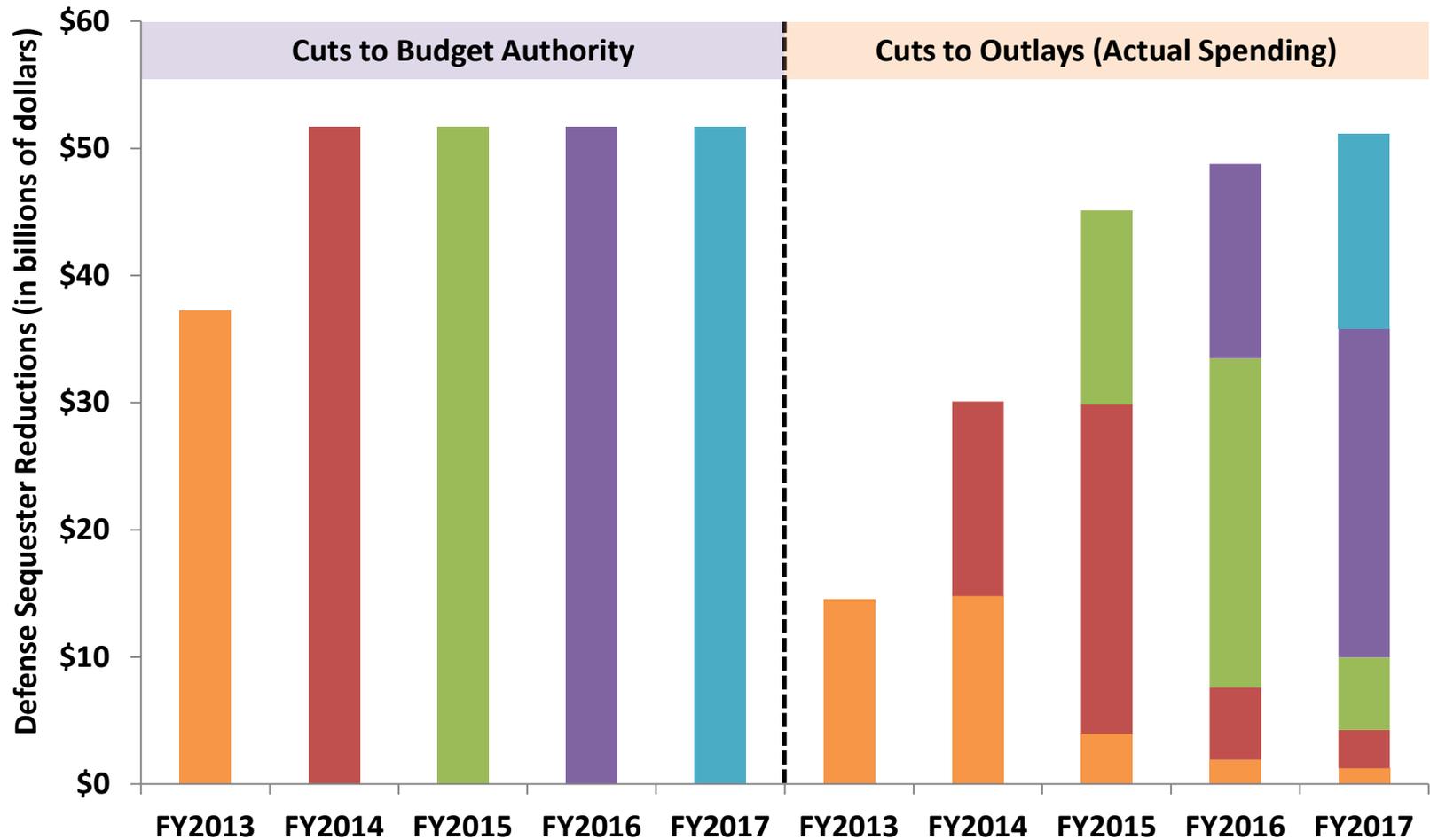
- **Cuts hurt when they actually happen (reducing outlays).**
 - The furlough experience is a good example
 - Economic pain
 - For individuals
 - For the broader economy (businesses that depend on spending from the individuals who were furloughed)
 - Political pain
 - Constituents who were furloughed had plenty of time and motivation to express their feelings to their representatives and senators
- **But, unlike furloughs, most FY 2013 cuts are not actually happening in FY 2013.**
 - The cuts – and the pain from the cuts – are delayed to FY 2014 and beyond
 - The people who say there hasn't been a large economic impact from the sequester are right – for now

- **Sequester cuts will affect spending for years**
 - Economic effects are felt when spending (“outlays”) is actually reduced, not when budget decisions are made
 - Furthermore, the delay is even greater because a large portion of cuts fell on slower spending accounts (such as procurement)
- **The following chart shows how the FY 2013 budget cuts will affect actual spending over five years:**



Note: Analysis includes sequestration cuts to budget authority of FY13 appropriated accounts and unobligated balances, assuming cuts to unobligated balances have the same effect on outlays.
 Sources: Department of Defense; Bipartisan Policy Center calculations

- If sequester continues, the effect on spending, and the economy, will intensify.
- Sequester's effect on spending will double in FY 2014.
 - And it will triple in FY 2015 (compared to FY 2013)
- The next chart shows the effect on spending if sequestration continues as scheduled:



Note: Analysis includes sequestration cuts to budget authority of FY13-17 appropriated accounts and unobligated balances, assuming cuts to unobligated balances have the same effect on outlays.

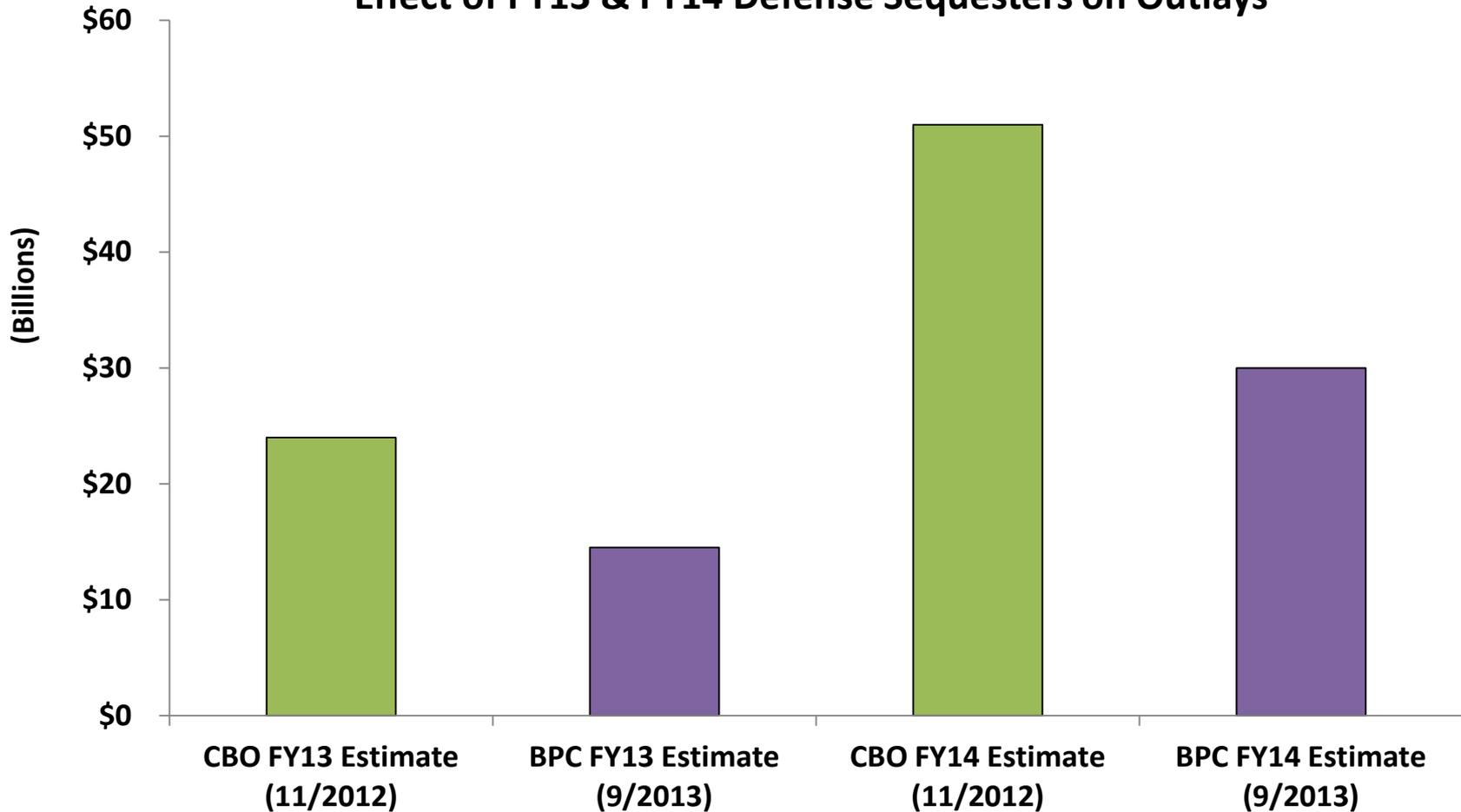
Sources: Department of Defense; Bipartisan Policy Center calculations

- **The Congressional Budget Office (CBO) projected that the repeal of sequestration for Fiscal Years 2013 and 2014 would result in:**
 - 0.4% higher GDP at the end of calendar 2013
 - 400,000 more jobs at the end of calendar 2013

- **But people haven't seen the impact yet**
 - Most of the cuts from the FY 2013 defense sequester will reduce outlays in FY 2014 and beyond
 - And if sequester continues in FY 2014, the FY 2014 outlay impact will be even larger

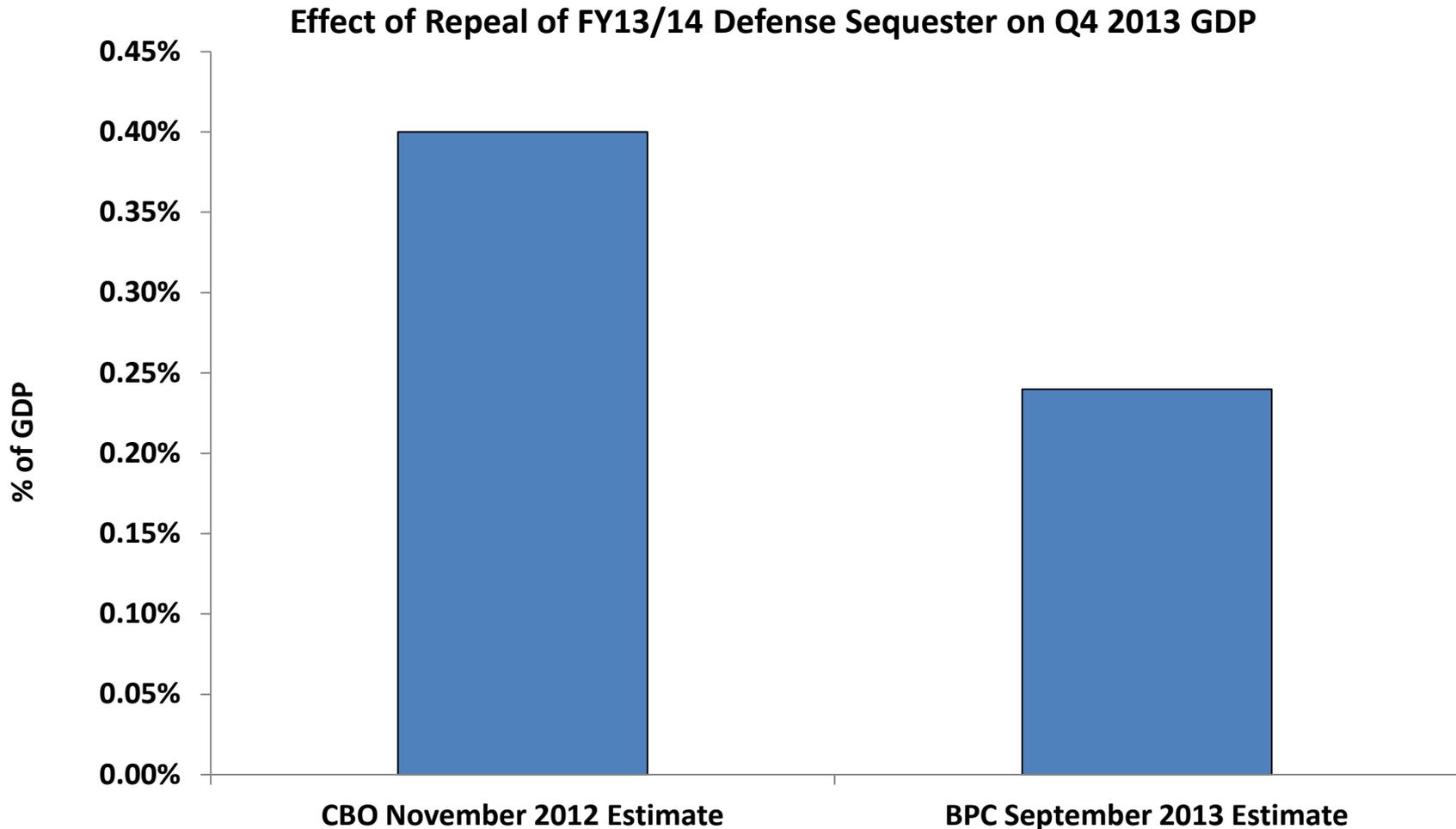
- Many people haven't seen the economic impact because most of the economic impact is still to come
 - CBO's projection (from November 2012) of economic impact was based on the expectation that spending cuts would take place faster than they did
- With new data, we now know the effect of the FY 2013 cuts on spending has been significantly delayed.
 - And hence, the economic impact will be delayed as well
 - But **it will** eventually hit
- The next chart shows CBO's November 2012 projection of the effect of the FYs 2013/2014 sequesters on spending, compared to BPC's updated October 2013 estimate using recent data:

Effect of FY13 & FY14 Defense Sequesters on Outlays



Sources: Congressional Budget Office; Bipartisan Policy Center calculations

- **CBO November 2012 Projection:**
 - U.S. Economy (GDP) would be 0.4% larger at the end of 2013 if the FY 2013 and FY 2014 sequesters were repealed.
 - Assumed larger impact on FY 2013 outlays than occurred
 - Since then, Congress reduced the size of the FY 2013 sequester and cuts were shifted to slower spending accounts
- **Now that we have a better sense of when the outlays will be affected, we can re-estimate the economic impact**



Note: Estimate is of the increase in fourth quarter 2013 GDP if the FY 2013 and FY 2014 defense sequesters had been repealed.

Sources: Congressional Budget Office; Bipartisan Policy Center calculations

- There are three possible reasons why there hasn't been an immediate and more severe impact on the defense industrial base:
 1. The Budget Control Act's sequestration mechanism cut budget authority, not outlays
 - Appropriation categories that matter most to the defense industrial base typically see less than 50% of budget authority disbursed by Treasury as outlays in the first year of new budget authority
 2. Industry cut overhead early and is now buying back stock and increasing dividends
 3. Large defense firms have backlogs of work under prior contract awards that are supporting 2013 sales and earnings.
 - A sampling of larger defense contractors shows that they ended 2012 with a backlog that covered 43%-65% of expected sales

- One metric is outlays reported by Treasury.

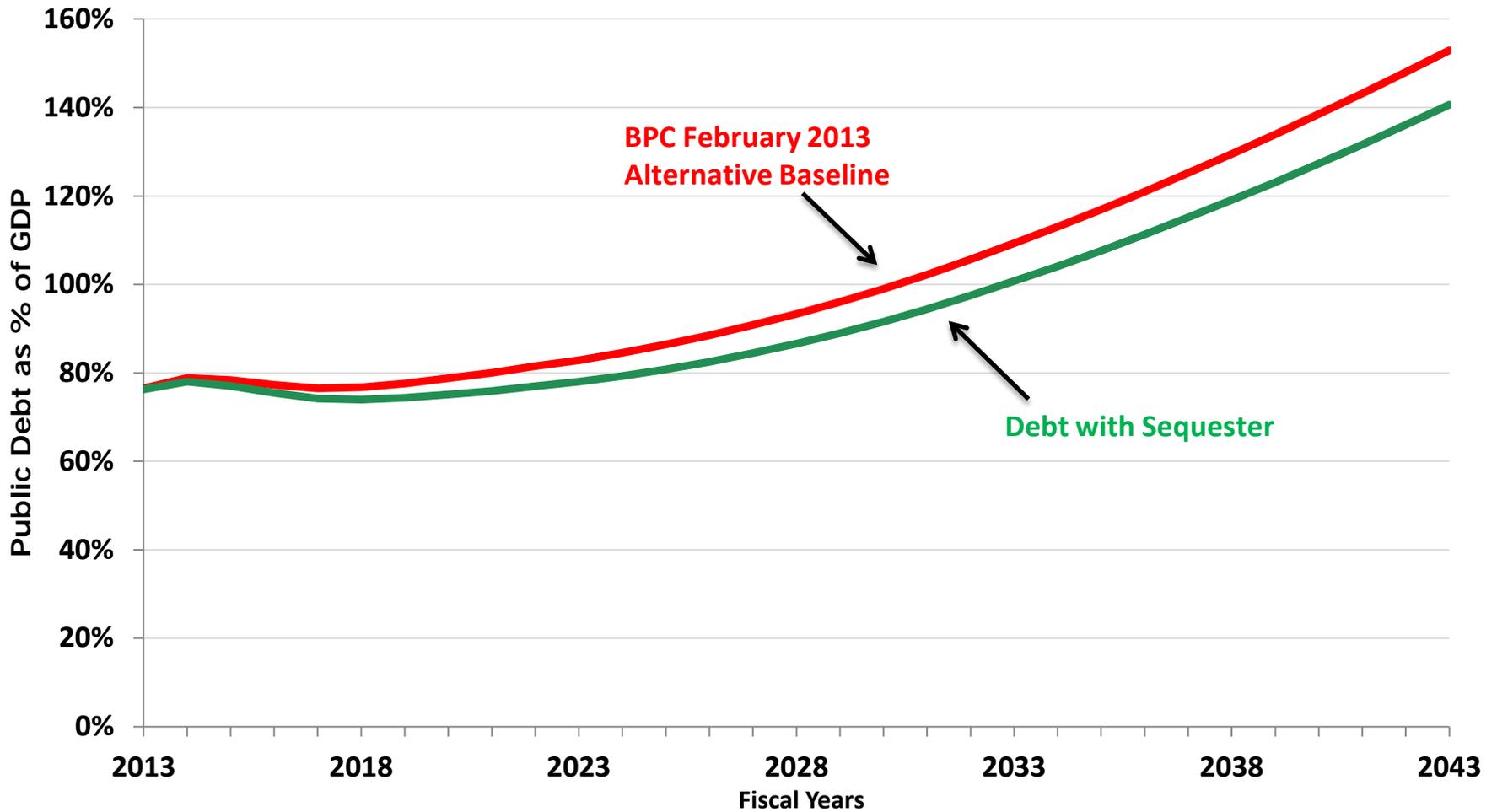
The monthly statements show steady +10% year-over-year declines in outlays from May-August:

	Oct-12	Nov-12	Dec-12	Jan-13	Feb-13	Mar-13	Apr-13	May-13	Jun-13	Jul-13	Aug-13
Total DoD outlays	62.9	54.2	50.3	50.5	43.7	53.7	46.8	55.0	41.9	49.0	54.2
Less: Military Personnel	26.1	15.8	11.1	6.4	11.5	11.3	11.1	16.1	6.5	11.6	17.0
Rest of DoD budget	36.8	38.4	39.2	44.1	32.2	42.4	35.7	38.9	35.4	37.4	37.2
Yr/yr % change	7%	-6%	-14%	8%	-20%	-11%	-3%	-11%	-12%	-10%	-18%

Note: Figures in billions of dollars.

Source: U.S. Treasury Financial Monthly Statements; Bloomberg

- **People are right: The impact has not been as visible as expected, so far.**
 - Because the cuts in spending have been delayed
 - No great harm to the economy – yet
 - But the impact is still coming – it has not been cancelled, but merely delayed
- **When the cuts hit in FY 2014...**
 - People will see them
 - Businesses will feel them
 - More pain is coming and it will be more intense
- **All this despite minimal reduction in the long-term debt**



Note: The BPC Alternative Baseline assumes current law, except that: 1) funding for combat operations overseas winds down; 2) Medicare physician payments are frozen at 2013 levels (“doc fix”); 3) the sequester is waived; 4) expiring tax provisions are extended as they have been in the past; and 5) aid for Hurricane Sandy is not extrapolated for future years.

Sources: Congressional Budget Office (February 2013) and Bipartisan Policy Center extrapolations

- Deficit problem can't be fixed if we only pay attention to defense topline.
- We need structural reforms to the composition of the defense budget, which BPC will soon be producing in part 2 of its study.



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