

Congress of the United States
U.S. House of Representatives
Committee on Small Business
2361 Rayburn House Office Building
Washington, DC 20515-6515

To: Members, Committee on Small Business
From: Committee Staff
Date: September 17, 2012
Re: Hearing: "Sequestration: The Threat to Small Businesses, Jobs, and the Industrial Base."

The Committee on Small Business will meet at 1:00 p.m. on Thursday, September 20, 2012, in Room 2360 of the Rayburn House Office Building for a hearing titled, "Sequestration: The Threat to Small Businesses, Jobs, and the Industrial Base." The purpose of the hearing is to review the probable effects of sequestration on small business contractors and the industrial base. Specifically, the Committee will receive testimony examining how small businesses are likely to be affected if cuts to the federal workforce, prime contracts and subcontracts are not properly targeted. The hearing will also examine how these losses will affect employment and the long-term health of our industrial base.

The first panel will include the Honorable Mike McCord, Principal Deputy Undersecretary of Defense (Comptroller) supported by Mr. Richard Ginman, Director of Defense Procurement and Acquisition Policy. The second panel will include Ms. ML Mackey, Chief Executive Officer of Beacon Interactive Systems, Cambridge, MA, on behalf of the National Small Business Association; Ms. Laurie Moncrieff, President, Adaptive Manufacturing Solutions, Burton, MI, on behalf of the National Defense Industrial Association; Dr. Stephen S. Fuller, Ph.D., Dwight Schar Faculty Chair and University Professor Director, Center for Regional Analysis School of Public Policy, George Mason University, Arlington, VA; and a witness selected by the minority.

I. Introduction

Given that the national debt exceeds \$16 trillion, few would dispute that greater fiscal responsibility is needed and that federal spending must be cut. To support that goal, Congress voted in good faith for the Budget Control Act of 2011 (BCA) and created the Joint Select Committee on Deficit Reduction (Super Committee) charged with finding a way to save \$1.2 trillion.¹ The BCA also created an incentive for the Super Committee to succeed in the form of an alternative approach that would be triggered if the Super Committee failed to come to agreement. That alternative is sequestration – a means of imposing across-the-board cuts on many government programs. In fact, the Joint Select Committee did not come to an agreement and absent congressional action, sequestration will take effect on January 2, 2013.² While the sequestration cuts were initially proposed by the White House, there are senior members of the Administration who believe that they would be detrimental to the economy and national security.³ Therefore, as Congress seeks to find ways to cut spending using a scalpel rather than a meat axe,⁴ the following memorandum will briefly explain the background of sequestration, how it will be implemented, and the consequences of implementation for small businesses, especially small contractors.

II. Brief Overview of Sequestration

The term “sequestration” refers to the process of mandatory spending cuts applied as a uniform percentage to all specified spending programs. Sequestration was first used as a legislative tool under the Balanced Budget and Emergency Deficit Control Act of 1985⁵ (BBEDCA) to enforce deficit targets. From 1990 until 2002, a series of laws used sequestration to limit discretionary spending and impose a pay-as-you-go (PAYGO) requirement on direct spending and revenue

¹ Budget Control Act of 2011 (BCA), Pub. L. No. 112-25; 125 Stat. § 240 (2011).

² *Id.*

³ Austin Wright, *Bob Woodward book could bolster Republican attack on W.H.*, POLITICO, Sept. 7, 2012, available at <http://www.politico.com/news/stories/0912/80889.html>, quoting Defense Secretary Leon Panetta as saying that sequestration “would have a ‘catastrophic’ effect on national security [and would] ‘be like shooting ourselves in the head.’”

⁴ J. Craig Anderson, *Fiscal Cliff Threatens Arizona*, AZCENTRAL.COM, Aug. 14, 2012, available at <http://www.azcentral.com/business/articles/20120814mccain-fiscal-cliff-threatens-arizona.html>, quoting Senator John McCain as saying of budget cuts, “You can’t do it with a meat axe; you have to do it with a scalpel.”

⁵ Balanced Budget and Emergency Deficit Control Act of 1985 (BBEDCA), Pub. L. No. 99-177, 2 U.S.C. §§ 900-922 (1985).

legislation.⁶ However, PAYGO authorization lapsed in 2002, and was only recently reestablished by the Pay-As-You-Go Act of 2010, which implemented a modified PAYGO requirement on direct spending and revenue legislation.⁷

Most recently, under the BCA, Congress agreed to increase the debt limit to at least \$2.1 trillion in exchange for significant savings achieved over the next decade by amending and modifying BBEDCA and PAYGO.⁸ These savings are achieved in two principle manners. First, the BCA placed statutory caps on most discretionary spending until FY2021, with a few key exceptions,⁹ expected to reduce spending by \$917 billion.¹⁰ The adjustable caps are applied against the total amount of discretionary spending, and divided between security and non-security spending for the first two years, not on specific accounts, and the cuts must be implemented through the normal appropriations process.¹¹ The projected caps are depicted in the following chart.

⁶ See Omnibus Budget Reconciliation Act of 1990, Pub. L. No. 101-508, 104 Stat. §§ 1388-573 (1990); Omnibus Budget Reconciliation Act of 1993, Pub. L. No. 103-66, 107 Stat. § 312 (1993); and Balanced Budget Act of 1997, Pub. L. No. 105-33, 111 Stat. § 251 (1997).

⁷ Increasing the Statutory Limit on the Public Debt, Pub. L. No. 111-139, 124 Stat. §§ 8-24 (2010).

⁸ BCA, *supra* note 1. The debt ceiling increase could be as high as \$2.4 trillion under certain circumstances.

⁹ *Id.* at § 101, 125 Stat. § 240 These include: (1) changes in concepts and definitions; (2) appropriations designated as emergency requirements; (3) appropriations designated for Overseas Contingency Operations/Global War on Terrorism (such as for military activities in Afghanistan); (4) appropriations for continuing disability reviews and redeterminations; (5) appropriations for controlling health care fraud and abuse; and (6) appropriations designated as disaster relief.

¹⁰ CONGRESSIONAL BUDGET OFFICE (CBO), LETTER TO JOHN BOEHNER, SPEAKER OF THE HOUSE AND HARRY REID, MAJORITY LEADER, UNITED STATES SENATE (August 1, 2012) available at <http://www.speaker.gov/sites/speaker.house.gov/files/UploadedFiles/BudgetControlActAug1.pdf>.

¹¹ BCA, *supra* note 1 at § 101, 125 Stat. § 248.

Statutory Caps on Discretionary Spending Absent Sequestration (in billions of budget authority).¹²

Fiscal Year	Discretionary Spending Limits
2012	\$684 security + \$359 nonsecurity
2013	\$686 security + \$361 nonsecurity
2014	\$1,066
2015	\$1,086
2016	\$1,107
2017	\$1,131
2018	\$1,156
2019	\$1,182
2020	\$1,208
2021	\$1,234

The second primary mechanism for achieving budget savings was intended to be the work of the Super Committee, which was directed to develop a proposal to achieve at least another \$1.5 trillion in savings by FY2021.¹³ However, if the Super Committee was unable to develop this proposal that achieved at least \$1.2 trillion in cuts, or if Congress failed to adopt the proposal, additional cuts were to be automatically triggered and take effect on January 2, 2013.¹⁴ The Super Committee announced that it was unable to reach a deficit-reduction agreement on November 21, 2011; thus, a \$1.5 trillion automatic spending reduction process has been triggered unless new legislation is enacted to eliminate or change the process before then.¹⁵

These automatic cuts take place in four stages. First, the statutory definitions of security and non-security are revised. If the Super Committee had been successful, the security category was broadly defined and included “discretionary appropriations associated with agency budgets for [DoD, the Department of Homeland Security (DHS), the Department of Veterans Affairs (VA), the National Nuclear Security Administration (NNSA), the intelligence community management

¹² *Id.*

¹³ *Id.* at § 401, 125 Stat. § 259.

¹⁴ *Id.* at § 101, 125 Stat. § 254.

¹⁵ Lisa Mascaro, *Super Committee Fails to Agree on Deficit-Reduction Plan*, LA TIMES Nov. 21, 2011 available at http://www.latimes.com/news/politics/la-pn-super-committee-20111121_0,4746337.story.

account], and all budget accounts in budget function 150 (international affairs).”¹⁶ However; if the Super Committee failed, thus triggering sequestration, a narrowly defined second definition (known as “revised security category”) applied, which only includes “discretionary appropriations in budget function 050.”¹⁷ Budget Function 050 is the function for National Defense, and includes “the military activities of the Department of Defense (DoD), the nuclear-weapons related activities of the Department of Energy (DoE) and the National Nuclear Security Administration, the national security activities of several other agencies such as the Selective Service Agency, and portions of the activities of the Coast Guard and the Federal Bureau of Investigation.”¹⁸ Thus, while under the previous chart, all spending from multiple agencies was included in the security category, the revised definition only applies to DoD and few key programs at other agencies. Thus, going forward, this will be referred to as the Defense limit or cap.¹⁹ This distinction is important, because the cuts to DoD under the original caps were estimated to be \$487 billion over ten years, but under revised definitions, the DoD’s share increases by approximately \$500 billion.²⁰

Second, the discretionary spending limits for FY2013-FY2021 are revised so that they are divided between security and non-security spending for all ten years.²¹ Thus, the caps provided above are revised as depicted in the following chart:

¹⁶ Budget Control Act, *supra* note 1.

¹⁷ *Id.*

¹⁸ H. COMM. ON THE BUDGET, *Budget Function*, available at <http://budget.house.gov/budgetprocess/budgetfunctions.htm#function050> (last visited Sept. 17, 2012).

¹⁹ BCA, *supra* note 1. at § 101, 125 Stat. § 248.

²⁰ Karen Parish, *Panetta, Dempsey: Sequestration Would Defeat Defense Strategy*, ARMED FORCES PRESS SERVICE, Feb. 16, 2012, available at <http://www.defense.gov/news/newsarticle.aspx?id=67226>, noting, “Under the 2013 budget request, the Defense Department will spend \$614 billion in fiscal 2013, divided between a \$525.4 billion base budget and \$88.5 billion covering war costs. The request incorporates the 2011 Budget Control Act’s requirement for a \$487 billion reduction in defense spending over the next 10 years. The [A]ct also included a ‘sequestration’ provision for an additional \$500 billion in across-the-board cuts to take effect in January if Congress does not pass a plan to reduce the budget.”

²¹ *Id.* at § 302, 125 Stat. § 256, contrasted with BCA at §§ 101, 302, 125 Stat. §§ 254, 256.

Statutory Caps on Discretionary Spending With Sequestration (in billions of budget authority).²²

Fiscal Year	Original Limits	Revised Limits	
		Revised Defense Limit	Revised Non-Defense Limit
2013	\$686 security + \$361 nonsecurity	\$546	\$501
2014	\$1,066	\$556	\$510
2015	\$1,086	\$566	\$520
2016	\$1,107	\$577	\$530
2017	\$1,131	\$590	\$541
2018	\$1,156	\$603	\$553
2019	\$1,182	\$616	\$566
2020	\$1,208	\$630	\$578
2021	\$1,234	\$644	\$590

Please note that instead of the original FY2013 cap of \$686 billion for DoD, DHS, VA, NNSA, IC, and IA, there is now a \$546 billion cap for just DoD. For FY2014-2021, there were not program specific caps under the prior scheme, but specific DoD and non-DoD caps are now in place.

Third, the annual amount of spending reductions required each year in each of these categories is further divided proportionally between discretionary appropriations and direct spending programs in each category, excluding certain programs and activities, as will be discussed later.²³ This creates four categories of spending: defense discretionary appropriations, defense direct spending, nondefense discretionary spending, and nondefense direct spending.²⁴ Finally, the additional required savings are achieved through a combination of a sequestration and the downward adjustment of the revised discretionary spending limits. Specifically, the reductions required are implemented in three parts: (1) for discretionary spending for FY2013, a sequestration of budgetary resources in that year; (2) for discretionary spending for FY2014-

²² BCA, *supra* note 1 at §§ 101, 302, 125 Stat. §§ 254, 256.

²³ *Id* at § 302, 125 Stat. § 257.

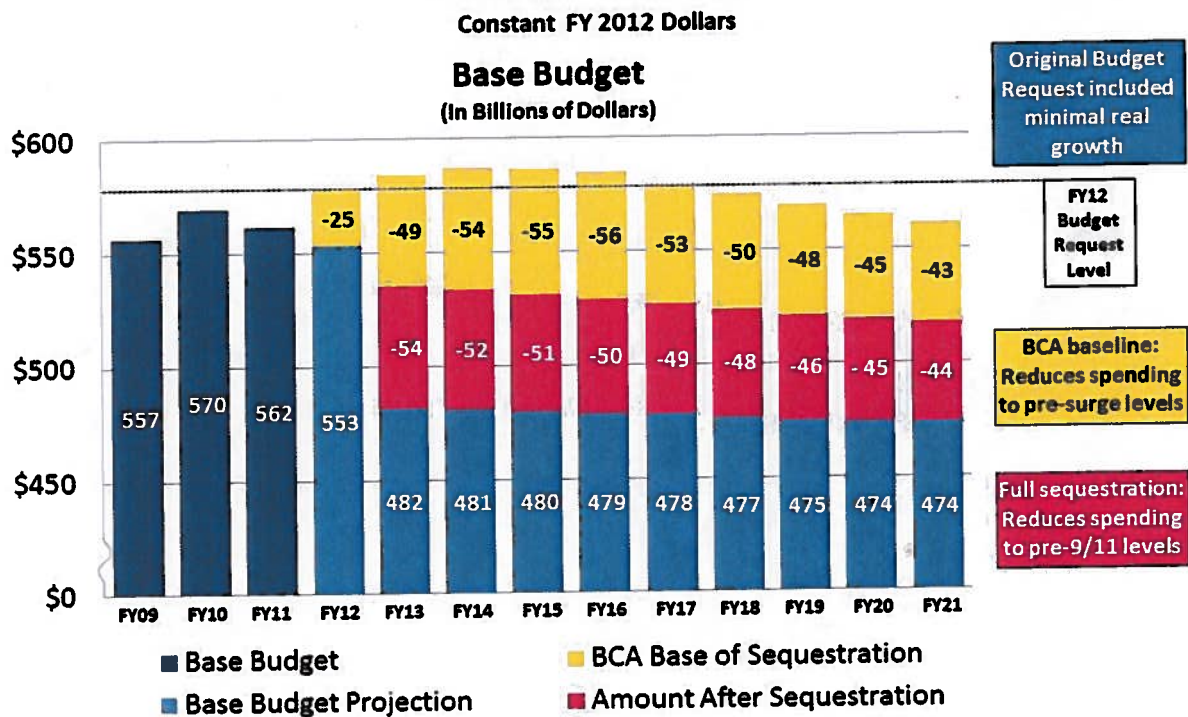
²⁴ *Id* at § 302, 125 Stat. § 257.

FY2021, a downward adjustment of the revised discretionary spending limits; and (3) for direct spending, a sequestration of budgetary resources in each year from FY2013 through FY2021.²⁵

The amount to be sequestered in FY2013 is calculated by OMB by taking the budget goal, subtracting the amount of deficit reduction achieved by the Super Committee, then subtracting 18% of the difference for debt service, then dividing by nine to allocate the saving across the remaining nine years covered by the BCA, and finally, dividing by two to allocate the spending reductions between defense and nondefense functions.²⁶

Thus, the House Armed Services Committee provided the following chart which illustrates how the cuts play out at DoD in constant dollars. For example, in FY2013 an additional \$54 billion in savings will need to be sequestered above the level provided in the BCA without sequestration.

National Defense Base Budget Topline January 2012 – Implementation of BCA Sequestration FY 2009 – FY 2021



²⁵ *Id* at § 302, 125 Stat. §§ 258-259

²⁶ *Id* at § 302, 125 Stat. § 257.

It is important to note that all the numbers provided in this document are projections, and various sources have interpreted the base numbers differently. Thus, while there is general consensus that through a combination of mandatory cuts and spending caps, the BCA will reduce spending by \$1.8 trillion between FY2012 and 2021, with mandatory cuts to discretionary spending accounting for over \$1.5 trillion of the savings,²⁷ the exact amount that will be sequestered will depend upon appropriation levels. Sequestering of funds may only be necessary during FY2013. However, during the FY2013-FY2021 period, the Congressional Budget Office (CBO) projects that the BCA will result in \$812 billion in cuts to discretionary spending by the DoD, with \$714 billion in other discretionary spending cuts, and \$335 billion in cuts to mandatory spending programs, as illustrated in the following table.²⁸

Total Reductions in Outlays by Type from the Budget Control Act, FY2012-FY2021²⁹
(in \$ billion, decrease in spending)

	FY12	FY13	FY14	FY15	FY16	FY17	FY18	FY19	FY20	FY21	Total
Discretionary	-27	-103	-140	-156	-165	-174	-179	-186	-194	-202	-1,526
Defense	-15	-57	-74	-82	-87	-92	-95	-99	-103	-107	-812
Non-Defense	-12	-46	-66	-74	-78	-82	-84	-87	-91	-95	-714
Mandatory	+3	-6	-14	-19	-20	-20	-21	-22	-23	-25	-170

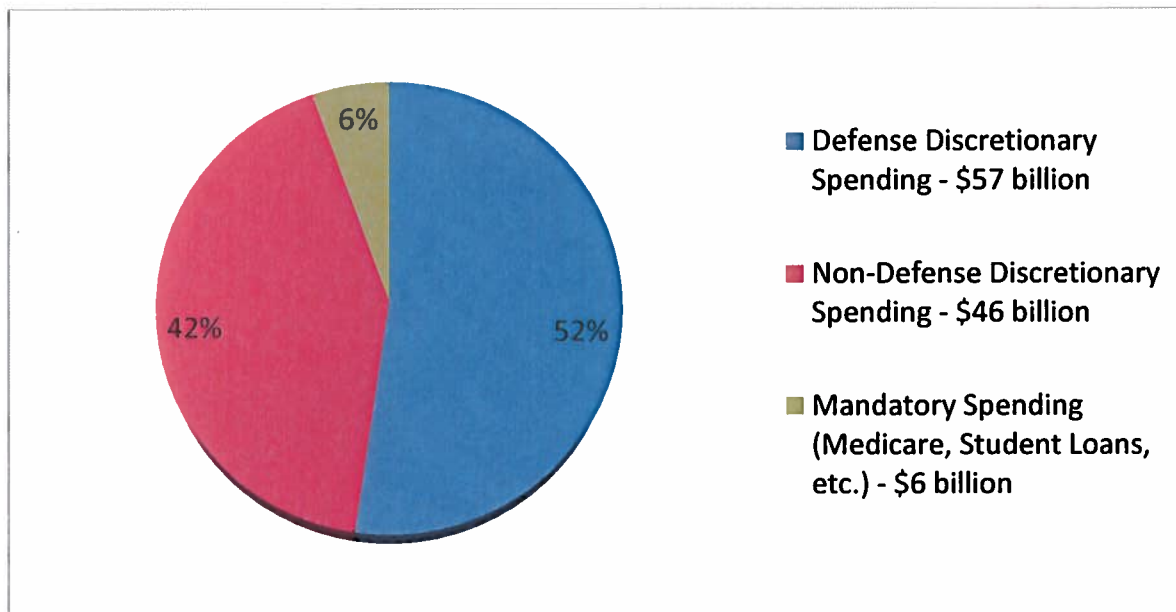
Based on current funding levels, that means that in FY2013, \$109 billion will need to be sequestered, as illustrated by the following graph, which demonstrates that 94 percent of the cuts will be borne by discretionary spending programs.

²⁷ CONGRESSIONAL BUDGET OFFICE (CBO), THE BUDGET AND ECONOMIC OUTLOOK (2012) [*hereinafter*, CBO Baseline]; CBO, PRELIMINARY ANALYSIS OF THE PRESIDENT'S BUDGET FOR FY2013 (2012) [*Hereinafter*; Analysis of President's FY13 Budget], THE BUDGET AND ECONOMIC OUTLOOK: UPDATE (2011); CBO, BUDGET AND ECONOMIC OUTLOOK: FISCAL YEARS 2012 TO 2022 (2012).

²⁸ *Id.*

²⁹ Mark Leavitt, CONGRESSIONAL RESEARCH SERVICE, *The Budget Control Act of 2011: The Effects on Spending and the Budget Deficit When the Automatic Spending Cuts Are Implemented* 4 (2012) citing CBO BASELINE AT BOX1-2; CBO, BUDGET AND ECONOMIC OUTLOOK: FISCAL YEARS 2011 TO 2021, BOX 1-1 (2011); CBO, BUDGET AND ECONOMIC OUTLOOK: FISCAL YEARS 2012 TO 2022 (2012). CBO, *Testimony before the Joint Select Committee on Deficit Reduction*, Oct. 26, 2011, Tables B-1 and B-2.

FY2013 Cuts By Source³⁰



III. Exemptions from Sequestration.

To understand the breadth of sequestration, it is necessary recognize which programs are exempt or to which programs sequestration has limited applicability. The BCA, citing to provisions established by the BBEDCA, exempts a limited number of programs from the sequester, and limits the effects of the sequester on a few other programs. For example, the BBEDCA, as applied to the BCA, exempts Social Security, Medicaid, refundable tax credits to individuals, and low-income programs such as: the Children’s Health Insurance Program, Supplemental Nutrition Assistance Program, Temporary Assistance for Needy Families, and Supplemental Security Income.³¹ Programs administered by the Department of Veterans Affairs are exempt,

³⁰ *Id.*

³¹ BBEDCA, *supra* note 5, at § 255, 2 U.S.C. § 905. This also exempts advances to the Unemployment Trust Fund; payments to various retirement, health care, and disability trust funds; certain Tribal and Indian trust accounts; Medical Facilities Guaranty and Loan Fund; specified federal retirement and disability accounts and activities; prior legal obligations of the federal government in specified budget accounts; Academic Competitiveness/Smart Grant Program; mandatory funding under the Child Care and Development Fund; Child Nutrition Programs (including School Lunch, School Breakfast, Child and Adult Care Food, and others, but excluding Special Milk); Commodity Supplemental Food Program; the TANF Contingency Fund; Family Support Programs; Federal Pell Grants; Medicaid; Foster Care and Permanency Programs; Supplemental Nutrition Assistance Program (SNAP, formerly known as food stamps); and specified economic recovery programs, including GSE Preferred Stock Purchase Agreements, the Office of Financial Stability, and the Special Inspector General for the Troubled Asset Relief Program.

and the President has notified Congress that he intends to use his authority under the BCA to exempt military personnel accounts.³²

Medicare is also given special treatment as part of sequestration. Under BBEDCA, Medicare may not be sequestered by more than 4 percent.³³ However, the BCA further reduces this cap to no more than 2 percent.³⁴

While Federal employee pay is not itself exempt from sequestration, the Conference Report accompanying BBEDCA provided that “that rates of pay for civilian employees (and rates of basic pay, basic subsistence allowances and basic quarters allowances for members of the uniformed services) may not be reduced pursuant to a sequestration order.”³⁵ Further, “a scheduled pay increase may not be reduced pursuant to an order.”³⁶

IV. Sequestration Transparency Act

While the law provides a laundry list of programs that are exempt or subject to a modified sequester, there is no definitive list of programs or types of spending that would absolutely be subject to sequestration or the enhanced budget caps. Therefore, Congress passed the Sequestration Transparency Act (STA),³⁷ which the President signed on August 7, 2012. This law requires the Administration to report to Congress within 30 days of enactment (September 6, 2012) on how sequestration will be implemented.³⁸ In the report, the President must identify by program, project and activity all accounts to be sequestered and estimate the sequestration percentages to be applied and the amounts necessary to achieve the required savings.³⁹

The President released the report (STA Report) on September 14, 2012, and it states that “[u]nder the assumptions required by the STA, the sequestration would result in a 9.4 percent reduction in non-exempt defense discretionary funding and an 8.2 percent reduction in non-

³² *Id.* See also, OFFICE OF MGMT. & BUDGET, EXECUTIVE OFFICE OF THE PRESIDENT, LETTERS FROM JEFFREY ZIENTS, ACTING DIRECTOR, TO JOSEPH BIDEN, PRESIDENT OF THE SENATE, AND JOHN BOEHNER, SPEAKER OF THE HOUSE (July 31, 2012).

³³ BBEDCA, *supra* note 5, at § 256, 2 U.S.C. § 906.

³⁴ BCA, *supra* note 1, at § 302.

³⁵ H.R. REP. NO. 99-433, at 93 (1985).

³⁶ *Id.*

³⁷ Sequestration Transparency Act of 2012, Pub. L. No. 112-155 (2012).

³⁸ *Id.*

³⁹ *Id.*

exempt nondefense discretionary funding. The sequestration would also impose cuts of 2.0 percent to Medicare, 7.6 percent to other non-exempt nondefense mandatory programs, and 10.0 percent to non-exempt defense mandatory programs.”⁴⁰ These numbers are somewhat surprising, since only a week earlier the Undersecretary of Defense for Acquisition, Technology, and Logistics, Frank Kendall, stated that a flat 11 percent cut would be applied to all discretionary accounts not explicitly exempted from the sequester.⁴¹ The Kendall estimate is 1.6 percent higher than the STA report, and presumably reflects a better understanding of DoD’s spending, but for the sake of clarity this memorandum will use the STA Report numbers when possible.

As illustrated in the chart below, the STA Report provides for \$108.914 billion in sequesterable cuts – slightly less than the \$109 billion figure cited previously.⁴² However, this can be accounted for by the fact that the STA Report only provided figures in the millions, so if the sequesterable amount was less than a million it was not reported in the detailed tables. The breakdown between discretionary and mandatory programs provides that \$96.331 billion in sequesterable funds comes from discretionary spending, but that only \$12.493 billion in sequesterable funds is attributable to cuts in mandatory spending programs.

⁴⁰ OFFICE OF MGMT. & BUDGET, EXECUTIVE OFFICE OF THE PRESIDENT, OMB REPORT PURSUANT TO THE TRANSPARENCY ACT OF 2012 1 (Sept. 14, 2012), available at <http://www.slideshare.net/civilbeat/sequestration-transparency-act-report> [hereinafter STA REPORT].

⁴¹ Frank Kendall, Undersecretary of Defense, Department of Defense, Opening Address at ComDef 2012, (Sept. 5, 2012), available at <http://www.defense.gov/news/newsarticle.aspx?id=117761>.

⁴² STA REPORT *supra* note 37 at Appendix A.

Mandatory versus Discretionary Spending Subject to Sequestration by Agency (in millions)⁴³

Agency	Discretionary Sequesterable	Discretionary Exempt	All Discretionary Sequestered	Mandatory Sequesterable	Mandatory Exempt	Mandatory Sequestered	Total Sequestered
Congress	\$4,255	\$167	\$350	\$19	\$174	\$1	\$351
Judicial Branch	\$6,515	\$409	\$534	\$260	\$1,005	\$20	\$554
Agriculture	\$23,774	\$2,689	\$1,956	\$13,775	\$134,287	\$1,052	\$3,008
DC	\$418	\$10	\$34	\$17	\$1,080	\$1	\$35
Commerce	\$10,911	\$1,505	\$896	\$248	\$111	\$17	\$913
DoD	\$290,582	\$290,582	\$52,238	\$493	\$10,771	\$49	\$52,287
Education	\$45,348	\$22,891	\$3,729	\$4,028	\$20,517	\$307	\$4,126
Energy	\$13,016	\$6,042	\$2,411	\$348	-\$499	\$27	\$2,438
HHS	\$80,091	\$12,753	\$6,564	\$317,422	\$589,228	\$6,791	\$13,355
DHS	\$43,233	\$9,147	\$3,725	\$5,000	\$5,389	\$379	\$4,104
HUD	\$44,185	\$228	\$3,659	\$0	\$8,503	\$0	\$3,659
Interior	\$12,001	\$3,548	\$980	\$4,459	\$3,268	\$340	\$1,320
Treasury	\$14,220	\$3,941	\$1,165	\$9,086	\$89,971	\$690	\$1,855
Justice	\$22,373	\$6,210	\$1,629	\$2,830	\$89,971	\$690	\$2,319
Labor	\$12,556	\$5,770	\$674	\$15,936	\$77,837	\$1,215	\$1,889
State	\$31,572	\$7,997	\$2,690	\$35	\$1,201	\$3	\$2,693
Transportation	\$19,887	\$8,908	\$1,618	\$7,152	\$52,825	\$543	\$2,161
Veterans Affairs	\$0	\$66,948	\$0	\$0	\$80,120	\$0	\$0
Army Corps of Engineers	\$6,934	\$1,621	\$577	\$377	\$8,918	\$28	\$605
Other Defense Civil Programs	\$208	\$37	\$17	\$3	\$138,923	\$0	\$17
EPA	\$8,699	\$1,427	\$714	\$25	\$0	\$2	\$716
Executive Office of the President	\$398	\$9	\$30	\$0	\$0	\$0	\$30
GSA	\$238	\$10,902	\$20	\$22	\$10,777	\$2	\$22

⁴³Id.

Agency	Discretionary Sequesterable	Discretionary Exempt	All Discretionary Sequestered	Mandatory Sequesterable	Mandatory Exempt	Mandatory Sequestered	Total Sequestered
International Assistance Programs	\$24,186	\$540	\$1,983	\$147	\$42,024	\$11	\$1,994
NASA	\$17,771	\$2,708	\$6,111	\$1	\$0	\$0	\$6,111
National Science Foundation	\$6,964	\$159	\$577	\$109	\$16	\$9	\$586
OPM	\$101	\$271	\$8	\$97	\$624,894	\$7	\$15
SBA	\$917	\$337	\$75	\$3	\$0	\$0	\$75
Social Security Administration	\$5,693	\$15,301	\$467	\$0	\$915,253	\$0	\$467
Other	\$10,234	\$952	\$900	\$4,048	\$197,194	\$309	\$1,209
Total	\$757,280	\$484,009	\$96,331	\$385,940	\$3,103,758	\$12,493	\$108,914

In contrast, the division between defense and non-defense programs is much closer – 54.581 billion of the sequestered funds will come from defense accounts, whereas \$54.234 billion will come from non-defense accounts.⁴⁴ Not surprisingly, the vast majority of the defense cuts will come from DoD, which will have \$52,287 billion sequestered, with the remainder coming from The Departments of Energy (Energy) Commerce (Commerce), Health and Human Services (HHS), Homeland Security (DHS), Justice (Justice), Transportation (Transportation) and other Defense Civil Programs.

⁴⁴ STA REPORT *supra* note 37 at Appendix A.

Defense versus Nondefense Spending Subject to Sequestration by Agency (in millions)⁴⁵

Agency	Nondefense Sequesterable	Nondefense Exempt	Nondefense Sequestered	Defense Sequesterable	Defense Exempt	Defense Sequestered	Total Sequestered
Congress	\$4,274	\$341	\$351	\$0	\$0	\$0	\$351
Judicial Branch	\$6,775	\$1,414	\$554	\$0	\$0	\$0	\$554
Agriculture	\$37,549	\$136,976	\$3,008	\$0	\$0	\$0	\$3,008
DC	\$435	\$1,090	\$35	\$0	\$0	\$0	\$35
Commerce	\$11,159	\$1,616	\$909	\$41	\$0	\$4	\$913
DoD	\$0	\$0	\$0	\$540,611	\$301,353	\$52,287	\$52,287
Education	\$49,376	\$43,408	\$4,036	\$0	\$0	\$0	\$4,126
Energy	\$10,423	\$2,602	\$854	\$16,841	\$2,941	\$1,584	\$2,438
HHS	\$397,456	\$601,981	\$13,349	\$57	\$0	\$6	\$13,355
DHS	\$48,165	\$14,468	\$3,956	\$1,566	\$68	\$148	\$4,104
HUD	\$44,185	\$8,731	\$3,659	\$0	\$0	\$0	\$3,659
Interior	\$16,460	\$6,816	\$1,320	\$0	\$0	\$0	\$1,320
Treasury	\$23,306	\$93,912	\$1,855	\$0	\$0	\$0	\$1,855
Justice	\$25,203	\$96,181	\$1,855	\$4,932	\$0	\$464	\$2,319
Labor	\$28,492	\$83,607	\$1,889	\$0	\$0	\$0	\$1,889
State	\$31,607	\$9,198	\$2,693	\$0	\$0	\$0	\$2,693
Transportation	\$26,699	\$61,393	\$2,144	\$177	\$340	\$17	\$2,161
Veterans Affairs	\$0	\$147,068	\$0	\$0	\$0	\$0	\$0
Army Corps of Engineers	\$7,302	\$10,530	\$595	\$114	\$9	\$10	\$605
Other Defense Civil Programs	\$211	\$65,340	\$17	\$0	\$73,620	\$0	\$17
EPA	\$8,724	\$1,427	\$716	\$0	\$0	\$0	\$716
Executive Office of the President	\$398	\$9	\$30	\$0	\$0	\$0	\$30
GSA	\$260	\$21,679	\$22	\$0	\$0	\$0	\$22
International Assistance Programs	\$24,333	\$42,564	\$1,994	\$0	\$0	\$0	\$1,994
NASA	\$17,772	\$2,708	\$6,111	\$0	\$0	\$0	\$6,111
National Science Foundation	\$7,073	\$175	\$580	\$68	\$0	\$6	\$586

⁴⁵*Id.*

Agency	Nondefense Sequesterable	Nondefense Exempt	Nondefense Sequestered	Defense Sequesterable	Defense Exempt	Defense Sequestered	Total Sequestered
OPM	\$198	\$625,165	\$15	\$0	\$0	\$0	\$15
SBA	\$920	\$337	\$75	\$0	\$0	\$0	\$75
Social Security Administration	\$5,693	\$930,554	\$467	\$0	\$0	\$0	\$467
Other	\$14,272	\$197,622	\$1,154	\$578	\$524	\$55	\$1,209
Total	\$848,720	\$3,208,912	\$54,243	\$564,985	\$378,855	\$54,581	\$108,914

The STA Report has a few key flaws. First, it does not provide the required data at the program, project and activity level, instead, providing data only at the agency, bureau and account levels. This lack of detail makes it more difficult to analyze the specific cuts. Second, the STA Report does not discuss or account for the costs that will be incurred in order to achieve the sequestration targets. The sources of these costs will be discussed later in this memorandum.

V. Application of the BCA and Sequestration

For discretionary spending, the main categories of spending are personnel costs and costs incurred using contractors – put simply, these are the things the government either makes (self-performs) or buys (uses contractors to provide or perform).⁴⁶ As contractors provide goods and services, these account for everything from utilities to office supplies and from help desk operators to manufacturers of major weapons systems. For example, within DoD, the \$52.287 billion in sequestration cuts can be further broken down as follows:

⁴⁶ There are federal administrative expenses outside of these figures, which are subject to sequester. BBEDCA, *supra* note 5, at §256(h). For example, while Social Security is exempt from the sequester, the administration of social security is not. While most of these costs are covered as personnel costs or contractor costs, some of these are costs that are incurred as payments to states.

Defense Spending Subject to Sequestration by Budget Category (in millions)⁴⁷

Defense Budget Category	Defense Discretionary Amount Sequesterable	Defense Discretionary Amount Exempt	Defense Discretionary Amount Sequestered	Defense Mandatory Amount Sequesterable	Defense Mandatory Amount Exempt	Defense Mandatory Amount Sequestered	Defense Sequestered
Operations and Maintenance	\$249,547	\$19,314	\$27,318	\$34	\$2,866	\$3	\$27,321
Procurement	\$162,990	\$4,944	\$15,320	\$0	\$0	\$0	\$15,320
Research, Development, Test, & Evaluation	\$79,493	\$11,722	\$7,473	\$0	\$0	\$0	\$7,473
Military Construction	\$17,256	\$4,952	\$1,624	\$0	\$0	\$0	\$1,624
Family Housing	\$2,076	\$39	\$195	\$0	\$0	\$0	\$195
Revolving and Management Funds	\$28,756	\$98,159	\$308	\$153	\$683	\$15	\$323
Military Personnel	\$0	\$151,452	\$0	\$0	\$6,950	\$0	\$0
Trust Funds	\$0	\$0	\$0	\$306	\$272	\$31	\$31
Total	\$540,118	\$290,582	\$52,238	\$493	\$10,771	\$49	\$52,287

With the exception of management and trust funds, each category of cuts reflects, directly or indirectly, the cost of hiring an employee to perform a task or the cost of hiring a contractor to provide a service or task. The effects of cuts to both personnel and contractor costs will now be addressed.

a. Cuts to Federal Personnel Costs

Currently, there are varied estimates for the total number of federal civilian jobs expected to be lost due to sequestration. In 2011, there were approximately 2.2 million federal civilian workers

⁴⁷STA REPORT *supra* note 37 at Appendix A..

excluding postal employees, and civilian personnel costs were about \$220 billion.⁴⁸ The STA Report does not provide information on personnel costs. However, if a 8.2 or 9.4 percent cut is applied to these individuals, since salaries themselves cannot be cut, that means that roughly \$20 billion in wages must be addressed through either furloughs or layoffs, which the government refers to as reductions in force or RIFs. However, the \$20 billion number is likely too low, since protections afforded to federal employees mean that the cuts themselves may trigger additional costs. Studies have shown that “[i]n many instances half or more of the first year’s savings from a [RIF] are lost in termination costs. A RIF initiated in the second quarter of a fiscal year is likely to produce little or no savings in that fiscal year.”⁴⁹ However, since under BCA the government must achieve the savings in the current fiscal year, a greater number must be cut.

In DoD alone, one report estimates that “sequestration would, however, force layoffs of roughly 108,000 DoD civilian employees soon after it takes effect.”⁵⁰ Another report estimates that under sequestration within DoD “spending reductions . . . would result in the loss of . . . 48,147 civilian DOD employees.”⁵¹ A third study estimates that when examining sequestration and the enhanced spending caps, “these spending reductions would result in . . . cutbacks in the federal workforce totaling 277,263 and decreases in the federal contractor workforce totaling 468,959 jobs.”⁵² Thus, while there are varied estimates of the exact number of jobs that would be lost in the federal workforce under application of the BCA, there is no question that the number will be significant.

The question for small businesses that work with the federal government is which employees will be cut. Traditionally, when staffing reductions occur, “each agency has the right to decide what positions are abolished, whether a RIF is necessary, and when the RIF will take place.

Once the agency makes these decisions, the retention regulations then determine which

⁴⁸ GOVERNMENT ACCOUNTABILITY OFFICE (GAO), FEDERAL WORKERS: RESULTS OF STUDIES ON FEDERAL PAY VARIED DUE TO DIFFERING METHODOLOGIES 1, GAO 12-265 (2012). This amount accounts for approximately 6 percent of the federal budget.

⁴⁹ Scott Lilly, *How Sequestration Would Work*, CENTER FOR AMERICAN PROGRESS, June 18, 2012, *available at* <http://www.americanprogress.org/issues/budget/report/2012/06/18/11751/how-sequestration-would-work/>.

⁵⁰ TODD HARRISON, CENTER FOR STRATEGIC AND BUDGETARY ASSESSMENTS ANALYSIS OF THE FY 2013 DEFENSE BUDGET AND SEQUESTRATION – BACKGROUNDER 18 (Aug. 2012) [*hereinafter* CSBA FY 2013] *available at* <http://www.csbaonline.org/wp-content/uploads/2012/08/Analysis-of-the-FY-2013-Defense-Budget.pdf>.

⁵¹ STEPHEN S. FULLER, GEORGE MASON UNIVERSITY, PREPARED FOR AEROSPACE INDUSTRIES ASSOCIATIONS, THE ECONOMIC IMPACT OF THE BUDGET CONTROL ACT OF 2011 ON DOD AND NON-DOD AGENCIES 12 (July 2012) [*hereinafter*, FULLER] *available at* http://www.aia-aerospace.org/assets/Fuller_II_Final_Report.pdf.

⁵² *Id.* at 12.

employee is actually reached for a RIF action.”⁵³ However, if the sequester is being applied uniformly across all eligible programs, agencies will have significantly less discretion to select which positions are abolished. The question then simply becomes which positions within each program office are abolished.

According to the Office of Personnel Management (OPM), which develops policy and regulations for RIFs,⁵⁴ “[w]hen an agency must abolish positions, the RIF regulations determine whether an employee keeps his or her present position, or whether the employee has a right to a different position.”⁵⁵ Under this methodology, “competing employees shall be classified on a retention register on the basis of their tenure of employment, veteran preference, length of service, and performance in descending order.”⁵⁶ For practical purpose, this means that employees with seniority whose jobs are abolished may bump lower level employees out of more junior positions and then take those positions for themselves.⁵⁷

Additionally, a RIF may put the government in a precarious position as newer and younger federal employees may be terminated due to their lack of tenure, while experienced federal employees may opt for retirement. Already, absent sequestration, there are concerns that “the fact that more people are eligible for retirement, combined with salary freezes and increased workloads, means more people in leadership and other critical positions will be leaving and taking a great deal of institutional knowledge with them.”⁵⁸ Therefore, there is likely to be a substantial gap in knowledge. For small contractors, no where does this play out more significantly than within the acquisition workforce.

A trained acquisition workforce is crucial to small business success. When contracting officers understand the laws regarding the use of small businesses and have experience implementing sophisticated acquisition plans, they are able to increase competition, drive down prices, and

⁵³ SUMMARY OF REDUCTION IN FORCE UNDER OPM’S REGULATIONS, U.S. OFFICE OF PERSONNEL MANAGEMENT, available at <http://www.opm.gov/rif/general/rifguide.asp#2> (last visited Sept. 10, 2012).

⁵⁴ 5 U.S.C. § 3502.

⁵⁵ SUMMARY OF REDUCTION IN FORCE UNDER OPM’S REGULATIONS; *supra* note 29; *see also* 5 C.F.R. § 351 for all pertinent regulations related to Reduction in Force.

⁵⁶ Order of retention – competitive service, 5 C.F.R. § 351.501(a).

⁵⁷ *Id.*; *see also* SUMMARY OF REDUCTION IN FORCE UNDER OPM’S REGULATIONS; *supra* note 29.

⁵⁸ PARTNERSHIP FOR PUBLIC SERVICE AND GRANT THORNTON LLP, BRACING FOR CHANGE: CHIEF HUMAN CAPITAL OFFICERS RETHINK BUSINESS AS USUAL 10 (Aug. 2012), available at ourpublicservice.org/OPS/publications/viewcontentdetails.php?id=209.

encourage innovation. In FY2010, there were a total of 74,630 acquisition professionals, including 35,048 contracting officers, overseeing over \$538 billion in contracts and nearly six million transactions exceeding \$3,000.⁵⁹ This means that each contracting officer, on average, was responsible for an average “spend” of \$15 million and 171 transactions. This number includes the 58 Procurement Center Representatives (PCRs) – employees of the Small Business Administration charged with ensuring that small business have the ability to compete on federal prime contracts. These individuals each oversee nearly \$10 billion in spending.

Of these individuals, 18 percent were eligible to retire in FY2010, and another 36 percent will become eligible to retire before FY2020, meaning that 54 percent of the workforce is at or close to retirement.⁶⁰ Twenty-five percent planned to retire before FY2016.⁶¹ Another 8.3 percent exit the workforce annually.⁶² Since a contracting officer must have at least four years of experience to begin training to be a senior level contracting officer, and that training takes at least 2 years, it will take at least six years to train a new hire to be a senior contracting officer.⁶³ Thus, “retaining existing workforce expertise” is frequently ranked as the top priority in the acquisition community.⁶⁴ GAO has also found contracting and contract management to be high risk areas for the government.⁶⁵

If sequestration and the enhanced spending caps are put into effect on January 2, 2013, these concerns are likely to be amplified. Not only will there be far fewer contracting officers – there will also be fewer PCRs and fewer employees in the Offices of Small and Disadvantaged Business Utilization. As noted above, cuts to federal employment are unlikely to yield significant, if any, savings if not implemented at greater than 9.4 or 8.2 percent. However, even an 8.2 percent reduction in the acquisition workforce will have a negative effect on small businesses. The federal employees responsible for overseeing contracts may lack the knowledge

⁵⁹ FEDERAL ACQUISITION INSTITUTE (FAI), FY2010 ANNUAL REPORT ON THE FEDERAL ACQUISITION WORKFORCE 2 (2011); FEDERAL PROCUREMENT DATA SYSTEM, Report Generated September 11, 2012 (on file with the Committee).

⁶⁰ *Id.* at 2, 9.

⁶¹ *Id.* at 9.

⁶² *Id.*

⁶³ DEFENSE ACQUISITION PORTAL, LEVEL III CERTIFICATION GUIDE, available at <https://dap.dau.mil/career/pmt/Pages/Certification3.aspx> (last visited Sept. 13, 2012).

⁶⁴ See, e.g., Jason Miller, *Acquisition Workforce, Contract Management Top CAO Priorities*, FEDERAL NEWS RADIO, Jan. 10, 2012, available at <http://www.federalnewsradio.com/547/2700322/Acquisition-workforce-contract-management-top-CAO-priorities>.

⁶⁵ GAO, HIGH RISK: UPDATE 125-138, GAO-11-278 (2011).

to properly ensure small business contracting opportunities. As the contracting officers will have additional demands on their time from dealing with terminations, as will be discussed in the next section, their workload will actually increase even though spending will decline. Thus, they will be forced to bundle contracts to manage their own workload, and the bundling of contracts itself excludes small business participation at the prime contract level. This bundling is likely to proceed unchecked, since the government already lacks sufficient PCRs to prevent bundling, and with these cuts there will be even fewer of these small business advocates. Given the large scope of bundled contracts, there are simply fewer companies able to compete for them, so market forces are not able to bring down prices. Thus, the government ends up paying more, exacerbating the very problem that led to the enactment of the BCA.

b. Cuts to Contractors

In FY2010, the federal government spent \$538 billion on prime contracts with federal contractors, including over \$107 billion with small businesses.⁶⁶ An additional \$74 billion was spent with small businesses as subcontractors – 35.4 percent of all subcontracted work from federal prime contracts, although this does not include small businesses simply considered suppliers rather than formal subcontractors.⁶⁷ Thus, over \$181 billion in small business receipts can be tracked to federal contracts. If the federal government were actually meeting the statutory small business goals, this number would be higher still – over \$206 billion.

As sequestration is implemented, many of these contracts will be canceled or modified to a reduced scope. With prime contracts, if the contractor has been complying with the terms and conditions of the contract, the federal government may terminate the existing contracts as a termination for convenience.⁶⁸ Unlike a termination for default where the “the [g]overnment is not liable for the contractor’s costs on undelivered work and is entitled to the repayment of advance and progress payments,”⁶⁹ terminations for convenience require that when the government terminates a contract the settlement “should compensate the contractor fairly for the

⁶⁶ *Supra* note 35.

⁶⁷ Data on file with the Committee.

⁶⁸ Termination of Contracts, 48 C.F.R. § 49.

⁶⁹ Effect of Termination for Default, Termination for Default, 48 C.F.R. § 49.402-2(a).

work done and the preparations made for the terminated portions of the contract, including a reasonable allowance for profit.”⁷⁰

Under sequestration, the government may opt to terminate existing contracts for convenience in an attempt to generate savings. While some contracts may expire at approximately the same time as sequestration takes effect, most will need to be modified through terminations and changes. Former Administrator of the U.S. Office of Federal Procurement Policy (OFPP), Dan Gordon, has stated that terminations are “expensive, slow and labor-intensive.”⁷¹ Given the length of negotiating termination settlements and the expense associated with convenience terminations, the government ultimately ends up paying a substantial amount to the contractor, negating real savings while negatively affecting small firms who may be forced to cease expansion and even downsize.⁷² Even if the government does not have sufficient funds available from current appropriations, Supreme Court precedent suggests that appropriations would need to be diverted from other sources to cover the costs.⁷³

As military funding in Iraq and Afghanistan has started to decrease there has already been an increase in government contract termination. In FY2011, the government terminated 13,579

⁷⁰ General, Additional Principles for Fixed-Price Contracts Terminated for Convenience, 48 C.F.R. § 49.201(a); please note that the standards for Cost-Reimbursement Contracts Terminated for Convenience vary from the fixed-price contract noted and in those circumstances, under General, Adjustment of Fee, Additional Principles for Cost-Reimbursement Contracts Terminated for Convenience, 48 C.F.R. § 49.305-1, “(a) The TCO shall determine the adjusted fee to be paid, if any, in the manner provided by the contract. The determination is generally based on a percentage of completion of the contract or of the terminated portion. When this basis is used, factors such as the extent and difficulty of the work performed by the contractor (*e.g.*, planning, scheduling, technical study, engineering work, production and supervision, placing and supervising subcontracts, and work performed by the contractor in (1) stopping performance, (2) settling terminated subcontracts, and (3) disposing of termination inventory) shall be compared with the total work required by the contract or by the terminated portion. The contractor’s adjusted fee shall not include an allowance for fee for subcontract effort included in subcontractors’ settlement proposals. (b) The ratio of costs incurred to the total estimated cost of performing the contract or the terminated portion is only one factor in computing the percentage of completion. This percentage may be either greater or less than that indicated by the ratio of costs incurred, depending upon the evaluation by the TCO of other pertinent factors.”

⁷¹ Nick Taborek, *Surge In Canceled Deals Offers Preview Of Sequester Damage Ahead*, WASH. POST, Aug. 19, 2012, available at http://www.washingtonpost.com/business/economy/surge-in-canceled-deals-offers-preview-of-sequesters-effects/2012/08/19/51832c18-e730-11e1-a3d2-2a05679928ef_story.html.

⁷² Please note that Authorities and Responsibilities, Termination of Contracts, 48 C.F.R. § 49.101(e) requires the government to give priority to keeping small business contracts when seeking to terminate, indicating “if the same item is under contract with both large and small business concerns and it is necessary to terminate for convenience part of the units still to be delivered, preference shall be given to the continuing performance of small business contracts over large business contracts unless the chief of the contracting office determines that this is not in the [g]overnment’s interest.”

⁷³ *Salazar v. Ramah Navajo Chapter*, 132 S. Ct. 2181 (U.S. 2012).

contracts, valued at \$2.15 billion.⁷⁴ This represents a considerable increase from FY2006 when the government terminated 5,692 contracts valued at \$416 million.⁷⁵ Even more notable, is that in FY2011 only 7.5 percent of the contracts were terminated for default.⁷⁶ This means that the majority was terminated for convenience and must go through the time and cost intensive negotiation process, and may still result in litigation before the Civilian or Armed Services Board of Contract Appeals, or in front of the Court of Federal Claims before the parties can agree upon the amount to which the contractor is entitled.

While the total cost related to termination for convenience under sequestration is speculative, previous convenience termination fees illuminate substantial costs that reduce concrete savings. For example, in 2009 the Pentagon terminated a multi-billion dollar contract associated with the Army's modernization program.⁷⁷ Today, three years later, the negotiating process remains ongoing and the DoD expects to pay at least \$500 million to the contractor.⁷⁸ Additionally, this figure fails to take into account the cost of the resources and personnel spent to perform this process. This one example demonstrates the considerable costs associated with termination for convenience, which will likely be exacerbated due to sequestration.

In conversations with Committee staff, officials involved in the termination process have estimated the costs of termination to be between 25 and 100 percent of the costs saved, meaning that to save \$1 million, the government must terminate between \$1.25 million to \$2 in contracts. Thus, if a 9.4 or 8.2 percent savings from contracting is desired, rather than terminating over \$50 in prime contracts in FY2013, the government would need to terminate as much as \$120 billion – more than small businesses receive in prime contracts altogether. This process is further complicated since sequestration applies to funds not obligated by the civilian agencies prior to

⁷⁴ Taborek, *supra* note 47.

⁷⁵ Taborek, *supra* note 47.

⁷⁶ Taborek, *supra* note 47.

⁷⁷ Marjorie Censer, *The High Cost of Savings*, WASH. POST, May 25, 2012, available at http://www.washingtonpost.com/business/capitalbusiness/termination-fees-could-add-up-for-government/2012/05/25/gJQASyFqU_story.html.

⁷⁸ *Id.*

January 2, 2013, but in the case of DoD it applies to funds not obligated as of October 1, 2012.⁷⁹ Thus, DoD will be continuing to contract with funds subject to the sequester.

Advice being offered to firms on how to survive sequestration highlights the challenges small businesses will face. While a larger, more established firm may have the diversification necessary to survive by considering “[w]hat discretionary initiatives can be put on hold to reduce expenses, such as capital expansion, marketing campaigns, employee training, etc.” or holding key “affected employees on the bench,” small businesses rarely have the resources to consider these cost saving measures.⁸⁰ Given that the average size of an award to small businesses in FY2010 was approximately \$50,000, and that most companies had fewer than ten total federal contracts, the loss of one contract can prove devastating to a firm.⁸¹ Many industries that have appeared before the Committee have stated that their profit margin is less than 3 percent. These firms simply cannot absorb additional costs and survive.⁸²

While the loss of prime contracts and prolonged battles for termination costs will put some small businesses out of business, at least prime contractors have the ability to recoup termination costs and changes from the government. In contrast, subcontractors are dependent on the success of their prime contractor’s case, and then must themselves negotiate a settlement with the prime absent the same due process protections. While the termination for convenience clause included in the prime contractor’s contract with the government is included in subcontracts as a matter of course, not all subcontracts require that the prime itself suffer a termination for convenience before terminating its subcontractors. Even without the threat of sequestration, small businesses often complain that prime contractors choose to perform work in-house to achieve additional savings rather than adhering to teaming agreements and subcontracts.⁸³ Thus, the Committee is already receiving anecdotal reports of prime contractors declining to exercise options in advance of sequestration.

⁷⁹ George Little, Press Secretary, Pentagon, DOD News Briefing, (July 17, 2012) available at <http://www.defense.gov/transcripts/transcript.aspx?transcriptid=5078>.

⁸⁰ Michael Tinsley, *7 Tools for Sequestration Survival*, WASH. TECH., Aug. 30, 2012 available at <http://washingtontechnology.com/articles/2012/08/30/sequestration-character-test.aspx>.

⁸¹ *Supra* note 35, data analysis by the Committee.

⁸² *See, e.g.*, H.R. Rep. No. 112–017 (2011) (small businesses cannot survive three percent withholding on payments since profit margins are too low).

⁸³ Matthew Weigelt, *Small Firms 'Stiffed' on Subcontracts, Survey Says* FED. COMPUTER WEEK, June 20, 2012, available at <http://fcw.com/Articles/2012/06/20/subcontracts-survey-stiff.aspx?Page=2>.

As the terminations themselves are eventually resolved, it will be harder for small businesses to win new prime contracts. As previously discussed, a reduction in contracting officers and PCRs will lead to additional contract bundling, putting many contracts out of reach for small firms. Those contracts that are still available will be more expensive to pursue, because as spending goes down, “bid protests,” or the action by which contractors challenge an agency’s choice of contract awardee, invariably rise. This has already begun, with contractors filing “2,353 protests during the fiscal year 2011, an increase of over 18 percent compared to fiscal 2009 when federal spending on contracts peaked.”⁸⁴ Small firms have fewer resources to put towards bid protests and work with slim profit margins. For example profit margins in the construction industry are often below one percent.⁸⁵ Companies also avoid filing protests out of a fear alienating potential clients. Therefore, the bid protest system disfavors small competitors.⁸⁶

As sequestration progresses and the enhanced budget caps apply, the government will be forced to strategically look at both current and future contracts, resulting in a substantial decrease in government contract spending. It is likely that the government will seek to terminate contracts for convenience, but given the high termination fees this may result in relatively paltry savings for the government while devastating a small business and substantially weakening their ability to expand and stimulate the economy.

VI. Industrial Base Considerations

While small businesses are frequently credited as the job creators and innovators in the national economy, the small business contracting programs add two additional roles for small businesses. Small businesses bring competition, which any introductory level economics class illustrates will reduce costs. Further, the Small Business Act states that awards to small business should be promoted “(1) to be in the interest of maintaining or mobilizing the Nation’s full productive

⁸⁴ STEVEN M. MASER, WILLAMETTE UNIVERSITY, IBM CENTER FOR THE BUSINESS OF GOVERNMENT, IMPROVING GOVERNMENT CONTRACTING: LESSONS FROM BID PROTESTS OF DEPARTMENT OF DEFENSE SOURCE SELECTIONS 5 (June 2012), [*hereinafter* LESSONS FROM BID PROTESTS] available at <http://www.businessofgovernment.org/sites/default/files/Improving%20Government%20Contracting.pdf>, (suggesting that protests will become more common as the federal budget declines).

⁸⁵ Joel Stonington, *Most and Least Profitable Business Types*, BLOOMBERG BUSINESS WEEK, Jan. 1, 2011, available at <http://images.businessweek.com/slideshows/20110118/most-and-least-profitable-business-types/slides/2>, Noting, profit margin for nonresidential construction reported as 0.78 percent.

⁸⁶ LESSONS FROM BID PROTESTS, *supra* note 59, at 7.

capacity, [and] (2) to be in the interest of war or national defense programs.”⁸⁷ The importance of small businesses to the industrial base is not disputed, as DoD reports that:

the industrial base is not made up of only those who receive prime awards. The truth is that perhaps two-thirds to three-quarters of every dollar the Department awards at the prime level is spent for subcontracted goods and services at the so-called “lower tier” of the industry. But while these companies might be “lower tier” in this sense, they are not of lower importance – they are centrally important to a healthy industrial base. They are frequently rich in technology and dynamism. They are also important drivers of program cost – frequently down but sometimes up – and the sources of supply chain efficiencies or, alternatively, disruptions in major programs. So their health and performance are critical to us. Smaller firms, start-ups, and new entrants provide needed new technology, new faces, and new ideas to the defense industry. The nation’s small businesses add vitality to our base in both prime and subcontractor roles.⁸⁸

Indeed, former Deputy Defense Secretary William J. Lynn III stated last year that the “defense industrial base has emerged as a national asset, with thousands of firms and suppliers – some big, and others small – helping to equip the U.S. military. These firms, their suppliers, and their suppliers’ suppliers, . . . each are links in a chain that, if broken, can have outsized consequences on military capabilities.”⁸⁹

Thus, the effects of sequestration and implementation of the enhanced budget caps on the industrial base, especially the small business segment of the base, are of particular concern. The

⁸⁷ Small Business Act, § 15(a); 15 U.S.C. § 644(a).

⁸⁸ DOD, OFFICE OF MANUFACTURING & INDUSTRIAL BASE POLICY, ANNUAL INDUSTRIAL CAPABILITIES REPORT TO CONGRESS 2 (2011) [*hereinafter* 2011 INDUSTRIAL CAPABILITIES].

⁸⁹ John D. Banusiewicz, *Lynn: Spending Slowdown Must Preserve Industrial Base*, AMERICAN FORCES PRESS SERVICE, June 11, 2011, available at <http://www.defense.gov/news/newsarticle.aspx?id=64375>.

National Association of Manufacturers (NAM) recently issued a report on the economic and employment impacts of specific alternative scenarios for defense spending from fiscal years 2012 to 2022, and their report concluded that, “[w]ithin the overall manufacturing sector, the largest job losses are felt in the large nondurable sector (food, textiles, chemicals and fuels) and the transport equipment sector. The biggest proportional reductions are within transportation equipment and instruments. In particular, aerospace loses 3.4 percent of its jobs in 2015, and these losses persist as employment is still down 2.3 percent by 2022. Ships and boats are affected similarly, losing 3.3 percent of jobs by 2014 and 1.7 percent of jobs by 2022. The search and navigation equipment industry takes the biggest proportional hit. It shows a maximum loss of 9.3 percent of its employment in 2016 and 8.6 percent in 2022.”⁹⁰ The subcategories of manufacturing each play a key role in the defense of our nation and are already each areas of concern for the industrial base, with DoD expressing concern over the number of firms choosing to “exit the business.”⁹¹

As crucial as the manufacturing capabilities we risk losing are the advances the nation may never achieve. According to DoD in September 2011 – pre-sequestration – “the impact of top line budget constraints on future procurement and Research, Development, Test and Evaluation (RDT&E) funding levels means that industry design and development capabilities may be at risk.”⁹² Research provides not only new technology for weapons systems, but frequently allows the government to realize cost savings.⁹³ Consequently, when proposing its own budget cuts to meet the original \$487 billion in mandatory cuts, DoD proposed only cutting RDT&E by three percent - the lowest reduction for any major account – in order to protect future weapons system developments and future savings.⁹⁴ However, according to the STA Report, approximately \$7.5 billion in additional RDT&E spending will be sequestered in FY2013.⁹⁵ Small businesses play an important role in this area, since small businesses produced 16 times more patents per

⁹⁰ NATIONAL ASSOCIATION OF MANUFACTURERS, DEFENSE SPENDING CUTS: THE IMPACT ON ECONOMIC ACTIVITY AND JOBS 13 (2012) available at <http://www.nam.org/~media/6C787C12117F49D1BDA2B6526A14DC2E.ashx>.

⁹¹ 2011 INDUSTRIAL CAPABILITIES, *supra* note 63, at 16, 21, 26, 28, 44.

⁹² *Id.* at 14, 19-25.

⁹³ See, e.g., Thomas Atkinson, Naval Post Graduate School, *Skipping a Generation of Weapons System Technology: The Impact on the Department of Defense and the Defense Industrial Base* (2003).

⁹⁴ CSBA FY 2013, *supra* note 26, at 4.

⁹⁵ STA REPORT *supra* note 37 at Appendix A.

employee than large patenting firms.⁹⁶ Thus, sequestration may result in the loss of short- and long-term security by weakening the industrial base.

VII. Employment

While the above discussion focused primarily on companies with a contracting or subcontracting relationship with the federal government, through the multiplier effect many more companies and small businesses will be affected. For example, for each job created in the two industries previously discussed -- manufacturing and research -- additional jobs will be created. In the case of manufacturing jobs, 2.9 jobs will be created for each manufacturing job.⁹⁷ For every high technology and innovation based job, “five additional jobs are ultimately created.”⁹⁸ This multiplier effect is increasingly important when one considers that while small businesses have historically created 65 percent of net new jobs, in the past two years, they have created 67 percent of net new jobs.⁹⁹

Given that the Administration estimates “that it takes approximately \$92,000 of spending to create one job-year,”¹⁰⁰ it is not surprising that economists estimate that “[t]he magnitude of economic impacts resulting from BCA over the combined FY2012-FY2013 period . . . would result in the loss of 746,222 direct jobs including cutbacks in the federal workforce totaling 277,263 and decreases in the federal contractor workforce totaling 468,959 jobs, thus affecting all sectors of the national economy.”¹⁰¹ Once the multiplier effect is included, the numbers

⁹⁶ ANTHONY BREITZMAN, PH.D. AND DIANA HICKS, PH.D., OFFICE OF ADVOCACY, U.S. SMALL BUSINESS ADMINISTRATION (SBA), AN ANALYSIS OF SMALL BUSINESS PATENTS BY INDUSTRY AND FIRM SIZE (2008), available at <http://archive.sba.gov/advo/research/rs335tot.pdf>; see also C. J. ISOM AND DAVID R. JARCYK, OFFICE OF ADVOCACY, SBA, INNOVATION IN SMALL BUSINESSES: DRIVERS OF CHANGE AND VALUE USE (2009) available at www.sba.gov/sites/default/files/rs342tot_0.pdf.

⁹⁷ JOSH BIVENS, ECONOMIC POLICY INSTITUTE, UPDATED EMPLOYMENT MULTIPLIERS FOR THE U.S. ECONOMY 23 (2003) available at http://www.epi.org/page/-/old/workingpapers/epi_wp_268.pdf. For comparison, business services have a multiplier of 1.63.

⁹⁸ Leslie Brokaw, *The Multiplier Effect of Innovation Jobs*, MIT SLOAN MGMT. REVIEW, June 6, 2012, available at <http://sloanreview.mit.edu/improvisations/2012/06/06/the-multiplier-effect-of-innovation-jobs/#.UFD8C411RO>.

⁹⁹ SBA OFFICE OF ADVOCACY, FREQUENTLY ASKED QUESTIONS 1 (2012), available at www.sba.gov/sites/default/files/FINAL_FAQ_2012_Sept_2012_web.pdf.

¹⁰⁰ COUNCIL OF ECONOMIC ADVISERS, EXECUTIVE OFFICE OF THE PRESIDENT, ESTIMATES OF JOB CREATION FROM THE AMERICAN RECOVERY REINVESTMENT ACT OF 2009 (2009), available at <http://www.whitehouse.gov/administration/eop/cea/Estimate-of-Job-Creation>. A job year is one year of employment for a full time equivalent employee.

¹⁰¹ FULLER, *supra* note 27, at 12.

become bleaker: a loss of 2.14 million jobs; a decrease in personal earnings of the workforce by \$109.4 billion; and a reduction in GDP by \$215 billion.¹⁰²

While the BCA will have broad effects on all small businesses, those involved with government contracting face a particular hurdle: the Worker Adjustment and Retraining Notification (WARN) Act.¹⁰³ The WARN Act requires businesses with over 100 employees to provide 60 days advance notice to employees and state workforce agencies before conducting mass layoffs, generally defined as either shutting down a place of business or laying off more than 50 employees.¹⁰⁴ Failure to issue the required notices means that an employer will be liable to each aggrieved employee for an amount including back pay and benefits for the period of violation, up to 60 days, and penalties of up to \$500 per day for each unit of local government also entitled to the notice.¹⁰⁵ Consequently, many federal contractors including Lockheed Martin Corp., EADS North America and BAE, are concerned with whether such a notice must be issued in November, 60 days before sequestration takes effect.¹⁰⁶

The Department of Labor (DOL) has notified state workforce agencies that such a notice is unnecessary, stating that the unforeseeable business exception to the WARN Act applies since the “the closing or mass layoff is caused by business circumstances that were not reasonably foreseeable as of the time that notice would have been required.”¹⁰⁷ However, since enforcement of the WARN Act is through the federal courts and cases are not brought by the DOL, many have questioned whether the notice provides any protection for employers who follow its guidance, noting that sequestration is indeed foreseeable.¹⁰⁸ Furthermore, none of this guidance addresses employers in any of the 15 states with their own versions of the WARN Act.¹⁰⁹ These

¹⁰² *Id.* at 2.

¹⁰³ 29 U.S.C. §§ 2101-2109.

¹⁰⁴ *Id.*

¹⁰⁵ *Id.*

¹⁰⁶ Eric Katz, *Defense Industry Planning Pre-Sequestration Layoff Warnings*, GOVERNMENT EXEC., Sept 11, 2012, available at <http://www.govexec.com/contracting/2012/09/defense-industry-planning-pre-sequestration-layoff-warnings/58020/>.

¹⁰⁷ JANE OATES, ASSISTANT SECRETARY, DEPARTMENT OF LABOR, GUIDANCE ON THE APPLICABILITY OF THE WORKER ADJUSTMENT AND RETRAINING NOTIFICATION (WARN) ACT 3 (2012) citing 29 U.S.C. § 2102(b)(2).

¹⁰⁸ Eric Katz, *GOP Lawmakers to Contractors: Defy Labor Department, Warn Employees of Sequestration Layoffs*, GOVERNMENT EXEC., Aug. 6, 2012, available at <http://www.govexec.com/contracting/2012/08/gop-lawmakers-contractors-defy-labor-department-warn-employees-sequestration-layoffs/57240/>.

¹⁰⁹ Cal. Lab. Code §§ 1400 -1408; Conn. Gen. Stat. §§ 31- 51n, 31-51o; Haw. Rev. Stat. §§ 394B-2, 394B-9; 820 Ill. Comp. Stat. §§ 65/1 -65/99; Iowa Code §§ 84C.1 - 84C.5; Me. Rev. Stat. tit. 26, § 625B ; Md. Code Ann., Labor & Employment §§ 11-301, 11-302, 11-304; Mass. Gen. Laws 151a, § 71 Mich. Comp. Laws §§ 450.731 - 450.736;

state statutes may apply to firm with as few as 25 employees,¹¹⁰ and require notification as much as 90 days in advance.¹¹¹ The DOL notice does not provide protection against litigation under these statutes.

Consequently, many firms will issue WARN Act notices in early November. For small businesses, this can have many consequences – the most skilled of employees will look elsewhere for work, potentially leaving the company unable to complete its current contracts. Workplace morale will suffer, and consumer spending decline, thereby further exacerbating current economic conditions.

VIII. Legislative Proposals

Since the Super Committee failed, the House of Representatives has sought to avert sequestration through two legislative proposals. The first proposal, the *Sequester Replacement Reconciliation Act of 2012* (H.R. 5652), was introduced by Rep. Paul Ryan (R-WI-1) on May 9, 2012. This bill passed the House on May 10, 2012, by a vote of 218-199. However, although the legislation has been placed on the Senate Calendar, the Senate has not yet taken up the bill and the White House has issued a Statement of Administration Policy against H.R. 5652.¹¹²

H.R. 5652 “exempts mandatory defense spending from sequestration,”¹¹³ lowers “the Budget Control Act spending cap by \$19 billion in FY2013,”¹¹⁴ and if reconciliation is enacted into law “would turn off the remaining \$78 billion sequestration for FY2013 and replace it with mandatory spending reforms.”¹¹⁵ The CBO estimated that if enacted around October 1, 2012, this legislation “would yield net deficit reduction of \$237.8 billion over the 2012-2022 period. That figure reflects changes in direct spending and revenues from reconciliation provisions that

Minn. Stat. §§ 116L.17, 116L.976; N.H. Rev. Stat. §§ 275-F:1 - 275-F:12; N.J. Stat. Ann. § 34:21-1; N.Y. Lab. art. 25-A, §§ 860A - 860I; R.I. Gen. Laws § 28-14-4(c); Tenn. Code. Ann. §§ 50-1- 601-604; Wis. Stat. §§ 109.07 - 109.09.

¹¹⁰ Mich. Comp. Laws §§ 450.731 - 450.736.

¹¹¹ N.Y. Lab. art. 25-A, §§ 860A - 860I.

¹¹² OFFICE OF MGMT. & BUDGET, EXECUTIVE OFFICE OF THE PRESIDENT, STATEMENT OF ADMINISTRATIVE POLICY, H.R. 5652 – SEQUESTER REPLACEMENT RECONCILIATION ACT OF 2012 (May 9, 2012), *available at* http://www.whitehouse.gov/sites/default/files/omb/legislative/sap/112/saphr5652r_20120509.pdf.

¹¹³ Legislative Bulletin, The Republican Study Committee, *H.R. 5652 – Sequester Replacement Reconciliation Act of 2012 (Rep. Ryan, R-WI)*, (May 10, 2012), *available at* http://rsc.jordan.house.gov/uploadedfiles/lb_51012_reconciliation_2.pdf.

¹¹⁴ *Id.*

¹¹⁵ *Id.*

would yield gross estimated budgetary savings of \$310.0 billion through 2022, partially offset by a cost of \$72.2 billion through 2022 for the sequester replacement provisions in title VII of the legislation.”

The second proposal, the *National Security and Job Protection Act* (H.R. 6365), was introduced by Rep. Allen West (R-FL-22) on September 10, 2012. Specifically, H.R. 6365 provides a contingency plan to avert sequestration by eliminating automatic budget cuts provided that Congress passes a bill with substantial spending cuts for fiscal year 2013.¹¹⁶ It also “requires the President of the United States to submit an alternative plan to replace the sequester, and encourages the United States Senate to follow suit with its own alternative.”¹¹⁷ H.R. 6365 was passed by the House on Thursday, September 13, 2012, by a vote of 223-196. The Office of Management and Budget (OMB) has issued a Statement of Administration Policy recommending that the President veto H.R. 6365, because while “sequestration would be highly destructive to both defense and non-defense priorities” the bill does not include tax increases for those making over \$250,000 per year.¹¹⁸

IX. Issues Before the Committee

a. DoD’s Actual Projected Cuts

Given the disparity between Undersecretary Kendall’s 11 percent projected cut and OMB’s 9.4 percent cut at DoD, the Committee wishes to learn what DoD actually anticipates in terms of cuts, and whether these anticipated cuts account for the costs incurred to make the sequestration cuts.

b. DoD Response to the Small Business Segment of the Industrial Base Under Sequestration

¹¹⁶ H.R. 6365, 112th Cong. (2012).

¹¹⁷ Press Release, Congressman Allen West, *West Introduces National Security and Jobs Protection Act*, available at http://west.house.gov/index.php?option=com_content&view=article&id=4618:west-introduces-national-security-and-jobs-protection-act&catid=73:press-releases.

¹¹⁸ OFFICE OF MGMT. & BUDGET, EXECUTIVE OFFICE OF THE PRESIDENT, STATEMENT OF ADMINISTRATIVE POLICY, H.R. 6365 NATIONAL SECURITY AND JOB PROTECTION ACT (Sept. 12, 2012) available at http://www.whitehouse.gov/sites/default/files/omb/legislative/sap/112/saphr6365r_20120912.pdf.

Given the threats to small business participation in federal contracting, especially DoD contracting, posed by sequestration, the Committee hopes to hear from DoD on whether it is possible to protect small businesses during sequestration, and if so, how DoD intends to do so. Specifically, the Committee wishes to learn how DoD will protect prime and subcontract opportunities for small businesses, especially those in areas critical to the industrial base. As DoD is already failing to meet its small business goals, what corrective plans does it have, and how are these affected by sequestration? As the acquisition workforce is trimmed due to cuts, will there be sufficient contracting officers to avoid unjustified contract bunding? Will DoD implement any expedited procedures to help small businesses facing terminations or changes to their contracts? How will DoD address the treatment of subcontractors in the face of terminations and changes?

c. Current Consequences of Sequestration

From the small business witnesses and experts presenting testimony, the Committee hopes to better assess the consequences of sequestration already being experienced by small businesses. Specifically, are firms basing decisions on hiring and pursuing federal contracts on sequestration? Economic uncertainty is the antithesis of small business growth, yet the lack of plans for implementing the sequester have exacerbated small business uncertainty during a time when small businesses already face the possibility of tax increases and numerous regulatory changes.

d. Post-Implementation Consequences of Sequestration

While this memorandum has described some projected consequences of sequestration, the Committee wishes to use this opportunity to learn from small businesses and economists what they foresee as the consequences of sequestration. Specifically, the Committee will examine whether the technology and manufacturing sectors will survive sequestration, the effects of sequestration on the retention of current prime and subcontracts, and whether small businesses bear a disproportionate share of the burden.¹¹⁹

¹¹⁹ Mackenzie Eaglan, *Sequestration Hurts Small Business More Than Big Business*, ROLL CALL, July 18, 2012, available at <http://www.rollcall.com/news/Eaglan-Sequestration-Hurts-Small-Business-More-Than-Big-Business-216206-1.html>.

e. Opportunities for Small Businesses to Assist in Spending Reductions

The Committee will discuss the contracting reforms marked up by the Committee and included in the Section XVI of the National Defense Authorization Act for 2013 (H.R. 4310). These reforms attempt to leverage improved small business contracting practices to improve the health of the industrial base while increasing competition and saving taxpayer dollars. Coupled with surgical cuts decided upon by Congress or the Administration, these may offer a more responsible approach to cutting federal spending. The Committee will discuss these reforms with the small business witnesses as an option for allowing small businesses to be part of the solution to the debt crisis.

f. The Effects of Sequestration at SBA

While this hearing and memorandum focus on the issues facing small contractors working with DoD, there will be cuts at other agencies that may also uniquely affect small firms. If sequestration occurs, SBA will lose \$75 million in funding. Like the cuts proposed at DoD, the cuts at SBA are rather indiscriminate and more damaging than necessary. The Committee, in its annual Views and Estimates letter, has traditionally highlighted areas of waste or unnecessary duplication within the SBA that exceed the \$75 million figure.¹²⁰ However, the Committee is concerned that the sequester of an additional \$29 million from the agency's Business Loans Program Account coupled with uncertainty associated with sequestration could lead to significant disruption including temporary cessation of the SBA's lending programs. Therefore, the Committee welcomes feedback from the small business witnesses as to whether more targeted cuts at SBA would better serve small businesses. The Committee will continue to study these consequences, as well.

X. Conclusion

Given the dire consequences of allowing sequestration to progress unchecked, the Committee hopes to better understand the ways in which small businesses are uniquely harmed by

¹²⁰ See, e.g. COMMITTEE ON SMALL BUSINESS, VIEWS AND ESTIMATES OF THE COMMITTEE ON SMALL BUSINESS ON MATTERS TO BE SET FORTH IN THE CONCURRENT RESOLUTION ON THE BUDGET FOR FISCAL YEAR 2013 (Mar. 7, 2012) available at <http://smallbusiness.house.gov/calendar/eventsingle.aspx?EventID=283065>.

sequestration and highlight these concerns for our colleagues. As a consequence of these harms, competition for federal contracts may decline, jobs may be lost, tax revenues may decrease, innovation may be stifled, and the industrial base may be irrevocably undermined. The issues raised at the hearing should provide additional context for Committee members as they make decisions regarding sequestration.