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EVALUATING OPTIONS FOR A SUSTAINABLE DEFENSE

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Introduction

As the economy struggles to emerge from the deepest recession since the Great Depression, the federal government faces a dire fiscal situation. The budget deficit is projected to reach as high as $1.6 trillion in FY 2010 due in no small part to increased spending on fiscal stimulus programs and a sharp reduction in tax revenues due to the recession. But underlying the current fiscal situation is a structural deficit that the economic downturn only exacerbated. A telling indicator of this is that one of the fastest-growing items in the budget is net interest on the national debt. Given current projections, before this decade's end the federal government will spend more on net interest payments than on national defense for the first time in modern history. And as Congress and the administration focus more attention on reducing the deficit, all areas of the budget, including defense, will come under increasing pressure.

The following pages review five areas of potential savings in the defense budget, addressing many of the options presented in the report of the Sustainable Defense Task Force. The first two major areas of savings, achieving greater efficiencies and refocusing on the core business of defense, are changes that do not affect the size, composition, or capabilities of the military. While the savings from these areas would be relatively modest, they should be explored first before delving into more substantive changes to the Department. The three additional areas of savings reviewed are reforming the military personnel system, reforming the acquisition system, and altering the force structure. While these areas have the potential to yield much greater savings, they involve changes in the missions and capabilities supported by the Department and should consider factors beyond the budget.

Achieving Greater Efficiencies

The first area of savings to explore is achieving greater efficiencies in how DoD spends its money—in other words, getting the same or greater capabilities with fewer resources. As both Secretary Gates and his predecessor have pointed out, there are certainly wasted and misdirected resources within the Pentagon's budget. And it is prudent to search for and root out waste at all times, not just when budgets are tight.

Efficiencies alone are not likely to result in the magnitude of savings needed over the coming decade.

In recent months, the Pentagon has renewed its efforts to reduce waste and achieve greater efficiencies in several ways. Secretary Gates, in his May speech at the Eisenhower Library, directed the military Services to take an "unsparing look at how they operate" in order to reduce overhead and support costs.[1] While Secretary Gates acknowledged that he was not the first to attempt to cut DoD's overhead costs, what distinguishes his approach is that he plans to allow the Services to keep whatever savings they are able generate by reinvesting those dollars in their modernization accounts. While this does not reduce the overall budget, providing this incentive motivates the Services to look hard and dig deep to find efficiencies.

Undersecretary Carter followed up weeks later with an address to leaders in the defense industry and a memo to acquisition professionals. In the memo, he says that DoD must "abandon inefficient practices accumulated in a period of budget growth." He goes on to say that about one-third of the savings they envision will come from eliminating programs and activities that are no longer needed, and the remaining two-thirds will come from greater efficiencies within programs and activities that are needed.[2] Many of the specific proposals put forth to achieve greater efficiencies, such as leveraging competition, involving small businesses, and stabilizing production rates, are things that have been tried in the past to various degrees of success. One of the proposals he includes which has the potential to achieve significant cost savings is to limit the use of award fee contracts. According to the GAO, award fee contracts have a history of paying out high levels of award fees regardless of the performance of contractors—a practice akin to grade inflation.[3] Reducing or eliminating the use of these types of contracts could reduce costs by lowering profit margins on some programs.

While working to achieve greater efficiencies should always be a goal of the Department, efficiencies alone are not likely to result in the magnitude of savings needed over the coming decade. Moreover, similar efforts in the past have had a mixed record of success with results often far below expectations. Robert Hale, now serving as Under Secretary of Defense (Comptroller), noted in a 2002 report:

> The efficiency savings achieved in recent years appear to be modest compared with the size of the defense budget and fall well short of the tens of billions of dollars in savings some past studies have suggested might be possible. Nor have efficiencies

1 Robert Gates, *Remarks at the Eisenhower Library*, May 8, 2010. Accessed at http://www.defense.gov/speeches/speech.aspx?speechid=1467.

2 Ashton Carter, *Memorandum for Acquisition Professionals*, June 28, 2010.

3 GAO, *DoD Acquisitions: Contracting for Better Outcomes* (Washington DC: GAO, September 7, 2006) p.7. Accessed at http://www.gao.gov/new.items/d06800t.pdf.

> halted the growth in operating costs. After adjusting for changes in force size and inflation, day-to-day operating costs have consistently and persistently increased for decades.[4]

This should not serve as an excuse to forego efforts to achieve greater efficiencies but rather as a warning that the Department cannot rely solely on efficiencies and must also pursue additional options.

Refocusing on the Core Business of Defense

The second area of savings to explore is reducing, eliminating, or transferring programs and activities that are not part of the core business of defense. DoD's mission is "to provide the military forces needed to deter war and to protect the security of our country."[5] Yet many programs and activities funded within the DoD budget, including some items that have long been part of the defense budget, stray far from that mission. Three areas in particular that should be examined are the military exchanges, commissaries, and DoD primary and secondary schools in the United States.

DoD funds and operates three separate military exchanges (the Army and Air Force Exchange, the Navy Exchange, and the Marine Corps Exchange) which are essentially retail stores offering a wide array of consumer goods and services, similar to a Wal-Mart or Target but located on a military installation. The first exchanges were established more than a century ago to provide troops and their families with an affordable retail outlet in locations where little else existed. However, with the increasing availability, accessibility, and competitiveness of low-cost, private-sector retail chains both within the United States and around the world, there is no longer a compelling justification for maintaining DoD's network of exchanges. The Sustainable Defense Task Force's recommendation, which follows a budget option outlined by the CBO last year, is to consolidate the three exchanges into one organization and require it to pay all of its operating costs from sales revenue for a projected savings of $200 million annually. DoD should also consider simply eliminating the exchanges or selling them to a private operator since operating a chain of retail stores is far outside the core business of defense.

DoD also funds and operates a chain of grocery stores, known as commissaries, which sell food and other household goods at or below market prices. These stores date back to 1825 when Army posts began allowing officers to purchase items at-cost for personal use from commissary department storehouses. The use of these stores expanded over time with the intention of providing on-base retail options for Service members and their families.[6] However, times have changed over nearly two centuries, and the availability of a wide array of modern, private-sector grocery store chains—even at locations once considered remote posts on the frontier—has negated the need for DoD-operated commissaries. Currently,

4 Robert Hale, *Promoting Efficiency in the Department of Defense: Keep Trying, But Be Realistic* (Washington DC: CSBA, January 2002) p. i. Accessed at http://www.csbaonline.org/4Publications/PubLibrary/R.20020125.Promoting_Efficien/R.20020125.Promoting_Efficien.php.

5 DoD mission statement as listed on the main DoD web site, Defense.gov, accessed at http://www.defense.gov/admin/about.html.

6 *History Of U. S. Military Commissaries*, accessed at http://www.commissaries.com/history.cfm.

the commissary system operates with an annual subsidy of $1.3 billion from the defense budget.[7] As with the exchanges, DoD should consider eliminating the commissaries or selling them to a private operator. A portion of the savings from the annual subsidy could be used to increase the subsistence allowance by $300 per year, which the CBO estimates would fully compensate for the savings the average military family would lose from closing the commissaries. The resulting savings for DoD would total some $900 million annually.

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Another activity outside the core business of defense is the DoD-funded and operated primary and secondary school system within the United States, known as the Domestic Dependent Elementary and Secondary Schools (DDESS). This part of the DoD Education Activity (DoDEA) operates 63 schools in eight states and territories across the United States (Alabama, Georgia, Kentucky, New York, North Carolina, South Carolina, Virginia, and Puerto Rico). The origin of these schools dates back to the time of frontier Army posts "when adequate public education was not available in the local area," a condition that is no longer true in the states listed above.[8] It should be noted that DoDEA also operates schools in twelve foreign countries around the world, providing an American-style education curriculum that may otherwise not be available to the children of Service members deployed overseas. But within the United States, education has traditionally been the responsibility of state governments. Several options exist to move DDESS out of the defense budget, including handing over these schools to the states in which they reside or transferring this responsibility (and the associated budget) to the Department of Education. There is ample precedent for merging DDESS schools with local schools, for example Robins Air Force Base Elementary School in Georgia closed last year due to declining enrollment and students were transferred to the local county school system.[9] The savings in the defense budget from this option would total some $750 million[10] annually, although if funding were transferred to another federal department it would not reduce the deficit.

Reforming the Military Personnel System

The next area of savings to explore is reforming the military personnel system. Because DoD is the single largest employer in the United States—accounting for 51 percent of federal workers and employing more people than Wal-Mart and the Post Office combined—changes to military pay and benefits have a profound and lasting effect on the federal budget. Over the past decade, Congress has enacted new and expanded benefits for military personnel, retirees, and their dependents, and has increased basic military pay at

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7 CBO, *Budget Options Volume 2* (Washington DC: CBO, August 2009) p. 29. Accessed at http://www.cbo.gov/ftpdocs/102xx/doc10294/08-06-BudgetOptions.pdf.

8 DoDEA, *Annual Report of DoDEA—Americas* (DoD, 2009) p. 2. Accessed at http://www.dodea.edu/pubs/docs/AmericasAnnualReport-09.pdf.

9 Ibid., p. 3.

10 Author's estimate based on the total budget for DoDEA ($2.3 billion) and the proportion of students within DoDEA that attend DDESS schools (approximately one-third). This figure does not include cost avoidance from not having to replace and recapitalize DDESS facilities as part of the 5-year military construction program proposed in the FY 2011 budget request.

a rate higher than private-sector pay. While military compensation lagged behind private-sector compensation in the 1980s and 1990s, as a result of the increases enacted over the past decade, average real military compensation (RMC) now exceeds the 75^{th} percentile of earnings for civilians with comparable education and experience.[11]

At the same time, the labor cost structure within the military compensation system has grown out of balance. In the private sector, non-cash and deferred compensation for benefits such as healthcare and retirement pensions comprises 29 percent of total compensation.[12] Before General Motors was forced into bankruptcy, non-cash and deferred compensation was 46 percent of workers' total compensation. For the Department of Defense, 52 percent of total compensation goes to non-cash and deferred benefits. Just as GM struggled to remain competitive under the heavy burden of excessive labor costs, so too will the Department of Defense struggle in the years ahead to maintain its force structure if the labor cost structure is not brought back into balance.

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The Sustainable Defense Task Force echoes the recommendation of the Quadrennial Review of Military Compensation in proposing that allowances for housing and subsistence and associated tax breaks that military personnel receive be included when determining pay raises. Since these allowances are a form of cash compensation, it seems reasonable to include them when setting military pay raises equal to the Employment Cost Index (ECI), a measure of the increase in wages for private-sector workers. Moreover, enacting across-the-board pay raises greater than the ECI is no longer necessary now that military compensation has returned to levels at or above comparable private-sector pay, unemployment has risen, and the rate of deployments is projected to gradually decline. Instead, bonuses should be targeted to select career fields where recruitment and/or retention are critical.

The Task Force also recommends increasing the annual fee military retirees pay for healthcare coverage. The current TRICARE enrollment fee was set in 1995 at $460 per year for the basic family plan and has not been raised since. During that time the average annual health insurance premium paid by private-sector workers has risen to more than $3,500. The growing gap between what military retirees (many of whom work in civilian jobs) pay for TRICARE coverage and what they would otherwise pay for coverage under their or their spouse's employer is causing more retirees to stay in the military healthcare system. The TRICARE for Life program, which provides a wrap-around policy for Medicare-eligible retirees, currently has no enrollment fee. Increasing the enrollment fees for TRICARE for

11 CBO, *Evaluating Military Compensation* (Washington DC: CBO, April 28, 2010) p. 4. Accessed at http://www.cbo.gov/ftpdocs/114xx/doc11463/04-28-MilitaryPay.pdf.

12 Bureau of Labor Statistics, *Employer Costs for Employee Compensation – March 2010* (Washington DC: BLS, June 9, 2010). Accessed at http://www.bls.gov/news.release/ecec.nr0.htm.

retirees and instituting enrollment fees for TRICARE for Life, as proposed by the Task Force, would generate annual savings of $6 billion.[13]

What the Task Force does not address in its recommendations is the cost of retirement pensions. DoD currently offers a cliff vesting retirement plan effective after twenty years of service. Because only 15 percent of enlisted personnel and 47 percent of officers stay for twenty years, a relatively small number of people receive benefits from this plan.[14] Moreover, a cliff vesting system creates distorted incentives in that it encourages personnel nearing the vesting point to stay even if only for the purpose of attaining the benefit, and once a person passes the vesting point the incentive sharply reverses to encourage early retirement, since personnel can continue making 50 percent or more of their military pay while simultaneously drawing full pay at a civilian job. A number of options for reforming the military retirement system are proposed in the Tenth Quadrennial Review of Military Compensation, including altering the vesting and payout periods for the current system and establishing gate pays and separation pays.

One of the most attractive options proposed is to transition from the current defined benefit plan to a defined contribution plan. The US Military and colonial militias were the first organizations to offer pensions in America. It wasn't until the early twentieth century that many private employers began offering such plans. But in more recent years private employers, and even some state governments, have increasingly turned to defined contribution plans, such as 401(k) plans.[15] As of 1998, over 90 percent of retirement plans in the private sector were defined contribution plans.[16] Changing to a defined contribution plan offers several advantages for both DoD and military personnel: personnel who leave mid-career can take vested amounts with them; personnel can borrow against the plan; DoD can better forecast and control costs; and DoD can create a vesting schedule that provides a broader retention incentive rather than the current cliff-vesting incentive that provides little incentive for junior personnel. The downside to this change is that it would benefit those who serve for longer than twenty years relatively less than the current system.

Reforming the Acquisition System

Another area that is of perennial interest is defense acquisitions. According to the Defense Acquisition Performance Assessment Report from January 2006, some 128 studies have been performed addressing the issue of acquisition reform. Indeed, efforts to reform the acquisition system date back as far as the Civil War when uniforms provided for Union troops literally fell apart because too much "shoddy" material was used—a term that originally referred to leftover pieces of wool mixed into new material to reduce costs. The

13 CBO, *The Effects of Proposals to Increase Cost Sharing in TRICARE* (Washington DC: CBO, June 2009). Accessed at http://www.cbo.gov/ftpdocs/102xx/doc10261/TRICARE.pdf.

14 DoD, *Report of the Tenth Quadrennial Review of Military Compensation Volume II* (Arlington, VA: DoD, February 2008) p. 12-3. Accessed at http://www.defense.gov/news/QRMCreport.pdf.

15 Stephen P. McCourt, *Defined Benefit and Defined Contribution Plans: A History, Market Overview and Comparative Analysis* (Benefits and Compensation Digest, February 2006) p. 1. Accessed at http://www.ifebp.org/PDF/webexclusive/06feb.pdf.

16 DoD, *Report of the Tenth Quadrennial Review of Military Compensation Volume I* (Arlington, VA: DoD, February 2008) p. 31. Accessed at http://www.whs.mil/library/doc/Tenth.pdf.

term shoddy henceforth became associated “substandard military goods and contractors.”[17] While the defense industry and acquisition system of today bear little resemblance to the Civil War era, many of the same issues persist. These issues and the proposals to resolve them can be divided into two broad categories: reforming *what* DoD buys and reforming *how* DoD buys.

In the Sustainable Defense Task Force Report, the vast majority of the options for savings in defense (eleven of nineteen) involve changes to what DoD buys. It is true that cutting acquisition programs can yield some of the greatest savings in the near-term, but such decisions should not be based on budget considerations alone. These decisions should also consider which missions and capabilities DoD no longer needs to support, or should be accorded lower priority. For example, the Task Force’s proposal to move to a nuclear dyad by eliminating the bomber leg of the nuclear triad is not a decision that should be made for budgetary reasons alone. Such a significant change in our nuclear deterrent should be driven by an assessment that the threat environment has changed substantially enough to warrant such a change. The Task Force also proposes cancelling the Expeditionary Fighting Vehicle. In this instance, a case can be made that DoD no longer needs this capability because it has not called on the Marines to perform a contested amphibious assault since the Korea War, and with the proliferation of increasingly accurate long-range missiles, mortars, and artillery, it is not likely to do so in the foreseeable future. Yet once this capability is lost, it will likely be far more difficult—and costly—to recreate it should it be needed.

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The options the Task Force proposes involving the F-35, MV-22, and KC-X are all recommendations that put a greater emphasis on cost and schedule than performance. In each of these cases, the next-generation systems being procured have substantially greater capabilities than the systems they replace, but legacy systems, or upgrades to legacy systems, can provide a reduced level of capability sooner and at a lower cost. Again, such decisions should be made in concert with an assessment of future threat environments and whether or not the more advanced capabilities are likely to be needed. And such decisions must also take into account the impact they will have on the industrial base. That being said, in a period of constrained resources, it is certainly prudent to increase the relative emphasis placed on cost.

The Task Force’s recommendations do not address the issue of reforming how DoD buys things—the acquisition processes itself—though this area is also ripe for reform. Previous acquisition reform efforts have addressed the process by which requirements are developed and managed. One of the problems often cited is that requirements get piled on to weapon systems, each making the system more costly to develop and field. Many different organizations within the Department have a role in the requirements process, ranging from the Joint Requirements Oversight Council (JROC) to the various organizations within the Office of the Secretary of Defense that review and approve programs as they pass through

17 Mark R. Wilson, *The Business of Civil War* (Baltimore, Maryland: Johns Hopkins University Press, 2006) p. 149-50.

acquisition milestones. Yet few of the organizations that have the power to add, modify, or otherwise influence requirements have the responsibility to fund the programs. This misalignment between those who set requirements and those who budget for programs is at the heart of the problem. Creating a better organizational alignment between requirements and budget authority would reduce the incentive to add "exquisite" requirements that drive up costs and stretch out schedules. Congress could also improve the process by allowing greater use of multiyear procurement contracts, which could result in significant savings from better optimized production schedules.

Altering the Force Structure

The final area of savings to explore is altering the force structure. The Sustainable Defense Task Force Report recommends reducing US troops in Asia and Europe by one-third (and cutting end strength accordingly) and rolling back the size of the Army and Marine Corps to pre-2007 levels. Returning the Army and Marine Corps to a pre-2007 end strength may be prudent once deployment rates to Iraq and Afghanistan have subsided, since the increase was designed to reduce the strain repeated deployments put on the troops and their families. But if the intent of both of these measures is simply to reduce personnel costs, the Department would be better served in the long run by first tackling the underlying labor cost structure, as discussed previously, and only then adjusting the size of the force.

Some of the deepest cuts in force structure proposed by the Task Force are associated with the "strategy of restraint" developed by members of the Cato Institute. The report describes this strategy as one "that emphasizes our ability to bring force from the sea to defeat and deter enemies, rather than putting troops ashore in permanent policing roles." The central idea behind this strategy is that by reducing the number of missions DoD is expected to fulfill, the force structure (and associated end strength and weapon systems) can be significantly reduced—a minimalist approach to defense. It does not address which specific missions our military would sacrifice, what capabilities we expect our allies will be able to contribute, and the impact such a change in national strategy would have on the balance of power in different regions around the world. Again, such decisions should not be based on budgetary factors alone. They should be informed by a realistic assessment of the future threat environment and a determination of where the Department is willing to take risk.

Conclusion

For decades, the United States has enjoyed a comparative advantage over adversaries due in no small part to the sheer amount of resources it could devote to defense. But as the nation's fiscal situation deteriorates, that source of advantage is eroding. As deficit reduction efforts put downward pressure on all areas of the budget in the coming years, some savings can be found in the defense budget that would not affect the size, composition, or capabilities of the military—areas where DoD could do things more efficiently or stop doing things outside the core business of defense. Moreover, options to reduce personnel costs, acquisitions, and force structure that would affect the size, composition, and capabilities of the military can be structured so that the resulting force is better aligned with the threats most likely to be encountered in the future.

While a declining defense budget will force the Department to make many difficult decisions, it also presents an opportunity to transform the military into a more efficient and effective force. The most recent effort to transform the military, however, failed to achieve many of its goals despite the availability of ample funding. Somewhat ironically, the rapidly rising base defense budget may have prevented the Department from transforming because it allowed the Services to continue funding existing programs and not fully commit to transformation. The era of constrained resources that is now upon us and the possibility of a declining defense budget for years to come have the potential to force the Services to make the difficult choices that are necessary for transformation to be effective.

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