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AVOIDING A DOD BAILOUT

By Todd Harrison

Secretary Gates said recently: “If the Department of Defense can’t figure out a way to defend the United States on a budget of more than half a trillion dollars a year, then our problems are much bigger than anything that can be cured by buying a few more ships and planes.” He has a point. The problems in the defense budget are much bigger than the recent debates over buying more F-22s, cancelling the Presidential Helicopter, or building an alternative engine for the F-35 Joint Strike Fighter. In fact, the Department of Defense’s (DoD) problems are eerily similar to the challenges General Motors faced a year ago.

First, consider the labor cost structure of both GM and DoD. Noncash and deferred compensation for GM employees, such as healthcare and retirement pensions, accounted for 46% of total compensation in 2006—far higher than the private sector average of just 29%, as reported by the Bureau of Labor Statistics. In comparison, noncash and deferred compensation for active-duty troops in the US military is 52% of total compensation, according to the Government Accountability Office—an even higher share than GM. Military healthcare alone, not including veterans’ healthcare, costs over \$47 billion each year, nearly one tenth of the DoD base budget. At the current rate of growth, these costs will nearly double every ten years.

Another similarity between the two is that both organizations are in a period of disruptive change in the competitive environment. In GM’s case, its market share rapidly eroded as gas prices climbed higher, the economy slowed, and consumers turned to smaller, more fuel-efficient vehicles. GM found itself building a fleet of SUVs and trucks that consumers did not want and could not afford. Similarly, DoD now finds itself saddled with a number of weapon programs whose capabilities are ill-suited for the types of conflict the military currently faces and whose costs have risen beyond what the Department can afford. Many of the new weapons being funded today are optimized for middle-of-the-spectrum conflicts—that is, conventional, military-on-military conflicts such as Operation Desert Storm in 1991. But adversaries are well aware of the United States’ overwhelming advantage in the middle and are instead moving to either end of the spectrum: irregular warfare on one end and high-end, asymmetric warfare on the other. The challenge for DoD, as it was for GM, is that the competition is adapting faster than it can keep up.

A telling example is the Marine Corps' Expeditionary Fighting Vehicle (EFV), an amphibious vehicle designed to move Marines from ship to shore and then, once on land, to serve as a ground combat vehicle. In a high-end conflict against a sophisticated adversary, the ships launching the EFV from sea would likely not be able to get the EFV within range of the shoreline because they would be vulnerable to attack by anti-ship missiles, rendering the EFV useless. On land, the vehicle's flat bottom is vulnerable to roadside bombs, making it unsuitable for irregular warfare as well.

Moreover, just as the slowing economy complicated GM's efforts to revitalize its business, the state of the overall federal budget will prevent DoD from spending its way out of these problems. Deficits are at record levels, and OMB projects that interest payments will rise at a real rate of 13% annually over the next ten years. If these trends continue, by 2018 interest payments on the national debt (\$725 billion) will exceed total national defense spending (\$698 billion) for the first time in modern history. President Obama's plan for the base defense budget slows growth over the coming years, but it nevertheless puts him on track to spend more on defense in a single four-year term than any other president since World War II, adjusting for inflation. The combination of record deficits, soaring interest payments, and an already high level of defense spending makes any significant increase in the defense budget unlikely.

As a result, the Department of Defense must make some difficult decisions. If the overall defense budget remains relatively flat over the coming years, continued increases in personnel-related costs will crowd out funding for acquisitions. Rather than accept this as inevitable, DoD should begin taking steps to rein in personnel costs. For example, few employers today offer pensions (i.e. defined-benefit plans) and healthcare benefits for retirees—much less a package that becomes effective after only 20 years of service. But in the US military, people who enlist at 18 can retire and begin drawing a pension at only 38 years of age and have healthcare coverage for themselves and their dependents for life—while continuing to work full-time in a second career. Even GM's much-derided labor contracts did not provide benefits this rich. While changes to these benefits, such as increasing the time-in-service required before retirement or increasing insurance premiums for retirees, would be politically difficult, more modest changes could also help begin to control costs. For example, once deployments to Iraq and Afghanistan begin to subside, the number of troops could be reduced to pre-war levels, rather than maintaining a larger standing military indefinitely at what the CBO estimates will cost \$14 billion per year. DoD also spends \$4 billion each year moving members of the military (and their families and possessions) between bases. Rather than uprooting families every couple of years, DoD could cut the number of moves in half and save \$2 billion each year.

But personnel costs are only one part of the equation. The Pentagon must also rethink the types of weapons it is buying and how it buys them. Over the past decade, DoD has attempted to develop new weapons that are more complex and costly than it can afford, leading to lower quantities procured and a backlog of systems now in need of replacement

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or upgrade. The ratio of funding for procurement versus research and development (R&D) in the base defense budget bears this out, having fallen from a high in 1983 of 3.5 dollars spent on procurement for every dollar spent on R&D to the current level of 1.4 to 1. The F-22 program is a good example of this: R&D costs rose by some 50% while the quantity procured fell from 750 to just 187. If DoD does not learn to control R&D costs—and its appetite for “exquisite” systems—programs like the F-35 Joint Strike Fighter may end up in a similar situation.

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The challenges GM faced a year ago are instructive for DoD today. The Department is fundamentally on an unsustainable path, and a sharp change in direction is needed to correct its course. A massive infusion of funding in excess of the current defense plan—a DoD “bailout” of sorts—would only delay the inevitable day of reckoning, much like giving more loans to GM without restructuring the company. Instead, as the Defense Department finalizes its budget request for FY 2011, it must rethink both its personnel costs and weapons programs—and understand the tradeoffs between the two. While there are no easy solutions, the sooner these decisions are made the less painful they will be to carry out.

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