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ANALYSIS OF THE FY 2013 DEFENSE BUDGET AND SEQUESTRATION

by Todd Harrison

Summary: The FY 2013 budget request projects nearly zero real growth in the base defense budget over the coming years and a gradual shift in resources to focus more on air and sea power. Sequestration would alter virtually every aspect of DoD's planning by forcing a uniform reduction in budget authority of roughly 10.3 percent across all accounts other than military personnel. Outlays, however, lag behind budget authority and would only be reduced by 4.6 percent in FY 2013. The delayed effect between budget authority and outlays means that defense contractors would not feel the full effect of sequestration immediately. Sequestration would, however, force layoffs of DoD civilian employees soon after it takes effect. Base closures are specifically prohibited under sequestration, and because the president has exempted military personnel accounts, no uniformed military personnel would be separated from the service or receive a cut in pay because of sequestration.

The Fiscal Year (FY) 2013 defense budget currently being debated in Congress is a departure from previous budgets in several respects. It is the first budget submitted following the release of the Pentagon's new strategic guidance, marking the beginning of a "pivot" from the wars of the past decade to the Asia-Pacific region. It is also the first budget request in more than a decade to propose a real decline in defense spending from the level currently enacted. Moreover, the prospect of sequestration hangs over the budget, threatening to cut some 10 percent of funding if Congress does not act to prevent it. Secretary of Defense Leon Panetta has argued that the budget request is a "complete package," that "there is little room here for significant modification," and that any further funding reductions, such as those called for by sequestration, would require the Department to fundamentally rethink its new strategy.[1] Nevertheless, the FY 2013 request is unlikely to survive unscathed and the Department will likely be forced to revise its strategic guidance.

[1] Leon Panetta, "Major Budget Decisions Briefing from the Pentagon," press briefing, Washington, DC, January 26, 2012.

For this reason, the specifics of this budget request matter less than the general themes it contains. The budget is likely to be modified substantially by the Congressional authorization and appropriations process, and the across-the-board cuts sequestration would impose—or some alternative to sequestration devised by Congress—would further disrupt the detailed plans contained in the budget. Instead of diving into the details of the budget request and the proposed changes in specific programs, this analysis focuses on the overall direction of the budget request, its alignment with the new strategic guidance, and the details of how sequestration would be implemented. It evaluates the impact sequestration would have on different types of accounts and notes the things sequestration would not affect. It also explores some of the major budgetary issues facing the Department even if sequestration is avoided.

Overview of the Budget Request

The Obama Administration's FY 2013 budget requests a total of $620 billion for the Department of Defense (DoD).[2] The base budget for the Department includes $525.4 billion in discretionary funding and $6.3 billion in mandatory funding. An additional $88.5 billion is requested for ongoing military operations, primarily in Afghanistan.

Total defense-related spending, however, includes more than the DoD budget alone. The budget request also includes $19.4 billion in discretionary and mandatory funding for defense-related atomic energy programs, $7.7 billion for defense-related activities in other agencies, and $137.7 billion for veterans' benefits and services. The Treasury must also set aside $67.2 billion to cover unfunded liabilities in the Military Retirement Trust Fund. Together these expenses total $852 billion, or 23 percent of the total federal budget.

The FY 2013 budget request is the first budget proposal following the enactment of the Budget Control Act (BCA) of 2011. The BCA sets budget caps for the discretionary part of the federal budget and includes an enforcement mechanism, known as sequestration, designed to cut spending automatically if it exceeds the budget caps. The BCA also created the Joint Select Committee on Deficit Reduction, commonly known as the Super Committee, and charged it with finding an additional $1.2 trillion in deficit reduction over the coming decade. Because the Super Committee did not reach any agreement on additional deficit reduction, the law requires that the budget caps be lowered to achieve the $1.2 trillion in deficit reduction through spending cuts. Half of these cuts apply to the 050 budget function for national defense and the other half applies to non-defense accounts. A detailed discussion of sequestration and its impact on the defense budget is included in a later section.

[2] All figures are in FY 2013 dollars unless otherwise noted.

Table 1: Summary of Defense-related Funding in the FY 2013 Budget Request

Account	FY 2013 Request *(in billions)*
DoD Base Discretionary	$525.4
DoD Base Mandatory	$6.3
DoD Overseas Contingency Operations	$88.5
DoD Total (051)	***$620.2***
Department of Energy	$17.8
Department of Labor	$1.4
Other Agencies	$0.2
Atomic Energy Total (053)	***$19.4***
Department of Justice	$4.8
Department of Homeland Security	$1.6
Other Agencies	$1.4
Defense-Related Activities Total (054)	***$7.7***
Department of Veterans Affairs	$137.4
Other Agencies	$0.4
Veterans Total (700)	***$137.7***
Payment to Military Retirement Fund	**$67.2**
Total Defense-Related Funding	***$852.2***

Base Defense Budget

The base defense budget funds the peacetime costs of the Department of Defense. The FY 2013 request is a 2.3 percent real decrease from the level enacted for FY 2012, and, if enacted, it would return the base defense budget to roughly the level it was in FY 2008. The Future Year Defense Program (FYDP) included with the budget projects that the base defense budget will remain essentially flat for the next five years, growing at an annual rate of just 0.1 percent above inflation. The FY 2013 FYDP, adjusted for inflation, projects a total of $2.7 trillion in base defense spending over the next five years compared to a projection of $2.9 trillion in last year's FYDP.

In January 2012, before the budget was released, the Obama administration unveiled new strategic guidance for the Department in light of the fiscal constraints of the BCA and the evolving geopolitical environment. The strategic guidance categorizes all of the things the Department does into ten primary mission areas, ranging from counter terrorism and irregular warfare to humanitarian and disaster relief operations. It places a greater focus on the Asia-Pacific region and emphasizes air and sea capabilities.[3] Although the

[3] Department of Defense, *Sustaining U.S. Global Leadership: Priorities for 21st Century Defense* (Washington, DC: Department of Defense, January 2012), p. 2.

strategic guidance was released only a few weeks before the budget request, it was intended to inform program decisions in the budget. The new priorities outlined in the strategic guidance should therefore be reflected in the budget as changes in funding levels from the previous FYDP.

Figure 1 compares the FY 2013 FYDP to the FY 2012 FYDP by major accounts. While the FY 2013 FYDP reduces the overall level of funding by roughly 7 percent in real terms compared to the previous FYDP, the reductions are not uniform across all accounts. Procurement and military construction funding are reduced the most, down an average of 14 percent and 23 percent respectively compared to the previous FYDP.[4] Research, development, test, and evaluation (RDT&E) funding, in contrast, is only reduced by 3 percent compared to the previous FYDP. Funding for military personnel is 7 percent less, due primarily to reductions in Army and Marine Corps end strength, and the budget for operations and maintenance (O&M) receives only a 4 percent reduction. The smaller reductions in O&M and RDT&E relative to other accounts are consistent with two of the priorities highlighted in the new strategic guidance: maintaining "a ready and capable force" even as overall force structure is reduced, and continuing investments in science and technology "to sustain key streams of innovation that may provide significant long-term payoffs."[5]

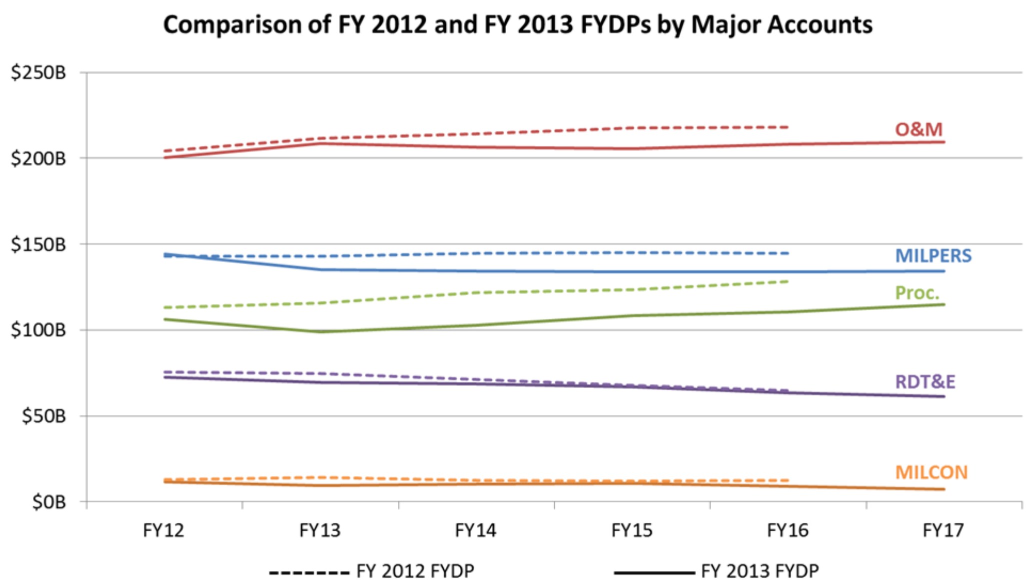

Figure 1: Comparison of FY 2012 and FY 2013 FYDPs by Major Accounts

The new budget also shifts the balance of funding among the Services according to the new strategic guidance, which calls for a greater reliance on air and sea power as part of the pivot to the Asia-Pacific region. Table 2 lists the funding by Service in the FY 2013 FYDP, adjusted for inflation, and the percentage change from the corresponding year in

[4] Unless otherwise noted, all comparisons between FYDPs are the average percentage change for the four overlapping years in the two FYDPs (FY 2013 to FY 2016).
[5] Department of Defense, *Sustaining U.S. Global Leadership,* pp. 7-8.

the FY 2012 FYDP. While each of the Services faces a cut in FY 2013 relative to the level forecasted for FY 2013 in last year's budget, the Army receives the greatest cut at -8.9 percent while the Air Force and Navy / Marine Corps receive smaller cuts at -5.8 percent and -4.3 percent respectively. This trend continues over the remaining years of the FYDP.

Table 2: Funding in the FY 2013 FYDP by Service (in FY 2013 dollars) and Percentage Change from the FY 2012 FYDP

	FY13	FY14	FY15	FY16	FY17[6]
Army	$134,489 (-8.9%)	$132,047 (-9.7%)	$130,052 (-9.0%)	$128,542 (-9.7%)	$128,628 (N/A)
Navy / USMC	$155,609 (-4.3%)	$153,009 (-6.3%)	$156,701 (-4.6%)	$154,909 (-5.7%)	$155,917 (N/A)
Air Force	$139,920 (-5.8%)	$144,569 (-5.8%)	$144,206 (-6.2%)	$146,734 (-6.5%)	$147,432 (N/A)
Defense-Wide	$101,774 (-5.4%)	$101,473 (-7.3%)	$102,706 (-8.9%)	$103,544 (-7.6%)	$102,880 (N/A)

These figures, however, do not include all of the Army and Marine Corps' personnel costs. In the FY 2013 request the Army and Marine Corps move funding for 49,700 soldiers and 15,200 marines from the base budget to the Overseas Contingency Operations (OCO) budget, which effectively avoids the budget caps imposed by the BCA.[7] This shift in funding reduces the Army and Marine Corps base budgets in FY 2013 by $4.9 billion and $1.2 billion respectively.[8] Table 3 lists the funding by Service over the FYDP with these personnel costs moved back into the base budget where they previously resided. With this adjustment, the shift in budget share among the Services is not as clearly aligned with the strategic guidance. While the Army still receives a larger cut over the FYDP than the other Services relative to the funding projected in the previous FYDP, the Air Force receives the largest reduction in FY 2013.

Table 3: Funding in the FY 2013 FYDP by Service Adjusted for Base to OCO Migration (in FY 2013 dollars) and Percentage Change from the FY 2012 FYDP

	FY13	FY14	FY15	FY16	FY17
Army	$139,389 (-5.6%)	$135,722 (-7.2%)	$132,502 (-7.3%)	$129,767 (-8.8%)	$128,628 (N/A)
Navy / USMC	$156,809 (-3.5%)	$153,909 (-5.7%)	$157,301 (-4.3%)	$155,209 (-5.5%)	$155,917 (N/A)
Air Force	$139,920 (-5.8%)	$144,569 (-5.8%)	$144,206 (-6.2%)	$146,734 (-6.5%)	$147,432 (N/A)
Defense-Wide	$101,774 (-5.4%)	$101,473 (-7.3%)	$102,706 (-8.9%)	$103,544 (-7.6%)	$102,880 (N/A)

[6] Comparisons to the previous FYDP are not possible for FY 2017 because the previous FYDP ended at FY 2016.
[7] Office of the Under Secretary of Defense (Comptroller), *Overview: FY 2013 Defense Budget* (Washington, DC: Department of Defense, February 2012), p. 4-13.
[8] Office of the Under Secretary of Defense (Comptroller), "Fiscal Year 2013 Budget Request," presentation, Washington, DC, February 2012, p. 27.

The FYDP, however, has not historically been a reliable indicator of where the budget is headed. Figure 2 compares the FYDPs produced with each budget request over the past four decades, color-coded by administration, to the actual base defense budget enacted into law. During the steepest part of the previous downturn in defense spending (FY 1985 to FY 1994), the FYDPs released in each year's budget request consistently overestimated the level of defense funding in future years. Moreover, the amount of overestimation increased from the first year of the FYDP to the last year. From FY 1985 to FY 1994, the FYDPs projected an average of 5 percent more in the first year and 30 percent more in the last year of the FYDP than the Department ultimately received in total budget authority. This pattern may be repeating itself in the current downturn—both the FY 2011 and FY 2012 FYDPs were 5 percent higher in the first year than the level of funding Congress enacted for that same year.

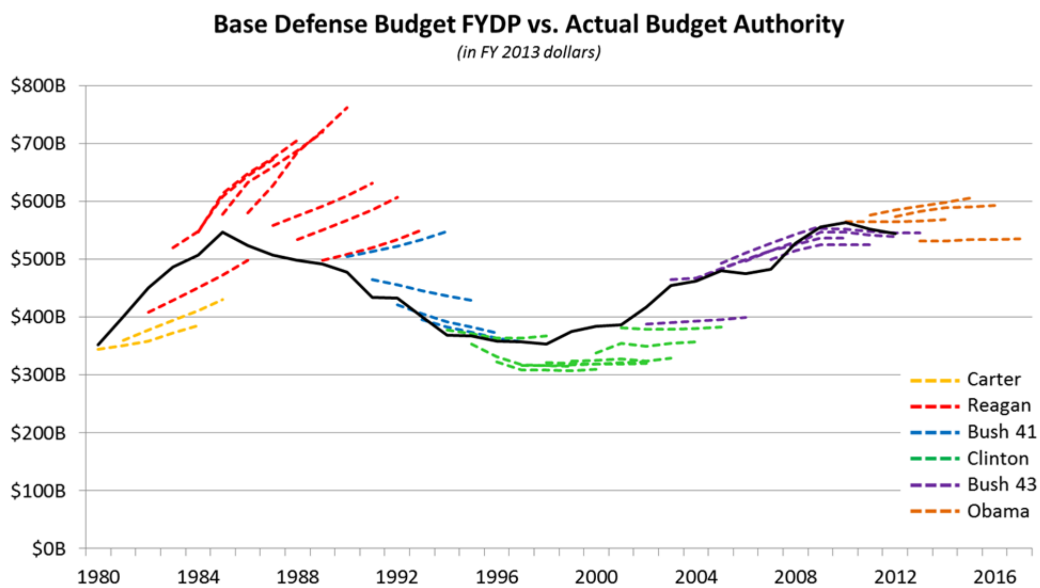

Figure 2: Comparison of FYDPs to Enacted Budget Levels

Also of interest in a presidential election year is the effect a change in administration could have on future budget projections. The last FYDP of the Carter administration and the first FYDP of the Reagan administration, for example, both projected real annual growth of 4 percent over the five-year period. Similarly, the transitions from Reagan to George H.W. Bush, George H.W. Bush to Clinton, Clinton to George W. Bush, and George W. Bush to Obama also show relatively little change from the last FYDP of the outgoing administration to the first FYDP of the new administration. This is because the preparation of the defense budget begins more than a year in advance of the budget release. The first budget of a new administration must rely heavily on the budget the Department prepared under the outgoing administration—it simply does not have the time or resources to build an entirely new budget. As Figure 2 shows, significant shifts in the FYDP due to a change in administration are more often observed in the second FYDP of a new administration. For this reason, the FY 2014 FYDP is unlikely to change significantly due to the outcome of the presidential election.

War Funding

The budget request also includes $88.5 billion for ongoing military operations, primarily in Afghanistan. War-related funding has declined significantly in recent years, falling by more than half in real terms from the peak reached in FY 2008. The decline is due almost entirely to the drawdown in Iraq, which was completed in December 2011. The FY 2013 request includes $2.9 billion for operations in Iraq and $85.6 billion for operations in Afghanistan. In 2011 President Obama announced a plan to begin drawing down forces in Afghanistan from the surge level of more than 100,000. This reduction in forces is reflected in the budget by a 20 percent reduction in funding and a 25 percent reduction in the average troop level compared to current levels.

The funding for operations in Iraq and Afghanistan has demonstrated a remarkable correlation with the number of troops deployed. While the cost of military operations depends on a number of factors, including operational tempo, fuel prices, materiel needs, and the composition of forces, a driving factor appears to be the total number of troops deployed. As Figure 3 shows, the annual cost of each operation has scaled relatively linearly with the number of troops deployed over the past nine years. In Afghanistan the cost to support each troop has averaged $1.2 million per year, while in Iraq the cost has averaged $0.6 million per year. The sharp difference between the two figures can be attributed to the relative lack of infrastructure and access in Afghanistan. As a land-locked country, Afghanistan has proven to be a logistical challenge for keeping troops supplied. For example, the decision by authorities in Pakistan to close border crossings into Afghanistan following the successful raid on bin Laden's compound was estimated by DoD to cost some $100 million per month due to the extra expense of moving supplies into the country through alternate routes.[9]

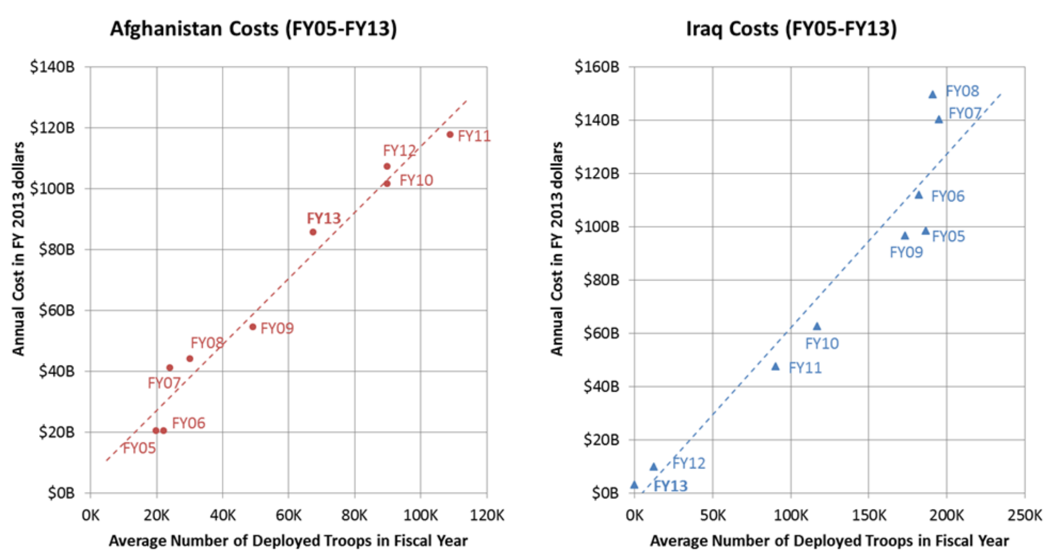

Figure 3: Cost of Operations in Afghanistan and Iraq versus Number of Troops Deployed

[9] Karen DeYoung, "Pakistan border closure costs U.S. $100 million a month," *Washington Post*, June 13, 2012.

Historical Perspectives

Three metrics are commonly used to compare the current level of defense spending to previous levels, each of which can lead to different conclusions about the current state of the defense budget. The first is defense spending in inflation-adjusted dollars. A total of $647 billion is included in the FY 2013 request for national defense (both the discretionary and mandatory parts of the 050 budget function). As Figure 4 shows, defense spending since World War II has risen and fallen in cycles. The most recent buildup in defense spending began in FY 1999 and accelerated after the terrorist attacks of 9/11. Spending on national defense remains relatively high by post-World War II standards when viewed in inflation-adjusted dollars. By this measure, total national defense spending, even if war funding is removed, remains near the previous peak in FY 1985 of $561 billion (in FY 2013 dollars). The FYDP projects that the base national defense budget will stay at this level through FY 2017.

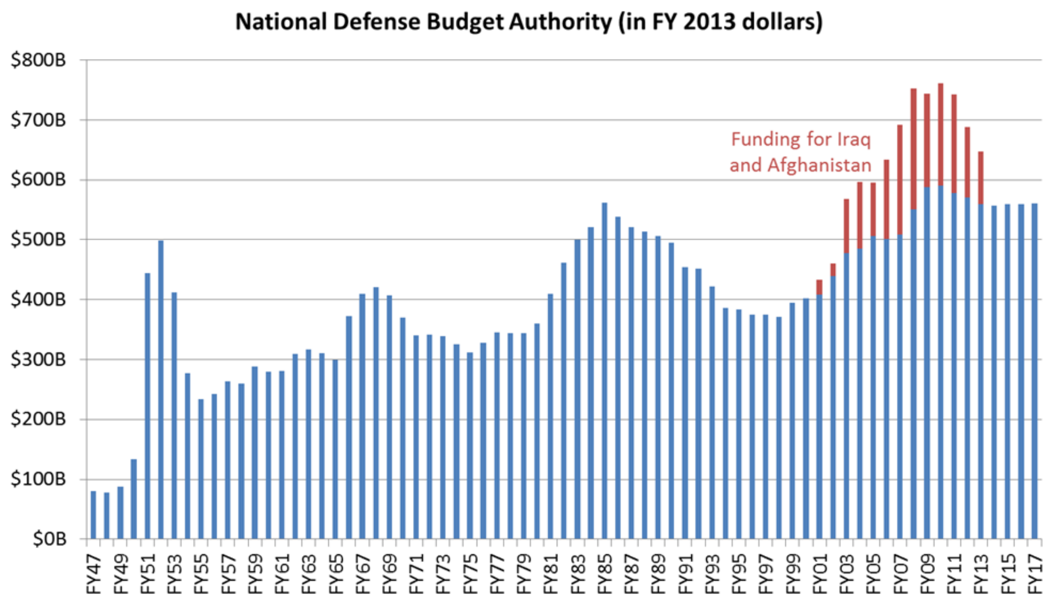

Figure 4: Total National Defense Budget Authority in FY 2013 Dollars

The national defense budget is 4.0 percent of GDP in the FY 2013 budget request and 3.4 percent if war funding is excluded. This is well below the post-World War II average of 6.4 percent of GDP. Moreover, the FYDP projects that the base national defense budget will decline as a percentage of GDP to 3.0 percent in FY 2017—roughly the level it was in FY 2001. The apparent discrepancy between defense spending being near a peak level in inflation-adjusted dollars but not as a percent of GDP is due to the different rates of growth in the defense budget and national economic output. National defense spending has grown and declined several times since the end of World War II. GDP, in contrast, has grown at a relatively steady pace, averaging real annual growth of 3.2 percent from 1947 to 2012. In periods when defense spending and GDP grow at nearly the same rate, defense spending as a percent of GDP remains steady. But when GDP grows at a faster rate than defense spending, defense spending as a percent of GDP declines. Defense spending as a percentage of GDP does not indicate whether or not defense spending is increasing or decreasing. Rather, it indicates the share of national economic output devoted to defense. Given the size of the U.S. economy, the current level of defense spending appears affordable by historical standards.[10]

Another metric often used for comparison is national defense spending as a fraction of overall federal government spending. By this measure, national defense has ranged between 16 percent and 70 percent since the end of World War II, averaging 33 percent of the federal budget. Over the past 20 years, national defense spending has averaged 18.5 percent of the federal budget, the same level proposed in the FY 2013 request including war funding, or 15.2 percent if war funding is excluded. This compares to 23 percent for social security, 14 percent for Medicare, 7 percent for Medicaid, 6 percent for interest on the national debt, and 14 percent for all non-defense discretionary spending in the FY 2013 request.

Together, these three metrics—national defense spending in inflation adjusted dollars, as a percentage of GDP, and as a percentage of total federal spending—indicate that defense spending is at a high level by historical standards but is affordable given the size of the U.S. economy and is consistent with modern-day norms as a portion of overall federal spending.

Sequestration

When Congress passed the Budget Control Act of 2011, it set into motion a process for cutting federal spending across both defense and non-defense accounts. Because the Super Committee did not agree to additional deficit reduction, the law requires an automatic sequestration of funds beginning on January 2, 2013. The following section walks through how sequestration would affect the DoD budget and the impact it would have on major accounts.

Mechanics

The mechanics of how sequestration would be implemented in the DoD budget can be divided into two parts. The first part is the calculation of the dollar amount of the reduction required. The BCA sets a cap on total national defense funding, defined as the 050 budget function. For FY 2013, this cap starts at $546 billion. Funding is then reduced by $54.7 billion because the Joint Select Committee on Deficit Reduction (a.k.a. the Super Committee) failed to achieve any of the $1.2 trillion in deficit reduction it was charged to find.[11] The effective budget cap for the FY 2013 discretionary national defense budget is $491 billion.[12] The budget caps for future years would be reduced by an identical amount of $54.7 billion.

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[10] It is affordable in the sense that the United States can sustain the current level of funding, if the public is willing to pay the taxes required, without damaging the economy in the long run.

[11] Part of the reduction, roughly $700 million, would come from the mandatory part of the national defense budget. For a more detailed explanation of mandatory funding under sequestration, see Todd Harrison, *Defense Funding in the Budget Control Act of 2011* (Washington, DC: Center for Strategic and Budgetary Assessments, August 2011), pp. 3-4.

[12] Technically, the reduction in FY 2013 is not a reduction in the budget cap but rather a "penalty" sequestration. This has the same effect as reducing the budget cap in terms of limiting funding, provided

The BCA requires that the national defense budget for FY 2013 be reduced to $491 billion through a process known as sequestration. The amount of the reduction depends on the budget in effect at the time. If a continuing resolution is in effect, for example, the amount of the reduction would be the difference between the annualized amount of budget authority under the continuing resolution and $491 billion. This analysis assumes the level of funding in the FY 2013 budget request is effect. If a higher level of funding is in place, the reduction required will be larger.

The total amount of discretionary national defense funding in the FY 2013 request is $639 billion, including $88.5 billion for OCO. The BCA specifies that any funding designated as OCO-related is not counted against the budget cap. Thus, the total amount of national defense funding in the request that would count against the budget cap is $551 billion, or $59.2 billion higher than the effective budget cap of $491 billion. The base DoD budget is $525 billion, or 95.4 percent of the 050 national defense budget function. DoD would therefore receive 95.4 percent of the cuts, or $56.5 billion.

The second part of sequestration is the application of these cuts to defense accounts. The BCA specifies that the reductions be applied as a uniform percentage cut across all accounts, which means virtually every part of DoD would be affected. The only significant discretion allowed under the law is that the president can exempt military personnel accounts, which the Obama administration has already notified Congress it intends to do.[13] But exempting these accounts does not decrease the dollar amount of cuts required. The same amount of reduction must be divided among all non-exempt accounts, resulting in larger cuts to O&M, procurement, RDT&E, and military construction.

The uniform percentage cut is applied to total available funding in non-exempt accounts at the time of sequestration. The total available funding includes whatever budget authority is in place for FY 2013, including OCO funding, and unobligated balances from previous years. While OCO funding does not affect the dollar amount of the cuts because it does not count against the budget cap, it does affect the calculation of the percentage cut required across non-exempt accounts. The FY 2013 request includes $525 billion for the base DoD budget and $88.5 billion for OCO. The DoD Comptroller also projects that $81.6 billion will be carried forward in unobligated funds, although the exact amount of unobligated balances will not be known until just before sequestration occurs.[14] Using these values, a total of $696 billion would be available in DoD accounts. Some $149 billion of this is in military personnel accounts, which would be exempt from sequestration.

Congress does not preemptively cut the budget below the original cap. See Congressional Budget Office, *Sequestration Update Report: August 2012* (Washington, DC: Congressional Budget Office, August 2012), p. 4.

[13] Executive Office of the President, Office of Management and Budget, Letter to the Honorable Joseph R. Biden, Jr., July 31, 2012, available at http://www.whitehouse.gov/sites/default/files/omb/legislative/letters/military-personnel-letter-biden.pdf.

[14] Office of the Under Secretary of Defense (Comptroller) Directorate for Program and Financial Control, *Financial Summary Tables* (Washington, DC: Department of Defense, February 2012), Section G.

Table 4 summarizes the amount of funds available for obligation by major account assuming the FY 2013 request is enacted into law.

Table 4: FY 2013 Funding by Major Account (in thousands of dollars)

	FY13 Base Budget Request	FY13 OCO Request	FY13 Estimate of Unobligated	Total Available Funding
MILPERS	$135,111,799	$14,060,094	$182,992	$149,354,885
O&M	$208,759,219	$63,986,203	$9,300,134	$282,045,556
Procurement	$98,823,354	$9,687,241	$41,186,380	$149,696,975
RDT&E	$69,407,767	$245,516	$8,328,401	$77,981,684
MILCON	$9,571,929	$0	$11,226,072	$20,798,001
Family Housing	$1,650,781	$0	$677,794	$2,328,575
Revolving Mgmt Funds	$2,124,320	$503,364	$9,760,291	$12,387,975
Trust Funds	$0	$0	$944,106	$944,106
Total	*$525,449,169*	*$88,482,418*	*$81,606,170*	*$695,537,757*

The calculation of the uniform percentage cut across all applicable accounts would therefore be:

$$Percentage\ Cut = \frac{\$56.5\ B}{\$525.4B + \$88.5B + \$81.6B - \$149.4B} = 10.3\%$$

If military personnel accounts were not exempt from the cuts, the pool of applicable accounts would be larger, which would in turn make the percentage cut smaller:

$$Percentage\ Cut = \frac{\$56.5\ B}{\$525.4B + \$88.5B + \$81.6B} = 8.1\%$$

Impacts on Major Accounts

An important fact about the BCA is that the budget caps apply to budget authority. Budget authority is the amount of money appropriated by Congress in a given year. Depending on the type of funding appropriated, DoD has multiple years over which to spend its budget authority. For example, in defense acquisitions it can sometimes take two or three years to award a contract, obligate funding, and pay a vendor. When the money is actually transferred from the U.S. Treasury to person or company, it becomes an outlay. The rate at which DoD estimates budget authority for FY 2013 will become outlays is shown in Table 5 by major account. As this table indicates, nearly all military personnel funding and more than two-thirds of O&M funding is spent in the same year it is appropriated. Procurement and RDT&E funding, in contrast, have more of a delay between budget authority and outlays. Only 22 percent of procurement funding and 49 percent of RDT&E funding become outlays in the year in which they are appropriated.

Table 5: DoD's Estimated Outlay Rates for FY 2013 Budget Authority[15]

	FY13	FY14	FY15	FY16	FY17
MILPERS	94%	5%	1%	0%	0%
O&M	69%	25%	3%	1%	1%
Procurement	22%	33%	21%	11%	7%
RDT&E	49%	39%	8%	3%	1%
MILCON	5%	30%	31%	19%	9%
Family Housing	60%	25%	7%	4%	2%
Revolving Mgmt Funds	64%	17%	5%	-1%	2%

The delay between budget authority and outlays means that while sequestration will result in an immediate cut of 10.3 percent in budget authority, the reduction in outlays will be more gradual. Moreover, because budget authority becomes outlays at different rates in different accounts, the reduction in outlays will not be uniform across all parts of the budget. Table 6 shows the estimated reduction in total budget authority and outlays for FY 2013 by major account, again assuming the FY 2013 request is enacted. The reduction in outlays for procurement and RDT&E—the accounts that primarily fund defense contractors—would be 3.5 percent and 5.9 percent respectively. The reduction in outlays for O&M would be higher, 6.9 percent, because more O&M funding is spent in the same year it is appropriated. Service contractors that perform maintenance, logistics, and other support functions are typically funded from O&M accounts, while contractors for the development and production of weapons systems are funded from procurement and RDT&E. Sequestration would cause overall defense outlays to drop by roughly 4.6 percent in FY 2013 in addition to a 2.5 percent reduction in outlays already expected due to the decline in war-related funding.

Table 6: Estimated Reduction in Budget Authority and Outlays by Major Account (in thousands of dollars)[16]

Major Account	**FY13 Budget Authority (including OCO)**			**FY13 Outlays (including OCO)**		
	Before Sequester	After Sequester	% cut	Before Sequester	After Sequester	% cut
MILPERS	$149,171,893	$149,171,893	0.0%	$148,912,000	$148,912,000	0.0%
O&M	$272,745,422	$244,518,976	-10.3%	$293,241,000	$273,055,854	-6.9%
Procurement	$108,510,595	$97,280,825	-10.3%	$124,558,000	$120,208,810	-3.5%
RDT&E	$69,653,283	$62,444,859	-10.3%	$71,820,000	$67,613,315	-5.9%
MILCON	$9,571,929	$8,581,329	-10.3%	$19,403,000	$18,958,526	-2.3%
Family Housing	$1,650,781	$1,479,942	-10.3%	$2,103,000	$1,958,239	-6.9%
Revolving Mgmt Funds	$2,627,684	$2,355,745	-10.3%	$6,117,000	$5,090,197	-16.8%
Total	***$613,931,587***	***$565,833,569***	***-7.8%***	***$666,154,000***	***$635,796,941***	***-4.6%***

[15] Ibid., Section F.
[16] The reduction in outlays by major account was calculated by starting with the projected outlays in the FY 2013 budget request, subtracting the portion of these outlays due to FY 2013 budget authority and unobligated balances before sequestration (using the outlay rates from Table 5), and adding back the outlays due to FY 2013 budget authority and unobligated balances after sequestration (also using the outlay rates from Table 5).

The fact that sequestration acts on budget authority rather than outlays provides some insulation for defense companies because it allows more time for adjustment. If sequestration occurs, defense firms will be able to continue working on contracts already awarded because sequestration does not affect funding that has already been obligated. Sequestration will, however, affect DoD's ability to award new contracts and exercise options on contracts. Over time, this will result in a decline in revenues for defense firms, but it will be three or four years before defense companies feel the full impact of sequestration. This gives industry more time to adjust employment levels through natural attrition and early retirements rather than forcing immediate layoffs. Few immediate layoffs, if any, are likely to occur as a result of sequestration going into effect on January 2nd because on January 3rd virtually all contractors will be working on projects and activities where funding has already been obligated and thus is not subject to sequestration. The defense industry will be forced to downsize and employment in defense companies will decline if sequestration occurs, but this downsizing will happen gradually over the months and years that follow as outlays decline.

While sequestration will not force an immediate reduction of 10 percent of the defense contractor workforce, it will force an even larger immediate reduction in the size of the DoD civilian workforce. Because DoD civilians are paid directly by the U.S. Treasury, nearly all budget authority for DoD civilian employees becomes outlays in the first year, whether through O&M accounts or other accounts. Because sequestration occurs in January, a quarter of the way into the fiscal year, roughly 25 percent of this funding will have already been spent by the time sequestration occurs. DoD would therefore need to reduce its civilian workforce by as much as 13.7 percent for the final 9 months of the fiscal year to achieve a 10.3 reduction in spending for the overall year. In the FY 2013 budget request, DoD reported that it plans to employ 791,000 full-time equivalent civilians.[17] This means that as many as 108,000 DoD civilians could lose their jobs in the weeks immediately after sequestration goes into effect. And the longer DoD waits to reduce its civilian workforce once sequestration goes into effect, the deeper it will have to cut civilians for the remainder of the fiscal year.

What Sequestration Will Not Do

While sequestration will affect nearly every part of DoD, it also important to note several things sequestration will not do.

- No Base Closures: The law specifically states that "No actions taken by the President … may result in a domestic base closure or realignment that would otherwise be subject to section 2687 of title 10, United States Code."[18]

- No Layoffs or Furloughs of Military Personnel: Because the president has already given notice to Congress that he will exempt military personnel accounts in the event of sequestration, no members of the uniformed military, whether in

[17] Office of the Under Secretary of Defense (Comptroller), *National Defense Budget Estimates for FY 2013* (Washington, DC: Department of Defense, March 2012), p. 260.
[18] *Emergency Powers to Eliminate Budget Deficits Elimination of Deficits in Excess of Maximum Deficit Amount, 2 U.S. Code*, § 907c (b).

the active or reserve component, would be separated from the Service because of sequestration.

- No Reductions in Pay for Military Personnel: Basic pay, allowances for housing and subsistence, retirement pay, special pays and bonuses, and many other benefits would not be affected by sequestration because they are funded through military personnel accounts. The one notable exception is military healthcare, which is primarily funded through the Defense Health Program in the O&M section of the budget. Because this is an O&M account rather than a military personnel account, it would be subject to sequestration. To avoid a reduction in healthcare services, DoD would need Congressional approval to reprogram approximately $3 billion from other accounts to restore full funding for military healthcare.

- No Immediate Program Terminations: While sequestration will reduce funding for nearly all acquisition programs across DoD, it will not directly terminate programs. An across-the-board reduction will force DoD to renegotiate many contracts to be able to buy in smaller quantities since less funding will be available. This would likely cause unit costs to rise and reduce the Department's purchasing power, which could cause DoD to reconsider continuing some acquisition programs in the future, particularly if the cuts currently mandated under the BCA for FY 2014 to FY 2021 remain in effect.[19] But sequestration alone will not result in the immediate termination of acquisition programs.

Key Budgetary Issues for DoD

Regardless of whether or not sequestration occurs on January 2, 2013, the Department has a number of budgetary issues it will need to address in the near future. As the Department transitions from the wars in Iraq and Afghanistan to an evolving and uncertain future security environment, it faces a number of critical choices. As Bernard Brodie wrote in 1959, "We do not have and probably never will have enough money to buy all the things we could effectively use for our defense. The choices we have to make would be difficult and painful even if our military budget were twice what it is today."[20]

While the overall level of funding for defense is important, the way this funding is spent is perhaps even more important. This section highlights two major areas of the defense budget that require particular attention over the coming decade for the Department to adjust successfully in a fiscally constrained environment: military personnel costs and funding for readiness and training.

[19] If sequestration goes into effect and defense firms (and investors) believe the cuts will stay in effect for the foreseeable future, the defense industry overall could begin planning to reduce capacity and possibly to jettison capabilities on the assumption that DoD will not have the funding necessary to continue certain programs in the future.
[20] Bernard Brodie, *Strategy in the Missile Age* (Santa Monica, CA: RAND, January 15, 1959), p. 359.

Military Personnel Costs

Total military personnel-related costs, including the Defense Health Program, are $168 billion or 32 percent of the proposed FY 2013 base defense budget, as shown in Figure 5. The budget request includes a number of initiatives designed to reduce personnel costs, including raising the fees military retirees pay for healthcare and reducing the annual raise in basic pay for FY 2015 and beyond. If enacted these changes would reduce personnel costs by $30 billion over the FYDP, but Congress has shown little inclination to support these changes.[21] If DoD cannot control the growth in military personnel costs by changing the compensation system, it will have little choice but to reduce the number of personnel by more than is already planned or take deeper cuts in modernization or readiness. Over time this will limit the range of military options available to future presidents and, if left unchecked, would eventually result in a military too small or unprepared for even the most basic missions.

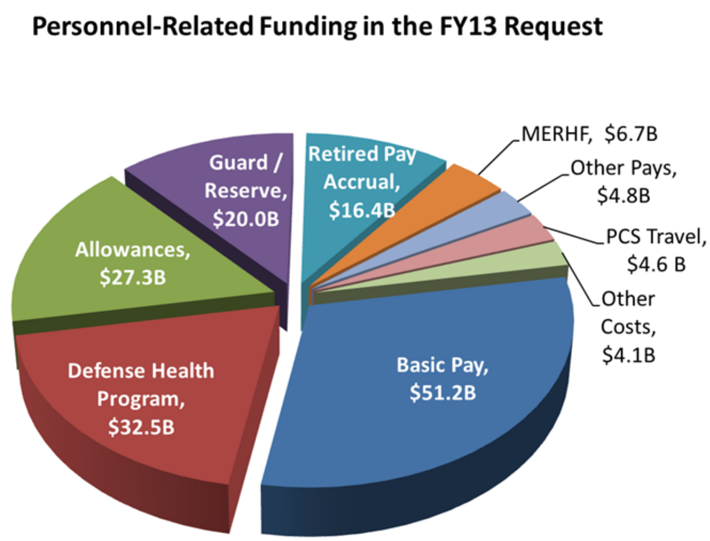

Figure 5: Military Personnel-Related Funding in the FY 2013 Budget Request

Instead of focusing on what to cut and how much it would save, the Department could instead focus on getting better value from its compensation resources. To do so, the Department must first understand how service members value different forms of compensation and how they make tradeoffs between different forms of compensation. Do service members prefer cash compensation up front rather than a larger amount of deferred compensation in the future, and by how much? Do they prefer some types of benefits, such as free dependent healthcare, to other types of benefits, such as commissary privileges? Do service members value benefits commensurate with what it costs the government to provide them? Understanding these preferences would make it possible to identify opportunities to both reduce costs and maintain or improve the attractiveness of the compensation system by shifting resources from undervalued forms of compensation to more highly valued forms of compensation. CSBA, in partnership with TrueChoice Solutions Inc., conducted a proof-of-concept study using this

[21] Office of the Under Secretary of Defense (Comptroller), "Fiscal Year 2013 Budget Request," p. 17.

methodology and found that it has the potential to yield significant savings while simultaneously improving the way service members value the overall compensation system.[22]

Readiness and Training

The FY 2013 request also includes $125 billion in funding for readiness and training, as shown in Figure 6. Readiness funding includes the O&M budget activities for Operating Forces ($107 billion), Mobilization ($7 billion), and Training and Recruiting ($11 billion). The Army, Navy, and Air Force receive almost identical amounts of readiness funding in the FY 2013 request, despite their considerable differences in number of personnel and types of equipment operated.

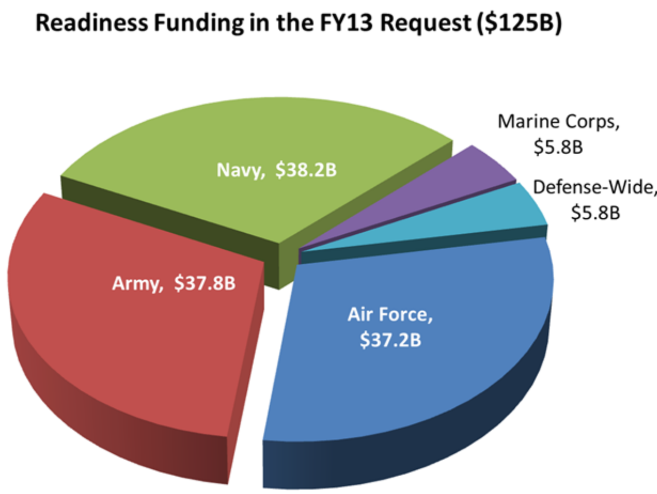

Figure 6: Readiness Funding in the FY 2013 Budget Request

The new strategic guidance explicitly makes preserving readiness a higher priority than preserving force structure.[23] The question then is how much funding is enough to preserve readiness? To know if the current level of funding is too little or too much, the Department must first understand the relationship between the level of funding and the level of readiness. The Congressional Budget Office examined this question in a 2011 report and concluded that DoD "has not been able to clearly identify the relationship between the department's O&M spending and the readiness of military units." Moreover, it found that "the information needed to determine that linkage—effective measures of readiness and detailed data on spending—is not readily available or may not, in fact, exist."[24] In other words, DoD does not have a sound analytical basis to justify why it

[22] For a more detailed description of this methodology and the results of the proof-of-concept study using this approach, see Todd Harrison, *Rebalancing Military Compensation: An Evidence-Based Approach* (Washington, DC: Center for Strategic and Budgetary Assessments, July 2012), available at http://www.csbaonline.org/publications/2012/07/rebalancing-military-compensation-an-evidence-based-approach/.

[23] Department of Defense, *Sustaining U.S. Global Leadership,* p. 7.

[24] Congressional Budget Office, *Linking the Readiness of the Armed Forces to DoD's Operation and Maintenance Spending* (Washington, DC: Congressional Budget Office, April 2011), p. 2.

plans to spend nearly a quarter of its annual budget to maintain readiness or if this level of funding is sufficient.

Too often, the Services use metrics that measure how many training objectives have been accomplished as a proxy for readiness. For example, pilots have assigned training they are required to accomplish periodically, and they know how many flight hours it takes to do that training. Their required readiness budget is determined in part by how many flight hours are required to accomplish the assigned training. But it is not clear how the assigned training translates into actual performance because some of the training may be ineffective, unnecessary, or excessive. True readiness metrics should measure how well a unit or individual performs in an operationally relevant environment, not how many training objectives have been met. Without true measures of readiness, DoD cannot know if it is adequately funding readiness. To fully understand the relationship between funding and readiness, DoD should consider conducting controlled experiments in which it varies the level and type of readiness funding for similar units and measures their performance over time.

Preserving readiness—or rather current funding levels for readiness—at the expense of force structure is a clear priority in the new strategic guidance. It is not clear, however, if DoD would (or should) continue to prioritize readiness in the face of additional budget reductions. In a declining budget environment where the ultimate floor in funding remains uncertain, there is a need to balance near-term readiness with long-term capability and capacity. While reducing readiness is never an easy choice, the level of readiness can be adjusted on an annual basis, whereas force structure can take years to rebuild once it is lost, and new military systems often take a decade or more to develop and field.

Conclusion

The FY 2013 budget request represents a notable shift for the Department. While the budget and underlying strategic guidance are unlikely to survive the year unscathed, they represent an inflection point in defense planning in terms of both the future threat environment and the future budget environment. Consistent with the new strategic guidance, the budget indicates a shift in resources—albeit a gradual one—to focus more on air and sea power, particularly those capabilities that would be most applicable in the Asia-Pacific region and in an anti-access, area-denial (A2/AD) environment.[25] The budget also projects nearly zero real growth in the base defense budget over the coming years compared to the previous budget request, which projected 3 percent real growth in the future.

Sequestration, if allowed to go into effect, would alter virtually every aspect of DoD's planning. It would force a uniform reduction in budget authority of roughly 10.3 percent across all accounts other than military personnel. Because of the delay between budget

[25] Anti-access strategies are designed to prevent an adversary's forces from entering an area, while area-denial operations are designed to deny an adversary freedom of action within an area. See Andrew Krepinevich et al., *Meeting the Anti-Access and Area-Denial Challenge* (Washington, DC: Center for Strategic and Budgetary Assessments, 2003), pp. 4-5.

authority and outlays, the corresponding reduction in outlays from sequestration would be roughly 4.6 percent in FY 2013. The lag between budget authority and outlays means that the full effect of sequestration on defense contractors would not be immediate and would not appear to require large-scale layoffs in January of 2013. Sequestration would, however, force layoffs of roughly 108,000 DoD civilian employees soon after it takes effect. Base closures are specifically prohibited under sequestration, and because the president has exempted military personnel accounts, no uniformed military personnel would be separated from the service or receive a cut in pay because of sequestration.

Given the tremendous amount of fiscal uncertainty the Department faces in the coming months, it is difficult to imagine how the Department can plan for the FY 2014 FYDP, which is due in less than six months. Regardless of what happens to the FY 2013 budget and sequestration, two areas of the budget will require particular attention in the coming years: military personnel, and readiness and training. Together these two areas consume more than half of the base defense budget. Further cuts to overall defense spending will not only require a fundamental rethinking of strategy, but also a new approach to get better value from the resources DoD devotes to military compensation and readiness.

DoD faces a number of hard choices in the months and years ahead. It can change the way it does business by trying to get better value from the programs and activities is funds, or it can change the business it does by adjusting its strategy and force structure. Given the perfect storm approaching—the combination of sequestration and the pivot from Iraq and Afghanistan to the Asia-Pacific region—DoD may have little choice but to do both.