RESPONSIBLE DEFENSE SERIES

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The Seven Deadly Sins of Defense Spending

By David Barno, Nora Bensahel, Jacob Stokes, Joel Smith and Katherine Kidder

Center for a New American Security

About the Report

"The Seven Deadly Sins of Defense Spending" is part of an ongoing program called Responsible Defense at the Center for a New American Security (CNAS). The program examines how the United States should maximize its national security in an era of defense spending reductions. The program published its first report, "Hard Choices: Responsible Defense in an Age of Austerity," in October 2011 and its second report, "Sustainable Pre-eminence: Reforming the U.S. Military in a Time of Strategic Change," in May 2012.

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THE SEVEN DEADLY SINS OF DEFENSE SPENDING

By David Barno, Nora Bensahel, Jacob Stokes, Joel Smith and Katherine Kidder

In many respects, the biggest long-term fiscal challenge facing the department is not the flat or declining topline budget, it is the growing imbalance in where that money is being spent internally. Left unchecked, spiraling costs to sustain existing structures and institutions, provide benefits to personnel, and develop replacements for aging weapons platforms will eventually crowd out spending on procurement, operations and readiness – the budget categories that enable the military to be and stay prepared.

Defense Secretary Chuck Hagel[1]

We've been living with unconstrained resources for 10 years, and, frankly, we've developed some bad habits.

Chairman of the Joint Chiefs of Staff Gen. Martin Dempsey[2]

I. EXECUTIVE SUMMARY

By David Barno, Nora Bensahel, Jacob Stokes, Joel Smith and Katherine Kidder

The Department of Defense (DOD) faces a stark choice. With reductions in defense spending looming, decisions made during the next year will chart one of two paths: one that avoids tough choices about cutting excess and inefficiencies, or one that embraces painful but necessary reforms to the structural underpinnings of the department. The first path will inevitably follow the precedent of past defense budget drawdowns and lead to deep cuts in force structure, readiness and modernization, and produce a much-diminished U.S. military. The other, more difficult, path preserves these capabilities by fundamentally reforming the underlying causes of DOD cost growth. With the right choices for reform, the U.S. defense establishment can consume fewer resources and still meet America's global strategy requirements for many decades to come – but bold and resolute action is required now.

We identify seven categories – the Seven Deadly Sins – of defense excess and analyze each individually in order to find savings and suggest enduring reforms. Each "sin" represents a trend in defense spending that, if left unaddressed, will imperil DOD's ability to perform its core missions. These Seven Deadly Sins would need to be addressed regardless of the budgetary environment, but declining budgets make their resolution more imperative. We estimate that reforms in these seven areas could save between $340 billion and $490 billion over the next 10 years – largely offsetting the cuts required by the Budget Control Act (BCA) over the same period while improving the business model of DOD. The areas for reform include:

1. Redundant Overhead, Layering and Workforce

POTENTIAL SAVINGS: $100 BILLION TO $200 BILLION OVER 10 YEARS

From FY 2001 to FY 2012, the annual defense budget grew by nearly $250 billion in real terms. That growth included more than $1.2 trillion in war spending and directly fueled an explosion of headquarters and staff manpower. Service staffs in the Pentagon, joint commands and defense agencies, including the DOD civilian and contract workforce, all ballooned during this period. In the face of force structure cuts, DOD's overhead costs must be reduced by at least the same percentage in order to maintain combat power. The Defense Business Board argues that cuts of 5 percent to 15 percent in overhead costs can be achieved without affecting future mission readiness. Some estimates based on private sector experiences with de-layering have achieved 15 percent to 20 percent savings while improving organizational effectiveness.

2. Inefficient Business Practices

POTENTIAL SAVINGS: $46 BILLION OVER 10 YEARS

Many aspects of the defense enterprise are essentially no different from the private sector. Savings can be gleaned by reforming key business practices in many common commercial areas. A series of reforms borrowed from the private sector – including the use of strategic sourcing, employing reverse auctioning for contracts, reducing the redundancy of IT management systems and moving towards full auditability – could save money and improve DOD managers' access to data that can help them make better, more cost-conscious decisions in the future.

3. Excessive Acquisition Costs and Overruns

POTENTIAL SAVINGS: $50 BILLION TO $100 BILLION OVER 10 YEARS

The acquisition process for major weapons systems faces many problems. Four steps could help create better outcomes: Streamlining the process for generating requirements and making real trade-offs on systems up-front; continuing to develop the acquisitions workforce; fostering a productive two-way dialogue with industry; and keeping the rapid acquisitions process for fast-changing capabilities and technologies while fixing the "normal" process.

4. Excess Infrastructure, Installations and Management Costs

POTENTIAL SAVINGS: $17 BILLION OVER 10 YEARS

Previous studies by DOD have estimated that the Department maintains a basing capacity more than 20 percent above its needs. The Base Realignment and Closure (BRAC) process has proven to be a viable and effective process for closing bases. Earlier rounds save DOD an estimated $12 billion per year. Both service chiefs and service secretaries have publicly supported a new round of BRAC. Congress should authorize DOD to begin a round right away. In addition, meaningful savings can be achieved by closing DOD schools in the U.S.; consolidating management of the base and post exchange systems; and reducing spending on base support and facilities maintenance.

5. Unaffordable Increases in Cash Compensation

POTENTIAL SAVINGS: $25 BILLION OVER 10 YEARS

One of the largest contributors to the trend of rising military personnel costs is the growth in cash compensation. Military personnel cash compensation increased by 52 percent between 2002 and 2010, adjusted for inflation. Over the past 12 years, pay increases for military personnel have grown much faster than both inflation and private sector compensation. Basic pay has increased 29 percent after inflation, and nontaxable allowances for housing and subsistence (food) have also grown at a high rate. DOD should restore the level of growth to a more sustainable trajectory for the future.

6. Unsustainable Growth of Military Retirement System Costs

POTENTIAL SAVINGS: $38 BILLION OVER 10 YEARS

The military retirement system must be made fiscally viable in order to preserve such benefits for those who serve today and will serve into the future. The Military Retirement Fund (MRF) faces a future liability to be paid by the Treasury

Department that is currently estimated at $1.3 trillion, a number expected to grow to $2.7 trillion by FY 2034 – a trend which is patently unsustainable. Assessments of the military retirement system have long pointed to three key problems: inequity, inflexibility and unaffordability. To address these issues, DOD should shift from the current defined-benefits system to a defined-contribution system for all new recruits, vesting at four years of service. Current service members would remain in the current system but could opt-in to the new system.

7. Escalating Military Health Care Costs

POTENTIAL SAVINGS: $64 BILLION OVER 10 YEARS

The current trajectory of DOD health care costs is untenable and threatens to divert an ever-increasing share of the defense budget away from other critical priorities. In the past 12 years, military healthcare costs have seen a real increase of 118 percent. These recent increases in defense health care costs have not been driven by the effects of current conflicts or by the costs of treatment for injuries suffered by service members in combat. Instead, growing numbers of beneficiaries, decreased cost-sharing and greater utilization have driven increases. In response, DOD should adjust TRICARE fees to reflect growth in health care costs, introduce co-payments for TRICARE for Life and increase pharmaceutical cost sharing via higher co-payments.

Addressing the Seven Deadly Sins of defense spending will require a strong consensus for change, accountability for results, realignment of authorities, united White House and Pentagon leadership and – most important – support from Congress. If these reforms are not pursued with urgency, DOD will have no choice but to find savings through deep cuts to force structure, modernization and readiness – the very core capabilities required for the U.S. military to maintain global pre-eminence. In an era of increasing fiscal austerity, DOD will be less and less able to provide those forces if increasingly inefficient and wasteful business processes and runaway personnel expenses continue unabated – and that is a price that the United States simply does not need to pay.

II. INTRODUCTION

The Department of Defense has reached a fork in the road. The decisions that will determine its future are imminent as the Fiscal Year (FY) 2014 defense budget is debated on Capitol Hill, the new defense secretary undertakes his Strategic Choices and Management Review and the 2014 Quadrennial Defense Review gets underway. The 10-year cuts to DOD budgets contained in the Budget Control Act (BCA) of 2011 have also begun to bite, carving nearly a half-trillion dollars out of future defense spending plans. The choices facing DOD are stark.

One path leads to a Defense Department that preserves most of its present ways of doing business – from costly acquisition processes; excess bases and overhead; and inefficient business practices to escalating costs for pay, benefits and health care. The skyrocketing costs of this path will soon consume so much of the defense budget that only a significantly smaller set of military capabilities will be affordable. Cost savings would have to come from cutting force structure, modernization and readiness, rather than from reducing inefficient and unnecessary overhead. This is the default path that the United States has repeatedly chosen in previous drawdowns.[3]

The resulting military – much different, smaller and less capable – would almost certainly require that the United States change its long-standing global engagement strategy to one that is substantially less ambitious.[4] Deep force structure cuts might mean that the U.S. military could only be fully engaged in one region at a time, thus emboldening potential adversaries and threatening alliance commitments in other regions. Postponing or cancelling key modernization programs would have similar effects and would also jeopardize the U.S. ability to ensure free access to the global commons, including the high seas, international airspace, outer space and cyberspace. And lower readiness levels would inevitably increase the costs of future conflicts, in both blood and treasure.

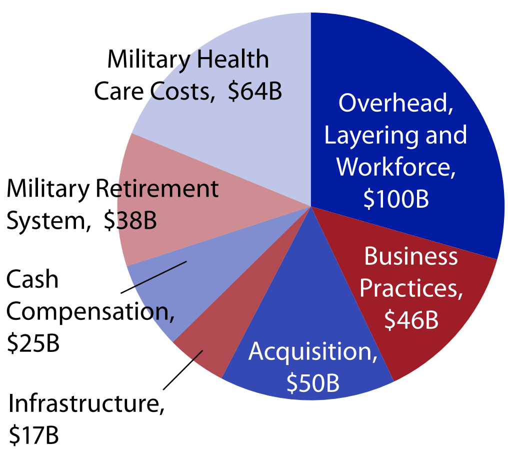
As budgets constrict, burgeoning structural costs in these areas risk hollowing out the U.S. military if left unchanged. Avoidance is no longer a viable option.

The other path leads to a Defense Department that has reformed its structural underpinnings, adopted modern business and personnel practices, shaved away excess capabilities and contained its costs. This path requires difficult, politically charged decisions and fundamental structural reforms to create a lean DOD, finding savings in the "tail" to offset deep cuts from the "tooth" of military capabilities. In the words of former Under Secretary of Defense for Policy Michèle Flournoy, the goal is to "try to protect mission-essential capabilities by first going after the big pots of money associated with transforming the defense enterprise, instead of taking the bulk of the cuts in force structure, readiness and modernization."[5] A reformed DOD with a newly streamlined "back office" could readily support a highly capable U.S. military despite the planned cuts to the defense budget and thus sustain the nation's current strategy of global engagement for years to come.

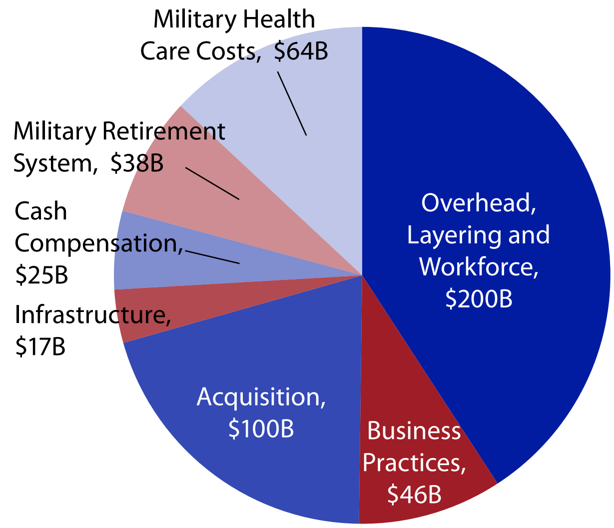
Combining robust military forces with less defense spending requires reforming the underlying cost structures in the "back office" of DOD. Past drawdowns have reduced end strength, force structure and combat capabilities but often avoided difficult decisions about reforming DOD. Tackling these issues is unpopular, both inside and outside of

FIGURE 1: ESTIMATES OF TOTAL SAVINGS OVER 10 YEARS IN BILLIONS OF CONSTANT FY 2012 DOLLARS

Low Estimate Total Savings: $340 billion



High Estimate Total Savings: $490 billion



Source: Center for a New American Security.

DOD, and is politically difficult. But today, rapidly escalating internal costs in the department leave no practical alternatives. As budgets constrict, burgeoning structural costs in these areas risk hollowing out the U.S. military if left unchanged. Avoidance is no longer a viable option.

This report examines what we call the Seven Deadly Sins of defense spending – key business and management issues that must be reformed to ensure that DOD avoids the first path and goes down the second. Each "sin" represents a trend in defense spending that, if left unaddressed, will imperil DOD's ability to perform its core missions. These Seven Deadly Sins would need to be addressed regardless of the budgetary environment, but declining budgets make their resolution more imperative.

The Center for a New American Security (CNAS) has done substantial work in recent years outlining recommendations to reform military force structure, overseas posture, readiness and modernization.[6] This report builds on those findings but focuses on the areas that make up the key structural costs of the defense enterprise. We estimate that reforms in these seven areas could save between $340 billion and $490 billion over the next 10 years.[7] (See Figure 1.) These savings would help to offset some, if not all, of the currently planned cuts to DOD spending even as budgets shrink.[8] But this would require undertaking fundamental and politically contentious defense reforms.

III. THE CHANGING STRATEGIC AND BUDGETARY CONTEXT

Converging political, economic and military trends are generating new consensus about reducing the U.S. defense budget. The end of the war in Iraq, the looming conclusion of combat operations in Afghanistan, the fracturing of a Republican consensus on defense spending that goes back to the start of the Cold War and broad support for reducing deficits are collectively exerting immense pressure on future defense spending. Moreover, Americans are weary of the costs of a decade of high spending on inconclusive military engagements abroad that many view as having done little to make the nation more safe, despite massive costs and significant numbers of lives lost.[9]

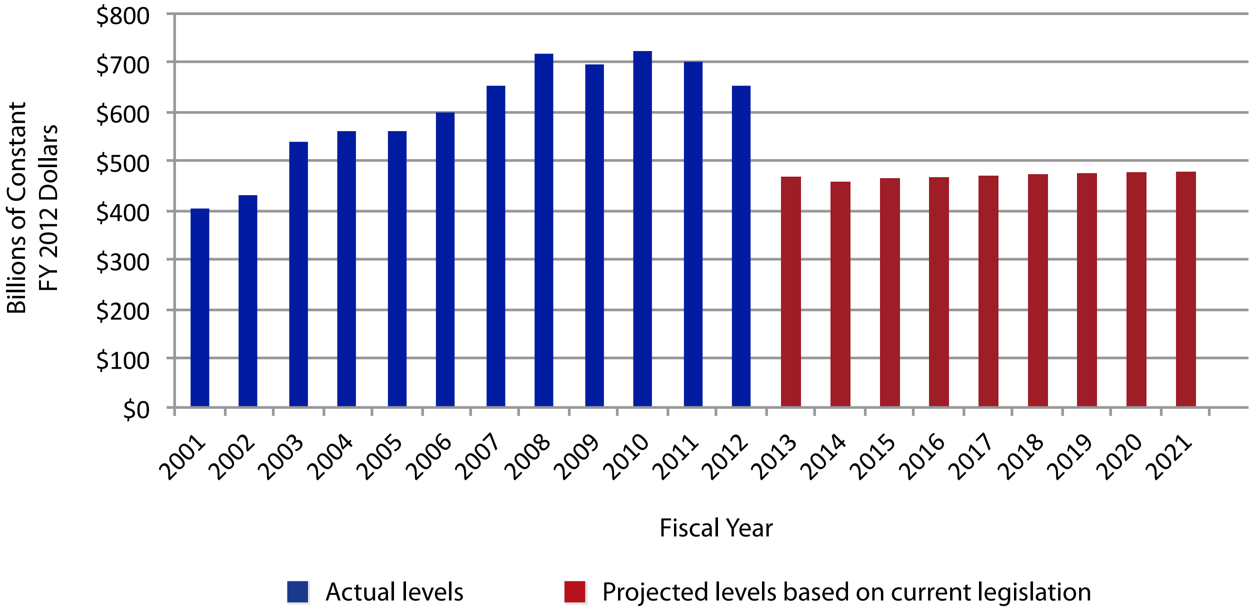
The triggering of automatic budget cuts known as sequestration on March 1, 2013, marked a major course change in the direction of U.S. defense spending. For the first time in a generation, spending by the United States for defense will decline significantly within a single fiscal year, with DOD charged to cut $41 billion between March 1 and September 30, 2013.[10] The BCA will require similarly deep cuts in each fiscal year until 2021. (See Figure 2.) This 10-year series of deep mandatory cuts, long thought to be avoidable, now marks the realistic new trajectory of defense spending – at substantially lower levels than those of the past decade.[11] Although these decade-long cuts may be softened by new legislation, the overall direction of defense spending is unmistakable. Even if Congress modifies the law so that the cuts end up being less than the $500 billion required by the BCA, defense budgets will still decline from recent projections. In an environment where the fiscal pressures associated with the mushrooming national debt intersect with the lack of an existential threat, public perceptions are that DOD spending is too high.[12] In fact, cuts beyond those mandated through sequestration remain possible as these pressures continue to grow. The next debt ceiling showdown will likely occur later this year,[13] for example, and may renew calls for further defense cuts – just as the August 2011 debt ceiling deal resulted in the deep cuts and sequestration mechanism of the BCA.

Yet with the right choices for reform, the U.S. defense establishment can consume fewer resources and still meet America's global strategy requirements for many decades to come – but bold and resolute action is required now.

The sequestration cuts are not simply the newest incarnation of the cyclic cuts to defense spending made after every major war. These impending defense cuts will occur in a unique setting – one in which the internal costs of running DOD have deeply eroded the buying power of the defense dollar. From 2001-2012, basic pay for military personnel increased by 29 percent[14] and defense health care costs by 118 percent.[15] As the total defense budget grew in constant FY 2012 dollars from $406.5 billion in FY 2001 to $655.4 billion in FY 2012, these costs were largely masked inside the massive spending of the entire department. This spending has fueled a military force second to none in its well-trained troops, modern equipment and extraordinary combat capabilities. But these wartime budgets have also camouflaged enormous increases in costs per service member, back-office functions and excess infrastructure and overhead.

Without reform, these escalating costs will increasingly crowd out spending for core

FIGURE 2: DEPARTMENT OF DEFENSE BUDGET, 2001-2021



Source: Data from Department of Defense and Congressional Budget Office.

Note: Figures are measured in budget authority and include base spending and supplementals (including OCO funding). FY 2001 to FY 2012 are approved budget levels.

defense priorities, including force structure, end strength and procurement. Despite this upward arc in expenses, however, DOD has done little to explore the types of substantial reform that have transformed many U.S. businesses into far leaner enterprises in recent decades. In fact, the last substantial reform of DOD business practices occurred under Defense Secretary Robert McNamara in the early 1960s, who sought to apply lessons from his experiences as an executive at Ford.[16]

DOD has now reached, in business parlance, a "burning platform" moment: a crisis demanding immediate action.[17] Deep structural reform is required to shrink costs and deliver strong defense with fewer dollars. The alternative – making deep force structure cuts while preserving the status quo of archaic business practices and unaffordable manpower-related costs – will deliver a smaller, hollow U.S. military increasingly unable to sustain America's role in the world. Given its unsustainable costs, this alternative also threatens the future of the all-volunteer force if personnel costs crowd out other types of spending. The history of past drawdowns suggests that this problematic outcome could well occur, with the looming crisis simply deferred a few more years down the road while internal costs continue to escalate. Already, the Defense Department is approaching the current crisis of sequestration by identifying possible cuts to force structure and military capabilities.[18] Yet with the right choices for reform, the U.S. defense establishment can consume fewer resources and still meet America's global strategy requirements for many decades to come – but bold and resolute action is required now.

IV. THE SEVEN DEADLY SINS OF DEFENSE SPENDING

This report takes on the challenge of finding efficiencies and associated significant cost savings in DOD's business and personnel practices. We spare no category of structural spending. We identify seven categories of defense excess and analyze each individually in order to find savings and suggest lasting reforms. Yet these issues must be addressed holistically in order to scale back defense spending in ways that are balanced, sustainable and able to deliver needed military capabilities at the lowest possible cost to the nation.

The Seven Deadly Sins are:

1. Redundant overhead, layering and workforce;
2. Inefficient business practices;
3. Excessive acquisition costs and overruns;
4. Excess infrastructure, installations and management costs;
5. Unaffordable increases in cash compensation;
6. Unsustainable growth of military retirement system costs; and
7. Escalating military health care costs.

We examine each of these problems, identify options for reform and estimate the savings that these options could generate. We do not intend to present a comprehensive list of possible reforms, nor do we attempt to calculate the savings figures down to the exact dollar. Instead, we seek to illustrate different types of reform and the order of magnitude of potential savings. Our estimates are deliberately conservative, and yet, taken together, our illustrative examples could save nearly enough money to offset the cuts required by the budget caps in the BCA and preserve robust combat power. Further savings could be reinvested in maintaining force structure, research and development for advanced technologies and other efforts to ensure that the U.S. armed forces remain the pre-eminent military in the world.

The First Deadly Sin: Redundant Overhead, Layering and Workforce

POTENTIAL SAVINGS: $100 BILLION-$200 BILLION OVER 10 YEARS

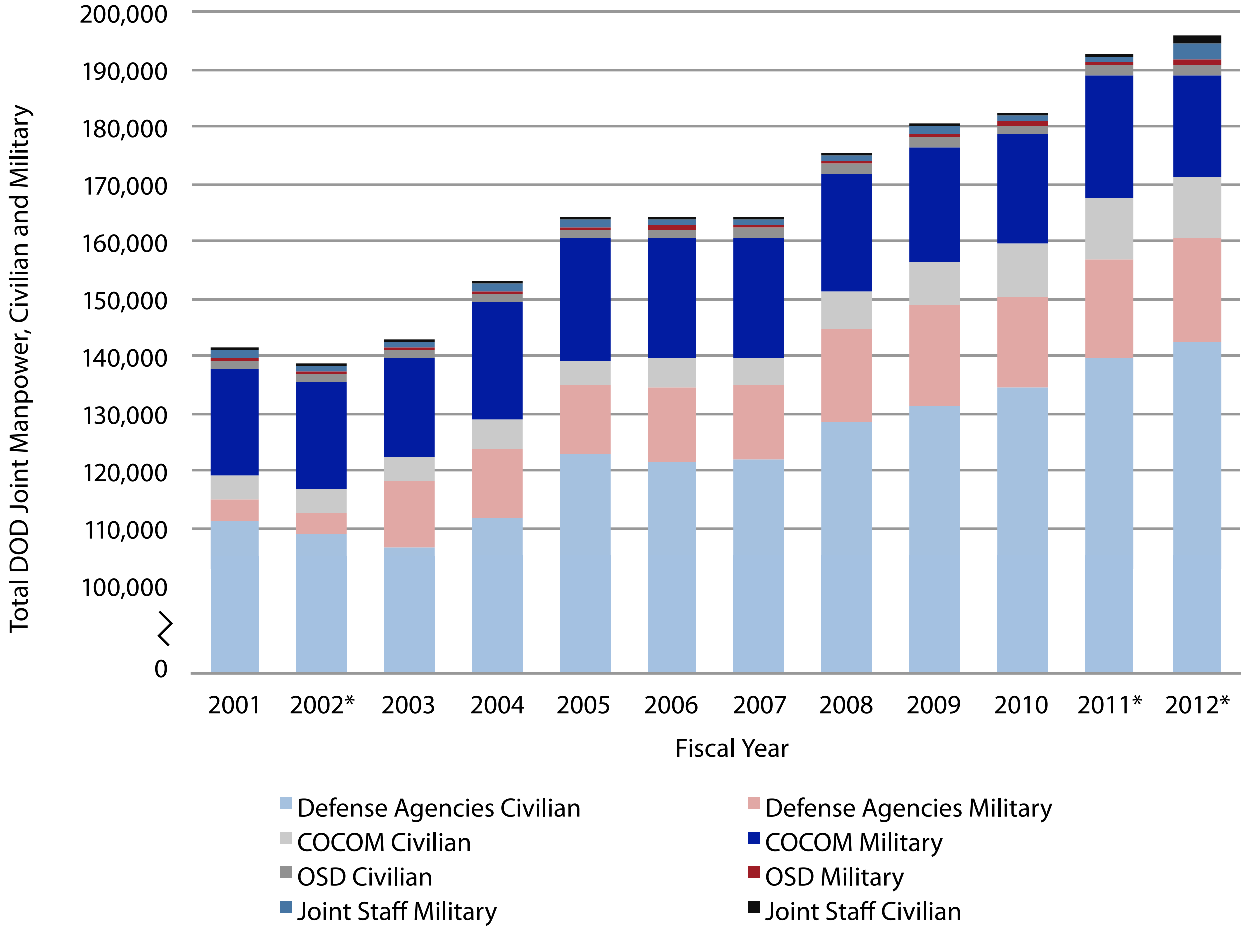
Overview

From FY 2001 to FY 2012, the annual defense budget grew by nearly $250 billion in real terms.[19] That growth included more than $1.2 trillion in war spending and directly fueled an explosion of headquarters and staff manpower.[20] Service staffs in the Pentagon, joint commands and defense agencies, including the DOD civilian and contract workforce, all ballooned during this period. (See Figure 3.) DOD spent $212 billion on overhead costs in FY 2011 – equivalent to the 49th-largest GDP in the world and more than the entire GDP of Israel for that year.[21] As former Defense Secretary Robert Gates said late last year, "One need only spend 10 minutes walking around the Pentagon or any major military headquarters to see excess and redundancy."[22]

Challenges

The problems start at the top. The Office of the Secretary of Defense numbers around 2,700 people (nearly 5,000 when contractors are included).[23] OSD's policy office alone has grown from around 600 people in the mid-1990s to nearly 1,000 people today.[24] On the military side, the office of the Joint Chiefs of Staff has increased from 1,265 people in 2001 to 4,244 people in 2012,[25] and the staffs of the military services have increased as well.[26] (Part of the growth in the Joint Staff came as a result of taking on duties of the closed Joint Forces Command.) While some of this growth is due to the demands of multiple conflicts over the last decade, the necessity of sustaining these inflated levels as the wars in Iraq and Afghanistan come to an end is highly dubious.

FIGURE 3: DOD JOINT MANPOWER GROWTH, 2001-2012
(Totals do not include contractor workforce.)



Source: Department of Defense Manpower Requirements Reports.

*FY 2002, FY 2011 and FY 2012 are based on Department of Defense estimates, not actuals.

Elsewhere, the defense agencies and combatant commands saw massive growth over the last decade. The number of service members working for defense agencies grew nearly four-fold, and the number of civilians working for defense agencies grew by 28 percent, an increase of nearly 31,000 employees for civilians alone.[27] From 2001 to 2012, U.S. Central Command's (CENTCOM) military staff grew by nearly 36 percent, while its civilian staff expanded more than five-fold. U.S. European Command (EUCOM) grew its military staff more than 10 percent and its civilian staff by more than 35 percent – even as it spun off a new command, U.S. Africa Command.[28] Moreover, the extensive use of contractors has obscured much of the growth of these commands and agencies. (See discussion below.) From 2001 to 2010, DOD's civilian staff grew from 687,000 to 778,000, more than a 13 percent increase.[29] A 2010 study found that the United States has among the lowest tooth-to-tail ratios among industrialized countries – meaning that its level of combat power ranks very low compared with the size of its administrative costs.[30] Before the military considers painful cuts to end strength and combat

Because preserving combat power is a prime objective during times of reduced resources, it makes sense that substantial cuts to overhead should precede any cuts to operational forces.

capabilities, the excess overhead of staff and headquarters should be reduced in order to preserve maximum combat effectiveness.

Savings Options

1. Reduce total overhead spending by a percentage equal to or greater than force structure cuts. At a time when combat forces are likely to see substantial cuts across all four services – the Army and the Marine Corps have already announced 14 percent and 10 percent reductions in end strength, respectively[31] – a commensurate set of cuts on the headquarters, overhead and staffs resting atop the Defense Department would only seem logical. Because preserving combat power is a prime objective during times of reduced resources, it makes sense that substantial cuts to overhead should precede any cuts to operational forces.

The Defense Business Board has estimated that reforming infrastructure and overhead could reduce spending by 5 percent to 15 percent without affecting future mission readiness.[32] Some estimates based on private sector experiences with de-layering have achieved 15 percent to 20 percent savings while improving organizational effectiveness.[33] DOD estimates that roughly $200 billion per year of the base budget from FY 2012 to FY 2016 will be spent on overhead – or more than $1 trillion dollars.[34] Reducing that by five percent would save approximately $10 billion per year, or about $100 billion over the next decade. More aggressive efforts that saved 10 percent could net $200 billion in savings over 10 years.

Any effective reductions in overhead costs must include the military services, since they are responsible for 73 percent of DOD's administrative infrastructure.[35] Specifically, DOD managers must understand the hidden costs of military manpower performing non-military tasks. Military personnel constitute both the most expensive manpower and those most in demand for uniquely military tasks as the services confront force reductions over the next decade. One important way to reduce overhead costs while ensuring combat power is to reassign some of the more than 340,000 military personnel who serve in these essentially civilian jobs, such as administrative support for Pentagon staffs.[36] Where possible, those positions should be eliminated. Otherwise, the positions should be filled by cheaper civilian DOD employees.

Although we can offer illustrative suggestions for how to trim overhead costs, efficiencies will ultimately have to come from a thorough review executed by the Department itself – followed by resolute action to close unnecessary agencies and departments and phase out programs with little value. GAO has suggested principles to guide such a process. They include consolidating or eliminating organizations on the basis of geographic proximity and span of control, and centralizing overlapping functions and services. To aid in that task, GAO also suggested that the Secretary of Defense direct the service secretaries and the heads of the DOD components to continue to look for staffing and organizational efficiencies and to update management instructions in order to provide better, more complete information about staffing and organization.[37] Better information can facilitate rational decisionmaking about how to reduce overhead without degrading DOD's combat effectiveness.

The remainder of the savings suggestions in this section represent illustrative options DOD leadership could employ as part of a Department-wide effort to achieve the overall savings targets discussed above.

2. Reduce the DOD civilian workforce by 75,000 people or 150,000 people. Personnel costs drive much of the cost of overhead. Reducing personnel could drive overhead consolidation and would also follow the private sector in taking advantages of substantial increases in productivity over the last 10 years. One important way to reduce costs is to roll back the size of the civilian workforce from today's peak of 778,000 DOD civilians. At the low end, reducing the civilian workforce by 75,000 people could save $37.4 billion over the decade; [38] the remaining workforce would still exceed 2001 levels. A more aggressive approach could reduce the civilian workforce by 150,000 people, saving more than $74.3 billion over the same time period.[39]

3. Count and roll back the contractor workforce to 2001 levels. The burgeoning contractor workforce represents an additional source of overhead growth, although finding information on contractors presents significant challenges because contractor headcounts are not included in DOD's standard manpower documents. Instead, the costs are largely hidden within the Operations and Maintenance accounts. Nevertheless, the contractor workforce is undoubtedly huge: In 2010, Deputy Secretary Ashton Carter estimated the contractor workforce at 766,000, a figure that was bigger than the civilian workforce at the time and did not include the military intelligence organizations.[40] A July 2009 estimate found that 10,800 contractors work for the combatant commands alone.[41]

DOD should immediately institute a process for finding out how many contractors its employs. Once known, DOD should roll back contractor spending to 2001 levels.[42] It is hard to gauge exactly how much money such an initiative would save, but it would surely be substantial. The Project on Government Oversight estimates that from FY 2001 to FY 2010 the amount of DOD services contracts grew by 137 percent.[43]

4. Streamline combatant commands. Another initiative would be to fold U.S. Africa Command (AFRICOM) back into EUCOM.[44] AFRICOM had $282 million in operating expenses in FY 2012 and included about 2,000 personnel, so even if half of its staff were transferred back to EUCOM, the change could still save as much as $1.4 billion over the next decade.[45] This arrangement would mirror the long-standing dual-continent role performed by EUCOM that included both Europe and Africa prior to 2008. Another logical consolidation would be to merge U.S. Northern Command (NORTHCOM) and U.S. Southern Command (SOUTHCOM) into a single command dedicated to the Western Hemisphere. Alternatives might include down-sizing either AFRICOM or SOUTHCOM into smaller sub-unified commands nested under EUCOM and NORTHCOM, respectively. All options would pare redundant staff overhead and save operating expenses while risking little in the way of reduced mission capability.

5. Consolidate the military service medical commands. The military health system is a complex organization that maintains hundreds of medical facilities worldwide. As discussed later in this report, DOD spending on health care has rapidly increased over the past 12 years. The Army, Navy and Air Force currently maintain separate medical command structures, but several studies have shown the economic benefits of consolidating the service medical systems.[46] In 2006, a working group convened by DOD identified three viable alternatives to the current military health system that would have increased sharing of resources, grown use of common operating processes and reduced duplicative functions and organizations.[47] DOD did not choose any of these three options and decided on a different model that GAO said "left the existing command structures of the three services' medical departments over all military treatment facilities essentially unchanged."[48] If DOD had adopted one of the three alternatives recommended by the 2006 working group, it might have saved an estimated $292.2 million to $478.3 million per year – totaling $1.8-$2.9 billion by now – with additional savings in years to come.[49] DOD should re-examine these options for consolidating the service medical commands and explore whether new options are available.

6. Reduce duplication and overall funding for counter-IED initiatives. As the improvised explosive device (IED) became the signature weapon of enemy forces attacking American service members in Iraq and Afghanistan, DOD rapidly increased funding towards finding ways to improve safety in the battlespace. DOD established the Joint Improvised Explosive Device Defeat Organization (JIEDDO) in 2006 to lead, advocate and coordinate "all Department of Defense actions in support of the Combatant Commanders' and their respective Joint Task Forces' efforts to defeat Improvised Explosive Devices as weapons of strategic influence."[50] This directive essentially turned a 12-person Army task force focused on countering homemade bombs to a 1,900 person joint organization in just a few years. As of 2011, JIEDDO had received $18 billion to pursue these efforts. DOD also funds other C-IED efforts outside of JIEDDO – such as the rapid procurement of thousands of heavily armored vehicles for personnel transport, at a cost of $40 billion – which are not included in this total.[51] According to a 2012 study, GAO found that DOD funded 1,340 potential C-IED initiatives between 2008 and March 2012. Of the funding that could be identified, GAO counted $4.8 billion for C-IED initiatives during FY 2011 alone.[52] Among the military services and agencies, GAO found overlap in IED-related intelligence analysis, C-IED hardware development and IED detection. It concluded that although DOD has funded these various initiatives, it "has not yet developed a comprehensive database of these initiatives and the organizations conducting them."[53]

A previous report in CNAS' Responsible Defense series called for the elimination of JIEDDO in 2017, after U.S. combat operations in Afghanistan had ended.[54] Savings accompanying this closure amount to $1.2 billion through the rest of the decade. That recommendation remains viable today, but a clear consolidation of DOD's efforts and elimination of redundancy among those efforts is clearly in order and should happen as soon as possible.

7. Reduce redundancy in military service intelligence organizations. The Defense Intelligence Agency, National Geospatial-Intelligence Agency, National Reconnaissance Office and National Security Agency are DOD and national intelligence agencies that exist to support the core mission of the department. The joint staff and combatant commands also maintain sizable intelligence elements that deliver analysis and information to support operations. (The CENTCOM Joint Intelligence Center, for example, employed nearly 1,300 military and civilian personnel as of 2009.[55]) Additionally, the Air Force, Army, Marine Corps and Navy all maintain large separate intelligence organizations within their respective services to support their departmental functions.[56] As past reports in this series have illustrated, the growth in the size of the military intelligence apparatus over the past 12 years has been immense.[57] Significant savings could be found in the service departmental intelligence organizations, as many of these organizations likely duplicate efforts already being conducted by the combatant commands and other agencies.

The Second Deadly Sin: Inefficient Business Practices

POTENTIAL SAVINGS: $46 BILLION OVER 10 YEARS

Overview

DOD manages its business practices very differently than the corporate world does. In some areas, this makes sense. Acquiring and operating

Creative Destruction

In 1942, economist Joseph Schumpeter popularized the concept of "creative destruction," describing it as a process "that incessantly revolutionizes the economic structure from within, incessantly destroying the old one, incessantly creating a new one."[58] In the world of business, this has been widely interpreted to acknowledge the value of the perpetual cycle connecting the death of underperforming or obsolete businesses to the perpetual entrepreneurial creation of new ones. In this sense, "destruction" – the shedding of outdated or inefficient organizations – forms the necessary opportunity for new, high-performing organizations to arise. This death and re-birth cycle also helps to deliver ever leaner, more cost-effective models to replace those which no longer deliver best value.

This process of "creative destruction" in the private sector drives out underperforming or obsolete business functions. Yet DOD has no formal mechanism to carry out such rationalizations and divestitures. Organizations and functions that have gradually been added to the department since its founding in 1947 have only rarely been subsequently eliminated, even if their original purpose has long since changed or gone away entirely. The 2011 shuttering of U.S. Joint Forces Command (JFCOM) in Norfolk by then-Defense Secretary Robert Gates is one extraordinarily rare example of an attempted DOD divestiture of an entire organization, many of whose functions were deemed no longer essential. Yet in part because of major Congressional resistance, many of JFCOM's tasks (and the people doing them) were ultimately simply transferred to the Joint Staff.[59] Still, annual savings from this one divestiture action were estimated at $458.3 million a year for DOD.[60]

Entering a period of declining budgetary resources offers a unique opportunity to clearly define priorities. Understanding which functions are truly essential, which are important, which are vestiges of now-obsolescent requirements and which are simply nice to have is vital. The many duplicative functions between the military services and the joint service establishment represent one fertile source of possible consolidations, inactivations or divestiture of organizations and functions that are no longer essential.

Congress and the Department should establish a formal process for divestiture and creative destruction within DOD. In its December 2010 report, the National Commission on Fiscal Responsibility and Reform recommended the establishment of a "cut-and-invest committee" to cut two percent of the discretionary budget by reducing or eliminating lower-priority programs and then reinvesting half – one percent – back into the discretionary budget.[61] Congress should adopt this recommendation and apply it specifically to DOD. Utilizing the analytical capabilities and resources of the Congressional Budget Office, Congressional Research Service and especially the Government Accountability Office, Congress should stand up a committee that identifies functions to be consolidated or cancelled. This committee's recommendations in their entirety should then be adopted by a simple "up or down" vote similar to the mechanism used for the successful series Base Realignment and Closure (BRAC) actions in past years.

major defense systems, for example, has few direct analogies in the civilian world. Yet many aspects of the defense enterprise are essentially no different from the private sector. DOD buys vast quantities of office products, operates fleets of nontactical vehicles, contracts for diverse support services and employs extensive information technology. Savings can be gleaned by reforming key business practices in many of these common commercial areas.

Such reforms would be essential even if DOD were not facing a fiscally constrained environment. Any defense budget involves trade-offs between combat capabilities and support functions; thus, any inefficiency on the business side reduces the funds available for combat capability. This becomes even more critical as defense budgets decline. With a number of best-practice options available from the business world, DOD should consider adopting well-researched, proven reforms.

Challenges

Costly and inefficient defense business practices have been the target of criticisms for decades. Without question, the U.S. military leads the world in the advanced, even revolutionary, application of high technology in military power. Yet, equally indisputable, most of the business enterprise of DOD remains years, if not decades, behind the private sector in productivity and innovation.

The reasons for this gaping shortfall are well known: Data on inventories and costs are not readily available to decisionmakers or auditors. DOD lacks comprehensive data management systems to process information even when it is available. Identifying and addressing cost drivers within the budget remains elusive. Moreover, the department's annual financial statements are incapable of passing an audit today (although DOD is making progress toward that goal).[62]

Savings Options

1. Pursue strategic sourcing options. DOD contracts for a wide range of services, such as dining services and security, and for diverse goods ranging from office supplies to retail goods sold at Base and Post Exchanges (military stores that sell a wide variety of discounted goods).

However, DOD currently does not adequately leverage its size and buying power. For example, the Air Force maintains 149 bases. Until 2010, each base individually negotiated food service contracts for its dining facilities. In a 2010 pilot study, six installations negotiated a single strategic contract for food services, for a savings of eight percent of the total cost.[63] Such results are promising for each of the services and may provide compounding savings if implemented throughout the Department.

A DOD-wide strategic sourcing model could increase efficiencies without affecting the volume of goods and services purchased or contracted. It could provide better rates on goods and services by combining orders at a higher level. Strategic sourcing, as the name implies, is about more than just cost savings. If done correctly, it creates more efficient processes by improving the "value-to-price relationship," reducing costs while maintaining (and even improving) the quality of goods and services.[64]

Strategic sourcing has long been used in the private sector and is slowly gaining momentum throughout government agencies. The Office of Management and Budget and the General Services Administration began a government-wide strategic-sourcing initiative in 2008. It defines strategic sourcing as the "structured and collaborative process of critically analyzing an organization's spending patterns to better leverage its purchasing power, reduce cost and improve overall performance."[65] For example, the federal government saved $16 million on office supplies from June 2010 to August 2011 by implementing Office Supply Generation II, which enabled the General Services Administration to receive discounted prices through collective purchasing. The federal government spent $1.6 billion on office supplies during the same period; thus, in this example, strategic sourcing saved approximately one percent of total costs.[66]

Savings from strategic sourcing are expected to be high over the first three to five years, ranging from 15 percent to 25 percent. Even after the initial period, savings would continue to accrue from efficiencies introduced into the existing system. It would be reasonable to expect a savings rate of one percent per year going forward. DOD spends approximately $400 billion on goods and services per year.[67] DOD spends approximately $200 billion of that total on big-ticket acquisitions programs,[68] which are not conducive to strategic sourcing initiatives. Smaller purchases of goods and services, comprising the remaining $200 billion, present an opportunity to source strategically. Therefore, anticipated savings could yield up to $20 billion over 10 years.

Most of the business enterprise of DOD remains years, if not decades, behind the private sector in productivity and innovation.

2. Use reverse auctioning for contracts. Increasingly common in private and public practice since the 1990s, reverse auctioning provides incentives for providers of goods and services to compete for contracts by offering the lowest price. According to the Defense Acquisition University, reverse auctioning in the defense sector works well for high-volume goods and services that "do not need exact specifications, are available off the shelf, and are based on competing by the price alone."[69] Goods as diverse as rock salt, building materials and electronics – as well as services including telecom installation, car rentals and tax preparation – can be discounted through reverse auctioning. It typically applies to contracts totaling more than $150,000 that do not qualify as Major Defense Acquisitions Programs.[70] Savings rates range between 5 percent and 50 percent.[71]

A number of government, business and academic analyses estimate that DOD could save considerable amounts of money through reverse auctions. The Defense Logistics Agency, the first defense agency to implement reverse auctions, saved more than $34 million through reverse auctions from FY 2010 to FY 2012.[72] The IBM Center for the Business of Government estimates that 13.88 percent of defense procurement outlays can be shifted to a reverse auctioning system.[73] According to FedBid, the largest reverse auction marketplace used by DOD, defense agencies saved $107 million in FY 2010 and FY 2011 – slightly more than a 13 percent savings rate on $820 million worth of goods and services.[74] Assuming a more conservative savings rate of five percent, DOD could potentially save $2.6 billion annually by implementing reverse auctioning.

3. Reduce redundancy of IT management systems. DOD maintains a vast and diverse business operations portfolio that uses approximately 2,080 business information technology (IT) systems for accounting, acquisitions, logistics and personnel management. The existing systems, referred to as "legacy systems," are slow, duplicative and lack interoperability. Recognizing the need for more efficient and interoperable systems, DOD is in the process of creating improved IT systems called Enterprise Resource Programs (ERPs), which promise interoperability between systems, as well as better data management that enables cost savings. For example, a timely and accurate inventory of supplies reduces redundant orders while ensuring that capabilities are sustained.

A 2010 GAO study identified nine ERPs that promise significant across-the-board savings and efficiencies, encompassing financial services management, logistics modernization and resource planning.[75] According to both DOD and GAO, the nine systems will replace over 500 inefficient legacy systems. Because the old systems perform necessary functions, they must be maintained until their replacements are fully operational. Therefore, DOD must continue to maintain the old IT systems while simultaneously investing in the development of the ERPs. In FY 2011, DOD requested $12.2 billion to operate and maintain existing systems and $5.2 billion to modernize ERPs.[76] Until the ERPs are fully operational, DOD is essentially paying two bills simultaneously. Furthermore, for many of the systems, the ERP development process has taken much longer than originally anticipated, thereby compounding cost inefficiencies.

Every ERP that DOD is able to fully implement reduces the redundancy of simultaneously maintaining inefficient legacy systems and investing in modernization. For example, the General Fund Enterprise Business System (GFEBS) replaced 87 legacy systems costing $57.8 million dollars per year to maintain. The Global Combat Support System-Army replaced seven legacy systems which were costing DOD $63 million per year to maintain.[77] Moreover, fully implemented ERPs increase efficiency across the board and provide additional cost savings in perpetuity. But, although ERPs promise more efficient data processing and management, IT solutions are not a panacea for poor business management practices. ERPs will enable DOD to leverage efficient practices but will not create efficiency in and of themselves.

4. Improve business alignment and auditability. The Chief Financial Officers Act of 1990 and the Government Management and Reform Act of 1994 mandate DOD financial auditability. Yet DOD has still not been able to pass an unqualified audit. Former Secretary of Defense Leon Panetta detailed plans for achieving audit readiness for the Statement of Budgetary Resources (SBR) for General Funds by 2014, and for all financial statements by September 30, 2017. In order to meet these goals, DOD needs to identify and establish full accountability for everything in its purview – financial, material and personnel. Therefore, a clean audit is not just an end in and of itself. It also moves the department toward more effective and transparent business practices.

Yet a number of challenges persist that will make it hard to achieve fully auditable financial statements. DOD is a massive enterprise and maintains a wide portfolio of operations, making it difficult to align the various programs and budgets. Another challenge is changing the "erroneous perception that audit readiness is the sole responsibility of the Comptroller community."[78] Perhaps the largest difficulty is translating "business auditability" into incentives that are valued at the unit and command level. DOD needs to translate "auditability" into terms of mission readiness in order to create buy-in at every level. Unit commanders must see how auditability contributes to readiness – and then be schooled in how to use this new information transparency to more effectively manage their units and missions. The difficulties that DOD has in implementing the new ERP systems exacerbate this problem, because legacy IT systems lack the computing capabilities needed to provide real-time information.

The Office of the Under Secretary of Defense-Comptroller and the Deputy Chief Management Officer have renewed DOD's commitment to becoming auditable by FY 2017 and have pledged both "sustained attention and a plan that is widely supported within the DOD."[79] Senior leaders, from the service chiefs to unit commanders, are beginning to engage in the discussion. Although a good start, it is only the beginning of a sustained process. Business transformation requires institutional internalization and accountability at every level.

The Third Deadly Sin: Excessive Acquisition Costs and Overruns

POTENTIAL SAVINGS: $50 BILLION TO $100 BILLION OVER 10 YEARS, WHILE ALSO PROVIDING SIGNIFICANTLY BETTER ACQUISITION OUTCOMES

Overview

The process of acquisitions – which goes beyond purchasing to include design, engineering, construction, testing, deployment, sustainment

Building a Cost Culture in DOD

DOD needs to create a "cost culture" within the department that increases visibility on cost drivers, measures expenditures and both values and incentivizes frugality. But as one former service secretary recently noted, "The Defense Department is built for maximum effectiveness and maximum inefficiency."[80]

The very notion of considering costs is foreign in many key DOD processes – from defining the need for new weaponry to the development of contingency plans. Moreover, the ability to expose and see costs across the department is lamentably uneven. The lack of auditable records and clean audit statements further complicates gaining visibility of defense costs.[81]

Ultimately, changing the culture of the department, from the Pentagon all the way down to the unit level, will prove just as important as clean account sheets. Traditionally, military organizations throughout DOD have been held accountable for spending all of their budgets by the end of each fiscal year. Failure to do so – regardless of how wasteful or unnecessary such spending might be – resulted in a pared-down budget in the next year. In effect, frugality was punished, and all the budgetary incentives were to spend money, not to save it.

Perhaps the most important change that must take hold to build a DOD cost culture is the exposure of cost data across all segments of the department. Today, no one knows what most DOD activities cost – from running an installation to providing data services. Moreover, many organizations across the department are fighting the requirement to uniformly share and expose the data reflecting their costs of doing business.[82] The reasons for this foot-dragging are diverse, but the end result is an inability to compare – and compete – similar functions between and within the services.

Compounding this lack of visibility is the general reluctance to identify and assign accountability to "owners" of the "business units" that drive costs. For example, the senior commander of a military installation typically is not accountable for making that installation efficient – nor does he or she have control over determining personnel support costs, contracting for best-value services or making smart decisions to balance costs with effective solutions. Commanders across the force have little ability or incentive to compete with other installations for talent and best practices in transparent ways. In an environment where manpower and labor are often viewed as free commodities, budgets must be spent by fiscal year's end and no "bottom line" of profit and loss drives home the need for frugality, the current incentive and accountability structures are largely counter-productive.

Implementing a cost culture in DOD would be just one part of profound institutional reform inside the Department. Whatever results are desired from a comprehensive set of reforms, these outcomes must be integrated into a process that measures performance against the goals of the plan. This process should be equipped with functions that permit ongoing assessment and forecasting as the external environment continues to change. The comprehensive plan must be agile enough to continuously adapt to exigencies in the real world. Moreover, there would be value in creating a "Red Team" to identify opportunities and threats to the plan, both within and outside DOD.

and disposal – is an immensely complicated undertaking, and one fraught with difficulty.[83] Problems with acquisition date all the way back to the Revolutionary War.[84] In recent years, however, a combination of technological complexity, lack of a near-peer competitor and ineffective bureaucratic processes for generating requirements have allowed the system to spiral out of control – at the expense of the warfighter and the U.S. taxpayer. Over the past decade, DOD's approach to these problems has been to throw more money at them and create rapid-acquisition cells to circumvent a slow, broken process. Much of this approach is both wasteful and unsustainable, and it must change if DOD is to maintain its edge as funding declines.

The current acquisitions climate poses many challenges. Following a decade of war, the need to repair and replace equipment worn down in Iraq and Afghanistan must be balanced with financing the air and naval platforms necessary to resource a rebalancing to Asia and address emerging challenges. At the same time, investment in re-capitalizing current systems must be balanced against the need to develop advanced technologies that will maintain the U.S. technological edge decades into the future. These challenges must all be managed in a time of declining budgets. As a report from the Defense Science Board said in 2009, "Fixing the DOD acquisitions process is a critical national security issue."[85]

This section focuses on the acquisition of major defense systems, as we addressed DOD's acquisition of goods and services in the previous section.

Challenges

The problems with the acquisition system are well known. From 1960 through 2009, more than 27 major studies of defense acquisition were commissioned by presidents, Congress, secretaries of defense, government agencies and independent organizations.[86] The tally grows to more than 300 when nonofficial studies are included.[87] But few, if any, of the recommended reforms have been adopted.[88] Most recently, the overview of the DOD budget for FY 2013 stated, "DOD is not receiving expected returns on its investments in weapon systems. Programs continue to take longer, cost more and deliver fewer quantities and capabilities than originally planned."[89] Longer timelines mean that the current average development cycle for weapons systems is 15 to 18 years.[90] This elongated cycle continues at a time when the rate of technological change is accelerating.[91]

Costs have also grown. By 2013, when compared to first full estimates, the costs of DOD's weapons portfolio have increased by more than $400 billion, or about 38 percent. Timelines for delivering initial operating capability have slipped by an average of 27 months.[92] In the past 10 years, DOD has abandoned at least $46 billion worth of weapons programs that either did not work or were overtaken by additional requirements.[93] Although building cutting-edge technologies always involves some failures, cancellations of such magnitude are unsustainable over the long term.

Over the past decade, DOD's approach to these problems has been to throw more money at them and create rapid-acquisition cells to circumvent a slow, broken process.

The most dysfunctional aspects of the acquisition system include the following problems:

Overly burdensome regulations. In 1947, the regulations governing new weapons systems numbered approximately 125 pages. By 2009, the successor regulations totaled more than 2,000 pages, creating a huge regulatory burden and adding unnecessary complexity to the process.[94] Last year, the Defense Business Board characterized the current system as "too complex, too bureaucratic, too paper-laden, too lengthy and costly while disconnected and uncoordinated in both initiation and execution."[95]

Requirements focusing on desired capabilities instead of threats. Too often, weapons systems requirements push for maximum capabilities, rather than identifying what is necessary to confront likely threats.[96] That approach elevates system performance above all other factors, including cost – which eventually determines how many units DOD can buy – and timeline for delivery. Delayed timelines and skyrocketing unit costs flow directly from the pursuit of optimal capabilities. As Norm Augustine, former chairman and chief executive officer of Lockheed Martin, famously wrote, "The last 10 percent of performance generates one-third of the cost and two-thirds of the problems."[97] In addition, various stakeholders often change requirements throughout the acquisition process, which increases unit costs and delays delivery. These stakeholders include not only the military services, but also DOD civilians, the White House and Congress.

Lack of productive cooperation between DOD and industry. The relationship between DOD and industry should be built on cooperation – not recriminations. Instead, each side often sees the other as undermining the process and having unrealistic expectations about cost, performance and timelines. Over the past 10 years, infusions of money have substituted for effective dialogue between the two sides. As Deputy Assistant Secretary of Defense for Manufacturing and Industrial Base Brett Lambert explained earlier this year: "There was no need to talk to each other. Everyone was happy. When we had a program that was bleeding, we cauterized the wound with money, because we had it."[98] Both sides routinely fail to have early, productive cooperation to determine technical feasibility for systems.[99] Moreover, bidding incentives – a result of DOD acquisition regulations – continue to encourage industry to understate bids up front only to increase costs later in the process. Program managers also have perverse incentives, as any money they do not spend gets taken away from them. In a tight budget environment, growing animosity could make the problem worse as each side continues to try to squeeze more from the other.

Lack of trained workforce. DOD is the government's largest buying entity, so an effective acquisitions workforce is a strategic priority.[100] Without the background needed to make informed decisions, acquisitions officials can make costly missteps. Often, officials lack the technical know-how to really know what they are buying. In addition, a shortage of trained acquisitions workers means that some programs do not receive adequate attention. As GAO notes, "Lack of an adequate number of trained acquisition and contract oversight personnel contributed to unmet expectations and has placed DOD, at times, at risk of potentially paying more than necessary."[101]

Recent efforts have begun to move in the right direction. The 2009 Weapons Systems Acquisition Reform Act, which passed unanimously through both Houses of Congress, implements changes intended to limit cost overruns, strengthen oversight, enhance competition and end conflicts of interest.[102] The act created four new offices within DOD focused on improving the acquisition process: Systems Engineering; Developmental Test and Evaluation; Cost Assessment and Program Evaluation; and Performance Assessments and Root Cause Analyses.[103] Those offices have increased DOD's capacity for early scrutiny of requirements, cost and schedule estimates, testing and reliability. GAO recently found that the legislation is helping to reduce risk in acquisition programs, even as implementation challenges remain.[104]

In addition, the administration has pushed toward more effective processes through its "Better Buying Power" initiatives, first introduced in September 2010, with "Better Buying Power 2.0" following last November.[105] That effort focuses on improving the acquisition workforce, establishing realistic requirements early in the acquisitions process and streamlining bureaucratic processes, among other initiatives. According to GAO, the workforce efforts, in particular, have shown some progress.[106]

DOD's budget guidance for FY 2013, which drew on the defense strategic guidance released in January 2012, outlined four principles for deciding when to reduce investment in systems. It recommended substantial reductions to programs experiencing schedule, cost or performance issues; programs adding to capabilities that already exist, but at a much higher cost; programs entering service before they are needed; and programs deemed to exceed requirements.[107]

More recently, Vice Chairman of the Joint Chiefs of Staff Admiral James Winnefeld, who leads the Joint Requirements Oversight Council, signed a memo in January calling for program managers to request "requirements relief" in order to better balance cost, schedule and performance. The memo states that "relief should be considered especially appropriate in cases where significant cost savings may be achieved with marginal impact to operational capability (i.e., spending 15 percent of a program's budget to get the last 3 percent of … performance)."[108] Winnefeld has also spearheaded efforts to reduce paperwork and "requirements creep."[109]

These efforts are important, but insufficient to address the difficult challenges identified above. Deeper reform is needed to reduce waste and improve future defense capabilities.

Savings Options

To combat the biggest problems in acquisitions, DOD should pursue the following measures:

1. Streamline the process for generating requirements and make real trade-offs on systems upfront. Both civilian and service leaders should work hard to ensure that the "80 percent" solution gets chosen when such a capability will suffice, taking the advice of former Secretary Gates to avoid "exquisite" weapons systems.[110] DOD should consider the capacity for a weapons system to be delivered on time at a cost that allows for buying sufficient numbers to be as important as performance. Achieving those goals requires discipline in setting requirements throughout the acquisitions process. To help achieve that discipline, DOD should freeze requirements soon after evaluating trade-offs between cost, schedules and technical feasibility.[111]

2. Continue to develop the acquisitions workforce. Recruiting and retaining a knowledgeable and competent acquisitions workforce will help to improve outcomes and get better values for warfighters and taxpayers alike. Service chiefs should ensure that successful acquisitions professionals get promoted at the same rates as their peers.[112] In addition, DOD should work with Congress to increase use of the Defense Acquisition Workforce Development Fund and to ensure that this use is aligned with strategic workforce management goals.[113] Congress and DOD should also make it easier for non-American engineers to get the waivers required to work in the defense acquisitions workforce. Such waivers are offered when not enough Americans are available to fill the positions.[114]

3. Foster a productive two-way dialogue with industry. In dealing with industry, profit and effective acquisition outcomes do not have to be at odds.[115] DOD officials have acknowledged the need to rebuild the relationship through better communication, improved DOD processes to deal with industry and acquisitions policies that integrate industry feedback earlier.[116] Defense business leaders should seize the opportunity to make a parallel effort. DOD and industry should build a dialogue around integrating mature technologies into the next generation of weapons systems, starting at the requirements stage, and improving predictive analytic techniques for weighing trade-offs and costs for new systems. Another area where DOD and industry can cooperate is in reducing the regulations burden on contracting. Although we believe that starting from scratch on the entire system, as some have suggested,[117] would be too drastic, creating a "sunset date" on contracting regulations could help to gradually pare back and continually reevaluate the process.

Recruiting and retaining a knowledgeable and competent acquisitions workforce will help to improve outcomes and get better values for warfighters and taxpayers alike.

4. Keep the rapid-acquisitions process for fast-changing capabilities and technologies while fixing the "normal" process. The pace of technological development continues to accelerate, even as delays in defense acquisitions drag out delivery timelines. DOD must retain and build on the rapid acquisition capabilities that it employed over the past decade of war. Rapid acquisition is particularly necessary for IT systems, given fast-moving commercial breakthroughs. It will also grow increasingly important in other fields if acquisition is to move to a "payloads-over-platforms" model,[118] in which basic adaptable platforms (or "trucks") are designed to accept ever-evolving payloads to execute a variety of missions.[119] Yet although a specialized rapid acquisition process may grow in importance, DOD officials must not use rapid-acquisition shortcuts to avoid making changes to fix the "normal" process.

Finding savings in the acquisitions process is more art than science, and those savings will be manifested as much in better acquisition outcomes – systems that perform better and have cheaper unit costs and shorter delivery timelines – as in monetary savings. "Savings" in acquisitions means trading back-office costs for combat power, but it does not come with the clear savings figure we present in other sections. The following is a broad estimation meant to give readers a sense of the magnitude of increased combat power that could come from reforming the process for acquiring major weapons systems. According to the Congressional Budget Office (CBO), DOD will spend an average of $190 billion in constant FY 2012 dollars per year on acquisitions from FY 2013 to FY 2030, or roughly $1.96 trillion over the next decade.[120] Preventing just five percent of that funding from being wasted would amount to nearly $98 billion worth of additional buying power in DOD's weapons portfolio over the next decade. As mentioned above, DOD cancelled more than $46 billion in weapons systems investments over the past decade. Avoiding a repeat of that outcome in the coming decade would be a significant reform.

The Fourth Deadly Sin: Excess Infrastructure, Installations and Management Costs

POTENTIAL SAVINGS: $17 BILLION OVER 10 YEARS, WITH SIGNIFICANT ADDITIONAL SAVINGS ($10 BILLION TO $24 BILLION) OVER 20 YEARS

Overview

DOD manages a worldwide basing portfolio that spans 50 states, seven U.S. territories and 40 foreign countries.[121] That portfolio includes 550,000 buildings and structures, equaling 2.3 billion square feet, with a replacement value of $848 billion. For FY 2014, DOD requested $11 billion for military construction and family housing and $10.85 billion for sustainment, restoration and modernization of that portfolio – nearly two percent less than the FY 2013 request.[122] Finding savings within this massive portfolio can free up funds to focus on combat power.

During the post-Cold War drawdown, Congress established a Base Realignment and Closure (BRAC) process that generated bipartisan support for shrinking defense infrastructure. Previous BRAC rounds in 1988, 1991, 1993, 1995 and 2005 resulted in the closure of more than 350 installations.[123] Despite these successes, excess base capacity still exists. Furthermore, existing military end strength and force structure will decline during the coming drawdown, so fewer installations will be needed for this smaller force. DOD has already announced that the Army and the Marine Corps will shrink by 80,000 and 20,000 service members, respectively, from their wartime peaks, and end strength of all of the services will likely shrink further as budgets continue to decline.[124] DOD's budget guidance for FY 2013 states: "We cannot afford to sustain infrastructure that is excess to our needs in this budget environment."[125] In addition, DOD can no longer accept unnecessary costs in base management. Pragmatic cost-savings measures can result in real savings with manageable, even small, effects on base operations.

Challenges

In 2004, DOD estimated that it had a total excess capacity of 24 percent relative to force structure plans developed by the Joint Staff.[126] Despite this clear imbalance, the latest round of BRAC, in 2005, focused more on realignment than on base closures.[127] Existing capacity was only reduced by 3.4 percent, leaving more than 20 percent excess capacity. And as force structure continues to decrease over the next 10 years, this excess capacity is likely to increase.[128]

Both service chiefs and service secretaries have publicly supported a new round of BRAC, as have President Obama and Defense Secretary Hagel.[129] For example, the Air Force found in 2005 that it had 20 percent excess infrastructure, and since that time, its inventory has fallen by more than 500 aircraft and its number of personnel has fallen by about 48,000 airmen.[130] As Air Force Secretary Michael Donley wrote earlier this year, "One area where potential savings have not been fully exploited is installations. We need Congress to approve another round of base closures to help consolidate scarce maintenance and repair resources in a more efficient basing structure."[131]

By requiring an up-or-down vote on a proposed set of closures, BRAC has proven to be a viable and effective process for closing bases. This allows DOD – working with Congress and local communities – to periodically adjust its basing structure to reflect changes in the threat environment, force structure, technologies, doctrine, organization, business practices and plant inventory.[132]

Critics of the process often cite up-front costs, especially for the latest 2005 round,[133] and the exclusive focus on bases in the United States rather than overseas.[134] (Congressional approval is required to close bases in the United States but not to close bases overseas.) However, criticisms of the 2005 BRAC effort miss two key points. First, the initial high costs and limited savings from the 2005 BRAC were largely unique to that effort. The 2005 round happened during a major defense build-up and focused more on realignment than on closure. Military construction accounted for 70 percent of the costs from the 2005 round, compared with just 33 percent from previous rounds.[135] Military installations such as Forts Benning, Bliss, Bragg, Carson, Knox and Riley received approximately seven million square feet of new facilities financed through the Army's BRAC funds.

Second, increased costs for the 2005 round were caused primarily by that process being tied to the larger Global Defense Posture Realignment, which relocated forces back to the United States from overseas bases.[136] As GAO explained, the 2005 round included an unprecedented number of "complex realignments, such as designating where military forces returning to the United States from overseas bases would be located; establishing joint military medical centers; creating joint bases; and reconfiguring the defense supply, storage and distribution network."[137] Although the savings from the 2005 round were overstated – GAO estimates that the savings over 20 years will be about 72 percent lower than original estimates – the net savings over 20 years will still amount to an estimated $9.9 billion.[138] A new round of BRAC would involve fewer up-front costs and thus could save significantly more.

Both service chiefs and service secretaries have publicly supported a new round of BRAC, as have President Obama and Defense Secretary Hagel.

Savings Options

1. Authorize and conduct a new BRAC round. The amount that DOD could save with a new round of BRAC cannot be predicted accurately because the process itself will determine the extent, location and types of closures that best support DOD's missions. Yet savings from past rounds of BRAC can provide illustrative examples and give a sense of scale.

DOD estimates that it currently saves $12 billion per year from all previous BRAC rounds combined. The first four rounds – in 1988, 1991, 1993 and 1995 – account for $8 billion of that savings, and the 2005 round accounts for $4 billion.[139] BRAC does require significant up-front costs, but even with the 2005 round, DOD recoups the cost within a relatively short time period. The earlier BRAC rounds paid back up-front costs in fewer than 3.5 years after completion of the process, which comes six years after the round's start date, while the 2005 round will take an estimated 8.8 years.[140]

In light of the current strategic and budgetary dynamics, any subsequent round of BRAC is likely to mirror the pre-2005 rounds – with lower up-front costs, shorter time to recoup those expenses and more savings generated over time. As John Conger, Acting Deputy Under Secretary of Defense (Installations and Environment), recently testified to Congress, "Given the force structure reductions on the horizon and the budget constraints we face, we have every expectation that future rounds would have more in common with the first four BRAC rounds than the most recent round did."[141] Savings over the next decade would potentially total about $10 billion.[142] If past BRAC experiences hold, DOD could save an additional $10 billion to $24 billion from FY 2023 to FY 2033.

2. Close DOD schools in the United States. Although the vast majority of children of elementary and middle school age on military installations in the United States fall under the authority of their local state school district, DOD still runs approximately 58 primary and secondary schools for 19,324 students in six states.[143] Public school districts within the vicinity of DDESS schools can offer the same service to children residing on military bases. Furthermore, a growing number of service members are living off base and sending their children to local public school districts, decreasing the demand for DOD-run education.[144]

The 2011 Simpson-Bowles Commission found that planned maintenance and upgrades to current DDESS schools will cost DOD $1.2 billion from FY 2011 to FY 2015, increasing the cost per student from $51,000 in FY 2011 to $81,000 in FY 2015. This is far more than civilian school districts spend per pupil, which averaged $10,694 dollars nationwide in 2009.[145] As a more economic alternative, the commission recommended that military-dependent students be integrated into the local public school systems. DOD could offer local school districts a $14,000 allowance per student and would still save $1.1 billion in 2015 by cancelling all DDESS building plans.[146] This decision will need to be made soon, however, before DOD starts executing a costly program to upgrade these schools.[147]

3. Consolidate Base and Post Exchange systems. One benefit offered to service members is access to Base and Post Exchanges (BX and PX, respectively), stores that offer a wide variety of discounted goods. Currently, the BX/PX systems operate under three separate exchange systems: the Army/Air Force Exchange, the Marine Corps Exchange and the Navy Exchange. Each exchange system maintains its own distribution, IT and human resources programs.

A combined military exchange system would consolidate overhead without affecting service. It also would not affect employment rates at individual stores – an important point, given that many BX/PX employees are the spouses of active-duty service members. A single entity would also be able to leverage the advantages of strategic sourcing (as discussed above), allowing better economies of scale in relationships with manufacturers and service providers.[148] A Unified Exchange Task Force, convened in 2003, estimated that the savings from consolidation would amount to $245 million annually in constant FY 2012 dollars, or $2.5 billion over the course of 10 years. Most of the savings would come from reductions in overhead, although strategic sourcing would also play a role.[149]

4. Reduce spending on base support and facilities maintenance. The Simpson-Bowles Commission found that by standardizing spending per service member among the services around the lower common levels, base support spending (e.g. cutting grass) could be reduced by $2.1 billion in constant FY 2012 dollars, or 10 percent of the estimated 2015 level. According to the commission, the services spend different amounts per troop on base support, ranging from $10,800 per troop in the Marine Corps to $15,700 per troop in the Air Force in 2011.[150] Such an approach would encourage standardizing the costs of similar base services across the branches of the military and using a civilian organization rather than a military command to administer support services.

The commission also suggested reducing spending on facilities maintenance by $1.5 billion, or 19 percent below the $8 billion in constant FY 2012 dollars estimated for 2015.[151] The services have not reduced spending on facilities maintenance in proportion to the decrease in square footage that resulted from base closings over the past 10 years: Square footage fell by 21 percent, but spending increased by 18 percent in real (inflation-adjusted) terms.[152] An even lower level will be justified when all of the BRAC 2005 base closures are completed. And a further round of BRAC should bring facilities maintenance budgets down even more. Together, these two options could save $3.6 billion through 2015, with increased potential for further savings through the rest of the decade.[153]

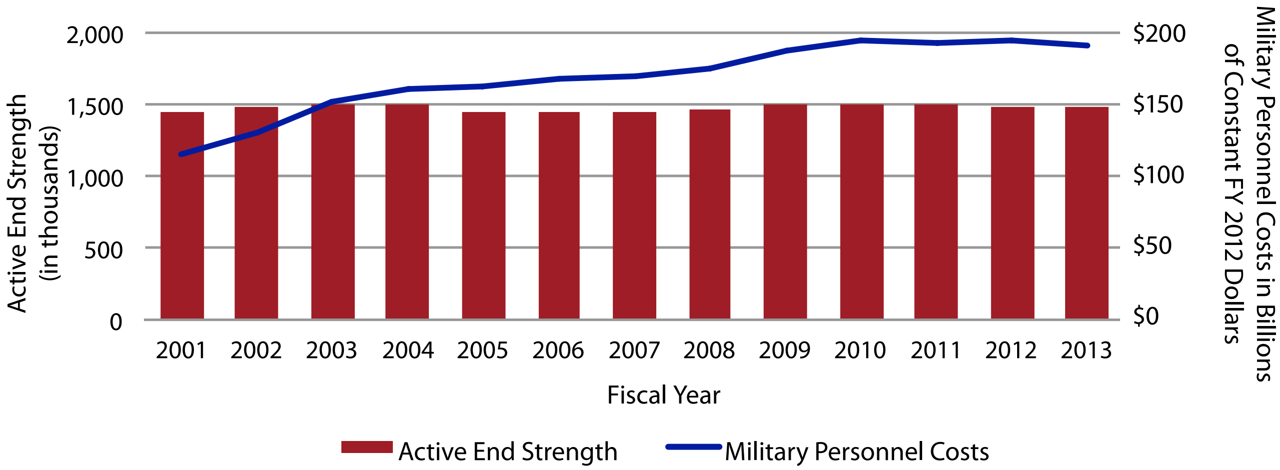
The Fifth Deadly Sin: Unaffordable Increases in Cash Compensation

POTENTIAL SAVINGS: $25 BILLION OVER 10 YEARS

Overview

DOD spending on personnel – including pay, benefits and retirement – threatens to consume the entire future defense budget by 2039 if current cost growth continues.[154] In FY 2001, DOD spent $115 billion in constant FY 2012 dollars on military personnel.[155] In FY 2012, DOD allocated $194 billion to personnel, a real increase of 69 percent over 12 years even though the size of the force remained relatively constant over that time.[156] (See Figure 4.) DOD has already announced plans to reduce active end strength by more than 100,000 service members.[157] The Army and Marine Corps will absorb the overwhelming majority of these cuts, returning their end strength to roughly the same levels as 2001.[158] Despite this five percent

FIGURE 4: ACTIVE END STRENGTH AND THE INCREASE IN PERSONNEL COSTS, 2001-2013



Source: National Defense Budget Estimates for FY 2003 through FY 2014.

Note: Personnel costs are equal to the sum of the total DOD Military Personnel Account and the Defense Health Program.

reduction in the force, CBO estimates that DOD will spend roughly the same amount in constant dollars on personnel costs in 2017 as it does today.[159] As retired Marine Corps Major General Arnold Punaro has warned, DOD must significantly reform personnel spending to avoid becoming "a benefits company that occasionally kills a terrorist."[160] Yet at the same time, preserving the all-volunteer force and not breaking faith with those who serve remain paramount priorities. Any potential solution must equitably balance all of these factors.[161]

This section addresses cash compensation; the next two sections of the report address retirement benefits and health care costs, respectively.[162]

Challenges

One of the largest contributors to the trend of rising military personnel costs is the decade-long growth in cash compensation. Military personnel cash compensation increased by 52 percent between 2002 and 2010, adjusted for inflation. During this same period, private sector wages increased 24 percent.[163]

As basic pay represents the largest share of current cash compensation, increases in annual raises drive up personnel costs considerably. For 10 of the 11 years between FY 2000 and FY 2010, Congress provided basic pay raises above the standard level determined by the Employment Cost Index (ECI), a measure of changes in the cost of labor across U.S. industries.[164] Over the past 12 years, basic pay has increased 29 percent after inflation.[165] These large pay increases were intended to improve recruiting and retention during the mid-2000s, particularly for the Army and its reserve components, which struggled to meet recruiting and retention targets at the height of the Iraq war.[166] As a result of these raises, military personnel today are commonly paid at rates comparable to, or better than, the rates that their immediate superiors in rank were paid in 2001.[167]

In addition to basic pay, nontaxable allowances for housing and subsistence (food) have also grown more generous. The military subsistence allowance rose 40 percent (in nominal dollars) between 2002 and 2010.[168] In 2000, military service members paid about 20 percent out-of-pocket toward their off-base housing costs, but by 2005, out-of-pocket housing expenses for the average military family were virtually eliminated.[169] Eradicating this cost sharing, along with changes in the civilian housing market, resulted in an 83 percent (nominal dollars) growth in the amount budgeted for housing allowances between 2002 and 2010, as well as the migration of many active-duty families off-base and into the private market.[170] Previous long waiting lists for on-base housing are no longer as prevalent, creating excess on-base housing that DOD has filled with non-active-duty families.[171]

Special pay and bonuses are small compared with other forms of current compensation, but they still totaled $7 billion in the FY 2013 budget.[172] This amount has largely been driven by the wars over the past 12 years, and it will likely decrease as the rate of deployments and overall size of the force decline. The amount of cash-in-hand has also been boosted by tax exemptions for pay received while serving in a combat zone.

Savings Options

1. Bring basic pay back in line with civilian pay increases. The trajectory of basic pay increases must be placed on a more sustainable path that will allow the military to maintain the all-volunteer force while compensating service members equitably and competitively. Between FY 2015 and FY 2018, after the combat mission in Afghanistan has ended, Congress should authorize basic pay raises at a rate less than the ECI to scale back the rapid growth in compensation over the past 12 years.[173] Military compensation must be competitive with the private sector, but this valuation varies across the hundreds of job types that comprise military service. If recruiting and retention rates fall short of their goals in the future, DOD should use targeted bonuses and special pay to address this problem rather than increasing basic pay rates for the entire military. Cash compensation is a highly valued form of payment among service members,[174] but annual across-the-board pay raises for all specialties do not provide the best tool for shaping a shrinking and increasingly specialized force during a period of constrained budgets.

Instead, Congress should authorize DOD to use a targeted approach that would enable the services to spend less money but still ensure that service members with key skills are retained to fill positions of high demand. Targeted pay increases provide an efficient and effective solution, and they will become more important as economic conditions improve, leading to more private-sector demand for service members with transferable skills. Furthermore, as discussed in the next section, providing basic pay raises below the ECI will reduce spending on accrual payments into the Military Retirement Fund, leading to future savings as well. With the currently planned personnel levels, this option would save DOD $14 billion over 10 years.[175]

2. Curb recent increases in allowance pay. Significant savings can be obtained by modestly increasing service members' share of off-base housing costs. In 2000, DOD paid, on average, 80 percent of housing allowances. Re-introducing cost sharing – with DOD paying 95 percent of housing costs from FY 2014 to FY 2019 and then 90 percent for the next four fiscal years – would save the department approximately $11 billion over 10 years while keeping the allowance more generous than historical norms.[176] This change would also provide an incentive for service members and their families to return to on-base housing, allowing DOD to capitalize on expensive revitalization projects that thus far have been underutilized.

The Sixth Deadly Sin: Unsustainable Growth of Military Retirement System Costs

POTENTIAL SAVINGS: $38 BILLION OVER 10 YEARS

Overview

The military retirement system has traditionally played a different role than that of civilian retirement systems. With an "up or out" personnel system, the armed forces operate a pyramidal mid- and upper-rank structure that severely limits the number of service members who are allowed to remain for a career of 20 years or more. And in effect, most of those military members who do stay for a career exit the system between years 20 and 30, often at the peak of their professional competence. Yet because retirement benefits do not vest until 20 years of service, the vast majority of those who serve receive no retirement benefits at all.

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The current "defined-benefit" military retirement system was designed 65 years ago, when retired military personnel faced more difficulty gaining civilian employment after service. Given today's longer life spans, better military health care (including battlefield care), improvements in military wellness and the fact that most military retirees now go on to have a second career, this approach may now be an artifact of an era long gone for most military members. Yet the current military retirement system has not caught up with these changes, and its costs have increasingly become unsustainable. The military retirement system needs to be changed to make it fiscally sustainable while still protecting benefits for those who serve today and will serve in the future.

Challenges

DOD contributes to military retirement through accrual payments to the Military Retirement Fund (MRF) based on the projected cost of future retirement payouts to current uniformed personnel.[177] Because retirement payouts are directly tied to basic pay levels, increases in basic pay have a compounding effect on compensation that must be paid for the remainder of a retiree's lifetime. They also thus dictate the amount of money DOD must allocate annually to the MRF.

In a system where retirement pay is based on a fixed percentage of final active-duty basic pay, steady increases in basic pay above inflation in recent years have significantly increased future retirement costs. DOD contributed $49 billion in FY 2012 to the military retirement fund. In FY 2021, it is expected to contribute $67.8 billion, a 38 percent increase.[178]

Over the past several years, numerous studies on military retirement have been commissioned by Congress, DOD and think tanks. Overwhelmingly, these studies have found that the military retirement system is overly expensive and outdated.[179] The system is costing more and more, but its benefits target limited numbers of those who serve. Because it only vests for the 17 percent of military members who stay in uniform for 20 or more years, the retirement system serves only about one out of six individuals who join the military. This creates a situation of concentrated generous benefits with distributed high costs.

The only serious attempt to reform the current retirement system was the Military Retirement Reform Act of 1986 (REDUX), which lowered the retirement benefits for those who joined the military after that year.[180] However, this law was essentially repealed in 1999, when service members were given the option of choosing between REDUX and its much more generous predecessor.[181] This change was largely a result of the service chiefs' vociferous claims that REDUX was harming retention. The chiefs made this claim despite a lack of evidence to support their position. To the contrary, analysis conducted by CBO found no statistical relationship between REDUX and retention.[182] CBO also made a broader claim that has been repeatedly confirmed: "Dollars spent on deferred compensation, such as retirement pay, have less impact on retention than dollars spent on the pay and benefits that service members receive while on active duty."[183] Retention rates might decrease if a new retirement system were installed, but they would not decrease significantly.[184]

The defined-benefit model was the nation-wide norm when the military retirement system was created more than 65 years ago.[185] Today, however, only 17 percent of employees in the United States participate in defined-benefit retirement programs.[186] These programs have been almost completely replaced with defined-contribution models, in which an employer contributes to a retirement account managed by the employee, such as a 401(k).[187] The retirement funds for many state and local government employees continue to follow the defined-benefit model, but growing risks of insolvency are quickly rendering that model unsustainable.[188] Despite the changes in the private sector and the warning signals emanating from state and local pension funds, the military retirement system remains largely unchanged, although the benefits it distributes have grown immensely over time.

Assessments of the military retirement system have long pointed to three key problems: inequity, inflexibility and unaffordability.[189]

Inequity. As noted above, only 17 percent of those who serve in the military receive any retirement benefits at all. A service member retiring at year 20 immediately begins to receive 50 percent of basic pay annually for life.[190] After year 20, each subsequent year served on active duty before retirement adds an additional 2.5 percent of the member's basic pay on top of that, up to a total of 75 percent at 30 years.[191] Small numbers of senior officers and senior enlisted personnel remaining beyond 30 years can continue to accrue additional annual retirement benefits, reaching 100 percent of basic pay at 40 years and continuing to increase beyond that. This system provides no benefits to the 83 percent of service members who do not serve long enough to retire, many of whom are younger troops who have fought in Iraq and Afghanistan over the past 12 years.[192]

Inflexibility. The inflexibility of the 20-year retirement system causes structural manpower issues within DOD. Service members with 20 to 25 years on the job are often just peaking professionally but are the most difficult group to retain. According to a recent study, "only 7% of personnel leave between the 15th and 20th year[s] of service compared to 76% who depart between 20 and 25 years."[193] This creates a personnel structure that is bloated at the middle levels and depleted at the senior levels.Very few service members leave voluntarily between years 15 and 20 because they face strong incentives to wait until they are eligible for retirement benefits. There is also a systematic reluctance, when approaching 20 years of service, "to separate even poor performers knowing that they will leave with nothing."[194]

The 20-year vesting requirement leads to an artificial one-size-fits-all approach to military personnel. The current system also does not differentiate between those who have served in combat and those who have not. Assault team members serving with SEAL Team Six who retire with 20 years of service receive exactly the same lifetime retirement benefits as an airman or soldier in an administrative career field who never deployed to a combat zone. The fundamental inequities of a system that provides identical lifetime benefits to both are manifestly evident. The current system tends to provide the wrong incentives at the wrong times, sometimes to the wrong people, and it does so at exorbitantly high costs.

Affordability. For each dollar that DOD spends on basic pay, it spends 33 cents on accrual payments to the Military Retirement Fund. In FY

2012, DOD spent $21 billion on contributions to the MRF.[195] This only accounted for 28 percent of total government spending toward military retirement for the year, as the Treasury Department spent $74.5 billion.[196] Outlays from the MRF to pay for current beneficiaries are expected to rise from $51.7 billion in FY 2012 to $55 billion in FY 2017 and $59 billion in FY 2022.[197] The MRF also faces a future liability to be paid by the Treasury Department that is currently estimated at $1.3 trillion and expected to grow to $2.7 trillion by FY 2034.[198] These costs are staggering – and patently unsustainable.

Yet the circumstances for which the system was originally intended have also dramatically changed. In 1940, life expectancy for men in the United States was 60.8 years. In 1950, it was 65.6 years. In 2008, it was 75.5 years for men and 80.5 years for women. The nature of service in uniform has also changed, altering previous expectations regarding both life expectancy and quality of life. In comparison to service members 60 years ago, today's service members, as a whole, are far less likely to be killed in battle or incur disabilities serious enough to prevent work in later years. The vast majority of retirees go on to second careers after they leave the military. These positive trends were unforeseen at the time the retirement benefit was created, and the retirement system has not been updated to reflect these changes.

Increases in annual expenditures by DOD for the MRF will slow as end strength is reduced and the number of future beneficiaries declines. The rise in retirement costs to DOD would also decrease if basic pay raises were reduced, as discussed in the previous section.

Recently, several senior leaders within DOD and in Congress have recognized the immense liabilities associated with military retirement costs in the face of a shrinking budget. On April 25, 2013, General Martin Dempsey stated that while any reforms should grandfather those currently serving, change is necessary to make the retirement system affordable. In his estimation, the retirement accrual fund "tends to suck money off the budget every year."[199]

Savings Options

The military retirement system should be revamped to improve its equity, flexibility and affordability. Any such reform should only affect future entrants to the military. Current retirees and currently serving military personnel should be grandfathered into the existing system, but they should also be able to opt into the new system if it better fits their needs. The short-term cost of such an option is unclear, but over the long term, transitioning to a new system will be more affordable and sustainable.

Shift from the current defined-benefits system to a defined-contribution system, vesting at four years of service.[200] DOD should contribute to individualized accounts that beneficiaries can begin drawing from at the designated Social Security retirement age. For illustrative purposes, a recent study suggested that 16.5 percent of basic pay would be a plausible amount.[201] A generous civilian employer typically offers to contribute 4 percent to 8 percent of an employee's salary to a retirement fund in his or her name, and this is typically done only if the employee matches the employer contribution.[202] The DOD system would contribute significantly more (more than double under this option) than comparable civilian retirement systems and would not require matching on behalf of the service member. Beneficiaries would also be able to pay into their accounts and access funds early under certain circumstances, such as pursuing further education, purchasing a home or opening a business. Benefits would be "portable," giving service members more flexibility in transitioning between the military and the private sector, an opportunity not feasible under the current 20-year vesting model.[203] The new system would also recognize the sacrifices of those serving in high-threat environments: DOD would double its contributions for the time that individuals are deployed to a combat zone.[204] DOD could also use increased contributions to provide financial incentives to retain service members who are in high-demand specialties or at particularly important points in their careers.

Shifting to a defined-contribution system has been recommended by numerous groups supported by DOD and Congress, including the Defense Science Board in 2000, the Officer Management Study Group in 2000, the Review of Morale and Quality of Life in 2001, the Defense Advisory Committee on Military Compensation in 2006, the 10th Quadrennial Review of Military Compensation in 2008 and the Defense Business Board in 2011.[205] Moving to such a system would allow DOD to shrink spending on military retirement from 33 percent to 16.5 percent for every dollar paid on basic pay.[206] Although some analysts argue that retirement reform would reduce recruiting and retention rates, evidence suggests that this would not be the case.[207] On the contrary, reform would improve flexibility by removing the primary incentive for large numbers of service members to exit the force after 20 years of service.

The reformed system would be considerably more attractive than the current one to a broader section of military personnel. Whereas the current system only benefits a small minority of those who serve in uniform, this new system would include virtually all service members.[208] The proposed system would not affect Department of Veteran Affairs benefits such as disability compensation and educational benefits.

Under the most simple terms (without factoring in added contributions for time served in a combat zone or for other incentives), it is estimated that under the reformed military retirement system, an enlistee with 22 years of service would receive $548,940 in compensation (55 percent less than under the current system), and an officer with 24 years of service would

Whereas the current system only benefits a small minority of those who serve in uniform, this new system would include virtually all service members.

receive $1,049,422 (60 percent less than under the current system). In contrast, an enlistee with 10 years of service would receive $212,593, and an officer with 10 years of service would receive $360,070. In the current system, both of these individuals would receive $0 in retirement benefits.[209]

This option is illustrative, in that it assumes that all currently and previously serving uniformed personnel are grandfathered into the current retirement system. It also does not account for the added costs associated with compensation for combat and other special circumstances.[210] More models would need to be created to test these factors. Even with some uncertainty surrounding near-term budget savings, it is clear that this system would be more equitable, vesting members earlier with transferable benefits; would widen the pool of beneficiaries; and at the same time, would make the system more affordable and sustainable to the taxpayer. This system would also provide the military services with more flexibility to shape the force – an essential tool given the looming defense drawdown. This reform would save approximately $38 billion over 10 years.

The Seventh Deadly Sin: Escalating Military Health Care Costs

POTENTIAL SAVINGS: $64 BILLION OVER 10 YEARS

Overview

DOD health care costs have grown substantially over the past two decades. The reasons are myriad and include: increases in general U.S. health care

The Department of Defense TRICARE Program

The DOD TRICARE program leverages the services of the military health system, as well as participating civilian health care providers, to support 9.7 million individuals worldwide. TRICARE has four main benefit plans. Three of these plans – TRICARE Prime, Extra and Standard – primarily serve active service members and their dependents; survivors; and retirees and their dependents. TRICARE for Life serves Medicare-eligible retirees and their dependents.[211]

TRICARE Prime functions similarly to a traditional health maintenance organization plan; care is centered around a primary care manager who provides referrals to specialists when necessary. TRICARE Prime is DOD's largest plan in both number of beneficiaries and cost to the department. Beneficiaries must enroll on an annual basis. Service members and their families pay no enrollment fees, whereas retirees and their families pay enrollment fees and copayments for services. For FY 2012, Prime enrollment fees cost $260 per individual and $520 per family. In FY 2013, these fees increased to $269 and $539, respectively.[212] In FY 2012, average out-of-pocket costs amounted to $96 for active-duty families and $967 for retirees and their families.[213]

TRICARE Standard and Extra allow beneficiaries more options in selecting providers than Prime, but at higher rates of out-of-pocket spending. Standard is a fee-for-service plan authorizing beneficiaries to go outside the TRICARE network for care. Extra is comparable to a preferred-provider-network plan and allows beneficiaries to obtain services within the TRICARE network at a reduced cost compared to Standard. Beneficiaries are eligible to use both Standard and Extra, depending on their needs and preferences. Beneficiaries have no enrollment fees but pay out-of-pocket costs in the form of deductibles and service fees. In FY 2012, the average active-duty family member paid $441, and retirees and their families paid an average of $1,036.[214]

TRICARE for Life (TFL) is the health care plan for Medicare-age retirees and dependents. Established in 2001, it serves as a second payer to beneficiaries enrolled in Medicare Part B, and it pays most costs not covered by Medicare. There is no additional enrollment fee for TFL. The average out-of-pocket cost for a TFL beneficiary in FY 2012 was $2,536.[215]

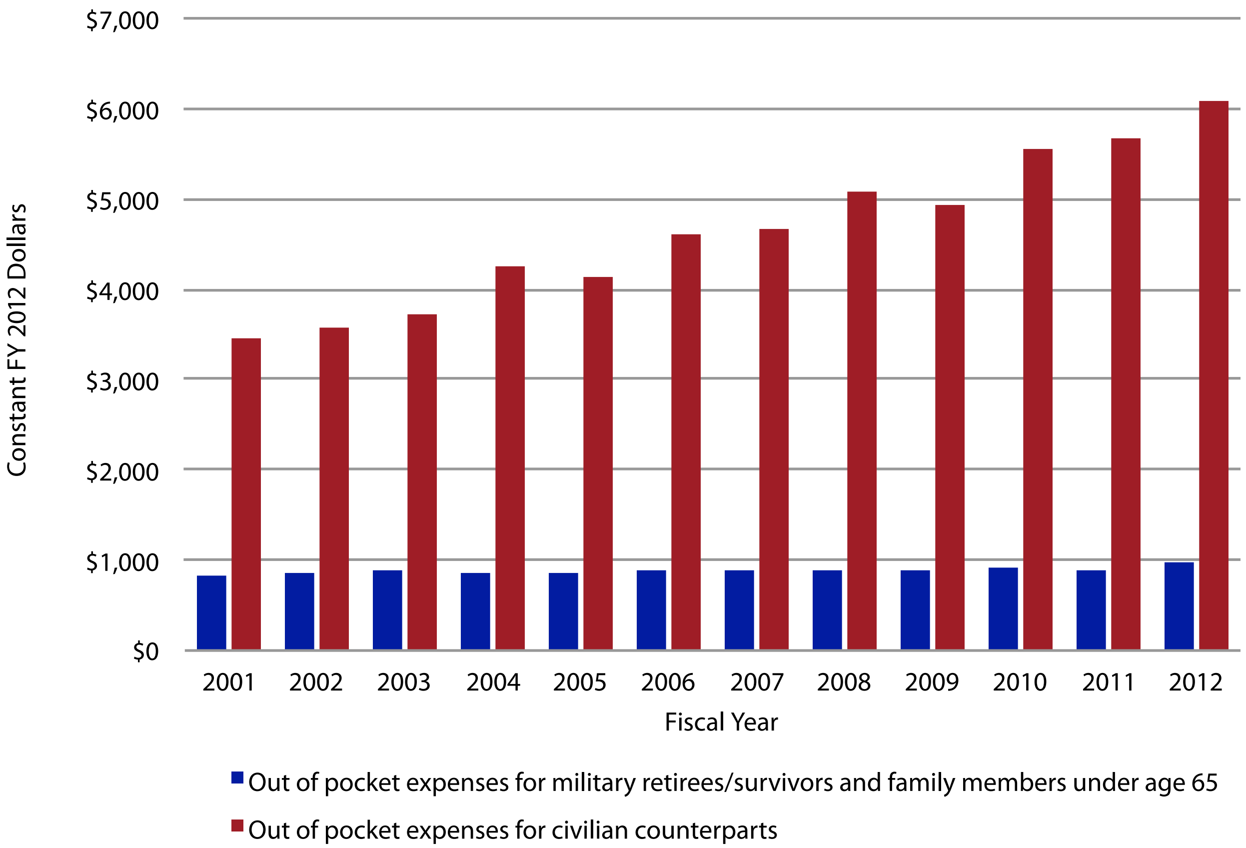
spending, decisions to expand the size of the eligible pool of DOD health beneficiaries, new programs and an unwillingness to increase the costs paid by beneficiaries. Many beneficiaries of the TRICARE program – DOD's health benefit program for the military community – pay insurance rates that have barely risen since the program was established in 1995. These costs to TRICARE beneficiaries are but a fraction of annual health care costs typically incurred by American families.[216] The current trajectory of DOD health care costs is untenable and threatens to divert an ever-increasing share of the defense budget away from other critical priorities. Action must be taken to put these costs on a sustainable footing.

In FY 1990, health care made up 4.5 percent of the DOD budget.[217] In FY 2012, it amounted to 9.6 percent.[218] The two decades in between experienced a series of policy, legislative and economic changes that vaulted defense health care to be one of the fastest growing area of defense spending. In the past 12 years alone, costs rose from $19 billion in FY 2001 to $52.8 billion in FY 2012, a real increase of 118 percent.[219] On the basis of current legislation, CBO estimates that DOD health care costs will expand by 68 percent over the next 10 years.[220]

Challenges

Recent increases in defense health care costs have not been driven by the effects of current conflicts

FIGURE 5: ANNUAL OUT-OF-POCKET MEDICAL EXPENSES FOR FAMILIES, CIVILIANS VS. MILITARY RETIREES



Source: Data from FY 2004 - FY 2013 Office of the Assistant Secretary of Defense (Health Affairs) reports, *Evaluation of the TRICARE Program: Access, Cost, and Quality*.

Note: Department of Defense figures are for TRICARE Prime beneficiaries. Civlian figures represent comparable HMO-style health insurance plans.

or by the costs of treatment for injuries suffered by service members in combat.[221] Instead, ballooning costs are caused by the increase in general cost growth within the U.S. health system and three key internal growth factors.

Relative costs borne by TRICARE beneficiaries have decreased. In 1995, TRICARE Prime charged enrollment fees for retirees of $230 per year for individuals and $460 for families. By way of comparison, individuals enrolled in civilian employer-sponsored plans in 1996 paid $444 per year and families paid $1,464 per year.[222] Therefore, individual retirees paid 52 percent of what their civilian counterparts paid, and the retiree family paid 31 percent of what its civilian counterpart paid. (See Figure 5.)

While health insurance costs for the general population have increased steeply since 1995, fees for TRICARE Prime beneficiaries remained virtually unchanged until 2012. Congress successfully blocked all DOD attempts to raise TRICARE Prime fees between FY 1995 and FY 2012.[223] As a result, the disparity in out-of-pocket expenses between a civilian employer-sponsored health care plan and TRICARE Prime has grown dramatically since 1995. TRICARE Prime fees simply failed to keep pace with the national rise in health insurance costs. As a result, by FY 2012, a military retiree family paid an average of $967 in out-of-pocket costs under TRICARE Prime, as opposed to $6,080 paid by a civilian family using an HMO through an employer.[224] TRICARE beneficiaries have largely been immune to rising health care costs experienced by civilians, while the overall price tag for the DOD health care system has risen at rates above the national level.[225]

Relative cost sharing between DOD and beneficiaries has also grown more unbalanced since the creation of TRICARE. In 1996, a retiree with a family of three paid, on average, 27 percent of actual total health care costs. In 2012, this had dropped to only 11 percent.[226] To begin to modestly offset these rising costs, Congress in FY 2012 approved increases in TRICARE Prime enrollment fees for retirees for the first time since the program's inception, from $230 to $260 for individuals and from $460 to $520 for families. These fees are subject to annual increases based on retirement pay cost-of-living adjustments.[227]

However, Congress has yet to act on the substantial growth in costs incurred by the creation of the TFL program. A 2007 DOD study found that from FY 2000 to FY 2005, TFL accounted for 48 percent of DOD health care cost increases.[228] In FY 2012, TFL beneficiaries paid $2,536 in out-of-pocket costs while their civilian counterparts paid $5,154, or more than twice as much.[229]

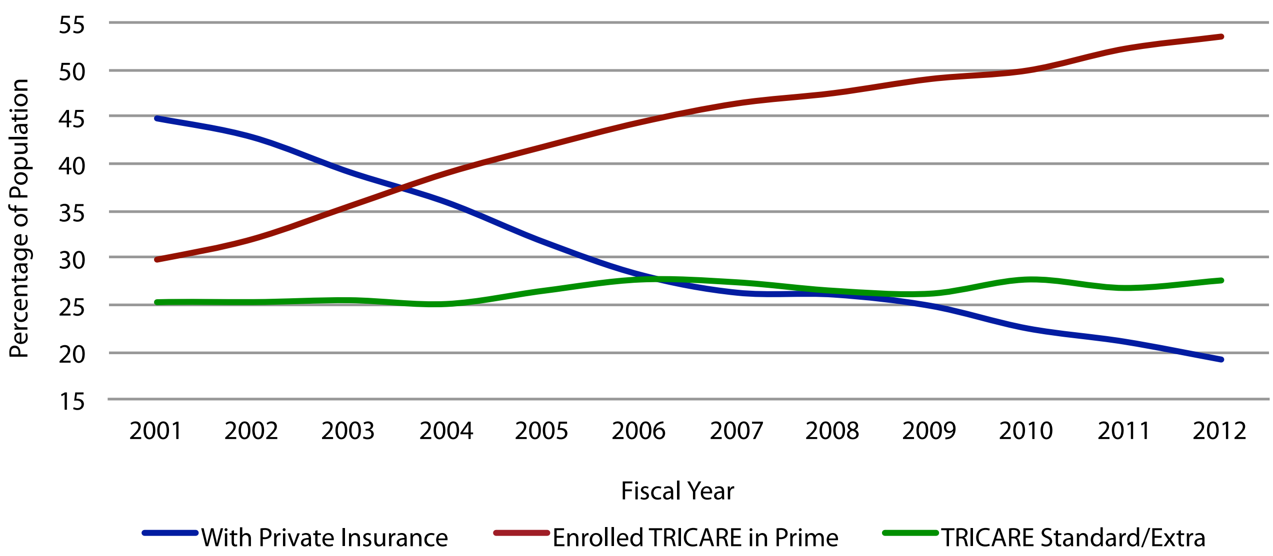
The number of beneficiaries eligible for – and choosing to use – TRICARE has increased. TRICARE programs have experienced a substantial increase in the pool of eligible beneficiaries, as well as in the number of individuals utilizing TRICARE.[230] In 2000, the group of beneficiaries was largely composed of active-duty service members and their families. But today, TRICARE extends generous benefits to almost all groups.[231] Enrollments in TRICARE Prime, the most generous plan, increased from 3.9 million enrollees in FY 2001 to 5.45 million in FY 2012.[232] Furthermore, the creation of TFL in 2002 introduced a new plan for a large group of beneficiaries that accrues health care costs at a higher per capita rate than other groups.[233]

The increased enrollment in TRICARE Prime is mostly explained by greater enrollment among retirees, who are choosing this generous plan rather than paying for private insurance.[234] (See Figure 6.) A 2007 survey of retirees and their families found that 78 percent had access to health insurance other than TRICARE, most commonly from an employer plan (80 percent of the surveyed population was employed) or a spouse's employer plan.[235] The decreasing cost of TRICARE relative to plans offered by civilian employers was largely responsible for the migration of retiree beneficiaries to the TRICARE system. This migration of beneficiaries to DOD-sponsored health insurance plans is expected to continue. DOD "estimates that care provided to retirees and their dependents will make up over 65 percent of DOD health care costs by 2015, up from 43 percent in 1999."[236]

Rising DOD health care costs are further compounded by the cost growth of civilian health care.[237] The millions of new TRICARE beneficiaries over the past decade have exacerbated these costs because these beneficiaries often rely on TRICARE-covered private-sector care and purchase pharmaceuticals at retail pharmacies.

Use of services per beneficiary has increased. Active-duty families enrolled in TRICARE Prime use medical services at a rate that is 82 percent greater than that of their civilian counterparts. Retiree families enrolled in Prime use services at a rate 60 percent greater than that of their civilian peers.[238] This difference is largely because DOD beneficiaries pay very low levels of fees, particularly

FIGURE 6: HEALTH INSURANCE MIGRATION AMONG MILITARY RETIREES UNDER AGE 65



Source: Office of the Assistant Secretary of Defense (Health Affairs), *Evaluation of the TRICARE Program: Access, Cost, and Quality* (February 28, 2013), 82.

in co-payments for services.[239] Health economics research shows that the decision to seek care and how often one seeks care depend largely on the amount of money that comes out of the patient's pocket through co-payments or prescription fees.[240] Because co-payments for TRICARE Prime have largely been kept artificially low – or nonexistent, in the case of TFL – essentially no constraints are placed on using these health care services.

Savings Options

1. Adjust TRICARE fees to reflect growth in health care costs. DOD and Congress should implement annual cost adjustments for enrollment and co-payment fees to help offset the nation-wide rise in health care costs. FY 2012 was the first year that TRICARE Prime enrollment fees were raised in 15 years, despite six years of DOD attempting to implement such changes.[241] The fact that Congress has repeatedly refused to consider increases in enrollment fees until last year reflects the political difficulty associated with such changes. Nevertheless, gradually increasing fees is a vital step to gaining control of runaway health care costs that are consuming an increasing portion of defense spending.

A 2011 CBO study estimated the cost of an option to reintroduce cost sharing that resembled requests in past president's budgets and the findings of the 2007 Commission on the Military Health System.[242] This option would raise enrollment fees, co-payments and deductibles for retirees under age 65 for the various TRICARE plans.[243] A retiree family would pay $1,100 per year to enroll in TRICARE Prime.[244] Other major changes include introducing annual deductibles for TRICARE Standard and Extra of $350 for individuals and $700 for families.[245] Such deductibles have never been a feature of these programs. Most important, this option indexes beneficiary payments to reflect changes in nationwide health care spending per capita.[246] Such changes would stop the migration of retiree beneficiaries from employer-sponsored health insurance plans to Prime that has been experienced over the past 12 years, free up health care services for the families of those who are currently serving and contribute to putting DOD health care on a more sustainable path. This option would save DOD about $30 billion over 10 years.[247]

2. Introduce cost sharing for TRICARE for Life. TFL beneficiaries essentially pay no out-of-pocket expenses beyond the amount already required for Medicare. In the general health care market, programs that provide additional insurance to supplement Medicare for individuals over the age of 65 cost an average of $2,100 in 2009.[248] This option would introduce a small annual enrollment fee of $200 that would be indexed to reflect changes in nationwide health care spending per capita. Eligible beneficiaries needing health coverage beyond what Medicare provides will likely choose to pay the enrollment fee to participate in TFL because of its relatively low cost compared with civilian equivalents. This option would save DOD $6.7 billion over 10 years.[249]

3. Increase pharmaceutical cost sharing. Total and per capita pharmacy usage has increased among TRICARE beneficiaries.[250] The increased costs to TRICARE are largely a result of beneficiaries using retail pharmacies, which tend to be more convenient for those not living on or near military installations.[251] Retail pharmacies are much more expensive than other options.[252] The FY 2013 National Defense Authorization Act (NDAA) authorized TRICARE to adjust pharmacy co-payment fees for retail and mail-order drugs in order to provides incentives for beneficiaries to use generics, but these changes "are not enough to sustain the benefit in the long term" and do not contribute a great deal to DOD savings.[253]

Congress should raise pharmacy co-payments paid by all TRICARE beneficiaries except active-duty service members. When obtaining pharmaceuticals at DOD facilities, beneficiaries would be charged $3 for generics and $9 for brand-name products.[254] Charges at retail pharmacies for 30-day supplies would be $15 for generics, $25 for formulary pharmaceuticals and $45 for nonformulary pharmaceuticals.[255] Beneficiaries would pay less for pharmaceuticals ordered through the mail rather than through retail or military pharmacies. Ordering pharmaceuticals by mail would cost beneficiaries $9, $27 or $45 for 90-day generic, formulary and nonformulary supplies, respectively.[256] Higher co-payments would likely reduce use of the TRICARE pharmacy system, as well as shift some beneficiaries toward other government or civilian pharmacy benefit systems.[257] These changes would further encourage beneficiaries to purchase generics and use the mail-order system to obtain pharmaceuticals at substantial savings to DOD. This option would save DOD approximately $27 billion over 10 years.[258]

V. IMPLEMENTING CHANGE AND THE WAY FORWARD

Addressing the Seven Deadly Sins of defense spending will require a strong consensus for change, accountability for results, realignment of authorities, unified White House and Pentagon leadership and – most important – support from Congress. If these conditions are not met, DOD will have no choice but to find savings through deep cuts to force structure, modernization and readiness – the very core capabilities required for the U.S. military to maintain global pre-eminence.

The reforms outlined in this report fall into two broad categories: those that require Congressional authorization and those that the White House and DOD can implement using existing executive authorities. Reforming defense health care; adjusting military pay, benefits and retirement; and divesting excess infrastructure ultimately will require legislation to change current statutes or enact new ones. By contrast, DOD already has the authority to reduce acquisition costs, trim excess overhead and reshape inefficient business practices. Yet indisputably, virtually all of these reforms will require a partnership between the White House, DOD and Congress. The Appendix to this report summarizes our recommendations from the preceding sections and identifies principal responsibilities for reform between the branches of government.

As commander-in-chief, **President Barack Obama** holds the ultimate responsibility of balancing the ends, ways and means of U.S. power in a dangerous world. He also juggles domestic and foreign policy concerns; shapes U.S. economic policies at home and abroad; and directs the use of U.S. military power. As federal budgets go down and defense spending shrinks, President Obama needs to continue to refine the strategic priorities in his January 2012 strategic guidance and reaffirm their importance. Most important, he needs to insist that DOD carefully steward every dollar and deliver robust military capability for the lowest possible costs. Tackling the seven sins will be impossible without his strong support and leadership – within the Pentagon, on Capitol Hill and directly to the U.S. military and the American people.

Addressing the Seven Deadly Sins of defense spending will require a strong consensus for change, accountability for results, realignment of authorities, unified White House and Pentagon leadership and – most important – support from Congress.

Secretary of Defense Chuck Hagel has the unenviable job of implementing and expanding upon a series of defense cuts that were initiated well before he took office. He will have to invest considerable time being an active, visible agent of change not only within his own often-recalcitrant department but also on Capitol Hill. Many of the reforms suggested by this report will trigger sharp and sustained opposition from lawmakers in Congress. Members will be anxious to protect bases, preserve jobs and – rightfully – maintain full oversight of DOD and its decisionmaking processes on everything from weaponry to personnel. Members of Congress will be particularly wary of reducing pay and benefits for military members, who have borne the brunt of two bloody wars over the past decade while most other Americans have made few, if any, sacrifices. But a defense secretary who has personally served in combat as a junior enlisted soldier also brings unique credibility to this debate. While recognizing the interests of those serving, Hagel must work closely with the service chiefs to educate members of Congress about the potentially devastating consequences of saving money by cutting military capabilities while failing to control internal cost growth identified in this report. He needs to marshal support for these unpopular efforts, building confidence that these reforms will be done fairly and even-handedly even as they have impacts across the nation.

These changes will also require public, unified support from the **Joint Chiefs of Staff** – the chairman and vice chairman of the Joint Chiefs, the four service chiefs and the chief of the National Guard Bureau. Their strong public leadership and aggressive support for these measures *as a single body* will carry immeasurable influence over the inevitable strong opposition that many of these measures will find in Congress, in the retired military population, among advocacy groups and even within the ranks of the military itself. The chiefs must help lead the way in educating Congress – and through them, the American public – on the absolute necessity of fundamental structural reforms to the Defense Department and the very real risks to military capabilities if changes are stymied. The Joint Chiefs should also spearhead efforts to reform military cash compensation, retirement and health care. They can help to ensure that efforts to put these programs on a sustainable fiscal path also keep faith with future service members.

The Congress of the United States will play a critical role in any efforts to reform DOD. Given its constitutional oversight and budgetary responsibilities, Congress must support even those reforms that do not require changes in legislation. Reducing civilian billets; consolidating or closing headquarters or functions; and streamlining requirements processes all touch on key Congressional interests. Such efforts require transparency, consensus-building and, ultimately, at least tacit support from lawmakers. Reforms such as raising TRICARE fees, limiting military pay raises and changing the military retirement system will require explicit Congressional authorization. As noted above, DOD's civilian and military leadership must help members of Congress make this case to the American people – including active and reserve service members, military retirees and their families. This will require a nearly unprecedented level of partnership and trust between the White House, Congress and DOD's civilian and military leadership.

VI. CONCLUSION

The Department of Defense faces a stark choice. Decisions taken in the next 12 months will chart one of two paths: one that continues to operate DOD in fundamentally unchanged ways and avoids tough choices about cutting excess and inefficiencies, or one that embraces painful but necessary reforms to the structural underpinnings of the Department. The first path will inevitably lead to deep cuts in force structure, readiness and modernization. It will produce a much-diminished U.S. military, giving up "tooth" to preserve "tail." The other, more difficult, path preserves these capabilities by fundamentally reforming the underlying causes of DOD cost growth.

DOD and Congress must seize the opportunity presented by sustained deep budget cuts to drive these reforms forward. They must work together to reform DOD business practices and to contain internal cost growth in order to provide the substantial military capabilities required to sustain the U.S. global engagement strategy. That strategy – the hallmark of U.S. foreign policy since the late 1940s – requires military forces that can span the globe, react to crises, deter adversaries and rapidly defeat a wide range of potential adversaries. In an era of increasing fiscal austerity, DOD will be less and less able to provide those forces if increasingly inefficient and wasteful business processes and spiraling personnel costs continue unabated – and that is a price that the United States simply cannot afford to pay.

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137. Government Accountability Office, "Military Base Realignments and Closures: Updated Costs and Savings Estimates from BRAC 2005" (June 29, 2012), 2.

138. Figure is in FY 2012 constant dollars. Ibid., 5.

139. Dorothy Robyn, Deputy Under Secretary of Defense (Installations & Environment), statement to the Subcommittee on Readiness, Armed Services Committee, U.S. House of Representatives, March 18, 2012, 9.

140. Katherine Hammack, Assistant Secretary of the Army (Installations, Energy and Environment), statement to the Subcommittee on Readiness, Armed Services Committee, U.S. House of Representatives, March 14, 2013, 7.

141. Conger, statement to the Subcommittee on Readiness, 8.

142. Estimated by Michael O'Hanlon, "A Moderate Plan for Additional Defense Budget Cuts," Policy Paper Number 30 (The Brookings Institution, February 2013), 27.

143. Defense Manpower Data Center, *A Study of Schools Serving Military Families in the U.S.: Education Quality, Federal Administration, and Funding*, DMDC Report No. 97-013 (October 1997), 2.

144. National Commission on Fiscal Responsibility and Reform, *$200 Billion in Illustrative Savings* (November 12, 2010), 23.

145. United States Department of Education, National Center for Education Statistics, *Digest of Education Statistics*, 2011, NCES 2012-001 (2012), Table 191.

146. National Commission on Fiscal Responsibility and Reform, *$200 Billion in Illustrative Savings*, 23.

147. Upgrades to DDESS schools are planned through 2015. In order to produce maximum savings, DOD will need to close DDESS schools before implementing upgrades. National Commission on Fiscal Responsibility and Reform, *$200 Billion in Illustrative Savings*, 23.

148. Gerry J. Gilmore, "Military Exchange Operations Plan Integration," Armed Forces Press Service, March 12, 2004, http://osd.dtic.mil/news/Mar2004/n03122004_200403121.html.

149. Ibid.

150. National Commission on Fiscal Responsibility and Reform, *$200 Billion in Illustrative Savings*, 22.

151. Figures are measured in FY 2012 constant dollars.

152. National Commission on Fiscal Responsibility and Reform, *$200 Billion in Illustrative Savings*, 23.

153. These savings are illustrative. The Simpson-Bowles Commission calculations were done in 2010. The BCA changes mean that much of the savings might already be occurring through sequestration cuts. Regardless, these changes should be institutionalized across the services. They should become business as usual, rather than being employed as short-term cost-cutting measures.

154. Todd Harrison, "Rebalancing Military Compensation: An Evidence-Based Approach" (Center for Strategic and Budgetary Assessments, July 2012), 1.

155. This figure is the sum of the total Military Personnel accounts and the Defense Health Program funded through the Operations & Maintenance accounts. Office of the Under Secretary of Defense (Comptroller), *National Defense Budget Estimates for FY 2001* (March 2000), 6,10.

156. According to Table 7-5 from the FY 2013 Green Book, active-duty manpower in FY 2001 was 1.45 million, and in FY 2013, it was 1.48 million. Office of the Under Secretary of Defense (Comptroller), *National Defense Budget Estimates for FY 2014* (May 2013), 7-5.

157. Office of the Under Secretary of Defense (Comptroller), *Fiscal Year 2013 Budget Request* (February 2012), 9, http://comptroller.defense.gov/defbudget/fy2013/FY2013_Budget_Request.pdf.

158. The triggering of sequestration in March of this year and further future cuts defense spending are expected to lead to further reductions in the size of the force. The magnitude of these reductions is not currently known.

159. See Congressional Budget Office, *Long-Term Implications of the 2013 Future Years Defense Program*, 4.

160. Elisabeth Bumiller and Thom Shanker, "Panetta to Offer Strategy for Cutting Military Budget," *The New York Times*, January 2, 2012, http://www.nytimes.com/2012/01/03/us/pentagon-to-present-vision-of-reduced-military.html?pagewanted=all&_r=0.

161. The FY 2013 NDAA authorized the establishment of an independent Military Compensation and Retirement Modernization Commission to review "current military compensation and retirement systems, force management objectives and changes in life expectancy and the labor force." It is not clear if this commission will be adequate to overcome substantial obstacles to reforms.

162. Cash compensation is composed of current and deferred payments. Current compensation includes basic pay, housing and subsistence allowances, special pay, bonuses and tax benefits. Deferred compensation is paid to retirees. For an overview of all major forms of military compensation, see Congressional Budget Office, *Costs of Military Pay and Benefits in the Defense Budget* (November 2012), 6.

163. Ibid., 16.

164. NDAAs for FY 2000 to FY 2010. For more on the Employment Cost Index, see Department of Labor, Bureau of Labor Statistics, *Employment Cost Index* (December 2012), http://www.bls.gov/news.release/pdf/eci.pdf.

165. Office of the Under Secretary of Defense (Comptroller), *National Defense Budget Estimates for FY 2003*; Office of the Under Secretary of Defense (Comptroller), *National Defense Budget Estimates for FY 2013*.

166. Beth J. Asch et al., "Cash Incentives and Military Enlistment, Attrition, and Reenlistment," (RAND Corporation, 2010).

167. When combining Basic Pay, BAS, and the average BAH, an O-5 with 20 years earns $10,163; in FY 2002, an O-6 with 20 years earned $10,264. Likewise, an E-7 with 20 years in 2013 earns $5,646; in FY 2002, an E-8 with 20 years earned $5,488. All dollars FY 2012 constant. Defense Finance and Accounting Service, "Basic Pay," (January 1, 2002); Defense Finance and Accounting Service, "Basic Pay," (January 1, 2013).

168. Congressional Budget Office, *Costs of Military Pay and Benefits in the Defense Budget*, 16.

169. Ibid.

170. Ibid.

171. Cindy Williams, "Making Defense Affordable" (Brookings Institution, February 22, 2013), 18.

172. Congressional Budget Office, *Costs of Military Pay and Benefits in the Defense Budget*, 18.

173. DOD proposed a similar plan in its FY 2013 and FY 2014 budget submissions. Office of the Under Secretary of Defense (Comptroller), *Fiscal Year 2013 Budget Request*,18; Office of the Under Secretary of Defense (Comptroller), *Overview: Fiscal Year 2014 Budget Request* (April 2013), 5-2. The 1 percent cap on military pay raises has faced pushback. See Gregg Zoroya, "Outcry Erupts Over 1% Pay Raise Proposed for Military," USA Today.com, April 25, 2013, http://www.usatoday.com/story/news/nation/2013/04/24/military-pay-raise-proposal-sparks-outcry/2110973/.

174. Harrison, "Rebalancing Military Compensation," 35-37.

175. Congressional Budget Office, *Reducing the Deficit: Spending and Revenue Options*, Report 4212 (March 2011), 76.

176. Cindy Williams, "Making Defense Affordable," 18.

177. In 1984, Congress mandated that DOD switch from a pay-as-you-go system to an accrual-based system for funding military retirement. As a result, the Department of Treasury assumed a $529 billion unfunded liability to pay over a 60-year period for service in the military prior to October 1, 1984. See 10 USC § 1465, "Determination of Contributions to the Fund."

178. Department of Defense Military Retirement Fund, *Audited Financial Report* (November 6, 2012), 17.

179. Maren Leed, "Keeping Faith: Charting A Sustainable Path for Military Compensation" (Center for Strategic and International Studies, October 2011), 25; Domenici-Rivlin Debt Reduction Task Force, *Restoring America's Future* (Bipartisan Policy Center, November 17, 2010), 112-113; and John Christian, *An Overview of Past Proposals for Military Retirement Reform* (RAND Corporation, 2006), 4-8.

180. As previously mentioned, a congressionally mandated commission is being established to review military retirement along with overall compensation, but an overhaul of the retirement system is unlikely to stem directly from this effort.

181. The predecessor to REDUX was the High-3 system, in which each year of service was worth 2.5 percent toward the retirement multiplier, up to a maximum of 75 percent. Under the REDUX system, each year of service was worth two percent toward the retirement multiplier for the first twenty years and 3.5 percent for each year after the twentieth, up to a maximum of 75 percent. The difference between the two systems is most dramatic at year 20, when an individual under the High-3 system would earn 50 percent of their highest 36 months while an individual under the REDUX system would earn only 40 percent of their highest 36 months. Office of the Secretary of Defense, "Military Compensation," MilitaryPay.Defense.Gov, http://militarypay.defense.gov/retirement/ad/04_redux.html.

182. Congressional Budget Office, *The Effects of the Military Retirement Reform Act of 1986 on Midcareer Retention* (February 1999).

183. Christopher Jehn, Assistant Director, National Security Division, Congressional Budget Office, "Military Pay and Benefits," Statement to the Subcommittee on Military Personnel, Committee on Armed Services, U.S. House of Representatives, February 25, 1999, 6.

184. Current compensation is a more useful tool for the military to use when dealing with retention problems.

185. A defined benefit – most commonly in the form of a pension – is a form of compensation in which an employer pays a retiree a predetermined, fixed amount during the time of retirement. A defined contribution is one in which an employer pays a predetermined amount into a current employee's personal account. This amount is based on a predetermined percentage, usually a fraction of that employee's salary.

186. Bureau of Labor Statistics, "Retirement Costs for Defined Benefit Plans Higher than for Defined Contribution Plans," *Beyond the Numbers: Pay and Benefits*, 1 no. 21 (December 2012), 1-4.

187. As of 2000, service members, like all federal employees, have access to the Thrift Savings Plan, a defined contribution plan similar to a traditional 401(k) plan found in the private sector.

188. Joint Economic Committee, *Republican Staff Commentary: The Pending State Pension Crisis* (September 26, 2012), http://www.jec.senate.gov/republicans/public/?a=Files.Serve&File_id=6bdeeee9-4560-4904-bb2e-73cea6de06ab.

189. For instance, the Defense Manpower Commission of 1976, the Defense Advisory Commission on Military Compensation of 2006, the 10th Quadrennial Review of Military Compensation, the Defense Business Board, the Stimson Center and the Center for American Progress all identify these three factors as driving the need for military retirement reform. Also see Christian, *An Overview of Past Proposals for Military Retirement Reform*.

190. If a retiree entered military service before September 8, 1980, retirement compensation is calculated based on the amount of basic pay received during their last month in uniform. For those who entered service following that date, retirement is calculated based on the average monthly basic pay of the highest paid 36 months of service. For more on the particulars of the military retirement system, see Charles Henning, "Military Retirement: Background and Recent Developments," RL34751 (Congressional Research Service, July 27, 2010).

191. Under this plan, those who entered service prior to September 8, 1980, retirement pay is calculated based on the final monthly basic payment received at the time of retirement. For those who entered service following September 8, 1980, retirement pay is calculated based on the average monthly basic payment over the last three years of service. This is known as "High-3." Service members can also opt for the Redux option which pays less than High-3 in most instances. Redux is the least popular retirement option, representing less than 1 percent of current retirees. Henning, "Military Retirement: Background and Recent Developments," 3-6.

192. This does not account for the benefits afforded by the Department of Veterans Affairs.

193. Defense Business Board, *Modernizing the Military Retirement System* (July 21, 2011), 11.

194. Department of Defense, *Tenth Quadrennial Review of Military Compensation* (February 2008).

195. Defense Business Board, *Modernizing the Military Retirement System*, 21.

196. Department of Defense, Office of the Actuary, *Valuation of the Military Retirement System* (February 2013).

197. Congressional Budget Office, *Costs of Military Pay and Benefits in the Defense Budget*, 27.

198. Ibid.

199. Karen Parrish, "Dempsey: U.S. Will Remain World Power Despite Budget 'Mess'," Armed Forces Press Service, April 25, 2013.

200. This model is adopted from a 2011 report by the Defense Business Board, which is one of the most recent studies in a long history of plans to reform the military retirement system. See Defense Business Board, *Modernizing the Military Retirement System*.

201. Ibid.; and Robert Levinson and Kevin Brancato, "Military Pension Change Could Save the Pentagon $37 Million," (Bloomberg Government, December 14, 2011).

202. Defense Business Board, *Modernizing the Military Retirement System*, 2.

203. Ibid., 14.

204. Note that the savings estimate provided below does not include a calculation for the cost of added benefits due to deployments or for individuals with high-demand specialties.

205. Library of Congress, *A Summary of Major Military Retirement Reform Proposals*, 1976-2006 (November 2007); and Department of Defense, *Tenth Quadrennial Review of Military Compensation*, xiii.

206. Defense Business Board, *Modernizing the Military Retirement System*, 22.

207. Congressional Budget Office, *The Effects of the Military Retirement Reform Act of 1986 on Midcareer Retention*; Harrison, "Rebalancing Military Compensation"; and Editorial, ArmyTimes.com, April 1, 2013.

208. The typical enlistment term is four years, whereas most officers who receive educational support through ROTC or one of the service academies are required to serve 4-5 years after graduation.

209. Levinson and Brancato, "Military Pension Change Could Save the Pentagon $37 Billion," 24.

210. Ibid.

211. For more details on the plans available to TRICARE beneficiaries, see Office of the Assistant Secretary of Defense (Health Affairs), *Evaluation of the TRICARE Program: Access, Cost Assessment and Program Evaluation* (February 28, 2013), 4, 47.

212. Department of Defense, *TRICARE Prime Enrollment Fees: Fiscal Year 2013 Update* (February 2013).

213. Office of the Assistant Secretary of Defense (Health Affairs), *Evaluation of the TRICARE Program: Access, Cost Assessment and Program Evaluation* (February 28, 2013), 83.

214. Ibid., 85.

215. Ibid., 88.

216. See Figure 5 on page 36.

217. Office of the Under Secretary of Defense (Comptroller), *National Defense Budget Estimates – FY 1997* (April 1996), Tables 6-6 and 6-9.

218. Office of the Under Secretary of Defense (Comptroller), *National Defense Budget Estimates for FY 2013*, 6. Total DOD spending was $650.558 billion in current FY 2012 dollars.

219. Office of the Under Secretary of Defense (Comptroller), *Fiscal Year 2013 Budget Request*, 5-2.

220. Congressional Budget Office, *Approaches for Scaling Back the Defense Department's Budget Plans* (March 2013), 15, 21.

221. Costs for injuries related to combat are primarily paid by the Department of Veterans Affairs to veterans and are not part of the DOD budget. Don Jansen, "Increases in Tricare Costs: Background and Options for Congress," RL34751 (Congressional Research Service, May 14, 2009), 2.

222. Civilian data is for 1996. Kaiser Family Foundation and Health Research & Educational Trust, Employer Health Benefits 1999 Annual Survey (October 1999), 62.

223. For TRICARE Prime, Congress also eliminated copayments for active-component family members through the FY 2001 NDAA. These fees have not been reintroduced. This same piece of legislation also reduced the catastrophic cap – the maximum amount a beneficiary can pay out of pocket – for retirees, survivors and former spouses from $7,500 to $3,000. See Congressional Budget Office, *Costs of Military Pay and Benefits in the Defense Budget*, 42.

224. Although the nominal fee for a retiree family enrollment under TRICARE Prime remained fixed between FY 2001 and FY 2011, its real dollar value declined by 21 percent. Ibid., 29.

225. DOD health costs increased 118 percent in constant FY 2012 dollars between FY 2001 and FY 2012. The total amount spent on health care in the United States increased 48 percent over the same period. Centers for Medicare & Medicaid Services, "National Health Expenditures; Aggregate and Per Capita Amounts, Annual Percent Change and Percent Distribution: Selected Calendar Years 1960-2011" (2011), Table 1; and Centers for Medicare & Medicaid Services, "National Health Expenditure Projections 2011-2021" (2011), Table 1.

226. Office of the Under Secretary of Defense (Comptroller), *Department of Defense Fiscal Year 2013 Budget Request: Overview*, 5-3.

227. Jansen and Blakeley, "Military Medical Care: Questions and Answers," 7.

228. Department of Defense, *Task Force on the Future of Military Health Care: Final Report* (December 2007), 15.

229. Office of the Assistant Secretary of Defense (Health Affairs), *Evaluation of the TRICARE Program: Access, Cost, and Quality* (February 28, 2013), 88.

230. Between FY 2005 and FY 2010, Congress established the Reserve Select and Retired Reserve plans in recognition of the sustained commitment of the reserve component in the wars in Iraq and Afghanistan. Congress further expanded eligibility in FY 2011 when it created the Young Adult plan for unmarried dependents up to age 26 who are not eligible for an employer-sponsored plan. In all, the number of eligible beneficiaries grew from 8.4 million in FY 2001 to 9.66 million in FY 2012. Jansen and Blakeley, "Military Medical Care," 8; Office of the Assistant Secretary of Defense (Health Affairs), *Evaluation of the TRICARE Program: Access, Cost, and Quality* (2005), 13; Office of the Assistant Secretary of Defense (Health Affairs), *Evaluation of the TRICARE Program: Access, Cost, and Quality* (2013), 10.

231. Leed, "Keeping Faith," 18-19.

232. After peaking in FY 2011, the number of beneficiaries enrolled in TRICARE Prime dropped slightly in FY 2012. However, as a percentage of the beneficiary population, TRICARE Prime enrollment continues to increase. In FY 2001, 57 percent of those eligible for TRICARE Prime were enrolled in the plan. In FY 2012, enrollment reached 70 percent. Office of the Assistant Secretary of Defense (Health Affairs), *Evaluation of the TRICARE Program: Access, Cost, and Quality* (2003), 8; Office of the Assistant Secretary of Defense (Health Affairs), *Evaluation of the TRICARE Program: Access, Cost, and Quality* (2012), 15.

233. To pay for this benefit, DOD switched to an accrual system that makes payments into the Medicare-Eligible Retiree Health Care Fund (MERHCF) to pay for future healthcare costs of current beneficiaries for Medicare-eligible beneficiaries using TRICARE for Life. This led to more accurate and responsible accounting practices but added an expensive program with up-front costs to the defense budget. Funded through the Military Personnel account, MERHCF added $10 billion of costs in FY 2003 alone. The president's request for FY 2013 included $9.7 billion for MERHCF. "Two of the major cost drivers for the Accrual Fund are the retail pharmacy network, which began in April 2001, and the TFL benefit, which began in October 2001." Office of the Assistant Secretary of Defense (Health Affairs), *Evaluation of the TRICARE Program: Access, Cost, and Quality*, 17.

234. As Figure 6 shows, nearly 25 percent more military retirees enrolled in TRICARE Prime in FY 2012 compared to FY 2001. TRICARE Standard/Extra also experienced an increase in the number of beneficiaries over this period.

235. Louis T. Mariano et al., *Civilian Health Insurance Options of Military Retirees: Findings from a Pilot Survey* (RAND, 2007), xv.

236. Jansen and Blakeley, "Military Medical Care," 18.

237. This increased use of private-sector health care does not translate into increased costs for beneficiaries, but costs to DOD are significantly higher as it must absorb the costs of more expensive civilian-based health care. Increasing use, combined with the overall increase in beneficiary population, has compounded effects on the total cost of health care to DOD.

238. Office of the Assistant Secretary of Defense (Health Affairs), *Evaluation of the TRICARE Program: Access, Cost, and Quality* (2013), 84.

239. According to DOD, "differences in coinsurance rates are a major reason for the higher utilization of health care services by Prime enrollees." Office of the Assistant Secretary of Defense (Health Affairs), *Evaluation of the TRICARE Program: Access, Cost Assessment and Program Evaluation* (2013), 84.

240. Emmett B. Keeler and John E. Rolph, "How Cost Sharing Reduced Medical Spending of Participants in the Health Insurance Experiment," *Journal of the American Medical Association*, 249 no. 16 (April 1983), 2220-2227; Richard N. Rosett and Lien-fu Huang, "The Effect of Health Insurance on the Demand for Medical Care," *Journal of Political Economy* 81 no. 2 (March/April 1973), 281-305; and Congressional Budget Office, *The Effects of Proposals to Increase Cost Sharing in TRICARE*, 23.

241. The debate surrounding this change created an outpouring of protests from military-retiree special-interest groups, even though the legislation only increased enrollment fees by $30 for retirees and $60 for families. Rick Maze, "Legion, MOAA unhappy with 2013 budget," ArmyTimes.com, February 14, 2012, http://www.armytimes.com/article/20120214/NEWS/202140316/Legion-MOAA-unhappy-with-2013-budget.

242. The FY 2013 president's request also recommended a similar plan. Congressional Budget Office, Reducing the Deficit.

243. This option would also raise copayments for TRICARE Prime beneficiaries. Ibid., 78-79.

244. This would amount to a fraction of the $5,200 paid in premiums by the beneficiary of a comparable civilian plan. Ibid., 78.

245. Ibid., 78-79.

246. Ibid., 79.

247. This estimate does not reflect the small increase in enrollment fees instituted in FY 2012 and FY 2013.

248. Office of Management and Budget, *Living Within Our Means and Investing in the Future* (September 2011), 20.

249. Ibid.

250. Office of the Assistant Secretary of Defense (Health Affairs), Evaluation of the TRICARE Program: Access, Cost, and Quality (February 28, 2013), 23, 77-80.

251. TRICARE beneficiaries have the option of filling their prescriptions at military pharmacies for free, at retail pharmacies where they must pay a copayment depending on the type of drug, or at a mail-order pharmacy, which is also free for generic drugs.

252. Retail outlets charge DOD up to 30 percent more than alternative sources to fill prescriptions for military families. Patricia Kime, "Tricare Adjusts Prescription Drug Co-Pays," ArmyTimes.com, September 7, 2011, http://www.armytimes.com/news/2011/09/military-tricare-adjusts-prescription-drug-copays-090711w/.

253. This legislation increases copayments for nongeneric drug prescriptions filled off base. It mandates that these copayments increase annually at the rate of the retiree cost-of-living adjustment. This increase in pharmacy copayments is intended to deter beneficiaries from filling prescriptions at retail pharmacies. To an extent, these increases in pharmacy copayments are similar to recommendations made under both the Bush and Obama administrations. Office of the Under Secretary of Defense (Comptroller), *Department of Defense Fiscal Year 2014 Budget Request: Overview*, 5-4.

254. CBO estimates that half of the savings from this measure would be attributable to TFL beneficiaries. Congressional Budget Office, *Reducing the Deficit*, 83.

255. Ibid.

256. Ibid.

257. Ibid.

258. Ibid.

Appendix

SUMMARY OF REPORT RECOMMENDATIONS AND COST SAVINGS

SUMMARY OF REPORT RECOMMENDATIONS AND COST SAVINGS

Appendix identifies principal responsibilities for reform between the branches of government.

SAVINGS OPTION	ESTIMATED SAVINGS	ACTION FOR CONGRESS	ACTION FOR SEC. OF DEFENSE	ACTION FOR JOINT CHIEFS OF STAFF
SIN 1: REDUNDANT OVERHEAD, LAYERING AND WORKFORCE	**$100-200 billion over 10 years**			
Reduce all overhead spending by five percent	$100 billion over 10 years		X	
Reduce all overhead spending by 10 percent	$200 billion over 10 years		X	
Reduce the DOD civilian workforce by 75,000 people	$37.4 billion over 10 years		X	
Reduce the civilian DOD workforce by 150,000 people	$74.3 billion over 10 years		X	
Roll back contractor spending to 2001 levels	unknown		X	
Fold AFRICOM back into EUCOM	$1.4 billion over 10 years		X	X
Merge NORTHCOM and SOUTHCOM	unknown		X	X
Consolidate the military service medical commands	$292-478 million per year		X	
Reduce duplication and overall funding for counter-IED initiatives	$1.2 billion over 10 years	X	X	
Reduce redundancy in military service intelligence organizations	unknown		X	

SAVINGS OPTION	ESTIMATED SAVINGS	ACTION FOR CONGRESS	ACTION FOR SEC. OF DEFENSE	ACTION FOR JOINT CHIEFS OF STAFF
SIN 2: INEFFICIENT BUSINESS PRACTICES	**$46 billion over 10 years**			
Pursue strategic sourcing options	$20 billion over 10 years		X	
Use reverse auctioning for contracts	$26 billion over 10 years		X	
Reduce redundancy of IT management systems	unknown		X	
Improve business alignment and auditability	unknown		X	
SIN 3: EXCESSIVE ACQUISITION COSTS AND OVERRUNS	**$50-100 billion over 10 years**			
Prevent five percent of waste in acquisitions funding over 10 years	$98 billion over 10 years	X	X	
Avoid repeating weapons systems failures of the past decade	$46 billion over 10 years		X	
Streamline the process for generating requirements and make real trade-offs on systems up-front	unknown		X	X
Continue to develop the acquisitions workforce	unknown		X	
Foster a productive two-way dialogue with industry	unknown		X	
Keep the rapid acquisitions process for fast-changing capabilities while fixing the "normal" process	unknown		X	

SAVINGS OPTION	ESTIMATED SAVINGS	ACTION FOR CONGRESS	ACTION FOR SEC. OF DEFENSE	ACTION FOR JOINT CHIEFS OF STAFF
SIN 4: EXCESS INFRASTRUCTURE, INSTALLATIONS AND MANAGEMENT COSTS	**$17 billion over 10 years; more in 20 years**			
Authorize and conduct a new BRAC round	$10 billion over 10 years; significant savings over 20 years	X		
Close DOD schools in the United States	$1.1 billion in 2015		X	
Consolidate the base and post exchange systems	$2.5 billion over the course of 10 years		X	
Reduce spending on base support and facilities maintenance	$3.6 billion through FY 2015, with increased potential for further savings through FY 2020		X	
SIN 5: UNAFFORDABLE INCREASES IN CASH COMPENSATION	**$25 billion over 10 years**			
Bring basic pay back in line with civilian pay increases	$14 billion over 10 years	X		
Curb recent increases in allowance pay	$11 billion over 10 years	X	X	X

SAVINGS OPTION	ESTIMATED SAVINGS	ACTION FOR CONGRESS	ACTION FOR SEC. OF DEFENSE	ACTION FOR JOINT CHIEFS OF STAFF
SIN 6: UNSUSTAINABLE GROWTH OF MILITARY RETIREMENT SYSTEM COSTS	**$38 billion over 10 years**			
Shift to a defined contribution system for all new recruits	$38 billion over 10 years	X	X	X
SIN 7: ESCALATING MILITARY HEALTH CARE COSTS	**$64 billion over 10 years**			
Adjust TRICARE fees to reflect growth in health care costs	$30 billion over 10 years	X		
Introduce cost sharing for TRICARE for Life	$6.7 billion over 10 years	X		
Increase pharmaceutical cost sharing	$27 billion over 10 years	X		
TOTAL POSSIBLE SAVINGS	**$340-490 billion over 10 years**			

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