Center for Strategic and International Studies (CSIS)

Preparing for a Deep Defense Drawdown

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DAVID BERTEAU: Good morning, ladies and gentlemen. I ask you to please take your seats.

I was down last week giving a speech in Florida, and I have a fairly loud whistle which I use for interrupting conversations where my voice won't penetrate. What I forgot was they had already put a lavalier mic on me. And it was on, so there were several people who had to be rushed off to emergency treatment for bleeding ears as part of the process. So I decided not to do that this morning.

Boy, I see a lot of familiar faces in the audience, and I want to welcome you all to the Center for Strategic and International Studies on behalf of our president and CEO, Dr. John Hamre, who can't be here this morning. We're really grateful to all of you for being here. This is the second of our military strategy forums for 2013. This is a series that we've been running for years and years with the generous support and sponsorship of Rolls Royce North America, who has the added advantage of, they actually don't tell us what to do or say. So it works out really well for them and for us.

But this is a unique and special military strategy forum. Usually what we have is, in fact, senior military or civilian officials from DOD, from the national security community or from our key partners and allies who are part of that process. This is a special one, because it's just an internal CSIS presentation. But the analysis is so compelling and the results are so profound and in some ways disturbing and in some ways an opportunity that we felt that this was the right audience to bring that to. I want to welcome, also, our viewers on the web. I know there are many of you out there, and we're glad to have you here as well, especially those of you in Boston and New York that have been encouraged to stay home today; we're delighted that you're able to join us on this.

I want to ask you all to please turn off your cell phones if you're in the room. Obviously, if you're on the web, you can do whatever you want. And probably not – (inaudible) – never mind, I won't go there. (Laughter.)

We're going to start here – our schedule today is a presentation from Dr. Clark Murdock, who will walk you through the charts. If you're on the web, you should be able to download these charts from the website and follow along. Here in the room, obviously, you'll have them up on the screen. Then we'll bring a panel up to join us here, and that panel will, in fact, provide some commentary and insight. I'll ask them the first question. Dr. Murdock will get the second question, and then we'll open it up to the floor for questions.

Unlike our general military strategy forum, where we use notecards to ask you to pass your questions in, we're going to open it up for – you actually get to raise your hand and hold the microphone in your hand and do kind of the normal way we do things, if you will.

We were talking earlier – you know, many of us have been at this game for a while. And occasionally, it can be a little discouraging when you realize that everything you've been working on for 40 years is still not fixed. But you think about how much worse it would be if we hadn't been working on it, and that gives you a little more enthusiasm.

Particularly important, of course, is the nexus of strategy and programs and resources, which is the core essence of why we have an organization in the Department of Defense. And in many ways, one of the core strengths of DOD over the decades has been its ability to incorporate strategy – ends, ways and means into a fiscally disciplined, constructed program, which we call the Future Year Defense Program, or the FYDP. When a transcriber writes that down in an audience, they usually spell it FIT-UP, which has a nice relevance to it, if you will, because it fits you up for what it is you're going to have to do.

But we've lost some of that over the last decade, decade-and-a-half. We haven't had to have that discipline structure in place. We were fighting two wars; there was a lot of urgency and immediacy, so you couldn't wait for it to be POMed and rolled out. It didn't need to for fiscal purposes, because if you had a problem, you didn't have to shove it into the out years of the FYDP; you just shoved it into the supplemental or the overseas contingency operations account.

And so we've lost a bit of that focus. What Clark Murdock did is step back and take a look at what the consequences of all that has been. Dr. Murdock has been a senior adviser and a program director here at CSIS for more than a decade; he has a long and very accomplished career as both a strategic thinker and a strategic planner and a strategic operator inside the government, both on the Hill and with the Defense Department and other agencies as well.

And so I want to turn the floor over to him, and ask you to please join me in a warm welcome for Clark Murdock. (Applause.)

CLARK MURDOCK: Thank you. It's great to see so many old friends, including a few mentors, although I still take full responsibility for everything that I say. One note – it's a real pleasure for me to do this. I've been a Pentagon groupie my whole career. I wrote my dissertation on Robert McNamara and what happened when he brought program budgeting and systems analysis to the Department of Defense. And here we are still doing the same thing, you know. It's amazing to me. Next slide.

The defense double-whammy – I have a good friend who says you always have to have some kind of metaphor. We've used double-whammy – whammy one being fewer defense dollars. We're all familiar with that; we've been talking about that. But the other one has been less well understood, and that is how much the defense dollar has lost in terms of purchasing power. And it's because of the aggregate impact of internal cost growth, which has not been controlled. And we're going to document that, but it's why a 20 percent reduction is going to feel a lot more like a 40 percent reduction, and why it is, I think, that Secretary Panetta and the Defense Department have reacted so strongly to the impact of this sequester cut, which, on the surface, looks like an 8-to-10 percent cut. But it's feeling – it's going to feel much deeper, because it comes on top of another 8 to 10 percent cut, and the defense budget, at the same time, is being hollowed out from within by internal cost growth. Next slide.

Fewer defense dollars – we defined the top line, as I said, from the Budget Control Act cuts – the additional cuts associated with the sequester. And we know – and the department

knows there will be further cuts as well, as part of any bargain – grand bargain that might replace sequester. President Obama offered a hundred billion in "fiscal cliff" negotiations, but that's just the beginning. Next slide.

This is the first of the "oh, my" slides. This is why there's going to be unrelenting pressure on the defense top line, because when you look at the growth of entitlements, the 3.1 percent is what's projected in the current five-year defense plan. By the time you get out to the mid-2030s, there's no room for discretionary spending of any kind. It's not just defense – domestic as well – so that the pressure on discretionary spending is going to continue, and this is going to be crisis after crisis for administration after administration, because the numbers are just unforgiving in terms of doing that. Next slide.

So we projected the top line – it's in constant 2013 dollars – currently at 660 billion (dollars), going down to 520 billion (dollars). The assumptions about OCOs spending are essentially for CBO – assumes the wars in Afghanistan and Iraq are over and we will go to a steady state level of 30K involved in operations at that time. Next slide.

It's instructive to compare defense drawdowns to past ones. And we'll see how things change from the first two after Korea and Vietnam to the second two after the Cold War ended – I capitalized Cold War – you'll forgive me for that – Cold War and in the current buildup. The solid line is active-duty end strength. In the first two buildups, it was increases in personnel that led the buildup. But in the Cold War, active duty manpower fell behind spending, and during the post-9/11 buildup, was almost steady – might have increased 1 or 2 percent overall. Where the dollars were spent were on three large categories: civilians and government contractors and active-duty hours for reserve components that have been called on. And what it means is that when you go to the drawdown, because of the internal cost growth of personnel, it's not returning to 400 billion (dollars) in constant 2013 dollars. It's returning to 520 billion (dollars). As Todd Harrison, who I regard as one of the finest defense analysts in this town – defense budget analysts – pointed out, we had a big buildup but we didn't get a whole lot more capability offered.

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Internal cost growth, personnel costs. This is from the defense budget paper 2012 that the administration put out. Personnel costs increased by nearly 90 percent while the number of military personnel increased by only 3 percent. O&M costs continue to go up about 1 ½ percent per year. It's been true for 20 – 30 years. As we said, $520 billion in constant 2013 dollars now buys an active-duty force that's 34 percent smaller than it was in 1978.

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Another "oh, my" slide: This is the top line that's projected from what's in the Budget Control Act we've talked about, and this is internal cost growth. And it includes – and the reason why health care and military personnel look relatively stable is that there's 100,000 fewer people in the force because of the cuts to Army and Marine end strength. The point here is that the growth is crowding out the money for military modernization – that is procurement and

RDT&E. As Todd Harrison pointed out in a brief he gave here two weeks ago at our conference that I hosted on preparing for the QDR, is that the growth rate of personnel in O&M could consume 80 percent of the budget by FY 2021.

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The opportunity costs of restoring the 32 percent of the budget that we've historically spent on military modernization, one of the chief tradeoffs is people. And in order to restore 32 percent of the budget in FY 2021, you have to give up 455,000 additional personnel. That is a much smaller force during that time. The numbers are pretty unforgiving.

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So how do we deal with it? I'll introduce a few concepts now and then I'll go again to charts. We talk about the affordable force and we reconceptualize the costs into two categories. That is institutional support and operational forces. We assign cost caps and then we reallocate resources. Even though I've spent much of my professional career working on defense reform, at the end of my career – not quite at the end of my professional life but getting close – I've decided that there are only two reforms that worked. One is, you've got to have a strong secretary of defense with a lot of intestinal fortitude. Bob Gates probably set the model for that in terms of decisions that he made in April of 2009 where he killed things. The hardest thing to do is this town is to kill programs, fire people.

And the other thing that works is – I learned when I was on the Hill from appropriators. If you want to create incentives, you cap programs. I don't care how many F-22s you get; this is all the money you're going to get. And the one thing that the secretary of defense controls – although I think he's never adequately used it – is dollars. They're not the commandant's dollars, they're not the MAJCOM dollars in the Air Force, they're not the MACOM dollars in the Army, they're not the Navy's headquarter dollars, but they're taxpayer dollars. And the secretary of defense owns them, and he can cap them and he can dole them out and he can control the database during that time.

So, we cap institutional support and then we think about our operational forces in two different categories that I've called "common core capabilities" and then "strategy." I'm a strategist but you notice strategy comes last in this analytic approach because we're in a time of austerity.

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We traditionally think an RDT& E procurement to O&M – operational force, institutional support, historically 68 percent of the budget; 32 percent of the budget for institutional support. And then we recategorize our traditional categories according to those.

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People want a little explanation of what goes into this; this is detail. I'm not going to go over it but it exists. Defense manpower center has coded every job in the Department of Defense as to whether it's part of the operational force or part of the institutional support. We did a deep dive into the data for FY 2012, and these are the assumptions, the methodology we used for how we distributed the cost between those two categories. There's a lot of detail that lies behind that.

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Then I stole something from the area of defense acquisition reform that's all the rage now. It's a big part of Ash Carter's Better Buying Power initiatives, the efficiency initiatives, and that's the notion of "should cost." So in 2012, what institutional support did cost was 32 percent of the budget. Well, you said we'll hold it at 32 percent. We're not going to tell the services or the force providers how to spend that 30 percent but that's all they're going to get for it. That should be a sufficient amount of the budget to pay for the necessary "organize, train and equip" Title 10 functions of the military services.

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Then, it's additive. We go through a drill where we define what the common core capabilities are. We don't know yet whether you devote 35 (percent) or 50 percent of the budget to it. That's an iterative data drill where you cost out. You convert our inputs where we have O&M per person, we have personnel costs per person, and we convert those into military force components with an estimate – to use a term that Arnie Punero has used in talking about the reserve components and the active-duty components about what a fully loaded BCT looks like, what a fully loaded tactical aircraft squadron – a bomber squadron – looks like. And you figure out how much you can actually buy for 35 (percent) to 50 percent of the budget.

And then to use another term at the risk of – your discretionary spending is that last 20 (percent) to 35 percent – where you actually do have different options, different priorities for how you spend the last portion of your budget. One thing you might decide to do is to double-down on your core combat capabilities because you're uncomfortable with how little capacity you actually have for the first tranche of spending. But 2012 Defense Strategic Guidance is one alternative. Andy Krepinevich has come up with a concept he calls "assured access." Stimpson Center did a recent study; they call their approach "strategic agility." Of course, it's noted that when you look at the defense strategic guidance and assured access and strategic agility, actually our capability priorities are all very similar. It's all SOF because you have to have something to do with counterterrorism; it's cyber, it's space, and so on.

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How would you apply this to the 2013-2014 QDR? Well, the first thing you go back is you have a strategy already and it's been recently updated in the 2012 Defense Strategic Guidance. And it's updated with direct presidential involvement, including several meetings that were held over in the White House, and then the president himself coming over to the Pentagon twice, including the rollout. So, this is his strategy. It's doubtful he's going to change it in the

transition from Secretary Panetta to secretary-to-be Hagel. But clearly there might be some changes you might want to make to the 2012 strategy.

Step two is essentially the drill we just talked about – that it's establishing how much – what's your bench – defense budget topline is and what kind of tradeoffs are you going to have to make in terms of buying capabilities with a deflated dollar in terms of its purchasing power – defense dollar. Implement cost caps to constrain spending on institutional support, as we talked about.

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Instead of looking at alternatives, we're just going to assume the strategy, make the necessary revisions, because the first level of knowledge is finding out how much capacity can you really buy for that 35 (percent) to 50 percent? I don't think we've ever really done that drill. And then you look at different ways of doing this discretionary spending in step five. And then you have to step back and say, if this is all the capability we can afford, is our strategy still valid?

And, of course, we do have a constant strategy but, as the newspapers made clear this morning, a lot of discussion within the federal government about how to apply that strategy in the specific instance of Syria, where it's clear that the national security team – which included the secretary of defense, the head of the CIA and the secretary of state – advocated one course of action and the president, who makes these decisions, took another course of action. So, you can have a common strategy. A lot has to do with how you implement that strategy. But the issue here is, is that you really have to start in a time of austerity of asking the question first of how much can we really afford? How much capacity do we really have?

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As I said when I got into this business – (inaudible) – Smith, how much is enough? Well, today I think the question isn't how much is enough; it's how much is affordable? And you have to start with figuring out how much capacity – because this is really a capacity issue. I think capabilities-based planning does a pretty good job of telling you what kind of capabilities you need to deal with future challenges. It doesn't do a good job of telling you how much capacity you have – the quantitative aspect of it. And when your dollar is weaker and you have fewer of them, you have to ask pretty realistically and dispassionately, how much can we afford? People talk about we're just going to have to learn how to do more with less. It may be we're really talking about doing less with much less, which I think is the case.

Okay, that's it. Final slide, I think, is just a placeholder. Right.

(Applause.)

MR. BERTEAU: It's the kind of presentation where you sort of say, should I give up now or can I wait till tomorrow? So, let's – we're going to – we'll bring the panel up now and remove the podium so that our honored guests on the right-hand side of the room will be able to

see Clark’s smiling demeanor as we go through this. So, I would ask the panel to come up and join me here.

(Pause.)

MR. : As Dr. Murdock mentioned, we evolved this analysis and the approach to dealing with it in a series of working groups that we’ve held, really, over the last year, I guess; perhaps a little longer than that. Some of the folks who participated in that working group are here in the room. Some of them are actually up on the platform with us. Others are wrestling with these questions from a different perspective.

So, we thought we’d provide you with an opportunity to both hear the commentary and insights of others who’ve been wrestling with the same set of questions, and then give you a chance to ask us, any of us, how we might approach this.

Joining me on the platform in addition to Dr. Murdock are three brilliant minds who are – who have spent their lives wrestling with all of these issues. They’re arranged in alphabetical order of last names, so there’s no order of battle in terms of the folks to my left, your right up here.

First is Mackenzie Eaglen, who is the resident fellow at the American Enterprise Institute. Next is Bill Greenwalt, who is currently vice president of acquisition policy at Aerospace Industries Association but who has been on all the sides of this issue. And third is Todd Harrison, a senior fellow at the Center for Strategic and Budgetary Assessments.

I’d like to ask the first question, and then, Dr. Murdock, you’re welcome to weigh in with any sets of questions you want, and then we’ll open it up to the floor. My question is really very simple. I mean, you’ve seen the description that we had here this morning. What do you think? What do we do? What is – what is going on here? Mackenzie, you want to go first?

MACKENZIE EAGLEN: Sure, I’ll jump in. Well, I think your work – your group has done outstanding work, and I enjoyed Clark’s presentation very much. It’s a reality check time for DOD, because the budget measures that have been instituted in the last four years aren’t dramatic enough and aren’t revolutionary enough to get through even just another dollar of defense cuts. This isn’t about just the sequester; this is about anything in between.

I, like Clark, have been studying this issue like them for a long time, and the strategy-resource mismatch – the tired phrase, but always true – it has never, ever been greater than now, and that’s to his point on the hollowing out of the defense budget. You know, on its face, it does appear that the percentage and the numbers are on par with drawdowns in recent history – in the last 100 years for the U.S. But obviously, the key point I take away from Clark’s presentation and your work is that this is not your grandfather’s defense budget.

So it’s not like any other drawdown. When you have people that are over 50 percent of your defense budget, it’s not like any other drawdown. And so I really liked the idea of reconceptualizing the military budget for a more intellectually honest discussion about what

costs are actually in there. The tired old O&M, R&D procurement and MIL PERS has got to be thrown out, because it allows policymakers to continue to skirt and avoid hard choices.

There should be account that's not military personnel – it should be called defense personnel, and it should account for almost three million people's salaries that are included in the Defense Department. And it should represent – and when you see that shocking pie, and you realize it's well over 50 percent right now and growing, as Todd has pointed out for all of us – and we source him regularly – then it's a wake-up call to action. So I really like the idea of reconceptualizing the budget to, again, make it more honest.

The real challenge we're going to face is – what we've seen through summary points of this work is, you've got to cut people. You can't just cut everything else. We've been disproportionately, already, raiding, for the last four years, the modernization accounts. We're going to keep doing that, because that's what DOD does; it's a quick fix, it's an early hit. It shows money quickly.

People are a wedge; you have to grow that money over time. The savings aren't as easy to generate. It's more complicated to do that – to let them go, whether that's layoffs, freezes, attrition, et cetera. Active duty is very different from DOD civilians and the processes that you want to do to get rid of these people. But that's the key takeaway, is that people are going to shrink significantly, whether DOD likes it or not.

And so far, they don't like, because while we're cutting a hundred thousand active-duty ground forces, not one DOD civilian has been cut from the payrolls in the last four years. In fact, under President Obama, the defense civilian workforce has grown by 10 percent. It's been growing even before that. So it's a hard thing to do.

But here's the real problem, and it's another reason we need to reconceptualize the defense budget, because even as the services, for example, are shrinking – hemorrhaging active-duty personnel – the costs of those smaller forces, when they're finally said and done, are still more. So there isn't a dollar that's saved. Any money that's generated from savings from those people that are being cut from the rolls are being fed right back into the rolls for the smaller people. That's how fast the costs of people are rising.

So to date, the services have been putting on Band-Aids, saying cutting end strength is going to – going to generate the money that we need to meet a sequester or another target. What I see – the screaming banner headline from all of this is, cutting end strength is – has worked up until now. The next step in this process is going to be fundamental pay overhaul. There's no other way around it.

It doesn't' mean you have to like it, but they're going – they're going to be backed into that corner, kicking and screaming. So the question is, do you want to do it kicking and screaming, or do you want to do it thoughtfully? And I mean everyone's pay; I don't just mean active-duty personnel. But certainly, military pay and benefits are a large part of this; DOD is separate. Cutting end strength just doesn't get you there.

MR. BERTEAU: Thank you, Mackenzie.

Bill, do you want to go next?

MR. GREENWELT: Sure, and I'll leave it to kind of the big strategy things here. I think that the presentation was, to me, a time of, you know, that we should all be took – you know, in a – in a – in a call for a great – it's a critical time, a great inflection point, take a look at how things have been going in the last 20, 30, 40 years, and maybe learn some lessons from where we're going.

And again, the strategists are going to figure out how to – where it is we should go; I'm actually more concerned about the plumbing of the process, and the ability of the rules and the incentive structure that outlines how we can actually meet whatever strategy is and whatever budget constraints we have. And I think one of the things that Clark talked about was the declining purchasing (power ?) – value of the defense dollar. And you can see that in the last decade or more – actually, we might take a longer historical process on that – of the costs imposed upon how to produce capability in the – in the Defense Department. And though – there's a cost of everything we do, and it's – and it's probably – this is a great inflection point, a great time to look at the plumbing, the acquisition process, the requirements process, the budget process, the personnel, as Mackenzie's talking about, how that structure's incentivized, how we use information technology. Frankly, the financial information that we have, which is not very good and which decision makers make decisions upon, those are kind of those nonsexy issues, but the reality is, is if we don't get our arms around them, the costs of providing greater capability are going to rise.

And the second thing I'm – you know, I'm obviously very concerned about is the industrial base. And Clark's chart on the various declines – and whatever the number's going to be, obviously, you know, we've been starting – turning the corner as far as the decline in defense budget and defense purchasing power. And it's very interesting to look at what happened to the industrial base in each of those downturns, and at the end of those downturns and the rise back – because inevitably, we go downturn and then we kick back up – it's a different industrial base. It can provide difference capabilities.

So the end of – end of Vietnam, where were we? We had a very – pre-Vietnam, civil military integration, a lot of commercial technology defense firms working together to produce capability, lots of highly innovative new technologies, the creation of the space industry, the creation of the microelectronics industry, so on and so on, and that – you go – we transition to a unique defense industrial base. And then the Reagan buildup comes up, and what are we doing? Well, we're producing products of 1960s, 1970s technologies, but we become a production base. We have lots of producers and because it's a unique industrial base, the commercial guys were no longer really playing except as conglomerates with unique defense units.

Then that downturn occurs, and we turn into the conglomerate sell-off. We transform into five or six large integrators. And then when the next buildup comes, how do we try to get our capability? We change our system, we try to bring in commercial technology, and that's through – that's acquisition reform. And that's essentially what we've been doing and

developing capabilities with the – with the base we had and the post-Cold War and a commercial technology, firms coming in with certain exemptions from the acquisitions rules.

What's the next downturn going to be like? What – where do you go? And I think that's the big question. There's not a whole heck of a lot – if we've – if we've kind of gotten innovation out of the world, we – and we're not quite as integrated with the civilian world as we would like, we're not – we're not producing large product, we haven't – we're not designing new systems, there's no new aircraft being designed currently on the boards. There's a lot of capability that is going to be lost potentially in this kind of a downturn. And those are issues that we have concern about the plumbing.

So as I go back, industrial base, acquisition reform, the finance and budget side of the house, personnel, those are all issues we're going to have to come to grips with in this type of austere environment.

Todd?

TODD HARRISON: First, I guess I'd like to compliment Clark. I think the methodology, the approach that you presented, I think is great. The main reason I like it is because it presents an iterative approach to bringing strategy and resources back into alignment. Too often, we don't realize that we need to iterate those two. We think that we can set a strategy based on some assumptions about funding and then be done with it. But as step 6 in your process showed, you set your strategy, you go through, you see what it would take to fully resource that strategy, and if that exceeds what you think your likely resources are going to be, you go back and you adjust your strategy. And that kind of planning, I think, has been lacking in the department recently. As Secretary Panetta keeps reiterating, the strategic guidance they put out about this time last year was apparently so fragile that it cannot withstand any level of budget cuts beyond what they assume they were going to have. Even $10 billion in cuts, they say, would cause them to throw the whole strategy out the window. That's a 2 percent cut. It's that fragile, apparently.

I think that that's not a wise approach, because you can spend all that time working on a strategy and it will be doomed to irrelevance from the beginning. And so I think that's why we're going to be going back to the drawing board now, regardless of what happens with sequestration.

And you know, part of the issue is we are in a constrained funding environment, but the truth is we're always in a constrained funding environment. We've never had unlimited resources for defense, we're just starting to feel it because the constraints are getting tighter. Even over the past decade with, you know, the budget growing year after year, and you know, this seemingly, you know, unending pool of money for the wars, it's – there still were constraints. And whenever you have constraints, your strategy is going to have to involve some level of risk. You're going to have to accept risk in some parts of your strategy. As the constraints get tighter, you're going to have to be willing to accept more risk in some areas of your defense strategy. So that's really where we are right now. We've got to sit down and have

a real discussion about where are we willing to take a little more risk? Where is it acceptable to take a little more risk?

The one criticism I would offer of the approach is Clark, you're just too darn optimistic. (Scattered laughter.) And I say that because if you – if you go back to the – one of your earlier slides, you know – and I am, you know, full of transparency here, I was part of the defense drawdown working group where we've been considering all of this for the past year – one of the assumptions at the beginning was the level of the drawdown. By the end of the decade, I guess FY '21, you're assuming a defense budget of 520 billion (dollars). That's in FY '13 dollars, so it would be more in FY '21 dollars. But in today's dollars, 520 billion (dollars), I believe 20 billion (dollars) of that is assumed to be war-related, so your base budget, 500 billion (dollars) in today's dollars. Well, let's put that in comparison: Right now, the base budget, the FY '13 request was $525 billion. That's not that much of a cut. That's a 5 percent reduction in real terms over a decade.

You know, I think that we very well – we very well may go deeper than that. In fact, if sequestration goes into effect, we'll go deeper than that immediately. Right in this year, we'll go down to about 486 billion (dollars) in the FY '13 base budget. So I think it could be worse than what we're even planning here.

So all of the charts showing how much, you know, personnel costs are growing, ONM costs are growing, how they're eating up a greater share of the budget, it'll only be more exaggerated if the budget comes down more steeply. And you know, again, you could try to manage that by cutting end strength and just making the force get smaller and smaller. The problem with that is you're on a losing curve there, because as – even if the budget just comes down to 500 billion (dollars) and stays there, if your personnel costs and your ONM costs continue to grow, you're going to have to continue to get smaller and smaller and smaller. Eventually, you will end up with a force that's too small to do anything. You won't be able to execute any strategy. So as Mackenzie, you know, was making the point, and I fully agree, we've got to address some of these issues.

The other reason I think it's a bit optimistic is the way that we talk about – the way DOD talks about a lot of these internal costs growth issues with compensation and with readiness. It actually understates the problem. Part of the reason it understates the problem is because DOD – for one thing, they usually only talk about the discretionary part of the defense budget; there's another 5 (billion dollars) to 6 billion (dollars) a year in mandatory DOD expenses that's assigned to DOD for – most of that goes to pay for the concurrent receipt benefit; that's another personnel cost that you've got to add in there.

But the other thing, the reason we understate a lot of this cost growth is DOD uses its own measures of inflation, DOD deflators, they call them. And I know I'm going to get into some budget geek stuff here, but there's a fine line between what you consider inflation and what you consider cost growth. And the DOD deflators – and no one's doing this with any kind of nefarious intent – but the DOD deflators, especially when it comes to personnel costs, they actually include some of what we would consider cost growth, growth in pay and growth in the cost of the benefits, they include some of that in their deflator. So it gets washed out as inflation.

If you use a neutral measure of inflation like the GDP deflator – which basically tells you how much a dollar in the economy buys – if you use that, then these – the cost growth is actually much higher. Where DOD says, using their deflators, that personnel costs have grown by about 30 percent adjusting for inflation from 2001 to 2012, using the GDP deflator, it's about double that. And so, you know, the problem is actually a little worse than DOD is letting on, just simply because of the way that they're accounting for inflation versus cost growth.

So with all those bright and cheery points, I'll turn it back over to David.

MR. BERTEAU: Thank you, Todd. I would note that it is a common occurrence here that Clark Murdock is accused of excess optimism. (Laughter.) So it's a – it's a – (chuckles).

Your point about – we've always had constraint budgets and we've never been – had more than we have – actually twice in the last 40 years, we've had two brief moments where we actually ran out of shortfall. They were terrifying moments in the Department of Defense.

The first was when President Reagan first took office, and the defense budget went up faster than the service could figure out what to put in it. It didn't take them long, however, to rectify that situation, and a couple of months in, they had figured out how to create a demand so that by one year after Reagan's inauguration, we had a 33 percent shortfall – actually, we had a $1.5 trillion FYDP and a $750 billion shortfall. Some of you may remember George Wilson's headline on that.

The second brief period occurred right after the fall of the Berlin Wall, where the budgets remained up and the threat diminished rapidly and we quickly faced the possibility of no longer having shortfalls. I think it was Alain Enthoven who actually said, the worst thing you can do to the services is take away their shortfalls, because then they don't know how to manage. That is, of course, an uncommon occurrence, and so we've not tested that theory. That only lasted about two months, and then the money disappeared, and so we got shortfalls back again pretty quickly. So we never learned any management lessons from either of those.

Clark, I promised you the opportunity to ask the first in-depth question. You can also provide commentary on your own commentary if you'd like. (Scattered laughter.) And then I'll give the ground rules for opening up the questions to the floor and our audience on the web.

MR. MURDOCK: I know I was given the opportunity to ask a question of the panelists, but I'm only smarting under the criticism that I'm too damn optimistic.

One other thing – and to counter that, I'm coming in with another factoid or two: The sequester, the way the sequester cuts are done have been much criticized by people like myself, because they're just across the board and they're imposed almost instantly. They're not strategic in any way so that – we know we're going to have to have a drawdown, and people say we need to have a balanced drawdown. Actually, the sequester cuts, if you're going to do cuts, is the best way to do them because you end up with a bigger topline, because you're taking more savings from the get-go. The sequester cuts, as opposed to a Murdock-recommended balanced approach towards how you do this , ends up with probably about $30 billion more in FY '21 to your

topline than you would have if you did it rationally. So that the numbers are cold right now, they're very cold. If you're going to do a drawdown, you do it as fast as you can so you get to savings as fast as you can, and you'll end up with a larger topline in the end.

MR. BERTEAU: Let me talk about how we're going to approach the questions. If you're watching on the web, you can email me at dberteau@csis.org. I'd say roughly half of the 150 people watching right now already have my email in your – in your contact files. So you can send us questions in; that will allow us to take advantage of your questions as well.

Here in the room, we have staff with microphones. So I'll ask you to raise your hand; I'll recognize you by pointing towards you or some other way indicating who I think ought to get the first microphone. Wait for the staff to bring you the mic; they'll hand it to you. If you'll stand up, identify yourself and your affiliation and then proceed to make your comment or ask your question. I'd like you to keep it to two or three simple, declarative sentences rather than a long speech, although I recognize that many of you have much to offer in this context. But I think we'd like to get to as many people as possible. So do I have anybody on this side of the room that's got a question they'd like to raise? Why don't we start right up here at the front table?

Q: Arnaud de Borchgrave, CSIS. For someone who is not an expert, one is tempted to conclude that we should now be moving rapidly toward robotic warfare and cyber warfare and forget about the Iraqs and Afghanistans of the future.

MR. BERTEAU: Who would like to comment on that?

MS. EAGLEN: I'm going to make a very limited comment to that. Just – it may or may not be the right approach to save money or be strategic. However, I would just caveat any new strategy changes or things that look like quick fixes to save money – for example, no more Iraqs, no more Afghanistans, no more counterinsurgencies and no more stability operations.

That sounds really good until you start looking at and examining the numbers behind, for example, the personnel tail that's required to operate unmanned systems. When we talk about cyber as a pot of money or a mission set or a potential future major command, which – DOD is moving in that direction – that pot of money is mostly people. And the money that's going to go towards it when it becomes a major command, like a CENTCOM at DOD – most of that money's going to just buy more bodies.

When you look at a drone – when I worked in the QDR independent panel – in the report, the panel was horrified to learn from the Defense Department – now, these numbers will go down with programs like the Navy's X-47B – but right now, remotely-piloted systems typically have about 17 people in the back office on average per drone to operate them, whether that's the processing or dissemination or whatever of the – of the data therein.

So these all sound like great future fixes in that we're not going to do this, so we're going to do that, and it'll save money. But if we know where the money is, and it's in the people, we should think through what the personnel requirements are for those.

MR. GREENWALT: I have one comment on that. I think, in whatever strategy we pursue or whatever budget we pursue, there is going to have to be a certain pot of money put aside to invest in technology disruptors and to invest in those new technologies and areas where we essentially are looking to change the face of the battlefield.

And they key thing there – and I go back – and again, whatever strategy – whatever technology it is, whatever disruptor that those happen to be that were moving forward – the key thing is, we have to create the right incentives so the industrial base and our science and engineering base can actually go out and try to tackle these problems.

And in an austere budget, the concern will be – is that we will focus more and more on our resources, as we have in this last increase, on operations and maintenance and keeping the current force together and not making those advanced technology investments. And so whatever we're doing there, we're going to have to figure out, what's the best way to do that and allocate those dollars. So just with that – whether those are the right ones or not, I don't know, but we need to continue to make those investments.

MR. HARRISON: I can't help but join in. When it comes to unmanned systems in particular – you know, I've looked at this before. The real savings are not in manpower like you would think, because, as Mackenzie said, you still have to have people to operate the aircraft to process the data, to do all the maintenance of the aircraft on the ground and everything that's involved in that.

The real savings from unmanned systems actually comes from training, and then a secondary effect from acquisition and from your manpower as a result of that. And what I mean is – I'll give you an example – our fighter aircraft. About half of our fighter aircraft in the inventory at any given time are coded for training. They have to be to train enough to keep a pipeline of pilots coming to fly those aircraft.

So we have to buy twice as many so that we can keep the pipeline of qualified pilots to fly them. With unmanned aircraft, it's different, because you don't have to be flying an actual aircraft to do realistic training, because you don't actually have to be in the air. So you can use simulators for a lot more of the training. Not all of it, but a lot more of it. So you don't have to have huge squadrons of aircraft sitting around doing nothing but training pilots.

So you save a lot of money in your acquisition, because you don't have to buy as many aircraft to have as much of an effective capability. And then, you don't have to have as many people to maintain those aircraft for the training squadrons, and you don't have to have as many pilots because they aren't spending such a large fraction of their time in training.

So there are savings from that, but fundamentally, that all requires a change in culture in the military. Within the aviation community, you know, you've got your fighter mafia, your bomber mafia, you know, all your different groups. And you know, right now, I think they're very resistant to the idea of switching over to unmanned systems for a variety of reasons. But I think fundamentally, it's going to require a cultural shift within the military.

MR. GREENWALT: I want to echo something that Mackenzie said in her comments. I think it's less about a new strategy and less about reliance – about a certain kind of capabilities that are less manpower-intensive than it is the day-to-day discipline with which you manage the enterprise.

Todd Harrison pointed out that in a briefing that he gave here two weeks ago that DOD made a number of proposals in the FY '13 request that would have limited the growth of personnel costs to – I think it was 0.9 percent, which would have been a drop from about 4 ½ percent, which has been the annual cost.

And that growth, it's just – you know, increasing co-pays, you know, some changes in the way TRICARE was administered and so on. Congress rejected all of them. You know, we can't afford to keep spending money the way that we do on personnel. That's just budgetary discipline; we have to manage it.

MR. BERTEAU: Arnaud, that question you raise, and the commentary up here are illustrative of a lot. We actually have a test case under way right now. You know, the Air Force's budgetary proposal with the FY '13 budget to eliminate the Global Hawk Block 30 and fly U-2s is an exact illustration of this very dynamic.

I think it illustrates the difficulty of wrestling with cost data, because – in fact, that was originally postulated as a cost savings. It turns out, as Todd points out, training is a big deal. As it's evolved, it currently looks like cost-per-flying-hour is about the same. Of course, the Global Hawk Block 30 stays on-station a whole lot longer, but there's no pilot in it, and so, you know, there's a cultural issue here, clearly, as well as an operational issue.

The training fleet's not the same as tactical fighter aircraft about – by about one-fourth of the U-2 flying hours or training and a very small percentage of Global Hawk flying hours training. Nonetheless, the way that issue's going to play out, I think, will illustrate your very point. And the likely real answer is, it's a mix, that's what we've got to have, and we tend to drive towards a single-point solution.

I have a question from the web, before I come back to the – to the audience here. This question is actually for anybody on the panel and Dr. Murdock: How bad does it have to get before the services will give up autonomy in exchange for maintaining capability and capacity? (Laughter.)

MR. : I mean, we have a system of government. I once, as part of a defense reform effort, was over interviewing a three-star British general about their defense procurement agency, the way they had a joint capability requirements process, the way they did this. And he said, but this is – none of this is relevant to your situation; this doesn't have anything to do with you. I mean, you've got a Congress; I don't know how you get anything done with a Congress.

Now, that's right; we do have a Congress, and that – we're always going to have a Congress. It means that it becomes very hard to do the kinds of things you need to do for effective cost management. And we're not there now and it's going to take a broader

understanding and educational process. John Hamre taught me, you know, a bit about how it can be done. He used to be Sam Nunn's authorizing guy who sat in on the defense appropriations.

And Sam Nunn and Les Aspin were death on unauthorized appropriations because that's where their political power lay. The way I think John Hamre functioned as a deputy secretary and a comptroller is that he met with big eight all the time on the Hill and worked out, you know, this is what we have to do to manage or control things. It's going to take a solution that cuts across the political system and it has to be managed that way. It can't be done through the adversarial process that we have now.

MR. : I'll make one comment on that. And again, I – Clark, I love your chart. If you look at the last drawdown and when it – when we created both a bipartisan consensus on changing the way we do business, adopting best practices, wherever they may be – whether they're in other governments of in the private sector or wherever – and we had that last big push of acquisition reform that came off of the hill and there was a desire to do something, it was right in the trough and carried through the trough of this.

And so as we – as these numbers, if they do come down the way that they're projected, there is an opportunity to revisit some of those ways of doing business. And there was that consensus, not only within the head of the Department of Defense but also on both sides of the aisle in Congress to try to do something differently to get more value for defense dollars. We may not be there yet as we've looked at the last few authorizations and appropriations acts, but we may there in a few years.

MR. BERTEAU: Let's take a question up here in the front and then one in the middle.

Q: Yeah, good morning. Tom Carter with Elbit Systems of America. And I know a few of you well over the years. Obviously, personnel, personnel, personnel costs. Now that the armed services conference report has a national commission on military compensation and hoping that some of you may be called to participate or possibly testify to that commission, do you have any – based on your analysis over the years and expertise – do you have any specific recommendations – two or three – that could be utilized by that commission?

MR. HARRISON: Can I jump on this grenade first? (Chuckles.) I put out a report last July, you can get it on the CSBA website, "Rebalancing Military Compensation: An Evidence-based Approach." And basically, my idea – my approach to that is instead of going into this talking about what are we going to cut, what benefits are we going to cut, how much are we going to cut back on pay increases, cut, cut, cut – and that's the approach that DOD has been taking so far, is they've been throwing over to Congress a number of cuts.

I think we got to take a fundamentally different approach. I think we've got to stop and ask, how do we get better value for our compensation dollars? It's not just about cutting. Yes, we do need to bring down cost, but we also – the compensation system exists for a reason, so we can recruit and retain the best and brightest for our military. And that's important. So what we need to make sure is that our compensation dollars are being used to the best value they can be.

Now, what we did in the study was we used an approach that's used in the private sector called preference-based benefits optimization. And we partnered with a company called TrueChoice Solutions. They do this for private corporations all the time. And we went out and we set up a trial survey with military personnel. And we had them go through – and it's not like a typical survey where you, you know, answer: yes, I like this, no, I don't like this.

What we did is we actually measured the utility function for different forms of compensation for people in the military. And we were able to segment the results by rank, by age, by whether they were married or not, live on base or not – all sort of different demographic characteristics. And what you find when you do that – you can do the economic analysis behind the scenes, and you can derive how much someone values a certain level of a certain benefit. And you can see if they value the benefit as much as it costs to provide the benefit.

When they value a benefit much, much less than it costs to provide it, we're not getting good value as a department. So you take things like TRICARE for Life – it's a Medicare supplemental policy. It only applies to military retirees once they turn age 65. The vast majority of the force – more than 80 percent – will never get this benefit. How much do you think they value that benefit? They should properly value it at nothing.

Even if you look at the segment of the force that's already served 20 years, they're already going to get a retirement, they – you know, if they live to 65, they'll get this benefit, that group still doesn't even value this benefit commensurate with what it costs to provide. DOD has to set aside $5,500 per person in the military every year to fund TRICARE for Life. That's $11 billion a year in the defense budget for this new benefit – it's only been around for about a decade. And I'm just picking on particular benefit there.

You can go through it and you can find where we're not getting good value for our benefits. And you're not just – you don't just want to cut it. And in some cases, you've already given the benefit to people – for current retirees. It's not fair to take it back. What you could do is change it, and perhaps asking people to pay a co-pay for that benefit or pay, you know, an annual premium. Or you could ask – you could allow people to opt out of the benefit that are currently serving and give them a different form of compensation instead where you are getting good value.

Things like basic pay, we're getting very good value for that. People value the cash in their pocket, as you would expect. Some things were surprising – things like the military exchanges – I always thought that, eh, that's probably not a good form of compensation, spending money on the military exchanges and the commissaries in particular. We spend 1.4 billion (dollars) a year on the military commissaries.

It seems like an inefficient kind of benefit, giving people subsidized food, subsidized groceries. It seems like we could do that more effectively just giving them money. It turns out people like these benefits. And certain groups – particularly officers – value the commissaries, many of them more than it actually costs to provide.

So it think you have to step back and look at it more objectively, go out get – collect data and understand how people value different forms of compensation, then you can make some really informed decisions about how to bring down compensation costs. And you can actually do it in a way where people like the new system better than the old system and you're saving money.

MS. EAGLEN: I'm glad you raised this commission because in a concept, it's a long-overdue idea. And it came from the QDR independent panel whose report came out in 2010 following the last QDR. That panel recommended a national commission on military personnel which would go much broader that just retirement. And the reason they did that, and the reason that what's in the authorization bill is a nice step forward, but frankly it's perverted and unserious from the real proposal that's in the panel. And it won't work. That's my concern.

If you're just going to target one type of deferred or in-kind benefits for service members or retirees – in this case, retirement – it's going to disrupt the entire system. This problem that has – it was examined by real experts, like Rudy deLeon at CAP and Dick Kohn down at UNC-Chapel Hill and others. The military compensation package – if you look at the pie, it's half basic pay, half deferred and in-kind benefits.

To tackle that challenge and still recruit a 21st century workforce that is dramatically changing for the military with the changing composition with America – declining propensity to serve, declining number of influencers, increasing number of Hispanics, very large increasing number of obese children are disqualified, et cetera, et cetera. We have an entirely new youth population in America and we need to adjust to that. So it's actually a great opportunity.

But you can't just go after military retirement. It'll never work. This is kind of like a base closure process. There has to be one-off step removed of risk for Congress to actually want to do and to vote on it and it has to be the whole package. You can't go after just housing, just education, just health care or just retirement. Every one of the pieces will have to be looked at as a whole pie, because when you're tinkering with just one, it's all pain and it's no gain.

So, Todd – I'm saying what he's saying in a totally different way. If you fundamentally overhaul the system, grandfather everyone in now and start fresh and start anew with a dual track compensation system for the force, which is what the QDR panel members recommended – a bipartisan report, 20 members of the defense establishment – what you can do then is offer gain. It's not about all cuts. It's not about cutting benefits; it's about changing some for the future and it's about adding new ones.

So 80 percent of the entire military, they don't serve a full career. They're the guys and girls in Iraq and Afghanistan who serve one or two tours and then get out. A lot of people feel like they deserve more – some sort of portable pension or retirement for that service, just like I get when I leave Heritage and go to AEI. I still have a 401(k), I can take it with me, it's my money. Troops deserve some kind of rucksack of benefits, whether they go into the Hill, they go into federal service, they go to Google – doesn't matter. They should get a portion of that retirement, for example, more tax breaks. You can increase your basic pay if you're going to cut back on other things like some of the other – the ones that aren't valued, like Todd said. So the

notion that changing military compensation is a third rail of politics is just a simple bumper sticker for people who don't understand and don't want to understand it, because Congress wants to do a lot of these things already. They want to give new benefits to service members, you aren't – who aren't giving a whole career but are frankly the backbone of the force. So if the approach is holistic, this will work, and it will work very well. But the way the commission is structured in this bill, unfortunately, it's set up to fail.

MR. : I would – I would just add there, exactly right. It's about rebalancing the compensation system. And for the commission, you know, to come up with a proposal that they can justify to the Hill, they've got to have evidence to support it, and so they've got to go out and do this data collection.

The other thing – and they've got to broaden their scope. Maybe they've got the flexibility to do that. I'm not exactly sure how the law is written. But then the big problem is the law was neutered at the last minute in the conference committee, so it does not require Congress to act on it. So the commission will submit their recommendations. There's no requirement for Congress to vote on it up or down, and so I think –

MS. : (Off mic.)

MR. : In all likelihood, they won't touch it.

MR. : Tom, the – we usually have commissions for one of three reasons. Reason number one, the most common reason is, it's a good way to punt or buy time on something that's too hard to touch. This one has some elements of that built into it, clearly.

Reason number two is actually – may also be relevant here, and it is in fact to provide cover for serious, real work to be done underneath it and to allow that work to be taking place, both analytically and in terms of policies and politics, because ultimately it's going to take a combination of really good analysis, really good policy assessment and really good politics before we're going to be able to solve this.

And the third and perhaps least common is a commission that actually sets out to do something and gets it done. You know, the criticisms you've heard here this morning are probably more aimed at that third and the difficulty of achieving that. I think we should probably try to take the attitude as analysts – as policy analysts in this arena that we're probably in that second category. And this may actually provide the cover for some serious work to be done underneath it.

With respect to evaluation – and I particularly note the base closure comment that Mackenzie made. She was thinking of it in the all-or-nothing, up-or-down vote. But if you want to know what people really value, look at what the fight is over when the base is closed, and it's – in fact, usually three things: commissaries and exchanges, the health care facility, whatever it may be, and the golf course, right?

Now, if those are in fact the priorities for the military pay and benefits system, we've got way bigger problems than Clark's 56 percent decline in place here. But that, of course, is driven largely by the retiree community, which is who is resident in place when you do that.

You know, we closed Fort Benjamin Harrison in Indianapolis in the 1998 base closure round, transferred the soldiers at Fort Center to Fort Jackson, South Carolina. Fort Benjamin Harrison has a brand new commissary and exchange today. So – and there's no fort anymore.

Of course, Indianapolis is still kind of the cutting edge of civilization, and so clearly there – we need to have this in place. I – the politics of this are hard, and I don't mean to decry either the good citizens of Indianapolis or the commissary and exchange systems in place. They're responding to the dynamics that are forcing them to respond to. That's all got to be taken into account here.

I think we had a question here at the middle table and then one at the back table. Keep your hand up, Charlie (sp). The mic's coming.

Q: Charlie Stevenson, SAIS. Clark, as you know, the Congress never has appropriated. According to McNamara's major force programs, it still votes money by service and by those appropriation lines items. So in terms of reconceptualization, are the services a help or a hindrance in bringing that about? And insofar as they're a hindrance, how do you overcome that?

MR. : No, that point is well taken. Congress appropriates one way, DOD plans another way and the services develop their budgets in yet a third way, and the interfaces between them are uncertain at best. I have to – I have to believe that when I compare the services – and I worked inside the Air Force for a while, although my background is really in OSD and I – that's my usual perspective, secretary of defense's perspective – budgets are most effectively done when they're done at headquarters, not when they're out in the distribution of the units, because everybody's putting together a budget – is putting together the budgets for the interests of the person that they report to. Navy, I think, has probably had the most effective process for a while. What I'm saying is, is that the budgetary process, I think, to a great extent has to be taken out of the services and given – the secretary of defense has to take control of it. McNamara wrote the programs during that time, controlled the database. When the POMs come in from the services each year, OSD spends the first five to six weeks figuring out what the services did with the database before they even get to the point of trying to identify what the issues are that they're going to work. I've often referred to – the secretary should have a big FYDP in the sky, you know, and that no one can change that FYDP without getting a "may I" slip from the comptroller's office during that time or whatever the office would be – CAPE, perhaps – that's responsible for the enforcement of that. So my belief is, is that much as I would say the Navy has, DOD has to take control of the budget, and that means working out (the understands ?) with Congress. Congress can appropriate it. You're not going to change the way Congress appropriates it, but you can certainly change the way DOD spends it and controls it, and that's what I think has to be done.

MR. : Let me make one other comment before we go to the last table. You know, we've got to – in DOD now to a simultaneous program and budget review. And in fact, the DOD directive for the planning, programming and budgeting and execution process – it used to be a system, it's now just a process, which I think is a diminishing – it's reflective of reality –you can't do a parallel program budget review. The budget always eats all the oxygen in the room, and that's what we've seen over the last few years.

But we actually have, I think, today the technical capability to do this much more rapidly than we used to. We could actually do them both between September and December, a program review first and then a budget review second. The ability to manipulate data, to manage the FYDP down to the program element and subprogram element level of detail is phenomenal now. We're not taking advantage of that capability. We're still spending the same kind of cycle time that we did when people were entering it on punch cards and running it through program and financial control in the OSD comptroller. So we're not taking advantage of either the time frame or the capability of the technology available to us. We're going to have to if we're going to respond to this kind of a budget environment.

Backroom table there.

Q: Morning. I'm Robert Haddock (sp); I'm a researcher at Special Operations Command. This question is for Clark and Todd. A footnote in the recent National Intelligence Council's Global Trends 2030 report asserted one person's view that due to interest – accelerating interests expense and entitlement spending, in the next decade the sustainable amount of U.S. defense spending will be as low as 2 ½ percent of GDP compared to 3 ½ (percent) right now for the base budget, and maybe as low as 1 ½ percent of GDP.

Todd and Clark, does this sound right to you, or reasonable, or possible? And if so, what do you think the implications would be? Thank you.

MR. : I've been, as I talked with some of the charts, focused on what I think is going to be unrelenting pressure on the defense stop line, which means that it will come down as a percentage of GDP, but it's also – the second whammy is the internal cost effect. So our purchasing power, in terms of effective capability, continues to decline even faster than the defense topline declines. And so I think it's quite possible that the overall numbers could go down to that percentage.

I never looked at a percentage of GDP or GM (ph) as being the relevant one anyway. To me, it's the size of the base budget and its purchasing power, and we're hollowing it out even as its coming down.

MR. HARRISON: Yeah, I take issue with the metric and the way that it's used there. I think defense spending as a percent of GDP is interesting when you're comparing defense spending across different countries. You can tell how much of their economy they're devoting to defense.

In terms of comparing U.S. defense spending over time, it's not a particularly useful metric, much like if you, you know, measured your salary as a percent of your home value. You're dividing it by some other factor that grows or declines on its own. And so what does it mean? What is the right level? What is the right level of defense spending as a percent of GDP?

You know, since World War II, we've averaged a little over 6 percent of GDP spent on defense. Right now, with war funding included, we're a little over 4 percent. If our economy gets growing again, which, of course, we all hope it does, hopefully, our economy will grow faster, and that means that defense spending as a percent of GDP will decline.

It doesn't necessarily mean that that's the – that's too little for defense or it doesn't mean that it's too much for defense. I think a better question is, you know, are we fully funding our strategy. That's a much more difficult question to answer, but I think that is the really relevant metric.

MR. BERTEAU: I think that question also, though, illustrates a very important fundamental dynamic that is really above and beyond what we're talking about today. The core fight that we're having in the politics of America today – over the debt ceiling, over debt, over deficit spending, over sequestration, over the share of that spending – is a fundamental fight over how do we restore fiscal and financial balance to the United States.

You know, when Admiral Mullen said a couple of years ago the number one challenge to national security is, in fact, our economy, that's not a trivial point. It's a point I think we all agree. I thought it was phenomenal watching Senator Kerry's nomination and confirmation hearing. In four hours of testimony, I believe he mentioned the budget and the economy more times than the secretary of state has mentioned in the last decade collectively combined, all right? And it wasn't in response to questions, it's because he recognized that connection and he put it forth, if you will.

And I thought it was an interesting commentary that it almost didn't come up in Senator Hagel's confirmation hearing, even though it's clearly the critical question that's driving everything at task here.

And so I think, Robert, your question really illustrates the connectivity at a much larger level than we're dealing with here today, and we need to keep that in mind as we go forward because, ultimately, the political solution is going to have to recognize that reality as well. At its core, we're trying to figure out how much do we have and how much is enough. The approaches that we've outlined today clearly are relevant inside that dynamic, but they don't set the upper bound.

Let's go to the table here and then I've got a couple more.

Q: Good morning. George Nicholson with StratCorp. You talked about personnel costs. I think about two months ago, CSIS had the commander of the Air Combat Command, Mike Hostage. We heard him last night, and one of the things the Air National Guard has been pushing is we are far more cost-effective, you need to downsize the active duty, you need to have the same number or more people in the Air National Guard.

And I think General Hostage last night and when he was here two months ago said we're – you know, having a different model right now. The Air Force right now is running a 1:1 dwell rate. With the political clout the Guard has on Capitol Hill – again, opposing all the initiatives the chiefs of staff did last year cutting force structure, during the BRAC Commission opposing most of those cuts because we have to have a flying unit in each state.

From the work you've done, Todd, and everything else, the concept that the Air National Guard will be more cost effective and we can do more with less if we increase the Air National Guard and reduce the active duty. Your comments.

MR. HARRISON: So, first of all, in all fairness, I was a former member of the Air Force Reserves, and so I have kind of a – an inside bit of knowledge on, you know, the Guard and Reserve component. But I – you have to, first of all, set aside the politics. Obviously, there are politics involved in these kind of decisions, but I think, fundamentally, when you drill down into this issue, it actually boils down to the assumptions you're using about the steady-state level of demand for different types of aircraft in the future.

If you are going to have a high steady-state level of demand in the future, then it makes sense to have more of your force structure in the active component. If you are going to have a low – lower steady-state demand for different types of aircraft in the future, then it makes sense to have more of your force structure in your Reserve component, and you can still surge them back in when you need to. So it's all about the assumptions.

And my critique of the Air Force's analysis is not really a critique of the Air Force, it's a critique of CENTCOM. If you look at the requirements that CENTCOM is giving the Air Force for what they think they'll need in the future, steady-state – so once, you know, we're out of Afghanistan, we're already out of Iraq – what they think they will need from the Air Force , steady-state in the future, it looks a little high.

The problem with this – it kind of gets back to the problems with our budgeting system altogether – is requirements often come from the CENTCOMs, and the CENTCOMS, they don't have the budget for this. So they are setting requirements largely unconstrained by resources. They're just throwing out wish lists of what they would like and then the services are supposed to provide it. And when they do that, that affects the services' planning decisions.

So, you know, the Air Force did what, you know, they were supposed to do, and they came back with a force structure that would meet the demand signal that they're getting from the COCOMs. Where we need to be scrubbing things is that demand signal. Is that a realistic demand signal. And you know what? Sometimes, we've got to tell combatant commanders there are constraints. You can't have everything. Now think a little smarter about how you want to use these forces and what do you really need.

And, you know, that's a difficult conversation to have because you obviously don't want to be, you know, denying the warfighter, the people on the pointy end of the spear, what they think they really need to get the job done. But at the same time, you don't want them to be padding their estimates just to be safe.

MR. BERTEAU: And also, I think I would note, George, that the approach that Clark Murdock outlined this morning brings the fiscal reality into those requirements at several steps along the way. And so it responds a lot to what – to what Todd has laid out there, not just for Guard and Reserve and active/Reserve mix, but others.

I have a question from the web, really for the whole panel. Cuts in funding do not necessarily equal reductions in tasks and work. Now, that's an observation I think we can all resonate with. How do we figure out what to stop doing?

MR. GREENWALT: Deciding to do something new, those are easy decisions. Deciding to kill something or to cut something are the hardest decisions of all because there's people that are associated with that; there's always somebody – you're looking – you empower somebody by

giving them additional resources or additional tasks, but when you ask people to absorb cuts, you're asking them to make difficult priority decisions. And again, it's – it has a lot to do with rigor and discipline and trying to manage the building in a way that hasn't been managed for a long time, if ever.

MS. EAGLEN: It's true, and it's probably one of the single-biggest problems for the secretary of Defense to address or not because it's – the supply-demand axis has been completely thrown out the window. So the budget cuts of the last four years have been to do more with less, and as Clark said this morning, but the reality is for the next phases of this is to do less with much less.

But demand has not caught up with that reality, whether that's driven by the combatant commanders or the White House or Congress or anyone else, and so what you've seen since the peak budget year in 2010, and even with the strategy change – you know, throwing out the QDR 2010, January strategic guidance pivot to Asia – less emphasis on the Middle East and other places – Middle East more so than anywhere else. But nonetheless sort of prioritizing regions.

The demands on the force are exactly at the same level as they previously were, even with all troops out of Iraq and expectations of, you know, 3(,000) to 5,000 in Afghanistan. Well, that doesn't quite add up, though, with the strategic guidance, so the department is not living in reality that it's time to do less with much less, it's still we're going to do the same, we're going to be everywhere, be all things to all people, the kitchen sink, the Michelin Man, the 1421, whatever the force planning construct is that we're calling the latest DOD strategy. Nothing has been taken off the table, virtually nothing in the roles and missions debate.

And so until that comes forward and Congress has a chance to say and weigh in, yes, we want fewer Marines at the embassies, for example. After Benghazi, they all don't all of a sudden. But five years ago, they did.

There are all kinds of debates about what are your choices here, but no one is having them. And it starts with the DOD because they are not presenting them. I think part of it's driven by Todd's point, and this sort of unconstrained requirements processed by COCOMs that also have no budget whatsoever, or no budget restraint put upon them. But it's also driven by our foreign policy, and our foreign policy calls for – even after Iraq and Afghanistan, all the – to make up for all the pent-up demand admissions like building partner capacity and forward presence and engagement and everything else. That's exactly equal to what we've been doing in the last 10 years. It's a remarkable thing.

MR. BERTEAU: We'll take our last question in the – in the front, if I can get a mic up front here. There we go.

Q: Good morning, I'm Fred Ruggiero (sp), Concurrent Technologies Corporation. And David, at the start, you said despite all the optimism that we were going to hear from Clark or something to that effect, that there were still going to be opportunities out there. And we've heard some of those, the opportunity to change the strategy, the opportunity to perhaps affect military compensation. But – and I open this question up to the whole panel – what do you see coming as an opportunity for the industrial base or the businesses that are out there?

Thank you.

MR. GREENWALT: I think – and I'm – and I'm still a relative optimist, even after as, you know, I've been depressed here for the last 20 minutes, having a hard time figuring out what to say – I think there is an opportunity, because there's an opportunity – austerity drives the need for innovation. Austerity drives the need to come up with new ways of doing business. Whether it's technological, business practices and so on, those are the areas where I think the industrial base can thrive and present new processes.

Now, where I'm concerned and I think – is that the internal need for business management change with the department, whether it's the requirements process, whether it's the budget process – which you know, all due respect to Clark, you know, we're talking about a kind of a Soviet model-type of budget process we created back in the 1960s, and we haven't really changed that. And we need to kind of rebaseline everything from the managerial side to start driving the industrial base to, you know, incentivize the industrial in the right way to provide whatever solutions there are to meet the strategy that the department wants.

I think there – as Mackenzie was saying – there's a – there's a desire to do everything, and I think there still will be a desire to do everything. And so it's going to be up to the department to provide the industrial base the right incentives so we can try to meet those missions. And I – and I think the industrial base can do that if properly incentivized, and the management structure is such that it can do that. And I'm – and I'm optimistic that we will make those changes because we did – we tried to do it the last time, we were very successful the last downturn. It didn't – it didn't create – it didn't solve everything, but we made a lot of change. And unfortunately, as the budgets went up, we lost a lot of that. And I think we're going to – we're going to continue to see that positive change.

Todd?

MR. HARRISON: Yeah, I would – I would say that cyber is one area that's going to go in the future regardless of what happens with the budget. I think SOF, special operations forces, that's also going to grow regardless of what happens with the budget. A lot of other areas, though – and I can say comfortably that those two areas will grow because they're relatively small, you know, compared to the overall budget – a lot of the other areas, though, in the defense industry, these are going to be challenging times. And you know, I – we are – the defense industry is already consolidated to a great extent from the last downturn. It has not reversed during the past growth in the defense budget.

So, you know, there's not a lot of room for additional consolidation. But I think there are opportunities for companies that can come in and truly innovate and give DOD something that they don't even know they need yet. They can fulfill a need they may not even realize that they have yet. So I think there are going to be opportunities for innovation in the future. And I think DOD is increasingly going to have to relax some of its requirements, relax some of its standards in the way that it normally does acquisitions to open it up, to bring in new entrance into defense, companies that might not have the legacy costs some of the, you know, incumbents have, that can innovate and come up with products that are just fundamentally different.

So even though, you know, overall, it's going to be down environment, there are going to be pockets of growth within that.

MR MURDOCK: People tend to forget how big defense is, that when you're looking at a $520 billion base budget in FY '13 dollars, and if you control, you allocate your costs so that you're spending 32 percent of that on modernization, that's a lot of dollars that's going to buy a lot of stuff. The whole rapid growth of the UAV fleet was all battlefield-driven and it was very rapid during that time. There'll be similar changes, you know, because it's still an awful lot of money. And even though the department is not doing a good job of its own financial management, the amount of dollars that it spends is so large that there's always going to be opportunities.

MR. BERTEAU: Fred, there's a question of where does innovation come from in national security, in that the history of this – we've been looking at this at CSIS for the last year, and we have a report we're going to put out later this spring – the history of course is that DOD buys its technology and it's developed either by DOD contract or by companies who are investing research and development in order to try to sell DOD something.

Those pots of money are shrinking and that methodology is not necessarily going to sustain us. But innovation is an inherent quality of the human spirit, and there's a ton of innovation going on all over the world. It's not funded by DOD; it's not necessarily bought and sold in the U.S., in everything from nanomaterials to communications to data management to sensors and integration. And what we have – and the declining budget, I think, will reinforce this, is a need to figure out how to harness global, commercial technology development and bring it into defense.

In the '90s when we had a drawdown, we went the opposite direction. We said, let's figure out how to do dual-use technology, take this great stuff we have in DOD and sell it in the commercial sector. We saw the result of that: It ended up with companies that are essentially defense-specific, because none of them made a go at doing that sort of thing. We now have to look at the reverse.

I want to thank you all for being here. I think – I can't speak for the rest of the panel, but if you didn't get your questions in, we'll be around and available to answer them. I want to thank those who joined us on the web. We had over 400 viewers on the web this morning. I'm sure that's mostly from Boston and New York, as I mentioned, and I wish them well.

I want to thank again Rolls Royce North America for underwriting this military strategy forum, and particularly since this is a little bit of an innovation and a deviation there, we welcome your feedback. As always, we're looking for input and comments in reactions from all of you, so thank you very, very much. Please join me in (welcoming ?). (Applause.)

(END)