Center for Strategic and International Studies (CSIS)

Defense in an Age of Austerity

Domestic Implications of a Defense Drawdown

Moderator:
Clark Murdock,
Senior Adviser and Director,
Defense and National Security Group, CSIS

Speakers:
David Berteau,
Senior Adviser and Director,
Defense-Industrial Initiatives Group, CSIS

Steven Grundman,
Principal,
Grundman Advisory LLC

Todd Harrison,
Senior Fellow for Defense Budget Studies,
Center for Strategic and Budgetary Assessments

Location: Washington, D.C.

Time: 12:45 p.m. EDT
Date: Thursday, September 29, 2011

Transcript by
Federal News Service
Washington, D.C.

CLARK MURDOCK: We're now going to take a slight pause in our discussion. I would say heretofore in the previous two panels and even somewhat over by our lunchtime speaker where we were talking about sort of matters of defense – defense policy, strategy, how changes in our role – in the United States' role in international affairs would affect the kinds of missions and capabilities that are most essential to executing that role.

And I think now we're going to take a look at the last portion of the phrase. What do we really mean by an age of austerity? We had one panelist before who said, let's get real. We've had 12 years of increases, real increases in defense budget.

We're now projected to take half as big a cut as we usually take after – half as big a cut as we usually take and over 10 years, not five years. This isn't a real defense drawdown compared to past defense drawdowns.

But then we've had other panelists who without too much exaggeration would say the Earth is collapsing around us if we take more than the initial tranche of a $450 billion cut over 10 years.

So now we're going to take a look a little bit more analytically, although we have also been told earlier today that those who take an economic perspective are by nature pessimists, but take a look at the implications of the defense drawdown for the budget itself, for the domestic economy and for the defense industrial base.

Todd Harrison, who has emerged as one of the most trenchant analysts of the defense budget will be our kickoff speaker, followed by Steve Grundman, who will address the domestic economic impacts, and my colleague – what is your name – David Berteau. (Chuckles.) Todd?

TODD HARRISON: OK.

MR. MURDOCK: Or you can stand here. It's your choice.

MR. HARRISON: I guess I need to turn this on. All right, so I guess any discussion of the numbers – the budget numbers that we're talking about right now should begin with a discussion of baselines. I know this may sound boring but I have to get this budget part out of the way up front.

There are a lot of conflicting numbers that are floating around about what the budget control act will mean for the defense budget over the next 10 years. And a lot of the conflicts you see are because people are just using different baselines for their numbers. Basically the higher the baseline that you're comparing to, the larger the cuts appear to be.

The highest baseline that's being used out there is the 10-year projection that's in the FT '12 president's budget request. The debt ceiling debate centered around the CBO

baseline. That's what CBO was using to score the bill that was presented to them. That is less than the president's budget when it comes to the DOD budget over the next 10 years.

And some are using the current level FY '11 appropriations for defense which is even lower if you just keep that flat out over the next 10 years. So there's no right or wrong baseline. I'm not going to take a position on that. You just need to be aware and acknowledge what baseline you're using when you throw around numbers. So I will try to do that today.

Now, if we look at the size of the downturn in defense spending that we're looking at over the next 10 years, the initial cuts in the budget control act passed back in August, it would reduce the base defense budget by about 1 percent from its FY '11 level. Here I am. I'm giving you my baseline. Now, if the trigger is pulled, then the budget would go down by about 11 percent from the FY '11 level.

To put it in perspective, that takes it back to where it is – where it was in 2007 when you adjust for inflation. Now, in real terms both of these cuts would be a little more of a reduction at about another 3 percent to account for inflation over the next couple of years. Now, compared to the FY '12 president's budget, the initial cuts are about an 8 percent reduction and the trigger would be about a 17 percent reduction.

And so when you hear Secretary Panetta and people in the House Armed Services Committee talking about the doomsday scenario under the trigger, you know, being, you know, close to a trillion dollars in cuts from the defense budget, that would bring the annual defense budget – and they're comparing it to the president's budget request as a baseline – that would bring it down by about 17 percent.

So that really gives you the range of cuts that we're talking about. No additional cuts. It would just be the initial cuts or if the supercommittee fails to reach some agreement, then we could see the sequestration. And so really it kind of bounds what we're talking about here.

Now, if you include the fact that over the next decade war funding is going to come down, then the reduction in the total DOD spending is a bit greater. By the end of the decade, if you assume that all war funding is eliminated – so by FY 2021, we no longer have a war budget – and if you assume that the sequestration goes into effect as currently written in law, then the total reduction in the total defense budget would be about 31 percent in real terms.

Now, how does that compare to previous downturns? Well, at the end of the Cold War, the drawdown from peak to trough – FY '85 was the peak, FY '98 was the trough – that drawdown was about 34 percent in real terms. At the end of Vietnam, it was a 26 percent downturn. At the end of the Korean War, 53 percent.

So 31 percent is actually kind of within the norm of what we would expect at the end of a major buildup. The problem is this downturn is a bit different. Previous budget cycles – Korea and Vietnam and the Cold War – they involved a buildup of military capabilities in terms of both manpower and procurement of new equipment. And those things could be reduced later when you had a builddown.

The past decade though was not really a buildup in a conventional sense. End strength stayed at around 1.5 million (dollars) in total end strength for the military. The Marine Corps and the Army grew but the Air Force and Navy actually lost in strength over the last decade.

And modernization of large parts of the force structure were actually delayed or skipped just because of the number of problems that we had with acquisition programs. By my tally, we did some research and there are about a dozen major acquisition programs over the last decade that were cancelled while still in development.

So no systems were ever fielded and they totaled to about $50 billion in sunk costs on those programs and we didn't get any systems out of them and in many cases these are things like the presidential helicopter, future combat systems, you name it. These are things that we're going to have to eventually do so we're going to have to go back and spend the money to procure these systems in the future.

So if we keep doing things the way that we have been over the past decade, then reducing the budget or even holding the budget flat over the next decade would require significant reductions in military capabilities. But being an optimist by nature I think, it doesn't have to be a doomsday scenario.

As one Air Force officer recently told me – I'll try to quote him as close as I can here – we either change the way we do business or we change the business we do. And I think actually we should do both. Changing the way we do business means taking on tough issues, like the growth in personnel costs.

I'm particularly thinking here of military health care costs, which as Secretary Cohen alluded to earlier, that's grown by 85 percent in real terms over the past decade. That can't continue. Or fundamentally reforming the entire military compensation system which is something people have not wanted to talk about.

This means looking at how we do pay, how we do other benefits, retirement benefits in particular. Changing the way we do business means that we should not expect DOD to do all of the things, support all of the missions that it does today. We have to make some strategic choices. And that's something that we have not done over the past decade.

We've been able to do basically everything we've wanted to do. We just ask for more money and it was available. But now we have to make some choices about how

and where we plan to compete militarily in the future and these choices have to be constrained by the resources available.

Our current strategy – to be everywhere and do everything – is simply unaffordable in the current budget environment. So I think, in closing here, that cuts within the defense budget should not be fair, should not be balanced. I think they should be targeted.

We should not end up with a budget – and I hope when they come out of the current strategy review we don't end up with a budget that keeps – that basically maintains the same share between the services. That's a good indication that we have not made strategic choices, that we are simply spreading the cuts across equally.

What we should do is we should make cuts based on strategic choices and a fundamental shift in strategy I think is required. It should not be a slight variation or tweaking of the QDR.

So if we target our cuts at low priority capabilities, what that means is we can actually continue to invest in higher priority capabilities that we think are needed to meet the likely threats of the future. So I will end there and then we can come back with questions later.

MR. MURDOCK: Thank you. (Applause.) Steve?

STEVEN GRUNDMAN: Great. That gets me right in the direction in which I wanted to go, Todd. So I'm going to talk about three things. I will have a few comments about austerity.

I will then – because I think it's my assigned duty – talk about, at least by some simple indicators, the macroeconomics of austerity and by some more qualitative measures the microeconomics of how austerity may play out, particularly in the markets for aerospace and defense goods and services.

But first, to reveal my bias, I'm quite keen on this honesty theme that got going in the first – in the first session, but in so doing also set up a little ironic tone to what I'm about to tell you.

So it indeed is my bias that it would be nice to be able to draw the line on reductions over the next 10, 12 years at $400 million. And not for any of the particular reasons that were expressed in the first panel – forgive me, I had to step out for the second. But just because I think we get good value in terms of power for that money.

That's not my assigned brief, so I won't go much farther than to have revealed that relative to what I guess I'll call the ulterior or overarching purpose of this conference. It sets up an irony because what I mostly want to tell you about what I think the macro and microeconomic effects are is that it's not that big a deal.

And then the further irony is, by contrast with the strategic issues at stake – which I think are quite profound, and yet we will probably spend most of the next three months arguing over this issue of how much is enough, around questions about jobs and the deficit and, you know, and all these micro and macroeconomic indicators instead of the thing that actually really is at stake here, which is the strategic posture of the country.

OK, so with that by way of introduction, just a couple of observations about the austerity backdrop that Todd set up. One is that – and forgive me if this is off the mark for many of you. But I hear – with respect to the $1.2 trillion bogey, I begin to hear people talk about the supercommittee being a salvation for defense posture, I suppose depending on your point of view in mind, and sequestration being a cataclysm.

But I think we have to keep reminding ourselves that there will be $1.2 billion taken – you know, there will be a $1.2 trillion hole taken out of deficit projections one way or the other, right?

So the only way the supercommittee is going to spare defense from more than $400 million of reductions is if they either come up with some revenues or they come up with some reductions that wouldn't already be taken out of Medicare and Social Security or other mandatory programs.

And I offer that because sometimes I think people forget that the supercommittee's got to come up with – actually strictly speaking – 1.5 (trillion dollars). Just by the way, remember that when their first report comes out, that they've been given a homework assignment that's slightly bigger than the actual bogey that has to be enacted into law by the 15th of January.

And without belaboring it, I want to get some round numbers of what the impact on DOD would be that create the foundation for the implications on macro and microeconomics that I use, and it is – it's actually I have a higher baseline even than Todd has, I'm afraid.

Above the FYDP baseline is the baseline that is also calculated by CBO of what the actual momentum of the program is, which tends to be about 2 to 3 percent higher than what's actually in the FYDP. OK, so by that calculation which I could belabor, or elaborate on, rather, if any of you are curious as to what I'm actually talking about there, I think of the worst case scenario as a 15 percent reduction.

You know, it's more than the nominal 10 percent reduction that's out there and I think it's certainly within the range of the variety of baselines and currencies that Todd was talking about.

So if I take that, turning to my next topic, you know, what is the significance of this for – I suppose, right, three things – GDP, employment and maybe the solvency of the government. I'll even stick my neck out on that.

It's like this. So in terms of the direct spending that the Department of Defense puts into the economy, a 15 percent reduction is about $85 billion a year compared to a $15 trillion GDP, it's – we calculated it. It's three one-hundredths of a percentage point. It's a lot of money but in the scheme of the economy it's not, OK?

With respect to the employment, I think the impact is more appreciable but I can't quite get up to the numbers that other folks like Congressman McKeon are talking about. So if I take 15 percent out of the $3.4 million defense related jobs – that's a figure that's calculated over in, I guess it's now called CAPE. It used to be called PAE, my old office. Fifteen percent of that is about a half a million jobs, right?

So if in a fell swoop we took a 15 percent reduction that actually proportionately flowed down to employment, there's a few – all other things being equal assumptions here, that's a half a million jobs. What would that do to the unemployment rate? Well, that would add an appreciable, by my calculation, about a third of a percentage point, all other things being equal, to the unemployment rate, employment being at about 150 million people.

So you're adding a half a million to the 14 million people who are out of work, right? So that's the rough magnitude of the number. I'm hardly in a position to say whether that's a big or small number. But it's not a million – first of all, it's not a million jobs. It's not a full percentage point change to the unemployment rate as I've at least heard some people articulate.

I think those who are articulating that are putting a lot of credence in the sort of second order indirect effects of defense spending which I'm not including here. The last little sticking my neck out on solvency I will observe is just this and then I promise I won't persist in it.

If the fiscal crisis of this country were real, people would not be clamoring to buy 30-year Treasury bonds that pay 1 and 2 percent. OK, the very week after the budget control – was that the name of it? The budget control agreement – was signed, right, the stock market tanked. And what did everyone do?

They went out – everyone, you know, investors – and bought Treasury bonds and drove the rates further down. If we had a fiscal – a real, authentic fiscal crisis like they have in Greece where they have to pay 15 percent a year to get people to loan them money, our interest rates would not be 1 and 2 percent, I would observe.

The other little observation on the impact of these reductions in defense is that they will be unfortunately, particularly if they come fast, right, that's the real big problem with the sequestration solution is how fast they come, is they will end up disproportionately – I suppose depending on where you're sitting – on the investment accounts, right.

Because even though the ONS, the paychecks and the operating costs of the government actually put a lot more money – like $350 billion into the economy – it's the $200 billion a year in the investment accounts, procurement and RDT&E that would of necessity have to bear disproportionate reductions in the – as it were, in a fast – you know, trying to take $100 billion - $70 to $100 billion out of the program in one year.

You're going to have to follow the Willie Sutton rule, right? Those of you who don't know who Willie Sutton was, he was a bank robber arrested in 1952 and the reporter, you know, stopped him outside the courthouse and said, why did you rob all those banks, to which he responded, because that's where the money is, right.

So you would end up having to follow the Willie Sutton rule if you had to get a lot of money – $50, $70, $100 billion out of the program in one or to years, and moreover, in procurement programs in particular because those are the fast spend programs and they also come in bigger chunks than the R&D programs.

I am surely out of time so I will simply put this big caption around – oh, he's giving me two more minutes. I'll put a medium-sized caption, then – (laughter) – around the implications for the defense industry. I'm not an economist but I hang around with a lot of economists and I find that among their other deformities, economists tend to have three hands in most things, right.

They have on the one hand, on the other hand and they usually somewhere along the line come up with a third hand. Well, following that pattern, the implications for industry are sort of of three kinds. So on the one hand, this is an industry – and this is mostly what I do every day is work with the aerospace and defense industry.

This is an extremely healthy industry right now, almost to an unprecedented degree, very solid balance sheets, not bad, really pretty darn good market equity, you know, better than the old S&P 500, for example.

And you know, an extraordinary amount of cash flow, not in the last two years but, you know, the cash flow this industry generated between '04 and '09 was a lot. They all have a lot of cash on their balance sheets.

The issue on the other hand for the defense industry is they now have all these assets that are built up over a period of time when we have roughly, let's say over the last 12 years, doubled the investment accounts in the department.

They have all these assets that tend not to be too flexible because the character of the consolidation of the industry that happened after the last drawdown was to organize into pure play, a hothouse almost, if you will, defense companies that don't have a lot of flexibility in their assets.

And so their ability – notwithstanding their terrific financial condition right now – their ability to make rapid adjustments to changes in demand are constrained by the fact

that they have inflexible – lots of inflexible assets and also the fact that at the same time, you know, two things are going on.

Not only is the budget coming down, but also let's call it, you know, as an economist would, the composition of demand is changing. So not only at the same time the Defense Department is buying less, they're also buying different things than they were before – cyber security instead of another wing of something or battalion of armored vehicles is on the margin, so to speak.

So that's another challenge for the defense industry and I'll save the third hand for questions so as to be able to abide the time constraint. (Applause.)

DAVID BERTEAU: Thank you, Steve. I'll use a couple of fingers of that third hand in my opening remarks.

MR. GRUNDMAN: OK, fine. Just be careful which ones.

MR. BERTEAU: Secretary Cohen – yeah. Secretary Cohen tried to end several times in his talk today on a note of optimism. It slid a little bit more each time. I regularly give talks to groups around town and I gave one recently where I ended up saying, you know, things are really pretty bad and they're going to get a lot worse.

And the host said, can't you say something positive? You're ending on a pretty negative note there. And I said, you want me to say something positive? He said, yeah, yeah. I said, all right, I'm positive that things are bad and they're going to get a good bit worse. (Laughter.)

So notwithstanding the data that show that, you know, the drawdown that we're facing may be less severe than past drawdowns have been, there are some other causes for optimism. Earlier today, the U.S. House of Representatives with two Republicans and one Democrat in attendance took 20 seconds to pass a three-and-a-half day continuing resolution which will keep the government open until next Tuesday.

So this is – now, now this may not sound like a big deal. But let's take that data point and extrapolate. If it takes 20 seconds to do three-and-a-half days, they should be able to do the rest of the year in 30 minutes. (Laughter.) Now, that could be a series of three-and-a-half-day continuing resolutions passed 20 seconds at a time or we could actually cut the final deal.

We really actually – this is the intriguing thing. We know what the end game is for FY '12. It will take us a lot more than 30 minutes to get there. But it will actually only be the last 30 minutes that matters in that process.

Now, why do I use that as a starting point for optimism, if you will? Earlier this week, Secretary Panetta and Admiral Mullen were up testifying before the Hill and one of the members asked Mr. Panetta, who of course is going on and on about the danger of

sequestration and of cuts beyond the $450 billion that DOD is currently analyzing, if not contemplating.

And the member asked Secretary Panetta, are we shooting ourselves in the foot? I don't know if any of you saw this clip. And Panetta said, no, I think we're shooting ourselves in the head. And so what you have is a perceptive disconnect between that kind of rhetoric and the failure of DOD to be visibly planning for any kind of cut beyond the $450 billion.

And the reality that this is not that serious a cut in terms of pure dollar play and that in fact we ought to be preparing for more because under any scenario, under any scenario DOD will come down more than $450 billion in the next 10 years. So where does that leave us? It leaves us really asking the question – I love Todd's comment that we really don't want balanced cuts. We want targeted cuts. The difficulty of course is not in the balance across categories. It's in the balance by time. And this is really the fundamental disconnect between sequestration and any reasonable approach, if you will.

It is not hard to postulate a scenario in which you could cut substantially more than $450 billion out of defense as long as the dramatic majority of those cuts are in the out years which gives you time to create the strategy, the mission structure, the force structure that aligns with it, figure out what it is you need, send the demand signals to industry so they can invest that cash and what they're going to be – what we're going to be buying, et cetera.

So, but that's not the scenario that's playing out right now. The scenario that's playing out right now is somehow the White House believes that it has forced the Republicans to make a choice between the three hands, if you will. Hand one is cut defense. Hand two is increase taxes. Hand three is live with deficits.

I think they've miscalculated where the votes are on this point. I think the votes are in fact, we'll cut defense, thank you very much. And I think those votes are not changing any time soon. So under any of these scenarios, the question is not how much; it's when and what preparation we do to get there. And the fact that DOD is not recognizing that is a bit troubling. That's the situation.

What's the impact? The impact – I think almost every time I attend a speech by Secretary Cohen, he mentions the closure of Loring Air Force Base.

Now, since I closed Loring Air Force Base, this is near and dear to my heart and I actually had the opportunity to visit Loring Air Force Base a number of times, all of them under armed protection and with a secure car, if you will, because the Rotary Club was not nearly as innocent as he made them out to be in that context. (Laughter.)

Nonetheless, it is clear that there are places that when DOD ceases to be a big part of the game, the game changes very, very dramatically and there's a lot of data on that. There's also a lot of data that says in the long run almost every community is better off

after a DOD base closes because you actually do get economic recovery. You get diversity.

You get a better, a stronger business base, a better community, et cetera. But you know, at the time it's happening, that's rather difficult. I once testified before Congress – actually more than once but one that resonates in my memory about the benefit, the long-term economic benefits of base closure.

And Congressman Arthur B. Ravenel, Jr., of Charleston, South Carolina, drew himself up and looked down and he says, Mr. Berteau, what you say may very well be true. But let me tell you if you close my base, a thousand angels sent down from Heaven carrying that message ain't going to get Arthur B. Ravenel, Jr., reelected. (Laughter.)

So that's impact, OK? That's impact. And that kind of impact I think is one that we need to keep in mind. DOD has said that the most dramatic cuts under sequestration could reduce unemployment by as much as one-and-a-half million jobs which they calculate as 1 percent. I think their arithmetic is correct.

I presume since I haven't seen the analysis that underpins that, that that includes the military and civilian personnel reductions as well as the contractor reductions that would come from the sequestration numbers. It also – of course, they talk about the impact on the industrial base but it's essentially underanalyzed. It's sometimes underanalyzed in ways that I think they delude themselves.

Admiral Mullen talked recently about we'd be better off skipping a carrier than stretching them out, right? Now, he may – that may be true from the point of view of the ultimate cost of the carrier.

But I'll be damned if I can figure out how you keep the third and fourth tier supplier base alive while you wait for that next carrier to come along. You know, Huntington Ingalls Industries may be able to survive based on Virginia class submarines and overhauls but the third and fourth tier will in fact – there are big, big chunks of it that will just disappear entirely.

The same is true with satellites. We don't build very many anymore. There's some talk about we're building the last ones now. There is an industrial base underneath that that I think is under-recognized, underdocumented and at very grave risk.

At the same time, we also know – and Steve mentioned this – you know, it's not only that how much we're buying is changing. What we're buying is changing. It's also true that where it's being developed is changing.

We have a policy – an industrial base policy, an export control policy, a resource allocation policy – that's predicated upon the assumption that all new good defense technology will be developed first by defense companies in the U.S. and it will be ours to use. That's not true anymore.

And in fact, it's less and less true with each passing year. And we do not yet have a structure in place that looks at how do we take advantage of the globalization and the development of technology, particularly outside the platform base, in the content, in the communications, electronics and architectures that come into play there.

About 19 years ago, I chaired a commission looking at defense conversion. Our ostensible reason was to figure out how to mitigate the dramatic impact on the economy from the drawdown following the end of the Cold War. And after oodles of research- I mean, a table of documents this long – we concluded one simple thing.

If we have 4 percent real growth in the economy, you don't have a problem. If you've got 1 percent real growth in the economy, there's not a damn thing you can do about it from the defense perspective, right? Now, that was not what our sponsors – who happened to be the U.S. Congress – wanted to hear. So you didn't read much about that report.

But you can look at it even on a case-by-case basis. The Navy closed Mare Island Naval Shipyard in Vallejo, California, in 19 – the decision was in 1993. The closure was actually three years later. At the time of the closure, DOD calculated an estimate that unemployment in that area would go to 28 percent. It went to 8 (percent).

Now, 8 (percent)'s not trivial, although right now they'd be happy to have 8 (percent). Why did it go to 8 (percent)? Because the rest of the economy did quite fine, thank you very much, right? And I'm one of the believers of the theory that low multipliers are probably valid. Big multipliers are probably not.

There are a lot of people who would think there's a DOD multiplier of four or five out there. I think the reality is it's probably somewhere around 1.7. It's almost the most inefficient way possible to invest in economic development is to spend money on defense. That doesn't mean you don't do it.

It means you do it for national security reasons, and the economic benefits are a plus but they're not the reason that you do it in the first place. There are a number of issues, though, I think that we don't know enough about. And I think it would behoove us to look briefly at a research agenda that ought to be undertaken immediately in order to be able to mitigate this because we don't just have an FY '12 problem here, an FY '13 problem.

The history of drawdowns is very, very simple. We keep coming down until we have a reason to go back up and we never know when that reason to go back up is coming. So we have to plan for and assume that we're going to be coming down for the foreseeable future. That means we need to know more than we know.

What do we need to know? We need to know whether there is any relationship and what the relationship is between defense manufacturing and the ability of the U.S.

manufacturing base to be globally competitive. We don't know the answer to that question right now. We really haven't looked at it very much.

On the shipbuilding side, we know that in fact the kinds of things we do for warships really puts us at a competitive disadvantage with respect to the global shipbuilding industry. You can't build container ships the same way you build DDG-1000s. That's OK. I'd rather have the DDG-1000s.

But there are a whole host of other areas where in fact there could be a relationship between competitiveness globally in the manufacturing industrial base and where we spend our defense dollars. We don't know very well much about the stimulus nature of defense industry and defense manufacturing.

Now, DOD didn't get to participate in the 2009 stimulus bill in part because of analytical reasons that might or might not hold water, but in much larger part because of the politics. DOD had already had its stimulus. It was called eight years of supplementals, notwithstanding the fact that we actually didn't invest those supplementals. We used them for operations.

It is high time that we looked at converting the defense capital budget to a capital budget process. There are only three or four entities on the planet that don't use a capital budget for their capital items and the U.S. government is one of them. The others are all Third World countries. And it's high time that we came to that point.

We still have obsolete scoring mechanisms. Now, in the past, we've had a very interesting correlation. And if you know it, scoring is basically OMB's predilection – and it has some legitimate good governance purposes – that says at the time you sign up for a commitment, you budget the entire amount of that commitment for the year that you're doing it.

That means if you sign a 50-year lease, you budget all 50 years the first year. There is no sane economic entity in the world that would operate that way but that's the way the U.S. government operates. Now, in the past we've kind of had a policy change a little bit where we could rely a little bit more on the private sector in times of defense downturns.

And so we come to that now and yet OMB seems to be scoring more tightly than ever. So for instance, if you have an energy project that you would like to build on your base and you want to give the energy company your land to do it, you're going to have to score 50 years' worth of land payment equivalents in order to finance that.

You can't get there from here. And then the final one I think is we really need to know a lot more about the second, third and fourth tiers of our industrial base. And there's some efforts under way to do that.

They're going to produce some results but I don't know that we'll ever see them publicly because it might be that DOD is not comfortable with the answers. So those are my agenda items. And Clark, I'll – I didn't yield back any time, so over to you. Thank you.

MR. MURDOCK: Thank you. One of the things I've learned from this panel is that perhaps we misnamed the conference as a whole "Defense in an Age of Austerity." Well, maybe we're, you know, age of slightly reduced circumstances – (laughter) – or maybe it's not so serious as we all think although we had a number of people earlier in the day who thought we were in a very serious strait.

Frank Hoffman in his book presentation talked about, you know, we have to take account of the fact that our personnel costs keep going up, health costs keep going up, retirement costs keep going up.

And I refer to this as sort of a phenomenon of hollowing out the budget from within, because the way we make decisions about how we do health and how we do retirement and personnel costs really mean that if you're flattening out the top line, you have a much more severe impact on the actual capabilities that you can buy with it because I don't think there's any doubt that those studies have looked at it and of course it depends on how you define it is that the ratio of tooth-to-tail has been changing.

We get a lot more tail now and so if as, the point I think Steve was making, if you do this cut fast, you're going to be cutting tooth. And I just wondered if is it OK for us to continue to talk about an age of austerity. I mean, the Atlantic Council says the age of austerity. I'm not sure we're quite there yet. But how bad is it really? I'll start with you, Todd.

MR. HARRISON: If we're not willing to address any of the, you know, personnel costs within the budget and not just by reducing the number of personnel but by actually getting at the cost per person and limiting the growth and reversing some of the growth, if we're not willing to do that, if we're not willing to touch pay and benefits, then I think it is a big problem.

Right now if you added up military personnel, defense health program and the cost of DOD civilians in pay and benefits, those accounts add up to about 45 percent of the base defense budget. If you take that off the table, then your cuts are going to be disproportionately against things like peacetime operations and training and the acquisition of new weapons systems.

So you know, that's how I think people get to the hollowing out of the force if we don't modernize our equipment and in fact if we don't make up for some of the modernization that we missed over the past decade and even going back into the '90s and if we cut training then yeah, you could end up with a hollow force.

But you know, we don't have to make bad decisions. We can make better decisions. It just, you know, as Secretary Cohen alluded to, requires some courage on the side of the Congress.

MR. MURDOCK: Steve?

MR. GRUNDMAN: Well, I have a complex answer, I'm afraid. So how bad is it? A, I think it really does depend on the pace. If you have to take $100 billion out in 2013, it's going to be, you know – what's the right word. It's going to be very disruptive, very disruptive politically, bureaucratically, probably almost certainly operationally.

And moreover, if you do that, I think it calls into question the strategic posture of the American military which I think is a very big deal. My brief was whether it's a big deal for the economy or a really big deal for industry. And without diminishing the fact that it would be very disruptive, I try – right, I think we do have to keep these things in context, in perspective, rather – well, both.

So my third hand, just to get it out there, was that, you know, even if 50 billion – let's say the whole $50 billion of additional annual reductions were allocated only to the investment accounts – procurement and RDT&E – that would take the aggregate of our investment accounts back to a level that's about 25 to 30 percent higher than it was in 2001.

OK, now again, that's relative to where we are today that's a lot of churn in the industrial base that would have a big impact on, you know, employment, et cetera. But in the scheme of maybe a 20-year span of thinking about this, it's not a cataclysm I don't think.

Again, I think perhaps ironically the big issue is the strategic posture of the American military, what it can – what it is built to do in the world. Those things get called into question if you start, you know, taking $500, $600, $700 billion over these 10, 12 years out as opposed to maybe four.

MR. BERTEAU: Clark, I think it actually is a pretty serious problem. The numbers – it's easy to let the numbers characterize it as not that serious. But there's a couple of underlying dynamics that I think don't get captured by the numbers. You compare where we are today to where we were in 1990 in terms of force structure and civilian personnel.

We're one-third fewer today but we're spending the same amount of money on that one-third smaller force, in part because of Todd's comment about pay and benefits and that's largely where it is. And it's actually a disproportionate increase on the military side there.

Most of you are familiar with Norm Augustine's law of the pace of the cost of an individual tactical aircraft and how eventually if you keep going at the same pace we're

going now, at some point the entire defense budget buys one airplane and eventually the entire GDP buys one airplane – not in my lifetime, but eventually. That's the path we're on.

You could draw a similar chart of how much we're paying for a solider and eventually we're going to have one pilot as well for that one airplane, right? Now, Augustine called it Calvin Coolidge's revenge because Coolidge once said, why can't you just buy one airplane and take turns flying it and eventually that's all we'll be able to afford. But I think there's another part of it.

And this is the harder part. We have the highest defense spending we've had in quite some time. But we also have, I think, perhaps the biggest unrecognized shortfalls in our budget in terms of what's in the program and not funded, particularly in the Army where everything from GCV to JLTC to follow-ons and reset.

We've depended upon the annual supplementals to pay for an Army program that's not in the Army's own palm. And recognizing that makes it all the more complex and difficult. So I think it will feel like austerity and from an operations point of view it will be austerity regardless of what the numbers actually say.

And that's why it's so important – so critically important that there be a comprehensive way of thinking about why we're taking reductions, when we're taking reductions and where we're taking reductions.

MR. MURDOCK: I think that's an extremely important point. I think we'll stick with age of austerity for a while even if it's only perceived austerity and felt austerity as opposed to actual austerity. Questions? General Farrell?

Q: Yeah, I've been wanting to mention this since the first panel but now that I've got Dave Berteau up here, I think I'll spear him with it. It seems to me all the presentations have actually been overly optimistic to this point and here's why I say that.

Because the present force structure is unsupportable by the present budget and we've known this since about 2003, 2004. Every time the GAO puts a report out. We know that even at generous funding levels, we're about $100 billion a year short of supporting the present program.

So the Air Force and the Navy especially, and you mentioned the Army, but the Air Force and the Navy especially are on a glideslope that's downward because their equipment is so old and we've made no investments to replace it. You know, the age of the fighters now is approaching 20 years, the tankers and the big airplanes are 40 and 50 years old, the Navy fleet.

And so you're seeing a de facto reduction already in force structure. The Navy is below their objective of 313 ships. The Air Force is already suffering actual force

structure reductions. It's not mentioned or talked about, but you know, the Air Force force structure is declining.

And it's not programmed and it's not approved by Congress but it's going down. So aren't we a little even overoptimistic? I mean, it's going to be much – a much tougher thing in the future even if we only get the 450 billion (dollars) that's already programmed.

MR. BERTEAU: I'm positive that it's bad and getting worse. (Laughter.) But General Farrell, I think your point is an extension of the one I made about the failure to recognize the underfunding that's there already as we start. And I pick on the Army because I think that they've been the most dependent on supplementals in order to survive.

I think the Air Force and the Navy have had to live actually within their own investment accounts going forward. But I think also we have to recognize that this is not just a set of super decisions being made one decision at a time.

It's a failure to actually align what it is we want to have this military do and therefore what kind of, not only size of force structure, but the distribution of responsibilities and the kinds of capabilities and missions that were covered in the two morning panels and presumably will be resolved in the ultimate panel at the end of the day, who will tell us how to actually defend America pretty well for $450 billion a year.

I think it is a very demanding challenge to align our forces with our spending and it's an equally demanding challenge to align our industry with what it is we're going to be asking from them because right now we can't tell them.

We cannot tell the industry what it is we're going to need them to do. We don't know. They don't know where to invest. They have to guess. It's a pretty lousy prospect there. So I think you're right. On both of those levels, it's really demanding.

MR. MURDOCK: Steve?

MR. GRUNDMAN: I'll put a number to the point, which I agree with in principle. I don't think the magnitude of it is as big as you've described in part because this administration I think deserves a lot of credit beginning in, you know, January 2009 to get – you know, get the program that we couldn't afford out of the FYDP.

They've spent – they've had two cycles now to work that problem and I know they've worked it hard and they've gotten that problem down to what by the CBO – not my calculation – but I know the guys at CBO who do this and they're pretty solid citizens in my experience. There's $64 billion of underfunding in the current program.

That is to say, what I referred to before as that higher baseline, that is to say, the current – the actual momentum of cost you could expect the current program to really cost is going to add $10 to $15 billion a year on top of what's actually programmed.

So I agree with the point. I think it's not quite as big as you have described. And I think this administration deserves some credit for getting that bow wave, as it's sometimes called, down to a historically reasonable number. You wouldn't believe the bow wave that they inherited. It was probably 100 billion (dollars).

Q: In 2004 it was.

MR. GRUNDMAN: Yeah.

MR. HARRISON: And I would just add to that that I think this emphasizes the point I was trying to make, is that, you know, we've got to revisit our requirements of what does the military actually need to be capable of doing, what force structure do we really need for the roles and missions that we're going to give DOD.

And if we cannot afford what we are already doing at current levels of spending, then we've really got to bring these two back into alignment and we've got to do it quickly.

MR. MURDOCK: And I'm reminded again of the words that you used – maybe poignant is the wrong phrase to describe them – but Todd, in your presentation or your answer to the first question, you said we don't have to make bad decisions. That may be true. We don't have to do it but we always do. We like to. (Laughter.)

Next question, right there, that gentleman right there? Try to find a few people who haven't asked questions yet.

Q: Dave Patterson, National Defense Business Institute.

MR. MURDOCK: Oh, of course.

Q: From the University of Tennessee. You know, I'm kind of upbeat actually.

MR. MURDOCK: And a former part of the problem, I'll point out. (Laughter.)

Q: Well, you know, I'm kind of upbeat because I finally am able to agree with Dave Berteau that things are in dire straits. But I want to put a different point of view on all of this. You know, when Eisenhower said – talked about the military industrial complex, everybody said, yeah, you've got the contractors and you've got the military and they're in bed together.

He actually talked about the military industrial complex as with one other participant and that was Congress. And so we've had a continuing resolution for almost

the better part of the last three years. And if you consider that for the O&M month-to-month expenditures that we spend a premium of about 10 to 15 percent just because we pay our bills and write our contracts month-to-month.

You could easily make up the difference between the 74 billion (dollars) that the HAC put in R&D and the 71 billion (dollars) that the SAC put in. It adds to the uncertainty, the unpredictability and what that does for contractors is they add another 20 percent of risk and risk is money.

MR. BERTEAU: In the last – over the last eight years, 40 percent of the time, a significant portion of the U.S. government has been operating under a continuing resolution. That's unprecedented in our history. That's a level of uncertainty that's unprecedented in our history. Now, DOD has actually been among the least affected by that until recently.

And with any luck, that will remain the case. I am probably in agreement with your characterization that money could be saved by more stabilization. I am suspicious, however, that it would actually be spent anyway.

You know, at one level, the Pentagon is phenomenally good at spending money. And we all know – all of us who have been there know that the incentive structure does not reward anyone who fails to spend their current year's budget and ask for less next year, right? And so I think that, you know, we've got to figure out a way to change that incentive structure.

That's a little bit beyond the scope of either this panel or even today's event. But history also says that the only time you make those kinds of changes in true behaviors is when you are facing times of real hurt and real austerity.

So can we figure out a way to create an opportunity to make changes, not only in executive branch behavior but to point out to the legislature ways in which its own behavior could have consequences.

I actually don't think the appropriators would believe your numbers, David, that because of their CR-to-CR behavior it costs us 15 percent more money. I think they're say, show me, I don't buy it. And until we can show them, I don't – I wouldn't expect –

Q: Well, I said 10 to 15 percent.

MR. BERTEAU: You did say 10 to 15 (percent). I automatically go to your higher number for effect, right.

MR. GRUNDMAN: If I could just pile into that, that question and observation prompts me to wonder if maybe that's the way – going back to Colin's point and Harlan's about governance – that's the way to engage the popular interest in this problem is to say that this dysfunction of governance is not just embarrassing.

It's a national security problem because to some degree, that's actually what's more threatening to the military establishment than these numbers. It's the dysfunction of government. It's the inability to make choices.

And so maybe if the populace, if the citizenry understood this is not just embarrassing and boring, it's a national security problem, maybe even a crisis, maybe that's the way to get that popular engagement in these otherwise kind of arcane, you know, Washington CSIS conference things.

MR. HARRISON: Well, and just to make sure we're spreading the blame around equally to everyone, it's not just Congress either. It's also the administration and DOD. They're putting forth a budget each year that quite frankly is not realistic. We knew the FY '12 budget that the president put out was not realistic.

They are not going to get that much funding. We all knew it. The only question was how much would it be cut by Congress. And so what we end up with is not only do we have these continuing resolutions going on and we go from crisis to crisis, but it's resolved at the very last minute amongst a small handful of people and they have to cut billions of dollars out of the budget quickly.

So what do they cut? They cut quick money. Quick money comes from things like just slashing a little here and there from all these different acquisition programs, delaying the start of a program, going after unobligated funds.

You know, there's a lot of tricks you can do and all of a sudden you come up with 20 billion (dollars) in FY '11 or I think we're looking at 26 billion (dollars) in FY '12 rather than this being thought through by the department and by the services and saying,

OK, well, if we're going to have to take these cuts, where are we going to take them, we leave it to a handful of appropriators at the last minute to work out some sort of an arrangement. I hope that we can break the cycle with the FY '13 budget.

We should have some guidance going in there. It might not be until January 15th but we'll know whether or not, you know, sequestration is supposed to go into effect. Of course, Congress can go back and change that before it actually goes into effect a year later.

But you know, I hope that the FY '13 budget that comes out is in line with the caps that are in place at that time. If it's not, then we're just going to continue on the same cycle.

MR. MURDOCK: Final question, right over there I think.

Q: Hi. Colin with AOL Defense. A couple of my colleagues in the last week have reported that the sequestration is actually not automatic, that while the cuts may be

proposed, Congress still has to dispose of them, and that there would be time for them to amend them, to fix them. How real is sequestration and how likely is Congress to essentially ignore what the supercommittee, which is so great and all-powerful, does?

MR. HARRISON: I mean, Congress can undo any piece of legislation they have enacted the same way they enacted it. So is sequestration real? It's as real as the, you know, future Congresses allow it to be.

Here's what I think is real about it and why DOD should start preparing for that level of a budget cut. It's because all it takes for sequestration to go into effect is inaction in Congress. To stop it, they have to do something. To let it go forward, they just do nothing and it will go forward.

MR. GRUNDMAN: I will – I'm not 100 percent on this but I believe the impact on the mandatory programs would have to be actively undone. I think the discretionary programs still need appropriations.

But the mandatory program, I think sequestration – that that is I think what sequestration – someone in this room is surely more keen on this than me. But I think that's what sequestration means is the mandatory programs actually automatically are impacted.

MR. HARRISON: Yeah. You know, I think the way it's written is that they can – if Congress appropriates an amount that's above whatever the cap is, then sequestration kicks in after the fact and just blindly cuts money out of all the accounts.

MR. GRUNDMAN: OK.

MR. MURDOCK: Rather than end on a question of which our panel was divided, or at least uncertain –

MR. GRUNDMAN: No, no. Todd's got it.

MR. HARRISON: I will let others correct me if I'm wrong.

MR. MURDOCK: I'll take one more question, right there.

Q: Thank you. Ann Clarendon (ph), a visiting fellow at Brookings. I was just wondering, what implications do you foresee the spending cuts in both the U.S. and Europe as having on transatlantic defense trade? And as part of this, what impact might closer defense industrial collaboration between France and the U.K. have on the access of U.S. defense companies in both of those markets?

MR. BERTEAU: Oh, I love that question.

MR. MURDOCK: Todd, why don't you take that one? (Laughter.)

MR. BERTEAU: Go ahead, Todd.

MR. HARRISON: No, you go right ahead.

MR. BERTEAU: Clearly the potential is there if U.S. spending is going down and European spending is going down for smart people to wake up and realize that we could do a whole lot better if we figured out how to duplicate one another's expenses and to collaborate and cooperate and create a kind of a federated capability greater than we've done in the past.

The track record of success in this regard, however, is pretty thin and doesn't extend very far. That leads you then to the second part of your question, can we take any heart from the new U.K.-French alliance.

This is at least their third attempt to do so. It has already outpaced the previous two in terms of the number of words that have been written and produced by the two respective governments in terms of implementation.

So, on that measure alone, we're further ahead than we've been before. And I think that there have been no surprises as yet of areas where the French have said, we didn't mean cooperate there. We just meant elsewhere. So far every one of those areas have been easily identifiable and consistent with what one would expect.

So I think there is in fact some very real potential there. I think that it requires two things. One is a greater ability in Europe to rationalize reductions so that there's a clear recognition of reducing where there is redundancy already in place rather than simple national sovereign decisions that duplicate deductions and don't preserve capability that should be preserved.

That's going to be a big change for the Europeans. Among other things, they actually need the data to be able to tell when they're doing it before they make the decision. The second is it's going to be a recognition by the U.S. that when we talk about building partnership capacity, the number one target for investing and building partnership capacity is where we already have it.

And where we already have it is with NATO and with Europe. And if we're spending any money on partnership capacity, it ought to be where that capacity already exists and do the best we can to sustain it. So I think in both of those cases, there is room for positive optimism there and that's about as positive as I can end on any note on.

MR. MURDOCK: And we'll end the panel on that note. Join me in thanking them. (Applause.) We'll now break for about 10 minutes and then reconstitute for the final panel, the integrative panel, the capstone panel.

(END)