The effects of budget cuts are already being felt across the aerospace and defense industry, especially at small and mid-size companies that dominate the defense sector’s supply chain.”
MANDATORY SPENDING CUTS

Over the next decade, if sequestration continues, it will dramatically and disproportionately reduce the U.S. Department of Defense’s (DOD) modernization accounts, which comprise all aspects of DOD procurement, research and development and science and technology accounts that support systems and equipment used by men and women in the armed forces.

By not being able to upgrade aging weapons systems or any military fleet on the ground, in the air or at sea, the U.S. military and its industrial base will be more severely damaged than commonly believed. The reasons include:

- The full effects of sequestration in 2013 on DOD budgets were slightly mitigated by congressional relief and budget mechanisms that are one time use as monies were pulled from what amount to the Department’s reserve accounts;
- DOD inability to significantly curb its fixed operating and overhead costs quickly will mean that modernization funding, though roughly one-third of the defense budget, will likely absorb nearly half the cuts in the early years of a decade long sequester;
- Consequently, between fiscal year 2013 and fiscal year 2017 DOD could spend between 15 and 20 percent less on modernization – up to $147 billion less – than was projected in the president’s budget request and for which industry planned.¹

Investment shortfalls of this scale and immediacy – following a previous $487 billion cut to the DOD budget already incorporated into the president’s budget planning moving forward – will, over the next several years, force the defense industry to layoff thousands of employees from within the defense industrial base’s workforce, close facilities and research labs and lose unique and unrecoverable militarily skills – in the case of smaller companies with narrower profit margins they may choose to exit the defense supply chain altogether. The lost capacity and capabilities resulting from these cuts cannot be rebuilt or brought back quickly if U.S. national security imperatives or budget priorities change in the future.

The following analysis focuses both on the sequesters near-term impact on DOD Future Years Defense Plan – fiscal years 2013 through 2017 – followed by a discussion of the longer term effects on the industrial base over the next decade and beyond.

NEAR-TERM ANALYSIS

The Budget Control Act of 2011 (BCA) established two major cuts to projected defense spending from fiscal year 2012 to fiscal year 2021. First, the BCA directed a reduction of $487 billion in projected defense spending over ten years starting in fiscal year 2012. Second, it established a trigger mechanism that, if enacted, would reduce defense spending by more than $50 billion each year for a cumulative total of $500 billion by fiscal year 2021.

The first round of sequestration cuts went into effect in March 2013. For the entire fiscal year 2013, these cuts corresponded to a $37 billion defense budget cut because DOD received some relief from Congress and was able to use fiscal year 2011 and 2012 unobligated funds. The procurement account, which was $109 billion in the base budget request for fiscal year 2013, was decreased by about $9.8 billion or 8.9 percent. The research and development account of $69.4 billion was cut approximately $6 billion, or nearly nine percent. The cuts of

¹ Letter from Secretary of Defense Hagel of July 10, 2013 to Senators Levin and Inhofe.
$15.8 billion to the combined modernization accounts – which help sustain the nation’s defense industrial base – represented more than 40 percent of all reductions to defense spending.

Unlike in 2013, moving forward the Pentagon will not have the option of using prior-year unobligated funds. Furthermore, in fiscal year 2014 a full 12 months of sequester cuts – some $52 billion according to the Secretary of Defense – will come out of the defense budget, as opposed to the pro-rated amount in 2013. While total defense spending will decline 10 percent, Secretary Hagel indicated that the modernization accounts would go down by 15 - 20 percent, which is equivalent to $26 - 33 billion. Therefore, over the next two years modernization spending will be nearly $50 billion less than what the president has requested and for what defense companies had planned, organized and staffed.

If the fiscal year 2014 sequester ratios are projected throughout Future Years Defense Plan the cumulative reduction in modernization spending would range between $119 billion and $147 billion. This investment deficit could be mitigated somewhat if DOD is able to realize greater savings to other accounts – operations, infrastructure and personnel – early in the sequester timeframe through management reforms and efficiencies. However, the historical track record is not encouraging on this front, especially for any post-saving measure that requires congressional approval.

According to the Congressional Budget Office (CBO) the budget situation is complicated and exacerbated by a discrepancy between DOD’s estimates of what its activities, people and programs will cost versus how much CBO believes the likely cost to be. According to CBO implementing DOD current plan would cost an average of $550 billion a year from 2013 through 2017, or $21 billion per year more than DOD estimated. Under sequestration, therefore, the shortfalls would grow more severe.

**LONG-TERM TOP LINE ANALYSIS**

With a near-term outlook of degraded modernization accounts, the growing investment deficit within the DOD will be accompanied in the long-term by a steady decline in the purchasing power of every defense dollar. DOD fiscal year 2013 base budget request – prior to sequester – in real terms is about the same as it was in 2007, about $476 billion. Yet the cost of just about every major component of the defense budget – personnel, procurement, overhead, operations – is dramatically higher and projected to grow at rates in excess of inflation in the next decade.

Sequester caps will allow DOD funding to increase in nominal, current-dollar terms by an average of about two percent per year through 2021, reaching $563 billion. On an inflation adjusted basis, DOD spending will rise to the equivalent of $489 billion. This represents an average annual growth rate of just 0.3 percent or three percent over the BCA time frame – as opposed to the three percent annual increased projected in the president’s budget request.

In real-world terms the defense budget is essentially flat for the next decade. As a result, DOD will have to fund military capabilities over the next five to ten years using 2002-level purchasing power in constant dollars. This is especially damaging to the defense industry because no viable contract pricing model can ignore escalating costs in supplies, manpower and R&D innovation. Considering that the market costs of some commercial items outpace annual inflation, a reasonable case can be made that most contracts going forward will not provide sufficient profit margin to sustain a viable defense and aerospace industry.

Even if sequester was ended by 2015, the combined cuts in 2012, 2013 and 2014 will set the department back an estimated 18 percent in total budget purchasing power that will be impossible to recoup at the current annual real growth rate of 0.3 percent. It would require returning to an adjusted growth rate equal to the original
three percent in the president’s budget plan plus an additional one percent annually for the last seven years of the BCA period.

Furthermore, because the inflation-adjusted costs of DOD activities and programs will rise more rapidly than the budget caps allow, the cumulative sequester impact will become most apparent in the out years. From 2018 through 2021, the budget caps will be about 12 percent below an extrapolation of DOD’s five-year plan and 19 percent below CBO’s projection of the cost of that plan. DOD will have to cut back more – or find additional efficiencies – every year through 2021 to remain within the caps, primarily because the costs of providing compensation and acquiring weapons systems will grow faster than the rate of increase permitted under sequestration.

**INDUSTRIAL BASE IMPACT**

It is expected that modernization cuts will consist of further delaying funding of new weapons systems and equipment. After several major programs were terminated between 2009 and 2011, there are few systems left to cancel that would not leave the U.S. military dangerously exposed in the future – especially air, sea, space and cyber capabilities called for in the president’s 2012 Defense Strategic Guidance. Delaying these programs or reducing purchases will drive up unit costs and threaten to create the procurement “death spiral” in which higher prices lead to even smaller buys.

Ultimately, slashing procurement threatens industry’s ability to deliver these capabilities at needed quantities in the future when DOD can afford to – or is forced to – “buy back” the military modernization deferred during the early years of sequester.

With smaller investment budgets supporting a dwindling number of major programs built by a smaller industrial base in the wake of the Cold War, it is more likely that postponing production of a particular weapons system will cause the loss of technical expertise and manufacturing facilities. Defense companies will not continue to keep factories open and keep employees on the payroll in the absence of revenue to cover these costs. As Deputy Defense Secretary Carter said in 2011, “we cannot assume that the defense industrial base will always be there.”

The effects of budget cuts are already being felt across the aerospace and defense industry, especially at small and mid-size companies that dominate the defense sector’s supply chain.

The effects of budget cuts are already being felt across the aerospace and defense industry, especially at small and mid-size companies that dominate the defense sector’s supply chain.
THE WAY AHEAD

Secretary Hagel’s July 2013 letter to the Senate Armed Services Committee estimates that should sequester continue, cuts of 15 - 20 percent to defense investment accounts are likely in fiscal year 2014. To date it is unknown if these funding choices are being made with any consideration of the health of the nation’s industrial base. The 2012 Defense Strategic Guidance that accompanied the first $487 billion of BCA budget cuts referred to the important of maintaining “reversibility” in order to ramp up delayed or cancelled programs if needed in the future, yet it is not clear how that goal is being pursued, much less achieved.

When Secretary Hagel unveiled the initial findings of the Strategic Choices and Management Review (SCMR) in July he characterized the sequester as forcing a fundamental choice between:

- A much smaller military that is more technologically advanced as a result of minimizing cuts to modernization programs; or
- Retaining the military at near its current size but creating and deploying little or no new capabilities due to massive cuts to procurement and research and development.

Secretary Hagel described this latter scenario as “a decade-long modernization holiday.” America’s defense industrial base – a fraction of its Cold War size and still absorbing tens of billions of dollars in recent budget cuts – will not survive another procurement holiday in its current form, likely losing the capacity and capabilities needed to guarantee U.S. military technological superiority for the next generation.

Absent the release of the analysis produced during the SCMR industry is left without the information and context needed to prepare for what will be a very challenging future. It is not clear if the SCMR considered impacts to the industrial base when considering options to produce the savings required by the sequester.

SCMR did make clear that tough choices are needed today to confront and mitigate these future shortfalls. This would entail curbing the unsustainable growth of health care, compensation, peacetime operations and overhead, plus instituting a more rational and less cumbersome acquisitions regime. Yet, based on recent history, we can only conclude that modernization funding will continue to take cuts at a level well in excess of its current share of the defense budget unless Congress acts and ends sequestration.

An industrial base strategy, similar what the Center for Strategic and Budgetary Assessment has recently put forward in their recent study titled, “Sustaining the US Defense Industrial Base as a Strategic Asset,” is clearly needed not only to mitigate looming investment deficits but also to sustain the U.S. defense industrial base for the next generation. At the very least it starts with deciding which core, militarily-unique private sector capabilities are most needed in light of strategic priorities, coupled with a willingness to make tough choices to preserve those capabilities.

In this environment, a more productive and collaborative dialogue between industry and the DOD would help mitigate the risks associated with constrained resources. In the past, increasing defense budgets could mask systematic flaws in the U.S. government’s approach to dealing with the nation’s industrial base; this is no longer possible.

Both the executive and legislative branches must take sensible, long-term, measures to end sequester or at least mitigate the harm it does to our military and the companies that arm and equip it. Failure to do so would severely damage the defense industrial base as a commercially viable enterprise, as a reliable and responsive provider of urgent wartime needs and as a national strategic asset indispensable to America’s security.