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7 AREAS TO WATCH IN THE FY17 DEFENSE BUDGET

Katherine Blakeley

CSBA

Center for Strategic and Budgetary Assessments

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President Obama's final budget, to be released February 9th, is his last chance to put his administration's stamp on the nation's defense spending. Over the past 8 years, Obama has overseen a major evolution in the Pentagon's priorities. When he took office in 2009, the United States was involved in two major ground conflicts with the force posture and spending to match. There were about 137,000 U.S. servicemembers on the ground in Iraq and another 34,000 in Afghanistan. Active duty Army end strength was about to peak at 570,000, and tens of billions had been invested into Mine-Resistant Ambush Protected (MRAP) vehicles to reduce IED casualties. Today, despite the continued challenges of ISIL and instability in the Middle East, Pentagon brass are more concerned about the prospect of peer or near-peer competitors emerging in the next decade or two. Rather than MRAPs, planners fret over our electronic warfare and high-end strike capabilities, as well as ensuring sufficient end strength and presence to address the whole spectrum of potential conflict. President Obama's defense budgets have begun the slow process of reorienting the Pentagon from a focus on ground conflict to imagining—and being ready for—the potential conflicts of the future.

1: Topline Spending—and the Political Fight

This year, the Administration has chosen to bring out a defense budget that is right at the many-times revised BCA limits of $524 billion for the Pentagon's base discretionary spending, with a negotiated level of $58.8 billion for the Overseas Contingency Operations (OCO) budget. The October 2015 budget deal bumped up BCA limits for defense and non-defense discretionary spending evenly in FY16 and FY17, giving this year's defense budget a more stable foundation.

Compare that to the last few years. The FY14 budget came in at $52 billion over that year's cap and in the midst of planning for and executing the FY13 sequester, making it an exercise in wishful thinking.[1] While the FY15 budget came in at the level of the caps, they also had "toggles" for more spending, in the form of $26 billion for defense in the President's Opportunity, Security, and Growth Initiative, and relied heavily on OCO funding.[2] Trying to entice Congress to revise the BCA caps and spend more on defense by presenting an aspirational shopping list backfired, and Congress roundly ignored the initiative.[3] The next year, the administration took the opposite approach. The $524 billion base DOD budget for FY16 was $35 billion over that year's BCA cap, putting the onus on Congress to either make the cuts or find additional money.[4]

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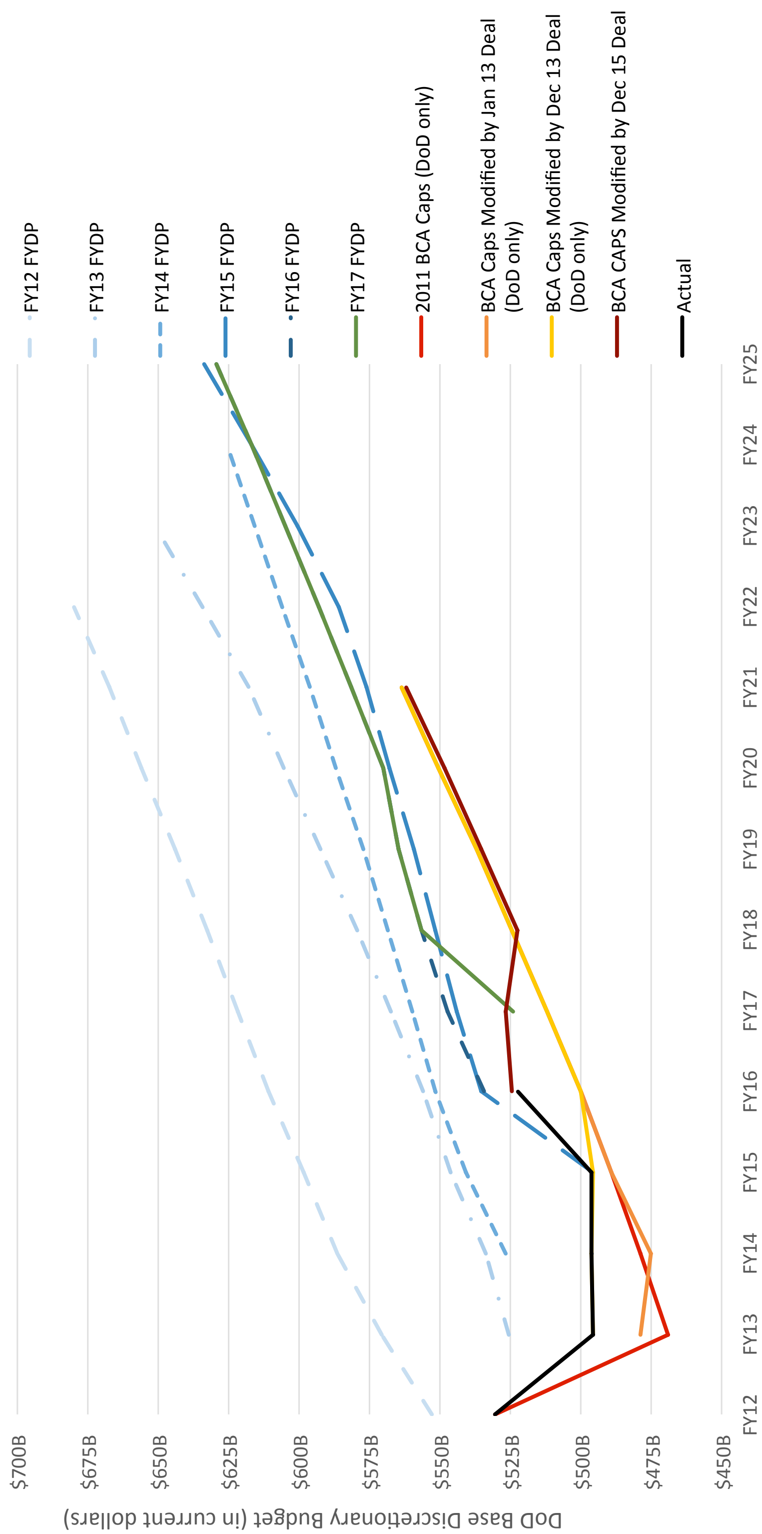
[1] Sydney Freedberg, "2014 Budget: Three Reasons Why Pentagon's Request Is Irrelevant," *Breaking Defense*, April 10, 2013, available at http://breakingdefense.com/2013/04/2014-budget-3-reasons-pentagon-request-irrelevant/.

[2] Office of the Under Secretary of Defense (OUSD) (Comptroller), *Opportunity, Growth, and Security Initiative Fiscal Year 2015* (Washington, DC: DoD, March 2014), available at http://comptroller.defense.gov/Portals/45/Documents/defbudget/fy2015/fy2015_ogsi.pdf.

[3] Sydney Freedberg, "DoD's $26B Budget Hail Mary 'Not Going To Happen:' Rep. McKeon," *Breaking Defense*, March 7, 2014, available at http://breakingdefense.com/2014/03/dods-26b-budget-hail-mary-not-going-to-happen-rep-mckeon/.

[4] Sydney Freedberg, "Rep. Randy Forbes Rips 2016 Request: A 'Wish List'," *Breaking Defense*, February 24, 2015, available at http://breakingdefense.com/2015/02/rep-randy-forbes-rips-2016-request-a-wish-list/.

FIGURE 1: DOD BASE BUDGET FYDP PLANS AND BCA CAPS



While the overall level of Pentagon spending in the FY17 budget is fairly defined, two big problems remain. Most pressingly, even though this year's budget will meet the renegotiated FY17 BCA level, it is still about $22 billion less than the Pentagon's budget plan last year called for in FY17. The Obama administration and top Pentagon leadership are going to have to walk a narrow rhetorical tightrope in justifying this budget, rather than the higher spending envisioned in the FY16 request. And although the FY17 budget will be right at the level of the BCA caps, the rest of the FYDP will be over the caps by a cumulative $104.5 billion between FY18 and FY21.

In Congress, some prominent Republicans are already sharpening their knives, calling on the administration to make up any difference between the FY16 plan for FY17 defense spending and the FY17 request by adding more money to the OCO accounts, which aren't subject to the caps.[5] Like last year, the Obama administration's position against putting more base budget money in OCO is weakened by the $20–30 billion of base funding that is already in the OCO budget, the additional $8 billion in base budget funds that was put into OCO as part of the December 2015 budget agreement, and the argument that this year's negotiated OCO level of $59 billion was intended as a floor, rather than a ceiling. Moreover, the 2016 Presidential election seems certain to keep defense spending in the news as a proxy for our national security and defense capability.

2: Finding $22 Billion

Coming in right at the Pentagon's prospective share of the amended FY17 BCA caps, this year's likely base discretionary budget request of about $524.2 billion will still leave the Department of Defense (DoD) short by about $22 billion of the planned spending this year.[6] The FY16 Future Year's Defense Program (FYDP) called for $547 billion in base discretionary spending—a gap of about 4 percent.[7] With last year's FYDP plan assuming savings from the structural reforms and the retirement of older platforms as proposed in the FY16 budget submission, the Pentagon may be starting out FY17 even further in the hole.

TABLE 1: FY16 AND FY17 FYDPS AND THE CURRENT BCA CAPS

current dollars (in billions)	FY17	FY18	FY19	FY20	FY21	FYDP
FY16 PB	$547.30	$556.40	$564.40	$570.00	$581.40	$2,820
FY17 PB	$524.20	$556.40	$564.40	$570.00	$581.40	$2,796
Current BCA caps for DOD, est.	$524.20	$526.30	$522.50	$548.40	$561.70	$2,695
delta	**$0**	**$33.90**	**$29.30**	**$21.60**	**$19.70**	**$104.50**

However, this $22 billion isn't quite as bad as it appears. If the Administration's request conforms with the $59 billion OCO floor the FY16 authorization and appropriations bills set out, it will

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5 "The 2016 Agenda of the House Armed Services Committee," National Press Club Luncheon with Chairman Mac Thornberry, The Press Club Ballroom, Washington, DC, January 13, 2016, available at http://www.press.org/sites/default/files/20160113_thornberry.pdf.

6 Mike McCord, DoD Comptroller & CFO, "The Bipartisan Budget Act of 2015: Defense Resource Priorities and Challenges," presentation to the Center for Strategic and International Studies Conference on the Future of the Defense Budget, November 30, 2015, available at http://www.scribd.com/doc/291697571/McCord-CSIS-Slides-Nov30-2015-v2.

7 OUSD (Comptroller)/CFO, "Fiscal Year 2016 Budget Request," presentation, February 2015, available at http://comptroller.defense.gov/Portals/45/Documents/defbudget/fy2016/FY2016_Budget_Request.pdf.

match the dollar level of the FY16 OCO appropriation, which included $9.1 billion in "base-to-OCO" O&M funding, split between the services. Given that the OCO account already contains about $20–30 billion in base expenses, it should be able to absorb a planned modest plus-up of the European Reassurance Initiative and the increased operational tempo of strikes against the Islamic State without losing too much of this $9 billion O&M cushion. Even so, the FY16 actual levels for O&M were just under $3 billion shy of the requested amounts. It's possible that O&M will have to absorb a similar amount in the FY17 PB.

There will likely be less wiggle room in military personnel. The FY17 FYDP level already incorporates the continuation in planned end strength reductions, down from 490,000 active duty Army in FY15 to 450,000 in FY18.[8] However, perhaps $1–1.5 billion can be found, similar to the $1 billion reduction from the FY16 request in the FY16 authorization.

TABLE 2: PB16 DEFENSE BUDGETS BY APPROPRIATIONS TITLE

current dollars (in millions)	FY16 PB	FY16 authorizations (base only)	FY17 in PB16 FYDP
MILPERS	$136,735	$135,559	$140,054
O&M	$209,834	$197,883	$214,928
Procurement	$107,735	$110,331	$110,350
RDT&E	$69,785	$70,006	$71,479
MILCON	$8,437	$8,153	$8,642
Revolving Funds and Other	$1,787	$1,608	$1,830
Total	**$534,313**	**$523,539**	**$547,284**

The balance of the potential $22 billion gap, perhaps $8–9 billion, will have to be absorbed by the RDT&E and Procurement accounts. Senior leaders at DOD have been hinting in this direction for months. According to Frank Kendall, the Undersecretary of Defense for Acquisitions, Technology, Logistics, the F-35 program is "not entirely fenced." Accounting for 42 percent of the Air Force's total modernization budget for the Air Force's top nine acquisition programs, coupled with further software delays and an already flattened funding profile in past years, the F-35A is the most likely bill payer for the Air Force.[9] DOD Comptroller Mike McCord has also said that there could be a reduction in about $2 billion of RDT&E funding for the Long-Rang Strike Bomber (LRS-B) program due to delays in the contract award.[10] However, as both the LRS-B and the KC-46 are defined as essential, top priority programs, expect the Air Force to make every effort to keep them on track. Space and cyber will remain key investment areas.

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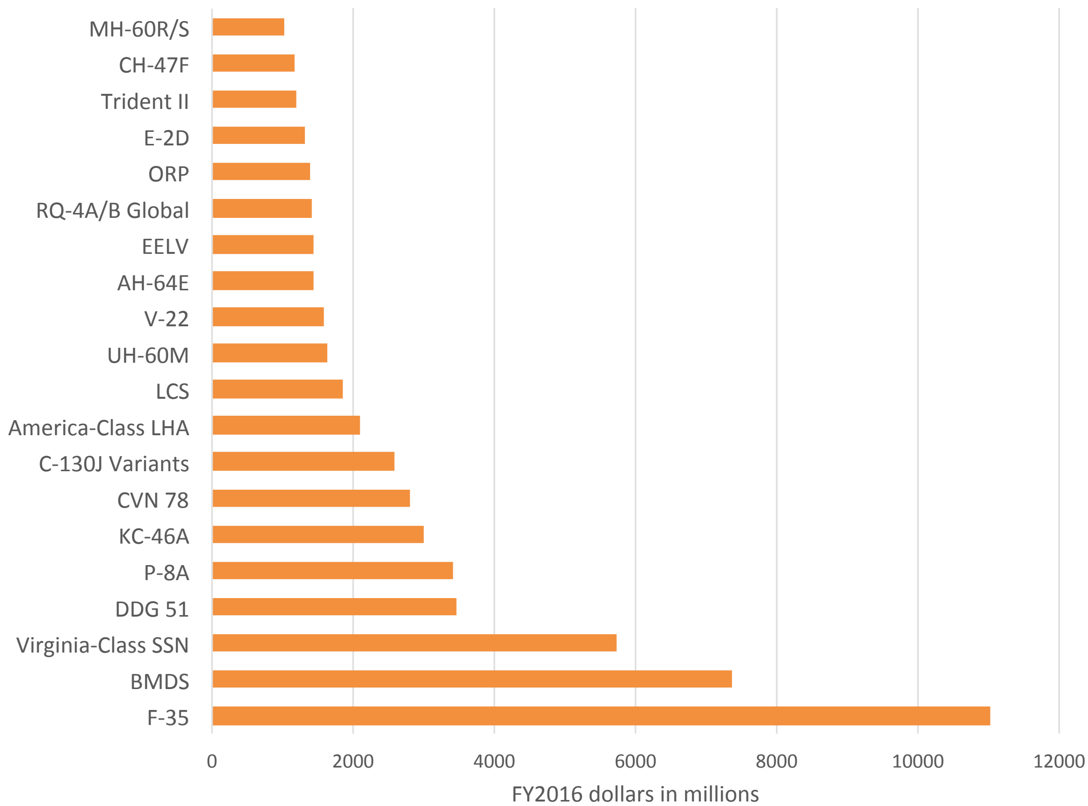
[8] OUSD (Comptroller)/CFO, "Fiscal Year 2016 Budget Request;" Jim Tice, "Army on Target for End-Strength Goal of 490,000," *Army Times*, September 10, 2015, available at http://www.armytimes.com/story/military/careers/army/2015/09/10/army-target-end-strength-goal-490000/72003776/.

[9] Jeremiah Gertler, *The Air Force Aviation Investment Challenge* (Washington, DC: Congressional Research Service, December 17, 2015); Colin Clark, "Kendall Says F-35 Budget Now Vulnerable; McCain Weighs In," *Breaking Defense*, December 2, 2015, available at http://breakingdefense.com/2015/12/kendall-says-f-35-budget-now-vulnerable-mccain-weighs-in/.

[10] Sydney Freedberg, "McCord: Weapons Slowdowns Coming In 2017's $584B Budget," *Breaking Defense*, November 30, 2015, available at http://breakingdefense.com/2015/11/mccord-weapons-slowdowns-coming-in-2017s-584b-budget/.

FIGURE 2: TOP 20 ACQUISITIONS PROGRAMS IN FY16 PB



On the Navy's balance sheet, Secretary of Defense Ashton Carter directed the Navy to budget for forty Littoral Combat Ships in total, rather than the planed 52. With potential savings of up to $1 billion in FY 2017 and $4 billion over the FYDP, the Navy should have the procurement resources in the near term to respond to Carter's directive to purchase capability over capacity. In naval aviation, this means buying additional F/A-18 E/Fs by FY18, in effect providing the Navy bridging aviation capacity in the near term before the F-35C is operational, as well as adding ten more F-35Cs than had been planned in the FY16 FYDP. [11] This will also keep the Boeing F-18 production line in St. Louis humming, a prudent hedge against further F-35 setbacks (and a potential argument for deeper cuts to the planned F-35C buy).[12] In shipbuilding, this means keeping the *Virginia*-class attack submarine on track, probably increasing the number of *Virginia*-class subs to receive the Virginia Payload Module, and protecting early funding for the *Ohio*-class replacement program, projected to be about $1.4 billion in FY17.

Without a big ticket, critical acquisitions program, the Army appears likely to see reductions in relative modernization dollars. However, with just three of the twenty largest acquisition programs (all Army helicopters), there are not as many dollars available to cannibalize.

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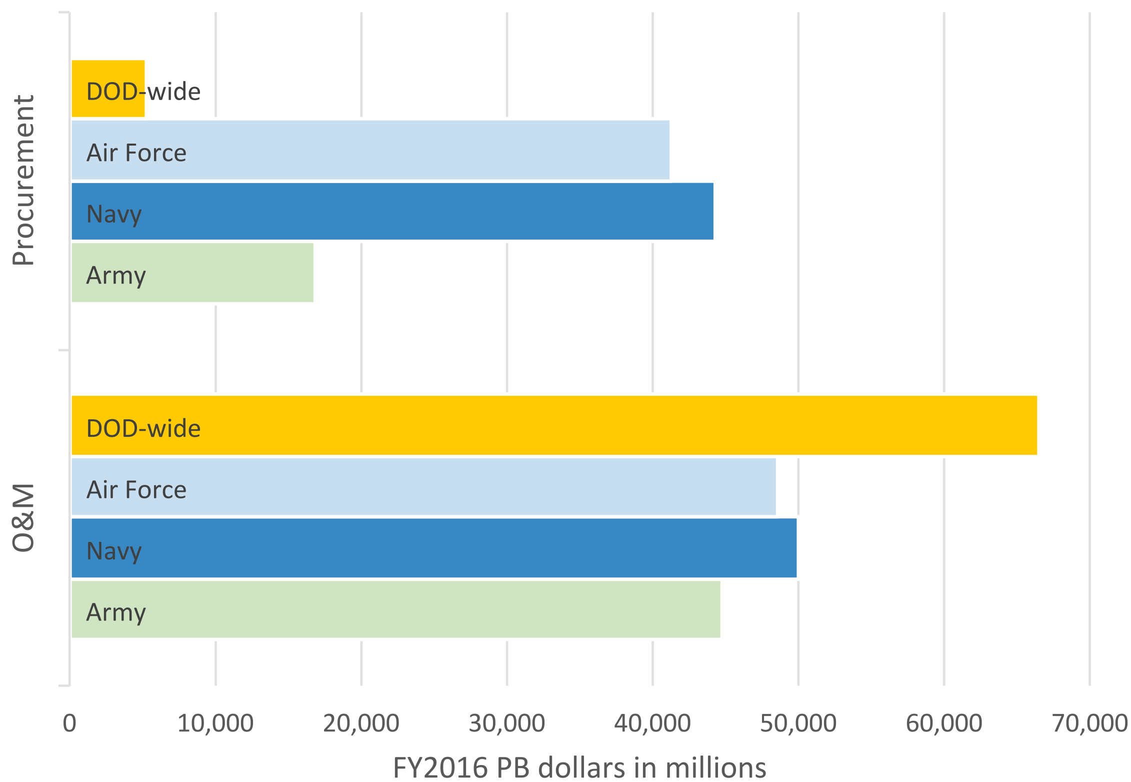
[11] "Navy Program Balance," memorandum for Secretary of the Navy, December 14, 2015, available at http://insidedefense.com/sites/insidedefense.com/files/documents/dec2015/12172015_car.pdf.

[12] Sydney Freedberg, "Navy, OSD Studies Could Save Boeing's F-18 Line," *Breaking Defense*, March 4, 2015, available at http://breakingdefense.com/2015/03/ew-fighter-trends-could-save-boeing-growlerhornet-line/.

Across the services, expect an even greater emphasis on the use of commercial off-the-shelf technologies, streamlined design and components, a push for open-architecture systems, and sustained attention to controlling the lifecycle operation and sustainment costs of systems.

FIGURE 3: FY16 PB PROCUREMENT AND O&M BY SERVICE



3: Force Structure vs. Modernization

As in past budgets, the Pentagon faces tough choices between maintaining current force structure and investing in modernization. Previous years' battles over proposals to retire the A-10 Warthog or the Navy's cruiser; this year's internal Navy division between more ships—and more presence—or a smaller, more technologically capable fleet; and hand wringing about how much Army and Marine Corps end strength we can afford are all elements of this debate. Once again the FY17 budget request seems likely to tend towards trimming or holding steady on current force structure in order to preserve the budgetary headroom for future capabilities further down the FYDP and beyond. Possible proposals in FY17 include a lot of reprises from previous budgets with possible tweaks or updating, including a new BRAC round, Navy cruiser modernization, removing restrictions on A-10 retirement, and restructuring Army aviation.[13] However, as in past years, Congress is likely to staunchly resist these near-term cuts to force structure, risking a longer-term deficit in both capacity and capabilities as early funding for future systems is deferred.

The just-released findings of the Commission of the Future of the Army, which recommended keeping eleven Combat Aviation Brigades rather than ten, and splitting the difference between the current status quo and last year's proposal to shift all Apaches from the National Guard to the

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[13] McCord, DoD Comptroller & CFO, "The Bipartisan Budget Act of 2015: Defense Resource Priorities and Challenges."

active-duty component of the Army, will certainly add fuel to the debate over Army aviation restructuring. Even with offsetting the increased costs of keeping the Apaches in the National Guard by reducing the planned buy of Black Hawk helicopters, the Commission's suggestion would increase the costs of the active component over the original proposal by about $2.5 billion over the FYDP.[14]

4: Betting on the Future

On the research, development, test, and evaluation front, the Pentagon's third offset strategy, articulated by Deputy Secretary of Defense Bob Work, has been announced as a key priority. With a proposed $12–15 billion of investment over the next five years in the priority areas of autonomous deep learning, human machine collaboration, assisted human operations, advanced human-machine teaming, and semi-autonomous weapons that will give the military leap-ahead capabilities and operational concepts. However, in FY17, investments in the Third Offset Strategy are likely to be small, perhaps around $1 billion. Funding is likely to ramp up over the FYDP as rubrics for investment and promising approaches are identified. Across the S&T portfolio, expect DOD to concentrate and protect investments in space, cyber, sensing, and advanced materials.

One area to watch closely in FY17 is how oversight of these look-ahead investments will be done. Will the Pentagon be able to adopt the fail-fast approach necessary to place bets on future technologies, and will Congress be able to tolerate funding investments that may run a high chance of failure, especially in a constrained budget environment? Similarly, both the Navy and the Army are angling to have their own versions of the Air Force's Rapid Capabilities Office to quickly incorporate technological advances into actual capabilities.[15] Although the Air Force's office has a good track record to date, including during the early stages of the enormous LRS-B project, Congress may balk if they see these rapid and flexible acquisition initiatives as eroding transparency and Congressional oversight of acquisitions programs. Similarly, the Air Force's turnaround on the Office of Responsive Space, essentially an RCO for space capabilities, may be a bellwether in this area.[16]

5: Structural Reforms

Relative to recent years, last year saw a very high level of interest in Congress for structural defense reforms. While some of the proposals that have been put forth by DOD and rejected by Congress year after year seem unlikely to gain any ground, strong interest in both the House and Senate Armed Services committee for a re-look at acquisitions, the Pentagon's Goldwater-Nichols structure, and military healthcare presage a more active Congressional interest in defense reform the FY17 National Defense Authorization Act cycle.

While BRAC will be a tough sell to constituent-minded Members, Congress did enact very modest compensation changes last year. Following part of the recommendation of the congressionally

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[14] Sydney Freedberg, "Army Commission: Pay More to Keep Apaches in Guard," *Breaking Defense*, January 28, 2016, available at http://breakingdefense.com/2016/01/army-commission-pay-extra-to-keep-some-apaches-in-guard/.

[15] Sydney Freedberg, "Cyber, Guard, Rapid Acquisition: Fanning's Priorities," *Breaking Defense*, January 21, 2016, available at http://breakingdefense.com/2016/01/secarmy-nominee-prioritizes-cyber-guard/; John Grady, "Sean Stackley Asks Congress for More Department of Navy Flexibility in Acquisition," *USNI News*, January 7, 2016, available at http://news.usni.org/2016/01/07/sean-stackley-asks-congress-for-more-department-of-navy-flexibility-in-acquisition; Richard Burgess, "Stackley: 'Taking Risk Up Front' With Prototyping, Experimentation Will Improve Acquisition," *Seapower Magazine*, January 7, 2016, available at http://www.seapowermagazine.org/stories/20160107-stackley.html.

[16] Mike Gruss, "A twist in the Air Force's Outyear Budget: Funding for ORS," *SpaceNews*, January 28, 2016, available at http://spacenews.com/a-twist-in-the-air-forces-outyear-budget-funding-for-ors/.

mandated Military Compensation and Retirement Modernization Commission, Congress took a small step towards retirement reform last year, creating a 401(k)-like system to allow the 83 percent of servicemembers who will not reach the full 20 years of service needed to retire with a pension to receive some retirement benefits. Congress also kept military pay raises at 1.3 percent rather than 2.3 percent, and allowed the Pentagon to gradually reduce the government's proportion of housing costs covered by the Basic Allowance for Housing to 95 percent. While the more sweeping changes to military health care suggested in January 2015 by the Military Compensation and Retirement Modernization Commission were too much to digest, Congress did permit slightly greater TRICARE pharmacy co-pays to encourage generic and mail-order pharmacy use.[17]

In FY17, acquisition reform will remain at the forefront, as Members grapple with the challenges of thinly spread defense dollars and a greater consolidation of modernization spending in expensive programs. The triple challenges of TRICARE, TRICARE for Life, and the military healthcare system may also see sustained attention in the FY17 cycle, with both the House and Senate Armed Services Committees holding hearings. Despite rising costs, military healthcare quality, access, and patient satisfaction will remain low. Secretary of Defense Carter will continue and consolidate his announced Force of the Future reforms. Although many do not require legislative action or approval, for those that do—like expanding the Career Intermission Program from a pilot program—expect close Congressional scrutiny and interest after a year of rapid personnel policy changes and more in the pipeline.

6: The Overseas Contingency Budget

At $58.8 billion last year, the OCO budget ultimately included $49.7 billion to support the 9,800 troops in Afghanistan, the conflict with ISIL, a greater rotational presence in Europe and ally reassurance as part of the European Reassurance Initiative, the Afghan and Iraqi security forces, and between $20–30 billion in base budget costs. In addition, the October 2015 budget deal allowed the shift of $9.1 billion in base O&M costs into OCO.

For FY17, the overall OCO level will be closely watched and is likely to become a piece of political ammunition. The October 2015 budget deal in Congress had initially explicitly set $58.8 billion of OCO funding as a floor, but legislators retreated from an explicit requirement due to scoring issues. However, many on the Hill continue to hold that the budget deal allows or even requires the Administration to make up any defense budget needs that can't be met under the base budget discretionary BCA levels by increasing the OCO request.[18]

The Administration is likely to submit an OCO request that is right at or slightly lower than the $58.8 billion appropriated in FY16.[19] Politically, President Obama has been strongly opposed to using OCO as a backdoor way to fund base defense needs outside of the BCA caps without commensurate increases for domestic discretionary spending—as the defense authorization showdown demonstrated. Although the October 2015 deal allowed for a lopsided increase to defense, don't expect the Administration to pursue further increases to OCO.

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[17] Pat Towell, *Fact Sheet: Selected Highlights of the FY2016 Defense Budget Debate and the National Defense Authorization Acts (HR. 1735 and S. 1356)* (Washington, DC: Congressional Research Service, December 4, 2015).

[18] Tony Bertuca, "Thornberry Worries Obama Will Raid FY-17 Base Budget to Pay OCO Costs," *Inside Defense*, January 13, 2016, available at http://nges.insidedefense.com/daily-news/thornberry-worries-obama-will-raid-fy-17-base-budget-pay-oco-costs?.

[19] Courtney McBride, "Carter cagey on OCO," *Inside Defense*, January 28, 2016, available at http://nges.insidedefense.com/insider/carter-cagey-oco.

Within OCO, Defense Comptroller McCord has said that President Obama's decision to extend the 9,800 troop level in Afghanistan through FY16 rather than drawing down to around 5,400 will cost an additional $3 billion next year.[20] However, the FY16 OCO appropriations funded a troop level of 9,800 with a total 'real' OCO budget of just $49.7 billion, about $2 billion lower than the initial FY16 request.[21] Similarly, last year's request for $16.4 billion in "In-Theatre Support" OCO funding, largely O&M money to support U.S. regional presence in the Middle East, should be able to absorb some of the increased op-tempo costs of the fight against ISIL.[22] Even with a projected increase in the European Reassurance Initiative to between $3–4 billion for increasing prepositioning, exercises, and Army rotational presence, as well as replenishing depleted munitions expended in airstrikes against ISIL at a cost of $1.5 billion, the OCO budget includes enough fungible funding to be able to meet $58.8 billion as a ceiling.[23]

7: Strategic Choices

President Obama's final defense budget seems poised to hew to the same strategic vision of the FY14, FY15, and FY16 budgets, especially since the FY17 FYDP outyears will track the same levels as the FY 2016 PB FYDP. The FY17 budget will almost certainly work from the same playbook, trying to mitigate the impacts of the BCA levels to readiness, continuing to trim end strength levels, and reduce force structure in the near to medium term to invest in advanced capabilities. Expect near-term slicing rather than decisive strategic shifts, and efforts to protect funding for high-priority future capabilities—nuclear, space, cyber, sensing, strike, resiliency, and communications.

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ABOUT THE AUTHORS

Katherine Blakeley is a Research Fellow at the Center for Strategic and Budgetary Assessments. Prior to joining CSBA, Ms. Blakeley worked as a defense policy analyst at the Congressional Research Service and the Center for American Progress. She is completing her Ph.D. in Political Science from the University of California, Santa Cruz, where she also received her M.A. Her academic research examines Congressional defense policymaking.

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[20] Megan Eckstein, "Pentagon Comptroller McCord: New 2-Year Budget Deal Helps Now Without Hurting In 2020s," *USNI News*, November 30, 2015, available at http://news.usni.org/2015/11/30/pentagon-comptroller-mccord-new-2-year-budget-deal-helps-now-without-hurting-in-2020s.

[21] Towell, *Fact Sheet: Selected Highlights of the FY2016 Defense Budget Debate*.

[22] OUSD (Comptroller), Chief Financial Officer, *United States Department of Defense Fiscal Year 2016 Budget Request: Overview* (Washington, DC: DoD, February 2015), Chapter 7, available at http://comptroller.defense.gov/Portals/45/Documents/defbudget/fy2016/FY2016_Budget_Request_Overview_Book.pdf.

[23] Tony Capaccio, "Pentagon to Boost European Reassurance Spending in FY17 Request," *First Word*, Bloomberg Government, January 19, 2016, available at http://about.bgov.com/blog/pentagon-to-boost-european-reassurance-spending-in-fy17-request/.

CSBA

Center for Strategic and Budgetary Assessments

1667 K Street, NW, Suite 900
Washington, DC 20006
Tel. 202-331-7990 • Fax 202-331-8019
www.csbaonline.org