

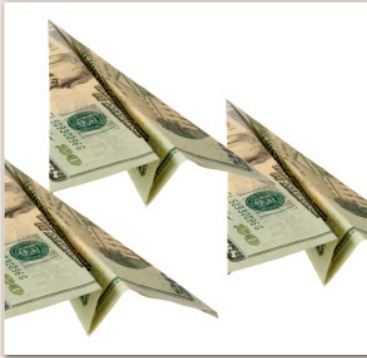
Budgeting Alternatives for the Department of Defense

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by Jacob Kohlhepp and David Grantham

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The United States careens from one budget crisis to another while the national debt — now \$20 trillion — continues to rise. This trend is a stark reminder that the federal budget process needs a complete overhaul. And, with one of the largest budgets in government, the Department of Defense (DOD) could be the first place to test a sensible process reform called zero-based budgeting.



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Indeed, given the DOD's \$530 billion budget for fiscal year 2016, the savings could range from \$31.8 billion to \$53 billion, based on the experience of corporations and national governments that have adopted zero-based budgeting.

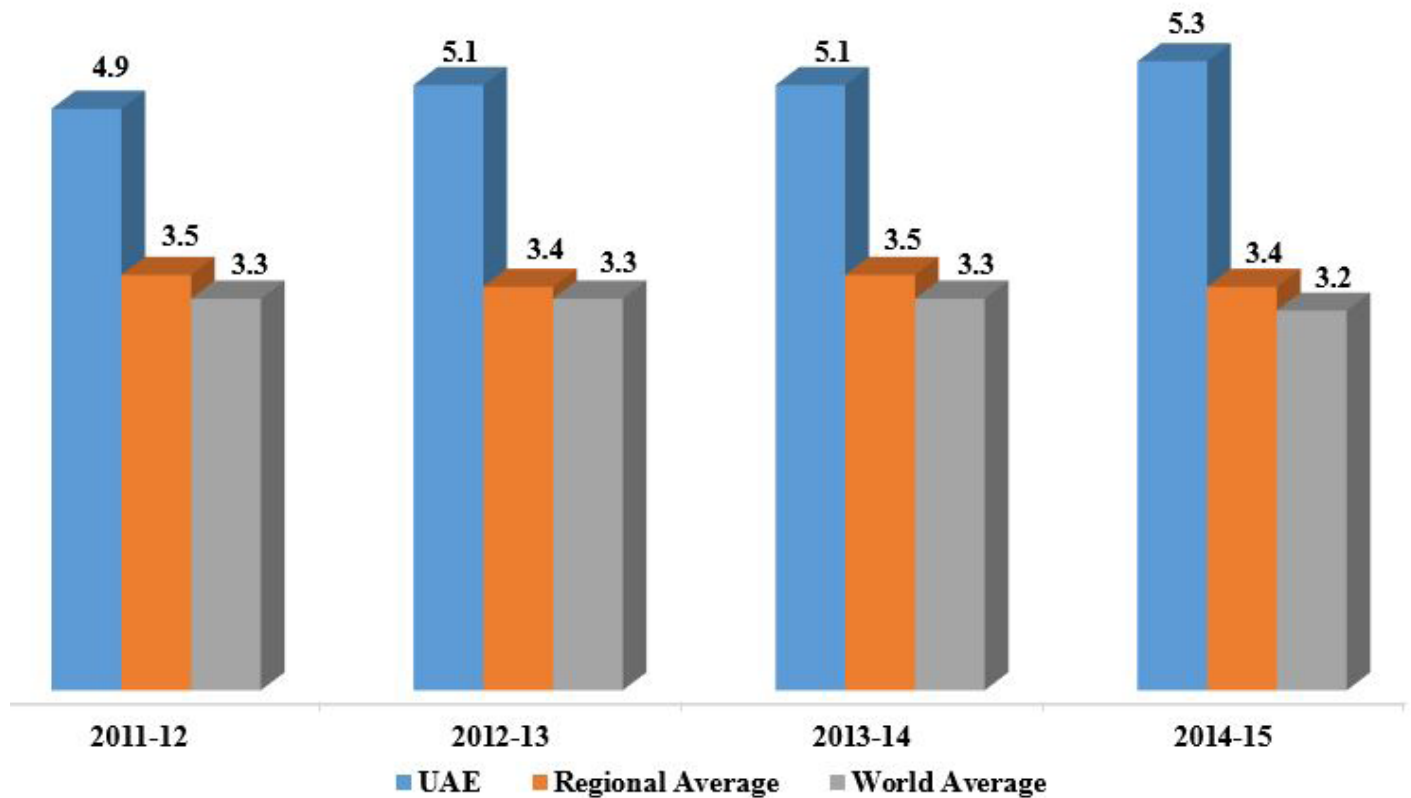
The Current Budget System Encourages Spending. Under the current system, known as “baseline budgeting,” the government sets the previous year's spending as the starting point for the future. Budget preparers assume all of the same programs and operating procedures, and only adjust the next year's fiscal outlook upward to account for actual spending, inflation and population growth. Since inflation and population growth are almost always positive, the budget almost always rises.

The U.S. government prefers this method because it avoids having to reinvent the wheel each year. It also costs very little and, for the most part, prevents officials from rigging budget documents or reports.

One of the most powerful criticisms of baseline or incremental budgeting is the incentives it generates. Specifically, the system goes beyond favoring the status quo — it actually encourages spending growth. By starting the conversation at the previous year's spending level, which in the DOD's case does not account for new conflicts or unanticipated flare-ups, baseline budgeting tilts the scales in favor of more spending. Further, it allows politicians to have their cake and eat it too: They can appear to cut the budget when all they are doing is changing the rate of spending growth.

The system also encourages budget officers to spend all of their funds before the end of the year. Why? If an official fails to use all of his allocation, the government reduces that unit's starting baseline for the following year. And because an official cannot be sure of surplus funds until the last few months of the budget year, he or she will likely be forced to spend the money quickly and inefficiently. A National Bureau of Economic Research (NBER) study actually documented this occurring: Researchers found that

Global Competitiveness Score (1 to 7 scale; least to most competitive)



Source: Klaus Schwab, *The Global Competitiveness Report*, World Economic Forum, various editions.

federal procurement spending was five times higher in the last week of the fiscal year than the weekly average for the rest of the year, and the quality of the projects was scored well below average.¹

(In the military, we called this the “use it or lose it” period. Every year, around the same time, we submitted a list of new “needs” for the budget, some of which were frankly unnecessary, to ensure we did not lose money in the coming year’s budget.)

Another Approach to Defense Spending? Zero-based budgeting requires departments and budget officials to start with the assumption that their unit will receive zero funds. Budgets are then constructed with every dollar requiring justification.² Precise analysis like this might avoid the kind of broad, unspecified budget reductions that resulted in 40,000 troops being cut from the U.S. Army, while very

expensive civilian and headquarters staffs actually grew.³

The zero-based approach to budgeting can pose problems, though. Initial implementation is costly and time-consuming, and it does not necessarily take into account the long-term goals of the organization.

Moreover, there is a knowledge gap between the central leadership and the lowest autonomous units in large organizations. The transmission of information from the departments to the center determines leadership’s ability to interpret the given information and to judge whether the proposals are useful. In large organization, such as the DOD, departments can exploit the knowledge deficit of the center to promote inflated expense requests or inaccurate evaluations.⁴ For this reason, zero-based

budgeting is primarily used in smaller organizations, such as cities and companies.

However, zero-based budgeting can still work for large bureaucracies. Costs can be relocated within a department to increase efficiency and create long-term savings. The simple act of evaluating line items and programs from a zero baseline encourages department heads to be more cost-conscious.

Because nothing is assumed, every budget cycle is a competition, and the burden of proof is on those who wish to raise spending. This could drive DOD officials to prove they are most efficient. They would be forced to justify expensive programs, redundant positions and unnecessary infrastructure. This simple act would likely encourage officers to trim excess and focus on mission-critical areas of the military, like readiness and training.

A study from global management consulting firm McKinsey & Company found that a well-implemented zero-based budget could save large corporations 10 percent to 25 percent, often within as little as six months. The analysis also found that this type of budget provided bigger, sustainable savings over a longer period than traditional cost reduction methods, such as workforce reduction, offshoring and outsourcing.⁵ If the DOD achieved results similar to corporations, just a 10 percent savings over the entire DOD budget would amount to \$53 billion.

National Case Studies. Several countries use variants of zero-based budgeting on the national level. Two examples are the UAE and New Zealand.

New Zealand. New Zealand has used a system similar to zero-based budgeting since 1994. They call it the rigorous performance-based system. Every year, baselines are neither assumed to be zero nor assumed to be the same as the previous year. Departments are required to justify their suggestions for the baseline, and the government as a whole issues a statement of policy priorities for the next financial cycle.⁶

In terms of results, after 1994, New Zealand

had 14 years of budget surpluses after nearly 15 consecutive years of budget deficits.⁷ The system’s longevity is likely due to its lower administrative costs. By starting at a baseline other than zero the budget process is likely slightly less contentious and less redundant. It could be a cost-minimizing compromise between zero-based budgeting and incremental/baseline budgeting.

The United Arab Emirates. The UAE system is probably the purest example of zero-based budgeting in practice. The emirates’ national government implemented zero-based reforms with their three-year budget for 2011-2013.⁸ It required departments to build budgets from the ground up every three years. In the first year, budgeted spending was reduced by about 6 percent from the year before. The UAE jumped to 5th rank globally in efficiency of government spending, as measured by the World Economic Forum’s (WEF) Global Competitiveness Index.⁹ The UAE also moved three places to 24th place in its overall global competitiveness ranking, in part due to the budgeting reform.¹⁰ [See the figure.] These gains came during a period in which the Middle East region, at large, seemed to become more wasteful.

With a \$530 billion budget in 2016, one-year savings of 6 percent for all DOD spending would amount to \$31.8 billion.

A Zero-Based Budgeting Framework for the DOD. Defense officials could modify the zero-based approach to account for the structure of the DOD by implementing the following steps:

1. The Secretary of Defense could initiate a comprehensive budget review every four years, in the middle of each presidential term. This approach could potentially avoid political problems and provide time for the Pentagon to grow accustomed to zero-based budgeting.
2. Certain departments within DOD could be required to adopt zero-based budgeting as a way to identify wasteful and redundant programs. For example, the Government

“Corporations and governments have achieved significant savings from zero-based budgeting.”

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Accountability Office (GAO) has identified different, overlapping camouflage and uniform initiatives as a cause of waste.¹¹

3. Departments within the DOD could be allowed to rollover unspent funds at the end of the fiscal year. An NBER study estimates that rollover reform of budgets could allow a department or agency to maintain the same level of procurement for 13 percent less money.¹² In other words, departments within the DOD would likely spend less money more wisely if they did not feel compelled to exhaust their “use-it-or-lose-it” money before the end of the fiscal year. Similar savings across the DOD would free up more than \$68 billion in funds, based on the 2016 DOD budget.

Conclusion. The traditional government budgeting system is simply not working. Zero-based budgeting could specifically help refocus national security priorities by ensuring money is spent in areas that promote defense and military readiness. Successful implementation would encourage Congress to take similar steps in other areas of government and perhaps change course before the country collapses under the weight of its own debt.

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Notes

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