

June 19, 1984

REMOVING THE PENTAGON'S PERVERSE BUDGET INCENTIVES

INTRODUCTION

More effective use of its resources is rarely the result of today's U.S. military budgeting process. If a department improves its effectiveness, it is often rewarded with a budget cut. If an ineffective program is eliminated, the result is a budget reduction rather than the opportunity to reallocate the funds to a promising alternative. Given such perverse incentives, reform in any area--weapons procurement, tactics, manpower training--is impossible.

This state of affairs is the result of the current item-by-item, line-by-line budget process, in which each piece of equipment and every spare part are authorized and appropriated for individually. High-level officials, including Members of Congress, have to review thousands of details in order to make budget decisions, a method that thereby flaws many of those decisions.

If military budgets were to be submitted in broader aggregations, decisions at the high level would be more goal directed, and the military departments themselves would have greater freedom to allocate funds within the larger aggregations to their most effective use. Such changes would create powerful incentives for military budgeting.

MILITARY MANAGEMENT

Managing a defense structure entails two major activities. The first is administration and resource allocation--the creation of combat forces like armored divisions, air wings, and fleets and the training of crews and troops to maintain and operate them. Such management is carried out by the statutory military departments--Army, Navy, and Air Force. The second activity is

command of these forces in the field, a function of the unified and specified commanders. The Department of Defense was created after World War II with authority over both of these activities.

Centralization

In this examination of the administrative and resource allocation activities of military management, it must be noted that the most significant characteristic of the Defense Department is a highly centralized management plan. This takes two forms. First, the centralized Defense agencies have assumed a number of functions that each military department used to perform for itself, such as intelligence, auditing, mapping, and logistics. Critics had found, for example, that the Army paid less for a specific item than the Navy. This suggested that there was "waste" and seemed to argue for a single agency to buy the item for all services. The problem with this reasoning is the assumption that the centralized agency can buy everything at the lowest price. In fact, a single agency is more likely to pay a higher price, because there is no immediate basis for the kind of comparisons available to more immediate overseers and hence less incentive to manage diligently.¹

The second and more dangerous form of this centralized management is the ever increasing involvement of the Office of the Secretary of Defense, the Service Secretariats, and the military headquarters in every aspect of management and operations. Field agencies and commands have lost much of their authority, and have been largely reduced to the role of providing information for headquarters' staffs. As more information pours into the headquarters, greater emphasis is placed on "coordination" between the different staff sections, which often leads to watering down or filtering the information. Not only do traditional staff sections grow, but new ones are created, such as those for systems analysis or operations research, partly to reconcile the often inconsistent information that competing staffs and staff sections fed superiors. A major casualty of this process is the quality of the information. Advocates in the process know that decisions made in headquarters are influenced if not determined by the information sent in. Accordingly, information received by superiors in senior headquarters (and presented to congressional committees) is tailored to serve the budgetary and political objectives of the agency producing the information. Few senior decision makers seem to realize the extent to which the information they use is either manipulated or produced to obfuscate rather than illuminate.

¹ For recent examples of such an evaluation in activities like personnel training and medical affairs, see the accounts described in Archie D. Barrett, Reappraising Defense Organization (Washington, D.C.: National Defense University, 1983), pp. 191-239.

Weapons Procurement

Among the major criticisms of weapon programs are their large cost overruns, failure to meet performance specifications, and slippages in time availability. Just as serious, the current generation of weapons is so costly to maintain and operate that the opportunity to train troops and crews--allowing them to fly and shoot new equipment--is constrained. This has had adverse effects on morale and personnel retention. Moreover, the combat effectiveness of many weapons is unknown, mainly because operational testing of weapons and tactical doctrine is inadequate.²

The lack of knowledge about tactical and operational effectiveness is one of the principal reasons that weapons acquisition often seems out of control. Performance requirements are limited primarily by what seems feasible within the state of the technical arts and not by the anticipated use of the weapons. The specifications for technical performance requirements are too often driven by the motive to win funding approval (and advocacy). Because there is so little rigorous operational testing of performance characteristics, the preferences of technicians rather than users dominate the weapons development process.

THE BUDGETING PROCESS AND THE INCENTIVES IT CREATES

The driving force of the military budgeting process is advocacy. Military services try to maximize their budget. Given a changing technology that may upset the status quo between the various specialized military functions, each service presses to obtain development funds for new weapons that will fortify its future role. Weapons also justify units--divisions, wings, and fleets--and thus provide a rationale as well for funding manpower resources.

In the post-World War II period, there have been two major approaches to the budgeting problem. Prior to the arrival of Robert McNamara as Secretary of Defense in 1961, each military service was restricted in total dollars and manpower, but each had much freedom to interpret foreign policy and to decide what was the most important military threat and how to meet it. Critics argued that this caused the individual services to place an undue proportion of their resources in some areas, while giving less attention to others, resulting in an unbalanced total force structure.

This service rivalry over budgets was not all bad. It led to some worthwhile developments, as illustrated by the Polaris submarine-launched missile. The Navy won out over strong Air

² See J. A. Stockfish, Plowshares into Swords: Managing the American Defense Establishment (New York: Mason and Lipscomb, 1973).

Force opposition. Today, with the growing vulnerability of land-based missiles, few would fault this third leg of the U.S. strategic triad. But critics nevertheless argued that there was unnecessary duplication of weapons development. To try to control the alleged proliferation of weapons development, the power of the Secretary of Defense was increased in the 1958 Defense Reorganization Act. But even so, the basic incentives of the military services and their respective combat specialties remained unchanged. New weapons justified and maintained a service's "share" of R&D resources and reinforced a service's claim to both a military mission and an overall budget. New weapons became as necessary to fight the budget wars as to fight real wars and equip troops.

McNamara sought to eliminate the imbalances resulting from interservice rivalry, and in fact, eliminated many of the major ones. A management instrument he used was to identify and cost out major mission categories such as strategic, conventional, and mobility forces, and elements within these major groupings. But he gave the military departments no broad budgetary guidance. Rather he asked the military departments, operating through the Joint Chiefs of Staff (JCS), to present their recommendations on how to meet the threat. The services consistently presented force recommendations which, when costed out, exceeded the Secretary's (and Administration's) view of requirements by around 30 percent, and the JCS had no ability to force a resolution. The Secretary then "cut back" on the services' recommendations, not in terms of total dollars but in terms of specific force structure elements and weapons acquisition programs. The systems analysis process McNamara introduced into the Pentagon used cost effectiveness techniques to aid, and then support, the Secretary's decisions. In this fashion, fine-tuned decisions on force structure and equipment were made and then forcefully advocated before congressional committees.

The dialogue between the Office of the Secretary of Defense (OSD) and the military services was conducted in terms of cost effectiveness analysis terminology, but neither cost nor effectiveness was held constant by the Secretary or OSD. That is, some programs would be cut back on cost considerations, others because of effectiveness. This lack of consistent criteria was especially frustrating and dangerous for service advocates. On many occasions strong service claims about the alleged effectiveness of a program were turned around to justify budget cuts ("If this system is so effective, then we don't need as many of them"). Hence the services became very careful about the kind of information they transmitted to the civilian leadership. This also explains why the services today have so little incentive to do rigorous operational testing: the results of such tests could be used by both Pentagon officials and Congress to justify budget cuts.

Although centralized decision making has increased in the Defense Department with the passage of time, it has long been a

feature of U.S. defense management. Congress almost always has been concerned with decisions on how money is spent, or reviewing and approving the many details of administration.

In the past, Congress was usually more interested in "where" the money was spent, such as the shipyards in which repairs would be made and the location of garrisons, than on what it was spent for. In terms of broad categories of spending, however, Congress has been more generous toward procurement than toward such operating expenses as training and exercises. As a result, tactical and operational skills had to be acquired during the early phases of a war (often at the cost of excessive casualties). In this setting, the military services--or more accurately the chiefs of military technical bureaus--catered to congressional interests and adapted military management to that tradition.³ Secretaries of War and Navy were involved in the same game frequently enough to have inspired the humorist, Mr. Dooley, to remark that "the first qualification of a Secretary of the Navy was that he should never have seen salt water outside of a pork barrel."

INFORMATION AND BUDGETARY INCENTIVES

To the extent that it is a motivation of a government agency or bureau to maximize its budget, its information and reporting system cannot help but be influenced by this incentive.⁴ If the budget has to be justified in a detailed way, whereby the total

³ For those not familiar with military lexicon "Technical Services" and "Bureaus" refer to the specialized sub-elements of the old Army and Navy, like the Army's Ordnance Corps, the Navy's Bureau of Ships, and so on. In the pre-World War II period, these agencies were powerful fiefdoms, which operated arsenals and shipyards, and were seldom "controlled" by anyone, including service chiefs, Secretaries of War or Navy, or even the President. They dominated weapon selection and procurement with mixed results. For example, the Civil War could have been won by the Union within a year of its outbreak if the Army's Ordnance Corps had promptly moved to acquire Henry and Spencer repeating rifles. But the Chief of Ordnance, General Ripley, adhered to the idea that muzzle loaders were good enough. Only the personal and active intervention by President Lincoln caused the Army to buy enough Spencer repeaters to equip Union cavalry late in the war. (After the war the Army promptly got rid of these weapons, and did not get a magazine rifle until some thirty years later). Many similar experiences during World War II and afterward supported the notion that civilians should dominate weapons development and procurement.

⁴ It is the contention here that it is a motivation of bureau professionals to try to maximize their budgets. This is not to assert that it is their sole motivation. The assumption can be derived from the point that budgets are necessary to enable bureaucrats to "do their thing"--to defend the country, educate the young, and thereby serve the "public interest." Budgets are also proxies for and a source of power.

is the sum of many items, each of which is scrutinized and approved by the higher authority, then the information on each of these items will be influenced by the budgetary incentive. Hence, subordinate agencies have incentives to provide only the most favorable information or even to fabricate information.

Manipulation of data is widespread by bureaucratic organizations and achievable by a variety of techniques. Military organizations have exaggerated the capability of opponents and understated that of friends. One way to do this is to count the equipment (e.g., tanks or aircraft) only of the friend's or ally's combat organizations and to compare this number with the opponent's total equipment procurement, which would include items in repair depots, those used for training, and stocks procured for combat consumption allowances.⁵ On one occasion the Senate Armed Services Committee noted that the U.S. Army's statement of rifle assets and requirements behaved in strange ways; the amount required decreased as the size of the Army increased during the early period of the Vietnam buildup.⁶ The reason for this was that the Army wanted to minimize its purchase of M16 rifles, which it did not develop, while it tried to develop (on a crash basis) a newer and more exotic weapon.

The same sort of incentive prompts organizations to avoid gathering information. This is why so little operational testing is done. This problem springs from characteristics of testing per se. A test might show that a favored doctrine or weapon might not be as good as had been claimed. If prior decisions were made, involving either large amounts of resources or the personal prestige of decision makers or staff advocates, the results of the experiment could be embarrassing--even politically damaging. Those likely to be hurt might be professional military officers, civilian policy makers, prominent scientists who have "staked" their professional reputation on a particular approach, or Congressmen concerned about defense contracts for their districts.

So long as this relationship between information and budgetary incentives continues and its impact on weapons system specification and force structure design prevails, managing the Defense Department will remain problematical. Clearly, information and analysis will not be improved unless the incentives are changed. Better decisions cannot be made unless better information is available. Management changes, such as reorganizations, the strengthening (or weakening) of offices or staffs, the introduction of different

⁵ For an account of one such example relating to the Royal Air Force's estimates of the German air order of battle, after the Battle of Britain, see R. F. Harrod, The Prof (London: Macmillan, 1959), pp. 3-5.

⁶ See Hearings before the Preparedness Investigating Subcommittee, Committee on Armed Services, United States Senate, 90th Congress, First Session, Army Rifle Procurement and Distribution Program (Washington, D.C.: U.S. Government Printing Office, 1967).

reporting systems (the standard stuff of management experts and specialists) hardly come to grips with the real problems. Indeed, these traditional "cures" often worsen things. A more fruitful approach would be to find ways to harness the bureaucratic incentives constructively and to minimize the effects of negative incentives.

CHANGING THE INCENTIVES BY CHANGING THE BUDGETING PROCESS

Although it is true that Defense Department management has become too centralized, the real problem is that political decision makers make too many decisions with inadequate information. The budgeting process works to prevent them from acquiring, or using, the right kind of information from the military. This would continue even if, for example, the power of the Office of the Secretary of Defense were drastically reduced, but the requirement continued to justify budgets in the same highly detailed way to congressional committees.

Improvement of defense management to achieve greater efficiency and military effectiveness is not feasible unless the quality of information can be improved. This is impossible unless those who are most knowledgeable about specialized military combat roles have strong incentives to engage in detached study of their specialities. But when dollars are at stake, the quest for knowledge will not be critical or detached.

Creating the proper incentives requires that the service budgets be presented and acted on in larger aggregations. Item-by-item budgets must give way to budget categories that reflect an aggregation of related items. Conversely, the military should be given greater freedom to control and reallocate within those aggregations. These major budget aggregations should be determined by high-level civilian officials (in both the Executive and Congressional branches). Ways should be sought to minimize the involvement of the military in these high-level budgetary considerations. Rather, the expertise of the military professionals should be used to create as much combat capability as possible for the resources provided to them by the civilians.

For example, it might be decided that 20 active land force divisions are needed to meet U.S. commitments. These might cost, including a share of the R&D budget, \$100 billion a year. This dollar figure could be regarded as a "baseline" budget for the broadly defined military mission described as "land war." This amount (adjusted over time for inflation) should only be changed by the most senior civilian authorities on the basis of broad foreign policy changes, revised threat assessment, or major fiscal policy considerations. Initially, if there were three Marine Corps divisions and seventeen Army divisions, \$15 billion of the \$100 billion mission budget could be allocated to the Marine Corps, and the remaining \$85 billion to the Army. It could further be made known to both of these services that if one

of them were able to squeeze more combat effectiveness out of its budget than the other, some future budget reallocation in favor of the more efficient service might be made. Such an approach would harness interservice rivalry in a constructive way.

This would require that the civilian authorities have the means to evaluate and judge the potential combat efficiency of the competing services. For this purpose, emphasis should be placed on readiness evaluation (including unannounced drills) that emphasize unit tactical and operational skills. Shooting, target location and identification, performance of reconnaissance missions, ability to carry out tactical and strategic deployments with limited advance notice, capability to sustain operational activity--all these and other tactical and operational support functions can be tested and measured in imaginative ways relative to available resources. With such measures, civilian political authorities and unified operating commanders periodically could evaluate the outputs of the military departments, adopt a role similar to that of a consumer in the marketplace, and discard the present role of attempting to infer capability by examination of detailed budget information.

If budget aggregations were provided for mission categories, the military user would be put on notice that if he bought a costly weapon, he would have to give something up. Conversely, if he developed more efficient ways of maintaining equipment, the money saved could be used to buy something else. Such a system would introduce a strong incentive to eliminate marginal or redundant items. More important, it would create a strong incentive for military users to raise questions and acquire information about which items were redundant. The same skepticism should extend to costly, incremental technical performance features of proposed new systems.

The aim is to reduce greatly, if not to eliminate, the current connection between the total dollars received for equipment and the specific items procured, so that the decision to buy or not to buy a particular item will not affect the budget allocated to a given mission or military combat specialty. Under the present system, claims are made for development programs because they provide a justification for funding. Support of such claims by rigorous tests, often possible by field experimentation, is seldom attempted. Under the suggested approach, a service would find that its own best interests would be served by thorough operational testing. In such a setting, the service would acquire equipment to achieve effectiveness, rather than to obtain dollars.

To allow the services greater latitude to make choices, however, presents a potential problem that the wrong choices might be made to the detriment of force readiness and sustained combat operations. Needless to say, choices like these have a high foreign policy content. Combat ready forces (and their

wartime stocks), however, must be maintained. Defense authorities must see that this wider latitude does not undermine readiness.⁷

The general management philosophy implicit in the above is twofold:

First, the military departments and their major combat specialties should have maximum opportunity and incentive to try to get as much combat capability as possible from the resources budgeted to them. They must be able to make tradeoffs among the diverse, highly specific resources currently identified as budgetary line-items. To make these tradeoffs, they must economize on some items, but they must also be allowed to spend savings in other ways that contribute to combat effectiveness. This is simply another way of saying that military specialists should have more freedom than they now have to allocate (and reallocate) resources. This is also an argument for much less detailed decision making through budgetary channels on the part of Congress and the Office of the Secretary of Defense.

Second, the military departments must operate under resource and policy constraints. These must be set by the highest civilian authorities. The civilian authorities must allocate the budget in terms of major missions and statutory military departments. Moreover, they must specify combat readiness and sustainability in ways consistent with national security objectives and coordinated among the various combat specialties, including land, air, naval, and strategic deployment forces.

The underlying philosophy of this proposal is one whereby political authorities resist trying to manage in detail through budget channels and attempt to create more productive incentives, which would both encourage and allow the military professionals to manage resources effectively.

⁷ This subject, of course, has many dimensions: the role of reserves, mobilization planning, consistency among diverse combat and service element (e.g., land, tactical air, and strategic lift), foreign basing, arrangements with possible allies, and finally, criteria by which readiness of combat units may itself be specified and measured. Readiness criteria are unduly specific in terms of such input concepts as percentage of authorized troops or materiel present in the unit. As an alternative, emphasis should be placed on measures that are closer to military output, such as how quickly and well can a unit deploy and perform simulated missions. Apart from giving troops and crews desirable exercise and training, readiness evaluation exercises keyed to appropriate output measures would also provide much valuable information about equipment and manning requirements and about the management skills of individual commanders. But, again, strong incentives to generate this kind of information are lacking under the present budgeting and planning system.

CONCLUSION

Congress should aggregate its Defense appropriations along mission or service lines. The services, in turn, should be allowed to reprogram the funds within these categories to attain maximum efficiency. The current item-by-item budgeting creates the wrong incentives and a sense that the budget must be protected at any cost. Killing a marginal program results in lost budget dollars and no assurance (or even reasonable expectation) that those dollars can be spent on an alternative. Aggregate budgeting with reprogramming authority would create the proper incentive: to maximize effectiveness. Congress, of course, would retain the control it needs to implement a policy aim. It could, for example, preclude development of a certain kind of weapon simply by prohibiting expenditures for such weapons. Fine-grained budgeting and management by Congress--and perforce by the Pentagon--has proved counterproductive. Aggregate budgeting offers a solution that would not only improve military effectiveness but might even allow the Congress to pass a defense appropriations bill on time.

Prepared for The Heritage Foundation by
J. A. Stockfish*

* J.A. Stockfish is Senior Economist with the American Petroleum Institute, Washington, D.C. He is the author of Plowshares into Swords: Managing the American Defense Establishment, a study of military procurement.