

PRESIDENT'S FY 2016 BUDGET PROPOSAL

A DETAILED LOOK AT THE DEFENSE BUDGET AND THE THREAT OF SEQUESTER



FEBRUARY 11, 2015

© 2015 Squire Patton Boggs. All rights reserved.

This report was prepared for the use of our clients and friends. Consistent with fair use, this report may be quoted or reproduced in part without the express prior written consent of Squire Patton Boggs.

OVERVIEW

President Obama's defense base budget request for FY 2016 is \$534.3 billion, which is an increase of \$38.2 billion over the FY 2015 enacted amount. The request also includes \$50.9 billion for the Overseas Contingency Operations (OCO) account, a decrease of \$13.3 billion (-21%) from FY 2015. The OCO reflects the drawdown of US forces in Afghanistan, but accounts for the continuing threat in the Middle East from the Islamic State of Iraq and the Levant (ISIL) and US and allied efforts to counter Russian aggression in Ukraine.

There is good news for the defense industry in the FY 2016 budget if Congress enacts the totals the President has requested. Procurement and Research, Development, Test, and Evaluation (RDT&E), which together are referred to as the modernization accounts, are funded at \$177.5 billion, an increase of \$20 billion over FY 2015. This total includes major increases in funding for C-130Js, the F-35 Joint Strike Fighter, AH-64E Apaches, UH-60 Blackhawks and P-8A Poseidons. It also reflects significant increases for the Air Force Long Range Strike and KC-46A Tanker programs.

Ground programs that are receiving a plus-up for FY 2016 include the Joint Light Tactical Vehicle, the Armored Multi-Purpose Vehicle and the Marine Corps Amphibious Combat Vehicle. Shipbuilding increases include additional funds for the Gerald R. Ford (CVN-78), the DDG-51 program and the first ship of a new class of Fleet Replenishment Oiler. Spending for the LPD-17 class Amphibious Transport Dock is down significantly.

The Family of Medium Tactical Vehicles continues to be sustained through the OCO fund. The decrease of 21% from last year's level of funding will continue to have an adverse effect on those companies that supply individual and unit equipment, as well as consumables that are essential to troops in the field but not needed in great quantities when they return from deployment.

While a \$20 billion increase in the modernization accounts is significant, it must be looked at in its historical context in order to appreciate how much defense spending has been reduced over the past eight years. In terms of constant FY 2015 dollars, the FY 2016 total requested for the modernization accounts is about the same as in FY 2003. Spending in the modernization accounts rose steadily after 2003, hitting a peak of \$273.7 billion in FY 2008, before bottoming out in FY 2015 at \$157.1 billion. Even at \$177.5 billion, the FY 2016 requested spending on modernization is only at 65% of the peak year of FY 2008. In essence, the level of effort within the defense industry has contracted by 35% since then.

THE THREAT OF SEQUESTER FOR FY 2016

The defense budget exceeds the cap set for FY 2016 by the Budget Control Act of 2011 by \$35 billion. That means, if Congress were to appropriate the full base budget requested of \$535 billion and not alter the sequester provisions in the law, the Department of Defense (DoD) would be forced to cut each and every budget program by the same percentage across the board as it had to do in FY 2013. Because DoD can protect the military personnel account from sequester, the resulting percentage cut to the modernization accounts could be as high as 9%. If Congress were to pare back the budget request to meet the cap levels, it would completely eliminate the FY 2016 \$20 billion increase in the modernization accounts according to the DoD April 2014 report on the "Estimated Impact of Sequestration—Level Funding." Operations and Maintenance (O&M) funding would also be pared back by \$12.1 billion. This level of O&M funding would, for example, allow the Air Force to fulfill only 67% of its sustainment requirements. Army depot maintenance would be funded at 65%; Navy ship and aviation depot maintenance at 70%; and Marine Corps maintenance at 57%.

As the FY 2016 defense budget moves through the congressional authorization and appropriation process – hearings, mark-ups and floor consideration – Congress can take one of three courses:

1. cut the budget request by \$35 billion by eliminating and cutting back on personnel, acquisition programs and readiness;
2. appropriate the requested funds and allow sequester to take effect; or
3. amend the sequester provisions to raise the caps in part or eliminate sequester altogether.

The Politics of Sequester

Since sequester began, the President, the Service Chiefs, and both the Republican and Democratic members of the House and Senate Armed Services and Defense Appropriations Committees, have agreed that it is not a smart way to manage the defense budget. However, despite all the criticism and its effects on military readiness, no one has come up with a better alternative.

For example, in August of 2014, the then Chairman of the Senate Armed Services Committee, Senator Carl Levin, indicated that Congress would soon find a way out of sequester. According to Defense News, Levin had been engaged in behind-the-scenes talks to close tax loopholes and use the increased revenue to restore the cuts called for by sequester. Levin predicted that something would happen before the end of the last Congress. However, nothing materialized and Senator Levin is now retired.

There are three camps with different views about how (or even if) sequester should end. The Democrats, led by the President, believe that sequester must be repealed for both defense and domestic spending. Senator Bernie Sanders of Vermont, who is the Ranking Member on the Senate Budget Committee, has said that he will strongly oppose any attempt to increase defense spending by taking money from domestic programs. Senate Democrats who oppose fixing just defense will almost certainly prevent the Republicans from getting the 60 votes needed to move that kind of legislation. Even if such a bill made it to the White House, it is doubtful the President would sign it.

The second group consists of the defense hawks, mostly Republicans in the House and Senate, who strongly believe that the threats facing the country demand an increase in defense spending and therefore relief from sequester. The new chairman of the House Armed Services Committee, Congressman Mac Thornberry of Texas, has acknowledged that new revenues (read "taxes") may be needed to provide sequester relief for defense. Fellow conservative and member of the Senate Armed Services Committee, Senator Lindsey Graham of South Carolina, would seem to agree. Megan Scully of Congressional Quarterly quoted Graham as saying, "You can't do defense without nondefense," and that he too was considering revenue increases. But, according to Scully, Graham's fellow member on the Senate Armed Services Committee, Senator Jeff Sessions of Alabama, will consider ending sequester for only defense. Even if the defense hawks could get enough votes to move forward to provide relief only for the defense budget, such a plan would still find stiff opposition from the Democratic camp.

Finally, the third group consists of the deficit hawks, mostly conservative members of the House of Representatives. With the increase in conservative Republican members in the House as a result of the November elections, this block could number 90 to 100 votes. This segment of the Republican Party is committed to reducing federal spending and eliminating the deficit. This group will oppose any changes in sequester without a dollar for dollar reduction (and maybe even more) in other federal spending. They would also oppose any tax increases specifically aimed to increase federal spending, defense included.

After only a week into the budget process, it is too early to predict the outcome of this far-reaching debate. As the past is usually the best guide to predict congressional action, it appears that nothing will be seriously considered until almost the last minute. With time running out and the presidential election of 2016 moving into full swing, a short term compromise for FY 2016, in the form of partial relief for defense, is the most likely outcome. That could still require DoD to shed some \$20 billion to \$25 billion in procurement, RDT&E and readiness accounts. Worse yet, if Congress does not finish its work until late December, the cuts will have to be absorbed over the last three quarters of the new fiscal year. It will be a daunting task for DoD to absorb those cuts while actually executing the budget, and it will be something felt throughout the defense industry as DoD will freeze almost everything, except the most essential spending, until it knows exactly how much it will have to spend and can devise a plan to absorb the shortfall.

For questions regarding this analysis, please contact:

Jack Deschauer

Partner
Washington DC
T +1 202 457 6338
E jack.deschauer@squirepb.com

Jack Kingston

Principal
Former Member of Congress (1993-2015)
Washington DC
T +1 202 457 6523
E jack.kingston@squirepb.com

