

UNITED STATES GOVERNMENT ACCOUNTABILITY OFFICE

21st Century Challenges:
U.S. Financial
Condition and
Selected DOD
Transformation
Issues

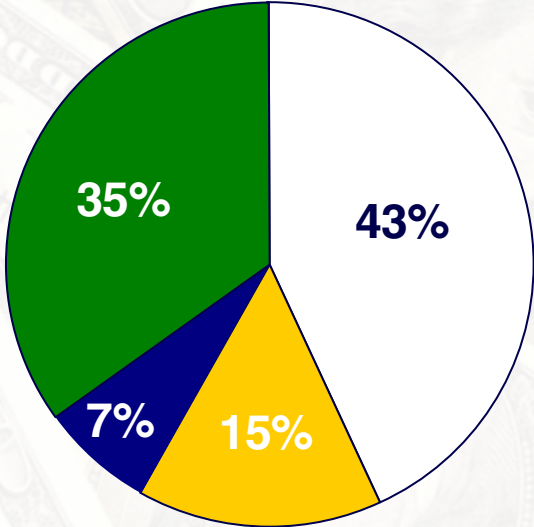
The Honorable David M. Walker
Comptroller General of the United States

Knight Center for Specialized Journalism
February 13, 2006

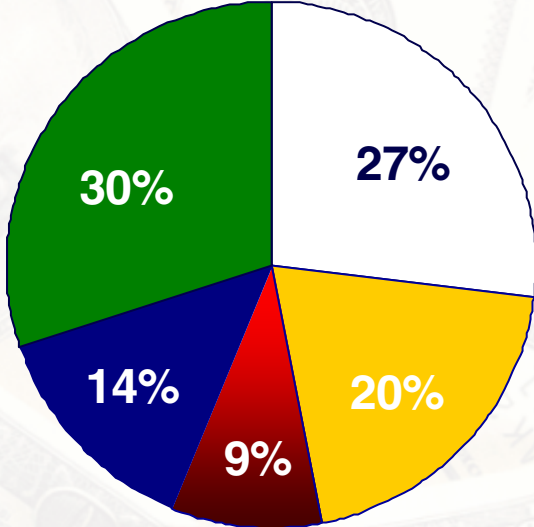


Composition of Federal Spending

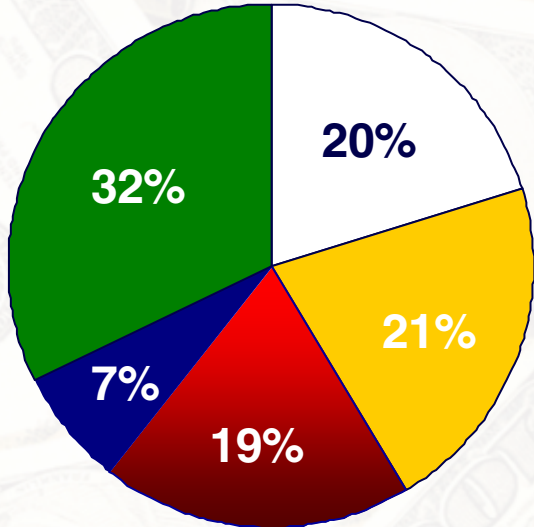
1965



1985



2005



Defense

Net interest

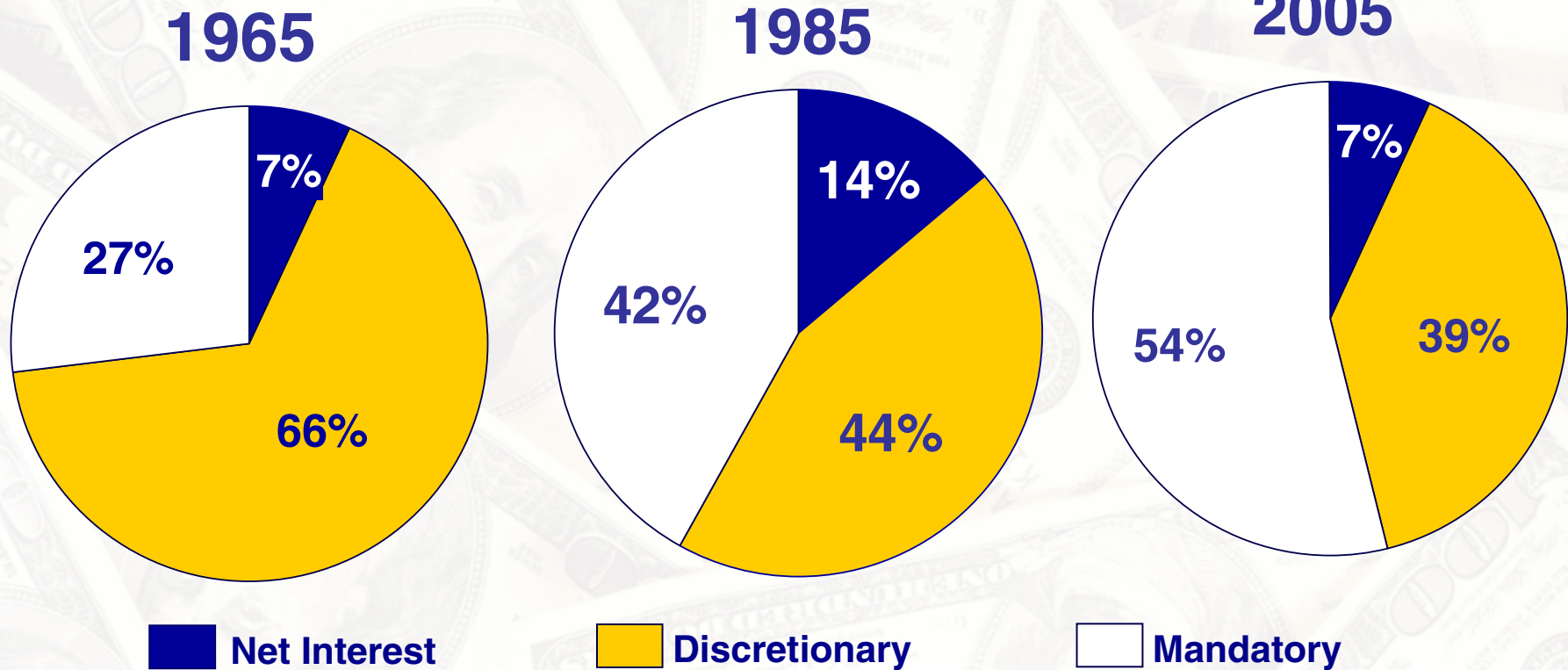
Social Security

All other spending

Medicare & Medicaid

Source: Office of Management and Budget and Department of Treasury, Financial Management Service.

Federal Spending for Mandatory and Discretionary Programs

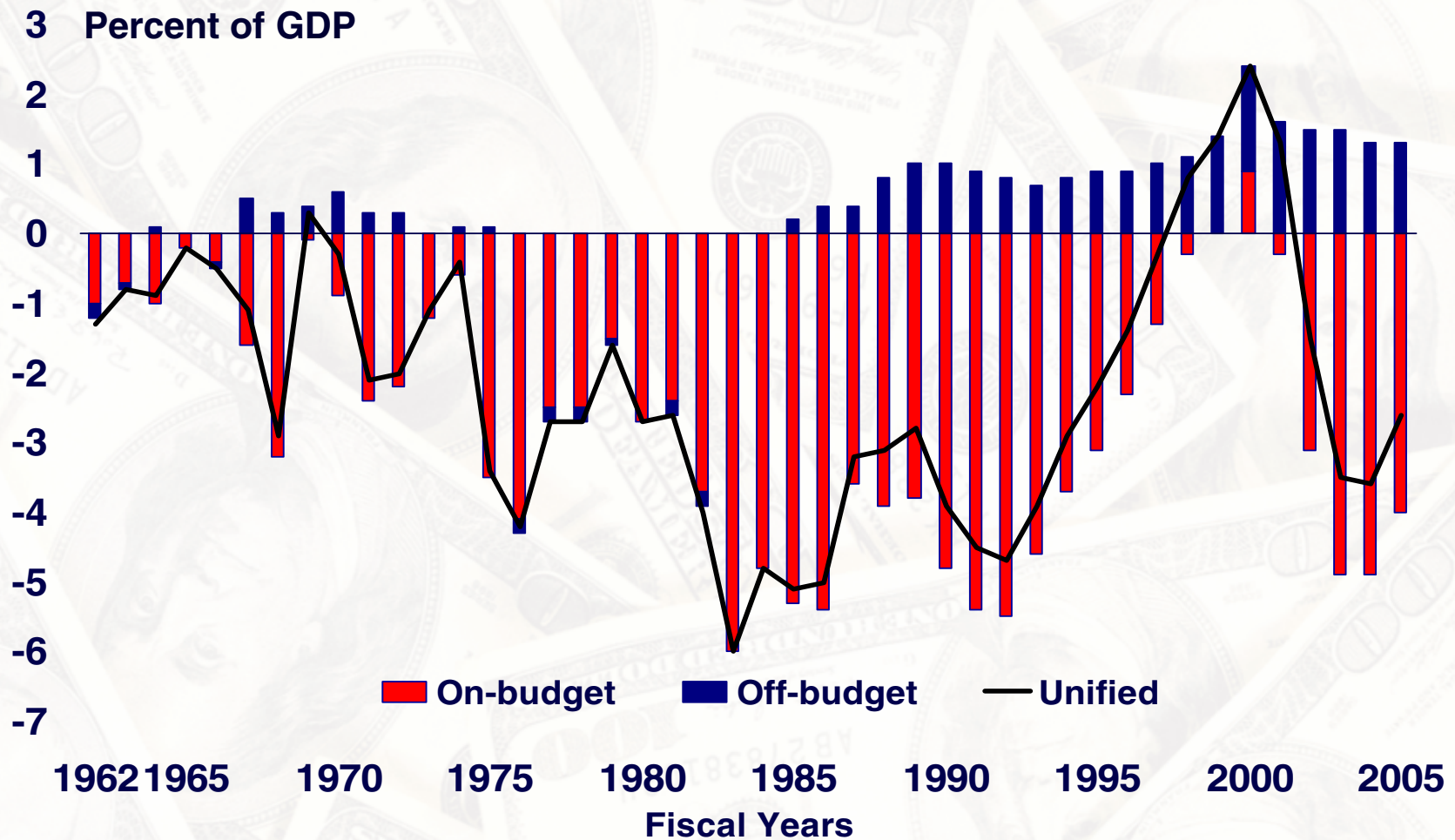


Source: Office of Management and Budget and Congressional Budget Office.

Note: Fiscal year 2005 data are estimated.

Surplus or Deficit as a Share of GDP

Fiscal Years 1962-2005



Source: Office of Management and Budget and Congressional Budget Office.

Fiscal Year 2004 and 2005 Deficits and Net Operating Costs

	Fiscal Year 2004	Fiscal Year 2005
	(\$ Billion)	
On-Budget Deficit	(567)	(494)
Off-Budget Surplus*	155	175
Unified Deficit	(412)	(319)
Net Operating Cost	(616)	(760)

*Includes \$151 billion in fiscal year 2004 and \$173 billion in fiscal year 2005 in Social Security surpluses and \$4 billion in fiscal year 2004 and \$2 billion in fiscal year 2005 in Postal Service surpluses.

Estimated Fiscal Exposures

(in \$ trillions)

	2000	2005
• Explicit liabilities	\$6.9	\$9.9
<ul style="list-style-type: none"> • Publicly held debt • Military & civilian pensions & retiree health • Other 		
• Commitments & Contingencies	0.5	0.9
<ul style="list-style-type: none"> • E.g., PBGC, undelivered orders 		
• Implicit exposures	13.0	35.6
<ul style="list-style-type: none"> • Future Social Security benefits 	3.8	5.7
<ul style="list-style-type: none"> • Future Medicare Part A benefits 	2.7	8.8
<ul style="list-style-type: none"> • Medicare Part B benefits 	6.5	12.4
<ul style="list-style-type: none"> • Medicare Part D benefits 	--	8.7
Total	\$20.4	\$46.4

Sources: Consolidated Financial Statements.

Note: Estimates for Social Security and Medicare are PV as of January 1 of each year as reported in the Consolidated Financial Statements and all other data are as of September 30.

How Big is Our Growing Fiscal Burden?

	2000	2005
Total Fiscal Exposures	\$20.4 trillion	\$46.4 trillion

Burden

Per Person	\$72,000	\$156,000
Per Full-time Worker	\$165,000	\$375,000
Per Household	\$189,000	\$411,000

Sources: GAO analysis.

Composition of Spending as a Share of GDP

Under Baseline Extended

Percent of GDP

50

40

30

20

10

0

Revenue

2005

2015

2030

2040

Fiscal year

■ Net interest ■ Social Security ■ Medicare & Medicaid ■ All other spending

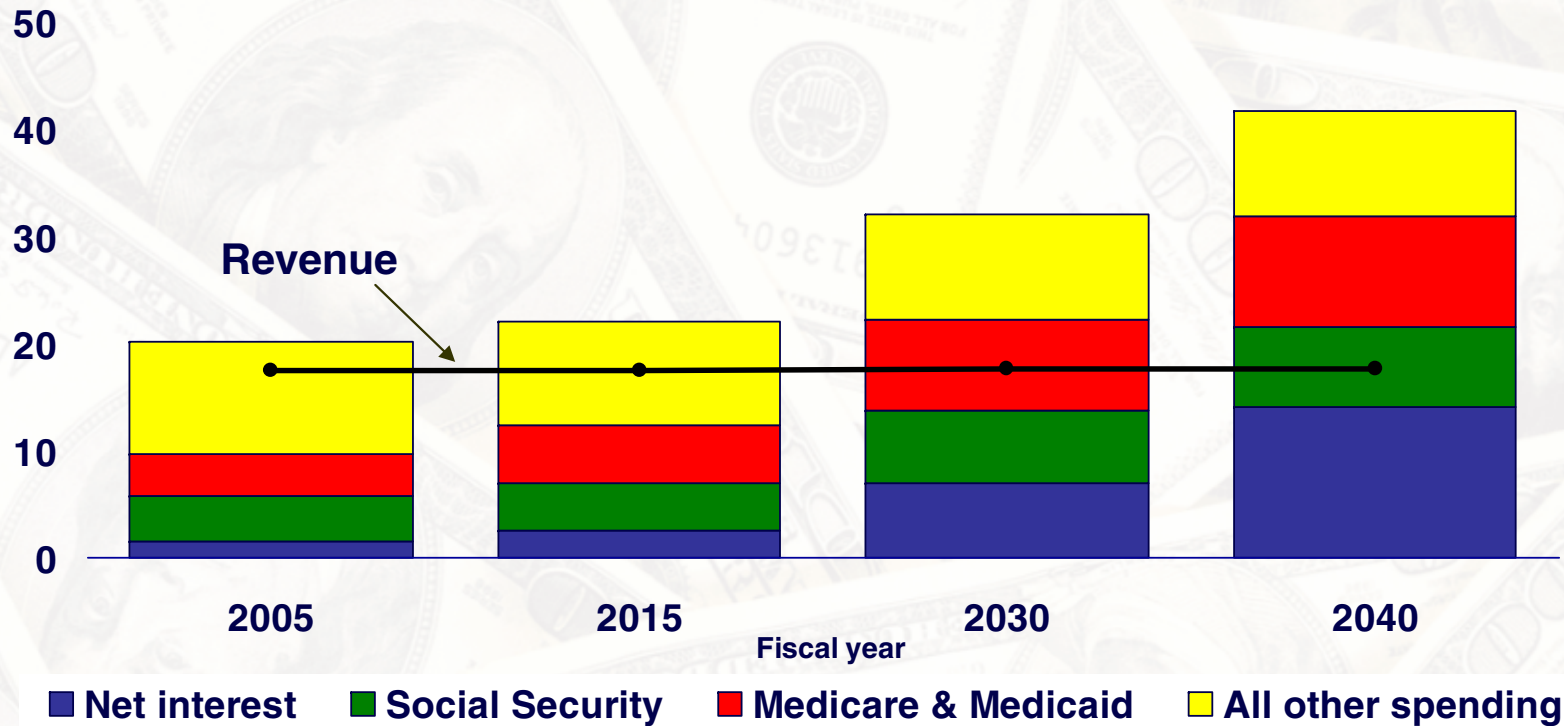
Note: This includes certain tax provisions that expired at the end of 2005, such as the increased AMT exemption amount.

Source: GAO's January 2006 analysis.

Composition of Spending as a Share of GDP

Assuming Discretionary Spending Grows with GDP after 2006
and All Expiring Tax Provisions Are Extended

Percent of GDP

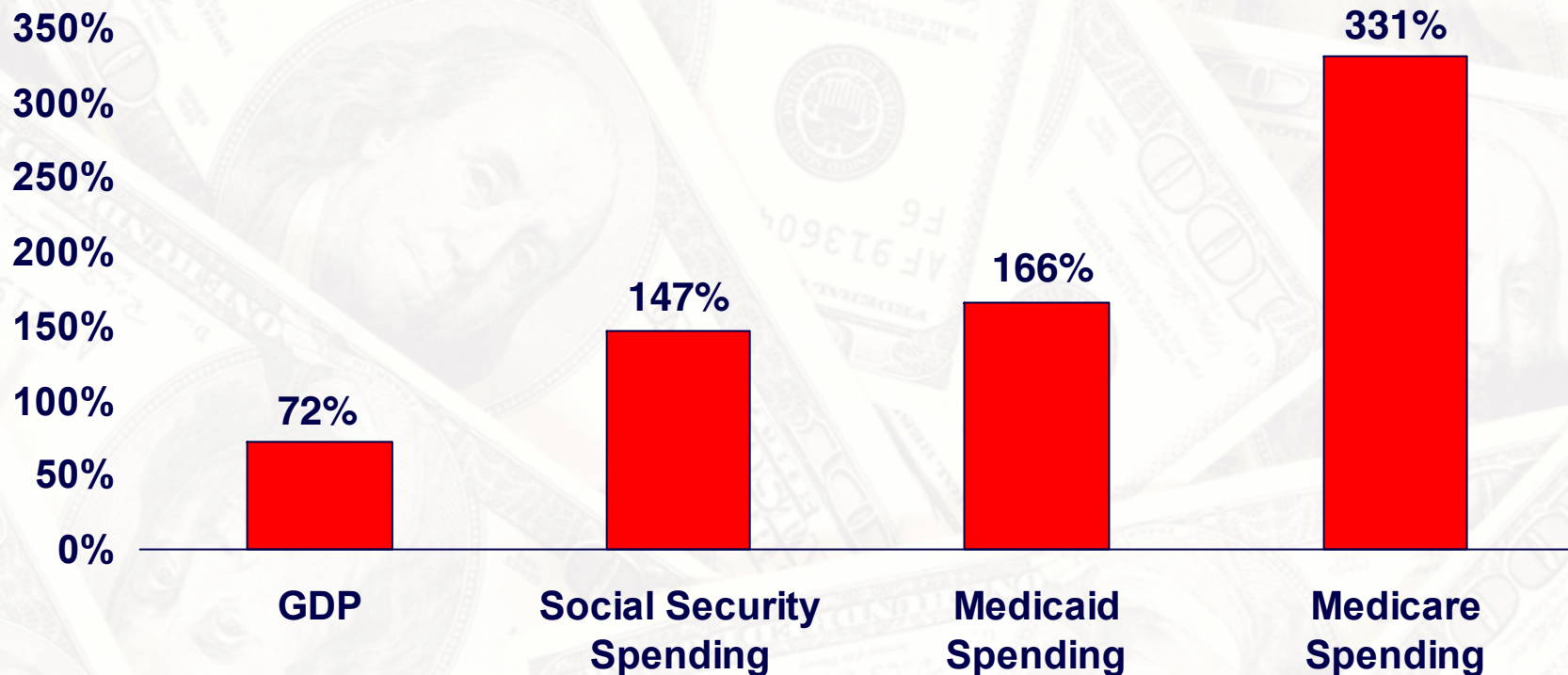


Note: This includes certain tax provisions that expired at the end of 2005, such as the increased AMT exemption amount.

Source: GAO's January 2006 analysis.

Growth in Spending for Social Security, Medicare, and Medicaid Expected to Outpace Economic Growth

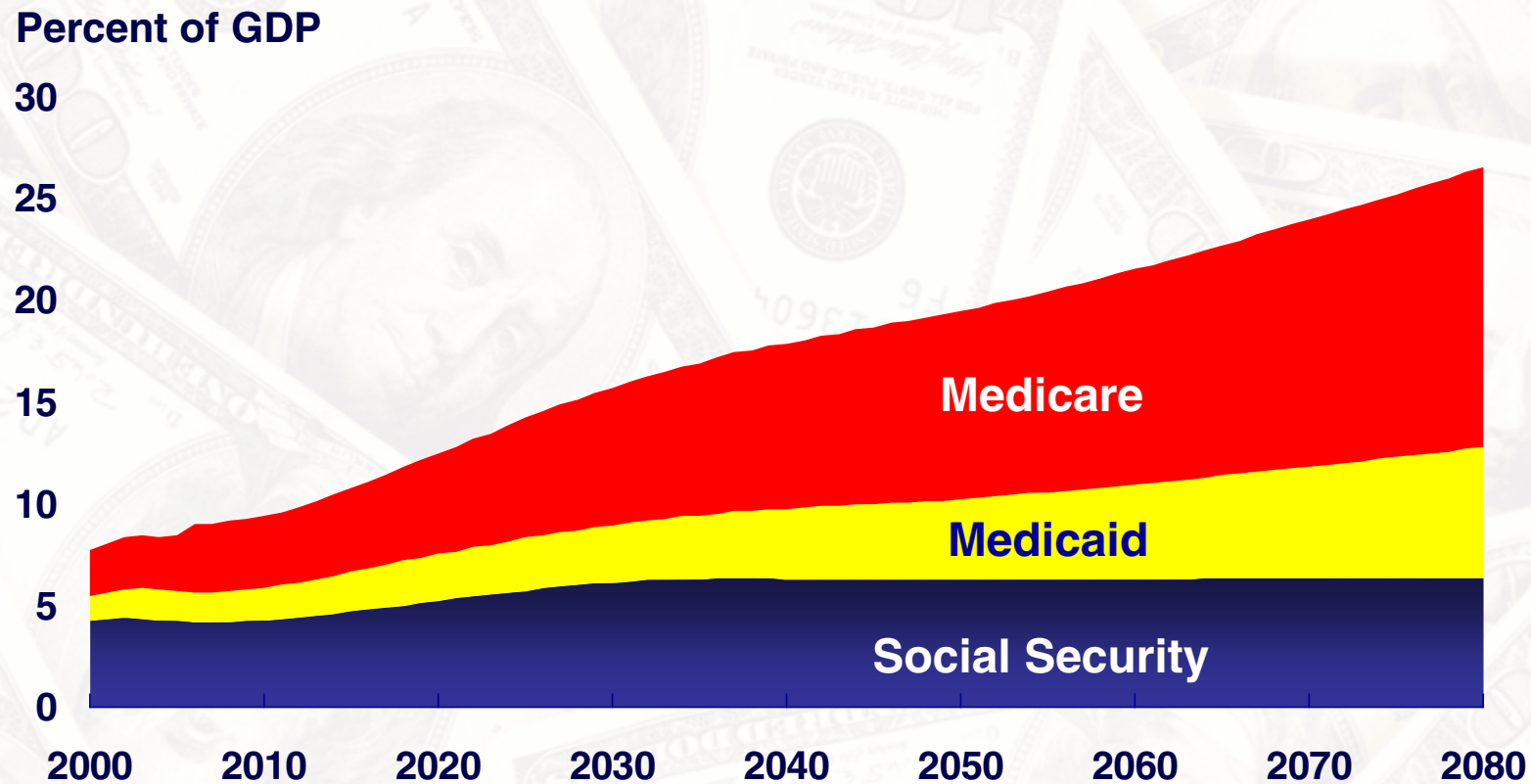
Growth in constant dollars 2005-2030



Note: Social Security and Medicare projections based on the intermediate assumptions of the 2005 Trustees' Reports. Medicaid projections based on CBO's December 2003 long-term projections for federal spending on Medicaid under mid-range assumptions.

Source: GAO analysis based on data from the Office of the Chief Actuary, Social Security Administration, Office of the Actuary, Centers for Medicare and Medicaid Services, and the Congressional Budget Office.

Social Security, Medicare, and Medicaid Spending as a Percent of GDP



Source: GAO analysis based on data from the Office of the Chief Actuary, Social Security Administration, Office of the Actuary, Centers for Medicare and Medicaid Services, and the Congressional Budget Office.

Note: Social Security and Medicare projections based on the intermediate assumptions of the 2005 Trustees' Reports. Medicaid projections based on CBO's January 2006 short-term Medicaid estimates and CBO's December 2005 long-term Medicaid projections under mid-range assumptions.

Current Fiscal Policy Is Unsustainable

- **The “Status Quo” is Not an Option**

- We face large and growing structural deficits largely due to known demographic trends and rising health care costs.
- GAO’s simulations show that balancing the budget in 2040 could require actions as large as
 - Cutting total federal spending by about 60 percent or
 - Raising federal taxes to 2 times today's level

- **Faster Economic Growth Can Help, but It Cannot Solve the Problem**

- Closing the current long-term fiscal gap based on reasonable assumptions would require real average annual economic growth in the double digit range every year for the next 75 years.
- During the 1990s, the economy grew at an average 3.2 percent per year.
- As a result, we cannot simply grow our way out of this problem. Tough choices will be required.

The Way Forward: Three Pronged Approach

- **Re-impose budget controls and enhance legislative process**
- **Improve accounting and reporting and other metrics (e.g. key national indicators)**
- **Re-examine, re-prioritize and re-engineer the base of current federal spending programs and tax policies**

21st Century Challenges Report

- Provides background, framework, and questions to assist in reexamining the base
- Covers entitlements & other mandatory spending, discretionary spending, and tax policies and programs
- Based on GAO's work for the Congress
- Issued February 16, 2005



Twelve Reexamination Areas

MISSION AREAS

- Defense
- Education & Employment
- Financial Regulation & Housing
- Health Care
- Homeland Security
- International Affairs
- Natural Resources, Energy & Environment
- Retirement & Disability
- Science & Technology
- Transportation

CROSSCUTTING AREAS

- Improving Governance
- Reexamining the Tax System

Illustrative 21st Century Questions: National Defense

- How should the historical allocation of resources across services and programs be changed to reflect the results of a forward-looking comprehensive threat/risk assessment as part of DOD's capabilities-based approach to determining defense needs?
- Can DOD afford to invest in transformational systems such as the Future Combat System and national missile defense at the same time it continues to pursue large investments in legacy systems such as the FA-22 and new systems like the Joint Strike Fighter, especially if cost growth and schedule delays continue at historical rates?
- Given the global availability of rapidly advancing technology, does DOD need to reconsider its approach for identifying critical technologies and protecting those technologies from being exploited in order to maintain its military superiority?

Illustrative 21st Century Questions: National Defense

- Given the growing encumbrance of pay and benefit costs, especially health care, within DOD's budget, how might DOD's recruitment, retention, and compensation strategies (including benefit programs) be reexamined and revised to ensure that DOD maintains a total military and civilian workforce with the mix of skills needed to execute the national security strategy while using resources in a more targeted, evidence-based, and cost-effective manner?
- Do the role, size, and structure of forces and capabilities comprising the strategic triad need to be adjusted to meet the challenges of providing strategic deterrence in the new security and fiscal environment?
- Does DOD need to create a senior management position responsible and accountable for taking a strategic, integrated, and sustained approach to managing the day-to-day business operations of the department, including ongoing efforts to transform DOD's business operations and address the many related and longstanding high-risk areas? Should specific qualifications requirements and periods of tenure or terms be established for selected DOD positions related to key business operations?

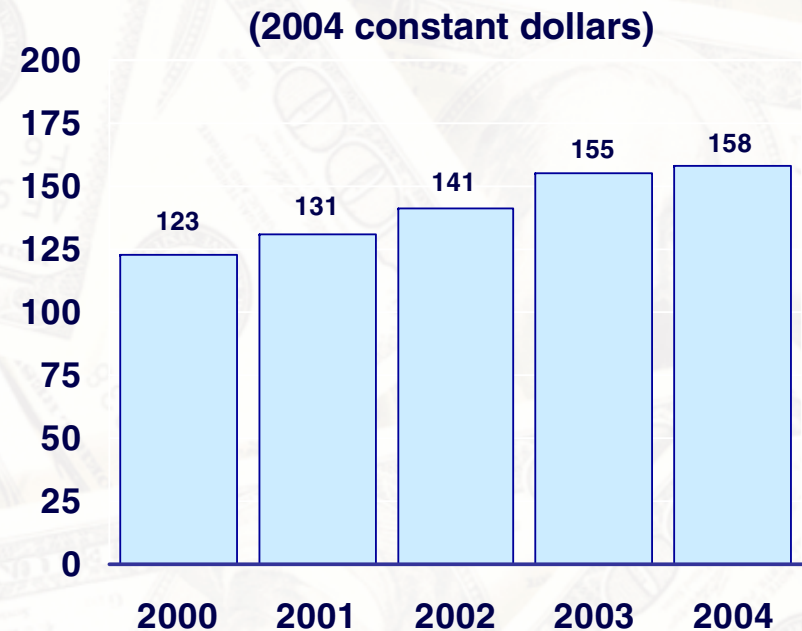
DOD Lacks An Affordable Plan to Balance Current Requirements With Investments in New Capabilities

- **DOD needs to reexamine its force structure and business processes to meet 21st century challenges.**
- **DOD plans to transform its military capabilities may not be affordable or sustainable.**
- **DOD's efforts to transform its business systems and processes will take many years to achieve.**

Active Duty Personnel Pay and Benefits Need To Be Reexamined and Revised

- The cost of active duty pay and benefits was \$158 billion in fiscal year 2004 and growing.
- Enhanced pay and benefits, including health care costs, increased costs to an average of \$111,783 per person.
- DOD needs to assess the affordability and sustainability of the compensation system and the reasonableness and appropriateness of the allocation to cash and benefits and whether changes could more efficiently achieve recruiting and retention goals.

Total Compensation Costs for Fiscal Years 2000-2004



Source: GAO analysis.

¹Our calculations include supplemental funding for the Global War on Terrorism. Since fiscal year 2002 over 100,000 mobilized reservists were paid out of the cash compensation. If you considered these personnel, the average costs to provide compensation would be about \$5,000 per capita lower.

DOD Continues to Confront Pervasive, Longstanding Management Problems Related to Its Business Operations

- **Management weaknesses cut across all DOD's major business areas, and its approach to business transformation was designated as high risk in 2005.**

Examples of longstanding issues include:

- **Supply chain management has been designated high risk since 1990**
- **Weapons System Acquisition was also designated high risk in 1990**
- **Financial Management has been designated as high-risk since 1995**

Weapons Systems Challenges

The complex process of buying weapon systems can be depicted in simplified form as:



Weapons Systems Challenges

It's not working because:

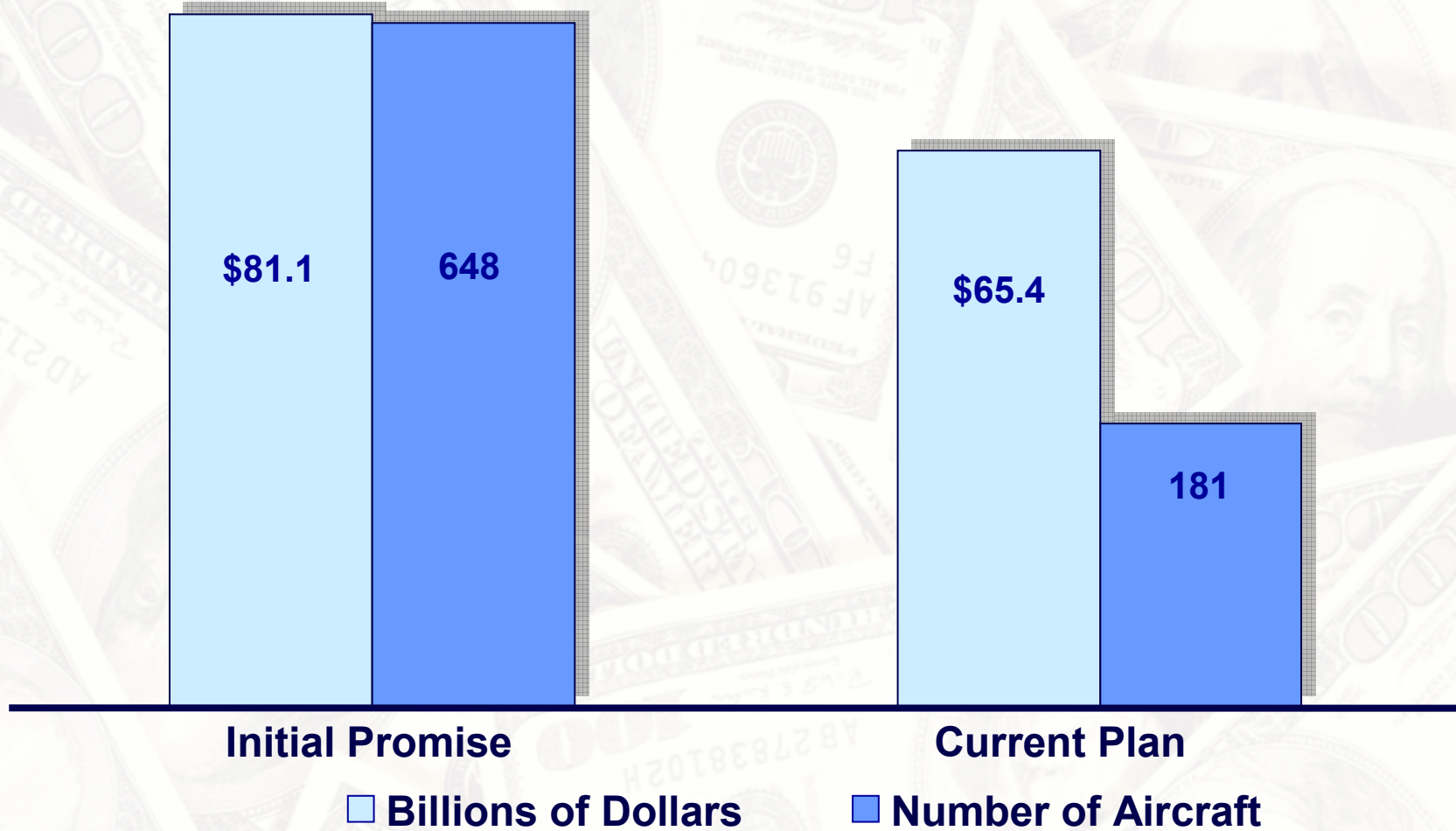
- DOD-wide process to get from “wants” to “needs” does not exist
- Overly optimistic promises as to cost, timing, and performance of key systems
- Contracting arrangements are overly complex and not sufficiently results-oriented
- Key program players turnover too frequently
- Program investment decisions are made without enough knowledge
- Program officials and contractors are not held accountable when results do not match promises (e.g. award bonuses even when contractors over-promise and under-deliver)

Needs/Wants: Demand for New Weapons Has Doubled

	2001	2006
Demand for New Weapons Is Now \$1.4 Trillion		
Top 5 Systems	\$291B	\$550B
All Major Systems Other	\$700B	\$1.4T

- Competition for discretionary funds both outside and inside DOD make getting this kind of money very unlikely
- Even if the money was available, cost growth would rob the buying power of the investments.
- 30-40% cost growth is the historical experience

F/A-22 Fighter Example



Source: GAO analysis.

The Way Forward: Selected Potential DOD Related Actions

- Revise the current approach to developing national military strategy (e.g., order, integration)
- Take a longer range, and more enterprise-wide approach to program planning and budget integration (e.g., life cycles, opportunity costs)
- Employ a total force management approach to planning and execution (e.g., military, civilian, contractors)
- Revise the process for developing and communicating key changes (e.g., DOD transformation, NSPS legislative proposal)
- Reduce the number of layers, silos, and footprints
- Strengthen emphasis on horizontal and external activities (e.g., partnerships)
- Differentiate between war fighting and business systems development, implementation and maintenance (e.g., resource control, project approval)
- Make it okay to pull the plug or reduce quantities of weapon systems and information systems projects when the facts and circumstances warrant it

The Way Forward: Selected Potential DOD Related Actions

(cont.)

- Recognize the difference between approving and informing
- Create a Chief Management Officer to drive the business transformation process
- Get the design and implementation of the NSPS right, including modernizing and integrating the DOD, Service, domain, unit and individual performance measurement and reward systems
- Employ a more targeted and market based approach to compensation and other key human capital strategies
- Streamline yet strengthen current commercial contracts (e.g., incentives, transparency and accountability mechanisms)
- Provide for longer tours of duty in connection with key acquisitions and operations positions (e.g., responsibility and accountability)
- Focus on achieving real success in connection with financial management efforts (e.g., systems, controls, information, compliance and opinions)
- Employ a more reasonable, strategic, and integrated approach to business information system efforts and financial audit initiatives

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