CBO TESTIMONY

Statement of
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on
Retail Activities at Military Bases

before the
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NOTICE

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Chairman McHugh and members of the Panel, I appreciate this opportunity to discuss the Defense Department's role in retail activities. My testimony will summarize the major findings of the Congressional Budget Office's (CBO's) recent study *The Costs and Benefits of Retail Activities at Military Bases* and will describe the options analyzed in that study.

OVERVIEW

The Department of Defense (DoD) provides a wide array of retail stores and consumer services at military bases for the benefit of current and retired military personnel and their dependents. DoD's retail operations have annual sales of $14 billion and employ about 96,000 civilian workers—one for every 15 active-duty service members. Those operations include commissaries (stores similar to civilian supermarkets), which have annual sales of about $5 billion, and military exchanges, which have sales of about $9 billion. The exchanges operate retail stores similar to department stores and also furnish a host of other shops and services, including on-base gas stations, furniture stores, florist shops, optical shops, fast-food outlets, and liquor stores.

DoD's retail activities go far beyond ensuring convenient and affordable shopping for on-base communities. The below-market prices in commissaries and exchanges attract retirees and reservists, as well as active-duty personnel who live off-base and might more conveniently shop elsewhere. Based on annual sales, DoD operates the 10th largest supermarket chain and the 12th largest general retail chain in the nation.

The current network of stores, which was designed primarily to serve families rather than to meet the needs of single troops, emerged during the early years of the Cold War. At that time, DoD's policy was that its retail activities were necessary to ensure that service members had access to adequate, affordable shopping. Today, the department no longer argues that it has to provide stores at military bases to make up for a lack of commercial alternatives. Instead, DoD justifies its stores with the argument that the low prices they offer are a cost-effective alternative to providing additional cash compensation to service members.

DoD's retail enterprises provide many benefits. For some U.S. military personnel stationed overseas, they remain the only affordable and accessible source of familiar products. For service members living in the United States, DoD's policy of selling goods at below-market prices makes its stores an important noncash benefit. The prices of commissary goods are about 20 percent below commercial levels, CBO estimates, and those of exchange goods are about 5 percent to 10 percent below commercial levels.

Despite their many benefits, government-run stores with below-market prices are not a cost-effective alternative to cash compensation. Instead, CBO finds that the military's role in retail activities has grown and persisted in part because many of the costs of those activities—including the cost of forgone taxes and forgone return on capital—fall outside the federal budget. When DoD uses cash compensation to attract and retain a high-quality military force, the full cost of that policy appears in its budget. When the department uses retail stores with below-market prices, much of the cost falls outside its budget.

If DoD had to pay the full cost of its role in retail activities, it might well reassess and reduce that role. Designing policies to make DoD bear those costs is not difficult. But such policies would entail difficult political decisions. Any meaningful debate over DoD's future retail activities may have to balance the inefficiency of subsidized, government-run stores as a way to attract and retain a high-quality force against the disrupted expectations and transition costs associated with changing the current system.

DoD's argument for the cost-effectiveness of its retail activities is straightforward. Commissaries receive an annual appropriation of about $1 billion. Each year they sell about $5 billion in goods, which have a commercial retail value of over $7 billion (according to price surveys commissioned by the Defense Commissary Agency). Thus, $1 billion in commissary appropriations appears to yield commissary customers $2 billion in price savings. The department's case for exchanges is even simpler: they offer savings to military personnel and at the same time generate an average of $300 million a year that the services distribute to support morale, welfare, and recreation programs for service members.

That argument, however, overlooks costs that fall outside DoD's budget. In addition to appropriated-fund support, DoD's retail activities receive a subsidy from society in the form of exemption from state and local taxes, a monopoly over on-base retail sales, and interest-free use of federal capital (from society's perspective, it is just as costly to invest federal capital in a commercial activity as it is to invest private capital). The total subsidy is the difference between what patrons pay for goods and services in DoD stores and what it costs society to provide those goods and services.

CBO estimates that in 1995, the total subsidy cost of DoD's retail operations in the United States was approximately $2 billion (see Table 1). Forgone state and

TABLE 1. SUBSIDY COSTS OF DOD'S RETAIL ACTIVITIES IN THE UNITED STATES, 1995 (In millions of dollars)

	Commissaries	Exchanges	Total
Business Income (Sales receipts minus the wholesale cost of goods sold)	260[a]	1,760[b]	2,020
Operating Costs			
Costs paid by DoD			
Paid from appropriations	670	160	830
Paid from surcharges or nonappropriated funds	270	1,540	1,810
Subtotal	940	1,700	2,640
Costs not paid by DoD			
Forgone return on capital	160	440[c]	600
Forgone sales taxes	230	370	600
Forgone excise taxes	100	100	200
Subtotal	490	910	1,400
Total	1,430	2,610	4,040
Subsidy (Total costs minus business income)	1,170	850	2,020
Subsidy Provided by DoD (Costs paid by DoD minus business income)	680	-60[d]	620

SOURCE: Congressional Budget Office based on data from the Department of Defense (DoD).

NOTE: Business income and operating costs exclude the wholesale cost of goods sold. Overhead costs and income from financial investments were allocated between DoD's U.S. and overseas activities based on sales.

a. Includes payments to DoD from vendors for handling coupons and other reimbursements.

b. Also includes concession fees and income from financial investments.

c. Includes $90 million in forgone monopoly rents.

d. This number is negative because the estimated appropriated-fund support that DoD furnished to U.S. exchanges in 1995 ($160 million) was less than their reported nonappropriated-fund earnings ($220 million) local taxes and the forgone return on capital—costs that are not evident to DoD—accounted for most of that subsidy. On average, the subsidy was equal to 24 cents per dollar in commissary sales and 13 cents per dollar in exchange sales.

Subsidies that are not paid by DoD help explain how the exchanges can sell goods at below-market prices and still generate earnings that, as a percentage of sales, are similar to those of private retailers. Most exchange earnings come from activities that benefit heavily from DoD's tax-free status, access to free capital, or monopoly over on-base sales. In 1995, sales of alcohol and tobacco (which benefit from DoD's exemption from state and local taxes) accounted for 25 percent of exchange earnings and 10 percent of sales receipts. Fees paid by private firms in exchange for the exclusive right to provide on-base services such as pay telephones, vending machines, or fast food accounted for 36 percent of exchange earnings. Returns on the exchange systems' financial investments accounted for another 20 percent of earnings. By contrast, sales of general merchandise in the exchanges' main stores—a retail activity in which the exchanges compete directly with off-base stores—did not generate any earnings in 1995, although they accounted for 73 percent of exchange sales.

DoD's retail activities in the United States pass much of their $2 billion subsidy on to their patrons in the form of below-market prices. But subsidized retail activities are an inefficient conduit for resources: not all of the subsidy that goes into the system comes out in the form of benefits for patrons. Two factors explain that inefficiency.

The first factor is that the government may not manage resources as efficiently or flexibly as private retailers, who are driven by competition and not restricted by civil service rules or the need to maintain political support. Commissaries are the most affected by those restrictions, and commissary managers have tried to overcome them by using private contractors for many services. But the resulting system is one of piecemeal contracts in which store managers cannot respond to the flow of customers by shifting workers from shelf-stocking to check-out or bagging. In addition, chains of private stores, which are able to serve the entire population in a region, sometimes enjoy economies of scale that are not available to DoD stores, which serve only the families of military personnel and retirees. That can be a critical problem in locations where military bases close but DoD stores remain open to serve the small remaining population of eligible personnel.

The second source of inefficiency reflects the basic economic tenet that the costs of providing price subsidies exceeds the benefits that consumers get from those subsidies. In effect, a portion of the price subsidy goes to waste because such subsidies lead patrons to consume goods even if the value they place on the good is less than the cost of providing it. For example, consider the last dollar that a service member spends in a DoD store. Although that purchase is subsidized by taxpayers, it yields the patron no more benefit than the last dollar he spends in unsubsidized stores. If the benefit—even taking into account any pleasure from shopping in a military environment—were greater, he would change his mix of purchases.

Together, those two sources of inefficiency explain why, in CBO's estimate, DoD stores in the United States absorb an annual subsidy of $2 billion but only produce benefits for their patrons on the order of perhaps $1.3 billion (see Table 2). Assessing the value of benefits is very uncertain, and that uncertainty is one of the weaknesses of relying on subsidized prices as a form of compensation. Nonetheless, given the competitive nature of the grocery and general-retail industries in the United States, it would be surprising if subsidized, government-operated stores did appear to be a cost-effective alternative to cash compensation.

Another weakness of subsidized stores, viewed as a form of compensation, is that the benefits they provide cannot be targeted toward the particular pay grades or occupations that DoD might want to retain or even toward those service members

TABLE 2. ANNUAL COSTS AND BENEFITS OF DOD'S RETAIL ACTIVITIES IN THE UNITED STATES (In millions of 1995 dollars)

	Commissaries	Exchanges	Total
Subsidy Costs	1,170	850	2,020
Possible Benefits to Patrons[a]			
Active-duty patrons	300	200	500
Retired and reserve patrons	600	200	800
All patrons	900	400	1,300
Subsidy Costs Minus Possible Benefits to All Patrons (Deadweight loss)	300	400	700

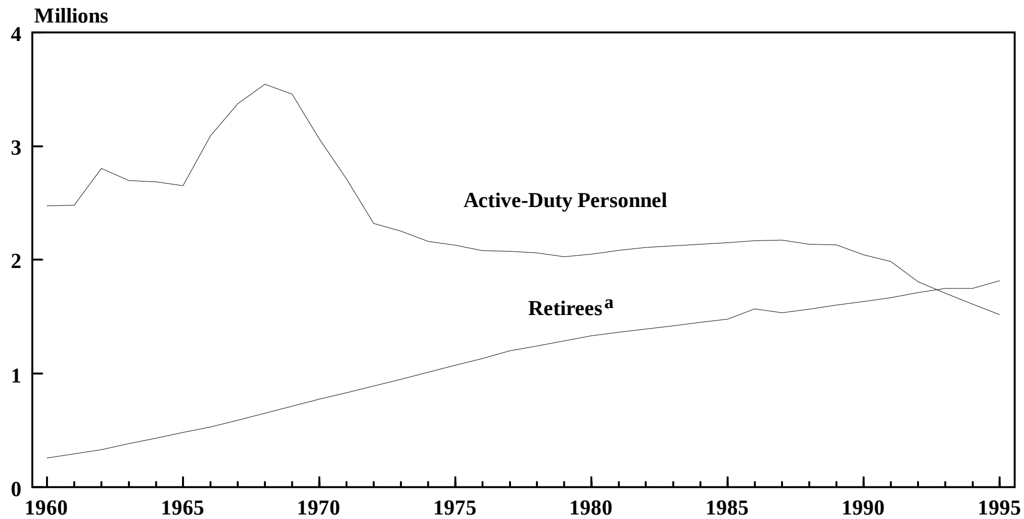
SOURCE: Congressional Budget Office based on 1995 data from the Department of Defense (DoD).

NOTE: Possible benefits to patrons and subsidy costs minus benefits are rounded to the nearest $100 million.

a. These estimates assume that the value of benefits to patrons is 80 percent of the patrons' apparent financial savings. CBO calculated apparent financial savings based on a 20 percent price difference between commissaries and commercial supermarkets and an average 7.5 percent price difference (the midpoint of the 5 percent to 10 percent range) between exchanges and commercial retailers.

it might want to assist financially. For example, only 6 percent of commissary sales in the United States are made to junior enlisted personnel in pay grades E-4 or below. In contrast, retirees and reservists account for over 60 percent of U.S. sales. That pattern reflects changes in the population of eligible personnel rather than any deliberate policy. In 1960, there was roughly one retiree for each 10 service members on active duty. Today, the number of retirees exceeds the active-duty population and continues to grow (see Figure 1).

FIGURE 1. NUMBER OF ACTIVE-DUTY AND RETIRED MILITARY PERSONNEL, 1960-1995



SOURCE: Congressional Budget Office based on Department of Defense, Washington Headquarters Services, Directorate for Information Operations and Reports, *Selected Manpower Statistics, Fiscal Year 1995*, DIOR/MO1-95 (1995).

a. Also includes families receiving survivor benefits.

Although DoD's retail system is not a cost-effective alternative to cash compensation, two factors explain its persistence and growth: DoD's budgetary incentives, and the pressures generated by perceived entitlements.

Retail activities are attractive to DoD because, as described earlier, the department does not have to provide all of the resources that go into them. The roughly $1.3 billion in benefits that active-duty, retired, and reserve personnel gained from DoD's retail activities in 1995 cost the department only $600 million.

In addition, the existing retail system (whatever its historical origin) is now viewed as an entitlement by many of its patrons. Even if a shift to cash compensation improved the quality of life for service members as a whole, some individuals and groups would lose benefits to which they feel entitled. No system of cash payments can distribute benefits in exactly the same pattern as the current retail system, in which retirees who live near DoD stores benefit more than those who live farther away, and families who prefer the brand-name goods sold in commissaries benefit more than those who might otherwise purchase private-label goods. In addition to military retirees, those most likely to lose from a change to cash compensation would include commissary and exchange employees and the network of manufacturers, brokers, and distributors that supports the current system.

Over time, DoD's large role in retail activities has affected the nature of the military in ways that are not easily quantified. Some of those effects are positive. For example, many military leaders view the on-base shopping provided by commissaries and exchanges as an integral part of the military way of life, a means to foster a sense of community and cohesion.

Yet negative effects can also be seen, particularly when the department's desire to use retail activities to generate earnings conflicts with its other goals. For example, sales of tax-free tobacco and alcohol at below-market prices are profitable for DoD, but they may detract from service members' health and readiness. And although efforts by DoD to discourage black-market activities overseas can reduce exchange earnings, failure to make such efforts can undermine the integrity of U.S. troops and the message this country wishes to send to its allies.

More broadly, DoD's use of retail stores to capture resources may distort the focus of the system. Giving overseas personnel access to U.S. goods is arguably a core function of that system. But the desire to attract patrons and generate earnings may drive DoD to focus on providing attractive, high-quality stores in the United States—where the system faces stiff competition from commercial retailers—rather than providing the same quality of service overseas, where military personnel have fewer alternatives.

The desire to generate earnings also affects the mix of goods sold in DoD stores. Selling discount goods to junior enlisted personnel in competition with Wal-Mart and other discount retailers is not very profitable, and it becomes less so as the number of junior enlisted personnel declines relative to the number of retirees. Today, the types of merchandise that generate the greatest earnings for exchanges (including upscale gift items such as Lladro figurines, Coach handbags, and Villeroy and Boch china) are often those that attract retirees who have the most discretionary income. Finding the appropriate balance between discount store and upscale department store has long been a source of controversy for the exchanges. But that controversy has intensified in the post-Cold War period as the exchanges have tried to maintain their sales and earnings by appealing more to retirees and reservists.

In a narrow budgetary sense, it may be less costly for DoD to compensate military personnel with low prices than with cash. Yet it is unclear whether that practice is in the best long-run interests of the military or of U.S. society. For that reason, CBO's study examined four alternative strategies for DoD's retail activities in the future. The first two focus on reducing budgetary costs. Those alternatives would encourage DoD to maintain a large role in retail activities, allowing the department to capitalize on its federal, tax-free status. The other two options focus on the broader social costs of DoD's retail activities. They would encourage the department to face the full cost of its retail activities and, thus, to limit its role.

STRATEGIES THAT WOULD REDUCE BUDGETARY COSTS

CBO's first alternative (cost reduction) focuses on maintaining the size, scope, and basic pricing policies of commissaries and exchanges while lowering their operating costs. This approach appears to reflect the current strategy of the Department of Defense. Consistent with the designation of the Defense Commissary Agency (DeCA) as a performance-based organization, it calls for federal waivers and legislation to free commissaries from some of the legal and policy constraints that limit their ability to control costs. This alternative would also consolidate the three separate exchange systems that now exist in an effort to reduce operating costs and increase their ability to generate earnings for morale, welfare, and recreation programs.

CBO estimates that this cost-reduction alternative, if aggressively pursued, could save DoD $200 million to $300 million a year. One weakness of the approach, however, is that providing DeCA with the same freedoms enjoyed by private enterprises will not necessarily lower costs as long as commissaries depend on the political budget process rather than on competitive markets for most of their operating income.

CBO's second alternative (a resale authority) might be regarded as an extension of the first option. It would further reduce the budgetary costs of DoD's retail activities by merging DeCA and the exchange systems into a single entity, commonly referred to as a resale authority. The authority could be organized as either a government corporation or a revolving fund with personnel and acquisition rules similar to those that apply to nonappropriated-fund activities. The resale authority could reimburse DoD for any support the department provided, and the difference between its receipts and expenditures in any year would be included in the federal budget.

The resale-authority approach would provide large budgetary savings: perhaps $800 million to $1 billion a year. As a result, a resale authority might require little, if any, appropriated funds. Some savings would come from freeing commissaries from the constraints they operate under as a federal agency and from combining commissary and exchange stores at bases where separate facilities are too small to be economical. Almost half of the savings, however, would come from raising the price markups on commissary items to the levels used in exchanges (a move that might seem logical under a consolidated system). In addition to providing budgetary savings, this option would eliminate the need for commissary and exchange managers to negotiate over such factors as how to allocate earnings from tobacco sales, who has the right to sell potted plants, and who should manage combined stores. It would also increase Congressional control over federal resources (nonappropriated funds) that are now outside the federal budget.

Both of the first two alternatives would reduce DoD's budgetary costs and, to a significant extent, preserve the current system in which on-base stores offer below-market prices to active-duty, retired, and reserve personnel. Neither option would change the degree to which the system relies on sales of tobacco and alcohol, and neither would address some of the fundamental questions about the appropriate role for the military in retail activities.

STRATEGIES THAT WOULD FOCUS ON SOCIAL COSTS

The third and fourth alternatives that CBO examined take a different approach: they would limit the ability of on-base retail activities to capitalize on their federal status, thus forcing DoD to face the full cost of such activities. The third alternative (reliance on contractors) would require DoD to use contractors for all on-base retail activities. That would make the full costs of those activities more visible because private contractors running retail stores on military bases must earn a return on their capital and pay state and local sales and excise taxes. The fourth alternative (revising DoD's incentives) would achieve the same result by requiring DoD's in-house retail activities to make payments to the Treasury in lieu of forgone state and local taxes and return on capital. That approach would equalize the playing field between in-house and contractor activities but still leave DoD free to operate retail stores directly when doing so would be more cost-effective.

In theory, neither of those two alternatives would necessarily change the size, scope, or pricing policies of on-base stores. DoD could subsidize the contractors or its own stores so that they could cover the cost of capital and taxes and still provide commissary and exchange goods at today's prices. Nonetheless, faced with the full $2 billion cost of its U.S. system, DoD would probably no longer view subsidized prices in U.S. stores as a cost-effective form of compensation. As a result, both of those approaches would be likely to result in higher prices for many goods at on-base stores in the United States and a corresponding reduction in the size and scope of those retail activities. DoD could in turn offset the impact of higher prices on active-duty personnel in the United States by increasing their cash compensation by about $500 million annually.

These last two alternatives might have the greatest impact on those on-base activities—such as large retail stores and sales of alcohol and tobacco—that benefit the most from DoD's immunity from state and local taxes and that rely on below-market prices to attract patrons from off-base. Activities that depend on their proximity to personnel living and working on-base—convenience stores and services such as stand-alone fast food, pay telephones, and barber shops—would be less affected. DoD already relies on private concessionaires, who are subject to taxes, to provide many of those labor-intensive, high-value-added services.

DoD could still find it cost-effective to subsidize retail stores at a few isolated U.S. bases. With the playing field between contractors and in-house stores leveled, however, DoD would most likely choose to rely on contractors to provide such services in the United States. The large role that contractors now play in providing customer services and the small role they play in operating retail stores may be explained in part by the fact that sales taxes, excise taxes, and the cost of capital account for a high percentage of the value added in retail stores.

In addition, DoD could continue to offer goods overseas at their current subsidized prices. Yet the least costly way to do that, in the absence of a large network of in-house stores in the United States to provide economies of scale, might be through competitive contracts with private grocery and general-retail chains. Moreover, DoD might find that higher overseas cost-of-living allowances were a cost-effective tool for enhancing access to familiar goods in those urban locations where off-base stores offer an increasingly wide array of international brand-name goods and quality groceries.

These last two alternatives do not focus on reducing DoD's budgetary costs. In fact, CBO estimates that the cost of compensating active-duty personnel for the higher prices they would face at on-base stores would offset most of the savings DoD would achieve by reducing its retail role. Instead, these alternatives have a broader focus that takes into account costs, such as forgone taxes, that fall outside DoD's budget. By making DoD see the full cost of its retail activities, these approaches would encourage the department to limit its on-base retail activities to those that are truly cost-effective.

SELECTING AN APPROPRIATE STRATEGY

There are, of course, many reasons why reducing DoD's retail role and increasing its dependence on cash compensation might be undesirable. Although the gains to society as a whole would be more than large enough to compensate everyone who would lose, there would be no practical way to make offsetting payments to many of the losers—including military retirees, workers at DoD stores, and the private industry that supports the stores. In addition, DoD is trying to cut the costs of its entire infrastructure to free up funds for buying new weapons. CBO's estimates indicate that from a budgetary perspective, DoD could save the most by creating a centralized resale authority that would capitalize on the department's retail role rather than reduce it.

Nonetheless, CBO's analysis indicates that the military's justification for its U.S. retail system—that it is a cost-effective alternative to cash compensation—is not credible when the costs that the system imposes outside the defense budget are taken into account. From a broad social perspective, DoD's tax-free status and its use of retail activities to generate revenue for morale, welfare, and recreation programs appear to have distorted the focus of a system that was originally designed to provide necessary articles of convenience to service members with limited shopping options. In addition, DoD's role raises issues that go beyond economic efficiency. The most effective military may be one that is free to focus on its central mission, rather than one with control of a $14 billion-a-year retail empire that employs 96,000 civilian workers and competes with private companies. Those concerns suggest that fundamental changes in the current system deserve serious consideration.