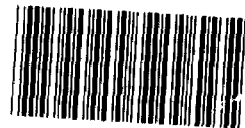


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STATEMENT OF
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COMPTROLLER GENERAL OF THE UNITED STATES
BEFORE THE
COMMITTEE ON ARMED SERVICES,
ACQUISITION AND PROCUREMENT POLICY PANEL
UNITED STATES HOUSE OF REPRESENTATIVES
ON
POTENTIAL FOR EXCESS FUNDS IN DOD



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Mr. Chairman, members of this panel, thank you for asking me to appear before you today to discuss the important topic of budgeting for inflation in the Department of Defense.

Last May Secretary Weinberger announced that he had found \$4 billion in excess of defense requirements. He attributed this excess to management improvements and inflation savings and requested that the funds be reapplied to meet defense needs identified in the fiscal year 1986 budget.

Secretary Weinberger's identification of excess funds from prior year appropriations raised Congressional concerns. We were asked by both Chairmen Aspin and Hatfield and Senator D'Amato to prepare estimates of DOD's inflation dividend and to investigate how much of this dividend might still be available.

We found that between fiscal years 1982 and 1986 the administration overestimated inflation rates. As a result, DOD budgeted more than was needed for inflation. We estimate that during these years the Defense Department received an inflation dividend of \$44.5 billion. A special multiplier approved by the Office of Management and Budget (OMB) for budgeting for inflation in major weapon systems accounted for \$14.2 billion of this amount. In our report of September 1985, we recommended that this multiplier be eliminated. Our recommendation is

supported by the Department of Commerce's Bureau of Economic Analysis (BEA) recent report showing that actual inflation in major weapon systems fell below inflation in the general economy in fiscal year 85. We note that in the fiscal year 1987 budget request, OMB did not use this special multiplier for calculating inflation in DOD's major weapon system accounts.

We could not determine the precise amount of excess funds that is still available in DOD. A major difficulty is that the accounting systems that track how funds are actually being used are not directly linked to the budgeting process. We believe much of the inflation dividend has either been spent on additional defense programs, has lapsed, or has been reprogramed for other uses. Reprograming actions in fiscal years 1980 through 1985 totaled about \$26 billion. In recent years, the frequency of reprograming actions initiated because surplus funds were available has increased sharply.

We concluded that some funds may still be available as unobligated balances because DOD has been unable to obligate funds as rapidly as planned when the funds were requested and appropriated. At the start of fiscal year 1986, DOD had authority to obligate \$440.4 billion. Of that amount, the current year estimate for fiscal year 1986 authority is \$289.4 billion; the balance was primarily unobligated balances from

prior years and estimates of reimbursable orders. At the end of fiscal year 1985, DOD reported that unobligated balances and lapses from appropriations were \$63.7 billion. This was \$12.1 billion more than DOD estimated in February 1985. I will now discuss these matters in greater detail.

THE DEFENSE INFLATION DIVIDEND

Before I explain how we estimated the size of the defense inflation dividend, let me take a few moments to describe the history of DOD's budgeting for inflation.

Prior to the early 1960's neither DOD nor any other federal department budgeted for inflation. During that period, low inflation rates presented little threat to the real purchasing power of federal budgets. In fact, at that time government-wide policy prohibited budgeting for inflation.

This situation changed during the 1970s when unexpectedly high rates of inflation eroded the purchasing power of defense appropriations. Late in the 1970s, the Administration directed all federal agencies to budget explicitly for inflation, but consistently mandated unrealistically low estimates of inflation for use in preparing federal budgets. DOD often cited high inflation as a cause of production problems in weapon system

programs which suffered substantial reductions in quantities purchased or lengthy stretch-outs of deliveries. The Carlucci initiatives included a recommendation for realistic inflation budgeting. In response, OMB, granted an exception that permitted DOD to budget for major weapon systems assuming that prices would be 30 percent higher than the Administration's projections of price changes in the general economy. This special weapons system multiplier remained in effect for the fiscal years 1983 through 1986.

To illustrate how the inflation budgeting process works in DOD, let us assume that DOD plans to initiate a program costing \$1 billion. Let us also assume that 20 percent of this program will be completed in the first year, 50 percent by the end of the second year, the final 50 percent in the third year. With no inflation, program expenditures would be \$200 million in the budget year, \$300 million the second year, and \$500 million in the third year.

However, if inflation is 5 percent per year, then first year spending will be \$210 million--an extra \$10 million due to increases in prices. In the second year, cumulative inflation will be 10.25 percent and expenditures will be \$331 million. In the third and final year, cumulative inflation will be 15.76 percent and expenditures \$579 million. Total spending on the

program over the three years includes about \$120 million dollars solely to cover inflation.

If this program had been in a major weapon system account DOD would have used a 6.5 percent rate (1.3 times the 5 percent inflation rate). Estimated spending in the three years would have been \$213, \$340, and \$604 million, respectively. Thus, for a major weapon system, DOD would have budgeted \$157 million to cover inflation versus \$120 million for a non weapon system program.

Currently, DOD's inflation budget is divided into four categories. Separate categories exist for pay and allowances of military and civilian personnel, fuel, major weapon systems, and all other DOD purchases. Chart I summarizes the details of DOD's inflation budgeting system.

Dividend Due to Inflation Overestimates

As I noted earlier, unexpectedly high rates of inflation in the 1970's created a major problem in executing defense procurement programs. During the 1980's inflation fell more rapidly than expected creating a potential for excess funds in the defense budget.

To estimate the size of DOD's inflation dividend, we gathered data on defense appropriations, inflation assumptions, and program spendout rates. We analyzed the defense budgets between fiscal year 1982 and 1986 and then replaced the original inflation assumptions with (1) actual inflation rates experienced during fiscal years 1982 through 1985 and/or (2) the most recent projections for fiscal years 1986 through 1990. We compared the actual rates (and the most recent projections for future years) with the amounts which were originally allocated for inflation, to determine the defense inflation dividend due to overestimates of inflation.

Chart II shows our estimates of this dividend for fiscal years 1982 through 1986. The total is \$30.4 billion, which does not include the dividend resulting from the special multiplier for major weapon systems. More than one-half of this dividend, about 52 percent, occurred in the procurement accounts, since major procurement programs require several years to complete and therefore are very sensitive to inflation assumptions. The largest inflation dividends occurred in fiscal year 1983 (see Chart III).

Dividend Due to Use of the Special Weapon Systems Multiplier

Chart II displays our estimate of the dividend due to the use of the special multiplier. This dividend amounts to \$14.2 billion. As I mentioned earlier, the special multiplier was not used in the fiscal year 1987 budget. In our report we discussed several reasons why the multiplier should be eliminated. Basically we believe (1) BEA statistics overstated inflation in major weapon systems, (2) over the long run, inflation in Defense Department purchases will approximate the inflation occurring in the general economy, and (3) providing special treatment for weapon systems is an inefficient budgeting practice that may become a "self-fulfilling prophecy" leading to future cost increases.

Congressional Action Resulting From Excess Inflation Funds in the DOD Budget

During fiscal years 1982 through 1986, Congress has routinely reduced DOD budget requests. Although some of the reductions were related to inflation savings, few congressional documents link reductions explicitly to inflation. Congress has reduced budget requests throughout the 1980s in response to decreases in fuel prices. However, the Congress clearly recognized non-fuel inflation savings as a source of appropriations reductions and transfers only in fiscal year 1985 and 1986.

- For fiscal year 1985, Congress transferred \$839.75 million from procurement accounts, which had benefited from inflation dividends to underwrite pay increases and additional operations and maintenance expenses in the fiscal year 1985 Supplemental Appropriations Act.
- For fiscal year 1986, Congress reduced procurement appropriations by \$1.036 billion. These "inflation fairness adjustments" were originally intended to offset overestimates of inflation used in developing the DOD budget request. An additional \$1.7 billion in "inflation premium adjustments" were intended to offset the dividend due to the use of the special inflation multiplier.
- For fiscal year 1986, Congress reduced the DOD procurement appropriations by an additional \$123 million on the basis of updated inflation projections.
- For fiscal year 1986, Congress provided \$6.3 billion in additional transfer authority for the military pay raise, payments to the military retirement trust fund, and other expenses, of which \$1,094 million was specifically identified as inflation savings.
- Between fiscal years 1982 and 1986 Congress reduced budget authority by \$3.09 billion due to lower fuel prices.

DIFFICULTY IN DETERMINING THE
AMOUNT OF EXCESS FUNDS AVAILABLE

We could not precisely determine how much of the excess inflation dividends are still available to DOD. Although DOD has an elaborate planning, programming and budgeting system, the financial management system used to track the execution of the budget does not enable us to easily audit the available funds in DOD that are in excess of program requirements.

However, as part of our efforts to oversee the defense budget, we do evaluate major procurement items in budget

requests. Last year we identified potential reductions of \$11.7 billion for items such as ammunition, ships, aircraft, and missiles in DOD's fiscal year 1986 request. Some of the suggested reductions were due to overestimates of inflation.

One of my primary goals as Comptroller General is to build an effective financial management structure in our government that provides reliable, consistent information for policy formulation and management control. Successful reform requires an integrated approach be taken for developing a comprehensive financial management structure. Until such a system is developed, it will not be possible to quickly and confidently determine the status of funds appropriated to DOD. As a result, we have examined unobligated balances and reprogramming actions to determine whether excess funds exist.

Unobligated Balances

DOD applies the concept of full funding in budgeting for major weapon systems. Unobligated balances are a natural part of the concept. However, no precise criteria define what unobligated balances should be, whether they are too large, or if they are growing too fast. Congress provides general guidance to DOD, namely that the level of unobligated balances for any single program should be the minimum funds needed to

fulfill outyear contracts. This level depends on cost estimates at the time Congress approved the program. It also depends on the number of years needed to negotiate contracts and obligate funds for approved items. Ideally, the aggregate level of unobligated balances should be the minimum funding (full funding) needed to fulfill outyear contracts for the sum of the individual programs. We could not determine the appropriate amount of funds required to cover contracts awarded in any year after the budget year, since detailed information on the need for unobligated balances is not readily available for most of the procurement appropriations. Consequently, we have analyzed aggregate data on unobligated balances and lapsing funds.

Between fiscal year 1980 and 1985, total unobligated balances (net of lapsing funds) have grown from \$24.2 billion to \$61.5 billion. Unobligated balances have also grown as a percent of total authority available for obligation from 10.8 percent in fiscal year 1980 to 14.5 percent in fiscal year 1985, although the rate of growth declined in fiscal year 1984 and remained level in fiscal year 1985. In each year, most of the unobligated balances occurred in the procurement accounts. For example, in fiscal year 1985, \$46.1 billion (75 percent) of the \$61.5 billion in unobligated balances were in the procurement accounts.

Between fiscal years 1980 and 1985, lapsing funds grew in absolute dollars. However, since the DOD definition of lapsing funds changed throughout this period, aggregate totals cannot be analyzed without a more complete breakdown of the components of this category of funds. This information is not readily available in DOD financial summary tables.

At the end of fiscal year 1985, unobligated balances were \$12.1 billion greater than projected by DOD just 9 months previously. In February 1986, DOD reported lapsing funds and estimates of unobligated balances for fiscal years 1986 and 1987 at \$62.7 billion and \$61.3 billion, respectively (see attached Chart IV). These estimates are below the fiscal year 1985 actual figure of \$63.7 billion, but are significantly higher than prior years estimates.

We believe that actual unobligated balances and lapsing funds in fiscal years 1986 and 1987 will likely remain higher than in past years, but DOD estimates may more closely reflect the actual figures than has been the case in the past.

DOD Reprogramming Actions

The Congress has given DOD limited authority to reprogram and transfer appropriated funds--to use money for different

purposes than was planned at the time the funds were appropriated. The total dollar value of reprogramming actions for fiscal years 1980 through 1985 was about \$26.1 billion. Although the dollar value of the reprogrammings increased between 1980 and 1985, it remained relatively constant as a percentage of total obligational authority (TOA), at about 2 percent.

Reprogrammings fall into three broad categories: above-threshold, below-threshold, and internal reprogrammings. If an action increases authorized procurement quantities or has been designated as an item of congressional interest, prior approval is required. Prior approval is also required for transferring funds between accounts. Notification to the Congress is required for reprogramming actions which meet or exceed given thresholds. Below threshold actions are those that fall below the above designated limits and do not require notification to the Congress, except when follow-on costs exceed the threshold. Internal reprogrammings include those actions that reclassify or realign funds but are not subject to threshold limitations.

In our September 1985 report (GAO/NSIAD-85-145), we noted that between fiscal years 1980 and 1985, the dollar value of above-threshold actions was about \$10.2 billion, or 39 percent of the total. Below threshold actions were slightly less at

\$9.4 billion, but accounted for a much greater number of total actions (about 92 percent). An additional \$6.5 billion was internally reprogrammed.

Our analysis of above threshold actions showed that in recent years the amount of money reprogrammed to solve program problems has declined. Over time more money has been reprogrammed for unplanned requirements and other items, primarily classified programs, (see Chart V). Funds that DOD identified as not needing reinstatement (in excess of the original purpose) increased sharply. Eighty-four percent of the funds reprogrammed above threshold in fiscal year 1985 were in excess of original requirements (See Chart VI).

CONCLUSIONS AND RECOMMENDATIONS

It has now become apparent that more funds for programs were available in DOD's budget than Congress intended and that some action should be taken to improve inflation budgeting in DOD. In our September 1985 and March 1986 reports, we recommended that the Secretary of Defense take the following actions:

- Continue to use the GNP deflator as the basic index for DOD inflation budgeting for the portion of the DOD purchases other than pay and fuel.

- Eliminate the use of the multiplier that projected inflation at 1.3 times the anticipated increase in the GNP deflator for the major weapon systems accounts.
- Distribute the funds budgeted for inflation among the various DOD appropriations accounts in consultation with OMB. (In effect, this would give DOD flexibility in deciding how to apportion the allowable inflation projections among the nonpay and nonfuel accounts.)
- Report to Congress at appropriate stages in the budget process any annual and projected inflation dividends or shortfalls that occur as a result of more information about inflation in the economy.

Some improvements are already underway. As I noted earlier, in fiscal year 1987, OMB set the multiplier at 1.0 times the anticipated increase in the GNP deflator for major weapon systems accounts. We believe Congress should require DOD to regularly report on inflation budgeting assumptions so that information is available in time to make adjustments during Congressional budget deliberations.

Also, Congress has reduced DOD budget requests and provided transfer authority to offset the effect of inflation dividends. We believe Congress should direct that unobligated balances be transferred into future budgets or supplementals, or be returned to the Treasury if these funds are found to be in excess of program needs.

Mr. Chairman, that concludes my prepared remarks. I will be happy to respond to any questions.

CHART I:

CATEGORIES USED BY DOD TO BUDGET FOR INFLATION

Description	Pay	Fuel	Major Weapon System	All Other Purchases
Appropriations Titles Con- taining the Category	Military Personnel O&M	O&M RDT&E	Procure- ment	All
Length of Spendout Period	1 year	1 year	Up to 7 years	Up to 5 years
Percent of Total DOD Budget	32%	2%	26%	40%
Deflator Used for Projection	OMB projec- tions of government salary increases	OMB pro- jections of crude oil prices	1.3 * projec- tions of GNP def- lator	Projec- tions of GNP def- lator

**Chart II: Estimates of the Total Inflation Dividend
in Defense Appropriations: Fiscal Years 1982-86**

<u>Fiscal year</u>	Due to Overestimates of Inflation ^a	Due to use of 1.3 Multiplier (billions)	<u>Total</u>
FY 1982	\$ 6.67	0.0b	\$ 6.67
FY 1983	8.43	\$ 4.17	12.60
FY 1984	7.41	3.47	10.88
FY 1985	5.23	3.36	8.59
FY 1986	<u>2.61</u>	<u>3.17</u>	<u>5.78</u>
Total	<u>\$30.35</u>	<u>\$14.17</u>	<u>\$44.52</u>

aDoes not include effects of budget reductions mandated by Balanced Budget and Emergency Deficit Control of 1985.

bA special multiplier for major weapon systems was not use in the preparation of the FY 1982 budget.

Source: GAO calculations using data from the Office of Assistant Secretary of Defense (Comptroller), National Defense Budget Estimates, fiscal years 1982 through 1986.

Chart III: Inflation Dividend by Major Defense Appropriation Title
Fiscal Years 1982-86^a

<u>Appropriation Title</u>	<u>Fiscal years</u>					<u>Total by title</u>
	<u>1982</u>	<u>1983</u>	<u>1984</u>	<u>1985</u>	<u>1986</u>	
	------(billions)-----					
Military Personnel	\$.10	\$.22	\$.18	\$.13	\$.09	\$.72
Operations & Maintenance	1.76	2.88	2.69	1.63	0.80	9.76
Procurement ^b	3.93	4.27	3.60	2.66	1.27	15.73
Research, Development, Test, & Evaluation	.62	.87	.78	.67	.38	3.32
Military Construction	<u>.26</u>	<u>.19</u>	<u>.16</u>	<u>.14</u>	<u>.07</u>	<u>.82</u>
Totals	<u>\$6.67</u>	<u>\$8.43</u>	<u>\$7.41</u>	<u>\$5.23</u>	<u>\$2.61</u>	<u>\$30.35</u>

^aDoes not include effects of budget reductions mandated by Balanced Budget and Emergency Deficit Control Act of 1985. Includes all defense expenditures except personnel expenditures on pay, allowances, and bonuses.

^bDoes not include any inflation dividend accruing due to the use of 1.3 multiplier. Estimates of funding for 1.3 multiplier are shown in Chart II.

Source: GAO calculations using data from the Office of Assistant Secretary of Defense (Comptroller), National Defense Budget Estimates, fiscal years 1982 through 1986.

Chart IV: Comparison of Actual and Estimated Unobligated Balances
(Including Lapsing Funds) Fiscal Years 1980-87^a

Military Function 051	1980	1981	1982	1983	1984	1985	1986 ^a Est.	1987 Est.
Actual	\$25.6	\$28.3	\$36.4	\$47.6	\$56.4	\$63.7		
DOD Current Year Estimate	\$24.7	\$26.0	\$34.5	\$39.0	\$43.8	\$51.6	\$62.7	
DOD Budget Year Estimate							\$55.7	\$61.3
Difference	\$0.9	\$2.3	\$1.8	\$8.6	\$12.6	\$12.1	\$7.0	
%Difference	3.6%	8.8%	5.2%	22.1%	28.8%	23.4%	12.6%	
Change in Overestimate (year over year)		\$1.4	(\$0.5)	\$6.8	\$4.0	(\$0.5)	(\$5.1)	

^aIn fiscal year 1986, comparison of current year and budget year estimates.

Source: DOD Financial Summary Tables, FAD 738, Budget Obligations and Unobligated Balances.

Chart V: Amount of DOD Above Threshold Reprograming Actions by Category:
Fiscal Year 1980-85

(\$ in thousands)

Category	FY 80	FY 81	FY 82	FY 83	FY 84	FY 85*	Total
Program Related Problems	\$697,393	\$329,037	\$991,017	\$843,296	\$539,915	\$577,781	\$3,978,439
Unplanned Requirements	\$282,138	\$315,262	\$357,992	\$353,130	\$724,105	\$556,369	\$2,588,996
Pay Raise/Cola	\$30,300	\$43,160	\$45,656	\$976,838	\$25,400	\$362,659	\$1,484,013
Other	\$76,999	\$175,788	\$96,317	\$185,985	\$285,234	\$542,641	\$1,362,964
Management Initiatives	\$50,796	\$32,405	\$155,900	\$152,740	\$69,909	\$141,450	\$603,200
Uncontrollable Expenses	\$80,701	\$0	\$84,800	\$0	\$0	\$0	\$165,501

Source: Figure 14, Appendix VIII, page 16, U.S. General Accounting Office, "Potential for Excess Funds in DOD," GAO/NSIAD-85-145.

**Chart VI: Percentage of Above Threshold Reprogramed Funds Requiring Reinstatement:
Fiscal Year 1980-85**

Reinstatement	FY 80	FY 81	FY 82	FY 83	FY 84	FY 85*	Total
Yes	20.3%	23.7%	8.3%	8.5%	3.8%	7.3%	10.2%
No	49.4%	43.3%	54.9%	56.9%	74.4%	84.4%	63.2%
No Data	30.3%	33.0%	36.8%	34.6%	21.7%	8.3%	26.6%
Total	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%

Source: Figure 16, Appendix VIII, page 18, U.S. General Accounting Office,
"Potential for Excess Funds in DOD," GAO/NSIAD-85-145.