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# REPORT TO THE CONGRESS

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**Estimates Of The Impact Of  
Inflation On The Costs Of Proposed  
Programs Should Be Available  
To Committees Of The Congress**

B-176873

*BY THE COMPTROLLER GENERAL  
OF THE UNITED STATES*

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DEC. 14, 1972



COMPTROLLER GENERAL OF THE UNITED STATES  
WASHINGTON, D.C. 20548

B-176873

01 / To the President of the Senate and the  
Speaker of the House of Representatives

This is our report entitled "Estimates of the Impact of Inflation on the Costs of Proposed Programs Should Be Available to Committees of the Congress."

Our review was made pursuant to the Budget and Accounting Act, 1921 (31 U.S.C. 53), and the Accounting and Auditing Act of 1950 (31 U.S.C. 67).

Copies of this report are being sent today to the Director, Office of Management and Budget; the Secretary of Defense; and the Administrator, National Aeronautics and Space Administration.

A handwritten signature in cursive script, reading "James B. Stacks".

Comptroller General  
of the United States

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ABBREVIATIONS

DOD	Department of Defense
GAO	General Accounting Office
OMB	Office of Management and Budget
SAR	Selected Acquisition Report

D I G E S T

WHY THE REVIEW WAS MADE

The General Accounting Office (GAO) examined the methods by which Government agencies consider inflation in estimating costs of long-term programs and disclose them to the Congress.

Background

Inflation is defined as a persistent and appreciable rise in the general level or average of prices for labor and material.

This report on policies and practices used in estimating and including allowances for inflation in program and budget requests is based on reviews of the

- M-151 1/4-ton truck program by the Army's Tank Automotive Command, Detroit, Michigan; 62
- 2--Gathright Dam Project of the Corps of Engineers, Norfolk (Virginia) District; 746
- 3--F-14 Aircraft Program of the Naval Air Systems Command, Washington, D.C.; 455
- 4--A-7D Aircraft Program of the Air Force Systems Command, Wright-Patterson Air Force Base, Ohio; 207
- 5--Viking Project of the National Aeronautics and Space Administration, Washington, D.C.; and 36

- 6 --Interstate Highway System of the Federal Highway Administration, Washington, D.C. 63

When an agency requests the Congress to authorize and appropriate money to proceed with a program, realistic cost estimates including inflation are needed to determine the total cost as accurately as possible.

GAO has developed criteria for making such a realistic estimate which include

- clearly identifying the task,
- determining the availability of valid data,
- providing for program uncertainties (risks), and
- recognizing inflation. (See p. 5.)

The Office of Management and Budget (OMB) has a long-established policy whereby allowances for future price increases, such as inflation, be excluded from budget requests presented to the Congress. Omitting estimates for inflation has resulted in understatements of estimated program costs and has been cited as a major reason for cost growth.

With a few exceptions, OMB has applied this policy to single-year and to long-term program estimates. OMB officials say that to budget for inflation would seem to provide

governmental sanction for a stated rate of inflation and that inflation would actually occur at, or in excess of, that rate.

#### FINDINGS AND CONCLUSIONS

Because OMB requires agencies to prepare long-term program estimates on the same basis as annual budget estimates, when this policy is followed, the program estimates are based on current costs without any attempt to project costs at the time funds will be needed.

However, some agencies included allowances for inflation in their budget requests despite the OMB policy. These amounts have not been so identified and, as a result, the Congress has not received budget estimates prepared on a consistent basis. (See p. 7.)

Programs and activities for which funds are budgeted and obligated for a single year without providing for inflation have little adverse effect. For long-term programs, however, OMB's policy may result in the Congress' approving programs on the basis of partial information.

GAO concurs that inflation should not be included in single-year budget requests. However, the total estimated cost of a long-term program including inflation should be available to congressional committees.

The impact of inflation on program costs can be severe, as illustrated by examples on pages 8 and 9. Agencies frequently prepared their own estimates--in contrast to the cost estimates submitted to the Congress--of the expected total program cost, including expected cost increases due to inflation.

In 1969, Department of Defense (DOD) requested authority from OMB to provide for inflation in its program estimates for major weapons systems and other large projects. This request was denied.

DOD then instructed the military services to prepare two separate cost estimates--one excluding inflation for OMB use and one including inflation for DOD use.

To provide more realistic cost projections for the Congress, DOD requested OMB's permission to incorporate some allowance for price increases in its fiscal year 1972 budget estimates for major weapons systems and major construction. OMB approved this request. (See p. 12.)

Fluctuations in inflation rates have made it difficult to foresee inflation's effects on long-term program costs. The labor index increase varied from 1.8 in 1960 to 9.4 in 1968. The material index varied from a decrease of 0.6 in 1960 to an increase of 4.3 in 1969. (See app. I.)

Even in these circumstances, more meaningful and more realistic estimates could be made of inflation. But recent controls established by the administration to stabilize inflation may provide a more reliable basis for estimating inflation in long-term program costs.

#### RECOMMENDATIONS OR SUGGESTIONS

GAO suggested to the Director, OMB,<sup>27</sup> that cost estimates for long-term programs include an estimate for inflation, which should be presented to the Congress as supplemental data.

AGENCY ACTIONS AND UNRESOLVED ISSUES

OMB did not agree that GAO's suggestions were either necessary or desirable. OMB believes that to include inflation in cost estimates, even on the suggested supplementary basis, would tend to increase Government procurement costs. (See p. 14.)

OMB has sound reasons for not desiring to include inflation as part of the formal Federal budget. GAO would not wish to promote a practice that would dampen incentive to reduce costs. However, to assess and authorize long-term programs, the Congress should have information show-

ing, as realistically as possible, these programs' total expected cost. Agencies should have estimates for inflation available to submit to appropriate congressional committees for their use when these programs are under consideration.

MATTERS FOR CONSIDERATION  
BY THE CONGRESS

GAO believes congressional committees should obtain agencies' estimates for inflation for long-term programs which are under consideration for program authorization and funding.

## CHAPTER 1

### INTRODUCTION

The General Accounting Office (GAO) examined the practices followed by selected Government agencies in providing for inflation in cost estimates for major long-term programs. The Congress and the public are concerned about the tremendous cost growth of many Government programs. Agencies have attributed the growth to many factors, including inflation. "Inflation" is defined here as a persistent and appreciable rise in the general level or average of prices for both labor and material.

Agencies request congressional authorization and funds for a program on the basis of need and anticipated cost. The Congress and agency management need realistic cost estimates, including estimates for inflation, to have the best available estimate of total program cost and to aid effective program selection, evaluation, and cost control during the acquisition process.

In our report (B-163058, July 24, 1972) on the theory and practice of cost estimating for major acquisitions, we developed criteria for realistically estimating program costs. The criteria included clearly identifying the task, determining the availability of valid data, providing for program uncertainties (risks), and recognizing inflation.

Generally, agencies estimate their long-term program costs on the basis of current prices. If they include inflation in these estimates, they normally apply percentages, which represent the expected price trends, to the current cost base. If basic program estimates are unrealistic, the estimate for inflation will be affected. Rapidly rising prices in recent years have had a significant impact on program costs. Omitting estimates for inflation has resulted in understatements of estimated program costs and has been cited as a major reason for cost growth.

The Office of Management and Budget (OMB) has the authority to monitor and approve budget requests. It has been OMB's long-established policy, stated in OMB Circular A-11,

that allowances for future price increases will be excluded from such requests, as follows.

"It will be assumed that on the average the general level of prices will be the same during the budget year as at the time the estimates are prepared, except where increases will result directly from laws already enacted (such as, increases in FICA [Federal Insurance Contributions Act] tax rates effective at future dates)."

With a few exceptions, OMB has applied this policy to both single-year and long-term program estimates and, in its budget reviews, has rejected provisions for anticipated price increases. OMB officials explained that to budget for inflation would seem to provide governmental sanction for a stated rate of inflation and that inflation would actually occur at, or in excess of, the stated rate.

For fiscal year 1972, the total Federal budget request amounted to \$249 billion, of which \$80 billion was for the Department of Defense (DOD) and about \$169 billion was for the civil agencies.

Principal officials of OMB are listed in appendix III.



## CHAPTER 2

### NEED FOR SUPPLEMENTAL DATA ON

#### INFLATION FOR LONG-TERM PROGRAMS

Although it is not the only reason for inaccurate program cost estimates, OMB's policy of not including allowances for rising prices in long-term program estimates has contributed to agencies submitting to the Congress significantly understated estimates for some of their major programs. OMB requires agencies to prepare long-term program estimates on the same basis as they prepare annual budget estimates. Therefore program estimates are prepared using costs current at the time of preparation, without any attempt to project costs to the time funds will be needed.

Despite the budgetary policy, some agencies included allowances for inflation in their budget requests, but these amounts were not identified for the Congress. Thus the Congress has received inconsistently prepared budget estimates. OMB has authorized some exceptions to recognize inflation, but these have been confined to specific programs and are not intended to cope with the general problem.

Fluctuations in the inflation rates in recent years have made it difficult to anticipate inflation's effects on costs. The administration, however, has taken steps designed to stabilize inflation and these may provide a basis for more realistic estimates for future long-term programs.

OMB officials are familiar with the problems the agencies and the Congress face in authorizing and funding long-term programs. They believe that the problems should not be solved by providing the Congress with estimates for inflation mainly because increases in estimates would tend to increase procurement costs.

We agree that agencies should not include inflation in the budget request for annual funds; however, for long-term programs, they should prepare estimates of the funds needed not only on the basis of current costs, but also the additional amounts, if any, that would be needed if changes in the economy are expected at the time when costs will be incurred.

## EFFECT OF COMPLYING WITH OMB POLICY

For programs and activities for which funds are budgeted and obligated for a single year, estimates prepared without providing for inflation have little adverse effect. For long-term programs, however, OMB's policy results in estimates that do not provide for reasonably anticipated program costs and may result in the Congress' approving programs and costs on the basis of partial cost information.

Initial program estimates were often submitted to the Congress for approval without providing for inflation. After program approval, revised annual estimates were based on current cost for each succeeding budget year. They included increases since the prior estimate. But each new estimate continued to exclude future cost increases, and the Congress still received incomplete cost data.

During hearings in 1970, the House Committee on Armed Services referred to the inaccurate long-range cost estimates due to inconsistent provisions for price changes or no provisions at all. The Committee's report cited cost growth of \$1.6 billion in the Anti-Ballistic Missile system and inadequacies from presenting the fiscal year 1970 estimate in terms of 1968 prices and the fiscal year 1971 estimate in terms of 1969 prices.

Inflation's impact on program costs can be severe, as the following examples illustrate.

### Gathright Dam

The Congress authorized this project in 1964 on the agency's total estimated program cost of \$13 million in terms of 1963 costs. Construction began in 1967.

For 4 successive years from July 1, 1967, the agency increased its cost estimate to incorporate inflation experienced to the beginning of each fiscal year. The amounts of the increases were \$0.8 million, \$1.1 million, \$1.7 million, and \$1.8 million, respectively. The total impact of

inflation recognized after the fact over the 4-year period was about \$5.4 million, or about 41 percent, of the original cost estimate submitted to the Congress.

#### A-7D aircraft

The Congress authorized acquisition of A-7D aircraft in fiscal year 1966 on the basis of a total estimated program cost of \$847 million. Apparently, the initial cost estimate did not provide for rising prices. Each succeeding year the agency increased its cost estimate for price increases and changes in other costs. The several factors contributing to cost growth were not separately identified. Agency officials stated that the program cost estimates in 1970 included about \$223 million for inflationary price increases.

In contrast to the cost estimates submitted to the Congress, agencies frequently prepared for their own use supplemental estimates of the projected total program cost, including expected cost increases due to inflation. In 1969 DOD requested authority from OMB to provide for inflation in its total program estimates for major weapons systems and other major projects. OMB denied this request, and DOD instructed the military services to prepare two separate cost estimates for their major programs--one excluding inflation for the budget submission and one including inflation for internal program evaluation.

## EFFECT OF NOT COMPLYING WITH OMB POLICY

Although including allowances for inflation was contrary to OMB policy, agencies sometimes included such allowances in their budget requests. These allowances were not usually identified separately in the budget presentation or otherwise disclosed to the Congress. The result has been that the Congress has received program estimates that have not been prepared consistently.

Officials of one agency said they interpreted OMB policy to mean that funds requested in the budget for the current fiscal year must be presented in terms of current costs, but total program estimates may include all expected costs, including inflation. According to OMB officials, this interpretation clearly conflicts with the policy's intent.

Examples of agencies' program estimates which have included inflation follow.

### F-14 aircraft

In its initial estimate for the F-14 aircraft program, the agency allowed \$816 million for inflation in the total estimate of \$6.2 billion. This amount was not separately identified in the agency's estimate, although the Congress became aware of the inflation allowance through testimony during committee hearings.

### Viking project

In November 1968 the agency estimated that the Viking project would cost \$364 million, excluding the cost of the launch vehicle. The estimate was prepared for the 1970 fiscal year budget presentation and did not include inflation. In the spring of 1969, the agency increased its estimate to include \$64 million for inflation, but the Congress was not informed and approved the project on the basis of the \$364 million estimate. In early 1970 the estimate was again revised to include an additional \$38.3 million for inflation. The fiscal year 1971 budget estimate included inflation of \$102.3 million, but it was not separately identified as such.

Fluctuations in inflation rates in recent years have made it difficult to anticipate inflation's effects on long-range programs' costs. Indexes of labor and material prices

compiled by the Bureau of Labor Statistics for 1958 through 1970 illustrate the problem. (See app. I.) The labor index varied from an increase of 1.8 in 1960 to 9.4 in 1968. The material index varied from a decrease of 0.6 to an increase of 4.3 in 1969.

We believe that more meaningful and realistic cost estimates that include inflation could be made, even in these circumstances. It would, however, require guidance based on the best available information and techniques for estimating inflation. Such guidance would provide the departments and agencies with a basis for achieving a desirable degree of uniformity in program estimates.

#### ACTION TAKEN TO PROVIDE FOR INFLATION

Agencies have taken various actions to estimate total expected costs and to allow for inflation in program estimates. Some of these allowances have been included, but not identified, in budget requests, whereas others have been clearly stated. The actions, however, were not studied approaches for coping with the general problem of providing for rising prices. Rather, they were designed to deal only with particular problems and circumstances.

For example, for Navy ship construction, OMB recognized that authority was needed to enter into long-term commitments on the basis of total expected cost. Therefore for several years the Navy has been authorized to include estimates for inflation in ship construction budget estimates on the construction portion of the estimate. This portion consists of the cost of design development, hull construction, and installation of Government-furnished items.

In early 1968 DOD began preparing Selected Acquisition Reports (SARs) for the Secretary of Defense to use. SARs summarized current estimates of technical, schedule, and cost performance and compared them with the original plan and the current approved program. Because of congressional requests for more accurate cost data for major programs, DOD began submitting SARs to the Congress. SARs include a section on economic change, a part of which is the expected cost of inflation. Problems arose, however, because the

budget estimates for major programs were not priced on the same basis as SARs. In a letter to OMB dated August 6, 1970, DOD cited problems resulting from a failure to reflect price increases in certain budget estimates and from the lack of a uniform policy for preparing SAR and budget estimates.

In its report dated April 24, 1970, the House Committee on Armed Services was concerned about the lack of consistent procedures in making long-range cost projections. The Committee felt these forecasts were inaccurate because they did not provide, or they inconsistently provided, for inflation. The report called for improved estimates for fiscal year 1972, as follows:

"\*\*\* The Committee believes that to make realistic long-range projections which could be truly useful to the Congress it is necessary to have some realistic measure of inflationary trends and the Committee believes that consistent factors should be used in all programs. The Department of Defense will be expected to issue new directives in this area before the submission of the FY [fiscal year] 1972 budget request."

To provide more realistic cost projections for both DOD and the Congress, DOD requested an exception to the provisions of OMB Circular A-11 to incorporate some allowance for price increases in its fiscal year 1972 budget estimates for major weapons systems and major construction. DOD's request stated that long-term Government-wide budgeting projections had acquired much greater importance in recent years. Price trends, DOD continued, must be incorporated to develop a realistic fiscal picture.

OMB approved the request for an exception to Circular A-11 to permit price indexes to be used in developing major long-range program estimates included in DOD's 1972 budget. OMB stated that it was important that the indexes chosen reflected general forces at work in the economy and not indexes primarily influenced by Defense decisions. In granting the exception, OMB placed a constraint on DOD in that the allowances for price increases were to be provided within the overall ceiling established for the 1972 defense budget. Subsequently, OMB approved a similar exception for fiscal year 1973 budget estimates.

CURRENT ACTION BY THE ADMINISTRATION  
TO CONTROL INFLATION

The administration has taken steps to establish controls designed to stabilize inflation. The steps were in two phases. Phase I was a complete price freeze, and phase II was a period of controlled price changes. The Secretary of the Treasury headed the Cost of Living Council established to enforce the freeze. For phase II, a Pay Board and a Price Commission were established under the Cost of Living Council. The Pay Board's purpose was to establish a yardstick for permissible increases in wage rates. The Price Commission had a similar objective for prices and for rents. The Pay Board and the Price Commission have issued guidelines for wage rate increases and prices for materials. Both established a percentage as the goal for the amount of increase that will be allowed.

These actions may provide a more reliable basis for estimating inflation in long-term program costs.

## CHAPTER 3

### AGENCY COMMENTS AND OUR EVALUATION

OMB's Assistant Director for Budget Review commented on a draft of this report in a letter dated June 5, 1972. (See app. II.) We proposed that cost estimates for long-term programs include an estimate for inflation, which should be presented to the Congress as supplemental data. The Assistant Director stated that OMB did not agree that this proposal was either necessary or desirable. OMB believed that to include inflation in cost estimates, even on the suggested supplementary basis, would tend to increase procurement costs to the Government. OMB believed also that two of the examples cited in this report were unfortunate choices on which to justify including the effect of inflation in the estimates, because cost increases occurred for a number of other reasons.

In our opinion, OMB's reply does not adequately consider the need for the Congress to have complete and consistent data for making its decisions. Information currently being submitted to the Congress on long-term programs contains cost estimates which are understated or which include allowances for inflation not separately identified. When allowances are included, they are inconsistently prepared by the agencies because of differing interpretations of OMB policy.

OMB's statement that to anticipate inflation in preparing long-term cost estimates would tend to increase costs does not, in our opinion, adequately recognize the benefits to the Congress and top management officials that would be achieved by providing more realistic cost data prepared on a consistent basis. We believe that more complete and consistent disclosure of all elements of costs affecting long-term program estimates would provide an improved basis for assessing priorities, authorizing long-term programs, and assessing and controlling costs.

We agree with OMB that cost increases in our examples occurred for a number of reasons; however, we believe these examples are appropriate illustrations of incomplete and inconsistent data submitted to the Congress.



## CHAPTER 4

### CONCLUSIONS

OMB, in our opinion, has sound reasons for not desiring to include inflation as part of the formal Federal budget. We do not wish to promote a practice that would act as a disincentive to reduce costs. Nevertheless, to assess and authorize long-term programs, the agencies should have information that shows, as realistically as possible, the total expected cost of long-term programs. We believe that, when estimating the costs of long-term programs, agencies should prepare estimates of the effects of inflation on these programs' costs and should have them available to submit to appropriate congressional committees for their use when these programs are under consideration.

We believe that the congressional committees should obtain agencies' estimates for inflation for long-term programs which are under consideration for program authorization and funding.

## CHAPTER 5

### SCOPE OF REVIEW

We conducted our review at DOD and the military departments and civil agencies responsible for the major programs shown below.

Department of the Army:

Tank Automotive Command, Detroit, Michigan--M-151 1/4-ton trucks  
Corps of Engineers, Norfolk District, Norfolk, Virginia--Gathright Dam Project

Department of the Navy:

Naval Air Systems Command, Washington, D.C.--F-14 Aircraft Program

Department of the Air Force:

Air Force Systems Command, Aeronautical Systems Division, Wright-Patterson Air Force Base, Ohio--A-7D Aircraft Program

Department of Transportation:

Federal Highway Administration, Washington, D.C.--Interstate Highway System

National Aeronautics and Space Administration, Washington, D.C.--Viking project

We reviewed OMB directives for preparing and submitting budget estimates and examined the agencies' practices relating to estimates for inflation for the major programs listed above.

INDEX OF LABOR AND MATERIAL  
FOR THE PERIOD 1958 THROUGH 1970

<u>Year</u>	<u>Labor (1957 = 100)</u>		<u>Material (1957-59 = 100)</u>	
	<u>Index</u> <u>(note a)</u>	<u>Increase</u> <u>(note b)</u>	<u>Index</u> <u>(note c)</u>	<u>Increase or</u> <u>decrease(-)</u> <u>(note c)</u>
1958	101.4	1.4	100.5	0.5
1959	108.2	6.8	101.6	1.1
1960	110.0	1.8	101.0	-.6
1961	113.2	3.2	100.9	-.1
1962	118.3	5.1	100.7	-.2
1963	122.1	3.8	101.2	.5
1964	126.2	4.1	101.8	.6
1965	131.8	5.6	103.2	1.4
1966	137.7	5.9	105.5	2.3
1967	140.8	3.1	107.5	2.0
1968	150.2	9.4	110.3	2.8
1969	158.7	8.5	114.6	4.3
1970	163.9	5.2	118.7	4.1

<sup>a</sup>Computed by GAO from average gross earnings of production and nonsupervisory workers, compiled by the Bureau of Labor Statistics.

<sup>b</sup>Computed by GAO.

<sup>c</sup>Wholesale price index--industrial commodities--compiled by the Bureau of Labor Statistics.

EXECUTIVE OFFICE OF THE PRESIDENT  
OFFICE OF MANAGEMENT AND BUDGET  
WASHINGTON, D.C. 20503

JUN 5 1972

Mr. James H. Hammond  
Deputy Director  
Procurement and Systems  
Acquisition Division  
U.S. General Accounting Office  
Washington, D.C. 20548

Dear Mr. Hammond:

Thank you for your invitation to Director Shultz to comment on your draft report to the Congress on provisions for inflation in budgets for long-term programs.

The summary, on page 15 of the draft report, of the Office of Management and Budget position on providing for inflation in budget estimates for long-term programs states our position accurately. We would rephrase the third point as follows, however:

[See GAO note 1, p. 19.]

[ See GAO note 1.]

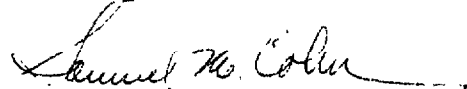
Both examples cited in the report, Viking Project and F-14 aircraft, are unfortunate choices as justifications for including the effect of inflation in the estimates. The cost increases associated with these programs occurred for a number of reasons; even if the cost estimates had included an allowance for inflation, these projects would have required substantial additional funds.

The draft report recommends that the Director of OMB:

- "-- identify the agencies having long-range programs for which there are needs to submit estimates for inflation to the Congress,
- "-- assist those agencies in developing a basis for estimating for inflation, and
- "-- develop a report format that will show total expected program costs excluding<sup>[2]</sup> allowance for inflation."

We do not agree that such a procedure is either necessary or desirable. We believe that the inclusion of inflation in cost estimates, even on the suggested supplementary basis, would tend to increase procurement costs to the Government.

Sincerely,



Samuel M. Cohn  
Assistant Director  
for Budget Review

GAO notes:

1. Material deleted from this letter concerns changes in wording incorporated into this report.
2. This word should be "including."

APPENDIX III

PRINCIPAL OFFICIALS OF  
THE OFFICE OF MANAGEMENT AND BUDGET

	<u>Tenure of office</u>	
	<u>From</u>	<u>To</u>
DIRECTOR, OFFICE OF MANAGEMENT AND BUDGET:		
Caspar W. Weinberger	June 1972	Present
George P. Shultz	July 1970	June 1972
DIRECTOR, BUREAU OF THE BUDGET (note a):		
Robert P. Mayo	Jan. 1969	June 1970
Charles J. Zwick	Jan. 1968	Jan. 1969
Charles L. Schultze	June 1965	Jan. 1968

<sup>a</sup>Under the President's Reorganization Plan 2, effective July 1, 1970, the Bureau of the Budget was incorporated into the newly established Office of Management and Budget.

Copies of this report are available from the U. S. General Accounting Office, Room 6417, 441 G Street, N W., Washington, D.C., 20548.

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