

National Security and
International Affairs Division

B-279943

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May 11, 1998

The Honorable Ron Wyden
United States Senate

Subject: Defense Budget: Projected Inflation Savings

Dear Senator Wyden:

On February 3, 1998, the Secretary of Defense testified before the Senate Armed Services Committee on the fiscal year 1999 Department of Defense (DOD) budget. In his statement, the Secretary said that DOD will be able to buy more defense programs in fiscal years 1999-2003 than previously planned because "President Clinton allowed the Department to keep about \$20 billion in savings projected from lower estimates of future inflation." You asked that we (1) identify the projected savings by fiscal year and the programs that DOD plans to buy with those savings, (2) discuss the implications of applying those projected savings to additional DOD programs, and (3) compare DOD's estimated savings to estimates provided to you by the Congressional Budget Office (CBO) and identify possible reasons for the difference in those estimates.

BACKGROUND

The Future Years Defense Program (FYDP) is an authoritative record of current and projected force structure, costs, and personnel levels that has been approved by the Secretary of Defense. The fiscal year 1999 FYDP supported the President's fiscal year 1999 budget and included budget estimates for fiscal years 1999-2003.¹

¹Unless otherwise stated, the years and dollar values shown in this letter are on a fiscal year basis.

Each year, the Office of Management and Budget provides DOD with guidance to use in preparing DOD's budget request and FYDP. The guidance includes the executive branch's assumptions for inflation, the price of fuel, and military and civilian pay raises. DOD uses these assumptions to reestimate the cost of its programs.

RESULTS IN BRIEF

As a result of lower projected inflation rates, DOD calculated that its future purchases of goods and services over the 1999-2003 period would cost about \$21.3 billion less than projected 1 year ago. According to DOD, it will be able to buy additional programs with assumed savings from the projected lower inflation. These programs include procurement items and civilian and military pay raises, which account for \$15 billion of the \$21.3 billion.

Our reviews of DOD's FYDPs over the past few years have shown that DOD has not been able to reduce its infrastructure and increase procurements as planned. This problem can be attributed somewhat to optimistic projections of future savings that did not materialize. If the projected inflation savings that DOD has factored into the 1999 FYDP materialize or the inflation rates fall even lower than projected, DOD can fund the additional programs. However, if the projected rates prove to be too optimistic, and the savings do not materialize, DOD will have to adjust its future budgets by cutting programs and/or request additional budget authority from the President and the Congress.

CBO estimated that lower projected inflation rates would save defense \$13.4 billion over the 1999-2003 period rather than the \$21.3 billion estimated by DOD. The most significant reason DOD's and CBO's estimates differ is that the declines in projected inflation are different. Other reasons are that the budget baselines are different and CBO's estimate includes savings from lower fuel costs, whereas DOD's estimate of \$21.3 billion does not include savings for lower fuel costs of about \$1 billion.

**PROJECTED SAVINGS AND PROGRAMS
THAT DOD PLANS TO BUY**

Table 1 presents, by fiscal year, DOD's projected savings from lower inflation estimates and the additional programs that DOD plans to buy with those savings.

Table 1: Application of Projected Inflation Savings to DOD Programs

Dollars in millions

Projected savings and programs	Fiscal year					
	1999	2000	2001	2002	2003	Total
Total savings	\$2,785	\$3,537	\$4,373	\$4,945	\$5,698	\$21,338
Program						
Additional procurement	2,000	1,200	900	2,100	2,700	8,900
Civilian pay raise	333	750	1,155	1,571	2,009	5,818
Military pay raise	44	60	61	62	64	291
Nuclear stockpile stewardship		600	500	700	600	2,400
Defense health		500	500	300	300	1,600
Air Force (classified)	100	100	100	200	200	700
- Chemical demilitarization		121	320	469	11	921
Counterdrug	100	100	100		100	400
Cooperative threat reduction	100		200			300
National Guard consequence management	100					100

Note: For fiscal year 1998, DOD projected inflation savings of \$846 million. Program totals do not add to the savings because DOD cannot precisely account for the allocated savings.

Source: DOD.

The following sections provide additional information on these programs and the funding increases. We do not discuss the Air Force classified program.

Additional Procurement

According to an official within the Office of the Secretary of Defense, about \$8.9 billion of the projected savings were applied to additional procurement items from 1999 to 2003. The funds were applied to meet DOD's procurement goals and to purchase higher priority programs and National Guard and Reserve equipment.

Civilian Pay Raise

DOD's 1998 FYDP for 1998-2003 included funding for civilian pay raises of 2 percent a year for 1999-2003. The 1999 FYDP provides funds for civilian pay raises of 3.1 percent in 1999 and 3 percent a year for 2000-2003. The additional funds allocated to this program are to pay for the raises.

Military Pay Raise

DOD's 1998 FYDP included funding for a military pay raise of 3 percent a year for 1999-2003. The 1999 FYDP provides for military pay raises of 3.1 percent in 1999 and 3 percent a year for 2000-2003. The additional funds allocated to this program are to pay for the raise in 1999 and the effects of that raise in subsequent years.

Nuclear Stockpile Stewardship

This program provides for the research, development, and engineering activities to support the safety and reliability of the nuclear weapons stockpile, without underground nuclear testing. The program, managed by the Department of Energy, is funded by the Department of Energy and DOD.

Defense Health

In our October 23, 1997, report entitled Future Years Defense Program: DOD's 1998 Plan Has Substantial Risk in Execution (GAO/NSIAD-98-26), we stated that DOD significantly underbudgeted the 1997 Defense Health Program and that shortfalls continued in the 1998 FYDP for 1998 and 1999. In its May 1997 Report of the Quadrennial Defense Review, DOD recognized that it had underestimated the cost of medical care. The projected funding increase reflects DOD's recognition that it underestimated costs.

Chemical Demilitarization

The Chemical Demilitarization Program was established by the National Defense Authorization Act for Fiscal Year 1986 (P.L. 99-145, as amended). DOD is required to destroy the complete chemical stockpile by April 29, 2007. The program is designed to destroy the U.S. inventory of lethal chemical agents and munitions and nonstockpile-related material and provide for emergency response capabilities, while avoiding future risks and costs associated with the continued storage of chemical warfare materiel. The additional funding of \$921 million reflects DOD's recognition that the cost of the program has increased. Specifically, DOD estimated in December 1997 that the projected life cycle cost of the program had increased by 27 percent over the previous year's estimate.

Counterdrug

DOD administers programs that support domestic and foreign law enforcement agencies with counterdrug responsibilities. The projected funding increase reflects DOD's increased support of those agencies.

Cooperative Threat Reduction

The Cooperative Threat Reduction Program was established in fiscal year 1992 to promote denuclearization and to reduce the threat of weapons proliferation in the recipient countries of the former Soviet Union. The proposed additional funding is to eliminate a chemical plant and accelerate the destruction of former Soviet missiles.

National Guard Consequence Management

This is a new program under which National Guard and Reserve forces can assist local, state, and federal authorities in responding to domestic incidents involving the use weapons of mass destruction. The cornerstone of the program is the creation of Army National Guard assessment teams to provide an on-site rapid response element for each state, U.S. territory, and the District of Columbia.

IMPLICATIONS OF APPLYING SAVINGS TO ADDITIONAL PROGRAMS

Since its bottom-up review in 1993, DOD has repeatedly stated that it must reduce its infrastructure to offset the cost of future modern weapon systems. Our analysis of DOD's FYDPs and infrastructure activities over the past few years shows, however, that the infrastructure portion of DOD's budget has not decreased as DOD planned.² Moreover, DOD has not met procurement goals established in previous FYDPs. In its Quadrennial Defense Review report, DOD stated that the primary source of instability in its current plans is the use of planned procurement funds for other activities. DOD identified unrealized savings from outsourcing and other initiatives as one of the three primary reasons for this chronic erosion of procurement funding. According to DOD, "Savings that fail to materialize result in unplanned expenses which must be paid from the few discretionary accounts, principally modernization."

Because DOD applied significantly lower inflation rates to its planned purchases over the 1999-2003 period, DOD projected a savings of \$21.3 billion that it plans to use to buy additional programs. If the projected inflation rates materialize or the inflation rates fall even lower than projected, DOD can fund the additional programs. However, if the projected rates prove to be too optimistic, and the savings do not materialize, DOD will have instability in its program and will have to adjust future FYDPs by cutting programs and/or request additional budget authority from the President and the Congress.

²Future Years Defense Program: DOD's 1998 Plan Has Substantial Risk in Execution (GAO/NSIAD-98-26, Oct. 23, 1997); Future Years Defense Program: Lower Inflation Outlook Was Most Significant Change from 1996 to 1997 Program (GAO/NSIAD-97-36, Dec. 12, 1996); Defense Infrastructure: Costs Projected to Increase Between 1997 and 2001 (GAO/NSIAD-96-174, May 31, 1996); and Future Years Defense Program: 1996 Program Is Considerably Different From the 1995 Program (GAO/NSIAD-95-213, Sept. 15, 1995).

SOME REASONS FOR DIFFERENCES
IN DOD AND CBO SAVINGS ESTIMATES

At your request, CBO estimated that defense's projected budget authority for 1999-2003 could be reduced by \$13.4 billion and provide about the same level of real financial resources for nonsalary purchases as assumed a year ago for the 1999-2003 period. CBO's projection varies from DOD's—\$21.3 billion—by about \$8 billion. In the following sections, we provide some reasons for this difference.

Declines in Projected Inflation Are Different

A year ago, CBO projected that the price index for the gross domestic product would grow by an average of 2.6 percent a year for 1999-2003. In its January 1998 budget outlook report,³ CBO projected that annual inflation would grow by 2.2 percent in 1999, 2.3 percent in 2000, and 2.4 percent for 2001-2003. At the direction of the Office of Management and Budget, DOD last year used a price index for the gross domestic product that projected the cost of nonpay purchases would grow by 2.1 percent for 1999-2003. For the 1999 FYDP, DOD used 1.5 percent for 1999, 1.6 percent for 2000, and 1.7 percent for 2001-2003. Table 2 shows the yearly decrease in projected inflation estimates used by CBO and DOD.

³The Economic and Budget Outlook, Fiscal Years 1999-2008, CBO, January 1998.

Table 2: Yearly Decrease in Projected Inflation Estimates

Fiscal year	Decrease in yearly inflation from 1997 estimates	
	CBO	DOD
1999	.4	.6
2000	.3	.5
2001	.2	.4
2002	.2	.4
2003	.2	.4

Source: CBO and DOD.

These differences in the projected decline in inflation account for most of the difference in DOD's and CBO's estimates.

Budget Baselines Are Different

The CBO estimates were computed based on nonsalary purchases for national defense programs (050 budget function). The DOD estimates were based on nonsalary purchases for DOD programs (051 budget subfunction). National defense programs (050) include three budget subfunctions: 051 DOD, military; 053 atomic energy defense activities; and 054 other agencies, defense-related activities (e.g., civil defense and management of strategic stockpile). DOD's budget is the largest part of national defense programs. For example, DOD's share of the budget authority requested for 1999 for national defense programs was 95 percent.

Projected Savings for Fuel Purchases

Projected savings for fuel purchases are included in CBO's estimate of \$13.4 billion. DOD computes those savings separately and has not included them in the \$21.3 billion. For the 1999-2003 period, DOD projects total savings for lower fuel costs of about \$1 billion, as table 3 shows.

Table 3: DOD Projected Savings for Fuel Purchases

Dollars in millions

Fiscal year	Projected savings
1999	\$159
2000	173
2001	194
2002	216
2003	238
Total	980

Source: DOD.

SCOPE AND METHODOLOGY

To identify the projected savings and programs that DOD plans to buy with those savings, we interviewed officials in the Office of the Under Secretary of Defense (Comptroller) and examined a variety of DOD documents. To identify reasons for the differences between DOD's and CBO's estimates, we discussed these estimates with officials from CBO and the Office of the Under Secretary of Defense (Comptroller). To ensure the technical accuracy of our letter, we provided DOD and CBO officials with draft copies of this letter. We have incorporated their comments, as appropriate. We did not verify the accuracy of DOD's or CBO's calculations.

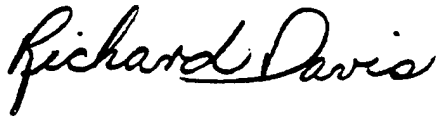
Our work was conducted from February through May 1998 in accordance with generally accepted government auditing standards.

We are providing copies of this letter to appropriate congressional committees; the Secretary of Defense; CBO; and the Director, Office of Management and Budget. We will also provide copies to others upon request.

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If you have any questions concerning this letter, please call me on (202) 512-3504. Major contributors to this letter were Robert Pelletier, Deborah Colantonio, William Crocker, and Robert Henke.

Sincerely yours,

A handwritten signature in cursive script that reads "Richard Davis". The signature is written in black ink and is positioned below the "Sincerely yours," text.

Richard Davis
Director, National Security
Analysis

(701142)

GAO/NSIAD-98-177R Projected Inflation Savings

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