

Statement of
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NOTICE

This statement is not available for public release until it is delivered at 10:00 a.m. (EDT) on Wednesday, April 30, 1986.

Mr. Chairman and members of the panel, I am pleased to appear before you today to testify on inflation adjustments in the defense budget. Since the early 1970s, much of the budget request for the Department of Defense (DoD) has included funds to cover anticipated increases in prices. In recent years, however, the Administration's inflation estimates have exceeded actual increases in prices, so that DoD has received more funds than it needed to compensate for inflation.

This excess funding has prompted questions about how better to budget for defense inflation. Improved forecasting methods might be of some help. But since no method can be expected to forecast inflation precisely, the Congress might also wish to examine more systematic ways of adjusting appropriations to correct for the inevitable errors in forecasting. On the other hand, more formal adjustment procedures will impose some cost by adding to the complexity of the budget process. In order to aid the Congress in assessing the costs and benefits of reform, my testimony today will explore the advantages and disadvantages of various approaches to inflation accounting.

I must stress that my testimony is limited to the effects on the defense budget of overall inflation in the economy. Other forms of cost increases--such as weapons cost growth resulting from slips in schedules or engineering changes--also have important effects on the defense budget, but must be dealt with on a case-by-case basis.

RECENT FORECASTS OF DEFENSE INFLATION

Policy for including inflation in the defense budget request is set by the Administration. Today, all parts of the DoD budget include estimates of anticipated inflation. For pay appropriations, which made up 32 percent of the fiscal 1987 defense budget request, the inflation allowance reflects the Administration's proposed changes in rates of civilian and military pay. For purchases from industry, which comprise 68 percent of the total 1987 defense budget, price increases are projected on the basis of the Administration's forecast of overall inflation in the gross national product (GNP) as measured by the GNP deflator. In the budgets for fiscal years 1983 to 1986, major weapons prices were forecast to rise more rapidly than the GNP rates, but in the 1987 budget they were set like other prices. The only current exception is for fuel purchases; fuel prices are forecast independently, based on anticipated market conditions.

From 1983 through 1985, Administration inflation projections exceeded actual rates by an annual average of 2.4 percentage points for general purchases (see Table 1). For major systems, the average error was even larger--3 percentage points. Such errors were not peculiar to the Administration. Inflation forecasts by the Congressional Budget Office (CBO) and by many private forecasters also exceeded actual levels.

CBO currently estimates that, because of these errors, defense budgets in 1983 through 1985 included \$23.2 billion for future inflation that now appears to be unnecessary. How much of this "inflation dividend" has already been recaptured by the Congress is uncertain. The Congress transferred \$6.3 billion of excess prior-year funds to meet new program obligations in 1986, as well as reducing DoD's original requests because of favorable price movements (in fuel prices, for example). An additional \$8.9 billion from 1982 through 1985 appropriations lapsed and was never spent. The Balanced Budget and Emergency Deficit Control Act of 1985 removed a

TABLE 1. INFLATION FORECASTS FOR DEPARTMENT OF DEFENSE OUTLAYS, FISCAL YEARS 1983-1985 (In percents)

Fiscal Year	General Purchases			Procurement of Major Systems		
	Predicted	Actual	Error	Predicted	Actual	Error
1983	7.0	4.0	3.0	8.5	6.7	1.8
1984	5.3	2.8	2.5	6.9	4.2	2.7
1985	<u>4.9</u>	<u>3.3</u>	<u>1.6</u>	<u>6.4</u>	<u>2.1</u>	<u>4.3</u>
Average, 1983-1985	5.7	3.4	2.4	7.3	4.3	3.0

SOURCE: Congressional Budget Office, from data compiled by the Department of Commerce's Bureau of Economic Analysis (actual) and Department of Defense budget documents (predicted).

further \$2.6 billion from prior-year unobligated balances. But because neither the Congress nor the Administration systematically identifies the portions of the reductions and transfers that are attributable to lower-than-expected inflation, the remaining inflation dividend, if any, cannot be calculated with precision.

Although overestimates of inflation have occurred in recent years, it is important to remember that just a few years ago, in the late 1970s, DoD systematically underestimated inflation. This underestimation led to underfunding defense accounts, particularly procurement, and contributed to disruption in weapon programs.

OPTIONS FOR FORECASTING INFLATION IN DEFENSE PURCHASES

By eliminating the 30 percent price differential for major weapon purchases, the Administration has recently taken one step to improve its estimates of defense inflation. (Because of the timing of this change, not all budget justification materials reflect the new policy.) Under the old method, which had been in effect since 1983, DoD anticipated that future inflation in major weapon systems would exceed the GNP inflation rate by 30 percent. From 1979 to 1983, inflation in major systems did exceed that for GNP, often by much more than 30 percent. In recent years, however, measured inflation for major systems has fallen below the GNP inflation rates, suggesting that a differential is no longer appropriate (see Table 2).

Making such a change is not unusual. Methods of budgeting for inflation have been modified periodically to reflect actual experience. The 30 percent differential was originally introduced, and more recently eliminated, in response to observed patterns of inflation. Other changes could be made in an effort to reduce forecasting errors. CBO's analysis--reported in our recently published special study on the topic--did not indicate, however, that forecasts for other broad-based indexes--such as the producer price index--would be likely to forecast defense prices more accurately than does the forecast for the GNP deflator.

TABLE 2. RELATION BETWEEN INFLATION RATES FOR MAJOR SYSTEMS AND GNP INFLATION RATES (By fiscal year)

Price Index	1979	1980	1981	1982	1983	1984	1985	Average 1979- 1985
Major Weapons Systems	12.2	10.9	12.6	11.1	6.7	4.2	2.1	8.5
GNP	8.4	9.3	9.3	6.3	4.1	4.2	3.5	6.4
Major Systems/ GNP	1.46	1.18	1.36	1.77	1.64	1.00	0.60	1.32

SOURCE: Congressional Budget Office, from data reported by the Department of Commerce, Bureau of Economic Analysis.

OPTIONS FOR ADJUSTING THE DEFENSE BUDGET AFTER ENACTMENT

Errors in inflation forecasting are impossible to avoid. The Congress could, however, choose to adjust the defense budget after enactment to compensate for such errors. There are several ways to make such adjustments, including the current procedure of ad hoc adjustments and several more systematic approaches.

Current Procedures

In recent years, both the Congress and the Administration have taken excess funds that were appropriated for inflation and used them for other purposes. For example, about \$1.5 billion in appropriations for previous years were used to pay for the purchase of MX missiles in 1985, and the battleship Iowa was recommissioned a year early by using excess prior-year appropriations. In April of last year, the Secretary of Defense identified \$1 billion in excess inflation funding for previous years. This sum, plus a further \$1.7 billion that appeared to the Congress to be in excess under the latest inflation projections, were reappropriated for other purposes in the 1986 defense budget.

Such ad hoc procedures may be appropriate in light of inflation's relatively small impact on the overall DoD budget. There may be no more need to adjust budgets explicitly for changes in inflation than for other forms of cost growth. But the lack of any explicit accounting for inflation

makes it difficult to calculate the amount of any inflation "dividend." Although the Congress took important steps last year to improve reporting of the financial status of the defense program, these changes are unlikely to lead to a systematic accounting for inflation.

Precise identification of an inflation dividend could be addressed through changes in the budget process. Such changes could range from additional reporting requirements to fundamental modifications in the way the Congress acts on the DoD budget request. They could also affect the degree of autonomy that DoD has to manage the process of inflation adjustment. In each case, the additional complexity and possible cost of a new budgetary procedure would have to be balanced against the gains from improved credibility of the defense budget.

Distinguish Inflation Funds from Real Program Costs

As one option for carrying out such a systematic approach, the Congress could require that DoD, in its budget requests, identify for each appropriation account the amount of funds projected for inflation. Then, when the Congress made changes in the budget request, it would--under this approach--indicate how much of every change should be for inflation funding. Similarly, when the Administration proposed supplemental appropriations, transfers of budget authority, or rescissions, it would be required to submit a revised inflation accounting showing the impact of new

inflation assumptions and program revisions. Otherwise, this option would not require any change in the way the Administration presents the budget or in the way the Congress reviews it.

This approach would avoid the controversy that arose over the Administration's \$4 billion budget offer in May 1985, which included about \$1.4 billion in "inflation savings." The Congress had no firm basis for accepting or revising this estimate; nor could the General Accounting Office (GAO) determine the correct figure.

On the other hand, this option would increase the work required to prepare and review the budget. Adjustments for inflation funding would have to be calculated each time a change was made in the budget. The Congress could, however, minimize its workload by establishing rules for making the calculations and then delegating the task to DoD, subject to Congressional review.

The Congress has begun to move in the direction of this option. The Appropriations Committees' reports on the fiscal year 1986 DoD Appropriations Bill, for example, identified reductions in the DoD budget that resulted from lower-than-anticipated inflation in previous years. This option would take an important additional step by requiring complete and systematic identification of changes in inflation funding every time the budget was revised by DoD or the Congress.

Use An Inflation Fund to Make Adjustments to Appropriations

The Congress has another option. Rather than intervening in the details of accounting for inflation, the Congress could give DoD more flexibility to manage those details by establishing a special inflation fund. Under this approach, anticipated inflation would be included in the various parts of the defense budget just as it is now. In addition, however, a special fund would be set up to compensate for errors in forecasting. Then, if actual inflation proved to be lower than expected, excess monies would be transferred from programs and would accumulate in the fund. The Congress could monitor the appropriateness of flows into and out of the fund as assumptions about inflation changed, and could periodically adjust the fund's level to reflect actual experience. Details of managing the fund's operation would be left to DoD, subject to review by the Congress. This fund would be analogous to the Foreign Currency Fluctuations Fund now in existence.

If such an inflation fund had been in existence since 1983, the excess funding that DoD received in previous years would have been removed from program funding and accumulated in the fund. This action would certainly have increased Congressional awareness of the inflation issue, and might well have led to earlier changes in budgeting policy. On the other hand, if the fund had been in place in the 1970s, DoD could have drawn on it to meet the costs of higher than anticipated inflation.

As these examples suggest, such a fund would allow DoD to react swiftly to changes in inflation, particularly if it were higher than expected. Currently, substantial increases in inflation funding must await Congressional action. This may not be a serious problem for DoD in a period of relatively low inflation. But if unanticipated inflation ever returns to high levels, rapid reaction would assure that defense programs would not be disrupted. Alternatively, during times when inflation is overestimated, this approach would provide a means to record and recover excess funding.

This option could, however, provide DoD with some budget flexibility that the Congress does not intend. For example, DoD could meet the expenses for a program of high priority, perhaps even including expenses only vaguely related to higher inflation, with money from the fund that the Congress intended for the inflation needs of other programs. The Congress could, of course, monitor programs of particular interest to avoid such changes.

Fund Inflation Through Supplemental Appropriations

Both of the previous options attempt to correct for misestimates of inflation by adjusting the budget after it is enacted. A third option would be for the Congress to appropriate only the costs of the defense program measured in currently prevailing prices, omitting any provision for inflation. The Congress could then make supplemental appropriations as necessary if prices increase. This mechanism would reduce the forecasting problem by

delaying the time when inflation is estimated until well into the fiscal year. This approach would be similar to what was done before 1970, when budget requests included no provision for inflation (except in shipbuilding). History suggests that the Congress would have a better idea of actual inflation if it waited a year before acting. In the 1979-1984 period, errors in price forecasts made while the budget was being spent were only one-third as great as those made when the budget request was prepared.

This option could pose problems for DoD. The Antideficiency Act prohibits DoD from entering into contracts when funds have not yet been appropriated. Moreover, Congressional delays in enacting the supplemental appropriation could significantly constrain DoD's operations, especially if inflation rates began to rise rapidly again.

Under this approach, DoD should receive most of what it needs to meet inflation. The history of supplemental bills shows that the Congress provides 90 percent of what DoD requests. Supplemental appropriation bills, however, would become larger and more complex. In recent years, these bills have been restricted mainly to pay adjustments, but under this approach they would have to include substantial budget authority for procurement, operations, and support as well. This change would certainly add to the Congress's workload. Moreover, it could revive a number of contentious issues already dealt with during the initial budget debate.

Finally, eliminating inflation from the procurement and military construction appropriations would deviate from the full-funding principle first adopted in the 1950s. This principle requires that the current Congress provide all funds needed to complete a weapon at the time it is first authorized. For many weapon systems, adjustments for inflation may amount to 50 percent or more of the total acquisition cost. Thus, under this option, one Congress would be committing its successor to meet these costs.

CONCLUSION

The recent history of excess inflation funding in a period of growing fiscal austerity has prompted questions about how best to budget for defense inflation. If the Congress desires a firmer basis for acting on the inflation portion of the defense budget request, it may want to consider the alternatives outlined in my testimony.

On the other hand, inflation is only one of the factors making budget estimates imprecise. Changes in defense budgets can also be caused by uncertain cost estimates, schedule delays, and unforeseen changes in operational requirements. Moreover, each of the changes I have discussed today would add complications to the budget process at a time when efforts are being made to simplify and streamline it. Instead, the Congress may wish simply to insist on better DoD accounting procedures and more timely reporting when program costs change.