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Budget Reform and the
Federal Financial Management System

by

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It is no secret that the Federal Government today faces a budget problem of astonishing proportions. When I first joined the Budget Bureau, we were struggling with a budget that totalled \$100 billion. Today, interest outlays alone exceed that amount. When I came to the General Accounting Office, total outlays were \$266 billion. Today, people are seriously discussing the possibility of deficits of that magnitude in the next few years.

It is evident to me, and to many other people, that we have a problem. Most of the attention has focussed on the difficulty in achieving a political consensus on the best way to close the deficit. Given the present distribution of political

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power, the consensus-building process is concentrated in the Congress, and in the congressional budget process. When the issues are divisive, and consensus proves difficult, as it has in the past several years, there is a strong tendency to blame the process.

Many people, both within the Congress and elsewhere, assert that the process is not working. Some propose to abolish the process. Others, including me, believe the process needs to be preserved, strengthened and improved.

I have no illusions, however, that a better budget process will magically produce consensus. The issues and choices are extraordinarily difficult. A better process can illuminate those choices, but it cannot substitute for the leadership and political courage needed to make them. I am convinced that anyone who believes otherwise has a profoundly mistaken view of the nature of our political system.

My conviction that leadership and courage are essential, however, is balanced by an equally strong conviction that systems and processes also matter. To make wise decisions, we must have the issue presented in an understandable context, we must know what the choices are, and we must have a reasonably reliable basis for judging the consequences of deciding one way rather than another. Lacking that structure and information, we may be reduced to the equivalent of rolling dice. It is the role of

the budget process to provide the machinery through which leadership and political courage can be brought to bear on resolving the urgent issues we face.

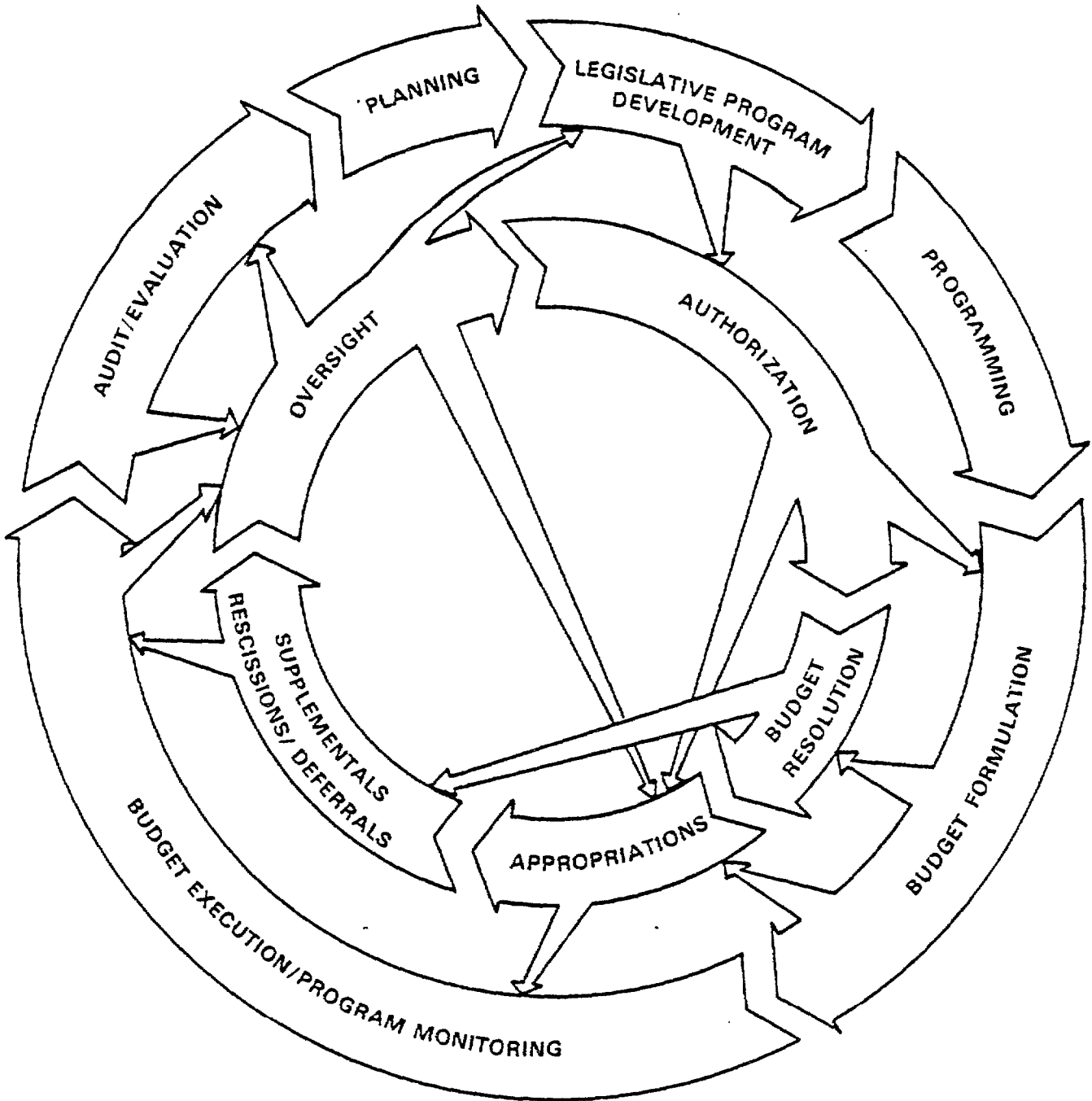
That machinery--our financial management system--is in urgent need of a major overhaul. The symptoms of disrepair are less visible than the budget deficit, but they are equally real.

- The processes by which we decide how much to spend, and for what purposes, are cumbersome, repetitive and time-consuming.
- Controls over how the money is spent are so detailed that program managers find it very difficult to be innovative or efficient. Yet, these cumbersome controls are routinely found to be ineffective in preventing abuse.
- Budget, accounting and management information systems are often obsolete and incompatible. They yield data which are unreliable, inconsistent and all too often irrelevant to the needs of decisionmakers.

The congressional budget process is a key component of the government's financial management structure, but the structure extends far beyond the Congress. Moreover, the structure is so complex and intertwined that it cannot be rebuilt in pieces. Figure 1 is an effort to describe this interrelatedness in

Figure 1

FEDERAL FINANCIAL MANAGEMENT PROCESSES CHART



grossly oversimplified terms. There are serious weaknesses in every phase of that cycle. This fact is documented in innumerable studies by the General Accounting Office, and I assure you that we are not alone in detecting those problems. To explain what I mean, I would like to spend a few moments describing some of these structural weaknesses and their consequences.

Lack of Program Cost Data

To control costs, we must know what the costs are. Today it can be almost impossible to determine the true cost of a program. There are several basic reasons. First, the available financial data focus on obligations (the point at which an item is ordered) and on outlays (the point at which cash is disbursed). Neither is a consistently reliable measure of the resources being consumed to carry out a program.

Second, while budgets are usually prepared on a program basis, the accounting records are often maintained by categories of expense (travel, personnel, etc.). It is often difficult or impossible to accumulate accounting data on a program basis.

Third, some costs are simply not recorded. This is usually the case with depreciation and the accumulation of unfunded pension liabilities.

Lack of Program Output Data

Unit costs are commonly used by managers as a way of monitoring

efficiency. To calculate unit costs, however, you need to know both the costs and the number of units. The cost data is seriously deficient and the output data is often nonexistent.

To be fair, I want to stress that measuring the output of Federal programs is not an easy task. It requires explicit agreement on the objectives of the program and on appropriate ways to measure progress toward those objectives. Neither is simple. In addition, it may require a very sophisticated and complex data collection system, particularly if the program operates through grantees and contractors.

Lack of Reliable Project Reporting Systems

The difficulties in keeping track of progress on major weapons systems have been noted for years. Cost overruns, schedule delays and performance deficiencies come to light after it is too late to do anything about them. Efforts to rectify the problem, such as the quarterly Selected Acquisition Reports (SARs), have been only moderately effective. The data in the SARs is compiled separate from the main line Department of Defense accounting systems, does not tie to the accounting data, and is not necessarily consistent or comparable from one year to the next. Despite its limitations, however, the SARs provides better information than is available on most major civil projects.

Before leaving this point, I want to stress that the ramifications of this weakness can be very serious, particularly

in the national security area. The consensus supporting the current defense buildup is potentially quite fragile. A continuing image of defense costs growing out of control could rapidly undermine that consensus.

Lack of a Comprehensive Budget

A federal budget of about \$850 billion may seem huge. It is. In reality, however, the budget is a good bit larger than this. How much larger depends on where you draw the line. I have already noted that we do not record depreciation or the accumulation of unfunded pension liabilities. This is only part of the problem.

There are also whole agencies which are simply defined as being outside the budget. They range from the relatively small Rural Telephone Bank (\$140 million) to an interesting entity called the Federal Financing Bank. The FFB, an arm of the Treasury, is expected to make \$24 billion in loans in fiscal year 1984 (\$10 billion, net of repayments), none of which is counted in the budget. Also excluded from the budget is a \$27 billion operation called the U.S. Postal Service, which some people continue to consider part of the Federal Government.

Even these exclusions, however, pale in significance compared to the statutory provision requiring that the entire Social Security system be excluded from the budget a few years hence. As a professional, I find it difficult to conceive of a

rational way to set priorities when enormous chunks of government are excluded from the process.

Lack of a Comprehensive Picture of
Financial Condition

Paralleling our lack of a truly comprehensive structure for setting budget priorities is our lack of a comprehensive set of financial statements. Many have ridiculed the idea of setting a value on the Washington Monument and carrying it on the books as an asset. That is not the issue. I do not argue that our financial statements should look exactly like those of a corporation. The Federal Government is a unique entity, and its financial statements should reflect that fact. But we do need a systematic way of recognizing in financial terms the cumulative impact of our decisions and actions.

The Federal Government has enormous assets and enormous liabilities and other claims on future resources. Knowing the magnitudes and their distribution over time is an essential part of the context within which current decisions must be made.

Treasury has made an important first step by issuing prototype financial statements. At this stage, however, the effort is still experimental. A great deal remains to be done to make the statements more reliable, informative and useful.

Lack of a Systematic Approach
to Capital Investment

The Federal Government is a major participant in developing and maintaining a wide array of public capital facilities. Sometimes the involvement is direct, with the Federal Government owning the facility. In other cases, the government is a source of financing for facilities owned by others.

This capital investment activity is managed through numerous departments and agencies. There is no structured approach to capital investment issues and no coordinated policy mechanism for assessing capital investment priorities for the government as a whole. The lack of visibility for investment decisions is coupled with a budget and accounting approach which treats capital spending as if it were the same as spending for current operations. That is, capital costs are usually expensed in the year in which they are incurred. This practice, in the context of a budget which focuses on short-term outlays, creates what some consider to be a systematic bias against capital investment.

Lack of Modern System Designs
and Supporting Equipment

For the most part, I have spoken of weaknesses in financial data and concepts. Those problems are made much worse by--to some extent they may stem from--the antiquated systems on which we rely for financial and other management information.

The basic approach to financial management system design dates back to World War II, when financial management responsibilities were rapidly decentralized to meet the needs of a wartime government. That pattern has continued. Each agency has acted independently to build the accounting and other administrative information systems which it thinks it needs. Little effort has been made to link the systems together within or across agencies or to build new systems designed to take advantage of modern technology.

The result is a patchwork of fragmented, uncoordinated systems characterized by gaps and inconsistencies. In this environment, agencies are commonly unable to provide reliable, routine data needed by managers. Accounting data comes from one system; budget data from another; and output and workload data from a third. There is little assurance that the data elements and reporting intervals, for example, will be sufficiently consistent to permit data to be combined reliably from the separate systems.

Overhauling the Structure

After reciting this litany of problems (and many more items could be added), it is time to say a few words about how I think we should deal with them.

I am convinced that the problems are pervasive and endemic to the entire structure of financial management. The solution

must be similarly comprehensive. We should start by reexamining why we have a financial management structure, what purposes it must serve and how it should serve them.

My own notion is that there are two basic reasons for having a financial management structure,

- to facilitate making decisions, and
- to facilitate assuring that those decisions are carried out.

Working from this central approach implies some things about the way the structure should be built. There should be an orderly flow of

- decisions,
- the information needed to make those decisions, and
- information about the implementation of those decisions.

After a good deal of thought, we at GAO are convinced that it is possible to build a new structure which meets those criteria. We have not attempted to design the structure in detail, but we have identified some features which we believe are essential. I would like to start by talking about decision processes and then turn to information needs.

Planning and Programming

The classical view of the management cycle usually starts with identification of major organizational goals and objectives

and the identification of techniques for achieving those goals and objectives. The same logic should apply in the Federal Government.

An effective planning and programming process, focusing on the major policy issues, should contain six key elements:

- o A mechanism to evaluate and set realistic goals and develop strategies to implement them.
- o A program structure which looks at agency activities in a mission or output oriented manner, and relates the costs of programs to the outputs (program results, benefits) produced or missions served.
- o A multi-year view for those programs where sound choices cannot be made using the one-year budget focus.
- o A means to aggregate program costs by major activity area and agency as well as government wide.
- o The ability to apply modern analytic techniques to help make choices between alternative goals, missions, strategies, and programs, and ensure that programs are affordable and balanced given national priorities.
- o Feedback mechanisms that reliably and consistently monitor and evaluate the actual costs, outputs,

efficiency and effectiveness of programs, and that systematically provide useful performance information and analyses to those who need it.

A planning and programming system which contains these six crucial elements would enable the Congress, the President, and agency officials to focus their time and attention more systematically on the major policy and program options.

Budgeting

Once the broad policy and major program directions are set, there follows the task of fitting the pieces together into a coherent financial and management plan--the budget. The process of formulating the budget is the central mechanism by which government establishes priorities among competing goals and programs.

As we think about alternative ways of improving and strengthening that process, we should keep one fundamental point in mind. Despite the technical complexity of today's process, the real purpose of budgeting in the public sector is the achievement of political consensus. The President's budget should emerge from the reconciliation of conflicting interests within the Executive Branch. When that phase is complete, the search for consensus shifts to the congressional arena--to the reconciliation of conflicting interests within the Congress and between the Congress and the Executive Branch.

Efforts to "reform" the process should encompass both the executive and congressional components and should emphasize facilitating consensus. However, some ways of achieving consensus are more desirable than others. Among the less attractive methods is hiding the decision, which can be accomplished in a variety of ways. Another is to make the decision so fuzzy that it means all things to all people. This approach may yield consensus, but it makes life very difficult for a program manager who needs to know what the program is expected to do.

There is a large array of improvements that have been suggested. Most have focused on the congressional phase of the cycle, because that is where the problems are most visible. Proposals include biennial budgeting, mission budgeting, capital budgeting, elimination of the second resolution, consolidation of appropriation accounts, committee reorganization, and so on. I think we should look very closely at all these suggestions and adopt those which would streamline the process. I am particularly attracted to anything that eliminates useless repetition and triviality from the process, improves the quality of information available for decisions, promotes the comprehensiveness of the budget process, and helps Congress focus its attention on major policy choices.

It would be a mistake, however, to limit our concern to the congressional phase of the process. The problems pervade the

executive branch, as well. There, too, we find pointless repetition and unnecessary detail, producing intolerable levels of work intensity. For top policy officials, there is the added problem that time wasted is time taken away from major policy decisions requiring their attention. Thus, reform efforts within the executive branch phase of the process are just as urgent as in the congressional process and should have the same basic focus.

Improving the Quality of Information

A better structure and process for planning, programming and budgeting is essential, but not sufficient. Those decision processes can operate most effectively only if they are systematically supplied with timely, relevant and reliable information.

The essential elements of information must start with comparable data on costs and outputs.

What we need is an integrated system in which cost data and output data flow together in a disciplined fashion. The system should supply routine reports to managers and policy officials on unit costs, for example, comparing actual unit costs to the budget plan and to historical trends. Reports of this sort will permit relatively easy monitoring of program implementation as well as providing a more reliable basis for developing budgets and explaining them.

Adequate Systems Support

The decision processes and information flows that we see being needed can be developed efficiently only through the use of modern information technology.

Government will be making very large investments over the next few years in a steady replacement of obsolete equipment. We think there are three basically different ways of approaching that investment. One is to continue the practice of replacing equipment without changing system concepts and functions. A second would be to upgrade the system designs in each agency, but not disturb the underlying concept of highly decentralized operations.

The third alternative would involve reexamining our current approach to decentralization. In the abstract, at least, we think there may be merit in some degree of consolidation of accounting and financial operations. The needs of smaller agencies might be met much more efficiently by purchasing services from a few large finance centers, located in the largest agencies, rather than by maintaining separate systems. Economies of scale in this area can be very dramatic. The cost of issuing a payroll check, for example, varies from \$2 to \$15. Most of that variation results from the scale of operations, and there are similar variations in the cost of other routine financial operations.

High Quality People

Well structured decision processes, efficient and reliable information flows and sophisticated supporting systems cannot function effectively without good people to operate them. If we are going to have a modern, integrated financial management system, we must find ways of attracting able, dedicated people to operate it. We must recruit bright young people, train them well, and offer attractive career opportunities. We suspect this will require rethinking some of our traditional personnel practices.

For example, I do not think it is reasonable to expect a sustained commitment to improve financial management when the leadership for that effort has an average tenure of two years or so. I think it is worth exploring the idea of establishing Chief Financial Officer positions in the major agencies, with a fixed tenure, occupied by individuals with extensive experience in operating financial management systems.

Consolidated Financial Statements

Once our financial management structure has been overhauled, we think it would be useful, and relatively easy, to produce more meaningful summary reports about the overall financial condition of the Federal Government. An important first step in this direction has been the development of prototype statements by

Treasury. But we should not expect statements that look exactly like those of a major corporation.

An example is the balance sheet, which represents an important discipline for the accounting process. But it would be a mistake to assume that a few numbers on a balance sheet can capture the complexity of government. Thus, I believe any balance sheet for the government should be accompanied by a variety of supplementary schedules and explanatory narrative. These should seek to make the numbers meaningful to the public, as well as to the financial expert.

I think it is also important to conceive of consolidated financial statements as providing an additional context for decisionmaking, rather than replacing existing material such as the budget documents.

Conclusion

Today's divergent, fragmented and often antiquated financial management information systems have been built gradually over many years. Replacing them with a more modern, efficient and comprehensive set of systems will take many years as well. But the dynamic, complex political and economic issues facing the nation today and into the next century demand a financial management system that provides the best possible information

to those entrusted with making the tough public policy choices that confront the nation. I have mentioned only a few of the many considerations that should go into the overhaul.

A modern structure will not emerge by accident, nor can it be created through the isolated efforts of a few individuals or organizations. Building the structure will require major investments of time, people, and money over an extended period. Even more important, the investments must be made by a large number of agencies in a coordinated fashion, pointing toward a common set of objectives. It is clear that the numerous individual actions must all be part of a coherent strategy, serving the needs of the government as a whole.

If we undertake the effort, we must be prepared to devote the necessary resources to do it right and to give it the leadership and commitment it deserves. With those ingredients, we can build a financial management system to meet the needs of the American people in the 1990s and beyond.

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