

October 1999

# BUDGET ISSUES

## Budgeting for Inflation in Civilian Agencies





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# Preface

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In recent years, the Department of Defense (DOD) has experienced increases in purchasing power (called inflation dividends) that occur when inflation is lower than had been projected at the time funds were requested. DOD has used those savings to fund a larger program without requesting or receiving additional resources. In 1998, DOD calculated that lower-than-expected inflation would reduce fiscal years 1999 through 2003 procurement costs, i.e., nonsalary purchases, by \$21.3 billion compared to what had been projected 1 year earlier.<sup>1</sup> Of this amount, \$2.8 billion, or approximately 1 percent of DOD's annual budget, was savings estimated for fiscal year 1999. DOD was allowed to keep these savings and, in some cases, authorized to redirect funds to programs and purposes other than those originally planned, authorized, and appropriated.

Given DOD's experience, the question of whether civilian agencies should also identify the effect of lower inflation on their funding requirements has been raised. To understand better the challenges to developing this capability in civilian agencies, this staff study describes how inflation is treated currently in budgeting for DOD and civilian discretionary nonpay activities. We developed case studies in three civilian agencies: the Department of the Interior's Bureau of Land Management (BLM), the Department of Energy's (DOE) Office of Environmental Management, and the National Aeronautics and Space Administration (NASA). We also reviewed our prior work pertaining to inflation changes in both civilian agencies and DOD and obtained written responses from DOD to questions on how it budgets for inflation. We have not included a discussion of funding for civilian and military pay because decisions on annual increases are not tied to the rate of inflation. However, these costs can be more significant than the costs associated with nonpayroll-related inflation since federal agencies are required to absorb these increases.

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## Results in Brief

For a number of reasons, DOD has experienced greater changes in purchasing power due to inflation and has a better ability to track these changes than civilian agencies. More specifically, DOD is able to identify changes in inflation because of three factors not found in most civilian agencies: (1) large dollar amounts structured by function that can be

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<sup>1</sup>When we started this study, DOD projected the cost of nonsalary purchases would grow by an average of 2.1 percent per year for 1999 through 2003. DOD's most recent projections, in its 2000 Future Years Defense Program (FYDP), are 0.8 percent for 1999, 1.5 percent for 2000, and 1.6 percent for 2001 through 2003.

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aggregated to a relatively few account titles,<sup>2</sup> (2) a budget planning process that spans multiple years and serves as a baseline for measuring change, and (3) full funding for major weapons systems and other large procurements, which provides appropriations up front for the total estimated cost of a program or project at the time it is undertaken regardless of when the funds will actually be obligated.

In contrast, civilian agencies, for a number of reasons, have less potential to experience large changes in purchasing power due to a change in estimated inflation rates, and have a difficult time tracking fluctuations in inflation. One reason is that funding for capital assets in civilian agencies, with few exceptions, is fundamentally different than in DOD. For the most part, civilian procurement is funded on an incremental basis, that is, only for the amount that is expected to be obligated during the first year. Thus, no matter the size and length of the procurement, the annual budget process provides a regular opportunity to reassess (and reestimate for such factors as changes in inflation) an agency's funding requirements. In addition, while 40 percent of federal procurement activities are carried out by civilian agencies, they are spread over approximately 700 disparately structured accounts across many agencies and individual contracts. Taking these factors into consideration, requiring civilian agencies to track changes in inflation would not be cost-effective.

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## Background

The issue of budgeting for inflation was first addressed in response to escalating inflation, primarily in DOD programs. Although, since 1982, DOD inflation estimates have often been higher than actual inflation, the reverse was true in the late 1960s and 1970s when the Administration systematically underestimated inflation in its budget requests to the Congress. (See "Related GAO Products.") Until the 1970s, only shipbuilding appropriations allowed for anticipated inflation. By the mid-1970s, in reaction to escalating inflation, the Administration proposed in the President's Budget request and the Congress allowed DOD to include an inflation allowance for certain categories of expenditures, first for major weapon systems, then fuel, and finally for all military procurement and construction spending. Eventually, defense and civilian agencies were

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<sup>2</sup>A DOD account title (or primary account) consists of all functionally related appropriations accounts. For example, DOD's Procurement account title in the President's Fiscal Year 2000 Budget includes 20 appropriations accounts, such as, Procurement of ammunition, Army; Weapons procurement, Navy; and Missile procurement, Air Force.

allowed to include estimates for the cost of inflation in agency operating accounts as well.

As the rate of inflation declined, concerns shifted to the issue of overfunding for inflation. Beginning with DOD's fiscal year 1987 authorization act,<sup>3</sup> the Congress required DOD to monitor and report on changes in inflation three times a year. No comparable requirement existed for civilian agencies. Although this requirement was eliminated in fiscal year 1989 when projected savings were in decline, DOD continues to identify changes in inflation and adjust its estimates as necessary for its annual submission to the President's Budget and the Office of Management and Budget's (OMB) Mid-Session Review.<sup>4</sup>

In the 1990s, especially in recent years, spending caps have limited the amount of funding available for defense and civilian discretionary programs. The Budget Enforcement Act<sup>5</sup> established dollar caps on discretionary spending for fiscal years 1991 through 2002, which, until fiscal year 1998, were adjusted for inflation. Since then, budget authority and outlay caps in particular are almost level in dollar terms from fiscal year 1998 through fiscal year 2002.<sup>6</sup> Thus, not all agencies are funded at a level sufficient to keep pace with inflation. As a consequence, while lower inflation may, in some instances, increase the level of resources over what was planned, it does not necessarily produce a windfall for these agencies. Instead, it reduces the size of program cuts that need to be made to stay within funding levels and overall spending caps.

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<sup>3</sup>The National Defense Authorization Act for Fiscal Year 1987, Public Law 99-661, 100 Stat. 3980-81 (1986).

<sup>4</sup>The President is required to transmit a supplemental update to the President's Budget sent to the Congress the previous February. This supplemental contains revised estimates of the budget receipts, outlays, and budget authority for the current fiscal year and the next 5 fiscal years.

<sup>5</sup>The Budget Enforcement Act of 1990 and subsequent amendments (the Omnibus Reconciliation Act of 1993 and the Budget Enforcement Act of 1997) are collectively referred to as the Budget Enforcement Act (BEA). These acts amend the Balanced Budget and Emergency Deficit Control Act of 1985 (the Deficit Control Act).

<sup>6</sup>The rate of inflation was approximately 3.4 percent in fiscal year 1991 and gradually decreased to approximately 2.6 percent in fiscal year 1997. According to the Congressional Budget Office, if 1999 appropriations equaled 1998 budget authority adjusted for inflation, total outlays (including those from previously enacted appropriations) for both defense and nondefense would exceed their respective discretionary caps by about \$8 billion.

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## Budgeting for Inflation in the Department of Defense

Although DOD does not explicitly identify estimated inflation in its budget request, its functional structure and large account titles enable it to apply inflation factors to its accounts and to calculate the effect of any subsequent changes. In addition to DOD's account structure, two other attributes help identify large savings (or losses) from changes in inflation: (1) a 5-year planning baseline from which to measure adjustments and (2) full funding of major procurements, which provides funding at the time a project is undertaken and increases the base on which inflation factors are applied.

The account structure of DOD is organized by function. In contrast, civilian agencies' accounts are characterized by a mix of account orientations with an emphasis on programs and processes. For example, DOD's primary accounts are made up of the following functional areas: Military personnel; Operation and maintenance; Procurement; Research, development, test, and evaluation; Military construction; and Family housing, as well as Revolving and management funds. DOD builds inflation into its budget and its long-term planning document—the Future Years Defense Program (FYDP)—and makes annual adjustments to inflation using these large account titles.

DOD also is the only agency that has a long-term, structured budget planning process that covers a 5-year period and is adjusted annually. DOD constructs its budget request and FYDP on the basis of the Administration's economic assumptions provided for the previous year's budget. For example, the budget for fiscal year 2000 is developed assuming the rate of inflation contained in the fiscal year 1999 budget, but is revised to reflect current economic assumptions in December just before the President's Budget is released. DOD uses one overall price index for all nonpayroll purchases except fuel. DOD applies the difference between the old rate and the new to each primary account using a formula based on projections of future inflation rates and the projected rate of spending for components within the accounts.

DOD's long-term planning estimates assume full funding for most DOD procurement programs. DOD procurement represents about 60 percent of total federal procurement activity. When a contract is fully funded, the total cost of the project (or a useful project segment) is estimated using current economic assumptions and the entire amount of budget authority is provided in the first year. Although DOD fully funds most procurement programs, DOD's ability to track changes caused by fluctuations in

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projected inflation provides an opportunity to review and adjust funding levels in the same way that the annual budget process provides a check on incrementally funded programs.

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## Budgeting for Inflation in Civilian Agencies

Funding for inflation generally is not requested, funded, or tracked separately in civilian agencies' nonpersonnel, discretionary budget requests. Although agencies are expected to build inflation into their submissions to OMB, there is no single inflation rate that applies across all agencies and the approximately 700 civilian accounts with procurement activities. Agencies include inflation in their estimates but, especially in recent years, they cannot assume that they will get sufficient funding to cover inflation because of discretionary spending limits. According to OMB officials, OMB usually allows an agency to decide how best to absorb inflation costs. Although civilian agencies fund 40 percent of federal procurements, funding is appropriated annually in increments so that there are opportunities to adjust for inflation in annual appropriations. Even when inflation rates are more favorable than estimated, not all contracts allow for inflation adjustments, and, in the agencies we studied, inflation is only one of several cost drivers.

OMB requires that agencies build inflation into their budget estimates, but not as a separate cost item. Civilian agencies are instructed in OMB Circular A-11, *Preparation and Submission of Budget Estimates*, to use budget year numbers for nonpay costs (i.e., agencies project estimates for their fiscal year 1999 budget request in 1999 dollars, not in 1997 dollars, when the estimate is prepared). Civilian agencies thus build inflation into their estimates. Notwithstanding, OMB policy states that consideration of price changes as a factor in developing estimates does not necessarily mean that the full rate of anticipated inflation should be included automatically.<sup>7</sup>

Agencies build inflation into their funding requests to OMB by estimating what nonpay costs will be in the future budget year using a variety of

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<sup>7</sup>Every budget year, OMB issues a set of economic assumptions that agencies use to formulate the current services baseline. The current services baseline reflects the projected costs of continuing federal programs without any policy changes and is included in the President's Budget as one of several analytical presentations. Although civilian agencies are required to use OMB's economic assumptions to construct this baseline, agencies are expected to use nonpersonnel inflation assumptions that best reflect their programs in their budget submissions to OMB.

indices and assumptions. Civilian agencies, with the concurrence of OMB, may use more than one type of price index to estimate inflation. These indices are based on program specific factors, such as local market conditions or product requirements. For example, NASA uses indices that represent a weighted average of Data Resources Incorporated (DRI) indices and the consumer price index for new initiatives. NASA's inflation index tends to be 1 to 2 percent higher than the gross domestic product price index due to NASA's reliance on relatively high labor rates and exotic materials. In another example, DOE's Office of Environmental Management has developed six specialized escalation models for tracking inflation and other factors that affect the costs of projects.

Caps on discretionary spending have made it less likely that an agency's funding level will accommodate increases for inflation. The Department of the Interior's budget submission, which includes BLM, identified certain expenses, such as rent increases, security and communications charges, and working capital fund charges, as "uncontrollable," and separated these changes in expenses from other programmatic changes. Displaying adjustments in what it calls uncontrollable expenses allows Interior to identify inflation separately. However, OMB officials told us that this type of budget detail has become increasingly irrelevant as annual caps hold many agencies' budgets at or below a level that accommodates inflation. Generally, only high-priority programs receive funding to accommodate inflation. Also, since federal agencies are required to absorb mandatory pay increases, fewer funds are available for procurement activities. Accordingly, it cannot be assumed that a reduction in expected inflation will produce a funding windfall if inflation was funded partially or not funded at all.

Most civilian agencies receive incremental funding for procurement activities, that is, they receive funding on a year-to-year basis. The annual budget cycle and the yearly revisions of inflation estimates provide opportunities for the Congress to consider inflation in making funding decisions for civilian agencies, although here too, discretionary caps limit the amount of funds available.

During contract performance, as opposed to during an agency's budgeting cycle, savings that occur due to a change in projected inflation do not always accrue to the government. The contract terms determine whether the contractor or the government bears the inflation risk and thus incurs the costs or reaps the benefits from a change in inflation during contract performance. For example, in firm fixed-price contracts, the contractor is



typically at risk for all aspects of contract performance and so incurs the costs or benefits associated with changes in inflation that are higher or lower than expected.<sup>8</sup> Thus, any inflation dividend accrues to the contractor, not the contracting agency. Of the agencies we studied, only BLM primarily uses fixed-price contracts. BLM contracts for services and supplies, such as hazardous materials removal, road construction and restoration, and fire engines.

For cost reimbursement contracts (these include cost plus fixed fee, cost plus incentive fee, or cost plus award fee contracts), the government bears the risk of inflation during contract performance and any inflation dividend would accrue to the government. Thus, where funds are allocated to a contract based on its estimated costs, including inflation, and inflation is less than expected, the government receives an “inflation dividend” vis-a-vis its budget estimate. This is more likely to occur in complex procurements involving multiyear contracts, such as those that occur in DOD. The majority of NASA’s procurement dollars involve cost reimbursement contracts, which are primarily associated with the Space Shuttle and Space Station. DOE’s Office of Environmental Management also primarily uses cost reimbursement contracts.

In the current economic environment, inflation is only one cost driver nested among other more significant cost drivers, such as changing technology or availability of materials and labor. Officials at NASA’s Langley Research Center stated that they use a “guideline audit trail” to track monthly changes in costs, but they do not track the details of those changes. An official at another agency stated that with inflation rates as low as they are at present, inflation currently is not a major factor in the escalation of costs. This official also stated that over time and over the development of a project, inflation virtually gets lost.

In our earlier report on budgeting for inflation in DOD, we stated that it is not clear that monitoring inflation below the appropriation account level would be helpful or useful.<sup>9</sup> We believe this applies to civilian agencies as

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<sup>8</sup>Some fixed-price contracts have economic price adjustment clauses that allow the contractor to be reimbursed for uncontrollable costs, including inflation. For example, some BLM contracts include economic price adjustment clauses, such as lease escalator clauses or operating cost escalator clauses (for use with services and utilities).

<sup>9</sup>*DOD Inflation: Budgeting and Monitoring Inflation Funding in the Department of Defense* (GAO/NSIAD-88-79, April 26, 1988).

well. DOD, like civilian agencies, uses a variety of contract types, but because DOD is able to build, track, and adjust inflation using a small number of large account titles, it does not need to go below the primary account level to identify savings or losses due to changes in inflation. DOD's planning process, in addition to providing a baseline for measuring changes over multiple years, provides a top-down, integrated perspective. Thus, savings (or losses) due to changes in inflation can be viewed in the context of overarching decisions on the appropriate level of funding for DOD in any single budget year.

It would be difficult and, we believe, not cost-effective to require civilian agencies to monitor changes in inflation. This conclusion is based on several considerations: (1) the large number of small pools of resources potentially affected across multiple civilian agencies and contracts, (2) the variety of inflation assumptions used by civilian agencies in developing estimates, (3) obstacles to developing a baseline from which to measure savings and losses, including separating inflation from other cost drivers, (4) the current environment of low, stable inflation coupled with caps on discretionary spending, and (5) the prevalence of incremental appropriations for civilian procurement that permits adjustments already.

On September 13, 1999, we provided the Departments of Defense, Energy, and Interior, as well as NASA and OMB, a draft of this staff study for review and comment. Between September 22 and October 5, 1999, all of the reviewers informed us, either orally or in writing, that they agreed with the information presented and had no comments.

For future contacts regarding this staff study, please contact Paul L. Posner at (202) 512-9573. Individuals making key contributions to the study included Denise M. Fantone, Hannah Laufe, and Marcus Melton.

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# Scope and Methodology

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We developed case studies in three civilian agencies: the Department of the Interior's Bureau of Land Management, the Department of Energy's Office of Environmental Management, and the National Aeronautics and Space Administration. Since purchasing power increases or decreases due to changes in inflation, entities that spend a large proportion of their budgets on multiyear procurements will potentially experience greater changes due to inflation than those that do not. We therefore selected entities with relatively large dollar volumes of contracting activity, relatively large contracts, and highly centralized procurement and budget activities. We based our selections on information derived from interviews with officials at OMB, analysis of budget and procurement data pertaining to the case studies, and consultation with congressional staff.

We interviewed OMB staff familiar with OMB executive branch budget policies and procedures to get a governmentwide perspective on recent trends in funding for inflation in civilian agencies. For those programs selected for further study, we interviewed the agencies' OMB program examiners, agency budget and procurement staff, project managers, and, for some programs, cost estimators. We also reviewed our prior work pertaining to inflation changes in both civilian agencies and DOD, and obtained relevant reports from the Congressional Budget Office and the Congressional Research Service. DOD provided us with written responses to questions on how it budgets for inflation. We also looked at broad trends in discretionary funding to provide context for our work. Our work was performed in Washington, D.C., and Hampton, Virginia, from August 1998 through August 1999 in accordance with generally accepted government auditing standards.

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# Related GAO Products

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*1999 DOD Budget: DOD's Procurement and RDT&E Programs* ([GAO/NSIAD-98-216R](#), August 14, 1998).

*Department of Energy: Office of Environmental Management's and Defense Programs' Fiscal Year 1999 Budget Requests* ([GAO/RCED-98-213R](#), July 24, 1998).

*Defense Budget: Projected Inflation Savings* ([GAO/NSIAD-98-177R](#), May 11, 1998).

*Future Years Defense Program: Lower Inflation Outlook Was Most Significant Change From 1996 to 1997 Program* ([GAO/NSIAD-97-36](#), December 12, 1996).

*DOD Budget: Controls Needed Over Inflation Dividends* ([GAO/NSIAD-93-62BR](#), December 14, 1992).

*DOD Inflation: Budgeting and Monitoring Inflation Funding in the Department of Defense* ([GAO/NSIAD-88-79](#), April 26, 1988).

*Budget Issues: Budgeting for Inflation in Selected Civil Accounts* ([GAO/AFMD-86-34BR](#), March 20, 1986).

*Budget Issues: Potential for Excess Funds in DOD-March 1986 Update* ([GAO/NSIAD-86-76](#), March 7, 1986).

*Potential for Excess Funds in DOD* ([GAO/NSIAD-85-145](#), September 3, 1985).

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