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Responding to the Budget Deficit

The federal government has had a budget deficit in every fiscal year since 1970. Although the size of the deficit has fluctuated from year to year, the clear trend over the last quarter century has been toward ever larger deficits. If that trend continues, it will present dramatically increasing risks to the U.S. economy.

Reducing the deficit is the most critical challenge facing the Congress and the President—and the most difficult. Meeting that challenge means making hard choices involving the defense budget, domestic programs, and taxes. These choices are complicated by an uncertain economy and inadequate information. GAO recognizes its responsibility both to provide information and analysis needed for current decisions and to suggest reforms that will help avoid similar problems in the future.

Nature of the Deficit

The current budget deficit has both a cyclical component and a structural component. The cyclical component is the portion that will disappear when

the economy operates at a high level of employment; the structural component is defined as the portion that will remain. Cyclical deficits were frequent through the early 1960's. Since 1965, however, a structural imbalance has been added. Recently, the structural deficit has become dramatically larger. It is no longer safe to assume that high levels of employment and normal economic growth will eliminate the budget deficit.

In developing strategies for reducing the deficit, the Congress and the President will need to consider both the expenditure and revenue sides of the budget. The gap between them can be closed only by reducing the rate of expenditure growth, raising the rate of revenue growth, or both.

The task of constraining outlays is made particularly difficult by the increasing rigidity of the budget in the short run. This inflexibility takes three forms. One is entitlement programs such as Social Security, Medicare, Food Stamps, and pension programs for civilian and military personnel. In these programs, eligibility and benefit levels are largely



Charles Bowsher, Comptroller General, is flanked by Milton Socolar, Special Assistant to the Comptroller General (left), and Frank Fee, Assistant Comptroller General for Operations.

determined by the authorizing legislation. Constraining the costs of these programs requires further changes in legislation.

A second form of inflexibility comes from activities (such as procurement) for which current outlays are the results of commitments made in prior years. Once the decision is made to build a ship, for example, the outlays flowing from that decision may continue for 7 years or more. In other cases, such as the procurement of aircraft and tanks, reducing the acquisition rate may drive up unit costs and cause much of the anticipated savings to evaporate.

A third element of inflexibility is interest on the public debt. Over the next 5 years, the costs of debt service seem likely to be the most rapidly growing item in the budget. Our accumulated past deficits have risen to the point where the cost of financing them has become a major cause of future deficits. The only reliable way to reduce these costs is to reduce the deficit itself. Not only would that reduce the amount of debt on which interest must be paid,

it is also likely to produce lower interest rates for both the federal government and other borrowers because of reduced pressure on financial markets.

Addressing the Problems

There is a growing consensus in the business and financial communities, as well as among most economists, that budget deficits the size of those now projected constitute a serious threat to the future vitality of the American economy. The threat lies in the combined risks of escalating inflation, rising interest rates, reduced levels of private investment, and the loss of overseas markets because of distorted exchange rates.

Because of the severity of these risks, it is essential that the structural deficit be reduced substantially over the next few years. Deficit reduction efforts by the Congress and the President in 1984 were an important first step, but much more must be done.

Defense Spending. Current projections show defense outlays rising from 22.1 percent of the budget in 1980 to 29.6 percent in 1989. The defense buildup has been a major source of recent growth in the budget. The Defense Department's budget increased from \$143 billion in 1980 to \$258 billion in 1984 and \$284 billion in 1985. If that growth is to be restrained as part of a deficit reduction strategy, the Congress and the Administration will need to take a very close look at the need for each of the new weapons systems being developed. To assure maximum effectiveness for the defense dollar, the Congress will also need to look carefully at the pace at which these systems are being procured and deployed and at the balance between procurement of new systems and the resources needed to operate and maintain those systems once they are deployed. In fact, GAO's work has found that future operating and maintenance costs may be substantially underestimated.

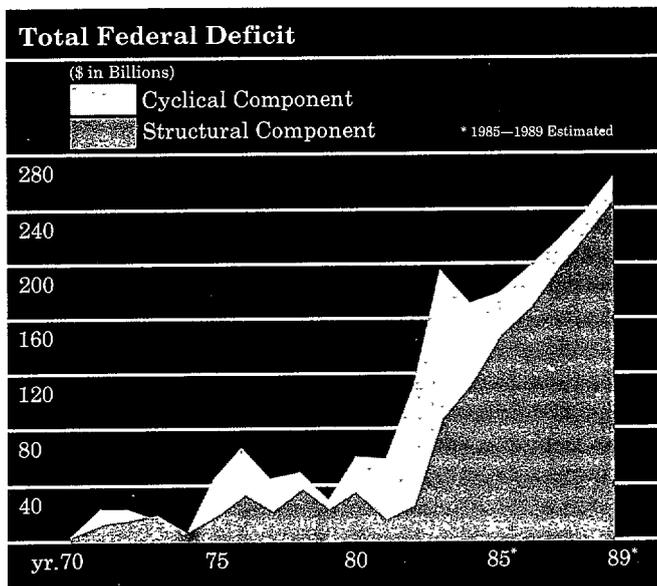
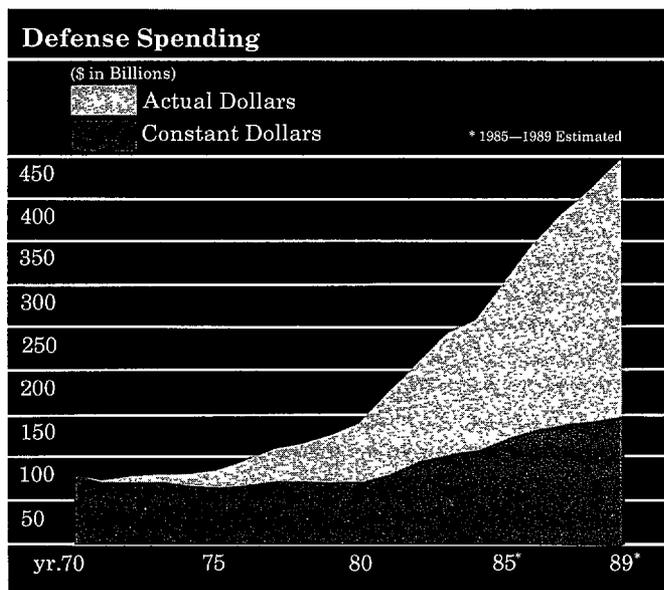


Table 1

Year	1965	1970	1975	1980	1985	1989
	(% of total)					
National Defense	40.19	39.39	25.23	22.07	26.82	29.64
Entitlements	28.20	32.64	45.95	46.02	42.68	40.22
Discretionary Spending	24.78	21.02	22.05	23.26	16.79	14.53
Net Interest	6.83	6.94	6.77	8.65	13.72	15.62



Domestic Spending. Although the growth of domestic spending has been curtailed in many areas, some domestic programs still threaten to grow more rapidly than the Congress may consider acceptable. Of particular concern are recent trends in agricultural programs, the continued escalation of health care costs, and the growth of military and civilian employee pension costs, all of which are issues on which GAO is working. It is also important that the effect of recent changes in a variety of domestic programs be carefully reviewed. There may still be room for further reductions through improved program efficiency. GAO also believes the practice of fully indexing for inflation should be reconsidered, not only because of its cost, but also because of the additional budgetary rigidity which it causes. Finally, the growth in the size of the national debt and the share of the budget devoted to interest payments heightens the importance of effective debt management.

Revenues. To the extent that the structural deficit cannot be reduced quickly enough through expenditure reduction, additional revenue will be needed to further close the gap. As a share of the total economy, federal revenues from social insurance taxes have grown significantly over the past 15 years and the personal income tax has been relatively stable. Revenue from all other sources has actually declined. The drop in corporate tax revenues has been particularly dramatic. In order to raise any additional revenue needed to finance the budget, the Congress and the President may

need to consider increasing revenue from the personal income tax, altering recent trends on business taxation, or introducing new forms of taxation.

Financial Management. Sound decisionmaking is made much more difficult in the absence of reliable information. Weaknesses in the government's financial management systems seriously limit the accuracy and usefulness of government financial information. Erroneous information available to policymakers in the late 1970's suggested that each year's deficit was temporary. Much of the error in these projections came from overly optimistic assumptions about how the economy would perform, but the problem also grew out of the lack of reliable information about the costs and results of ongoing federal programs and projects. Without that information, it is extremely difficult to develop dependable estimates of future budget requirements. By themselves, improved financial management systems will not solve the problem of the deficit. But those systems are essential if the Congress is to have both the reliable information it needs to make these difficult decisions and the control it needs to help assure that the problems of the past are not repeated in the future.

These are areas that the Congress must examine if it is to meet successfully the challenge of reducing the deficit. The pages that follow outline recent GAO work concerning those issues and ongoing and future work that will contribute to resolving them.

Charles A. Bowsher

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Social Security—The Major Entitlement Program

Probably no other federal program directly affects more Americans than social security. Social security helps to provide income protection to over 40 million retirees, disabled persons, dependents, and survivors. In fiscal year 1985, nearly \$200 billion in benefits will be paid out, and more than 115 million workers will have their wages taxed to pay the bill. Social security taxes presently account for about 30 percent of all federal revenues.

Because of social security's importance, GAO is assessing the effects of population changes, studying ways to improve the quality of service to the public, reviewing the disability programs, and identifying needed steps to strengthen Social Security Administration (SSA) management.

Assessing the Effects of an Aging, Changing Population

The Congress needs up-to-date analyses to make decisions on social security. Of particular importance is information on the effects of demographic and socioeconomic changes in the nation. Since 1960, the 65-and-older population has grown twice as fast as the rest of the population, and this trend is expected to continue into the next century. GAO is studying how the growing number of elderly people will affect the services and costs of social security and other entitlement programs. Also, women have entered the work force in record numbers and more people retire early. GAO will be studying the effects of these trends and the fairness of current rules to women.

Improving Quality of Service

Quality of service in the social security program traditionally has been defined as accurate, timely payments and correct determinations of eligibility. GAO monitors SSA operations from this standpoint.

In 1984 GAO found that SSA temporarily underpaid the public by at least \$2 billion over a 34-month period because of delays in recomputing benefits. Replacing aging computers may help alleviate these delays. Currently underway is GAO's study of SSA operations from the "customer's" point of view. First, GAO is sending a questionnaire to beneficiaries and SSA employees to obtain their views on the quality of service. Second, because requests for assistance generally involve calling or

visiting local SSA field offices, GAO will evaluate services provided at this level.

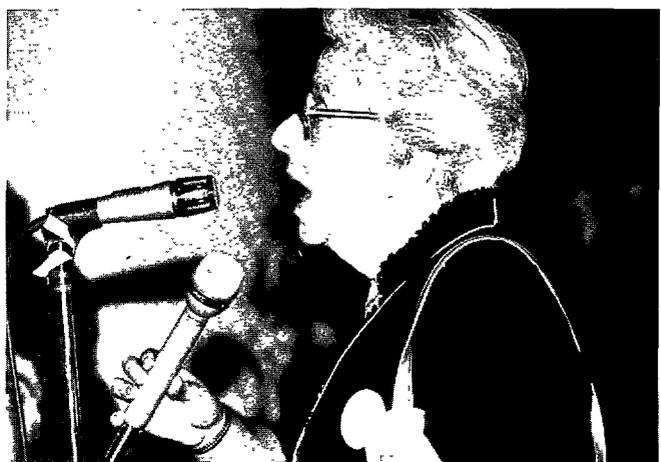
Social security disability programs were recent targets of publicity and public concern when SSA began removing people from disability rolls and denying them benefits. Over 500,000 people had benefits terminated since this major effort began in 1981.

In fiscal year 1984, following up on several 1982 and 1983 studies on how the terminations were handled, GAO reported on the status of people who were removed from the disability rolls. GAO found that many were reinstated on appeal. Some others did return to work. A third group did not go back to work despite their income loss. Additionally, GAO reported that SSA overpays millions of dollars each year because it does not reduce disability payments—as the law requires—for certain people receiving workers' compensation.

In response to heightened public interest, the Congress examined the disability programs (with GAO's active involvement), and both houses passed reform legislation in 1984. In the future, GAO will focus on monitoring the new law's implementation and looking for ways to (1) strengthen program management and the federal-state government partnership, (2) streamline the complex appeals process, and (3) improve the fairness of eligibility decisions.

Strengthening SSA Management and Computer Systems

In 1982 SSA began to spend \$500 million to replace its antiquated computers. GAO has been monitoring



this effort. In 1984 GAO reported to the Congress that SSA had purchased a major data communications terminal system that could not originally do what it was supposed to do; this caused many performance problems for 2 years after installation. GAO is now examining SSA's new computers for security, protection of privacy, and ability to adapt to legislative changes.

SSA's management problems have historically extended beyond computers. Increasing program size and complexity, rapid turnover in top leadership, and difficulties in hiring and retaining good staff, among other things, have created obstacles.

GAO testified before the Congress in 1983 and 1984 on SSA's management problems. During this past year, GAO also addressed the recommendations of the Congressional Panel on Social Security Organization, chaired by former Comptroller General Elmer B. Staats. The panel was set up to look at how SSA could be made independent of the Department of Health and Human Services. GAO supported the basic conclusions of the panel regarding SSA management problems but noted that many of these problems were not necessarily related to its independence. In 1985 and 1986, GAO intends to make a broad-based study of how well SSA manages its primary functions and operations.



Other Entitlements and Pension Programs

Pensions and entitlement programs other than social security cost nearly \$250 billion in 1984. Such programs support millions of people with food, housing, health care, retirement income, and other needs. Efforts to cut federal spending have focused on these other entitlements and pensions, and some welfare programs have already been cut. The challenge will be how to reduce spending while maintaining a decent quality of life for the needy and aged.

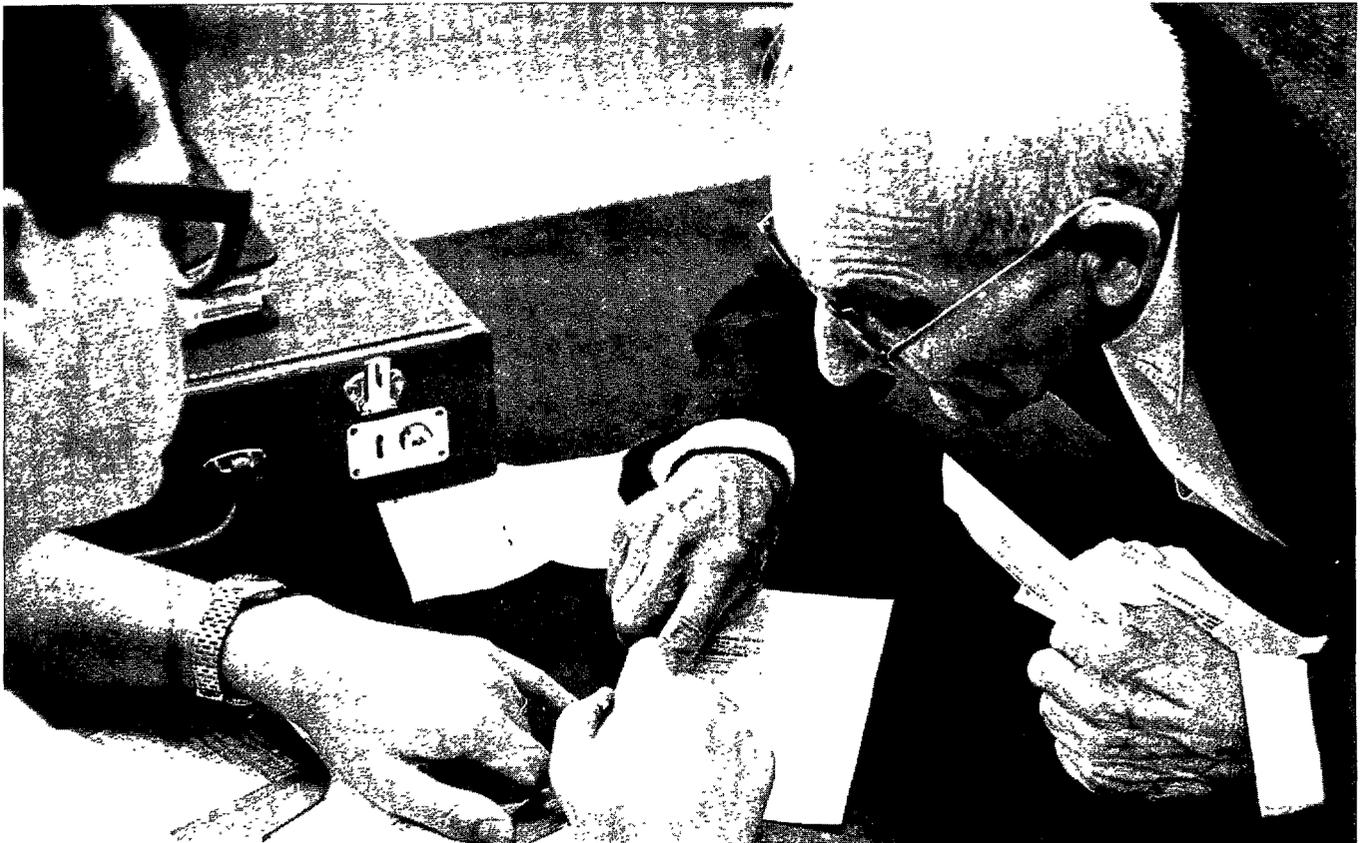
Many of these programs can be more economically administered, and service to recipients can be improved. GAO's work focuses on program management and operations with an eye toward cutting costs.

Controlling Spiraling Health Costs

Federal spending on Medicaid and Medicare has jumped dramatically from \$19.5 billion in 1974 to an estimated \$90 billion in 1984, about 360 percent. By 1990 these costs are expected to be nearly \$170 billion. Inflation partly explains the increases; but other factors also fuel this growth, including more

people receiving care, advances in medical knowledge and technology, and the health care system's structure. The cost growth needs to be curbed, and the system's structure must be redesigned to better encourage and reward efficiency.

This past year, one of GAO's health-related reports addressed higher costs to the federal government and others resulting from a private corporation's purchase of 54 hospitals, 18 nursing homes, and other assets of another company. The corporation sought reimbursement from federal Medicare and Medicaid programs for increased capital costs (depreciation and interest) resulting from the change in ownership. At a Congressman's request, GAO looked into the matter and found that during the year after the acquisition, the hospitals' (1) interest expenses increased by about \$62.5 million, nearly tripling, (2) depreciation expenses increased by about \$8.4 million, and (3) home office expenses decreased by about \$15.7 million. Overall, then, costs increased about \$55 million during the first year. GAO reviewed the corporation's cost allocation to 2 of the 54 hospitals and estimated that the acquisition caused an increase in capital costs



charged to Medicare of \$26 per patient per day at one hospital and \$21 at the other. Daily Medicaid costs per patient were caused to rise \$31 and \$27 at the respective hospitals. In June 1984, following GAO's report and testimony, the Congress passed legislation disallowing increased depreciation and interest costs associated with buying and selling hospitals and nursing homes.

GAO is currently evaluating Medicare's new fixed payment strategy for cutting hospital costs. This strategy tries to get hospitals to control costs, mostly through reductions in patients' length of stay. GAO will report on the effects (such as possibly higher home health care costs) of this controversial approach. GAO will also focus on identifying and categorizing major possibilities for containing costs while assuring quality care.

Gauging the Effects of Recent Legislation on Welfare

In a major study this past year, GAO evaluated how the 1981 Omnibus Reconciliation Act affected recipients of Aid to Families with Dependent Children (AFDC), a federally funded, state administered welfare program. GAO found that stricter eligibility standards reduced the caseload by 493,000 cases and lowered spending by \$93 million per month. When dropped from the AFDC rolls, most people who had been working and receiving aid kept their jobs and stayed off welfare. Also, those dropped from the AFDC rolls generally lost Medicaid benefits, and GAO found many remained without any medical insurance coverage



over a year later. GAO's study led to major legislative changes in the Deficit Reduction Act of 1984 affecting the AFDC program. One change set up a transition period to continue Medicaid coverage for people successfully working their way off welfare; another change raised the limits on allowable income.

GAO is currently examining trends in poverty for specific groups (single female heads-of-households, working poor, elderly people, and the homeless) and is linking these trends to needed changes in federal programs. Future GAO studies will (1) analyze whether welfare programs are appropriately designed to serve the needy, (2) examine the balance between the government's need to verify information and individual privacy rights, and (3) review the government's methodology for measuring poverty.

Reforming Pension Programs

Regarding federal civilian retirement benefit payments, which totaled \$20.6 billion in fiscal year 1983, GAO has been providing the Congress with information needed to make pension reforms. In 1983 the Congress passed legislation to include new federal employees in both social security and federal civilian retirement. In fiscal year 1984, the Congress acted on GAO's proposed alternatives to reduce some problems caused by the legislation. Also in 1984, GAO reported on the features of retirement programs outside the federal government. GAO's in-depth analysis covered eligibility, vesting provisions, social security, employee contributions, early retirement, disability provisions, survivor benefits, and other program features. GAO will later compare this data with current features of federal pensions.

GAO monitors the oversight of 700,000 private pension plans by the Internal Revenue Service, the Department of Labor, and the federal Pension Benefit Guaranty Corporation. GAO reported on such issues as (1) the need for the Corporation to raise insurance premiums on single-employer pension plans and (2) special statutory provisions affecting multiemployer pension plans in the construction, trucking, and entertainment businesses. GAO is now focusing on the adequacy of pension funding. In 1985 GAO will complete a comprehensive assessment of multiemployer plans and begin a review of women's equity issues in pension plans.

Defense

Defense follows entitlements as the largest category of federal spending. In fiscal year 1984, the U.S. defense budget was \$258 billion. And it has grown rapidly, rising from \$143 billion in fiscal year 1980.

Recognizing how difficult it is to use large and rapid budget increases efficiently, GAO is focusing on how well the Department of Defense (DOD) spends the taxpayers' dollars. Also, in this period of huge federal deficits when the accuracy and reliability of information is particularly critical to congressional decisionmaking, GAO is looking at ways for improving the quality of budget information that DOD reports to the Congress.

Analyzing the Effects of Increased Defense Budgets on Military Capability

This past year, GAO reviewed DOD's assessment of the military services' overall war-fighting capability in 1984, compared to 1980. GAO reported that progress was made in increasing the size of the forces, modernizing weapon systems, and improving the quality of personnel. This progress was not, however, matched in other areas—namely, equipment condition and supplies inventories—and in DOD's ability to sustain its military forces. For instance, inventories of munitions and war reserves necessary to keep U.S. forces fighting are substantially below requirements.

Specific examples of readiness problems were reported. For instance, the reported readiness of U.S. Air Forces, Europe, declined in 1983, primarily due to the shortages of equipment and supplies. GAO also reported that the Navy's tactical air forces did not meet their readiness goals; shortages of essential assets, such as spare parts and munitions, limited aircraft carriers' ability to meet war-time deployment schedules. GAO will continue to provide information as the Congress evaluates military capability and considers future DOD budget requests.

Reviewing DOD Programs and Budgets

The Defense Department's acquisition of major weapons comes under GAO's scrutiny. Examples of GAO's recent work included reports on

- problems in the conduct of tests and test results of the Pershing II missile (opposite page);

- the need for DOD to reevaluate the MX missile and its ability to meet the evolving Soviet threat; and
- reliability problems in tests of the vehicle intended to replace the jeep.

Three GAO reports since 1980 stated that the Army's Division Air Defense (DIVAD) gun—called the Sergeant York—had yet to demonstrate its effectiveness and reliability. GAO testified before the Congress and briefed congressional committees on the need for the Army to proceed cautiously in buying the still unproven weapon. DOD responded to congressional concerns by delaying the more than \$500 million procurement of the 117 DIVAD guns authorized in fiscal year 1984 until further testing.

Overall, GAO's defense-related reviews led to \$3.85 billion in measurable financial benefits to the taxpayers in 1984. For example, using GAO's work, the Congress trimmed DOD's ammunition budget by \$440 million. It also directed DOD to purchase rather than lease computer equipment, which, according to DOD estimates, will save \$467 million in fiscal year 1984 and \$244 million in future years.

Congressional oversight of DOD activities included a request for GAO to review U.S. military, economic, and intelligence activities in Central America. GAO gave numerous briefings to Members of the Congress and their staffs and issued three reports. GAO rendered a legal decision that found DOD had improperly used operations and maintenance funds for other purposes in Honduras and therefore avoided congressional controls on spending.

The Congress will be deciding on future spending to continue modernizing and expanding the armed forces. GAO will contribute to these deliberations, in part, by examining

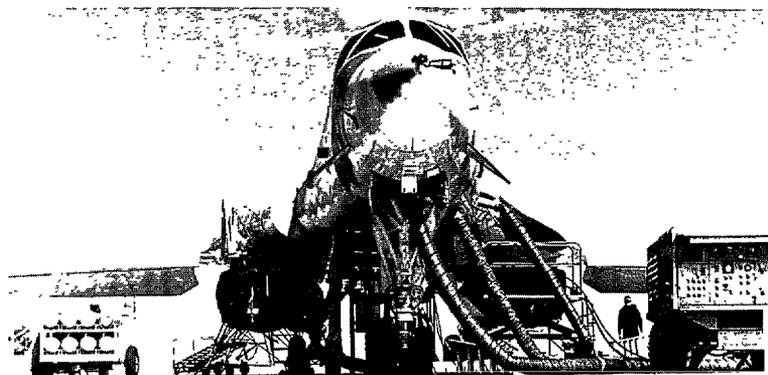
- the Navy's fleet expansion program and the adequacy of cost and budget estimates;
- the rationale for the Army's light division concept and how this concept will affect the Army's capabilities; and
- the justification and achievability of Air Force plans for modernizing and expanding tactical air forces.

In the future, the military's role in space will receive greater attention from the Congress and the American people. GAO intends to examine DOD's planning for the military's use of space and the implementation and coordination of these plans, in-

cluding aspects of the Administration's strategic defense initiatives.

Providing Accurate, Reliable Information

In the past fiscal year, GAO analyzed Department of Defense cost information on its Five-Year Defense Program and major weapons dating back to 1963. GAO found that cost projections have consistently been underestimated. For individual weapon systems, the federal government has spent an average 32 percent more per year to procure fewer weapons than originally programmed. Underestimations of costs, of course, create uncertainties and difficulties for congressional decisionmaking. If that pattern continues, the defense program for fiscal years 1985 through 1989 could cost between \$253 billion and \$319 billion (in current dollars) more than DOD has estimated. GAO recommended a number of ways that DOD could improve its cost-estimating process and make its cost-estimating reports to the Congress more reliable, useful, and understandable.



Debt Service

Some 17.5 percent of federal spending in 1984 was payment on the national debt. The national debt is, simply stated, the cumulative result of past decisions to finance wars, defense buildups, social programs, and other activities through borrowing. It is roughly the sum total of our past budget deficits.

In 1984 the national debt rose to over \$1,500,000,000,000 (\$1.5 trillion). Economists, public officials, and political scientists may disagree on the immediate repercussions of this level of debt, but it is clear that the rapidly growing national debt—and its associated interest costs—will have to be borne by future generations. Particularly in recent years, as the graph below shows, the national debt has risen substantially.

Managing the Debt

The federal government, through the Department of the Treasury, finances its debt by selling various

securities, most of which are marketable and owned by private individuals, companies, and financial institutions. The maturity of these securities ranges from 3 months to 30 years. They are actively traded (in mid-1984, over \$50 billion worth were traded on an average daily basis) in large, complex, and highly liquid markets.

Because the government has enormous funding and refinancing requirements (nearly \$1 trillion in 1984) and because its securities form the benchmark for pricing other types of securities, the federal government's presence in the bond market has considerable influence on the economy. Since the mid-1960's, the Treasury has emphasized a borrowing strategy designed to make financial markets stable rather than strictly to keep the federal interest costs minimal. If Treasury tried solely to reduce the interest paid on the debt, it would tend to offer long-term securities during recessionary trends (when interest rates are low) and short-term securities during periods of high growth and infla-



tion (when interest rates are high). This policy would conflict with corporate borrowing plans, forcing higher costs on the private sector and worsening inflationary or recessionary trends.

Therefore, the Treasury has offered its securities on a regular basis, without regard to business cycles and interest rates. Predictable offerings of standard debt instruments with various maturities have been the general rule. Federal interest costs may actually, over the long run, be lessened by an approach that does not unduly disrupt private borrowing plans or reinforce economic cycles. This is because reduced uncertainty, in the view of market analysts and participants and the Treasury, tends to drive down interest rates.

Studying the Federal Treasury's Securities Market

In recent years, the bankruptcies of several securities dealers sent shockwaves through the Treasury securities market. Individual citizens, local school boards, and financial institutions—all of

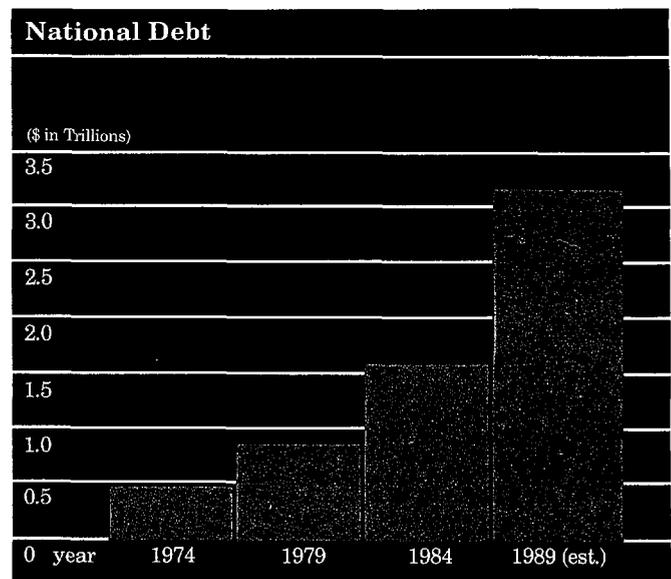
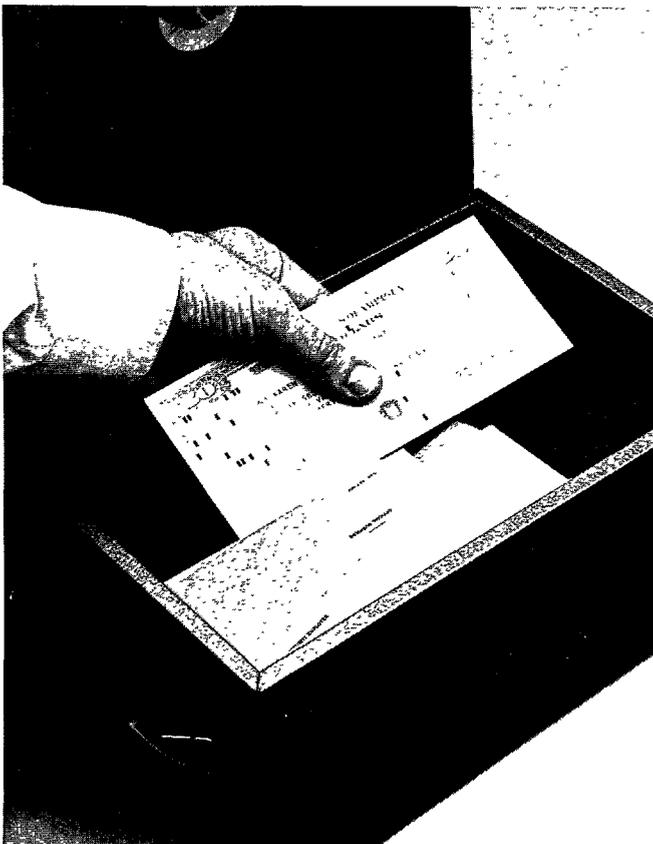
whom thought they had made totally safe investments—lost millions of dollars.

The federal government regulates the Treasury securities market in an informal manner. Concerned by the bankruptcies and the alleged improper conduct of some dealers, the Congress has asked GAO to undertake a long-term, comprehensive study of the Treasury securities market.

GAO began its work mid-way through 1984. After an initial broad survey, a series of studies has been designed.

- The first will describe the characteristics of the government securities market and private dealers in this market.
- Another study will assess the risks present in the market and implications for the federal government and the public.
- The third study will evaluate the Federal Reserve Bank of New York's oversight of the Treasury securities market.
- GAO's other studies will evaluate different proposals for the appropriate level of bond dealer capital and assess the costs and benefits of alternative regulatory strategies. Such alternatives include the current, relatively unregulated approach, industry self-regulation, and more stringent federal regulation.

Within the coming year, GAO will begin reporting its findings to the Congress.



Federal Aid: A Focus On Block Grants

In recent years, federal aid to state and local governments has significantly changed. Actual federal outlays increased nearly 4 times during the 1970's—from \$24.0 billion in 1970 to \$91.5 billion in 1980. In the 1980's, however, the rate of growth slowed. Actual outlays rose only to an estimated \$98.8 billion in 1984.

Moreover, greater emphasis has been placed on providing federal aid through general purpose and broad-based grants than through narrow categorical grants designated for specific purposes. In 1981 the Congress consolidated 80 categorical programs into 9 block grants covering health and social services, education, community services and development, and energy assistance. The categorical approach was often criticized for being overly fragmented, costly, and unresponsive to diverse public needs. The block grant approach shifted much of the control and accountability from federal to state governments. States have greater discretion to allocate funds on the basis of their particular needs and objectives, and traditional federal management activities have been curtailed.

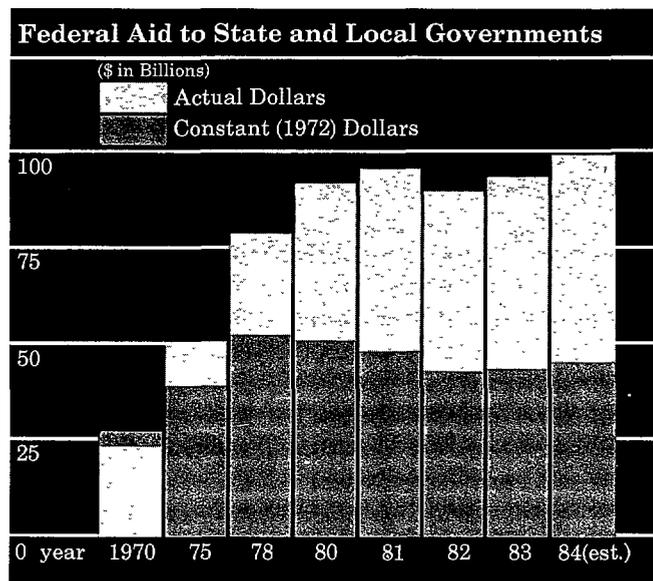
Studying Block Grant Implementation

Because the Congress is now considering reauthorization of some block grant programs and further changes to federal grant programs, the results of the 1981 grant consolidations have been of great interest. GAO provided the Congress extensive information on block grant implementation in 13 states (California, Colorado, Florida, Iowa, Kentucky, Massachusetts, Michigan, Mississippi, New York, Pennsylvania, Texas, Vermont, and Washington). In a series of reports and several congressional testimonies, GAO documented states' fiscal, programmatic, and managerial responses to their new responsibilities. Some of GAO's major findings are highlighted below.

- Although federal spending cuts accompanied most block grants, states often added more of their own monies to maintain funding levels. For health and social services, total spending actually increased in many states. However, particularly when adjusted for inflation, spending decreased in most states. In addition, for community services and education, states took few steps to compensate for federal funding cuts. The federal government and states will find the next few years to be pivotal on the funding question. This is particularly true since

federal categorical program dollars in the pipeline and emergency job program funds—which promoted fiscal stability during early block implementation—will no longer be available.

- States tried to maintain continuity in offered services, especially for such programs as crippled children services where the states have been traditionally involved. States changed some services to better address their needs or cut funding in programs to cope with limited resources.
- More governors, state legislatures, and interest groups were involved in shaping state block grant programs than the prior programs. States offered multiple opportunities for public participation on how to spend available monies. State political and administrative officials overwhelmingly preferred the block grant approach. Interest groups were less enthusiastic, partly because some were dissatisfied with state decisions.
- States' prior involvement in those programs consolidated into block grants helped ease their transition to greater control. Also, state officials reported to GAO numerous examples of administrative simplification. GAO could not quantify the savings from such improvements.
- Overall, information on national results of block grant programs has not been available. Data collection efforts were influenced mostly by states' own planning and budget needs. Through recent actions, the Congress moved to strengthen data collection requirements for some block grants so it could obtain more uniform national data.



Assessing Emerging Issues

As block grants continue to evolve, GAO will focus on how well existing block grants are meeting the Congress' objectives and whether more categorical programs should be consolidated. Two issues—funding and oversight—will be of particular interest. In this regard, GAO intends at appropriate intervals to (1) assess the effects of some block grants on people served; (2) review state mechanisms for accountability, including monitoring and auditing processes; (3) research alternative national funding formulas; (4) explore options for obtaining consistent national information; and (5) track state funding in block grant program areas.



Agriculture

Federal spending on farm programs has grown substantially since 1981. During the 1970's, programs designed to stabilize supplies and support farm prices and incomes cost between \$0.6 billion and \$5.7 billion annually. Beginning in 1981, however, record harvests and lower domestic and foreign demand led to huge surpluses. Prices fell, as did farm incomes. The federal government's programs responded: surplus commodities owned by producers were purchased outright by the government or placed under loan with the government—and used as collateral for the loans—to keep these surpluses off the market. These subsidies rose to about \$19 billion in 1983.

The increase in federal spending occurred against a backdrop of the worst financial pressures on farmers since the Depression. Declining values of farm assets, high interest rates, and low farm incomes compared to the 1970's combined to create a crisis for many farmers. As an indication of the traumatic conditions, the Farmers Home Administration (FmHA) reported as of September 1984 that almost 30 percent of active farm borrowers it had lent money to were delinquent on loan payments. Further, during fiscal year 1982 to 1984, over

22,000 farmers with FmHA loans had to discontinue their operations for financial reasons.

GAO has been looking for opportunities to reduce the cost of agricultural programs and improve the Department of Agriculture's service to farmers. Among recent efforts, GAO recommended ways to improve the actuarial soundness of the expanded Federal Crop Insurance Program to reduce insurance losses (which exceeded \$500 million in 1983). In the last year, GAO's work has emphasized the Payment-In-Kind (PIK) program and dairy price supports and has expanded into the farm credit area.

Overseeing the PIK Program

To reduce crop surpluses and the resulting federal outlays to farmers, the Department announced the PIK program in January 1983. PIK marked a fundamental change from previous farm programs, because the federal government paid farmers in surplus commodities from Commodity Credit Corporation inventories, rather than in cash, to keep their lands idle. Initiated without specific congressional approval, PIK quickly became controversial.



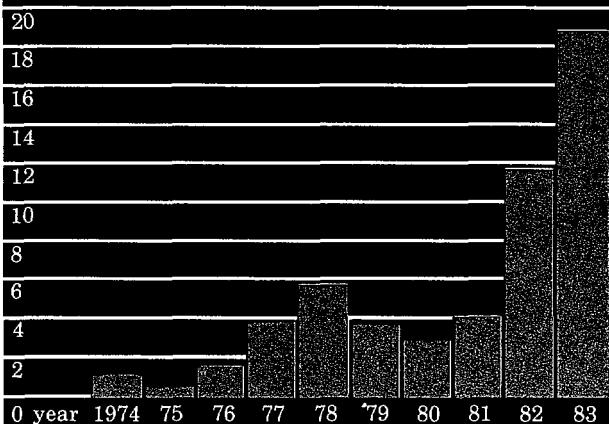
The Congress asked GAO to estimate how much the 1983 PIK program cost the taxpayers. In November 1983 testimony, GAO indicated the cost to be between \$10 billion and \$11 billion. Some PIK recipients had received payments valued in the millions of dollars because the Department of Agriculture believed the \$50,000 legal limit on subsidies to individual producers did not apply. The Department's reasoning: payments were made in commodities, not cash. GAO issued a legal opinion stating that the \$50,000 limit should have been in effect. In response to GAO's opinion and congressional concern, the Department limited to \$50,000 its 1984 PIK payments to individual producers, and this is expected to reduce PIK payments by \$288 million in 1984.

Evaluating the Dairy Price Support Program

The Department of Agriculture supports the prices dairy farmers get for their products by removing surplus butter, cheese, and nonfat dry milk from the market. In 1980 GAO responded to growing surpluses by identifying alternative ways to reduce them and resulting costs to the federal government. Since then, net budget outlays for surplus removal, including purchases, transportation, and storage, rose from \$24 million in fiscal year 1979 to \$2.5 billion in fiscal year 1983. The Department's dairy inventory went from about \$0.6 billion in September 1979 to \$4.2 billion in August 1984.

Net Outlays by Agriculture Department's Commodity Credit Corporation

(\$ in Billions)



GAO has undertaken various reviews of dairy price supports and the dairy inventory. This past year, GAO reported that disposing of surpluses by giving them to the military or to poor people would displace some commercial sales of dairy products. In search for ways to improve federal management of the dairy inventory and save costs, GAO is (1) reviewing controls over inventory storage and (2) exploring the possibility of purchasing user-ready packages of dairy products. GAO also plans to estimate the effect of the 1984 milk diversion program on prices and production and to explore other means for reducing milk production. These efforts are scheduled to be completed in time for the Congress' use in drafting the 1985 farm bill.

Strengthening Federal Farm Credit Programs

The Department's Farmers Home Administration, as a lender of last resort, provides credit to farmers unable to get financing from other sources at reasonable rates and terms. Delinquent payments for the 41 largest FmHA loan programs totaled about \$5.4 billion in July 1984. This has led to inquiries by the Congress, including requests for GAO to review the management of farms acquired after loan default. Also, GAO plans to study the operation of FmHA's loan programs and the efficiency of FmHA's loan application procedures.



Taxes

To reduce the budget deficit significantly, the federal government may well have to generate additional revenues as well as constrain the growth of spending. Raising and collecting taxes is always difficult, but in the future it will be doubly so. First, the size of the deficit is so large that changes to the tax laws will probably be necessary to bring the deficit down enough. Second, the current tax system is beset with problems. Tax laws are complex and difficult to administer. Taxpayers increasingly disregard the laws. And tax preferences (sometimes called "tax expenditures") enacted over the years to advance U.S. economic and social policies have eroded the tax base.

As the Congress meets these challenges, GAO is addressing certain major areas in which to provide assistance. GAO is studying measures to improve the tax laws and is also trying to find ways to help IRS administer the tax system more effectively and fairly and in the least costly manner.

Improving the Tax Laws

In the Deficit Reduction Act of 1984, the Congress adopted a number of recommendations from GAO's reports and testimonies.

- As the Congress considered repealing certain estimated tax penalty exceptions to simplify the tax laws, GAO provided information on the potential effects of such an action. The Congress did eliminate these exceptions, and, as a result, an estimated \$731 million in additional penalties will be assessed through fiscal year 1987.
- Tax laws affecting the life insurance industry were the subject of an in-depth GAO review. In revising these laws, the Congress adopted many of GAO's views, such as those concerning revaluation of life insurance reserves and determination of taxable income and calculation of the reserve deduction. Revaluation alone will result annually in about \$300 million of additional tax revenues.
- GAO questioned the need to print and distribute federal tax stamps on distilled spirits. The Congress repealed the requirement, saving an estimated \$2 million in annual administrative costs.

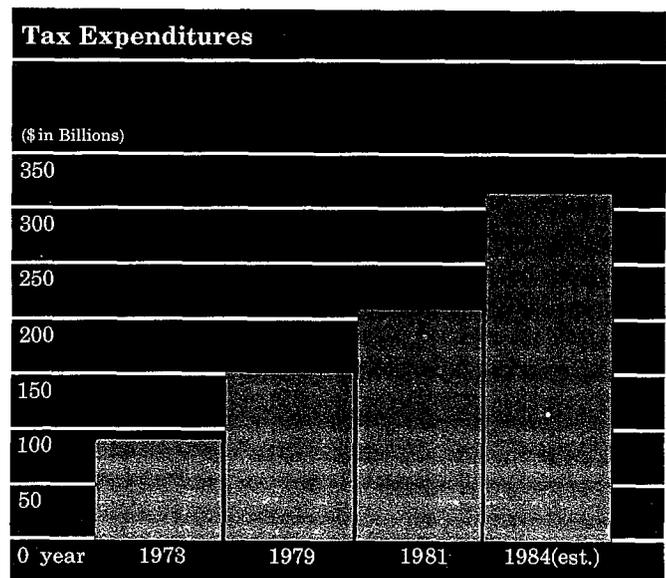
The Congress may soon explore various tax reforms and means for increasing revenues. GAO intends to help through its analyses. GAO's oversight of IRS' administration of the tax laws should continue to lead to legislative recommendations. GAO plans to expand its assistance by identifying tax provisions

that have proven particularly difficult to administer and by providing information on various tax reform proposals. Also, selected tax preferences, such as business energy credits, will be analyzed.

Strengthening Administration of the Tax Laws

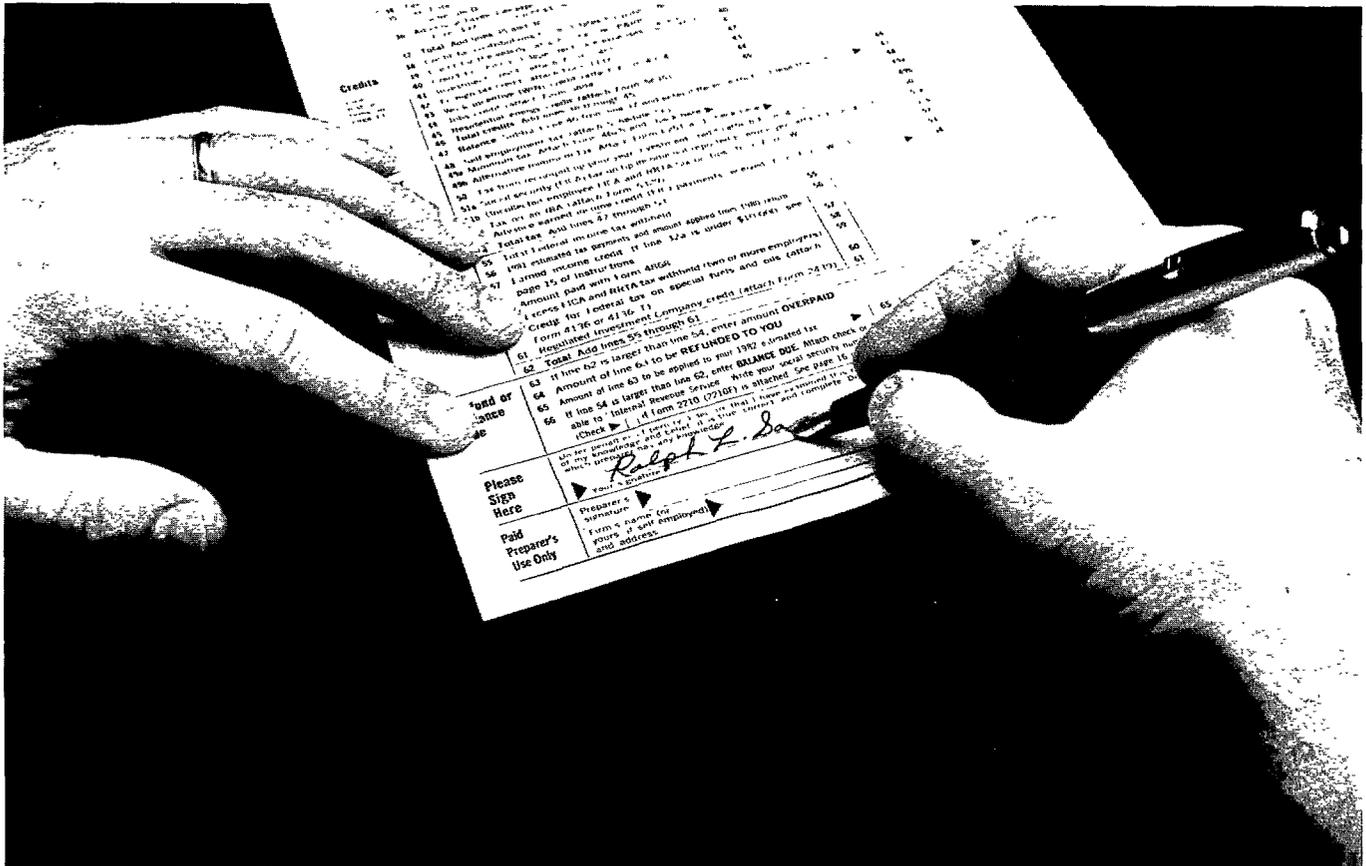
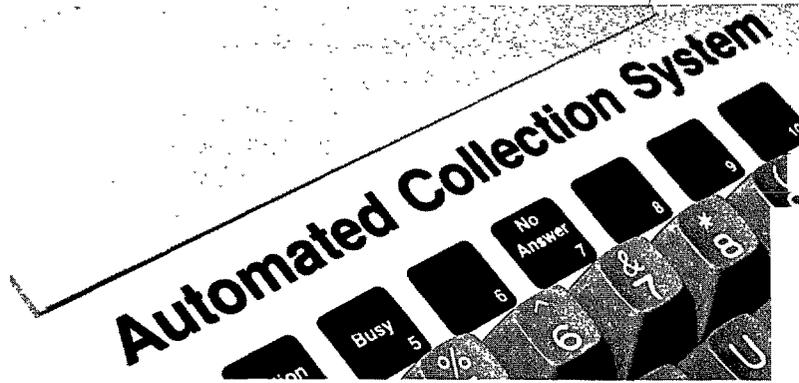
GAO's reviews of Internal Revenue Service activities aim at helping to make the tax system less costly to administer, with better service to the taxpayers and more equitable results. The following are examples of this work in 1984.

- GAO identified ways to strengthen and streamline IRS' administration of the Crude Oil Windfall Profits Tax Act. On the basis of GAO's recommendations, IRS has taken additional enforcement actions to collect more effectively the billions of dollars owed the government annually. Also, legislation has been introduced to provide for more rapid assessment of taxes and to speed up the appeals process.
- Based largely on GAO-developed information, the Congress decided to override administration efforts to substantially reduce IRS' taxpayer assistance programs.
- GAO found that IRS inappropriately abated (canceled or reduced) civil penalties worth \$21 million assessed against taxpayers for underpaying taxes or failing to file required information. IRS acted on GAO's recommendations for better determining whether such penalties should be abated.



- IRS agreed to act on GAO's recommendations aimed at speeding tax deposits to increase the government's interest earnings. GAO estimated that prior IRS practices cost the government over \$10 million in foregone interest in fiscal year 1981.
- GAO studied IRS computer technology—present and planned. The Internal Revenue Service and its contractors have found the study useful in modernizing and expanding IRS' computer capabilities.
- GAO reported on how the U.S. Tax Court could modernize its case processing, better cope with the growing case backlog, cut costs, and provide better service to taxpayers. Actions taken on GAO's recommendations should result annually in about \$100 million of additional revenue.

Over the next few years, GAO will pursue improvement in IRS' activities. In particular, GAO will focus on what to do about the multibillion-dollar unreported income problem, abuse of tax shelters, and unpaid taxes owed the government. As part of this work, GAO will review IRS' use of additional enforcement authority granted by the Congress in 1982 and 1984.



Financial Management

In an era of complex budget choices for a government which spends more than \$2 billion a day, the Congress and executive branch must have sound financial management systems and reliable information on which to base decisions and evaluate federal activities.

GAO's actions in fiscal year 1984 included:

- monitoring agency implementation of the 1982 Federal Managers' Financial Integrity Act; and
- assessing current problems in federal financial management and developing a comprehensive, integrated approach for addressing these problems governmentwide.

GAO also worked with the Congress as it considered and passed single audit legislation to strengthen financial management of federal aid programs.

Reviewing First Year Implementation of the Financial Integrity Act

In conjunction with the Financial Integrity Act, GAO comprehensively reviewed 22 federal agencies' work in assessing their own internal control and accounting systems. Although the agencies' own reports showed system weaknesses, GAO's review of these reports showed the agencies are establishing a process to evaluate, improve, and report on their financial management systems. An important result

of these efforts has been an increased awareness by federal managers of the need for good internal control and accounting systems.

Table 2 shows some areas in which significant weaknesses were identified and the number of agencies which reported weaknesses in each area.

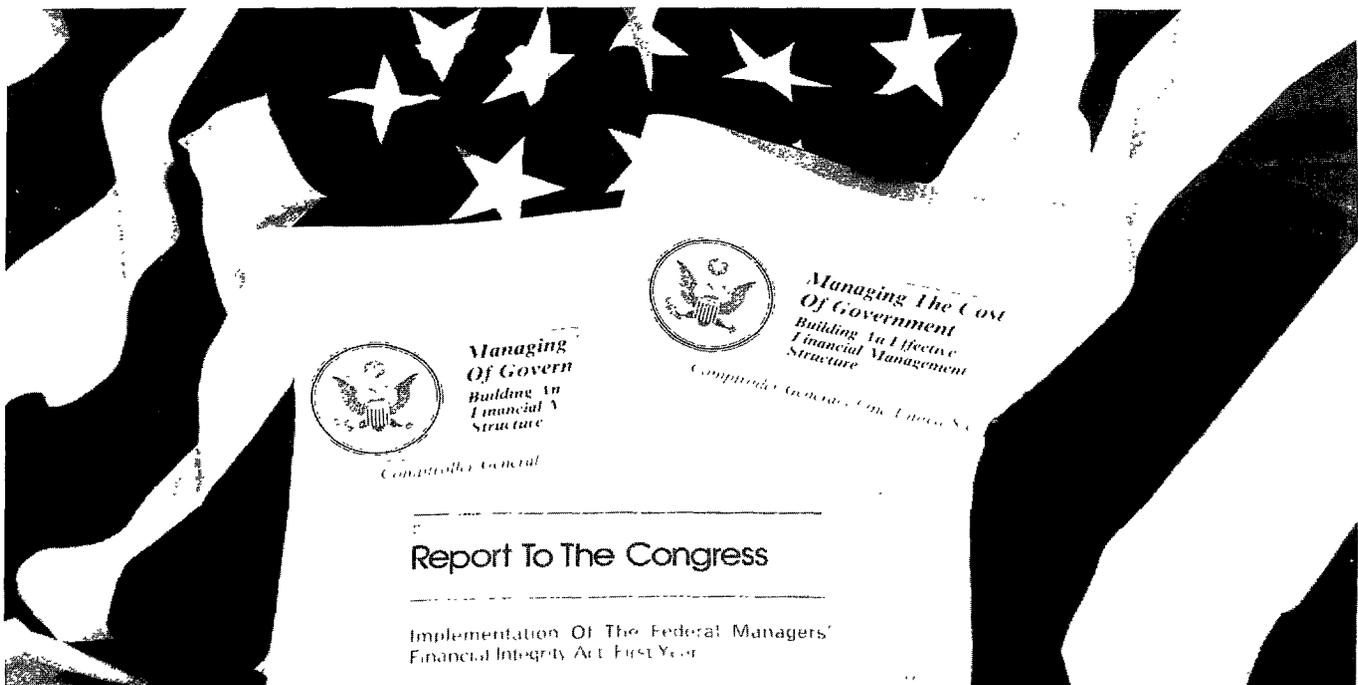
Table 2

Areas of Weaknesses	Number of Federal Agencies With Weaknesses ¹
Accounting/Financial Management Systems	16
Procurement	14
Property Management	13
Cash Management	12
Grant, Loan, and Debt Collection Management	12
Automated Data Processing	10
Personnel and Organizational Management	9
Eligibility and Entitlement	8

¹ Six Department of Defense agencies were counted as one agency here.

Reforming Federal Financial Management

The weaknesses identified in agency Financial Integrity Act reports are but one indication that cur-



rent financial systems, many now obsolete, face ever-increasing difficulties in coping with the demands placed on them. Perhaps the most visible evidence of these difficulties is the enormous amount of time and energy involved in obtaining consensus on the budget each year. Less visible, but equally important, problems include:

- The processes by which we decide how much to spend and for what purposes are cumbersome, repetitive, and time-consuming.
- Financial reports provide a flood of information, but much of it is unreliable, inconsistent, or irrelevant for decisionmaking. There is little of the reliable cost data essential for effectively monitoring program execution, anticipating overruns, and providing a basis for future program and budget planning.
- Major commitments of federal resources, such as retirement benefits and interest subsidies, are only partially recognized in the budget. Other activities—the Federal Financing Bank's \$106.9 billion loan portfolio, for example—are entirely excluded from the budget totals.

These problems and others, such as the need to replace antiquated computer systems with more modern ones, highlight the need for comprehensive, governmentwide financial management reform. One key element of that reform is the adoption of uniform accounting principles and standards comparable to those now used in the private sector and state and local governments. To assist in this effort, GAO issued its revised internal control standards in

1983 and its accounting principles and standards in 1984 to guide agency improvements in financial management.

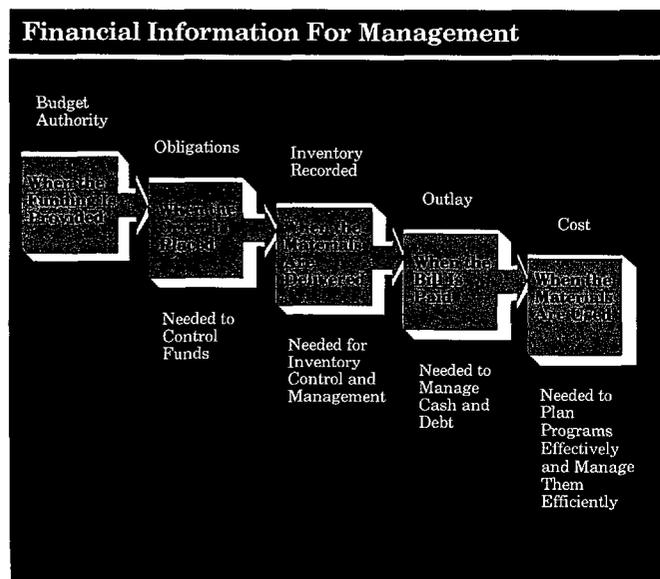
Successful governmentwide financial management reform must be part of an integrated approach. It will require a substantial commitment over a number of years by the Congress and the executive branch. The potential benefits are significant and include:

- the ability to measure cost input and performance output;
- the ability to compare costs of similar operations across the government;
- more accurate budget estimates based on actual past program and project costs;
- greater accountability for the use of public funds through better reporting on planned versus actual costs for programs, projects, and organizations.

A two-volume GAO report, *Managing the Cost of Government: Building an Effective Financial Management Structure*, identifies key problems and presents for discussion a conceptual framework that could be used as the basis for comprehensive reform. GAO is now working with congressional and executive branch officials to develop a consensus on the direction of reform measures, so that the federal government can build a financial management structure to serve the nation through the end of the 20th century and beyond.

Strengthening Financial Management of Federal Aid Programs

In October 1984, the Congress passed and the President signed legislation to strengthen financial management of federal aid programs. GAO worked closely with the Congress—as well as federal, state, and local government officials—throughout consideration of the legislation, which eventually became the "Single Audit Act of 1984." The act requires state and local governments receiving \$100,000 or more per year in federal aid to obtain an annual or biennial independent audit of its financial operations. If the audit reveals material noncompliance with applicable laws and regulations or material weaknesses in internal controls, the state or local unit must provide a corrective plan or an explanation of why no action is necessary.



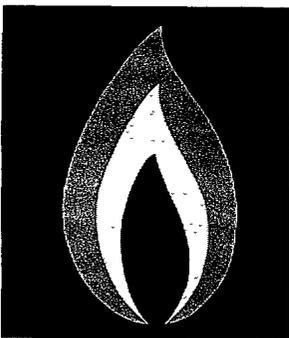
More Highlights of GAO's 1984 Work

Hazardous wastes, unless carefully disposed of, pose a serious threat to the environment. There is concern that at thousands of disposal sites across the country, improperly managed wastes may be seeping into water supplies, contaminating land, or poisoning the air.

The Congress established the \$1.6 billion "Superfund" in 1980 to clean up the most dangerous abandoned sites. Since then, the Environmental Protection Agency has completed cleanup efforts at only 6 of these sites. In 3 major reports and several testimonies related to the Superfund, GAO identified a range of management and funding problems to be addressed. Among these were (1) GAO's concern that the federal government might have to spend as much as \$26 billion to clean up the worst sites and (2) EPA's lack of standards for determining the most cost-effective solution to cleaning up a given site. In its last session, the Congress reconsidered extending the Superfund for 5 more years and substantially increasing money for cleanups; it eventually postponed final action on the proposed legislation until 1985.



Energy issues still receive congressional and public attention, despite noticeable improvements in the nation's energy picture. One issue is the Department of Energy's program to enrich uranium. GAO has explored for the Congress some factors affecting the program—namely lower growth in demand for enriched uranium, more foreign competition, and a glutted world market. Since the Congress has required the Energy Department to recover its enrichment costs, the Department has had to keep its prices high, which makes it difficult to compete in a buyer's market. In its 1984 work, GAO expressed concern about some of the



Department's actions, such as changing accounting procedures to lower costs used to calculate price. GAO pointed out that the Congress and the Department need to work on an approach to the difficult problems facing the federal uranium enrichment program.

Also in the energy field, GAO focused on the activities of the Synthetic Fuels Corporation, a publicly funded and established company. Reduced demand for energy led the Congress in 1984 to consider substantially cutting the \$14 billion available for synthetic fuels projects, and GAO has contributed a great deal of information to this debate. The Corporation's management problems in selecting projects and negotiating contracts also prompted several GAO investigations.

Drug trafficking has profoundly ill effects on society: drug abuse by young people and adults; crimes committed to pay for illegal drugs; billions of untaxed dollars diverted from the legal economy to organized crime; and strains on courts, prisons, and law enforcement agencies.

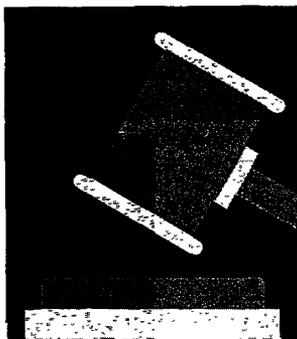
GAO has been looking for ways to bolster the government's efforts to control drug trafficking. In fiscal year 1984, GAO reported to the Congress on Drug Enforcement Administration (DEA) attempts to put major drug trafficking organizations out of business and jail their leaders. DEA agreed to carry out GAO's recommendation for better measuring the success of actions against high-echelon traffickers.



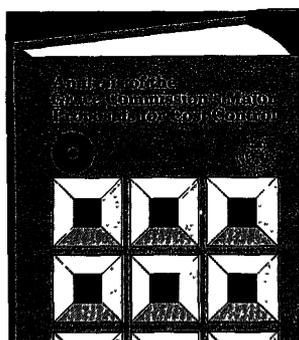
GAO also reported to the Congress on law enforcement agencies' steps to control U.S.-grown marijuana. Estimates show that production of domestic marijuana—perhaps over 2,000 metric tons in 1982—has been rapidly increasing. To a limited extent, DEA helps states combat this problem. In response to GAO's questionnaire, state law enforcement agencies stated that more resources, such as intelligence (data on marijuana trafficking), helicopters, and off-road vehicles, are needed to better thwart marijuana cultivation.

Bid protests by disappointed bidders for federal contracts are decided by the Comptroller General, who interprets how government procurement law and regulations should be applied. The Congress enacted the Competition in Contracting Act of 1984 to modernize federal procurement.

GAO's bid protest responsibilities have been affected in three major ways. First, the legislation establishes strict deadlines to ensure speedy resolution of bid protests. The involved federal agency has to report on the protest within 25 working days, and GAO has to issue a decision within 90 working days. Second, to make the process more meaningful, everything stops while the protest is being decided; i.e., the agency may not, except under specified circumstances, award or carry out the disputed contract. And third, to make the process more equitable, GAO may award successful protesters the costs of pursuing the protest.



The Grace Commission—a better known name for the President's Private Sector Survey on Cost Control—studied the federal government between June 1982 and January 1984 and made about 2,500 recommendations to help reduce program waste and/or improve management. After receiving the Grace Commission's proposals, the Congress asked GAO and the Congressional Budget Office (CBO) to evaluate recommendations which the Commission claimed to have the largest potential for savings—those estimated to save at least \$1 billion over 3 years. GAO and CBO reviewed nearly 400 of the recommendations, which accounted for almost 90 percent of the \$424 billion savings projected by the Commission.



In a February 1984 report, GAO and CBO provided the requested analysis and offered three overall

observations on the Grace Commission's important efforts. First, GAO concluded that roughly two-thirds of the Commission's recommendations examined by GAO have some degree of merit. Second, potential savings are much smaller than estimated. And third, most of the recommendations could be put into effect by the executive branch; these are administrative-type improvements. To realize most of the savings, however, the Congress would have to enact legislation to change policies or restructure programs.

Information management at the Social Security Administration (SSA) was the subject of two GAO reports and two testimonies to a congressional committee. GAO had reviewed SSA's acquisition of more than 1,800 data communications terminals for \$115 million.

GAO's first report concentrated on SSA's management practices in conducting the competitive procurement and in making the award to a contractor. GAO found inherent flaws in the system procurement management structure at SSA, including internal control deficiencies and inadequate oversight by the Department of Health and Human Services. These management flaws led to SSA's acquisition of equipment that did not begin to meet performance requirements consistently until 2 years after installation, thus impairing the quality of SSA's service to the public.



In a followup report, GAO addressed specific questions related to the contractor's actions in competing for the procurement award. GAO found that the contractor had misled SSA in numerous instances. GAO testified before the congressional committee that sufficient evidence existed for the government to initiate debarment proceedings, which could exclude the contractor from future government contracts for an appropriate time period. The committee concluded in its October 1984 report, partly on the basis of GAO's findings, that SSA deserves criticism for its contract award and administration and that the contractor played a large role in undermining the project.

GAO In Action

The General Accounting Office's major responsibility is to assist the Congress by providing information for its legislative activities and oversight of the executive branch. Through reports, testimony before congressional committees, legal opinions and comments on proposed legislation, and informal discussions with congressional staff, GAO contributes independent, nonpartisan information for congressional decisionmaking. GAO's audits and evaluations aim to improve federal government policies and operations, reducing costs where possible. In fiscal year 1984, the measurable benefits of GAO's work were \$5.2 billion.

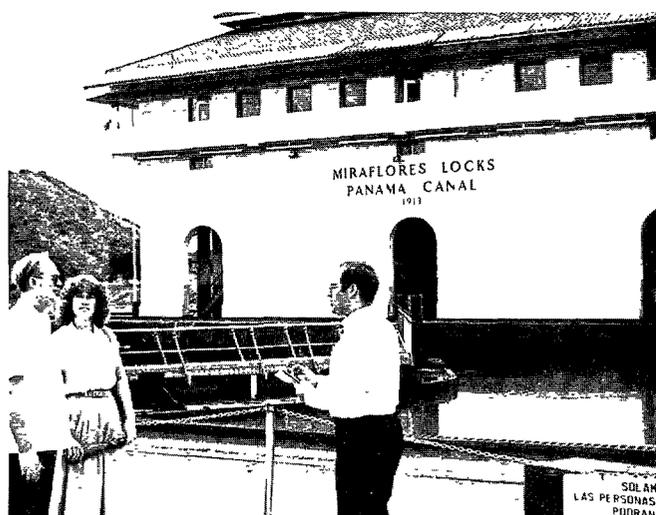
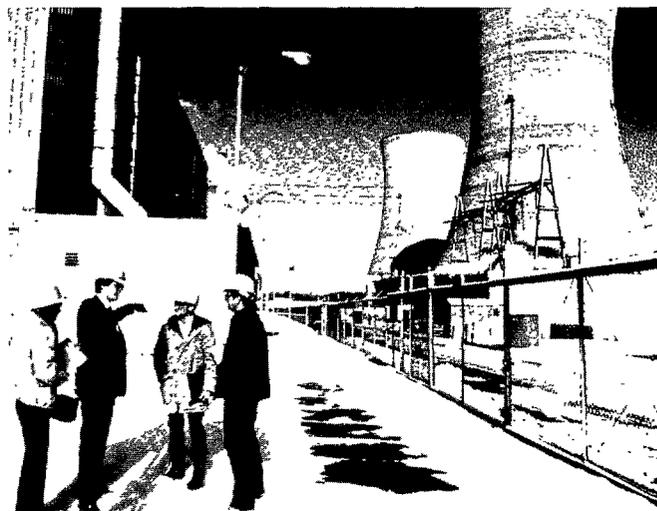
To fulfill its responsibility in fiscal year 1984, with an appropriation of \$272 million, GAO issued 634 reports to the Congress, its committees and members, and federal agency officials; testified 145





times before congressional committees; provided legal opinions and legislative interpretations 587 times; and assisted the Congress in many other ways.

This work is done by GAO's 5,000 employees. Roughly half of these people are assigned to headquarters' divisions and offices in the Washington, D.C., area, either in GAO's main building or at 80 "audit sites" located in federal agencies. The other half of GAO's staff are assigned to 15 regional offices (Atlanta, Boston, Chicago, Cincinnati, Dallas, Denver, Detroit, Kansas City, Los Angeles, New York, Norfolk, Philadelphia, San Francisco, Seattle, and Washington) and one overseas office (Honolulu) in the United States and foreign offices in Frankfurt, West Germany, and Panama City, Panama.



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