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Issue Paper
Department of Defense
1978 Budget

Issue #15: Growth of purchases in Operations and Maintenance

Background

This issue addresses the level of funding and the rate of growth for the "Operations and Maintenance" (O&M) appropriations of the four services. These appropriations provide the basic "standard of living" for the armed forces, operate and maintain the equipment in the current inventory, and provide expenses for the recruiting and training of military personnel. Salaries and related personnel expenses for military personnel are not included in O&M; the salaries and expenses of civilian personnel are funded in O&M, but have been excluded from this issue. The balance of the O&M appropriations can be referred to as "O&M purchases" and exhibits the following pattern of historical and projected growth.

	\$ Billions				
	1974	1975	1976	1977	1978
<u>O&M Purchases</u>					
Current Dollars	14.8	15.5	17.0	19.8	24.3
Constant 1977 Dollars	18.1	17.9	18.3	19.8	22.9
Real Growth (% Change Constant \$)		-1.1%	+2.2%	+8.2%	+15.7%



Funding required for O&M purchases should be, by its nature, governed - or driven - by workload factors. While many different workload factors apply to individual pieces of the program, total O&M purchases are largely governed by: (1) Manyears being supported (primarily military), (2) the composition of the force structure, and (3) related activity rates.

An analytical technique has been developed to measure fluctuations in force structure and changes in manyears being supported. The principle underlying this analysis is that the funding level which sustained the forces in the last actual year (1976) is adequate, after adjustment for inflation, to sustain the same forces in the budget year (1978). In addition, an allowance of 1% per quarter for real growth has been included in accordance with Presidential guidance of two years ago.

No offsetting adjustment has been taken for productivity, although this is an area where increased funding should result in management and operating efficiencies. This analysis indicates that the funding requested in 1978 exceeds the 4% annual growth level by approximately \$3.6 billion.

Impact on Readiness

Defense will probably not dispute the \$3.6 billion increase, but will contend that these funds are necessary to improve the readiness of the forces.

The problem appears to have its origin in the very large, unanticipated, impact of inflation during FY 1974. In preparing the 1974 Budget Defense, operating under OMB policy guidance, had not budgeted for inflation. The actual impact of inflation on O&M purchases exceeded 19% during that year. (This was the year of the fuel crisis and virtually all of Defense's fuel requirements are budgeted in O&M.) The most recent actual experience was FY 1974 at the time when the 1976 budget was being prepared. Based on the experience of 1974, the projection for purchases inflation in 1976 was approximately 15%. However, under A-11 policy which was still in force, Defense was not permitted to budget explicitly for inflation. In a logical attempt to cope with this problem, the Defense Department included in their 1976 O&M budget requests a large amount of program growth. This provided a hedge to absorb the anticipated high inflation. The recognition that very high inflation rates might well occur in 1976 led to approval of large increases for program growth.

In fact, inflation experienced in 1976 was only about half the amount which had been originally forecast and about half of these improvement programs were implemented, becoming part of the basic standard of living.

In preparing the 1977 budget, the extension of the program growth occurring in the past and new proposed improvements generated further large increases. The concept of "Improved Readiness" was presented as the single coherent rationale for these increases.

Our studies indicate that there is no effective method for correlating readiness indicators with funding. While various systems exist within DOD for measuring readiness, they are all imperfect as measures of readiness itself, and ineffective in terms of relating funding levels to readiness. The clear demonstration of this, in our opinion, is the fact that Defense has been unable to articulate, in any quantifiable fashion, either what the original readiness problem was, or consequently, how funding increases could contribute to the solution.



It is also not accurate to contend, as Defense may, that more funds will be beneficial even if we are unable to define the problem. The Services will frequently point to various logistics indicators and assert that readiness funding increases are necessary because the indicator is showing an adverse trend. Relying on an indicator for resource allocation, which is not correlated with resource changes or mission capability, is counterproductive for the following reasons:

- Funding may not change the indicator. Even where funding may improve the situation, the law of diminishing returns is particularly applicable to many of these logistics areas, showing little increase in the indicator after a significant resource increase.
- The indicator may not even be tied to mission capability, so that an improvement in the indicator may not improve readiness.
- The indicator may not be the critical path problem in the logistics support chain; therefore, even if the indicator is tied to mission capability and it improves, it may not improve mission capability if some other constraint still exists.
- Allowing the services to increase funding for readiness in areas where they have not provided adequate analytic justification perpetuates the problem, since the services interpret this as evidence that their "system" is working; i.e., leading to funding increases, and, therefore, is acceptable.
- On the other hand, recognizing the limitation of the current indicators and requiring better analytic backup for increased funding of logistics will provide a strong incentive for the services to identify the "real" problems or develop means of relating the problem to funding.

We believe there are certain improvements that can be made which will permit a realistic identification of the nature of readiness problems and an indication of potential solutions.

- DOD should develop broader based readiness measurement systems which will provide a measure of balanced logistics capabilities required for wartime mission capability and relate this measure to resources. The Air Force is currently working on a system along these lines.

- Poor reliability, due to DOD's acceptance of equipment which doesn't meet contractual reliability standards, is often a cause of the most severe "readiness" problems. Additional O&M funding for logistics support does not solve this type of problem. Services should be more willing to slip equipment delivery rather than accept poor reliability and live with serious and expensive logistics problems for the life of the equipment.

Statement of Issue

Should guidelines be provided to govern the rate of growth of purchases in O&M?

Pros.

- Establishes broad visibility and fiscal control over a major segment of the DOD budget which is currently governed by piecemeal and somewhat conflicting policies.
- Permits the President to establish effectively the desired rate of real growth in O&M purchases.

Cons.

- Failure to provide the full funding requested in this area will generate assertions that the "readiness" of the forces has been impaired.
- By taking a broad, level of effort approach to this area, the joint review is unable to address each individual proposed program change on its intrinsic merits.

Alternatives

- #1. Accept the service requests for O&M purchases in 1978, which total \$24.3 billion.
- #2. Accept the results of the joint OSD/OMB budget "scrub" which is forecast to reduce the service submissions by \$1.7 billion (DOD preference).
- #3. Provide guidelines to OSD for O&M purchases based on provision for anticipated inflation (using DOD projections) and a projected allowance of 1% per quarter for real growth over the 1976 program. Growth in excess of 1% per quarter in 1977 would be discounted against the allowable growth rate in 1978 and 1979. This alternative would reduce the service request by \$3.6 billion in 1978. (OMB rec.)

Analysis

<u>BA/Outlays</u> <u>(\$ Billions)</u>	<u>1976</u>		<u>1977</u>		<u>1978</u>	
	<u>BA</u>	<u>O</u>	<u>BA</u>	<u>O</u>	<u>BA</u>	<u>O</u>
<u>O&M Purchases:</u>						
Alt. #1 (Ser. req)	17.0	17.0	19.8	19.8	24.3	24.3
Alt. #2 (DOD Pref)	17.0	17.0	19.8	19.8	22.6	22.9
Alt. #3 (OMB Rec.)	17.0	17.0	19.8	19.8	20.7	21.2

	<u>Agency Request</u>	<u>1978 Outlays</u>	<u>1979 Outlays)</u>
(Difference from Alt. #1 (Agency Request)			
Alt. #3 (OMB Rec.)		-3.1	-.5)
(Alt. #2 (DOD Pref.)		-1.4	-.3)

Agency Request: Alternative #2. OSD estimates that the joint review will reduce the service requests by \$1.7 billion through the traditional methods of review.

OMB Recommendation: Alternative #3. It seems clear that a programmatic review of O&M purchases on an item-by-item basis has been unable, in the past, to keep the rate of real growth at the 4% annual rate decided by the President in his 1976 budget decisions. It also appears to us that Defense has been unable to define a real problem in the area of "readiness" which could be corrected by additional O&M funds.



Modernization

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Objectives
PE, PMI

Department of Defense
1978 Budget
Discussion of Agency Objectives and Program Evaluation Efforts

I. DOD MBO Submission for FY 1977/1978

- In general, DOD has a good Planning, Programming, and Budgeting System (PPBS) for identifying program objectives, for specifying key milestones related to their achievement, and for managing agency resources to achieve these objectives in the schedules agreed to in the program development and budget process.
- DOD's MBO effort focuses on objectives in major areas which are not adequately covered in the PPB System, primarily because they are not single service or single line item program areas. Examples include:
 - . Promoting NATO weapon system standardization and interoperability.
 - . Improving NATO combat effectiveness (joint training, headquarter collocation, specialization of combat and support tasks).
 - . Reducing unnecessary military support structure, overseas and in the U.S.
 - . Increasing the representation of minorities and women in DOD policy positions.
- The department's record on 1976 MBOs was uneven, although significant progress was achieved in several areas, including:
 - . Increasing combat strength in Europe
 - . NATO standardization/interoperability
 - . Increasing Reserve force readiness
 - . Reducing paperwork.



- DOD has done a good job in developing its MBOs for 1977/78, choosing priority objectives in several areas; milestones are specific enough to measure progress. Experience with the FY 1976 MBOs shows that significant accomplishment in some areas can be expected only if the Secretary or his Deputy use the MBOs on a regular basis as a management tool.

II. Program Evaluations

- DOD has an extensive program evaluation effort which is related to budget development through the formal PPB System. Both program impact and efficiency evaluations are included in the effort.

- Examples of completed (c) and on-going (o) evaluations include:

- ° Program Evaluations:

NSSM 246	(o)
NATO Theater Air Defense	(o)
Amphibious Lift Requirements	(o)
Navy Shipbuilding Program	(o)
Long-Range CONUS Base Planning Study	(o)

- ° Efficiency Evaluations:

Strategic Mobility Requirements	(o)
Rotary versus Fixed-Wing Aircraft Missions	(o)
North Atlantic Air Defense	(o)
New Missions for the Naval Reserve	(o)
Management Headquarters Study	(o)
Procurement Rate for B-1 Bomber	(c)
Air Logistics Pipeline Study	(c)
Civil Defense	(o)
Appropriated Fund Support of Nonappropriated Fund Activities	(o)

- DOD evaluation efforts are conducted by the various staff elements of the Office of the Secretary of Defense rather than in a single unit as well as by the military services, each of which has an extensive evaluation organization.
- In general, DOD force program objectives (e.g., the need for 16-2/3 active Army divisions or 26 active Air Force tactical fighter wings) are not amenable to precise definition through evaluation, although analysis is useful for providing rough limits.
- Much of DOD's force evaluation effort focuses on second order efficiency questions, defining cost-effective alternatives for achieving a predefined goal (e.g., the most cost-effective mix of mobility forces and prepositioned equipment for reaching a force build-up objective in NATO after M-Day).
- OMB staff has been a primary instigator of efficiency evaluations for the DOD, especially in the areas of personnel requirements and compensation, logistics, and construction.

III. Agency Management Quality and Process

- In terms of capability and the recent record, DOD's management quality is varied. Most staff elements in OSD are good to excellent. Management quality in the services is poor to good, with a few exceptions at certain support activities and in the operating forces.
- The management process is highly formalized, through the PPB System. A major weakness in DOD's PPBs, however, has been the lack of a system for tracking implementation of policy decisions, especially in areas other than weapon system acquisition. Secretary Rumsfeld has requested OSD staff elements to report by November 19 alternatives for improving the PPBS. The implementation gap is being addressed in this review.

Department of Defense
1978 Budget
Discussion of Presidential Management Initiatives

Agency Submission

Defense submitted its action plan related to the Presidential Management Initiatives on August 27, 1976. DOD's plan is comprehensive and covers all the initiatives outlined in the July 27 memorandum to department and agency heads.

OMB Assessment

The DOD PMI action plan has been reviewed by various OMB staff, and the comments have been sent to the agency. Generally, DOD submitted a good action plan. Internal DOD response has not been enthusiastic, however, primarily because the agency already has organizations and functional statements of responsibility for the areas covered in the PMI.

DOD's substantive performance, as opposed to the existence of responsible organizations and systems, in the various PMI areas ranges from very good to poor. The primary areas where DOD has lagged in the past are:

- Cash management
- ADP management
- Contracting out.

OMB staff is emphasizing improved performance in these areas in both the PMI effort and in the budget process.

Progress Reporting

DOD submitted its September and October reports a week late, although draft reports were submitted on time. Some progress is evident in weak areas such as cash management and ADP; however, response to OMB suggestions has been slow in others. Continued OMB, and high-level DOD, interest should result in improved responses in future reports.