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December 1992

# International Trade Issues



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**Comptroller General  
of the United States**

December 1992

The Speaker of the House of Representatives  
The Majority Leader of the Senate

In response to your request, this transition series report discusses major policy, management, and program issues facing the Congress and the new administration in the area of international trade. The issues include (1) enhancing U.S. competitiveness in an interdependent world, (2) promoting U.S. exports, (3) managing the U.S. Department of Agriculture's export programs, (4) negotiating and administering trade agreements, and (5) analyzing national security-related foreign investments.

The GAO products upon which this report is based are listed at the end of this report.

We are also sending copies of this report to the President-elect, the Republican leadership of the Congress, the appropriate congressional committees, and the designated heads of the appropriate agencies.



Charles A. Bowsher

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# International Trade Issues

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International trade has become an increasingly critical part of the U.S. economy. The share of national income generated by exports has more than doubled over the past 30 years. Exports now account for about 10 percent of the U.S. gross domestic product and are an important source of job creation. Nevertheless, many believe that despite its rising exports the United States is losing ground in the new global competition.

As we reported 4 years ago, the U.S. economy has become increasingly intertwined with those of other nations in a new international marketplace; many of those nations have gained considerable economic power since World War II. As a result, the United States needed to better balance its domestic economic goals and policies with the constraints imposed by the realities of the interdependent global economy. A major priority then was the need to address the macroeconomic imbalances resulting from the very large federal budget deficits. The United States was consuming more than it produced and importing the difference, which led to large U.S. trade deficits. These trade deficits, and borrowing to finance the U.S. budget deficit, led to the United States' becoming the world's largest

debtor nation. Unfortunately, these problems remain.

Some progress has been made at the program level in areas we reported on in 1988, but work remains to be done. While the Departments of Commerce and Agriculture have addressed some of the organizational and management problems in their export promotion programs, there is now a need to develop and implement a comprehensive, governmentwide strategy for such programs, which are spread among several agencies. Multilateral trade negotiations, thought to be at midpoint in 1988, remain uncertain despite recent progress, and effective enforcement remains a key to making trade agreements work. New bilateral initiatives offer the promise of expanded trade, but knotty issues still need to be addressed. And as international competition sharpens and foreign firms show interest in acquiring high-technology and other national security-related firms, continued attention needs to be paid to the impact of foreign investments in U.S. industries on this nation's defense capabilities and competitive position.

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# Enhancing U.S. Competitiveness in an Interdependent World

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In our 1988 transition series report on international trade, we highlighted the increasing interdependence of the U.S. economy and other nations' economies. The United States had set in place macroeconomic policies that differed from other countries'. These policies had helped transform the United States into the world's largest debtor nation, dependent on capital from abroad to finance substantial portions of its large, persistent federal budget deficit. We urged the administration to address the imbalance between savings and the deficit, specifically by reducing the deficit without endangering long-term economic growth.

Unfortunately, since our last report, the budget deficit has grown, and the national savings rate has been insufficient to meet the needs of both private sector investments and government borrowing. Furthermore, a long period of slow economic growth and of relentlessly increasing competition from other nations has prompted the growing realization that the United States needs to focus on long-term investment as a way to enhance its competitiveness in the global marketplace. Formulating economic policies will require a difficult balancing of domestic goals with international economic objectives and constraints.

Moreover, with the end of the Cold War, the traditional national security and foreign policy concerns—formerly centered on military confrontations—have receded in importance; new ones focused on economic competition with other major industrialized countries have become more prominent. Some of these countries have relationships between their governments and their business communities that differ significantly from those in the United States. The perception that the United States is losing ground in the transnational marketplace to these countries has forced leaders in business and government to question current economic and social policies, including the role of government in rebuilding the economy and developing a national strategy for enhancing the United States' competitive position.

The new economic environment will require a careful examination of how government programs and policies affect the competitive position of the U.S. economy. For example, at the macroeconomic level, the new administration will need to adopt policies that support private sector investment by keeping the cost of capital at reasonable levels. At the government program level, it must develop efforts that support rising

productivity in the private sector, such as an improved infrastructure and a better educated and trained labor force. Finally, it must encourage private sector firms to improve their own goals, policies, and management systems as their critical contribution to enhancing U.S. competitiveness. Such a comprehensive effort is needed to help ensure that the United States will be able to sell its goods and services on world markets and that its citizens can enjoy a rising standard of living.

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# Promoting U.S. Exports

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The U.S. government spends significant amounts on export promotion programs—about \$2.7 billion in fiscal year 1991—in addition to about \$21.4 billion in export loans, credit guarantees, and insurance. Both the Commerce and Agriculture Departments have major responsibilities for export promotion. However, as we said in our 1988 transition series report, Commerce's activities in that area faced significant difficulties. Since then, attention has been focused on the fact that there is no explicit governmentwide strategy or set of priorities to apportion export promotion funds. This situation has been addressed recently in legislation, but carrying out the new legislative mandate poses challenges. As our economic advancement becomes more dependent on success in trading with others, the way we spend federal money to help market U.S. products and services abroad will be of great importance.

Our 1988 transition series report said that the effectiveness of the Department of Commerce's export promotion activities was weakened by significant organizational and management problems. Commerce has since addressed a number of these problems. However, compared with total government

support for exporting, Commerce has relatively few budgetary resources with which to carry out its programs. Consequently, because of these resource constraints, improvements in the management of this department's programs can have only a limited effect on government efforts to assist exporters.

Export promotion programs are spread over 10 different agencies, and funds are not allocated on the basis of any specific governmentwide strategy. As a result, for example, agricultural exports receive about 75 percent of the total outlays for export promotion, yet they represent only about 10 percent of U.S. exports. Consequently, the federal government does not have any reasonable assurance that its export promotion funds are being channeled into areas with the greatest potential returns.

While various reorganization proposals were advanced during the 1980s, none were adopted. However, the Export Enhancement Act of 1992 (P.L. 102-429) incorporated our recommendations for devising a governmentwide strategic plan to promote exports and for creating a unified federal budget for export promotion that would be consistent with priorities established in the

plan. The law also gave the Trade Promotion Coordinating Committee (TPCC), an interagency committee chaired by the Secretary of Commerce, responsibility for coordinating export promotion programs.

The new legislative mandate and the TPCC's organizational responsibility for developing a cohesive federal export promotion program have been established. But successfully implementing this new authority will be the key to defining a stronger, more effective federal role in assisting U.S. exporters. Therefore, the administration needs to develop a sound strategy and policies for carrying out this role.

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# Managing the U.S. Department of Agriculture's Export Programs

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Agricultural trade has continued as a major issue in recent years. World surpluses of agricultural commodities have increased, subsidized agricultural export competition has intensified, and the number and costs of U.S. agricultural export programs have risen. Moreover, disputes over agricultural subsidies have been the major impasse in the current round of multilateral trade negotiations under the General Agreement on Tariffs and Trade (GATT).

Our November 1988 transition series reports on agriculture issues and on international trade issues urged greater management control over the U.S. Department of Agriculture's export programs—including preparing better funding criteria, providing written guidelines, and developing an evaluation methodology—to improve U.S. agricultural export performance. Improved internal controls were needed to enhance the management and operations of export programs. While some improvements have been made in the management of Agriculture's export programs since then, a number of management changes are still necessary.

The Department's Foreign Agricultural Service (FAS) now manages over \$10 billion a

year in agricultural export programs and export credit assistance. These programs are designed to increase U.S. agricultural exports, and develop and maintain foreign agricultural markets for U.S. products. They include the Export Enhancement Program, the Export Credit Guarantee Programs (GSM-102/103), the Market Promotion and Cooperator Foreign Market Development Programs, the Food for Peace Program (P.L. 480, title I), the Trade Show Program, and a wide variety of overseas agricultural trade-related activities. Congressional support for enhanced agricultural export promotion and foreign market development was underscored in the export title of the Food, Agriculture, Conservation, and Trade Act of 1990.

However, FAS lacks a coherent and comprehensive strategy to promote agricultural trade. Internal controls in programs remain inadequate, program evaluation is limited and generally ineffective, and program accountability is insufficient. Problems in the management and operation of agricultural trade offices overseas and trade shows abroad also need to be addressed. Our work on Iraq and the former Soviet Union raised concerns over compromising the export credit guarantee

programs for foreign policy and national security considerations. Questions persist about the creditworthiness of these countries and the financial impact on U.S. taxpayers.

To address the above concerns, FAS needs to, among other things, expedite development and implementation of a long-term agricultural trade strategy consistent with legislative requirements under the export title of the 1990 act; establish enhanced planning, decision-making, and program evaluation processes; and improve internal controls and documentation to ensure greater accountability and more efficient and effective program management. FAS should also develop clear, consistent, and appropriate export program criteria to ensure that taxpayers' funds are correctly used. FAS is in the process of implementing some program management reforms. These changes must be monitored and their effectiveness assessed.

Other matters related to agricultural trade appear in our transition series report Food and Agriculture Issues (GAO/OCG-93-15TR, Dec. 1992).

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# Negotiating and Enforcing Trade Agreements

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The aim of U.S. trade negotiations is to remove foreign barriers to imports and unfair governmental incentives to exports, thus encouraging the free flow of international trade. The principal multinational trade regime has been the GATT. In 1988, the parties to GATT were at what they believed was the midpoint in negotiations on the so-called Uruguay Round. At this writing, the round has still not been concluded. However, initiatives to reach bilateral agreements with other countries have advanced. Some of these initiatives, nevertheless, need the attention of the new administration.

The United States has historically been a leader in GATT negotiations. Therefore, the new administration must quickly determine its position on the current GATT round. The expiration date for the current fast-track authority gives the new administration very little time to act without congressional extension of the authority. Vigorous and effective systems for monitoring and enforcing agreements are essential to avoid violations, delaying tactics, and drawn-out dispute settlements. The administration should show resolve in using the powers granted in the Omnibus Trade and Competitiveness Act of 1988, which provided

authority for a unilateral response to unfair trade practices when established processes prove ineffective or untimely.

Despite the difficulties in reaching a GATT agreement, the United States has been able to advance trade liberalization through bilateral and regional initiatives. The U.S.-Canada Free Trade Agreement, effective in 1989, put in place a process to gradually remove all tariffs and most other barriers by 1999. By closely monitoring implementation and seeking issues in which U.S. and Canadian interests coincided, the two countries were able to accelerate tariff phase-out, with industry support, on many items.

Furthermore, the U.S.-Japan Structural Impediments Initiative attempted to deal with the two countries' basic economic (and social) structures that caused the growth of trade imbalances. This attempt underscored the close interrelationships between the two economies. Facing structural questions—such as the technology policies, the financial market structures, and the business/government relationships of other nations—will be of even greater significance in the more closely integrated global marketplace.

More recently, the United States, Mexico, and Canada concluded negotiations and signed the North American Free Trade Agreement (NAFTA), scheduled to become effective in 1994. The most significant aspect of NAFTA is that it binds Mexico's recent market-oriented economic reforms to international obligations, thereby making these reforms more permanent. Though NAFTA will likely have only a modest net effect on the U.S. economy, much controversy remains as to the scope and extent of social and economic adjustments that will be caused by its implementation, such as effects on employment, immigration, and the environment.

The new U.S. leadership must quickly assess the consonance of NAFTA with its own priorities and determine what actions it needs to take. If the administration is not satisfied with the agreement in its current form, it could try to (1) use implementing legislation to overcome concerns about the social and economic adjustments or (2) reopen negotiations with Mexico and Canada to modify the agreement or to obtain clarifying side agreements.

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# Analyzing National Security-Related Foreign Investments

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Sharp increases in foreign direct investment in the United States in the late 1980s generated concerns about the consequences of foreign ownership of U.S. assets. Our 1988 transition series report noted that experts feared that foreign acquisitions of national security-related or high-technology U.S. firms could affect this nation's defense capabilities. We noted the potential competitive effects of transferring U.S. technology secrets to other countries through foreign purchases of and joint ventures with U.S. firms. These investments also raised a number of other potential issues, such as increased foreign political influence and effects on domestic employment. And at that time a perception existed that the information available to analyze foreign investment was inadequate.

In response to these concerns, the Congress enacted the Exon-Florio Amendment to the Defense Production Act in 1988, authorizing the President to investigate and block or suspend new foreign acquisitions or mergers that threaten U.S. national security. It also passed the Foreign Direct Investment and International Financial Data Improvements Act of 1990 to expand government statistical information on foreign investment.

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**Analyzing National Security-Related  
Foreign Investments**

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Under the Exon-Florio Amendment, the interagency Committee on Foreign Investment in the United States has reviewed over 700 foreign investments of possible national security concern. In practice, the amendment's review criteria have been applied to a very narrow range of circumstances, with the President deciding to block only one investment. Although the Congress intended that national security be defined very broadly, it has proved especially difficult to assess the national security impact of acquisitions of U.S. firms by those of our allied nations, such as Japan or France. Moreover, at the point when the acquisition is reviewed, the President may be faced with limited choices—either to approve the proposed investment that may be a welcome capital infusion, helping to maintain the firm's U.S. production and employment, or to oppose the acquisition and perhaps see the U.S. firm suffer continued business difficulties.

Furthermore, the case-by-case reviews under the Exon-Florio provision are not required to address broader issues of U.S. competitiveness in industry sectors essential to maintaining leadership in advanced technologies. In addition, the review process is not designed to cover other international

business relationships, such as research and production agreements, that raise technology transfer issues similar to those surfaced by foreign direct investments.

In mid-1992, the proposed sale of a U.S. defense contractor to a company partially owned by the French government raised the level of concern about the Exon-Florio process. Revisions to the statute were made as part of the fiscal year 1993 Defense Authorization Act. These revisions include certain prohibitions on foreign government ownership of U.S. defense contractors and a requirement that foreign government-controlled entities acquiring U.S. firms producing defense-related technologies undergo the full Exon-Florio investigation process. The new statute also broadened the analytical criteria to be used in the investment review process to include the impact of the acquisition on the (1) United States' international technology leadership in areas affecting national security; (2) proliferation of nuclear, chemical, and biological weapons; and (3) capabilities of countries that support terrorism.

Further, the government's official statistical base on foreign investment has been

improved under the 1990 act. Although data are still about 2 years old when they are published, there is now greater detail available, for example, in the industry categories and the separation of firm operations such as wholesaling and retailing.

Nevertheless, the new administration will need to establish guidelines and precedents for interpreting these statutory changes at a time when the streamlining of U.S. defense industries may bring continued foreign acquisitions of national security-related U.S. firms. In addition, the administration will have to consider supplementing the current case-by-case analysis of foreign acquisitions with efforts to anticipate and deal proactively with the broader competitive and defense concerns raised by foreign acquisitions and investments.

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## Related GAO Products

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Enhancing U.S.  
Competitiveness  
in an  
Interdependent  
World

High-Technology Competitiveness: Trends in  
U.S. and Foreign Performance  
(GAO/NSIAD-92-236, Sept. 16, 1992).

Automotive Industry: The Competitive  
Challenge to U.S. Companies  
(GAO/T-NSIAD-92-7, Jan. 27, 1992).

International Trade: U.S. Business Access to  
Certain Foreign State-of-the-Art Technology  
(GAO/NSIAD-91-278, Sept. 12, 1991).

Management Practices: U.S. Companies  
Improve Performance Through Quality  
Efforts (GAO/NSIAD-91-190, May 2, 1991).

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Promoting U.S.  
Exports

Export Promotion: Problems in the Small  
Business Administration's Programs  
(GAO/GGD-92-77, Sept. 2, 1992).

Export Promotion: Overall U.S. Strategy  
Needed (GAO/T-92-40, May 20, 1992).

Export Promotion: Federal Programs Lack  
Organizational and Funding Cohesiveness  
(GAO/NSIAD-92-49, Jan. 10, 1992).

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Managing the U.S. Department of Agriculture's Export Programs

U.S. Department of Agriculture: Improved Management Could Increase the Effectiveness of Export Promotion Activities (GAO/T-GGD-92-30, Apr. 7, 1992).

U.S. Department of Agriculture: Management Issues Remain Unresolved in the Market Promotion Program (GAO/T-GGD-92-25, Mar. 25, 1992).

Iraq's Participation in the Commodity Credit Corporation's GSM-102/103 Export Credit Guarantee Programs (GAO/T-NSIAD-91-13, Mar. 14, 1991).

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Negotiating and Enforcing Trade Agreements

Mexican Oil: Issues Affecting Potential U.S. Trade and Investment (GAO/NSIAD-92-169, Mar. 18, 1992).

U.S.-Mexico Trade: Survey of U.S. Border Infrastructure Needs (GAO/NSIAD-92-56, Nov. 27, 1991).

Agricultural Trade Negotiations: Stalemate in the Uruguay Round (GAO/NSIAD-91-129, Feb. 1, 1991).

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Analyzing  
National  
Security-Related  
Foreign  
Investments

Foreign Investment: Analyzing National Security-Related Investments Under the Exon-Florio Provision (GAO/T-GGD-92-49, June 4, 1992).

Foreign Direct Investment: Assessment of Commerce's Annual Report and Data Improvement Efforts (GAO/NSIAD-92-107, Mar. 18, 1992).

Foreign Investment: Concerns in the Banking, Petroleum, Chemical, and Biotechnology Sectors (GAO/NSIAD-90-129, May 30, 1990).

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General

International Trade Issues (GAO/OCG-89-5TR, Nov. 1988).

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# Transition Series

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## Economics

Budget Issues (GAO/OCG-93-1TR).

Investment (GAO/OCG-93-2TR).

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## Management

Government Management Issues  
(GAO/OCG-93-3TR).

Financial Management Issues  
(GAO/OCG-93-4TR).

Information Management and Technology  
Issues (GAO/OCG-93-5TR).

Program Evaluation Issues (GAO/OCG-93-6TR).

The Public Service (GAO/OCG-93-7TR).

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## Program Areas

Health Care Reform (GAO/OCG-93-8TR).

National Security Issues (GAO/OCG-93-9TR).

Financial Services Industry Issues  
(GAO/OCG-93-10TR).

International Trade Issues (GAO/OCG-93-11TR).

Commerce Issues (GAO/OCG-93-12TR).

Energy Issues (GAO/OCG-93-13TR).

Transportation Issues (GAO/OCG-93-14TR).

Food and Agriculture Issues

(GAO/OCG-93-15TR).

Environmental Protection Issues

(GAO/OCG-93-16TR).

Natural Resources Management Issues

(GAO/OCG-93-17TR).

Education Issues (GAO/OCG-93-18TR).

Labor Issues (GAO/OCG-93-19TR).

Health and Human Services Issues

(GAO/OCG-93-20TR).

Veterans Affairs Issues (GAO/OCG-93-21TR).

Housing and Community Development

Issues (GAO/OCG-93-22TR).

Justice Issues (GAO/OCG-93-23TR).

Internal Revenue Service Issues

(GAO/OCG-93-24TR).

Foreign Economic Assistance Issues

(GAO/OCG-93-25TR).

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**Transition Series**

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Foreign Affairs Issues (GAO/OCG-93-26TR).

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General Services Issues (GAO/OCG-93-28TR).

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December 1992

# National Security Issues



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Comptroller General  
of the United States

December 1992

The Speaker of the House of Representatives  
The Majority Leader of the Senate

In response to your request, this transition series report discusses major defense policy, management, and program issues facing the Congress and the new administration. These issues involve (1) reassessing military roles and missions; (2) managing the downsized and restructured force; (3) reassessing U.S. commitments, forward presence, and security assistance programs; (4) controlling the spread of weapons of mass destruction; (5) reforming weapons system acquisition while preserving the industrial base; (6) addressing environmental challenges; (7) following through on inventory and other management initiatives; and (8) improving financial management.

As part of our high-risk series on program areas vulnerable to waste, fraud, abuse, and mismanagement, we are issuing related reports; Defense Weapons System Acquisition (GAO/HR-93-7, Dec. 1992); Defense Inventory Management (GAO/HR-93-12, Dec. 1992); and Defense Contract Pricing (GAO/HR-93-8, Dec. 1992).

The key GAO products upon which this transition series report is based are listed at the end of the report.

We are also sending copies of this report to the President-elect, the Republican leadership of the Congress, the appropriate congressional committees, and the Secretary-designate of Defense.

A handwritten signature in cursive script that reads 'Charles A. Bowsher'.

Charles A. Bowsher

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# National Security Issues

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At the time of our 1988 transition series, the defense budget had started to decline from its peak in the mid-1980s, and relations with the Soviet Union were allowing the United States to look for ways to further reduce defense spending. There was no hint, however, of the momentous changes that were about to take place. In 1989, the Berlin Wall fell, and the Warsaw Pact crumbled as a military force. In 1990, Iraq invaded Kuwait and triggered Operations Desert Shield and Desert Storm. In 1991, an attempted military coup in the Soviet Union failed and hastened the dissolution of the country into 15 separate republics. There was general agreement that the Cold War was over.

In response to these events, the Department of Defense (DOD) has begun to cut its forces and is now moving toward a 25-percent reduction by 1997. DOD is halfway toward reducing military and civilian forces by 800,000. It is proposing to pull about half of its forces out of Europe and is closing many bases around the world and at home. Even with these cuts, the defense budget is still targeted at over \$275 billion in fiscal year 1997. Many in the Congress argue that these cuts are not enough, that they do not fully reflect the dramatic changes that have taken place in the world, and that they will result

in a force that is just a smaller version of the Cold War force. The major issues cited in this transition series report revolve around this debate. How much can the United States reduce its force? How much can be saved? What shape should the new force have?

Reducing defense spending will be complicated by a number of financial issues that are currently not fully recognized in DOD's spending plans. There is a significant mismatch between the \$1.4 trillion fiscal year 1993-97 defense spending plan and budget realities. The spending plan does not recognize (1) over \$35 billion in potential weapons cost growth, (2) about \$12 billion in congressional actions delaying some proposed program terminations, (3) an estimated \$5.4 billion in funding for defense conversion to commercial activities, and (4) \$60 billion in additional cuts proposed by the President-elect. In addition, the spending plan assumes \$53 billion in management savings, the majority of which may not be achieved, and \$5 billion in base closure savings that will not be realized during the period. As a result, DOD may be faced with additional program reductions of over \$150 billion.

Additional items will add pressure for more defense spending in the longer term. For example, cleaning up hazardous waste on defense property is now estimated at a total of \$24.5 billion, and disposing of chemical weapons will cost at least \$8 billion. Both these estimates are expected to grow.

In addition to these new issues, we also cite some of the same issues that were present in 1988. At that time, we highlighted inventory management and weapons acquisition as two areas needing focused management attention. The Department has taken major steps over the past 4 years to tackle the numerous problems we cited, and if properly implemented, these initiatives will go a long way toward improving the efficiency and effectiveness of these activities. Because of the resources consumed by these functions and their importance to maintaining defense forces, we continue to highlight them this year and urge that the Congress and the new administration go even further in making fundamental reforms.

In 1988, we also pointed out efficiencies that are possible through a careful examination of military service roles and missions. Little was done to address that issue, and this same concern was expressed by the

Congress last year when it called on DOD to do such an analysis. We again believe that this analysis will be crucial to streamlining our military forces for the post-Cold War era. We also cautioned in 1988 of the dangers of recreating the "hollow force" that existed in the post-Vietnam era by cutting readiness and training too deeply and too fast. Performance in the Persian Gulf War indicated that readiness was at very high levels, but as deep cuts in the budget are proposed, the same danger exists during the 1990s.

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# Reassessing Military Roles and Missions

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The end of the Cold War has materially altered the international security environment—setting the stage for the most fundamental and potentially far-ranging reexamination of the nation's defense policy and structure in 40 years. Instead of the global threat from the Soviet Union, the United States now faces potential regional threats around the world, many of which cannot be fully anticipated. Policymakers are confronted with complex and difficult choices as they attempt to achieve a critical balance between the need to protect national security interests and the affordability of programs to that end. The complexity and difficulty of the choices will be compounded by the huge federal budget deficit and emerging but unpredictable threats to U.S. interests.

The Congress has directed the Joint Chiefs of Staff to examine the roles and missions of the armed services to eliminate unnecessary redundancy and duplication. Making changes will require taking on entrenched bureaucracies in the Pentagon and power centers in the military services, as well as prevailing cultural attitudes—both internal and external to the defense establishment. Our work has shown, for example, that individual services have developed and

acquired weapons systems to meet particular missions without adequate consideration of other services' capabilities. Close air support systems and antiarmor systems developed by the Air Force, the Army, and the Marines are two examples.

A reexamination of military roles and missions appears to offer many opportunities to provide a more cost-effective means of meeting defense needs that exist today. In the area of conventional warfare, for example, DOD should consider whether the current number of Army light infantry and Marine divisions is more than what is necessary to meet expected threats. Opportunities also exist for placing less reliance on carrier battle groups by changing the way they have been historically deployed. Increasing the use of alternative naval forces, such as surface action groups and amphibious ready groups, may reduce the demand for the much more expensive carrier battle group.

Scrutiny also needs to be given to strategic roles and missions. Our recent analysis of the performance of the strategic nuclear triad's weapon systems should help policymakers weigh options and costs and make critical choices about future

requirements for deterrence. We found that sea-based strategic weapons are more cost-effective and less vulnerable than the other two strategic legs. We also found that the B-2 is extremely costly, at over \$2 billion apiece, and of questionable value as a strategic bomber. The B-1B and the B-52 will continue to remain a viable strategic bomber force for years to come.

In the post-Cold War era, the military services will be challenged to perform new and enhanced missions in such areas as peacekeeping, narcotics interdiction, and disaster relief. United Nations' requests for DOD assistance—including supplies, military airlifts and sealifts, logistics, and personnel—for peacekeeping operations have increased substantially in the past 2 years and may likely continue in the near future. Similarly, DOD's involvement in narcotics control and the agency's assistance in drug interdiction efforts have expanded considerably: DOD's contribution rose from \$300 million in fiscal year 1989 to \$1.2 billion this year. DOD has also increased its involvement in providing humanitarian and disaster assistance in such places as Somalia and Bangladesh as well as within the United States. The value of these missions, as well as the resources devoted to them, must be

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**Reassessing Military Roles and  
Missions**

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assessed in the context of the military's  
more traditional role of protecting the  
nation.

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# Managing the Downsized and Restructured Force

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In response to budget constraints and a decreased post-Cold War threat, difficult decisions must be made about how best to structure, train, support, and maintain a smaller, increasingly U.S.-based force so it is highly ready, sustainable, and capable of responding to a crisis on short notice. DOD's challenge will be to maintain high levels of military capability while at the same time significantly reducing the number of both military and civilian positions.

To implement the new security strategy announced in February 1991, DOD has developed a base force concept, which calls for a reduction in military forces by 25 percent by 1997. The Congress will likely debate whether further cuts in military forces below the base force are possible because of the decline in the Soviet threat. A major concern is whether further cuts will result in a repetition of the "hollow Army" of the 1970s and will leave the United States unable to effectively protect national security interests in a still dangerous world. Policymakers will have to balance these concerns as forces are eliminated and restructured and capabilities are assessed against potential regional threats.

A key issue in the defense arena will be how many and what kinds of forces should make up U.S. military forces. In particular, scrutiny should be given to the mix of active and reserve forces. Consideration needs to be given to whether (1) certain missions can be transferred from the active forces to the less expensive reserves, (2) a greater number of support forces are needed in the active forces, and (3) some reserve units are not needed and can be deactivated. At the same time, the Army could expand the use of certain reserve support forces in its contingency force and should examine each of the elements of the force structure being withdrawn from Europe to determine whether any of these units' missions could be shifted to the reserves.

Furthermore, in light of the Gulf War and the new security environment, sustaining U.S. forces will require a reexamination of critical issues. DOD's forces must be restructured and reduced without sacrificing the U.S. capacity to respond in time of crisis. Key issues include

- the capability for airlift and sealift that is needed to quickly respond to regional crises anywhere in the world,

- the need to continue existing land and sea prepositioning strategies,
- the extent to which high levels of readiness and overall military capability are being maintained, and
- the extent to which U.S. forces will depend on support and sustainability resources from allies.

Planning for and managing reductions in the number of civilian and military personnel and their accompanying adjustment and assistance programs will also be of critical importance. DOD is just over halfway toward meeting its goal of eliminating nearly 800,000 active duty and civilian jobs from the peak strength levels it reached in fiscal year 1987. Further reductions are expected as a result of additional base closures and other budgetary trade-offs. These cuts will continue to affect local communities and military and civilian personnel who are making the transition into the civilian work force. The Congress has authorized special funding for community adjustment and assistance programs. Our work indicates that DOD needs better plans for reducing its work force, especially its civilian work force, to ensure it retains the right skills.

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# Reassessing U.S. Commitments, Forward Presence, and Security Assistance Programs

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The end of the Cold War requires a reassessment of the U.S. military presence overseas, of host government contributions to the United States for maintaining its forces, and of military assistance programs provided to U.S. allies. DOD proposes cutting forces in Europe from over 300,000 in 1989 to 150,000 by 1995. The Congress has mandated deeper cuts, down to 100,000, by 1996. Determining the right size and composition of overseas forces will be a major challenge. U.S. forces stationed in Europe and the Far East will be affected by such factors as threats, allied capabilities, new status of forces agreements, and the willingness of allies to increase their contributions to the defense burden. The North Atlantic Treaty Organization (NATO) is reconsidering its mission and structure and the future role of U.S. forces. Also, proposed changes to the NATO members' status of forces agreement with Germany could directly affect the training and operational readiness of U.S. and other NATO forces. These new changes will influence decisions affecting the size and composition of U.S. forces deployed to Europe. Similar concerns must be addressed for U.S. forces stationed in the Far East.

Congressional concerns about increased allied burden sharing will continue. Our work in NATO, Japan, and Korea shows there are further opportunities for host country contributions to the United States to offset the costs of stationing U.S. forces. For example, increases in South Korea's contributions for depot maintenance, war reserves, indigenous labor, and military construction could save the United States \$500 million or more annually.

U.S. security assistance programs, including foreign military equipment sales, training, and economic support fund activities, provided billions of dollars to foreign countries during the Cold War. The fall of the Berlin Wall, the communists' loss of power in Central and Eastern Europe, and the dissolution of the Soviet Union have eliminated the Cold War rationale for the U.S. foreign assistance programs. The radically changed environment has resulted in some modification to security assistance goals, with new or added focus on providing aid for establishing democratic institutions and civilian control over the military, on stabilizing regional tensions, and on combating illegal drug trafficking.

While there have been some changes in our security assistance programs, we recently reported that a limited number of traditional recipients continue to receive the majority of security assistance. The two main recipients, Israel and Egypt, have been provided massive economic and military aid since the Camp David agreements in 1978, which among other things, called for a peace treaty between the two countries. Rounding out the top six recipients are Greece, Turkey, Portugal, and the Philippines, all receiving substantial security assistance funds as part of their base rights agreements with the United States. Even though bases in the Philippines were recently closed, in fiscal year 1993 these six countries will receive \$6.2 billion, or 83 percent, of the total \$7.5 billion in U.S. security assistance funding.

The challenge to the Congress and the new administration will be to determine U.S. security priorities and the corresponding size and shape of a security assistance program that will be flexible and adaptable in a world with divergent regional threats.

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# Controlling the Spread of Weapons of Mass Destruction

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Concerns about the effectiveness of existing controls over the proliferation of weapons of mass destruction have been heightened by post-Gulf War revelations about Iraq's nuclear weapons program, uncertainly over the security of nuclear weapons material in the former Soviet Union, and Chinese transfers of nuclear and missile technology to the Middle East. These events highlight shortcomings in the international community's ability to detect clandestine weapons programs and control the transfer of the equipment, material, and technology necessary for weapons proliferation. Halting weapons proliferation in the 1990s will require increased international cooperation to strengthen verification of existing agreements, to control international technology transfers, and to dispose of Cold War nuclear and chemical weapons stockpiles in the former Soviet Union. Through various programs and initiatives managed by the Departments of State, Defense, Commerce, and Energy and the Arms Control and Disarmament Agency, the United States has an important leadership role to play in each of these areas.

The new administration and the Congress will face difficult issues concerning the existing nonproliferation treaties and

regimes such as the Nuclear Nonproliferation Treaty, the Missile Technology and Control Regime, and the Australia Group on chemical weapons. Among these issues are (1) how to increase participation in these regimes by potential "problem states," (2) whether to adopt more intrusive verification procedures to determine compliance, and (3) how to strengthen enforcement. Policymakers will also have to determine how best to help former Soviet republics in the timely dismantlement of their nuclear and chemical weapons and missile delivery systems. Although more than \$800 million has been authorized to assist this effort, it is unclear whether the funded activities will accelerate the dismantling process.

To improve the effectiveness of export controls in this changing security environment, the U.S. government first needs to continue its efforts to strengthen multilateral export control regimes, to include initiatives to broaden participation, and to coordinate and share information about export control decisions. On a bilateral basis, the United States should also work with the states of the former Soviet Union and the Warsaw Pact to ensure that

they set up and maintain effective export control systems.

The Departments of Commerce, State, and Defense, with input from the intelligence community and the Department of Energy, all have responsibilities for developing and administering controls over dual-use items—those with both military and civilian uses. Similarly, two agencies—the Commerce Department and the Customs Service—share primary responsibility for preventing or detecting the illegal export of controlled items. This is an appropriate time for the administration to reassess the roles of these agencies and the various interagency coordinating mechanisms that are currently in place.

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# Reforming Weapons System Acquisition While Preserving the Industrial Base

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The research, development, and procurement of weapons systems account for about 30 percent of all defense spending. DOD is pursuing close to 100 major weapons system acquisitions at a projected research, development, and procurement cost of over \$1 trillion. Over the years, such expenditures have produced many of the world's most technologically advanced and capable weapons systems. Nevertheless, the manner and process in which weapons requirements are determined and weapons are acquired have often proved costly and inefficient—if not wasteful. The combination of unrealistic spending plans, costly weapons requirements, overly optimistic cost estimates, and high-risk acquisition schedules has resulted in an annual budget cycle of weapons cost overruns that require increased funding or program adjustments that reduce, delay, and/or stretch out the programs.

A gap between DOD's future year spending plan and available funds amounts to billions of dollars. DOD's tendency to overestimate the amount of future funding available for planned programs and the agency's tendency to underestimate program costs result in more programs being started than can be executed. DOD's attempts to narrow the

planning-funding mismatch will be hampered if assumed savings are not realized and program costs increase beyond planned levels—a historically frequent occurrence. For example, DOD's projected savings of over \$100 billion from weapons systems terminations and new acquisition approaches has been reduced by \$12 billion in programs restored by Congress and \$5.4 billion for defense conversions to commercial activities. Greater defense funding cuts will further hurt efforts to bring plans in line with funding levels and will seriously challenge policymakers in determining how many weapons programs we can afford.

Past efforts to reform the acquisition process have not eliminated these problems. A prevailing culture that depends on generating and supporting new weapons acquisitions has defeated past reform efforts. DOD must rededicate its efforts to improving weapons acquisition. This will require top management commitment and further movement toward centralized management and consolidation of acquisition roles, missions, and support functions. Clear accountability for implementing reforms is also critical.

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**Reforming Weapons System  
Acquisition While Preserving the  
Industrial Base**

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Overpriced defense contracts and improper influence in the contracting process are two highly vulnerable areas subject to fraud and abuse. Vulnerabilities related to inadequate cost estimating, defective pricing, and improper contracting practices cost the taxpayers billions of dollars more than necessary for goods and services purchased.

Details on our concerns about DOD's annual expenditure of billions of dollars on weapons system research, development, acquisition, and vulnerability to contract fraud and abuse are available in our high-risk reports.

As the defense budget is reduced, policymakers will face a number of critical issues related to preserving technological leadership and ensuring the existence of the industrial base capabilities required to meet U.S. national security needs. The issues include (1) defense industrial restructuring and adjustment to a declining defense market; (2) the impact of relying on foreign sources for critical technology and products to meet defense needs; (3) the impact of foreign investment in key industries supporting defense; (4) and the impact on U.S. competitiveness of technology transfer to other countries through various

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**Reforming Weapons System  
Acquisition While Preserving the  
Industrial Base**

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government programs, including arms sales and weapons coproduction agreements. Our work shows that DOD needs to take a more active role regarding each of these issues.

DOD has taken the position that free market forces generally will guide the restructuring of the defense industrial base. The agency has also stated that its ability to meet future national security needs will depend largely on the ability of individual companies to shift from defense to commercial production and then back again, as required. DOD should adopt a more realistic strategy for ensuring that government decisions and industry adjustments will result in the industrial and technological capabilities needed to meet future U.S. national security requirements. The current strategy does not adequately recognize that DOD will continue to make budget and contract award decisions worth many billions of dollars annually to develop and acquire weapons and other military equipment. These decisions greatly affect, directly and indirectly, the structure of the defense industrial base.

In addition, free market restructuring is often motivated by short-term considerations such as profit, rather than by considerations of how well the changes in

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**Reforming Weapons System  
Acquisition While Preserving the  
Industrial Base**

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the defense industry will serve long-term U.S. national security needs. Moreover, many defense companies may lack the experience and specialized knowledge to shift to commercial production successfully. In May 1992, DOD reiterated its free market strategy but stated its intention to assess and monitor the industrial base and to take action to preserve a needed critical capability in those "exceptional situations" when the capability may be lost and cannot be recovered in time to meet an emerging threat. It remains to be seen how well this approach will be implemented. However, unless DOD takes a more active role than it currently envisions in ensuring the existence of the critical capabilities most likely to be needed in the future, it risks losing these capabilities.

DOD also needs to take a more active role in assessing U.S. reliance on foreign sources and foreign investment relating to the defense industrial base. DOD has not systematically maintained data on firms that provide specialized technology to meet its critical needs. As a result, DOD generally does not know the extent to which it uses or depends on foreign technology and products to meet such needs. DOD also lacks agreed-upon criteria for assessing the

national security risks posed by dependencies. The lack of criteria impairs the ability of DOD to determine the actions it could or should take to reduce these risks. In addition, no federal agency or process systematically tracks foreign investment in companies that are primarily commercial but whose leading-edge technologies are important to U.S. leadership in defense technologies.

Similarly, DOD and other agencies involved in technology transfer programs, such as arms sales, coproduction, and codevelopment, need to place a higher priority on determining the long-term impact of such activities on U.S. competitiveness and the industrial base. No government entity collects data on these arrangements, even though many of these activities are believed to adversely affect the competitive position of U.S. companies and possibly to undermine U.S. security interests.

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# Addressing Environmental Challenges

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DOD faces several environmental challenges in the 1990s. In addition to having to comply with U.S. and foreign environmental requirements, to minimize pollution, and to comply with clean air and water legislation, DOD is confronted with a major task—cleaning up hazardous wastes. The annual cost of this task has increased from \$86 million in 1984 to an estimated \$1.6 billion in 1993. DOD does not know how much cleaning up environmental damage will cost. Estimates have increased to \$24.5 billion from the \$5 billion to \$10 billion anticipated in 1985. This latest estimate is likely to increase because DOD has not yet identified all of the contaminated sites and the extent of contamination to be cleaned up.

DOD has made significant strides in its recognition of such problems and in its efforts to address them. The increasing resources DOD devotes to cleaning up its contaminated areas and its initiatives to reduce pollution from current operations and weapons systems signal a new cultural attitude. The improvements notwithstanding, we believe that DOD does not yet fully recognize the magnitude of the task before it, including long-term cleanup costs.

One key to success in meeting this challenge will be information—on the nature of the pollution that must be cleaned up, on the location of the contamination, on the technologies available to do the job, on the costs of remedial actions, and on the progress of cleanup programs. We recently reported on the lack of sufficient information on, for example, DOD's underground storage tanks and the costs of reimbursing contractors for cleanup efforts. As an initial priority, DOD needs to consider the types of information needed by its decisionmakers and improve the availability and quality of such data.

Another issue facing DOD is the destruction of existing stockpiles of chemical weapons. Estimates to dispose of these weapons have increased from \$1.7 billion in 1985 to almost \$8 billion as of March 1992. DOD recently advised the Congress that additional costs should be expected.

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# Following Through on Inventory and Other Management Initiatives

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DOD is one of the largest, most diverse, and most complex organizations in the world. Over the years, DOD has responded to external and internal calls for streamlining its organization and for promoting efficiency and effectiveness. The 1986 Goldwater-Nichols Act can be credited for, among other things, the increased coordination that is beginning to become apparent within the military establishment—as witnessed, for example, in the successful joint operations in the Persian Gulf. At about the same time, the Packard Commission came out with a report whose recommendations sparked a series of efforts aimed at improving the Department's organization and management. The Defense Management Review report, issued in July 1989, is intended to address a number of actions to modernize the Department's operations and to save substantial sums, while maintaining the essential strength and readiness of the armed services. Following through with these initiatives must remain a high priority if promised savings are to be achieved.

The sheer size of the Department, coupled with the complexity of its programs and components, presents a Herculean challenge to those charged with substantially

improving Defense management overall. One of the main issues involves developing and fostering changes in management philosophy and organizational culture. An organization's culture has a strong influence on the behavior of its members and the success of the organization as a whole. Improvements in the area of inventory management, for example, will depend in large measure on leadership-inspired cultural changes, such as going from a "having more is always better" way of thinking to a "having what is needed when and where it is needed" philosophy.

DOD's supply inventory contained millions of items worth close to \$100 billion as of September 30, 1991. We estimate the cost of excess supplies is \$40 billion. In the past, DOD has not emphasized economy and efficiency in purchasing, maintaining, and distributing these supplies. However, it has recently initiated some projects based on the use of commercial distribution systems and other commercial practices to address these problems. These efforts need to be expanded throughout the supply chain. Even then, they will not be fully successful until DOD puts in place computer and data systems to aid in managing the supply system. Sustained top management commitment to fixing inventory management problems is critical. For a

further discussion of inventory management problems, see our high-risk report.

Another DOD initiative involves the consolidation of supply depots under the Defense Logistics Agency. If properly combined with other Department initiatives, this effort could result in more efficient and cost-effective operations. However, consolidation alone will not achieve these objectives unless it is accompanied by a stock positioning plan that is well thought out—one that takes into account the impact of the inventory reduction plan, of the reduced demand caused by reductions in the military force structure, and of the inventory reductions associated with adopting commercial “quick response” practices.

Another initiative is the improvement of DOD’s business processes, such as financial and personnel management, through the establishment of the Corporate Information Management (CIM) System. This initiative is expected to provide about \$36 billion in savings. In the short term, the CIM system is to reduce or eliminate information systems that perform the same function. In the longer term, the CIM system is to (1) implement new or improved business practices (in, for example, the way DOD buys and distributes

supplies); (2) create uniform business processes for common functions; (3) improve the standardization, quality, and consistency of data from defense management information systems; and (4) develop standard information systems to meet common functional requirements. On the basis of DOD's past experience, we believe it will be difficult to achieve the savings promised by the CIM system.

In addition, DOD is projecting \$5 billion in savings in the next 5 years as a result of base closures. Our work, however, raises serious questions on whether these savings will be realized.

The Defense Business Operations Fund was established in fiscal year 1992 to place industrial funds, stock funds, and other defense support functions under centralized overview and control. DOD estimates that the Fund will have sales of goods and services of about \$81 billion in fiscal year 1993. Two of the basic objectives of this initiative are to capture all the costs of operating a business area and to charge customers the actual cost of the goods and services they received. While achieving these objectives could establish a more businesslike operation, key policies and systems involving standard cost

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**Following Through on Inventory and  
Other Management Initiatives**

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accounting, rate-setting, cash management, capital asset accounting, and intrafund transactions have not yet been fully developed. DOD must strongly commit itself to managing the Fund if the potential financial and management benefits are to be achieved.

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# Improving Financial Management

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To control costs, it is first necessary for managers to determine what the costs are. Currently, DOD is unable to do this for many of its activities because its financial systems and practices are out of date, inaccurate, and unreliable. Consequently, the kind of relevant, credible financial information that program managers, commanders, and top executives need to reduce costs and measure performance is often not available.

Achieving compliance with the Chief Financial Officers' Act of 1990 (which the Congress enacted to improve financial management governmentwide) could significantly help DOD reach its goals. The act's provisions are consistent with DOD's financial initiatives. The act further requires financial audits for numerous government activities that control hundreds of billions of dollars in assets. However, our recent financial audits of the Air Force and the Army have shown that the military services are still unable to produce financial statements that are sufficiently reliable for an auditor to express an opinion on them. For example, we identified over \$200 billion in adjustments needed to improve the accuracy of Army and Air Force financial reporting. Accordingly, the statements'

usefulness to government decisionmakers and the public is therefore limited.

DOD is primarily relying on long-term initiatives to provide solutions to its financial management problems. However, DOD also needs to make short-term improvements in internal controls and in the quality of financial data in its existing systems. Making fundamental, comprehensive improvements in DOD's financial operations will require personnel at all levels to adopt priorities and business practices that have not previously been in place within DOD. Changes on this scale will require sustained personal attention and leadership from top officials, including the Secretary of Defense, and a willingness to look beyond DOD to supplement its existing financial management expertise.

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# Related GAO Products

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Acquisition Management: A Rare Opportunity for Lasting Change  
(GAO/NSIAD-93-15, forthcoming).

Defense Contract Pricing (GAO/HR-93-8,  
Dec. 1992).

Defense Inventory Management (GAO/HR-93-12,  
Dec. 1992).

Defense Weapons System Acquisition  
(GAO/HR-93-7, Dec. 1992).

Triad Project Summary (GAO/PEMD-92-36R,  
Sept. 28, 1992).

Financial Management: Immediate Actions Needed to Improve Army Financial Operations and Controls (GAO/AFMD-92-82,  
Aug. 7, 1992).

Russian Nuclear Weapons: U.S. Implementation of the Soviet Nuclear Threat Reduction Act of 1991 (GAO/T-NSIAD-92-47,  
July 27, 1992).

NATO: A Changing Alliance Faces New Challenges (GAO/NSIAD-92-252, July 22, 1992).

Technology Transfer: Japanese Firms Involved in F-15 Coproduction and Civil Aircraft Programs (GAO/NSIAD-92-178, June 10, 1992).

Major Acquisition: DOD's Process Does Not Ensure Proper Weapons Mix for Close Support Mission (GAO/NSIAD-92-180, Apr. 17, 1992).

Hazardous Materials: Upgrading of Underground Storage Tanks Can Be Improved to Avoid Costly Cleanups (GAO/NSIAD-92-117, May 13, 1992).

National Security: Perspectives on Worldwide Threats and Implications for U.S. Forces (GAO/NSIAD-92-104, Apr. 16, 1992).

National Security: Papers Prepared for GAO Conference on Worldwide Threats (GAO/NSIAD-92-104S, Apr. 16, 1992).

Operation Desert Storm: Army Had Difficulty Providing Adequate Active and Reserve Support Forces (GAO/NSIAD-92-67, Mar. 10, 1992).

Financial Audit: Aggressive Actions Needed for Air Force to Meet Objectives of the Chief Financial Officers Act (GAO/AFMD-92-12, Feb. 19, 1992).

Foreign Investment: Issues Raised by Taiwan's Proposed Investment in McDonnell Douglas (GAO/NSIAD-92-120, Feb. 6, 1992).

Hazardous Waste: DOD Estimates for Cleanup of Contaminated Sites Improved but Still Constrained (GAO/NSIAD-92-37, Oct. 29, 1991).

Military Presence: U.S. Personnel in the Pacific Theater (GAO/NSIAD-91-192, Aug. 20, 1991).

Drug Control: Status Report on DOD Support to Counternarcotics Activities (GAO/NSIAD-91-117, June 12, 1991).

Defense Budget and Program Issues Facing the 102nd Congress (GAO/T-NSIAD-91-21, Apr. 25, 1991)

Industrial Base: Significance of DOD's Foreign Dependence (GAO/NSIAD-91-93, Jan. 10, 1991).

Army Force Structure: Lessons to Apply in Structuring Tomorrow's Army (GAO/NSIAD-91-3, Nov. 29, 1990).

U.S.-NATO Burden Sharing: Allies' Contributions to Common Defense During the 1980s (GAO/NSIAD-91-32, Oct. 23, 1990).

Department of Defense: Improving Management to Meet the Challenges of the 1990s (GAO/T-NSIAD-90-57, July 25, 1990).

Military Presence: U.S. Personnel in NATO Europe (GAO/NSIAD-90-4, Oct. 6, 1989).

Defense Issues (GAO/OCG-89-9TR, Nov. 1988).

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# Transition Series

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# Financial Services Industry Issues



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**Comptroller General  
of the United States**

December 1992

The Speaker of the House of Representatives  
The Majority Leader of the Senate

In response to your request, this transition series report discusses major policy, management, and program issues facing the Congress and the new administration in the financial services industry. These issues include (1) regulating financial institutions, which are at a crossroads; (2) understanding rapidly changing financial markets; and (3) strengthening insurance industry solvency regulation.

As part of our high-risk series on program areas vulnerable to waste, fraud, abuse, and mismanagement, we are issuing separate reports on the Bank Insurance Fund (GAO/HR-93-3, Dec. 1992) and the Resolution Trust Corporation (GAO/HR-93-4, Dec. 1992).

The GAO products upon which this transition series report is based are listed at the end of the report.

We are also sending copies of this report to the President-elect, the Republican leadership of the Congress, the appropriate congressional committees, and the designated heads of the appropriate agencies.

A handwritten signature in cursive script that reads 'Charles A. Bowsher'.

Charles A. Bowsher

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# The Financial Services Industry

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The nation's financial institutions and markets are vital to a smoothly functioning economy. Our November 1988 transition report discussed problems and solutions for our financial services industry, which was experiencing its most turbulent and troubled period since the Great Depression. Banks, savings and loans, and insurance companies were failing at rates not seen for decades. The securities and futures markets became linked, and in 1987 they experienced their most severe decline in 58 years.

Much has been done legislatively and administratively since our last transition report to address the weaknesses and vulnerabilities in the financial services industry that were evidenced during the past decade. In 1989, the Congress enacted the Financial Institutions Reform, Recovery, and Enforcement Act (FIRREA) to fund the cleanup of the savings and loan disaster and better ensure that the disaster did not repeat itself. In 1991, the Congress enacted the Federal Deposit Insurance Corporation Improvement Act (FDICIA) to better ensure a safe and sound banking industry and a financially strong deposit insurance system. In the wake of the 1987 stock market crash, many changes were implemented by the market regulators and the exchanges

themselves to ensure that market systems and mechanisms could better cope with any future massive shifts in investor sentiment.

Despite this progress, it is unrealistic to believe that the job is done. First, the cleanup of the savings and loan industry is not completed. The Resolution Trust Corporation (RTC) estimates that another \$25 billion will be needed to finish this effort, and the industry's new insurance fund must be provided with funding in 1993 so that it can meet its responsibilities. Second, great care needs to be taken to ensure that FDICIA is properly implemented. Third, the structure of financial regulation will need to be modernized sometime during the 1990s to recognize the realities of today's highly competitive financial marketplace. However, before action is taken, very careful consideration will need to be given to how and under what circumstances to safely expand the geographic and product-line powers of banking organizations. Fourth, changes in the financial services industry continue to accelerate at a dizzying pace. Regulators need to assess and fully understand how the proliferation of new products, such as derivatives, as well as domestic and international market developments affect their ability to ensure

that our markets and institutions continue to function safely, soundly, and smoothly. Finally, regulation of the insurance industry warrants more attention in light of the increasing number and size of companies that fail, the effects of those failures on policyholders, and the serious weaknesses that have been exposed in the state system of solvency regulation.

The new administration and the Congress must address these issues if we are to have a stable, efficient, and competitive financial system in the years to come.

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# Financial Institutions at a Crossroads

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Many of the provisions of FDICIA will, if effectively implemented, greatly strengthen the industry, the power of the regulators in identifying and acting on problems experienced by troubled depository institutions, and the deposit insurance system. FDICIA's accounting, corporate governance, and regulatory reforms are designed to accomplish these goals. Among other measures, FDICIA's early warning reforms provide for the timely disclosure of internal control weaknesses and violations of laws and regulations. The act's early intervention requirements are designed to ensure that regulators take prompt and appropriate action to correct unsafe banking practices.

We remain concerned about the lack of action by the Financial Accounting Standards Board or the federal regulators to effectively tighten the flexible accounting rules that helped to mask the industry's problems during the 1980s. Legislation needs to be considered for solving this problem. We have a number of additional concerns about the quality of bank examinations and the effectiveness of regulations that will be issued to implement FDICIA's provisions.

Though the banking industry had record profits during the first half of 1992, over 1,000 banks with assets exceeding \$500 billion remain on the Federal Deposit Insurance Corporation's (FDIC) problem bank list—largely as a result of bad loans made in the past. The insurance fund itself ended 1991 with a deficit of \$7 billion and, according to FDIC's estimates, faces potential costs of about \$40 billion between 1992 and 1995.

A discussion of our concerns with the act's implementation as well as the condition of the banking industry and its insurance fund is contained in our high risk report on the Bank Insurance Fund.

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## Expanded Powers

Recent proposals to expand banks' product-line and geographic powers were not successful. But there will no doubt be similar proposals in the future. A cautious approach should be followed in expanding the powers of banking organizations. It is unrealistic to expect that deregulation of geographic and product-line powers will do much in the short run to solve the banking industry's current problems. These problems stem largely from bad loans. While institutions entering new lines of business or

new territories might increase profits, they would also be exposed to the opportunity to lose vast sums of money. FDICIA's system of safety and soundness regulation should be in place and operating properly before the powers of banks are expanded.

However, implementation of FDICIA is not all that must be done to deal with the regulatory issues associated with expanded powers.

Each major decision about changing powers must also seek to ensure that

(1) treatment of uninsured depositors in bank failures is similar in all cases so that small banks can compete effectively with big ones, (2) holding company supervision is adequate and the responsibilities of the various federal regulatory agencies in supervising such companies are clearly defined, and (3) regulatory controls are sufficient to protect against conflict-of-interest abuses.

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## Regulatory Burden

With the passage of FDICIA, there is increasing concern that the cumulative effect of regulation may be placing too great a burden on the industry. Some industry-sponsored studies have estimated that FDICIA's new consumer disclosure, credit availability, and many other regulations are

costly. We are not now in a position to say whether the benefits of regulation exceed its costs. Nor is anyone else. But clearly, in today's competitive financial services environment, this topic needs to be considered and reviewed carefully.

As part of formulating a plan of action to deal with concerns over regulatory burden, it is critical that certain issues be addressed. There must be a clear understanding of what is meant by regulatory burden. In this regard, more needs to be known about how the perceived burden is divided between rules and requirements designed to promote safety and soundness and those designed to protect consumers. It is also necessary to decide whether the burden lies in what the statutes and regulations are trying to accomplish or in how the regulations are administered.

In addition to understanding the nature of regulatory burden, measures of its importance should be compared to other factors, such as overcapacity, lack of experience operating in competitive environments, or poor controls over risk-taking in explaining the performance of banks. Finally, the industry enjoys significant benefits as a result of its

regulated status. Any assessment of regulatory burden should weigh that burden against the benefits of a lower cost of capital, lower cost of funds, access to and control of the payments system, and access to the Federal Reserve.

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### The Savings and Loan Cleanup

In addition to coming to grips with further deregulation and regulatory burden issues, attention must also remain focused on the continuing cleanup of the savings and loan industry. The job is not done yet. In the more than 3 years since the passage of FIRREA, RTC has closed more than 650 failed thrifts and has sold more than \$287 billion of assets as of September 30, 1992. RTC's resolution efforts have been hampered by funding disruptions, the most recent of which occurred in April 1992. Since then, RTC has been unable to fund the resolution of most failed thrifts under its control.

In September 1992, RTC estimated that the current funding disruption had already increased its cost by at least \$600 million and would continue to add an average of about \$6 million each day. In October 1992, RTC estimated that it would need between \$8 billion and \$27 billion in additional loss funds to resolve its expected remaining

caseload of about 150 thrifts, bringing the total resolution cost estimate to between \$95 billion and \$114 billion. In December 1992, RTC's Chief Executive Officer indicated that \$25 billion in loss funds would be needed—near the upper end of the range estimated in October.

An early priority for the Congress and the administration will be to decide how to proceed with the funding for the remaining cleanup of the industry and provide that funding before the Savings Association Insurance Fund assumes full resolution responsibility in October 1993. Steps also need to be taken to ensure that this new fund is adequately financed by that time.

In addition to completing its resolution responsibilities, RTC can also improve its asset management methods and strategies. RTC has generally done a good job selling financial assets. However, its real estate sales approaches have sometimes been inefficient, poorly planned, and poorly executed. Moreover, RTC has not evaluated its real estate sales strategies to determine which methods were most effective for which type of asset and in which particular market each method worked best. As a result, there is no assurance that RTC is

maximizing recoveries on the sale of real estate assets. Furthermore, RTC's contracting system—a critical element in RTC's asset disposition approach—remains a key weakness in RTC's operations. Specific problems with the contracting system include poor contract planning and oversight. These problems have added millions of dollars in costs to the government's bailout efforts.

RTC needs to (1) better plan its real estate disposition strategies and determine which methods are most effective for different types of assets and different markets, (2) set disposition goals tied to maximizing recoveries, and (3) strengthen contract planning and the key information systems needed to oversee, manage, and dispose of assets. A more detailed discussion of these issues is contained in our high-risk report on RTC.

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# Better Understanding of Rapidly Changing Financial Markets Needed

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In October 1987, the nation's equity markets experienced their most serious disruption since the crash of 1929. Much has been done to help ensure that our markets can better cope with a "run for the exits" should the 1987 event repeat itself. But other events have greatly changed the world since 1987.

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## Globalization of Trading Markets

International trading has increased, and with it so too have concerns about the risks to investors, firms, and markets resulting from differences in standards and rules that various countries use to regulate or operate their domestic securities markets. These concerns include (1) the risks of trading with firms operating in countries with lower requirements and of financial problems in one country's markets affecting firms and markets in other countries, (2) the opportunity for illegal or improper activities by individuals operating outside of the country whose markets are being abused, and (3) the ability of U.S. firms to compete with firms that are subject to lower regulatory costs in other countries.

The efforts of international organizations such as the European Community and the International Organization of Securities Commissions to harmonize standards and

rules to meet these concerns have been resisted because of the vast differences among countries' regulatory approaches. None of the efforts have been completed.

As globalization of financial markets continues, U.S. regulators need to continue in their attempts to achieve meaningful harmonization. These efforts should include development of a coordinated U.S. strategy for achieving harmonized financial regulations either by working through existing international bodies or by negotiating directly with other countries. The efforts should also include an assessment of whether the current structure of regional and international financial organizations is capable of achieving harmonized financial regulations.

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## New Trading Systems

Here at home, the Securities and Exchange Commission (SEC) has sanctioned new trading systems in response to demands by institutional investors for lower trading costs and anonymity in their trading. Because these systems are small or only involve trading by sophisticated investors, SEC has not subjected them to the same level of regulation as existing markets. These new systems have taken some market share from

the existing markets, especially the New York Stock Exchange.

There is a lack of consensus about the effects of this trend on investors and the capital formation process. For example, some argue that when order flow is dispersed from a primary market, the market's efficiency and liquidity are impaired. Others argue that efficiency is not affected and that liquidity is, in fact, enhanced. Most, however, agree that without a primary market, other trading systems could not exist. This raises a fundamental issue of fairness because trading systems that compete with the primary markets incur lower regulatory costs while deriving benefits from the primary market.

The importance of these issues raises questions about the future structure of the U.S. markets. Attention needs to be focused on understanding the risks and benefits of new market systems to investors and market participants, and deciding which market structure will best meet the future needs of U.S. business for capital formation. In addition, decisions are needed about whether new trading systems that rely on prices derived from a primary market should pay the primary market for that service.

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## New Financial Products

There has been an explosion in the development and use of new financial products, such as currency and interest rate swaps. For example, the worldwide market for interest rate swaps grew from its inception in 1981 to a notional principal amount over \$3 trillion by 1992. These products, called derivatives, offer a way for financial institutions and corporations to protect themselves from volatility in interest and foreign exchange rates.

These products are risky, and they are generally unregulated. Information about financial institutions' losses from trading these products is limited. But some firms have lost hundreds of millions of dollars trading derivatives because of mispricing, poor risk management systems, or inappropriate trading strategies.

Financial regulators have expressed uncertainty and concern about the risks of derivative products and the potential threat they pose to the financial system. More needs to be known about the nature and extent of use of these products as well as the risks they pose to the financial system, including (1) the extent to which financial institutions use these products and have adequate systems to manage their risks,

(2) the resources and abilities of financial regulators to evaluate the risks these products pose, and (3) whether a different U.S. regulatory approach toward derivatives would be viewed as harmful by market participants and drive the business overseas.

In addition to these emerging market developments and the concerns they pose, some other areas also need attention.

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### Oversight of Investment Advisory Industry

Legislation is needed to strengthen SEC's oversight of the investment advisers industry. This industry, consisting of about 17,500 registered advisers who manage a total of more than \$5 trillion in assets, affects the lives of millions of Americans who set up a plan for retirement, for their children's education, or for their survivors. It is also an industry that has significantly damaged the lives of many individuals through fraud, embezzlement, or the provision of misleading or inappropriate advice.

SEC's current oversight program may be doing more harm than good by giving investors a false sense of confidence that SEC-approved advisers are both well qualified and well regulated. In 1992, SEC had only 46 inspectors for all registered advisers. In

1990, almost 60 percent of advisers registered for more than 1 year had never been inspected. SEC needs additional resources and enhanced registration and inspection programs. Enhanced programs would (1) verify adviser-supplied education and experience information and check all available federal criminal history sources; (2) identify advisers who should be registered but are not; (3) register all individuals at advisory firms who give advice; and (4) inspect adviser business operations within a reasonable time, such as within 1 year of registration, and periodically thereafter according to risk.

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**Government  
Securities  
Markets**

The market for U.S. Treasury and agency securities is perhaps the largest, most liquid securities market in the world, and it works reasonably well. However, the 1991 revelations of irregularities in bidding and secondary market trading by Salomon Brothers highlighted some impairments to the efficiency and integrity of the market that could raise the interest rates that Treasury has to pay on the debt. Interest on the national debt is now the third largest item in the budget. A slight increase in the interest rate Treasury pays on its marketable

debt would add billions of dollars to the deficit. The following actions are needed:

- Treasury rule-making authority under the Government Securities Act of 1986 should be renewed. This authority expired in 1991, and Treasury is now unable to update or promulgate rules involving prudential regulation of the government securities market as required by the 1986 act.
- Sales practice rules should be extended to the government securities market. Market participants need to be protected against such things as churning and unsuitable investments just as participants are protected in markets for corporate stocks and bonds.
- The government should be given backup authority to require that information on interdealer broker screens be made available to the public.
- Bidding arrangements should be changed to protect against rigged bids and to encourage the widest possible participation in auctions.

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# Strengthened Insurance Solvency Regulation Needed

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Insurance is an important component of the financial system. Between 1988 and 1991, an average of about 60 insurance companies failed each year. These failures have raised serious concerns about the quality of insurance regulation as well as the strength of the state guaranty funds that protect individuals when their insurers fail. Solvency regulation of the insurance industry is conducted solely by the states. However, because the business of insurance involves interstate commerce and because adverse developments in the industry could harm policyholders, the federal government has both ultimate responsibility for and an interest in its safety and soundness. In this regard, the Congress has exercised a direct oversight role through investigations and hearings.

We have several concerns about the quality of insurance solvency regulation and the protection for policyholders in the event of insolvency:

- The quality and usefulness of financial and management information provided to regulators and others is insufficient to evaluate the risks faced by and the solvency of insurers.

- The willingness and ability of state regulators to develop regulatory capabilities, consistent rules, and interstate coordination is insufficient to effectively regulate national and international insurance entities.
- The strength and fairness of the state guaranty funds is not adequate to protect policyholders should their insurer fail.

Insurers are required to report their financial results to the responsible state regulators using “statutory accounting principles.” Statutory accounting, in theory, is more conservative than generally accepted accounting principles, but in practice it has allowed insurance companies to overstate the value of their assets and inflate their reported surplus. Adoption of generally accepted accounting principles for insurance companies could provide a common framework for more meaningful financial reporting to the regulators. However, flexibility in generally accepted accounting rules for treatment of problem loans and investment securities still provides too much latitude to company managers in reporting asset losses. The accounting rules for insurance companies need to be strengthened to better ensure that financial information provided to regulators and

others is reliable for evaluating insurance company risks.

The need for more consistency in insurance regulation and the need to strengthen the regulatory capabilities of some states have become widely recognized. Several options at the state and federal levels have been proposed or implemented to address this problem.

First, the National Association of Insurance Commissions (NAIC) has established Financial Regulation Standards that it believes are necessary for effective state-by-state solvency regulation. A program to accredit states that adopt these minimum standards has also been created. We doubt the ability of NAIC to get the necessary degree of cooperation from the states because it has no authority either to require the states to adopt consistent laws or to monitor state compliance with the Financial Regulation Standards. Moreover, the standards themselves are weak, and the accreditation process lacks credibility.

Second, the National Conference of Insurance Legislators has proposed an interstate compact to shift some state authority to an interstate insurance

regulatory agency. This proposal could solve the lack of authority that cripples NAIC but only if all the states could agree on the form of the compact and the degree of authority that would be surrendered.

Third, two congressional bills have been introduced in the Congress that would create a federal agency with responsibility for regulating some insurers and for overseeing insurance regulation in the states. Direct federal involvement in insurance regulation could impose a consistent regulatory framework on the insurance industry and reduce the regulatory burden that large insurers now face in the 50 states. However, establishment of a new federal agency could be costly and could result in either an explicit or an implicit expansion of the federal safety net in the event of mounting insurer failures.

While many unanswered questions remain about the advantages and disadvantages of these specific regulatory alternatives, we believe that there is a clear need for a more consistent, uniform system of insurance regulation than currently exists in the state-by-state system. Moving toward a more effective national (although not necessarily federal) insurance regulatory system will

require considerable discussion of the alternatives and may entail greater federal-state cooperation.

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The financial services industry has played a vital role in the development of the modern U.S. economy, and it must continue to play that role. The United States has learned an enormously costly lesson from its experience with the savings and loan disaster. We must ensure that this episode in our nation's financial history is never repeated.

Our financial system continues to change, and with this change come a host of issues that need to be addressed to ensure the system's safety, efficiency, and competitiveness. This job will not be easy. But it remains as important today as it was in 1988 that the approach taken to addressing the issues remains focused on

- protecting against unacceptable financial damage to our financial institutions and markets as well as individual investors,

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**Strengthened Insurance Solvency  
Regulation Needed**

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- encouraging innovation and flexibility to keep up with rapidly evolving market developments, and
- allowing financial markets to function without undue interference.

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# Related GAO Products

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Bank Insurance Fund (GAO/HR-93-3,  
Dec. 1992).

Resolution Trust Corporation (GAO/HR-93-4,  
Dec. 1992).

Insurer Failures: Regulators Failed to  
Respond in Timely and Forceful Manner in  
Four Large Life Insurer Failures  
(GAO/T-GGD-92-43, Sept. 9, 1992).

Securities and Futures Markets:  
Cross-border Information Sharing Is  
Improving, but Obstacles Remain  
(GAO/GGD-92-110, July 28, 1992).

Investment Advisers: Oversight Is Inadequate  
for Investor Protection (GAO/T-GGD-92-46,  
June 4, 1992).

Depository Institutions: Flexible Accounting  
Rules Lead to Inflated Financial Reports  
(GAO/AFMD-92-52, June 1, 1992).

Insurance Regulation: The Financial  
Regulation Standards and Accreditation  
Program of the National Association of  
Insurance Commissioners (GAO/T-GGD-92-27,  
Apr. 9, 1992).

Securities Markets: Challenges to Harmonizing International Capital Standards Remain (GAO/GGD-92-41, Mar. 10, 1992).

Audit Committees: Legislation Needed to Strengthen Bank Oversight (GAO/AFMD-92-19, Oct. 21, 1991).

Credit Unions: Reforms for Ensuring Future Soundness (GAO/GGD-91-85, July 10, 1991).

Failed Banks: Accounting and Auditing Reforms Urgently Needed (GAO/AFMD-91-43, Apr. 22, 1991).

Bank Supervision: Prompt and Forceful Regulatory Actions Needed (GAO/GGD-91-69, Apr. 15, 1991).

Deposit Insurance: A Strategy for Reform (GAO/GGD-91-26, Mar. 4, 1991).

U.S. Government Securities: More Transaction Information and Investor Protection Measures Are Needed (GAO/GGD-90-114, Sept. 14, 1990).

Investment Advisers: Current Level of Oversight Puts Investors at Risk (GAO/GGD-90-83, June 26, 1990).

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**Related GAO Products**

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Financial Services Industry Issues  
(GAO/OCG-89-4TR, Nov. 1988).

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Health and Human Services Issues  
(GAO/OCG-93-20TR).

Veterans Affairs Issues (GAO/OCG-93-21TR).

Housing and Community Development  
Issues (GAO/OCG-93-22TR).

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December 1992

# Commerce Issues



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**Comptroller General  
of the United States**

December 1992

The Speaker of the House of Representatives  
The Majority Leader of the Senate

In response to your request, this transition series report discusses major policy, management, and program issues facing the Congress and the new administration in the area of commerce. The issues include (1) focusing the Department of Commerce's role on competitiveness issues, (2) investing in infrastructure to ensure mission effectiveness, (3) improving economic statistics to support efforts to revitalize the U.S. economy, and (4) planning a more accurate and less costly 2000 Census.

The GAO products upon which this report is based are listed at the end of this report.

We are also sending copies of this report to the President-elect, the Republican leadership of the Congress, the appropriate congressional committees, and the Secretary-designate of Commerce.

A handwritten signature in cursive script that reads "Charles A. Bowsher".

Charles A. Bowsher

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# Commerce Issues

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The Department of Commerce is a large, diverse agency responsible for numerous programs that cut across core national issues, including trade, technology, competitiveness, industry, environment, and economic activity. Commerce's missions include fostering technology, stimulating and regulating international trade, promoting commerce, analyzing social and economic activity, and studying the environment and natural resources.

Four years ago, we identified several important areas needing action at Commerce, including improving export promotion activities and controls, addressing problems associated with the decennial census, and monitoring progress on a new automated patent system. These are still relevant issues, though Commerce has made some improvements in export-related activities.

This report discusses the need for Commerce to (1) focus its missions on improving competitiveness and play a more significant role among the many federal agencies that share responsibility for that goal; (2) invest in infrastructure—which, according to Commerce's estimates, may require at least \$7.4 billion over 15 years,

including \$4.6 billion for modernizing the National Weather Service; (3) improve economic statistics to overcome concerns about their quality and coordination; and (4) change planning and decisionmaking for the 2000 Census to ensure that accuracy will not continue declining or costs will not continue rising. Census Bureau planning staff estimated that if the current approach to taking the census is retained for 2000, the costs could rise to about \$4.8 billion in current dollars, from \$2.6 billion in 1990.

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# Focusing Commerce's Role

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Enhancing the federal government's ability to spur economic growth by increasing competitiveness is one key to economic security. Commerce, with its programs in technology, trade, statistics, telecommunications, and industrial development, has a role in this effort. Its programs are at the heart of federal efforts to foster both near-term and long-term improvements in the productivity of the U.S. economy.

The current organization of the federal government may not maximize the nation's capacity to improve productivity and competitiveness. A number of congressional bills and private sector reports have offered proposals aimed at improving the federal approach to this important issue. They propose restructuring programs and agencies that deal with the major elements of competitiveness, such as international trade and technology, and generally suggest significant changes to Commerce's present missions or organizational structure.

With the growing convergence of sentiment on this issue, both inside and outside the government, there will likely be attempts to reorder the federal approach to competitiveness. If it is determined that

Commerce should play a key role in enhancing and promoting competitiveness, the Secretary must be ready to address two issues that impair Commerce's ability to achieve that aim. First, Commerce will need to better focus its mission on improving and promoting competitiveness. Second, Commerce will need to play a more significant role among the various federal agencies that share responsibilities for improving competitiveness.

---

**Focus on  
Promoting  
Competitiveness**

Commerce is in a unique position to promote competitiveness because it combines many of the essential elements of government programs necessary to meet the goal—statistical analysis, international trade, technology promotion, telecommunications, and economic development. However, Commerce's Inspector General (IG) has described Commerce as a loose collection of more than 100 programs delivering services to about 1,000 customer bases. While many programs are directly related to the goal of supporting commerce and industry, many others are, at best, only distantly connected to this goal.

The majority of Commerce's limited resources are applied to tasks that do not

have a tangible impact on improving competitiveness. For example, in fiscal year 1993, an estimated 59 percent of Commerce's budget and 37 percent of its staff is to be allocated to the National Oceanic and Atmospheric Administration (NOAA) for weather, oceanic research, and other activities—which are only tangentially related to improving and promoting competitiveness. In this environment, it is difficult to apply sufficient resources and attention to all necessary activities and mission priorities.

If Commerce is to play a key role in enhancing and promoting competitiveness, the Secretary will need to formulate and set forth a strategy that taps into Commerce's inherent potential toward this end. At the outset of developing a strategy, the Secretary will need to carefully examine current components of Commerce and work with the Office of Management and Budget (OMB) and Congress to consider spinning off or eliminating those components that do not fit, while clarifying the roles and interconnections among those that do. Further, because the programs in Commerce do not encompass all the essential elements of improving competitiveness and productivity, the strategy should ensure that

Commerce's programs are consistent with other agencies' efforts.

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Playing a More Significant Role in Improving Competitiveness

The Secretary will also need to address the fundamental problem that Commerce lacks the prominence and resources to play a significant role in improving competitiveness. While many federal departments share mission-related functions and programs with other departments and agencies, Commerce likely faces the most complex web of divided authorities. For example, Commerce shares its missions with at least 71 federal departments, agencies, and offices. Further, Commerce has traditionally taken a back seat to departments that had more prominent status, greater resources, and higher national priority in the Cold War world.

Now, in the post-Cold War era, the issues traditionally administered by Commerce have gained new priority and could push Commerce to a potential leadership position. Yet Commerce does not control a majority of the resources devoted to missions it shares with other agencies. For example, export promotion programs are distributed among 10 agencies. The U.S. Department of Agriculture, not Commerce, receives about

74 percent of total funding for these programs, although it accounts for only about 10 percent of U.S. exports.

If the incoming administration and the Congress determine that Commerce is to play a central role in improving competitiveness, then Commerce should occupy a more central position in the system of federal programs meant to achieve this end. To do so, the Secretary needs to work with the President, other Secretaries, and the Congress either to (1) secure clearer lines of coordinating authority over related programs in other agencies or (2) relocate those related programs into Commerce.

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# Investing in Infrastructure to Ensure Mission Effectiveness

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The ability of Commerce to effectively achieve its missions—especially those related to enhancing national competitiveness and measuring and analyzing the environment—are largely dependent on the state of Commerce’s technical and research facilities. However, in the past, inadequate attention to strategic issues and long-term responsibilities have left Commerce with some critical infrastructure needs requiring immediate attention, including long overdue capital investments and a lack of needed technology.

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## Significant Investments Needed

Past funding problems, shortcomings in departmental oversight, and planning inconsistencies have left Commerce in a position of needing to invest heavily in its infrastructure. Commerce estimates that infrastructure currently in disrepair—including federal laboratories, a fleet of ships, weather satellites and radars, information systems, and other facilities and equipment—will require investments of at least \$7.4 billion over a 15-year period. Regardless of whether they remain in Commerce or become candidates for relocation elsewhere, these infrastructure needs merit prompt attention. For example,

- The National Institute of Standards and Technology (NIST) has requested \$607 million over 10 years to begin overdue renovation and replacement of laboratories and other research facilities that are between 25 and 40 years old. NIST's mission to advance scientific and technological progress is already hampered by obsolete technical and environmental systems, unreliable power supplies at research buildings, and major safety and systems capacity problems.
- NOAA is at risk of not being able to effectively carry out current and future ocean research activities. Several of NOAA's vessels are currently inactive, and the remainder of the fleet is obsolete or deteriorating rapidly. However, NOAA's ability to successfully fulfill its mission depends on its having fully operational vessels or access to available charter vessels. NOAA estimates it will require about \$1.5 billion over 15 years to modernize its fleet.
- The National Weather Service (NWS) is to provide weather forecasting and warning services for the protection of life and property. However, much of its current equipment is outdated, expensive to maintain, and difficult to repair. For these reasons, NWS has embarked upon a

comprehensive \$4.6 billion modernization of equipment, facilities, and related information systems. This modernization will help to ensure NWS' ability to monitor critical weather data, forecast potential weather disasters, and assess environmental conditions.

- The Patent and Trademark Office (PTO) is in the midst of a 14-year, \$700 million effort to automate its patent system. Patent information is essential because it is the largest single source of information on emerging technologies.

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**Better  
Departmental  
Oversight Is  
Necessary**

Although the funding for some of the needed enhancement of infrastructure is now programmed, Commerce will need to pay particular attention to how these improvements are managed. Past oversight problems of procurement and system development have left Commerce vulnerable to overruns, inefficiencies, and suboptimal achievement of its goals. For example,

- Commerce's accounting and financial management systems are incapable of providing managers with reliable information necessary for long-term planning. Commerce has characterized the

systems as archaic, unable to produce reliable information, inadequately controlled, and often not used by managers. Both Commerce and OMB have identified these as high-risk areas, meaning that they are particularly vulnerable to fraud, waste, or mismanagement.

- NOAA's Next Generation Geostationary Operational Environmental Satellite system has encountered problems that have resulted in substantial cost growth, schedule slippage, and potentially reduced satellite capability. This put Commerce in the position of having to borrow a satellite from the European satellite consortium to ensure that NWS will be able to meet minimum mission requirements of protecting public safety through the forecasting of severe storms and issuance of warnings. Commerce reported to OMB that this is currently a high-risk problem.
- The NWS modernization program has exceeded its expected cost and is far behind schedule. The initial cost estimate of nearly \$2 billion has risen to \$4.6 billion, and the projected date for completing the planned upgrades has slipped from 1994 to 1998. Contract-related deficiencies have been identified by us, OMB, and Commerce's IG as

one of the major contributors to the delay and cost overrun. Satellite and radar systems have been especially problematic in the past, and close contractor oversight of information system development is vital to preventing similar problems in that phase of the project. The NWS modernization effort has been reported as a high-risk area several times and is still on the high-risk list.

- After investing nearly 10 years and \$417 million, PTO is unable to ensure that efforts to automate its patent system will meet expected benefits and fulfill users' needs. Some progress has been made in automating paper files and manual processes, but PTO's estimated completion dates and development costs continue to change.

Commerce's scientific and technical facilities are vital to improving national competitiveness or to protecting human life and property in the event of severe weather conditions. The incoming Secretary will need to pay close attention to Commerce's infrastructure to ensure that critical facilities, scientific equipment, and information systems are upgraded as efficiently and as timely as possible. This will require the Secretary to work with the

Congress and OMB to identify and build resources for those high-priority areas demanding greater funding and staffing requirements. To prevent future problems and ensure continued attention to infrastructure and other organizational capacity needs, the Secretary will also need to (1) ensure adequate departmental oversight and accountability for procurement and systems development projects, (2) place a high priority on improving financial management systems, and (3) provide continuing leadership in developing more effective strategic analysis and planning systems for all Commerce units.

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# Improving Economic Statistics to Support Efforts to Revitalize the U.S. Economy

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Many economists and policymakers have voiced concerns about the quality of the nation's economic statistics and their failure to keep pace with the changing U.S. and world economy. Without early attention to this problem, the new administration may find itself hampered by a lack of reliable and timely economic data as it attempts to revitalize the U.S. economy.

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## Wide Agreement That Economic Statistics Need Improvement

Concerns about the quality of economic statistics have been long-standing and bipartisan. The Carter administration complained that the economic information base appeared "to provide inadequate support for policy decisions." The Council of Economic Advisers noted in 1990 that structural changes were "making it increasingly difficult to track the course of the economy accurately" to the point where "many analysts question the accuracy of measurement of even the most basic variables, such as output and inflation." For example, we noted in a 1989 report that there is a strong possibility that exports are underreported in merchandise trade statistics. As a result, the U.S. trade deficit may have been smaller than reported.

The National Academy of Sciences concluded in a recent book that the existing economic statistics system does not provide a comprehensive picture of U.S. involvement in the global economy and that the government needs to devote more attention and resources to increasing the coverage and quality of international economic statistics.

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Decentralized  
Statistical System  
and Lack of  
Leadership Create  
Special Demands

While responsibility for supervising the organization and coordination of the federal statistical system lies with OMB, resources devoted to carrying out these responsibilities have been greatly reduced. The lack of OMB coordination of the statistical system puts added demands on Commerce and its two statistical agencies, the Census Bureau and the Bureau of Economic Analysis (BEA), which calculates the gross domestic product (GDP) and other economic indicators. BEA, in particular, relies extensively on source data provided by other government agencies in producing its statistical reports on the nation's economy.

A November 1992 Congressional Research Service report on the coordination of federal economic statistics characterizes the current situation as being like "an opera without a conductor." Without a strong OMB role in

coordination, Commerce must play an active part not only in coordinating the activities of the Census Bureau with BEA but also in negotiating governmentwide solutions to governmentwide problems with economic statistics.

A quick review of the specific problems identified during the formulation of the economic statistics initiatives is a good place for the new Secretary of Commerce to become familiar with the issues facing federal economic statistics programs. These budget initiatives called for real increases in the budgets of BEA, the Census Bureau, and other economic statistical agencies. Although the near-term solutions emphasized the need for additional resources, the long-term plans were to examine organizational, methodological, and other overall improvements. A search for systemic solutions seems appropriate given the systemic problems, such as the lack of overall coordination, facing federal economic statistical agencies.

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Commerce Must  
Ensure Integrity and  
Credibility of  
Economic Data

Press reports in 1991 and 1992 have called into question the integrity and credibility of economic statistics. We examined several allegations of manipulation of GDP and

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personal income estimates for the first quarter of fiscal year 1991 and found no evidence of the alleged manipulation. However, the very existence of these allegations poses a credibility threat to the federal statistical system. An October National Academy of Sciences' report said, "It is essential that an agency maintain credibility for itself and for its data and information. In particular, an agency must be perceived to be free of political interference and policy advocacy."

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# Planning a More Accurate and Less Costly 2000 Census

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Reforming the decennial census will be a very important task for the new Secretary of Commerce. The results of the 1990 decennial census indicated that the current approach appears to have exhausted its potential for counting the population at an acceptable level of accuracy at reasonable cost.

Innovative approaches to the census are possible, but their adoption requires prompt policy guidance and leadership from senior Commerce and Census Bureau officials early in 1993. Without decisive leadership at the start of the new administration, sufficient time will not be available to build the political consensus and public support necessary for major census reforms and to test and integrate the many interwoven procedures and technologies that constitute an undertaking as big and complex as the decennial census.

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## Decline in Census Accuracy Despite Increased Costs

In 1990, accuracy fell below that of the 1980 Census even as census costs escalated significantly. A broad, overall measure of census accuracy—the net undercount (the percentage of the population not counted)—had declined each census since it was first measured in 1940. However, the official estimate of the net undercount rose

to 1.8 percent in 1990, from 1.2 percent in 1980. A particularly disturbing component of this result was that the difference in the net undercount between blacks and non-blacks increased in 1990 to its highest level since 1940. Furthermore, the 1990 Census appears to have missed substantially more persons than suggested by the official net undercount estimate. Overall, we estimated that it missed a minimum of 9.7 million persons—about 3.9 percent of the count—and contained a minimum of 14.1 million gross errors, including double counts and fictitious enumerations.

The decline in the accuracy of the census cannot be attributed to spending less than was spent in 1980. The 1980 Census cost \$1.1 billion over 10 years, while the 1990 Census is estimated to have cost \$2.6 billion. Even adjusting for inflation and workload growth, the cost of the 1990 Census was still 25 percent higher than the 1980 Census. Census Bureau planning staff estimated that if the current approach to taking the census is retained for 2000, the costs could rise to about \$4.8 billion in current dollars.

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Census Reform  
Leadership  
Needed Now

Important decisions based on wide consultation and staff analysis are needed by the fall of 1993 to guide planning for field

tests of census methods and procedures scheduled for 1995, to shape budget and operational planning for the rest of the census cycle, and to guide discussions with state and local governments and other interested groups. The administration must also seek early and active consultation and cooperation with the Congress.

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Early Decisions  
Needed on Content  
of Census  
Questionnaire

Public cooperation is essential to obtaining accurate census data at a reasonable cost. For reasons not entirely under the Census Bureau's control, the mail response rate has been declining. In the future, this trend may continue because the environment for census-taking by the traditional mail-out and mail-back method may worsen. Although the Census Bureau cannot expect to solve the problems created by societal changes, it can reduce the effects of these problems by streamlining the questionnaire, thus making it easier for the public to cooperate with the census.

In 1992, the Census Bureau tested a simplified, more user-friendly short form—sent to about five of six households—and found that changes in the short form also can increase the level of cooperation with the census. For example,

the test results indicated that generally asking fewer questions can improve the mail response rates. As an indication of the magnitude of potential savings, the Census Bureau has estimated that a streamlined questionnaire in 1990 asking only five questions could have saved as much as half a billion dollars. The Census Bureau also should examine the need for the census long form, which had 59 questions, and the size of the sample to which it was sent—about 1 in 6 households. Not unexpectedly, the response rate in 1990 for the census long form was lower (60 percent) than that of the short form (66 percent).

An early decision on census content is required for political and operational reasons. A political consensus must be built to support a simplified census questionnaire or to ensure continuing support from the Congress and the public for a census with the traditional scope and content. An early decision also will provide time to find necessary substitutes for any data lost by streamlining the census questionnaire. A late decision either to add or eliminate a large block of questions poses significant operational risks to the census.

Early Decision  
Needed on Whether  
to Use Sampling

Even with a simplified questionnaire, the Census Bureau's test showed that it can expect a large number of Americans will still not return their form by mail. Statistical sampling of these nonrespondents would reduce the time and labor-intensive fieldwork required to follow up missing questionnaires. We, the National Academy of Sciences, and the Commerce IG have recommended that the Census Bureau explore if and how sampling can be used to improve the census. Census Bureau staff estimated that the cost of the 1990 census would have been reduced by \$460 million if the Census Bureau had sampled 10 percent of the nonrespondents rather than collecting data on all of them. In addition to these cost savings, sampling will reduce the total respondent burden and even potentially increase the data quality.

Sampling for nonrespondents will require early consideration by the Census Bureau and other key policymakers inside and outside Commerce. Legislation may be needed to allow the Census Bureau to sample those housing units not returning a form by mail. Because of its critical nature to census planning and the need for operational testing, legislation to permit sampling, if necessary, should be proposed to and

considered by the Congress as expeditiously as possible.

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Early Decisions  
Needed to Improve  
Address List and  
Geographic  
Information

An accurate and complete address list and associated geographic information is a cornerstone of a successful mail-out census. For the 1990 Census, the Census Bureau spent over a half a billion dollars to develop the means to identify the mailing address and physical location of about 100 million housing units. But even such an enormous expenditure of resources did not guarantee an accurate and complete address list. The Census Bureau estimated that it missed about 3.5 million housing units in 1990 and that about 2 million were erroneously counted. Furthermore, we estimated that the Census Bureau spent over \$300 million visiting or searching for vacant or nonexistent housing units.

The Census Bureau has major opportunities to improve its address list for the 2000 Census, but it must begin soon the process of updating, upgrading, and integrating its 1990 automated address control file and the associated automated geographic systems. In particular, an early decision is needed on the important role the U.S. Postal Service (USPS) might play in these activities. We

believe that letter carriers are in a much better position than temporary, inexperienced census workers to identify housing units and determine whether they are occupied. Moreover, recent USPS technological advances in building an automated national address list reinforce the practicality of USPS' increased involvement in updating the Census Bureau's address list and geographic information systems. Early decisions are necessary because cooperative arrangements between the Census Bureau and USPS will require extensive lead times to negotiate, plan, test, and prepare.

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## Related GAO Products

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Decennial Census: 1990 Results Show Need for Fundamental Reform (GAO/GGD-92-94, June 9, 1992).

Automated Patent System: Information on PTO's Program to Automate Patent Information and Processes (GAO/T-IMTEC-92-20, May 28, 1992).

1990 Census: Limitations in Methods and Procedures to Include the Homeless (GAO/GGD-92-1, Dec. 30, 1991).

Weather Forecasting: Cost Growth and Delays in Billion-Dollar Weather Service Modernization (GAO/IMTEC-92-12FS, Dec. 17, 1991).

1990 Census: Reported Net Undercount Obscured Magnitude of Error (GAO/GGD-91-113, Aug. 22, 1991).

Weather Satellites: Action Needed to Resolve Status of the U.S. Geostationary Satellite Program (GAO/NSIAD-91-252, July 24, 1991).

Trade and Economic Data: Many Federal Agencies Collect and Disseminate Information (GAO/NSIAD-91-173, May 1, 1991).

Census Reform Needs Attention Now  
(GAO/T-GGD-91-13, Mar. 12, 1991).

1990 Census Adjustment: Estimating Census Accuracy—A Complex Task (GAO/GGD-91-42, Mar. 11, 1991).

Decennial Census: Preliminary 1990 Lessons Learned Indicate Need to Rethink Census Approach (GAO/T-GGD-90-18, Aug. 8, 1990).

Ocean Research Fleet: NOAA Needs to Plan for Long-Term Fleet Requirements  
(GAO/RCED-90-42, Nov. 13, 1989).

Weather Satellites: Cost Growth and Development Delays Jeopardize U.S. Forecasting Ability (GAO/NSIAD-89-169, June 30, 1989).

Commerce Issues (GAO/OCG-89-11TR, Nov. 1988).

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