

THE ROOTS OF FRAUD AND ABUSE
IN THE DEFENSE ACQUISITION PROCESS

Paper Prepared for
Joint Service Conference on Professional Ethics
January 11, 1991

Frances V. Harbour
George Mason University

ROOTS OF FRAUD AND ABUSE IN
THE DEFENSE ACQUISITION PROCESS

On June 14, 1988, a team of Department of Defense (DoD) investigators, led by June Gibbs Brown, then Defense Department Inspector General, informed the public of Operation "Ill Wind." The "Ill Wind" team, which had been investigating procurement since September 1986, obtained more than 250 subpoenas. On June 14, it executed searches of 40 defense contractors' offices.¹ By December 1990 thirty-five people, including five government employees, had been found guilty of charges stemming from the investigations.² Operation "Ill Wind" focused primarily on conspiracies by defense companies and their consultants to obtain insider information from the government, collusion among firms in bidding for contracts, and bribing federal officials.³

Other allegations of wrongdoing have surfaced in the past two and a half years: designing "soft" tests and misrepresenting negative results;⁴ submitting false invoices;⁵ and questionable honoraria to both House of Representatives and Senate Armed Service committee members by major defense contractors.⁶

Other activities that have raised eyebrows in recent years should be added to the more spectacular headlines. Cheap "buy-ins" deliberately bid low to get an initial contract, and are followed by inflated subsequent contracts. Questionable quality control by some companies in the absence of warranties produces systems that do not work well, waste money and time, and may even let a user

down in a critical moment. Although astronomical spare parts and subcomponents prices are most often produced by quirks in accounting practices and designs produced without sufficient attention to cost efficiency, there can be no doubt that some of the high prices are the result of deliberate padding, if not outright fraud.

The difficulty of preventing and detecting all of these practices is compounded by revolving door personnel practices in which government officials routinely move to defense firms upon retirement, and in which high-level corporate figures are given political appointments in the Department of Defense.⁷ That the "revolving door" affects government officials can be seen by the effect of recent tightening of the rules. In the months following announcement of new regulations in 1989, 32 high level officials in the Defense Department, NASA, the Internal Revenue Service, and the Federal Aviation Association abruptly resigned.⁸

Response by Government and Industry

The past two and a half years have seen substantial efforts by both industry and government to control the problems of fraud and abuse. Voluntary codes of conduct, expanded armies of corporate compliance officers, and new government rules all have improved compliance with ethical business practices.

In some cases punishment for lawbreaking has been severe. Sunstrand Corporation was forced to pay a record-breaking fine of \$115 million after having been found guilty of overbilling the

government substantially for a variety of military hardware. Their invoices, for example included executive perquisites ranging from country club dues to household servants. In July 1990, GE, charged with padding bids that affected more than 200 military contracts, agreed to pay more than \$16 million in fines. Earlier in the year, Northrop was found guilty of falsifying weapons test results on cruise missiles and Harrier jets. They paid \$17 million in fines.⁹

Nor do individuals escape. Charles F. Gardner, a former Unisys vice president, was sentenced to 32 months in prison for bribing federal officials.¹⁰

Most people in the defense industry claim, probably correctly, that misspent dollars are a much more serious problem than actual skulduggery, both in absolute terms and relatively. Congressional micromanaging, over-regulation, short production runs and other inefficiencies produced by off-again on-again defense budgets, redundancies, so-called "gold-plating," and retrofitting equipment in the light of changed requirements cost taxpayers huge sums.¹¹ Storage costs alone for "unrequired" materials amount to millions of dollars a year.¹²

The problem of waste is clearly a serious one. It must be addressed if the American public is to get the maximum from the defense budget. It is not, however, the only problem. Moreover, even a watertight case against waste cannot justify even a low level of fraud and abuse.

The first step in improving the ability to deal with such

ethical violations is understanding their roots. We cannot design sensible reforms unless we know which elements within the structure of the procurement system provide temptations and which elements offer opportunities to take unfair advantages. The problem probably cannot be eradicated entirely, however, since some of the incentives to cheat and opportunities to do so are embedded in the very structure of system itself. Enormous but unstable defense budgets, a business relationship at once inbred and cutthroat, the sheer complexity of the process, and systematically requiring persons with less experience to monitor and regulate those with more all contribute to the problem.

The Boom and Bust Leviathan

The main reason for dishonesty in the acquisition system is also the most banal: There are very large amounts of money involved. If the 1991 budget authority for defense were converted to the Gross National Product (GNP) of a country, the U.S. Department of Defense would have an economy the size of a substantial regional power. At \$289 billion for fiscal year 1991 (excluding funds for the Persian Gulf), it would come in tenth in the world: between Poland and China.¹³ Historically, between 20 and 30 percent of the budget goes for procurement, strictly construed.¹⁴ Many of the problems of procurement proper, of course, apply to military construction and research and development, two of the other major functional sections into which the defense budget is divided.

Adding to the temptations inherent in the sheer scale of a superpower's defense spending are incentives to cheat produced by sudden changes -- up as well as down -- in the budget. Too much money, too fast produces one kind of problem. Beginning in the late 1970s under Jimmy Carter and accelerating in the first of Ronald Reagan's terms, a large but tight market was suddenly infused with substantial amounts of new money. Initially there was relatively little guidance from the political level on just how this money was to be spent.¹⁵ Moreover, many argue that there was actually too much money to spend with an adequate degree of control by the government.¹⁶ This apparently led to the temptation by companies to acquire -- by hook or by crook -- as much of the increased money as possible, because there was no telling how long the good times would last. Uncertainty, plus an increased stake, plus a bottom-line mentality created abuses. At the same time, too many contracts and too many new contracts all at once, weakened the effectiveness of oversight.

Ironically, suddenly shrinking budgets also increases the incentive to deal fast and loose. Defense budget authority and now outlays have been shrinking in the second Reagan term and in the administration of George Bush. Companies have thus been expecting and experiencing hard times. For example, the three major nuclear laboratories, Sandia National Laboratories, Lawrence Livermore Laboratory, and Los Alamos Laboratory, have been urged by Secretary of Energy James Watkins to shift their focus in the direction of new energy sources, environmental problems and

industrial competitiveness.¹⁷ Tighter defense budgets increase the incentives for competition between companies for business and for profiting more from the fewer dollars available. Getting a contract and keeping it become more critical with the wolves at the door.

As of early December 1990, a new pressure to spend money in certain areas seems to be building. The strong pressure to decrease defense spending is facing the possibility of a war in the Persian Gulf. The new scenario increases demands for transportation, desert equipment, conventional armaments, spare parts, and support material for the troops deployed in the region. Events over the next month or two will determine whether stinginess or prodigality (to use the Aristotelian terms) will probably govern the overall levels of the FY1992 defense budget. If a substantial conflict does occur, one strong possibility is that Congress and the President may actually pursue both tendencies at once. That is, they may cut to the bone the components of the budget devoted to Europe and Asia as well perhaps as nuclear and other strategic programs, while substantially increasing spending for capabilities relevant to the Middle East. Wars always spawn profiteering.¹⁸ As in periods of prodigality, the temptation of large sums of quick money and overtaxed oversight offer both temptation and opportunity. In addition, in wartime, speed not accountability is the most important criterion of procurement success. If the combination of deep cuts and rapid increases becomes U.S. budgetary policy in the early 1990s, then the Department of Defense and

defense industries will experience the incentive structures of feast and famine simultaneously. There will be too much new activity to control effectively in some areas and the cut-throat competitive tactics of shrinking pies in others.

The Enemy Brothers¹⁹

The Defense Department and the defense contractors are locked in a highly interdependent but at the same time conflictual relationship. As Jacques Gansler has observed in his classic study of the defense industry, "In spite of [the] acknowledged commonality of interest and this close relationship between government and industry at the aggregate level, on individual programs the situation is closer to an adversary relationship than to a mutually beneficial joint effort."²⁰

Making the corporations' dilemmas (whether of windfall or cutbacks) more acute is the fact that the federal government is the defense companies' best, sometimes only, client. In economic terms, this is known as a monopsony relationship. If it does not get and keep government contracts, such a company is in serious, even terminal, trouble. The Defense Department does not often fully appreciate the importance of this factor in its negotiations, but the companies do.²¹

If DoD's budget is comparable in size to the GNP of Poland or China, in complexity its procurement system can be considered more like a country's command economy than, say, Sears Roebuck's or Macy's purchasing systems. In addition to obviously military

requirements, the Defense Department procures many items that are not in any traditional sense weapons. DoD must arrange for the manufacture and acquisition of everything from socks, uniforms, and underwear by the million, to the materials for life aboard submarines and ships and barracks in the midwestern United States, to the contents of daycare centers and hospitals for service people and their families, to pencils (manual inscribers) and more modern implements for thousands of offices. Not surprisingly, the contracts involved are very large. For example, the Defense Department owns or has on order nearly a million and a half fire-retardant shirts.²² However, in most of these cases, the federal government is not the sole buyer of these products. This means some companies are less seriously fettered by their federal contracts than more traditional defense-oriented firms. Scale still produces incentives to get and squeeze contracts, but the competitive razor is less sharp.

For companies who do make weapons systems, especially high technology weapons systems, on the other hand, without a comparatively small number of government contracts, many of the firms would perish. A number of companies, especially so-called third-tier companies, are leaving the market and others are diversifying their activities to include some nondefense products, or at least more than one defense system.²³ Nevertheless, the federal customer remains a hard economic fact of life, both attractive and dangerous.

The importance of getting a contract is enhanced still further

by the fact that if a company does succeed in getting a contract (after much red-tape as well as normal competition-induced pain and agony), it is much, much easier to get the follow-on contracts. At that point, a company becomes the sole or one of a tiny number of sources for a procured item and, equally importantly, its spare parts. In spite of the added requirements for enhancing competition represented by the 1984 Competition and Contracting Act, (as well as provisions in the Carlucci and Thayer Initiatives, and the aspects of the Packard Commission Report that have been implemented) this remains true. For the biggest items (for example, the building of submarines) the subsequent contracts are virtually assured. It is easy to see why getting the first contract is crucial to the well-being of a company. This relationship produces incentives to "buy in," to fiddle the bidding process by obtaining insider information about bids and engaging in other questionable practices up to and including actual bribery.

It should be noted that the 1984 Competition and Contracting Act does make competition tougher than before. Most observers believe this act is at least a partial a success from the standpoint of reducing waste. From the government's point of view, there are limits to the products that can be meaningfully subject to competition. However, although there is some controversy on this point, the act apparently does make those products, services, and systems that are subject to competition cheaper.²⁴ From the point of view of the defense companies, the Competition and

Contracting Act adds another layer of uncertainty to the system. A far-sighted company official may also laud the aggressiveness and sharp edge it rewards. Nevertheless, for the defense firms, this act adds an additional degree of danger and anxiety to the system.²⁵ A company may lose one of its lines if it is not careful and getting the initial contract is harder.

Industry-based critics obliquely point to another consequence of the increasingly competitive market as a source of ethical problems in the system: They report an increasing reliance on salesmanship and proposal writing, rather than excellence in research and development (R & D), as a source of contracts. Defense News editor Fred Reed makes the connection clear. First, companies are increasingly tempted to oversell their products, in effect, to lie about them. Second, if the company does convince the client that the product is better than it actually is, the inevitable (and just) result when it does not live up to expectations will be disappointment and a label of failure. A weapons system may be good, but remain a failure, since no system could be as wonderful as the one which was sold. Fear of the label may lead to coverups. And finally, lying early in the process creates a dishonest environment in which still other abuses may occur.²⁶

The interaction of high stakes, competition, the small number of parties, and mutual dependence leads to an atmosphere at once inbred and cutthroat. Companies have an incentive to get contracts, virtually at any price. Government does not (or has

not) felt it could punish abuses very harshly, since it does not have many easily available sources for the weapons systems the Defense Department genuinely needs.²⁷ Even debarring companies, which can be done merely on suspicion of wrongdoing but is not automatic even for indictments, is instituted to protect the government, not to punish the companies.²⁸ If a company seems too important to the national security to debar, it is not debarred. For example, although the Air Force did debar the division of Northrop guilty of faking weapons tests, they resisted pressure to debar Northrop as a whole.

In such an interdependent relationship, each side feels at mercy of other. Just as in the international system, this leads to the temptation to take any advantages offered by the inevitable closeness and yet to insulate one's self as much as possible from the embrace of the other. The system thus creates incentives to industry and to individuals to oversell even good products, to take improper 'shortcuts,' to evade regulations wherever possible, to obtain information about other companies' bids, and to take part in all of the shady practices which have found their way into the press in recent years. It also creates incentives for the government to try to prevent problems by miring the industry in an ever-tightening web of rules. There are also civil servants, primarily civilians in the more recent allegations, and members of Congress and their staffs who are accused of being willing to take advantage of the joint plight of industry and government by taking favors as well as bribes. The opportunities and dangers of this

system together produce a strong financial incentive on both sides to bend, if not break, the legal as well as moral rules. That so many do not do so is a remarkable testimony to their integrity.

A Maze of Regulations

Adding to the financial incentives to take advantage are the opportunities presented by a procurement system that is incredibly complicated, and sometimes contradictory. (For example should a procurement officer choose the cheapest bid or the one with a warranty?) Even after the uniform Federal Acquisition Regulations were set up, (and almost immediately revised) defense procurement regulations take up more than 30,000 pages, plus thousands more of DoD administrative regulations. There were more than a hundred distinct reform provisions passed by Congress from 1981-1986 in Department of Defense authorization acts and in the Competition in Contracting Act of 1984, according to David Lockwood of the Congressional Research Service.²⁹ Some of these were designed to streamline the process, notably milestone budgeting for development of a few noncontroversial programs and increased use of multiyear authorization. Many of the reforms, including some with considerable intrinsic merit, have made the process of defense procurement even more complicated than before. Mandated accounting practices, realistic cost estimates, and programs designed to make the spare parts acquisition process more competitive are examples of useful but complicating reforms.³⁰ Recently, efforts have been made to streamline the regulations themselves, but the system

remains unwieldy and highly bureaucratized.

The complexity of the system and the multiple entry points where decisions to buy or not to buy can be influenced produce opportunities for exploitation. By obtaining inside information or uneven application of the rules, people or companies can be excluded on the one hand or set on an inside track on the other.

Complexity also creates opportunities for abuse by accident. It has been plausibly suggested that no one can possibly know and understand all of the regulations. Even experts may commit illegality by oversight or error. This problem of complexity is compounded for the small business participants. As Jay Yale Lubkin of Defense Science points out: think of trying to do income taxes.³¹

David and Goliath?

In such a complicated system, the consequences of inequalities in expertise may be very important. An honest but inexperienced person may be no match for a dishonest but experienced one when it comes to oversight, contracts, and managing regulations. The system is stacked against many military program officers. Military officers in charge of many procurement programs are on two-year assignments. For the most part, although they are highly competent military officers, they are not experts in procurement. As Norman Augustine, Chief Executive Officer of Martin Marietta, put it, "[W]hen you are expected to spend half your life in a cockpit, or foxhole, or on a ship, it's very hard to be as effective as

somebody in business."³² The problem may be getting worse, not better. Indeed, between 1984 when Congress required program managers of major weapons programs such as the B-1 bomber and Abrams tank to remain at their posts for four years or more, the average tenure actually declined from twenty-four to twenty-one months. The most able officers may be moved out the fastest -- once the acquisition experience "ticket" has been "punched."³³ Using shortterm personnel to manage procurement causes other problems. For example, informal understandings on both sides may be lost when the government person leaves.³⁴

Conversely, the often short-lived political appointees at top of the defense and procurement system may know industry but often not defense or the defense acquisition system. Some argue that this expertise trade-off is worthwhile. In cases where appointees do have defense industry expertise, they also have pre-existing ties to defense firms, which may create at least psychological conflicts stemming from former connections.

Emphasizing industrial but not defense expertise does not solve the problem of the revolving door, however, by which a defense political appointees, military officers, and civil servants go to work for defense contractors after retirement from the government -- and know beforehand that this is a possible future career move. To a considerable extent, the move from government to business is natural and perhaps inevitable. Individuals work where their expertise lies. When they leave the government they have to work somewhere. Nevertheless, the temptation to "play

ball" while on the government side is a real one as is the temptation on the business side to take advantage of old connections. Regulations about future employment have been tightened in recent years but the revolving door has not been and perhaps Constitutionally cannot be shut altogether.

The short tenure of military acquisition officers puts considerable pressure on the civilian procurement personnel. They, of course, are subject to all of the revolving door temptations of the military and political officials. Moreover, the permanent civil service component, whose primary expertise is defense procurement, is reportedly demoralized and unhappy. The suspicious atmosphere, lack of respect, and the lack of room for real initiative because of the mountains of red tape designed to protect the inexperienced and control bad apples are among the sources of their malaise.³⁵ Inadequate education and training is reportedly an additional problem for many. Perhaps not surprisingly, the civilian component is leaving government in record numbers; many eventually end up working for contracting firms. Thus, lack of experienced civilian procurement workers is beginning to become a problem as well.³⁶

Much of the real procurement expertise thus resides with the defense firms. Their incentives, their continuing experience, and the revolving door insure this. Corporate officials are not, as a group dishonest. However, corporate structures do reward success and punish failure as defined by financial profit and loss. Until recently, success was not questioned too closely. Moreover, given

the large number of individuals required to obtain and to carry out defense contracts and their expertise, those who are inclined to abuse the system are hard to stop.

In addition, companies (as well, to be accurate, as DoD) have access to another source of expertise, contacts and information. There is a virtual army of consultants in and around Washington. These consultants are the least regulated and least regulatable element of the defense industry. A comparatively small number of consultants were apparently the source of many of the alleged recent violations of legal and ethical rules in 1988.

Conclusion

In an unwieldy and high-stakes system, the comparatively small sins of billing high on estimated costs, overselling, using easy weapons tests and soft program milestones, obtaining and offering personal favors, and sailing close to the wind on regulations are apparently fairly common practices. When self-deception is added in, these activities may easily go over ethical and legal lines, especially when government supervision relaxes or difficult economic times appear on the horizon.

Out-and-out bribery, falsification of weapons tests, clearly fraudulent billing processes and other deliberate blinders-off wrong-doing apparently goes on much more rarely. Even so, a comparatively small number of really shady individuals can cause serious problems for companies and for the industry as a whole. A few such individuals can drag whole companies into noncompliance

with the law. When this comes out, the whole company gets a bad name. Given the degree of suspicion with which defense firms are regarded at the best of times, a comparatively small amount of wrongdoing can make the whole industry look corrupt in the public eye. Moreover, publicly revealed malfeasance may contribute to a climate in which it is difficult for other companies and individuals not to feel they must follow similar practices in self-defense. In short, a few people can do a lot of damage.

Notes:

1. Ruth Marcus and Molly Moore, "250 Pentagon Sobpoenas Served," Washington Post, June 17, 1988, p. A1; Ruth Marcus, "An Inside Look at the Scandal," Washington Post, July 2, 1988, p. A1, A10.

2. Robert F. Howe, "Defense Contractor Gets Prison Term," Washington Post, December 2, 1990, p. A6.

3. Helen Dewar and Molly Moore, "Hill Schedules Hearings on Pentagon Probe," Washington Post, June 24, 1988, p. A-10; Dana Priest, "Defense Officials Wined, Dined at Va. Estate," George C. Wilson, "Defense Fraud Charges Said to Be Months Off," Washington Post, July 8, 1988.

4. "GAO Says Weapons Tests Too Easy, Data Misused," Washington Post, July 18, 1988, p. A3.

5. Barnaby J. Feder, "G.E. Agrees to Pay \$16 Million Fine," Washington Post, March 7, 1990.

6. Dan Morgan and Eric Pianin, "Contractors often Bypass Pentagon," Washington Post, July 10, 1988; Nick Kotz, "America's Defense Dependency," Washington Post, June 28, 1988.

7. See, for example, William Proxmire, "Cleaning Up Procurement: Why Military Contracting is Corrupt," New York Times, December 17, 1985.

8. Judith Havemann, "Congress Grants Bush Request for Delay on New Ethics Rules," Washington Post, May 16, 1989; Judith Havemann, "New Ethics Law Provokes Resignation," Washington Post, May 23, 1990.

9. Barnaby J. Feder, "G.E. Agrees to Pay \$16 Million Fine," Washington Post, March 7, 1990.

10. Robert F. Howe, "32nd Person Convicted in Ill Wind Probe," Washington Post, March 31, 1990.

11. Peter Grier, "Augustine: Charting the Way through Rough Seas," Military Forum, July/August 1988. David Packard, "Reform in Weapons Acquisition," Key Speeches: Aerospace Industries Association of America vol. 1, no. 7 (August 1988), p. 3; Robert Higgs, "Military Scandal, Again," Wall Street Journal, June 27, 1988.

12. Molly Moore, "GAO: Military Doesn't Know that Enough Is Enough," Washington Post, March 3, 1990.

13. Helen Dewar, "Pentagon Keeps all Major Programs," Washington Post, October 18, 1990, p. A-1; Charles W. Kegley and Eugene R. Wittkopf, World Politics: Trend and Transformation (New York, St. Martin's Press, 1989), p. 164 lists Gross National Products.

14. Richard A. Stubbins, "The Defense Budget," in Federal Budget Policy in the 1980s, ed. Gregory B. Mills and John L. Palmer (Washington D.C.: The Urban Institute Press, 1984), p. 86.

15. Sandra Sugarawa, "Contractors See Difficult Times Ahead," Washington Post, June 22, 1988.

16. Sandra Sugawara, "Contractors See Difficult Times Ahead," Washington Post, June 22, 1988, p. A8.

17. Washington Post, July 26, 1990.

18. See, for example, Helmuth Carol Englebrecht and Frank Cleary Hanighen, Merchants of Death (New York and London: Garland Publishing, 1972), esp. 3-24.

19. This concept was used by Raymond Aron to describe the relationship between the United States and the Soviet Union. Raymond Aron, Peace and War: A Theory of International Relations, trans., Richard Howard and Annette Baker Fox (Garden City, N.Y.: Anchor Press/Doubleday, 1973), p. 259. He also coins the useful term "enemy partners."

20. Jacques Gansler, The Defense Industry (Cambridge, MA: The MIT Press, 1984), p. 1972.

21. cf. Gregg Easterbrook, "Sack Weinberger, Bankrupt General Dynamics, and Other Procurement Reforms," Washington Monthly, January 1987, p. 36 and Jim Martin, "The Symptoms Are Not the Disease," Defense Science, August 1988, p. 8.

22. Molly Moore, "GAO: Military Doesn't Know that Enough Is Enough."

23. Cheryl Pellerin, "Defense Contractor Ranks Decline," Defense News, August 15, 1988, p. 1.

24. Richard Stevenson, "Competition for Contracts Trims Costs for Pentagon," New York Times, 31 March 1988.

25. Grier, "Augustine," p. 75.

26. Fred Reed, "Lying: A Way of Life in Military Procurement," Defense News, December 12, 1988, p. 35.

27. See, for example, Proxmire, "Why Military Contracting is Corrupt," p. F3.
28. See, for example, Myron Struck, "Procurement Loopholes Spark DoD Tussle," Defense News, December 12, 1988, p. 20.
29. David Lockwood, "Defense Acquisition Reform: Issues for the 100th Congress," Major Issues System: Issue Brief (Order Code IB87206), June 14, 1988, p. 1.
30. *ibid.*
31. Yale Jay Lubkin, "Procurement Sometimes Is Illegal: The \$7.29 Engineer," Defense Science, November 1988, p. 25.
32. Grier, "Augustine," p. 77.
33. Molly Moore, "Military Revolving Door Quickens," Washington Post, July 3, 1990, p. A21.
34. "Acquisition Policy: Interview with Frank Lewis, Harris Corporation," Defense Science, November 1988, p. 43.
35. Allan V. Burman, "Defense Acquisition: How the Game Has Changed," Paper presented at the Inter-University Seminar on Armed Forces and Society Bi-Annual Conference, Chicago, Fall 1987), p. 10.
36. Center for Strategic and International Studies, U.S. Defense Acquisition: A Process in Trouble (Washington D.C.: Center for Strategic and International Studies, Georgetown University, 1987), p. 35-37.