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Capital Budgeting for the Federal Government

Statement of
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Before the
Subcommittee on Economic Development
Committee on Public Works and Transportation
House of Representatives

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Mr. Chairman and Members of the Subcommittee:

I am pleased to have this opportunity to discuss with you our views on the concept of capital budgeting and its usefulness in making federal budgetary decisions. Later in my statement, I will explain GAO's capital budgeting proposal, and why I think it is a good idea for the federal government. Before doing that, however, I would like to focus for a moment on our nation's most pressing budgetary problem--the federal deficit, and how budget reform relates to it.

THE FEDERAL DEFICIT AND BUDGET REFORM

The number one problem facing the nation today is how to reduce the federal deficit. We as a nation are faced with making a fundamental policy decision--how much are we going to spend on government programs and services and how are we going to pay for them? The federal government needs to realize that it can no longer act as though it has virtually unlimited financial resources. This will require difficult budget decisions.

The recent Congressional/White House negotiations illustrate the difficulty of making those revenue and spending decisions. Although some agreements were reached in cutting the deficit, which was an accomplishment, I think that the public and the financial markets will be carefully reviewing those budget decisions to ensure that they result in concrete rather than superficial improvements. Also, they are expecting more than short-term actions on reducing the deficit. They are looking for discipline and accountability in how we manage the government's financial resources. Therefore, in order to restore public confidence, we need to develop concrete steps for improving the way we budget.

Furthermore, let me express a word of caution. I am concerned that any reluctance to face the deficit problem and improve our budget practices will lead to a proliferation of constitutional proposals that, if adopted, would interject major new uncertainties into institutional relationships at the federal level. This could include a constitutional amendment limiting spending growth and requiring a balanced budget, or giving the President line-item veto authority or enhanced rescission powers. I am sure the Congress will want to study these various proposals carefully to weigh the institutional, economic, and budgetary implications.

There are, however, steps we can take that do not raise such balance-of-power questions, such as improving the budget's structure and numbers and streamlining the congressional budget process. These should not be seen as "solutions" to our budget deficit problem, but rather as steps that can help our lawmakers in making decisions and taking actions on the budget and the deficit.

Mr. Chairman, let me now discuss one major proposal for improving the budget's structure--capital budgeting.

COMPREHENSIVE FRAMEWORK FOR PLANNING, PROGRAMMING, AND BUDGETING FOR CAPITAL INVESTMENTS DOES NOT EXIST

Based upon the work we have done during the past 3 years beginning with our February 1985 report, Managing the Cost of Government, we believe it is time to rethink the budget's structure. Since fiscal year 1969, the federal government has used a unified, cash-based budget. It was created so that the President and the Congress could address the cash flow--checks received and issued--of the government as a whole as well as in its parts. This budget structure generally has served the government and public well in terms of providing a comprehensive report of the cash receipts and outlays of the government. However, it has made no systematic distinction between outlays for capital investments and those for current operations. We believe such a distinction is important in order to provide a better and clearer understanding of the government's financial position and the true costs and benefits of its programs. This will lead to more informed budgetary decisions.

Before I go any further Mr. Chairman, let me briefly highlight the magnitude of our federal capital investments. Office of Management and Budget (OMB) data show that, in fiscal year 1986, federal outlays for physical investments ranged from $84 billion for acquiring federally-owned assets, to $107 billion if one also includes grants to state and local entities in support of their capital projects. In addition, federal direct loan disbursements amounted to $42 billion. In total, these capital investments represented about 13.2 percent of total federal outlays in fiscal year 1986.

Under the current unified budget, a dollar spent is a dollar spent. The current budget treats outlays for capital and operating activities the same, even though they are different in a key respect--capital outlays do not reduce the resource base of the government the way current outlays do because they represent asset exchanges. When an outlay is made to acquire an asset, whether it is a building or a loan note, it produces a future stream of benefits to the government. Under present budget scorekeeping rules, however, a $100 million expenditure to build a hydroelectric plant, for example, contributes to the deficit the same as a $100 million expenditure for current military fuel costs, even though the investment in the power plant will produce benefits to the government and public for years to come.

A capital budget component within the unified budget would resolve these deficiencies, but more importantly, it would also provide many benefits. Mr. Chairman, let me now discuss in detail several of the key benefits of capital budgeting.

BENEFITS OF CAPITAL BUDGETING

Provide More Deficit Control Options

Because the unified budget does not distinguish between the receipts and outlays for capital investments and those for current operations, it does not identify by operating and capital component the resulting deficit and borrowing requirements. For example, in fiscal year 1986, the government incurred a deficit of about $221 billion. The budget does not identify what portion of that amount was applicable to capital investments and what portion was applicable to current operations.

By not distinguishing between the receipts and outlays for capital investments and current operations, federal deficit control actions have no choice but to focus solely upon aggregate deficit totals. For example, Gramm-Rudman-Hollings deficit targets apply equally to capital and operating programs, which may unnecessarily restrict the debt control options available to federal lawmakers. In this regard, the federal government is clearly out of sync with state governments and, for that matter, the private sector.

At the state level, 37 states have a distinct capital budget whereby the capital and current operations amounts are reported separately either within an overall budget or as separate budgets. Most of these states distinguish between capital and current operations for targeting balanced budget requirements. More importantly, 34 of our states require their governments to execute balanced budgets; all but a handful limit that requirement to the current operations part. Debt financing is permitted for their capital projects, subject to separate state debt limitations. At the federal level, however, the lack of distinction between capital investments and current operations closes off this option for targeting deficit reduction actions. It also makes it difficult to compare federal budgets and deficits with those at the state level.

In short, a capital budget would provide the President and the Congress an additional basis for targeting areas for deficit reductions in times of deficit spending. For example, Gramm-Rudman-Hollings deficit targets could be established for the capital and/or operating components of the budget as well as for the total budget.

<u>Eliminate Disincentives Toward Capital Investment</u>

A capital budget would also help eliminate budget process disincentives toward physical capital investment. Under the current unified budget, physical capital expenditures in a given year are reflected as if they were costs incurred in that year. For example, during the construction of a federal building, this scorekeeping practice "front-end loads" the costs shown in the budget for the acquisition, since the project will have sizable start-up cash payments. Such a project would be at a disadvantage during budget deliberations when competing with an alternative means of acquiring the use of a building that would have lower front-end costs, such as leasing, which has significantly higher long-term costs. This could result in decisionmakers selecting the leasing option even though it will entail larger, long-term costs. More importantly, it could result in disapproval of the project because of its initial effect on the budget even though the long-range benefits would be large. In a sense, it requires a capital asset to have a one-year payback to be able to compete equally with current operating costs, a clear manifestation of our focus on short-range thinking.

The disincentives toward physical capital expenditures also make it difficult to invest in productivity enhancing capital assets, at least for on-budget agencies. In the past, this has been a factor in taking certain programs off-budget. For example, the debate several years ago on revitalizing the U.S. Postal Service addressed the need for the Postal Service to make large capital investments. It was recognized then that as an on-budget agency the Postal Service would be hard pressed to obtain the necessary funding, because of the budget scorekeeping practices that reflected a year's capital expenditures as if they were costs for that year.

A capital budget approach would deal with this budget bias by using a different scorekeeping approach. Capital expenditures would be distributed in budget reporting over the useful life of the capital investment. The amount reflecting each year's cost would be reported in the current operations part of the budget. Because of their long-term benefit stream, it is appropriate to annualize the costs of capital investments--known as depreciation--over the fiscal periods receiving the benefits. This would put capital investment amounts on a comparable basis with current operation amounts and eliminate the current budget bias against capital projects. I should add that the budget would continue to report total payments made in a given year for physical capital, but this total would appear in the capital component of the budget as a financing requirement, not as a current year cost.

Would More Accurately Report the Costs of Federal Direct Loans

Similarly, a capital budget would more accurately report the costs of the federal government's direct loan programs, a subject of much debate this past year. Under the current unified budget, federal direct loans are fully reported as cash outlays in the year they are made. No recognition is made of the fact that the government, in making these loans, receives a real financial asset (the note promising future repayments), and that at least a portion of the loan outlays will be repaid in the future. This omission overstates the cost of loan programs in their early years. An opposite effect develops in later years when loan repayments flow back to the programs. The repayments are netted against new outlays and result in understating the costs.

Our proposed capital budgeting approach would overcome these distortions by reporting in the current operations portion of the budget the annual net cost of the loan programs and reflecting loan outlays and receipts in the capital or financing portion of the budget. This would put loan program costs on a more comparable basis with grant program costs.

This treatment of loan programs would provide another potential benefit--it could reduce the incentive to undertake loan asset sales and other asset sales mainly to reduce the short-term deficit, something many people liken to selling your garage to reduce your home mortgage. A capital budgeting approach with an emphasis on controlling current operating costs and deficits would eliminate this particular incentive for loan asset sales because, under the rules of capital budgeting, proceeds from asset sales would not count as current operating revenues.

<u>Start Providing a Link to Financial Statements</u>

A capital budget would start providing a link to agency-level and governmentwide financial statements, something we believe is essential to increasing both accountability and discipline in our financial management system. Such statements disclose the cumulative effect of decisions on the government's financial resources and provide early warning signals to policy formulators and the public.

A capital budget would provide a useful complement to the financial statements. The two taken together would provide enhanced information on the government's assets, liabilities, and operations. The financial statements would provide a snapshot of the cumulative results of past capital acquisitions adjusted for depreciation, while the capital budget would show the planned activities.

Mr. Chairman, although a capital budget would start providing a link to agency-level and governmentwide financial statements, I want to point out that our current financial management systems cannot provide the financial information and accountability needed by the Congress, federal managers, and the public. Important legislation addressing these problems, such as the Financial Integrity Act and the Debt Collection Act, has been enacted, but further improvements are necessary. I believe such improvements, if they are to be effective and lasting, must be guided by a cohesive framework under centralized leadership that is responsible for developing and implementing a governmentwide plan for improving financial management systems. Agencywide and governmentwide financial statements and the performance of annual financial audits will provide accountability and discipline. A copy of recent correspondence to the Chairmen of the House Committee on Government Operations and the Senate Committee on Governmental Affairs on this issue is included in attachment V.

Focus Attention on Nation's Physical Infrastructure

A capital budget would also help focus public attention on the nation's physical infrastructure needs. Federal, state, and local governments have invested hundreds of billions of dollars in physical capital investments--highways, bridges, water and sewer systems, airports, buildings, and the like. With the increased pressure on the federal budget and the ongoing debate about the federal government's relationship with other public sectors and the private sector, the way in which the federal government, states, and localities plan, budget, and protect the public capital investments needed for the future takes on added significance.

Mr. Chairman, I would now like to discuss the structure of GAO's capital budgeting proposal.

GAO'S CAPITAL BUDGETING PROPOSAL

Maintain Unified Budget But Report Separately on Capital and Operating Amounts

The federal government currently uses a unified budget that reflects the full scope and impact of government activities. GAO's proposal for restructuring the budget would result in the continued reporting of receipt and outlay totals for the federal government as a whole. Our unified restructured budget would, however, identify the operating and capital components for the unified budget total and for each of its functions, agencies, and programs. It would, therefore, maintain the unified budget's comprehensive coverage. Also, it would include account listings and schedules that report total program costs where programs involve both capital and non-capital items. By no means would we want to go back to the days of object class budgeting, when it was hard to ascertain total program costs.

As I indicated earlier, a budget restructured along these lines would permit budget balancing targets to be more focused upon current operations, if the Congress and President so desired. I should add, however, that with such a focus it would still be necessary to monitor and control the total borrowing requirements of the government, including borrowing for capital projects. Federal borrowing for capital projects would be no different than other federal borrowing in their impact upon the aggregate economy, credit markets, and interest rates.

I would now like to refer you, Mr. Chairman, to attachment I of my statement, which illustrates in a very abbreviated form the current unified budget. It reflects the $220.7 billion deficit for fiscal year 1986. My remaining attachments are also for fiscal year 1986. I should note, however, that because of our innovative approach and the quality of existing data on capital expenditures and depreciation, we had to make several assumptions. Therefore, I would emphasize that the numbers are approximations for illustrative purposes only.

Attachment II illustrates our unified restructured budget. It would contain both an operating budget and a capital budget within the unified budget. Within each of these budgets, revenues and expenditures would be reported. The unified budget would combine the operating budget surplus/deficit and the capital budget financing requirements into a single unified budget total. One final adjustment would be made in order to report the total unified budget deficit on a cash basis as it is now. An adjustment would be made for the annual depreciation costs on government-owned assets. This would allow the unified budget deficit--referred to in the attached illustrations as "total financing requirements"--to be consistent with current budgeting procedures.

Mr. Chairman, let me now discuss in further detail what would be included in the separate operating and capital components of the unified restructured budget.

Operating Budget Component

As you can see in attachment III, the operating component of the unified budget would consist of all cash revenues and expenses for those programs and activities that are not classified as capital investments. It would also include interest on the national debt and the annual capital consumption charge--or depreciation--on physical assets owned by the federal government. (The budget deficit is currently presented on a cash basis only and, as such, does not include depreciation.) For credit programs, it would include only the annual net cost of credit activities for each year. Thus, the operating component of the unified budget would reflect the annual net cost of running the government. An operating surplus/deficit would be reported based on these revenues and expenses.

Capital Budget Component

The capital component of the unified budget, as illustrated in attachment IV, would report both capital revenues and expenses. Capital revenues would include user fees, gasoline excise taxes, and similar amounts which are directly related, either by law or activity, to capital investments. It would also include revenues from the sale of capital assets. Capital investments would include the cost of capital programs which lead to the acquisition of physical assets or direct loan disbursements. It is important to note that the amount by which capital expenses exceed capital revenues would be reported as "capital financing requirements." The term capital financing requirement is used instead of capital deficit to reflect the fact that the government is financing a capital asset which has value and will produce a future stream of benefits, rather than incurring a cost.

Defining Capital Assets

There has been a great deal of discussion and debate, Mr. Chairman, over how to define the items that will be included in the capital component of the budget. We believe that it is necessary to have a narrow and disciplined view of what would be classified as capital. Under our proposal, we would define capital assets as being of two types--physical assets and financial assets.

Physical assets would be assets with form and substance, that is, tangible, whose ownership resides or will reside in the public domain, and which typically provide services or benefits, including for national defense and security, for more than one year. Such assets would include, but would not be limited to, roadways and bridges; airports and airway facilities; mass transportation systems; waste water treatment and related facilities; water resource projects; medical facilities; resource recovery facilities; public buildings; space and communication facilities; railroads; defense facilities; major weapons platforms; and strategic petroleum reserves and mineral stockpiles.

Financial assets, as we define them, would include any legal instrument such as stocks, bonds, notes, and other securities held by the federal government.

I have to acknowledge, however, that the above definition is still too general. We need to establish good definitional standards in order to distinguish between capital investments and operating expenses. GAO is currently conducting a major study in this area.

It is not only crucial to establish good definitional standards, but also to monitor, through an independent audit, how those standards are applied. This would minimize the chances of officials misclassifying operating amounts as capital amounts, a gimmick that was used in New York City in the mid-1970's and earlier.

The Impact on the Executive Branch and Congressional Budget Process

Concerns have been raised, Mr. Chairman, regarding the impact capital budgeting would have on the executive branch and congressional budget process. The concerns are that capital budgeting would increase the complexity and workload of the process. Many of these concerns stem from the perception that a capital budget is completely separate from the operating budget. However, if capital budgeting is implemented in the form we propose--and within the unified budget--then this perception is avoided. Indeed, the new budget structure might help simplify budget debate and actions by providing a more meaningful breakdown of the budget's totals.

Within the executive branch, our proposal would require changes in how information is presented in the President's budget. Information currently provided by agency, appropriation account, and budget function would continue to be reported. However, there would be a clear identification of the appropriation accounts, or parts of accounts, that are for capital purposes, and there would be new summary tables showing the capital and operating breakdowns within each agency and budget function. There would be no other changes in how the President's budget is prepared, reviewed, and approved.

On the congressional side, the main effect would be on the budget resolutions and related actions. Current functional categories--defense, housing, etc.--would be broken down into capital and non-capital sections, and the resolutions' aggregate totals would have capital and non-capital components. This also could and should carry through to affect the way budget deficit targets are set in legislation such as the Gramm-Rudman-Hollings legislation.

SUMMARY

We believe that capital budgeting within the context of the unified budget would be a major step in instilling better accountability and discipline and in improving our budget decisionmaking and control processes. It should be implemented as a key reform of our budget process and our financial reporting systems.

This concludes my prepared statement, Mr. Chairman. I would be glad to answer any questions.

ATTACHMENT I

CURRENT UNIFIED BUDGET OF THE U.S. GOVERNMENT
(dollars in billions)

	1986
Total revenues	$ 910.0
Total expenditures	1130.7
Surplus/deficit(-)	$-220.7

ATTACHMENT II

UNIFIED RESTRUCTURED BUDGET OF THE U.S. GOVERNMENT
(dollars in billions)

	1986
Operating budget	
Operating revenues	$ 873.2
Operating expenses	981.7
Capital consumption charge (depreciation)	50.0
Operating surplus/deficit(-)	-158.5
Capital budget	
Capital revenues	$ 36.8
Capital investments	149.0
Capital financing requirements	-112.2
Items not affecting funds	
Depreciation	50.0
Total financing requirements	$-220.7

OPERATING COMPONENT OF RESTRUCTURED BUDGET
(dollars in billions)

	1986
Operating budget	
Operating revenues	
General taxes	$ 464.1
Earmarked taxes	288.7
Market earnings	120.4
Total operating revenues	873.2
Operating expenses	
Defense functions	$ 210.8
Civil functions	634.9
Interest on debt	136.0
Capital consumption charge (depreciation)	50.0
Total operating expenses	1031.7
Operating surplus/deficit(-)	$-158.5

ATTACHMENT IV

CAPITAL COMPONENT OF RESTRUCTURED BUDGET
(dollars in billions)

	1986
Capital budget	
Capital revenues	
Loan Receipts	$ 20.5
Direct capital taxes	16.3
Capital asset sales	--
Total capital revenues	36.8
Capital investments	
Loan disbursements	$ 42.2
Capital additions	106.8
Total capital investments	149.0
Capital financing requirements	$-112.2

 ATTACHMENT V

Comptroller General
of the United States

Washington, D.C. 20548

June 25, 1987

The Honorable Jack Brooks
Chairman, Committee on Government
Operations
House of Representatives

Dear Mr. Chairman:

The federal government's lack of effective financial management and accountability is being increasingly highlighted through our own reports as well as those made by agency heads under the Federal Managers' Financial Integrity Act and by the inspectors general. Recent reports are replete with examples of problems ranging from an inability to account for a half billion dollars of foreign military sales deposits to an inability to manage or report on the loans and accounts owed to our government. Billions of dollars are being spent on uncoordinated efforts to upgrade accounting systems which have routinely failed to meet their objectives. I am concerned about our government's inability to effectively hold federal managers accountable for their financial activities, generally because we lack essential financial data.

I am also concerned about our continued reliance on antiquated systems that do not provide the information required for effective management, program, funding, and revenue-generating decisionmaking. We can no longer afford to rely on systems and concepts that do not provide the financial information and accountability needed by the Congress, federal managers, and the public.

I know that you share my concern over the government's lack of effective financial management and accountability as evidenced by your strong leadership in sponsoring important legislation addressing these problems, including the Financial Integrity Act, the Single Audit Act, the Inspector General Act, the Prompt Pay Act, and the Debt Collection Act. Your leadership is needed once again.

ATTACHMENT V

We must build on these past legislative initiatives to continue improving federal financial management. I believe that improvement, if it is to be effective and lasting, must be guided by a cohesive framework under centralized leadership and must provide accountability and discipline. Agencywide and, ultimately, governmentwide financial statements and the performance of annual financial audits will provide this accountability and discipline. The financial management leadership must be capable of developing an overall plan of action which clearly defines objectives, and, equally important, this leadership must be capable of implementing that plan.

System improvement will not come about overnight. It is therefore crucial that the reform initiative be started promptly and have the assurance of continuity of its leadership, purpose, and approach across successive administrations. To achieve this, a financial management leadership structure must be legislatively mandated rather than left to ad hoc groups or initiatives.

Experience has shown that major federal management reform of any kind is more likely to succeed if it has a legislative underpinning. Consequently, we drafted the attached bill to address the long-standing financial management problems.

Very briefly, the bill provides for

(1) centralized leadership that is responsible for developing and implementing a governmentwide plan for improving financial management systems and reporting annually on the plan's progress,

(2) corresponding financial management leadership in executive branch departments and agencies, and

(3) annual preparation and audit of agency and governmentwide financial statements to foster accountability and system integrity.

I believe this legislation will enable us to more effectively manage and control the federal government's financial activities, will begin to restore the accountability and credibility of our government to the public, and will result in measurable monetary savings to the government of billions of dollars.

I am sending you our draft bill for your consideration because of your long-standing leadership in this area. I am also sending a copy of our draft bill today to the Chairman, Senate Committee on Governmental Affairs. I would be pleased to work with you concerning this bill and would appreciate the opportunity to meet with you in the near future to discuss these important issues.

Sincerely yours,

Charles A. Bowsher

Charles A. Bowsher
Comptroller General
of the United States

Enclosures - 2

Note: This letter was also sent to the Chairman, Senate Governmental Affairs Committee.