CAPITAL BUDGETING

HEARING

BEFORE THE

SUBCOMMITTEE ON GOVERNMENT MANAGEMENT, INFORMATION, AND TECHNOLOGY

OF THE

COMMITTEE ON GOVERNMENT REFORM AND OVERSIGHT HOUSE OF REPRESENTATIVES

ONE HUNDRED FOURTH CONGRESS

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104th CONGRESS

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1st Session

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ERRATUM

On both the Title Page and the Contents Page—Change "March 8, 1995" to "March 2, 1995".

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CAPITAL BUDGETING

THURSDAY, MARCH 2, 1995

HOUSE OF REPRESENTATIVES,
SUBCOMMITTEE ON GOVERNMENT MANAGEMENT,
INFORMATION, AND TECHNOLOGY,
COMMITTEE ON GOVERNMENT REFORM AND OVERSIGHT,
Washington, DC.

The subcommittee met, pursuant to notice, at 2 p.m., in room 2154, Rayburn House Office Building, Hon. Stephen Horn (chairman of the subcommittee) presiding.

Present: Representatives Horn, Flanagan, Davis, Bass, Clinger, Maloney, Mascara, and Wise.

Staff present: J. Russell George, staff director; Mark Brasher and Anna D. Gowans Young, professional staff members; and Andrew G. Richardson, clerk.

Mr. HORN. The Subcommittee on Government Management, Information, and Technology will convene.

We have with us today the chairman of the full committee, Mr. Clinger of Pennsylvania, and I would like him to make the first opening statement.

Mr. CLINGER. Thank you very much, Mr. Chairman, and I very much appreciate you holding today's hearing. I look forward to this hearing as a first in a series of discussions on an issue which I have long championed: the creation of a unified Federal capital operating budget.

The concept of capital budgeting is very simple. It is nothing more than a planning device, relied upon by business leaders and many State and local officials, to help prioritize spending for the future. A properly implemented capital budget would enhance the usefulness of the budget as an overall reporting, control, accounting, priority setting, and fiscal policy tool. It affirms what we all know, that capital is a vital but limited resource, and that capital budgeting promotes the development of long-term strategies to ensure that future infrastructure needs will be met.

In my view, the benefits of a capital budget include; first, its assistance in encouraging greater focus on our Nation's deteriorating physical assets to permit more rational investment decisionmaking; second, the promotion of intergenerational equity by burdening future generations with debt solely for assets that provide future tangible benefits; and third, encourage the unbiased treatment of capital activities by revising budget inequities which currently require front-end loading of capital costs.

In addition, a unified capital budget can help us to better assess what we mean by a balanced budget and to determine whether current Federal bookkeeping practices accurately reflect both short and long-term budget goals.

I am always frustrated by the lack of information inherent in our current budget process. Cuts are displayed agency by agency, program by program, or function by function. Yet there is generally no differentiation in the substance of the cuts. We fail to show whether cuts are one-time reductions in an agency's operating expenses or whether they reflect significant reductions in investment spending which must be recouped later to prevent unsustainable infrastructure loss. Similar information is lacking about our spending priorities. We fail to assess to what extent we are investing in assets, consumables, operating expenses, and human development programs. The current budget process makes no distinction and little sense.

A unified capital budget would simply help us to better plan for the future. It is not a gimmick, and contrary to some assertions, it would not permit excess spending to be hidden from public view. It would simply identify and promote well-reasoned planning for two very fundamental and distinct economic activities: spending on assets and spending on operations.

So as a strong advocate of responsible capital budgeting, I encourage all our Members to listen carefully to today's testimony and join me together with our colleague, Bob Wise, in supporting H.R. 767 to provide for a unified capital budget.

I want to welcome our colleague, Mr. Mineta, who has long been interested in this and Mr. Thornton, who has also been a champion for this concept. It is one we all worked on both in this committee and the former Public Works Committee, now the Infrastructure and Transportation Committee. I think we all recognize it could really make a tremendous contribution to our ability to control our budget.

I know that we have trouble convincing Directors of the awesome Office of Management and Budget to see the wisdom of this course, but I am hopeful that this time we will have better luck.

Mr. Chairman, again, I thank you for holding these hearings. I think it is a start of what I hope will be a successful journey that has been underway now, at least in my regard, for 16 years.

Mr. HORN. Thank you very much, Mr. Chairman.

Now I would like to ask the ranking minority member, Representative Maloney, for an opening statement.

Mrs. MALONEY. Thank you, Chairman Horn.

I want to thank Chairman Clinger for his leadership and hard work on this. Capital budgeting is an area that has a great deal of bipartisan support. In fact, my opening statement is very similar to his. So I am going to ask permission to have it submitted for the record, along with other Members, Chairwoman Collins and others that are members of this committee, part of the permanent record.

And we have a distinguished set of witnesses. I am looking forward to hearing what they have to say. I know what I am going to say, so I want to hear what they have to say. I might mention we have a witness from the city of New York which has used capital budgeting very successfully in the strategic planning and investment and infrastructure of the city.

Thank you, Mr. Chairman.

[The prepared statements of Hon. Carolyn B. Maloney, Hon. Michael P. Flanagan, Hon. Cardiss Collins, and Hon. Bud Shuster follow:]

PREPARED STATEMENT OF HON. CAROLYN B. MALONEY, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF NEW YORK

Mr. Chairman, thank you for holding this hearing on capital budgeting. It is always useful to examine the operation of the budget process and to look for constructive improvements. I am especially pleased that we have several witnesses present from local government, including New York City, which have employed capital budgeting.

Local governments cannot print money and incur debt the same way the Federal government can and therefore operate under serious fiscal constraints. They have to rely increasingly on their own resources and less on help from the Federal government. We can all learn from the tough choices that they have to make.

I am open to the idea of establishing a more explicit capital budget at the Federal level, assuming we can properly define what constitutes capital expenditures. Capital budgeting can work if it is structured to help congress and the President make choices which increase long-term national productivity and our stock of capital assets. It can help us set priorities and choose between competing capital assets chasing scarce funds. But it won't work if it is treated as a gimmick used to shelter too much of the budget from the hard fiscal choices we have to make.

A capital budget can work as a long-range planning tool, and as a means to make difficult choices within the national budget. We have allowed our national infrastructure to decay, and we have not planned for future needs to the degree necessary. We have too often chosen the quick fix, in preference to some of the major decisions we should make about our highways, rail systems, bridges and aviation system.

I want to commend Chairman Clinger, Congressman Wise and others for introducing legislation which attempts to apply capital budgeting at the Federal level. I understand that we may deal with that legislation more specifically at a future hearing, once members gain a better understanding of the concepts and the controversies involved.

Based on what I have seen, I am not sure that I agree with all of the suggestions that have been made as to what might constitute capital expenditures. We can probably agree that they include things like roads, bridges and mass transport. However, I would be very skeptical about including items such as defense and weapons systems. A useful capital budget would enhance our ability to understand the budget and make hard choices. It is not one which includes most of the old budget under a new name.

Thank you again Mr. Chairman.

PREPARED STATEMENT OF HON. MICHAEL P. FLANAGAN, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF ILLINOIS

Thank you Chairman Horn. I am looking forward to working toward a better understanding of how the capital budgeting process works in Fairfax County as well as New York City and how the federal government might benefit from a similar process. We all have a stake in public facilities that operate well and at the same time are cost effective to deliver. I understand the difficulty in combining these two qualities and congratulate Fairfax County and New York City on their success.

I am particularly interested in how adopting a capital budgeting process helps balance a budget, be it a city budget, county budget or a federal budget and how effectively capital budgeting can be defined when applied to the federal government. My concerns regarding capital budgeting include placing constraints on debt levels of the federal government before we implement capital budgeting and what is the appropriate entity to decide on these constraints. I am also conscious of capital budgeting being used as a tool to mask deficit numbers for political purposes.

That said, I certainly agree with the notion of projecting cost in anticipation of budgeting concerns and strongly believe in a balanced federal budget. Therefore, I am looking forward to learning more about the capital budgeting process and how it will work to make the federal government run more efficiently.

I thank Chairman Horn for holding this hearing as well as the witnesses for taking the time to better inform us on this complex issue.

STATEMENT OF HON. CARDISS COLLINS, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF ILLINOIS

Mr. Chairman, I welcome this opportunity to discuss once again the issue of capital budgeting. Over the past decade, we have tried many approaches to our methods of budgeting, but we have had limited success.

For example, we have had Gramm-Rudman. We have had "pay as you go". Just recently, the House passed a version of a line-item veto, which I believe raises serious Constitutional problems.

Most importantly, a few weeks ago, the House passed the most extreme proposal, the balanced budget amendment. I, therefore, must wonder whether the issue of capital budgeting may be coming too late.

During the consideration of that amendment, Congressman Wise offered a proposal to use capital budgeting as the basis for a balanced budget. The proposal failed, and we may soon be locked into a constitutionally mandated balanced budget that fails to distinguish between investments in our future and payments for current operating costs.

I cannot help but ask what the ultimate point of the subcommittee's work here today is expected to be. Unfortunately, decisions have already been made concerning the budget. We appear to be closing the barn door after the horses have left.

Hearings on capital budgeting are exactly the sort of hearings that should have been held prior to the rushed consideration of the balanced budget amendment. Yet I am sure that the Judiciary Committee gave it little thought before it brought the balanced budget amendment to the Floor.

Recently, the Human Resources and Intergovernmental Relations Subcommittee has been conducting hearings on restructuring HUD and HHS. However, before they could draw any conclusions, the Appropriations Committee made massive cuts at these two agencies, foreclosing any thoughtful approach to downsizing activities.

Similarly, it seems a bit unreal to be discussing capital budgeting, and its primary purpose of encouraging long term investment rather than operating costs, at the same time the Appropriations Committee is doing just the opposite.

Let us think for a moment about some of these cuts: the Summer Youth Employment and Training program, assistance to educationally disadvantaged children, and the Safe and Drug Free Schools Act. These are all important investment programs. They are investments in our children, the human capital of this country.

Similarly, there have been enormous cuts in our infrastructure, particularly at HUD, where its budget has been brutally slashed, and its ability to provide the minimum necessities of housing for those in need has been made impossible.

I commend Chairman Clinger in particular for his interest in the use of capital budgeting to direct our spending toward investment. I note that he was the only Republican to support the Wise substitute to the balanced budget amendment, to establish a separate capital budget.

However, I cannot help but believe that these thoughtful approaches to budgeting are being rendered irrelevant by the mad 100 day dash to pass a balanced budget amendment, a line-item veto, and draconian appropriation rescissions to finance a capital gains tax cut.

The new Republican agenda seems to based on a novel approach to legislation: Act first. Think later.

STATEMENT OF HON. BUD SHUSTER, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF PENNSYLVANIA

The current Federal budget process has failed this nation in its treatment of investments. Specifically, the process does not recognize both the economic value of infrastructure investments and their unique funding mechanisms.

In its failure to achieve a balanced budget, the Federal Government is often compared to a household, business, or state government, each of whom must balance a budget. A closer look at how households, businesses, or states balance their budgets, however, proves the absurdity of the current budget process.

Households commonly take out large loans for a home mortgage or education loan—in other words, capital expenditures. A business must balance its books, but it also has the option of borrowing for assets that will provide a positive economic return over time. Similarly, while states must balance their budgets, some 37 states utilize a capital budget.

I am not suggesting that a capital budget be used to justify deficit spending, but I do believe it is obvious that capital budgeting would be a highly useful tool to improve budgeting decisions. While I support efforts to cut spending, the current process makes no distinction between cuts in wasteful programs and investments in our economic future.

Over the long run, a focus on reallocating spending toward infrastructure investments will help lower the budget deficit. In terms of Federal spending programs, the government can best promote economic growth by making investments that improve the productivity of the private sector and create jobs.

Numerous economic studies have documented the link between carefully targeted increases in infrastructure spending and increases in private sector productivity. For example, testimony before the Transportation and Infrastructure Committee found that: if, since 1970, the U.S. had maintained the 1950s and 1960s share of GNP for core infrastructure (roads, bridges, airports, water and sewer systems, etc.), productivity growth would have been 50 percent higher.

Transportation and other infrastructure investments add value. Reduced travel time and improved safety benefit the entire economy since it allows every business and individual to operate more efficiently. This is the proper role of government—making infrastructure improvements that would not otherwise be made by the private sector but are critical to our economy. These investments that add long-term value should not be treated the same for budget purposes as operating expenditures.

Congestion takes a terrible toll on the nation's economy. In major urban areas it is estimated to cost $40 billion yearly. An efficient transportation system is central to lean production and just-in-time manufacturing. By 1995, more than half of the nation's manufacturers will use just-in-time delivery. In a similar vein, businesses cannot grow and create jobs if there is an inadequate water and sewer infrastructure to support expansion.

With the globalization of the world's economy, our economic prosperity will depend on our ability to export goods and services on a competitive basis. To achieve export-based growth, adequate infrastructure must be in place.

Our economic competitors recognize this fact, and are increasing their infrastructure investments. In 1992, Japan's investment in infrastructure as a percent of its GDP was roughly three times that of the United States. Of all the G-7 countries, the United States was last both in public infrastructure investment and productivity growth from 1978 to 1990.

A review of actual Federal spending trends for infrastructure demonstrates the failure of the current process. Public investment in infrastructure fell from nearly 2.0 percent of the GDP in 1959 to a little over one percent today. As a share of the total federal budget, infrastructure investment dropped from 4.0 percent in 1959 to 2.1 percent today.

While America spends nearly $1 trillion dollars annually on transportation and transportation services, representing 17 percent of the gross domestic product, there are billions of dollars of unmet infrastructure needs.

Nearly one-fourth of our highways are in poor or mediocre condition, with another 36 percent rated only fair. More than 70 percent of peak-hour travel on urban interstates occurs under congested or severely congested conditions, compared to 55 percent in 1983. The cost to eliminate the existing backlog of highway deficiencies is approximately $212 billion.

One out of three bridges is rated structurally deficient or functionally obsolete and needs major improvements ranging from deck replacements to complete reconstruction. The cost to eliminate all backlogged bridge deficiencies is approximately $78 billion.

For public transit, almost one-fourth of the Nation's rail transit facilities are in poor condition, and one-fifth of transit buses must be replaced as soon as possible. Additional investment of as much as $11 billion every year is needed to improve the Nation's transportation systems so they can provide adequate service throughout urban, suburban, and rural areas.

By the year 2003, at least 32 large U.S. airports will suffer delays of more than 20,000 hours a year, up from 23 currently delay-plagued airports. The delays that exist today throughout our aviation system cost our economy as much as $6 billion every year. It will cost $30 billion in capacity improvements to meet the projected demand.

The Nation's inland waterways contain a series of outdated and antiquated locks and dams that hinder the movement of coal, grain, and other bulk products. In 1990, 10 locks on the inland waterway system averaged more than three hours of delays per barge tow, while many other locks had lesser delays. With the use of the inland waterway system expected to increase each year, delays are likely to continue to rise.

Immediate construction needs for the inland waterway system could reach as much as $4.3 billion, but we are currently investing at a pace that will see us falling further behind these needs. Additional investment of hundreds of millions of dollars will be needed each year for modernization and replacement of the Nation's locks and dams to meet the demands of the inland waterway system.

Our environmental infrastructure is also facing severe deterioration because of substantial underfunding. More than 20 years after the passage of the Federal Water Pollution Control Act of 1972, our wastewater treatment infrastructure remains inadequate to the task of cleaning up the Nation's waters.

The Nation's total sewage treatment needs are estimated to be a minimum of $137 billion, and a shortfall of $62 billion in unmet needs is projected by the end of the decade. The needs are especially urgent for metropolitan areas trying to remedy the problem of combined sewer overflows and small communities lacking independent financing ability.

To pay for certain infrastructure improvements, the Transportation and Infrastructure Committee, over time, has established a series of trust funds to collect user fees and then spend those funds on capital improvements. Specifically, the funds are the Highway Trust Fund, the Airport and Airways Trust Fund, the Inland Waterways Trust Fund, and the Harbor Maintenance Trust Fund.

Each of these trust funds was established with a specific contract between the government and the user. This contract specified that certain user fees would be levied on the users of highways, airports, inland waterways, and ports. In return, the government pledged to use the receipts to build transportation infrastructure for the taxpayer's use.

Unfortunately, the Federal government has violated this contract with transportation users. Each of the four trust funds carries a large cash balance. These balances represent taxes paid by users that are being held by the Federal government to mask the true size of the deficit.

For the Highway Trust Fund, the balance of unspent funds is nearly $20 billion. The Aviation Trust Fund cash balance is over $12 billion; the Inland Waterways balance is $220 million; and the Harbor Maintenance balance is $450 million. These surpluses show that the current budget process does not recognize the unique nature of these funds and the value of capital investments.

Despite the fiduciary responsibility the Federal government has undertaken in establishing these trust funds, large balances have built up because spending out of the funds is artificially held down to mask the size of the operating deficit. In effect, these deficit proof, pay-as-you-go programs are cut back to finance other programs, funded out of general revenues, that are the true cause of the deficit.

To rectify this breach of promise with the American taxpayer, the leadership of the Transportation and Infrastructure Committee has introduced H.R. 842, the Truth in Budgeting Act. H.R. 842 would remove the four transportation trust funds from the unified budget and free up available balances to meet our infrastructure needs.

In considering capital budget proposals, I urge this Committee to consider the unique nature of the transportation trust funds. While the focus of H.R. 842 is to take the trust funds off-budget, various capital budgeting proposals are compatible with the goal of H.R. 842—which is to spend the earmarked taxes collected to pay for infrastructure improvements.

As this Committee is well aware, last session of Congress the Transportation and Infrastructure Committee held two days of hearings on capital budgeting and reported a capital budget proposal, based on the bill introduced by Chairman Clinger, to the floor as part of H.R. 3400, the Penny-Kasich budget bill. The Committee's provision was eventually stripped out of the omnibus bill in the Rules Committee.

In conclusion, as I noted previously, the Transportation and Infrastructure Committee currently has placed a priority on taking the transportation trust funds off-budget. The goals of this off-budget legislation are similar to those expressed by capital budget proponents and I recommend that the Government Reform and Oversight Committee look favorably upon H.R. 842. I support the concept of capital budgeting and I look forward to working with the Government Reform and Oversight Committee to achieve a capital budget, without adversely affecting the deficit.

Mr. HORN. Thank you very much.

Over four-and-a-half decades ago in 1949, as most of us know, the first Hoover Commission on reorganizing the executive branch of the Federal Government recommended the adoption of capital budgeting.

Applying the capital budgeting techniques widely practiced by State and local governments, universities, and the private sector would enable the Federal Government to better target its scarce dollars allocated to infrastructure. Incorporating this planning information in the annual budgeting process is essential.

The President's budget documents show capital investments as an afterthought for informational purposes in the appendix. We need to move the capital decision process into the beginning of the process, into the planning stage. That is what every good effective local government, university, and private firm does to benefit its citizens and shareholders. So should the Federal Government.

Capital budgets can have their pitfalls. Some have attempted to widen the definition of capital to include a large number of social programs that are not always associated with a particular asset. Although it is worthy of consideration, this gimmickry sometimes has damaged the bond ratings of several large municipalities and discredited the notion of capital budgeting. However, incorporating capital budgeting into the planning process is crucial and we should avoid this type of abuse in doing so.

I look forward to hearing the testimony of our witnesses. We are delighted to have two distinguished Members of Congress open this hearing this afternoon. First, I would like to ask Mr. Norman Mineta, the distinguished ranking member and former chairman of the Committee on Transportation and Infrastructure, former mayor of San Jose, CA, and a very distinguished public servant to begin the testimony.

STATEMENT OF THE HON. NORMAN Y. MINETA, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF CALIFORNIA

Mr. MINETA. Thank you very much, Mr. Chairman. I really appreciate this opportunity to appear before you and the members of the subcommittee.

At the outset, let me commend you, Mr. Chairman, for calling this hearing. Let me also commend you for your continued support as a fellow colleague on the Committee on Transportation and Infrastructure regarding the importance of physical investments to our Nation's long-term economic vitality.

I would also like to pay special recognition to the very distinguished ranking Democratic member of the subcommittee, Mrs. Maloney of New York, who as a member of the New York City Council for 10 years has had good firsthand experience with capital budgeting at the local level.

Last, I am pleased that we are joined by the two real leaders in the House on the issue of capital budgeting. First, Chairman Clinger and our colleague Congressman Wise who presently is not here, but in any event, both of these Members have championed the cause of capital budgeting over a long period of time. They have introduced bills, they have held hearings, they have sponsored symposiums. They have lobbied the White House and done just about everything you can think of in promoting this issue. And so in my book, Mr. Chairman, they are to be commended for their leadership.

Mr. Chairman, Federal programs come in many shapes and sizes. Dollars are spent for highways, Federal salaries, health benefits and foreign aid, just to name a few. These are different programs, with different purposes, with different needs, and with different impacts on the economy.

Yet under the Federal Government's unified budget, there is no distinction that is made between $1 spent for investing in our Nation's physical infrastructure and $1 spent to cover day-to-day operating expenses. That is, money spent for salaries, foreign aid, transfer payments. These are all accounted for in the same way as money spent on highways, transit, water treatment facilities, and other physical infrastructure.

But indeed, they are not the same. As I said, they have very different impacts on our economy. Capital investments enhance our productivity, efficiency, and standard of living. Consumption and operations meet day-to-day needs but leave no discernible long-term legacy.

Many argue that our current method of accounting biases pending decisions against physical infrastructure by requiring infrastructure to be paid for all at once rather than during its useful life. Thus, infrastructure investments are not judged on their long-term economic return but rather on a distorted view of their up front impact.

Now, the concept of a Federal capital budget is not new. The Federal budget itself was expanded in the 1950's to include information on investment spending. Reform in the 1980's required even more investment information in the unified budget, as evidenced by inclusion of special analysis D, at Chairman Clinger's urging, as part of the Federal budget. And the most recent strong endorsement of capital budgeting came from Vice President Gore's National Performance Review. Earlier, the National Council on Public Works Improvement also recommended capital budgeting, as did the Competitiveness Policy Council.

Now, many other industrialized countries have gone further than we have in employing a capital budgeting system. Most of our municipalities and States, in fact, 49 according to the National Conference of State Legislatures, distinguish in some way between spending for capital investments and spending for operating expenses, either through a capital budget or investment account that charges depreciation to the operating budget or by issuing bonds and making payments on an annual basis. Such a system reflects the fact that while undifferentiated borrowing is harmful, borrowing for selected investments such as infrastructure that contribute to long-term economic growth can have economic justification.

Businesses also know the difference between borrowing to consume and borrowing to invest. Borrowing is a smart move when the money is used to finance productive investments that help a business modernize its equipment, expand, or become more profitable. But borrowing money to pay salaries or executive bonuses or to send employees to expensive conferences rather than to modernize would be foolish.

And I believe it is time the Federal Government organize its budgetary affairs on the same sensible basis as State governments and private businesses.

By borrowing for current expenses, the government is asking future generations of taxpayers to pay for the cost of running the government today. But borrowing to invest is different. If the government passes part of the cost of building a road to future taxpayers, it also gives them something in return: a new highway that will encourage economic development, facilitate commerce, and increase economic growth for years to come.

Remember, infrastructure is not just potholes; it is productivity. It is not just concrete; it is competitiveness.

Instituting a capital budget would force policymakers to decide whether or not each investment is worth borrowing money to finance. In addition, the public would benefit from knowing that the government's current costs are being paid for and that any borrowing is for investments in the future rather than for paying for the present and saddling future generations with the bad debt.

Everyone agrees that the United States must make investments that are critical to future economic growth. Rather than going from crisis to crisis, the Federal Government should have an institutionalized system of long-term investment planning. Adopting a Federal capital budget, Mr. Chairman, would provide such a mechanism and this subcommittee indeed could help make it happen.

Thank you very much.

Mr. HORN. Thank you very much, Representative Mineta. Let me ask you, are you able to stay with us so we can have Mr. Thornton speak and then question both of you? Five minutes is essentially what it is going to be.

I am delighted to introduce now Representative Ray Thornton of Arkansas, the only gentleman that has been president of both the University of Arkansas and Arkansas State University. That's a distinction. It is difficult enough to head one institution but not two and we are delighted to welcome this very constructive Member here.

STATEMENT OF THE HON. RAY THORNTON, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF ARKANSAS

Mr. THORNTON. Thank you very much, Mr. Chairman.

I have shared with you that the reason I left the presidency of the university to return to Congress was because I got tired of all the politics. And I am sure that as President of Cal State, you know that there is a great deal of politics involved in academia.

Mr. HORN. I have told that story about 100 times since Ray told me and I refuse to pay him royalties on it. It is the best line I know.

Mr. THORNTON. But we do have something in common at our universities that needs to be reflected in this very important discussion and I want to commend you, Mr. Chairman, Mrs. Maloney, for your leadership in bringing this matter forward to hearing but especially Chairman Clinger and Bob Wise for their leadership in the effort toward capital budgeting.

The United States of America is possibly the only institution in the world that does not recognize the difference between an investment for the future and current operating expenses. And this leads to a distortion and inability to make wise choices, because when you are weighing against each other a current operating expense against a huge expenditure for an interstate highway system or for an airport or for the education of a contingent of people like the GI bill, anything that a family would borrow money for, a family understands this.

And I want to commend my colleague, Mr. Mineta, for his splendid presentation. He mentioned that all States—virtually all, 49. I don't know about the other one. I know it is not Arkansas because we have a form of capital budgeting in Arkansas that allows us to borrow money for the construction of hospitals and for higher education and public schools and for highways and other improvements both in human and physical infrastructure, human and physical capital. And we distinguish between that and the operating expenses of salaries.

There is a difference, Mr. Chairman, between the money for a new engineering laboratory that cost several million dollars and the payment of salaries to staff to clean the laboratory. One is operations. The other is an investment. It would be terrible if you had to take out of this year's operating funds your investment for technology that would be useful for many years in the future. And this distortion has really wrecked havoc upon making wise choices as we go into the very difficult task of setting priorities for our Nation.

May I ask that my formal remarks be made a part of the record?

Mr. HORN. Absolutely.

Mr. THORNTON. I am just free wheeling here.

Mr. HORN. I turned the light on when I noticed you were taking off there, Ray. We are delighted to put the full statement in, so go ahead. Don't interrupt yourself. You are on a roll there.

Mr. THORNTON. Well, I think it is just critically important to recognize that we are in a competitive world. That this country is not an island existing by itself, that we are in competition with formidle economic adversaries and we need to make wise choices to make sure that we maintain our strength for the future and in recent years our investments in future productivity have been declining as a share of our Nation's budget. And that I think is leading to difficulty in maintaining our capability to act competitively with other nations.

The thing that we need to try to do is to understand clearly the choices we are making. My granddad told me the story that I have shared with my friend Bob Wise that a family that is head over heels in debt can't borrow their way out of debt. But neither can they starve their way out of debt. His remark was you had to work your way out of debt.

The way you work your way out of debt is by making wise choices: investing in plants if you were a corporation. If you are a family, you don't borrow money for an ice cream cone or for groceries or for day-to-day expenses, but you don't hesitate to borrow money for a new home, to take a mortgage out on that home as long as you can pay the amortization of it. You don't hesitate to borrow money to educate your children.

The experience of this country following World War II was that for every $1 we spent on the GI bill, the United States of America realized in increased taxes on the income that those educated servicemen and women earned a return minimum of $7 per $1 invested.

There are some figures that indicate it may have been as high as $12. The most conservative is $7 return for every $1 spent on the human capital of a well-educated citizenry. And that is the secret to our competitiveness.

The only additional thing that my bill H.R. 1109 brings to the table is the recognition that an investment in infrastructure should include an investment in human infrastructure as well. That makes some difficult allocations, but it is possible to measure what kind of return you get from an investment.

And my addition to this discussion is that we should consider human capital as well as physical capital as we go into this. It may be that we need to have a commission outline the exact, precise differences because some people are very concerned about the difficulty of measuring an investment in the human mind, but no matter how difficult it is, Mr. Chairman, I think it is an essential part of this debate.

[The prepared statement of Mr. Thornton follows:]

PREPARED STATEMENT OF HON. RAY THORNTON, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF ARKANSAS

As Congress begins to set budget priorities for the coming year and consider a variety of deficit reduction measures, we are faced with an increasingly urgent need for fiscal responsibility and restraint. Congress has taken steps toward dealing with spiraling deficits through spending caps, discretionary cuts, and tax increases, but cutting and taxing are not going to be enough.

My grandfather used to say that if a family gets deeply into debt, they cannot borrow their way out of debt, nor can they starve their way out of debt; they must work their way out of debt—increase their productivity. On the national level, when unemployment is down and investment is up, the deficit situation improves. For too long, we have ignored investment in growth and productivity as a key component of deficit reduction.

My home state of Arkansas has, for most of this century, managed on a balanced budget. Its Arkansas Revenue Stabilization Act, by statute, requires that operating expenses be reduced to equal the actual revenues available during any given year. For many years, I have urged that the federal government adopt our approach.

Of course, Arkansas has recognized that investments in the future should not be confused with spending for current operations. Providing gasoline for a police cruiser is a current operational expense, but building a jail to restrain hardened criminals is an investment that provides value for many years. My state does not prohibit borrowing money for construction of prisons or highways or for building hospitals or public schools. Arkansas was one of the first states to invest in economic development and jobs by issuing bonds to build industrial facilities and provide equipment.

It is time that we learn from the American people. They know the difference between current expenditures and an investment in the future. Most families who prudently balance their budgets would not borrow money for groceries, telephone bills, entertainment, or other on-going, consumptive expenses, but they would certainly consider assuming a mortgage to buy a home or borrowing to buy a truck or to educate their children. That reasonable standard is appropriate for our nation. Why should we run the country differently than we run our households and businesses?

In my state, as in much of our region, surviving economically has meant having to work harder with fewer resources—a situation not unlike the fiscal climate Congress is facing today. In Arkansas, while balancing our operating budget each year, we do not hesitate to make investments in the factors that contribute to long-term economic growth—education and worker training, a sound infrastructure, and research and development capabilities that spawn commercial activity.

The objective of enhancing long-term economic growth for our nation is not well-served by a budget process focused on short-term results. The existing presentation of the federal budget obscures the distinctions between current consumptive spending and long-term capital investments or expenditures of a developmental character.

That is why I have introduced H.R. 1109, the Capital Budgeting Act, which addresses the need for improved budgetary information to clarify our choices of expenditure. My colleague, Bob Wise from West Virginia has proposed a similar measure.

The Capital Budgeting Act would require that the budget submitted to Congress by the President be a unified budget comprising an operating budget and an investment budget for each of the three major components of the budget—general funds, trust funds, and enterprise funds.

The investment budget set forth in my proposal would represent only the major activities and programs which support the acquisition, construction, and rehabilitation of investment assets and which support education and job training and investments in research and development. All other activities, project, and programs would be presented in the operating budget.

As Congress looks for ways to allocate federal funds more responsibly, a capital budget would ensure a continued focus on the government's total financial operations, while providing better and more relevant information upon which to base both overall fiscal policy as well as program priorities within the federal budget.

H.R. 1109

A BILL

To improve budgetary information by requiring that the unified budget presented by the President contain information which facilitates consideration of choices between spending which is consumption oriented, spending which is of a development character, and spending which is in the nature of a capital investment, and for other purposes.

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled,

SECTION 1. SHORT TITLE.

This Act may be cited as the "Capital Budgeting Act of 1995".

SEC. 2. STATEMENT OF FINDINGS AND PURPOSE.

(a) STATEMENT OF FINDING.—The Congress finds that—

(1) the objective of enhancing long-term economic growth is not well served by a budget process focused on short-term results,

(2) long-term economic growth depends not only upon a stable social, political, and economic environment and a higher level of national savings, but also upon a sound public infrastructure, an educated citizenry and workforce, an investment in research and the discovery of knowledge, and the harnessing of inventive genius into the workplace and market place,

(3) the existing presentation of the Federal Budget obscures the distinctions between long-term capital investments, expenditures of a developmental character, and current operational spending, and

(4) the public interest will be served by a Federal Budget presentation which presents information showing long-term effects of expenditures.

(b) PURPOSE.—It is the purpose of this Act to require that the unified budget present—

(1) an operating budget, and

(2) an investment budget divided into—

(A) federally-owned capital, and

(B) developmental investments,

for each of the major components of the budget (general, trust, and enterprise funds) in order to ensure a continued focus on the Government's total financial operations, while providing better and more relevant information upon which to base both overall fiscal policy as well as program priorities within the Federal Budget.

SEC. 3. CAPITAL AND OPERATING BUDGETS.

(a) IN GENERAL.—Title 31, United States Code, is amended by inserting after section 1105 the following new section:

"SEC. 1105A. CAPITAL AND OPERATING BUDGETS.

"(a)(1) The budget of the United States submitted by the President under section 1105 of this title shall be a unified budget composed of—

"(A) an operating budget, and

"(B) an investment budget divided into federally-owned capital and developmental investments.

"(2) Operating and investment budgets shall be presented separately for unified funds, general funds, trust funds, and enterprise funds.

"(b)(1) Actual, estimated, and proposed amounts shall be presented for unified funds, general funds, trust funds, and enterprise funds, and, at a minimum, shall contain:

"(A) For the operating budget:

"(i) Operating revenues.

"(ii) Operating expenses.

"(iii) Operating surplus/deficit before interfund transfers.
"(iv) Interfund transfers.
"(v) Operating surplus/deficit.
"(vi) Federal expenditures financing the operating expenses of State and local governments.

"(B) For the investment budget:

"(i) For federally-owned capital: the office buildings, equipment, and other assets that are owned by the Government for use in its operations together with a showing how such assets will improve the efficiency and effectiveness with which government agencies carry out their missions.

"(ii) For developmental investments (including grants and loans to non-Federal entities for improving physical infrastructure, research and development, and investment in human capital through education and training): the amounts to be invested together with a projection of how such investments will improve the prospects for higher rates of economic growth on the future.

"(2) For both categories of investment budgets, the following information will be presented:

"(A) Investment funds together with investment revenues.
"(B) Financing requirements before interfund transfers.
"(C) Interfund transfers.
"(D) Projected effects upon economic growth.

"(3) The investment budget shall represent only the major activities, projects, and programs which support the acquisition, construction, alteration, and rehabilitation of such investment assets and the major programs and activities which support non-military research and development, education, and job training. All other activities, projects, and programs shall be represented in the operating budget.".

(b) CLERICAL AMENDMENT.—The table of sections for chapter 11 of title 31, United States Code, is amended by inserting after the item relating to section 1105 the following new item:

"1105A. Capital and operating budgets."

Mr. HORN. Thank you very much, Representative Thornton.

I would like to ask Chairman Clinger if he would like to begin the questioning.

Mr. CLINGER. Thank you very much, Mr. Chairman.

I thank both of our witnesses for their very fine testimony and for their understanding of what we are trying to accomplish with this legislation. As I mentioned in my opening statement, we have always had difficulty convincing Directors of the Office of Management and Budget of the wisdom of this approach. I should point out at the outset we are not talking about a separate and distinct capital budget, we are talking about a capital budget within the unified budget so we are not losing what we see as a raid upon the unified budget concept.

The thing I wonder if you could respond to is that the argument that is made, whether it is Mr. Schules or David Stockman or Dick Darman or Alice Rivlen, is that you are going to fence off a whole segment of spending here and you are going to build a constituency and it is just going to be a device to use to hype more increased spending on these sorts of things. You are going to insulate this whole thing and it is going to be very difficult to make the kind of cuts that are necessary.

Do you think that is a valid criticism of the concept of capital budgeting?

Mr. MINETA. Well, from my perspective, Mr. Chairman, it is not. Of course, I think part of it because I also bring a prejudiced view about it. When I think about a capital budget, I think of physical capital, fixed assets.

Now, we on our committee deal with physical assets that are funded by trust funds, so how can it be any different than, let's say, trust funds that will be doing physical investment as compared to utilizing those trust funds as part of that capital budget? And I don't see the distinction. If they are willing to say, yes, there are user fees that go into a trust fund for the construction of these kinds of physical assets, then it seems to me they ought to be able to recognize that that is in effect a form of capital budgeting. And it doesn't take much more then to expend that in terms of what we ought to be including across the budget throughout the functions of the budget. We should be able to determine those things that ought to go into the capital budget.

I think what happens is that people are afraid that there is some form of ownership there, but again these are funds that are distinctive because you try to make the distinction being the difference between operating money and something that gives you a long-term return.

Mr. CLINGER. I think any Director of the Office of Management and Budget is reluctant to see any ability to move money around. They don't like to have any limitation on their ability to do that and I think that is why they view the capital budget as a threat to their flexibility.

Mr. THORNTON. Mr. Chairman, I think you also hit upon an important point in this discussion when you pointed out that this is not an amendment to moving some funds out of the unified budget but rather obtaining additional information to make choices and calling for a presentation of what kind of income production, what kind of return you have upon investments, that it seems to me is to get the kind of information that decisionmakers then will use to make the decision; and I just don't see any real good argument against gaining the additional information as to the return on capital investments.

Mr. CLINGER. Ray, you obviously raised the critical issue in a debate about capital budgeting. How do you define what is capital? And obviously that is going to be a part of our discussion.

Mr. THORNTON. It will be very difficult.

Mr. CLINGER. I think the bill that I have introduced with Mr. Wise is at the moment very limited in that regard. I think we have felt that the opponents of the capital budget can come at you if they see you are going to try to expand the definition of capital and that has always been an argument against the capital budget in that everybody then will try and get in under the tent to be considered part of capital.

Mr. THORNTON. Certainly, Mr. Clinger, I would support the approach you outlined. I think that is far better than what we now have, but I think it is a mistake not to consider the importance of a new engineering laboratory funded by the National Science Foundation as an investment in the future which has a proven return. It is difficult to draw the line and that may be a political liability of the position that I have.

Mr. CLINGER. That has been the one concern I think that we felt we really had to be very precise in the definition because it made it too big a target for people if we didn't have that. I want to thank both of you for your very helpful testimony and that will clearly be part of the debate how do we define it.

Thank you.

Mr. HORN. Thank you, Mr. Chairman.

Representative Maloney.

Mrs. MALONEY. Well, I would like to thank both of the distinguished panelists for their testimony.

In New York City, we had a very strong capital budget that was planning strategically for the future, what we were going to invest in, where we were going to grow as a city, but it was distinctly different from human investment. That was our operating programmatic budget and I wanted to ask you, Mr. Thornton, you would include investing in people as part of the capital budget, is that what you said?

Mr. THORNTON. No. My proposal is to address only two elements of human capital. And that is basically the information that allows a human being to be programmed into a higher level of performance and competition and education in being able to do better than the uneducated people in other countries. I do not include expenditures for general support of human beings, of improvements in culture or other activities. It strictly develops the idea that we ought to, as a Nation, consider as capital the same thing that a family does. A family will borrow money to send kids to college or to medical school because they believe with some merit that a doctor upon graduation from medical school will have a very productive life and will contribute a great deal to society.

Mrs. MALONEY. I would like to ask Mr. Mineta if he agrees?

Mr. MINETA. Mrs. Maloney, I take a more restricted view on this. And I think in terms of to try to get some kind of a start on this thing, I think we ought to try to keep this as restrictive as possible in terms of what is meant by capital investment. What Congressman Thornton is talking about are really good issues. It may be that we ought to be doing that in the future in terms of that longer term investment, again, in education. But I think in terms of where we want to start in order to make our case, I think we should try to keep it relatively strict in interpretation.

Now, your experience in New York City and the people who will testify after me are much more expert in this. But I can recall when I was mayor of San Jose, we heard about something called the Beam shuffle. And what happened was that Mayor Beam was using capital—in fact, it was bond money to not only build a structure, but he was also paying the workmen, I mean, the engineers and everybody else.

Well, you can't do that in a capital budgeting situation because at the end of your 30-year bonds, you are still paying for the labor that you used to design the building 30 years ago. To me, that would be stretching it and I think that is the kind of thing that got New York City into a problem at that time. So I don't want to—I want to see this thing get off the ground. I want to see some successful efforts at it and I think at the beginning we ought to just be very strict as to what we mean by capital investment and I think that that is fixed assets and also one that has rather, you might say, tangible returns that you can measure in the lifetime let's say of that investment.

Mrs. MALONEY. Well, you raised a very good point. That type of budgeting did lead to the fiscal crisis in the seventies and afterwards we created a very strict budgeting system that day-to-day operations in human investments were separated completely and totally from the capital long range investment in the infrastructure of the city. I would like to ask, in Chairman Clinger's bill, whether you agree with some of the areas that he mentions for capital. He has many things that are the same as New York City, roads, bridges, et cetera. But he also has space and communications facilities. Would you agree that that is capital, Chairman Mineta?

Mr. MINETA. Well, again, I think there are productivity gains that you—that are measurable from those kinds of investments.

Mrs. MALONEY. Would you say yes to that?

Mr. MINETA. Yes, I would.

Mrs. MALONEY. Mr. Thornton says yes. Defense facilities and major weapons?

Mr. MINETA. Well, again—I don't know about weapons. I am not sure that I would have, let's say, an M–1 tank or a Bradley fighting vehicle in that sense.

Mrs. MALONEY. What about petroleum reserves and mineral stockpiles? Would that be an infrastructure capital budget item in your opinion?

Mr. MINETA. I would think of that more as an asset rather than—I am not sure in what sense in terms of—in order to build a petroleum reserve and the money that goes into building that petroleum, should that be considered—I guess yes. I guess in that instance, I would say yes.

Mr. THORNTON. Yes.

Mrs. MALONEY. I think the biggest difficulty really is how you define the capital budget and what is a fixed asset and both of you are such distinguished leaders in this body and have so much experience, I would just like to ask if you would try to define it in writing for us later for the record of what should be the capital budget. I am working off the chairman's bill, if you agree with it or not, in the definitions of a condition budget and I yield back the balance of my time.

Mr. CLINGER. Would the gentlelady yield for one question, if I might?

Mr. HORN. Certainly.

Mr. CLINGER. In the bill, we define capital assets meaning physical assets and financial assets, but would not include consumable inventories. In other words, that's why we put in the strategic oil reserves, because that is a financial asset and within our definition of capital assets.

I thank the gentlelady.

Mr. HORN. Thank you very much, Mr. Chairman. Those were excellent questions from Mrs. Maloney.

Let me ask if Mr. Mascara has any questions?

Mr. MASCARA. More of a statement, Mr. Chairman.

I am surprised as we are ready to enter the next century that the Federal Government does not use basic and fundamental accounting principles as it relates to this government. In fact, as a former county commissioner, I was one of the individuals who worked with the National Association of Counties in forming GASB. As an accountant, I worked with FASB, which is the Financial Accounting Standards Board, and now we do have a Government Accounting Standards Board. I say they could give us direction if we want to get into the nitty-gritty of what is an asset, long-term fixed asset, and what you can convert in the accounting business, what you can convert an asset to cash within 90 days is considered a short term asset. But I agree with both the gentlemen. We need to get on with the business of accounting for assets in this government, because I think if you were able to sit down—and I don't know whether we can or not sit down and list every asset. I would say that a Navy vessel that cost $140 million is an asset. It has a life, a distinguishable life and we could amortize that and charge that off, depreciate it just as we do in the private sector and I want to commend the chairman and all of you. And Mr. Wise, because we talked to Mr. Wise about the balanced budget amendment that I was supportive of and I think—you correct me if I am wrong, Mr. Wise—we talked about it, including capital assets as a part of what this government is worth. I think if you look at what we are worth, we are worth a lot more than we owe. If you are borrowing money in the private sector, they look at what you have and what your value is and what your net worth is; and this government is worth a lot of money that we don't have that information on.

Thank you, Mr. Chairman.

Mr. MINETA. Mr. Mascara, I think you will find this Wise bill is a real Clinger.

Mr. WISE. Mr. Chairman, it is also something you can toot your horn about.

Mr. HORN. And there are no Thorntons in it either, I suppose. I now yield to the gentleman from West Virginia. Mr. Wise, a long time expert on capital budgets.

Mr. WISE. Actually, I tell you when I realized I wasn't as much as an expert as I thought was when I started to explain it to the new Member, Mr. Mascara, who immediately started asking me some probing questions and I realized I was dealing with a real accountant.

Mr. Chairman, I would just ask unanimous consent to insert my statement into the record.

Mr. HORN. Without objection.

[The prepared statement of Hon. Robert E. Wise, Jr., follows:]

STATEMENT OF HON. ROBERT E. WISE, JR., A REPRESENTATIVE IN CONGRESS FROM THE STATE OF WEST VIRGINIA

Mr. Chairman, Members of the Committee, I would like to thank you for holding this hearing today. As you know, I have long been a supporter of capital budgeting. Earlier this Congress I sponsored an amendment to balance the federal budget using a capital budget and for several years Chairman Clinger and I have worked on legislation to establish a capital budget which highlights investment over consumption spending.

As a veteran of six years of service on the House Budget Committee, I have come to believe that many of the budget problems facing this Congress, particularly the shift in recent years from public investment toward consumption spending, have as much to do with the budget process as with decisions made—or not made—by the Congress.

Perhaps the greatest, and to me the most mystifying, problem with the current system is the fact that the federal government's unified budget makes no distinction between money spent on investments and money spent for consumption. Highways, federal salaries, health benefits and foreign aid, which are all examples of federal programs that are paid for through taxes and borrowing, are all accounted for in basically the same way. But all borrowing is not created equal. Borrowing for physical infrastructure can be justified if it pays for itself in the long-run by increasing the nation's wealth and capacity for future economic expansion. Borrowing to meet the day-to-day expenses of government cannot.

Both Chairman Clinger and I have introduced legislation that would divide the federal unified budget into an operating budget and a capital budget. Under our bills the operating budget would include all programs that meet the immediate obligations of running the government. The capital budget would include long-term, tangible investments in infrastructure. This legislation would direct the operating budget to be balanced but would allow the federal government to borrow money for certain investments in infrastructure that increase the national wealth and contribute to economic growth. Money borrowed for those infrastructure investments would be paid back over the life of the road, bridge, sewer system or other infrastructure investment.

The concept of a federal capital budget is not new. The budget was expanded in the 1950s to include information on investment spending. Reform in the 1980s required even more investment information in the unified budget. Many other industrialized countries employ a capital budget, and businesses and most state and local governments have investment budgets that separate long-term capital investments from year-to-year operating costs. Individuals and groups as diverse as former OMB Director Richard Darman, the General Accounting Office and the Progressive Policy Institute have endorsed distinguishing between investment and consumption spending in the budget. As a recent GAO report on the harmful effects of the deficit points out, "a new [budget] decision-making framework is needed, one in which the choice between consumption and investment spending is highlighted throughout the decision process, rather than being displayed for information purposes after the fact."

Businesses know the difference between borrowing to consume and borrowing to invest. Borrowing is a smart move when the money is used to finance productive investments that help a business modernize its equipment, expand and become more profitable. But borrowing money to pay salaries or executive bonuses or to send employees to expensive conferences rather than to modernize would be foolish.

I believe the federal government should make this same distinction in its budget. By borrowing for current expenses the government is asking future generations of taxpayers to pay for the cost of running the government today. But borrowing to invest is different. If the government passes part of the cost of building a road to future taxpayers, it also gives them something in return—a new highway that will encourage economic development, facilitate commerce and increase economic growth for years to come.

Instituting a capital budget would force policy makers to decide whether or not each investment is worth borrowing money to finance. In addition, the public would benefit from knowing that the government's current costs are being paid for and that any borrowing is for investments in the future rather than paying for the present and saddling future generations with bad debt.

All of us agree that the U.S. must make investments that are critical to future economic growth but that the budget deficit must also be reduced. Rather than going from crisis to crisis, the federal government should have an institutionalized system of long-term investment planning. Adopting a federal capital budget would provide such a mechanism.

Mr. Chairman, Members of the Committee, this is a time of fundamental change in the way government serves the people. In order to be more responsive to taxpayers' needs and more responsible with taxpayers' money, I believe the federal government should reform its budgeting to distinguish between consumption and investment. Adopting a capital budget would begin to effect this critical change and I hope you will seriously examine and ultimately endorse this important budget reform.

Mr. WISE. To say to you and to Chairman Clinger who has heard me say many times before what my real dream was that 1 day there will be a march on the Capitol by people waving placards saying "Cap Budgeting Now." We are almost there, Mr. Chairman, because Mr. Mineta can testify today as he did today in another committee there is another hearing on in which four private sector witnesses testified about the need for capital budgeting for the General Services Administration. So that movement is building and in fact I jokingly suggested, but maybe not so, that we ought to incorporate their remarks into this hearing, as well.

I do think we have a serious chance this time to move capital budgeting and I just want to thank you and the gentlewoman from

New York, Mrs. Maloney, for making this hearing possible and certainly Chairman Clinger and Mr. Mineta who has been a tireless advocate of it and Mr. Thornton.

Let me just say Ray that my hope would be in discussion—as you know, we have discussed whether it is limited to physical capital. I tend to agree with Mr. Mineta we want to get it instituted, but that we ought to at the same time be able to set up a commission or something that is evaluating what other types of capital which you can legitimately show have a long-term life.

Mr. THORNTON. Could I respond by saying that would be a splendid approach? I think people are concerned about human capital. And I think that some objective study needs to be made in order to lend credibility to the fact that certain investments are to be treated as capital investments. A commission would be a splendid idea.

Mr. WISE. Thank you. Thank you, Mr. Chairman.

Mr. HORN. Good suggestion. I now yield 5 minutes to the gentleman from Virginia, Mr. Davis.

Mr. DAVIS. Thank you. I won't take it all. I want to thank you both for testifying, and I think I agree with just about everything everybody said up here.

I would like to go back to the human capital issue, make a comment, and then get a reaction because you know as you read the futurists, if you read people like that, they are talking about we really are going to a technology, knowledge-oriented society where machinery and equipment probably mean less right now than human capital, but where you can take a bridge and you can sell that bridge, the government could as an asset, you can't really do the same with humans. That is hard to get your arms around it at this point.

Mr. THORNTON. That is certainly a very correct, indeed a wise observation. And no reference to my——

Mr. WISE. Actually, if I might say, Mr. Chairman, please feel free, refer to the Wise bill all you want.

Mr. THORNTON. But the effort to quantify is critical to an accurate categorization of human capital and there are some measures that can be made and you are absolutely right that as we move into future years, the investments that we make in human capital may be more determinative of our economic competitiveness than what we do in roads and bridges.

Mr. DAVIS. Right. I thank you for your contribution.

I yield back.

Mr. HORN. Thank you. Representative Maloney, do you have more questions you would like to ask?

Mrs. MALONEY. We are grappling with this terrible deficit right now, all of us. The way New York City worked is we could borrow on our capital budget only for roads and bridges and investment in infrastructure. We couldn't borrow on human investment or day-today operations.

How would this affect the Federal Government, this particular bill, where we are borrowing in all types of directions? The purpose of the capital budget was the flexibility to borrow on our investment in the future, but apparently in the Federal Government, you can borrow all you want. I guess I am asking Chairman Clinger this, how would it affect our current—would this mean that you couldn't borrow on human or day-to-day operations, but you would be able to borrow on day-to-day——

Mr. CLINGER. It wouldn't limit you. I think what has been said here is that right now we have no idea how much we are borrowing for day-to-day operations and how much we are borrowing for infrastructure because it is all mixed into one bag. What this would do at least, would differentiate between the two so you have more control.

Mrs. MALONEY. More control for planning.

Mr. CLINGER. Because it is a unified budget, there would not be the limitations such as you had in the city of New York.

Mrs. MALONEY. Thank you.

Mr. HORN. Chairman Clinger, do you have any further questions.

Mr. CLINGER. I do not. I would like to thank the panel.

Mr. HORN. Are there any questions from any Members who remain?

If not, we thank you both. You both have given excellent testimony and we appreciate your enthusiasm for this device that has been hidden for 16 years and hidden since 1949, so thank you for helping us.

Mr. MINETA. We thank you for your leadership.

Mr. THORNTON. Thank you for your leadership.

Mr. HORN. The next panel would please come in order. Panel two: Katherine Hanley, William Leidinger, and Thomas McMahon. We will introduce you more appropriately as I get to each one of you.

If you would remain standing, we have a habit here and practice that all witnesses but Members of Congress take the oath as to their testimony. If you would raise your right hand.

[Witnesses sworn.]

Mr. HORN. The clerk will note that all the witnesses did affirm it. You may be seated and we will now start.

Mr. DAVIS. Mr. Chairman, if I could introduce the first couple of panelists. I am just very, very pleased to have two people I think really are worthy of national recognition. They happen to be from Fairfax County.

First of all, the new chairman of our board of supervisors, who we can congratulate on winning the election to that position, that is Fairfax County, a county of 900,000 people, the largest in Virginia, Katherine Hanley. Mrs. Hanley was a member of the county school board prior and for 8 years was a member of the county board before her election to chairman in a special election and I consider her to be one of the experts on budgeting and capital budgeting in particular. And William Leidinger, our county executive, our chief administrative officer, who has guided this county, Fairfax County, over the last 2½ years, was prior to that a city manager in Richmond, VA, and a member of the city council in Richmond before coming to Fairfax.

And I think between all of them, Fairfax was voted the best financially managed county in the United States by City and State Magazine last year. It has a triple A bond rating and I just am very proud to welcome you before this committee and hear your testimony today.

Thank you.

Mrs. MALONEY. I am honored to be able to introduce someone from the great city of New York, Tom McMahon, who is director of city council finance. He has had a long, distinguished career and held many titles. I don't know all those titles, but believe me, he is important. And has brought a heavy, stern hand to the financial runnings of the city of New York and has helped it become a more effective body serving the people.

Thank you for coming, Tom. It is good to see you again.

Mr. HORN. Thank you very much. We will begin with Ms. Hanley, the chairwoman of the Fairfax County Board of Supervisors. Ms. Hanley.

STATEMENTS OF KATHERINE K. HANLEY, CHAIRWOMAN, FAIRFAX COUNTY, VA, BOARD OF SUPERVISORS; WILLIAM J. LEIDINGER, COUNTY EXECUTIVE, FAIRFAX COUNTY; AND THOMAS L. McMAHON, DIRECTOR, FINANCE DIVISION, NEW YORK CITY COUNCIL

Ms. HANLEY. Mr. Horn, Mrs. Maloney. Thank you, Mr. Chairman and members of the subcommittee. As Representative Davis has said, I am Kate Hanley, chairman of the Fairfax County Board of Supervisors. And I am pleased to be here today representing my fellow board members and the residents of Fairfax County. I very much appreciate the opportunity to share with you our capital budgeting program and its relationship to Fairfax County's fiscal planning process.

I believe our capital budgeting process works well and provides an effective approach to planning for and financing public facilities and improvements. As you have heard Representative Davis say, with me today is William J. Leidinger, county executive, and also our assistant director of the Office of Management and Budget, Susan Data, and Mr. Leidinger will present the county's details.

Mr. LEIDINGER. Thank you, Mr. Chairman.

Mrs. Maloney and Mr. Davis, other members of the subcommittee, let me begin by putting the county's budget in perspective, particularly the part of the budget targeted for capital projects. In the current fiscal year, our budget totals $3 billion. Of this amount, approximately $572 million or about 19 percent is associated with capital projects.

In Fairfax County, financing for capital projects comes from a variety of sources, including transfers from the general fund, cash pay down if you would, general obligation bond proceeds from debt we incur, Federal grant funds, State grant funds, and other sources such as sewer and solid waste fees and developer contributions.

The county's total paydown or pay-as-you-go financing program in the current year is about $30 million. In addition, general obligation bond proceeds are used to finance $348 million in capital costs in the current year. We currently have $624 million in general obligation bond authorization and the county sells approximately $150 million in bonds annually. We also have done a great deal of bond refunding in recent years as a result of favorable interest rates. Through the end of this current fiscal year, we will have completed almost $800 million in general obligation and sewer bond refunding resulting in a $31 million net present value savings in debt service for Fairfax County. Our current bonded indebtedness at the end of the current fiscal year will be approximately $1 billion.

Mr. Davis has already mentioned that Fairfax County has a credit rating of triple A from both Moody's and Standard and Poor's. We are only 1 of 33 States and local governments in the United States that total 30,000-and-some that have a triple A credit rating and we are justifiably proud.

We in Fairfax County consider the capital budgeting process to be a dynamic one, a process which is interactive with our overall budget fiscal goals and financial planning. Our process evolves around a long-term capital improvement program which identifies public improvement projects over a 5-year period. The process of prioritizing the projects for inclusion in our capital budget program results in political support and community consensus for the project and the appropriate financing mechanism. Projects such as new and expanded facilities, schools, facility repair and renovation, roads, transit improvement, public improvements including sidewalks, trails, storm drainage projects are all programmed within the 5-year plan.

The first year, the capital program is the foundation for next year's capital budget with the 4 remaining years serving as a guide in the financing and programmatic impact of undertaking the capital program.

Development of the annual capital budget process begins in the fall of each year when our county agencies submit budget proposals, their justifications, their costs, and related operating expenses and schedules. These submissions are reviewed by county staff and evaluated for need, consistency with the county's comprehensive plan, and funding requirements. Recommendations for appropriate funding and phasing of projects are reviewed and consolidated into the advertised program which becomes a subject of the board of supervisors' work sessions and public hearings before both the board of supervisors and the Planning Commission and ultimately the board of supervisors adopts the capital program.

The county board of supervisors adopts that capital program in full conjunction with the budget—the operating budget for the next fiscal year.

We see several benefits from our capital budgeting process, all of which ensure that decisions related to the financing of public improvements are balanced against current projected resources of our overall operating budget.

First, the Fairfax County capital budgeting process is essential in fulfilling the board-adopted 10 principles of sound financial management. In the mid-70's, the board of supervisors wisely endorsed a set of policies designed to maintain the triple A bond rating that was then awarded to the county. These 10 principles, reaffirmed in 1985 and again in 1988, stress the close association between the planning and budgeting processes and provide guidance in the planning and financing of public expenditures.

The principles relate to the integration of capital planning, debt planning, cash management and productivity as a means of ensuring prudent, responsible allocation of the county's resources. The key to the principles is the guideline that debt service on county bonds will not exceed 10 percent of total general fund disbursements in any fiscal year.

I have attached a copy of those 10 principles to the testimony we are providing today for your information and reference.

Over the years, firm adherence has been achieved to these financial principles and financial decisionmaking has allowed the county to maintain its triple A rating through two recessions, including the most severe recession and has established the county as a model of sound financial management.

Mr. Davis has already mentioned that Fairfax County was recently named the best fiscally managed county in the Nation.

Second, we believe the Fairfax County capital budgeting process focuses attention and promotes consensus on community goals and needs. The very process of annually identifying, evaluating, prioritizing, and programming public facility needs over a 5-year period helps match the expectations of the community with the realities of economic situation at hand.

A case in point, the recession in the early nineties from which we are still recovering had a significant impact on Fairfax County and its ability to fund capital project construction. Faced with the declining revenue base and associated expenditure reductions, the capital budget had to be downsized to fit the economic cloth.

Because the board established limits on debt service as a percentage of the total operating budget, a total of $220 million in bond funded capital projects had to be deferred. The board and the community worked to establish priorities, including public education, an adult detention center, and completion of a major roadway in Fairfax County, the Fairfax County Parkway. Those all remained in the capital program as we moved forward. Other projects simply had to be deferred.

In addition, the reduction in county resources required eliminating only the most critical emergency repair and maintenance projects from the pay-down capital program. As the county revenue base recovers in reaction to the current economy, our ability to increase operating expenses to incur additional debt service, additional resources are becoming available for the restoration of collected capital projects. These restorations are program based on continued reprioritization of community goals and facility needs.

Third, the Fairfax capital budgeting process encourages more efficient government administration. The county capital improvement program promotes coordination among governmental agencies and provides a check on potential overlapping or conflicting projects. Decisions related to site selection and the timing of construction activity can be made in relation to improvements planned by other county agencies, a variety of the county agencies.

For example, our planned roadway construction projects are closely coordinated with State roadway construction to minimize community disruption, to reduce county costs where possible, and to maximize the impact of improvements in any given area by providing a more efficient roadway network all at the same time.

Fourth and last, the county capital budgeting process fosters a sound and stable financial program. Through the 5-year capital planning process, the need for bonds or other financing mechanisms could be projected and programmed so that emergency financing measures are not required.

In addition, the operating costs of new and expanded public facilities can be included in forecasts of county disbursements requirements and appropriate actions can be planned to provide resources to staff the facility when complete. For example, we will be constructing a 750-bed expansion to our adult detention center, the additional annual operating costs which will be more than $14 million a year.

Budget decisions of the board for the current budget year and the impact of these decisions on future years' budgets are made considering increased operating requirements. An analysis of the operating costs associated with all capital improvements to be included in the capital program is reviewed and considered in the prioritization process. No county facility, newly constructed or renovated, is to be built to be held empty. Our policy of forecasting these operating budget impacts prevents surprise budget adjustments as facilities are completed.

In closing, I believe that our capital budgeting process effectively balances the need for public facilities and improvements against the realities of the county's financial position at any given point in time. The continually evolving process of identifying public improvement needs and prioritizing these against other budget requirements ensures its financing is in place or planned to minimize the impact of construction and facility operating costs on county residents. Our process provides for buy in from both the political leadership and the community for the need for the project and the costs of these improvements.

We are very proud of our approach to capital budgeting. We are very proud of the overall financial management program. And we are very pleased that what we do and the way we do it has been widely recognized by financial leaders and financial institutions. We believe that there may be aspects of our capital budget program and process that may be transferable to the Federal budget process.

I will be pleased to answer any questions you have.

[The prepared statement of Mr. Leidinger follows:]

PREPARED STATEMENT OF WILLIAM J. LEIDINGER, COUNTY EXECUTIVE, FAIRFAX COUNTY, VA

Let me begin by putting the County's budget in perspective, particularly the part of the budget targeted for capital projects. In FY 1995, the County's budget totals $3.0 billion. Of this amount, approximately $572 million or about 19% is associated with capital projects. In Fairfax County, financing for capital projects comes from a variety of sources, including transfers from the General Fund (paydown), general obligation bond proceeds, Federal grant funds for transportation/transit related projects, and other sources such as sewer and solid waste fee revenues and developer contributions.

The County's total paydown or "pay as you go" financing program in FY 1995 is approximately $30 million. In addition, General Obligation Bond proceeds are used to finance $348.0 million in capital costs in FY 1995. The County currently has $624.1 million in general obligation bonding authorization and the County sells approximately $150 million in bonds annually. We also have done a great deal of bond refunding in recent years as a result of favorable interest rates. Through the end of FY 1995, the County will have completed $782 million in general obligation and sewer bond refunding, resulting in a total of $31 million in net present value savings in debt service. The County total bonded indebtedness at the end of FY 1995 will be approximately $1.0 billion.

Since 1975, Fairfax County has had the distinction of having a "Triple A" rating from both Standard and Poor's Corporation and Moody's Investment Service, the nation's leading rating agencies. Fairfax County is one of only 33 of approximately 30,000 jurisdictions including states, counties and cities that have received this rating. The Triple A rating gives Fairfax County bonds the highest rating attainable which allows the County to sell bonds at the most favorable price. It is estimated that since 1978, the Triple AAA bond rating alone has saved the County $110 million in debt service costs on general obligation bonds. In addition, the Triple A rating opens up other avenues of capital project financing that otherwise would not be available.

I consider the County's capital budgeting process a dynamic one, a process which is interactive with our overall budget and fiscal goals. Our process evolves around a long term capital improvement program which identifies public improvement projects over a five year period. The process of prioritizing projects for inclusion in our capital budget program results in political support and community consensus for the project and the appropriate financing mechanism. Projects such as new and expanded facilities, facility repair and renovation, roads and some transit requirements, and public improvements such as sidewalks, trails and storm drainage improvements are programmed within the five year plan. The first year of the five year program is the foundation for the next years capital budget with the four remaining years serving as a guide on the financial and programmatic impact of undertaking the construction program.

Development of the annual capital budget process begins in the Fall of each year when County agencies submit project proposals, justifications, project costs and related operating expenses, and project construction schedules. These submissions are reviewed by County staff and evaluated for need, consistency with the County's Comprehensive Plan, and funding requirements. Recommendations for appropriate funding and the phasing of projects are reviewed and consolidated into an advertised program which becomes the subject of Board of Supervisors work sessions and public hearings before the Board and the Planning Commission. The County Board of Supervisors adopts the CIP in conjunction with the budget for the next fiscal year.

There are several benefits of the Fairfax County capital budgeting process, all of which insure that decisions related to the financing of public improvements are balanced against the current and projected resources of our overall budget.

1. The Fairfax County Capital Budgeting Process is essential in fulfilling the Board adopted "Ten Principles of Sound Financial Management."

In the mid 1970s, the Fairfax County Board of Supervisors wisely endorsed a set of policies designed to maintain the "Triple AAA" bond rating awarded to the County. These 10 principles, reaffirmed in 1985 and again in 1988, stress the close association between the planning and budgeting processes and provide guidance in the planning and financing of public expenditures. The principles relate to the integration of capital planning, debt planning, cash management, and productivity as a means of ensuring prudent and responsible allocation of the County's resources. Key to the principles is the guideline that debt service on County bonds will not exceed ten (10) percent of total General Fund Disbursements. I have attached a copy of these "10 Principles" to my testimony for your information. Firm adherence to these principles in financial decision-making has allowed the County to maintain its Triple A rating, through two recessions and has established Fairfax County as a model of sound financial management. In fact, Fairfax County was recently named the best fiscally managed county in the nation by City & State magazine.

2. The Fairfax County Capital Budgeting Process focuses attention and promotes consensus on Co-unity Goals and Needs.

The very process of annually identifying, evaluating, prioritizing, and programming public facility needs over a five year period helps match the expectations of the community with the realities of the economic situation. Case in point: The recession of the early 1990's had a significant impact on Fairfax County and its ability to fund capital project construction. Faced with a declining revenue base and associated expenditure reductions, the capital budget also was downsized. Because of Board established limits on debt service as a percentage of the total budget, a total of $220 million in bond funded capital projects was deferred. Board and community priorities of education facilities, the Adult Detention Center and the Fairfax County Parkway remained in the capital program while other projects such as storm drainage facilities, neighborhood improvements, libraries and human service facilities were deferred. In addition, the reduction in County resources required eliminating only the most critical emergency repair and maintenance projects from the paydown capital program.

As the County's revenue base recovers in reaction to the current economy, additional resources are becoming available for the restoration of selected capital projects. These restorations will be programmed based on continued reprioritization of community goals and facility needs.

3. The Fairfax County Capital Budgeting Process encourages more efficient government administration.

The County's Capital Improvement Program promotes coordination among governmental agencies and provides a check on potential overlapping or conflicting projects. Decisions related to site selection and the timing of construction activity can be made in relation to improvements planned by various agencies. For example, our planned roadway construction projects are closely coordinated with State road construction to minimize community disruption, to reduce County costs where possible, and to maximize the impact of improvements in the area by providing a more efficient roadway network.

4. The Fairfax County Capital Budgeting Process fosters a sound and stable financial program.

Through the five year capital planning process, the need for bonds or other financing mechanisms can be projected and programmed so that emergency financing measures are not required. In addition, the operating costs of new and expanded public facilities can be included in forecasts of County disbursement requirements, and appropriate actions can be planned to provide resources to staff the facility when complete. For example, Fairfax County will be constructing a 750-bed expansion to our Adult Detention Center, the additional annual operating costs of which will be more than $14 million. Budget decisions of the Board for the current budget year and the impact of these decisions on future years budgets are made considering increased operating requirements. An analysis of the operating costs associated with all capital improvements to be included in the capital program is reviewed and considered in the prioritization process. No County facility, newly constructed or renovated, is to be built to be held empty; our policy of forecasting these operating budget impacts prevents surprise budget adjustments as facilities are completed.

In closing, I believe that the County's capital budgeting process effectively balances the need for public facilities and improvements against the realities of the County's financial position. The continually evolving process of identifying public improvement needs and prioritizing these against other budget requirements insures that financing is in place or planned to minimize the impact of construction and facility operating costs on County residents. Our process provides for "buy in" from both the political leaders and the community of the need for and the cost of these improvements.

I am proud of the County's approach to capital budgeting and its overall financial management program and am pleased that these practices have been recognized by financial leaders. I believe that there are many aspects of the our capital budget program which may be transferable to Federal budget process.

Thank you for the opportunity to speak to you today.

FAIRFAX COUNTY'S TEN PRINCIPLES OF SOUND FINANCIAL MANAGEMENT

1. The planning system in the County will continue as a dynamic process which is synchronized with the capital improvement program, capital budget and operating budget. The County's land use plans shall not be allowed to become static. There will continue to be periodic reviews of the plans at least every five years. Small area plans shall not be modified in isolation from and in contradistinction to contiguous plans.

2. Annual budgets shall continue to show fiscal restraint. Further, it is imperative that a positive cash balance (surplus) be shown in the General Fund at the end of each fiscal year. If necessary, spending during the fiscal year will be reduced sufficiently to create such a cash surplus.

a. A managed reserve shall be maintained in the Combined General Fund at a level sufficient to provide for temporary financing of unforeseen needs of an emergency nature, and to permit orderly adjustment to changes resulting from termination of revenue sources through actions of other governmental bodies. The reserve will be maintained at a level not less than 2 percent of total Combined General Fund disbursements in any given year.

b. As part of the Board's policy on appropriation during quarterly budget reviews, nonrecurring revenues should be used for either capital expenditures or other nonrecurring expenditures. Quarterly review adjustments are not to exceed 2 percent of the Combined General Fund disbursements. The intent is to apply this restriction on an annual basis.

3. If a deficit appears to be forthcoming, the Board will reduce appropriations or increase revenues.

4. The County's debt ratios shall be maintained at the following levels:

Net debt as a percentage of estimated market value, which is now at 1.66 percent[1]; should always remain less than 3 percent.

The ratio of debt service expenditures as a percentage of Combined General Fund disbursements which is now at 9.2 percent[1] should remain under the 10 percent ceiling. The County will continue to emphasize pay-as-you-go capital financing. Financing capital projects from current revenues is indicative of the County's intent to show purposeful restraint in incurring long-term debt. To this end, for planning purposes, the target on annual bond sales will be $150 million, or $750 million over a five year period, with a technical limit of $175 million in any given year. This planning limit shall exist even though the ratio of debt to taxable property value remains less than 3 percent and the ratio of debt service to Combined General Fund disbursements remains less than 10 percent.

5. Fairfax County's cash management system is one of the best in the country and must continue to receive full support and cooperation from all County agencies, including the Public Schools. Such a system is an indication of the soundness and professionalism of the County's financial management.

6. The budgetary process will continue to be oriented toward management by objectives (MBO) and must continue deliberately toward full utilization of the system.

7. All efforts must be made to improve the productivity of the County's programs and its employees. The County's productivity analysis process is a dynamic part of the administration. Its presence, together with MBO, are indications of the strength of the County's commitment to continual improvement of its fiscal management.

8. A continuing effort to reduce duplicative functions within the County government and the autonomous and semi-autonomous agencies, particularly those which receive appropriations from the General Fund, must be made.

9. Underlying debt must not expand beyond that level already contemplated. The creation of additional sanitary districts for the purpose of incurring bonded indebtedness will be discouraged. Revenue bonds of agencies supported by the Combined General Fund will be analyzed carefully for fiscal soundness. The issuance of County revenue bonds will be subject to the most careful review. These revenue bonds must be secured by extremely tight covenants to protect the name of the County in its other borrowings.

10. Fairfax County must continue to diversify its economic base by encouraging commercial and, in particular, industrial employment and associated revenues. Such expansion of business and industry must be in accord with the plans and ordinances of the County.

Mr. HORN. Thank you very much. We will get to that shortly.

Mr. McMahon, please proceed.

Mr. MCMAHON. Yes, thank you, Mr. Chairman, Congresswoman Maloney. Thank you for the opportunity to come down and testify. I have prepared remarks which I will, with your permission, submit and just summarize.

As a staff person to the city council, as the director of the finance division, we look at the capital budget from a legislative perspective, which I think is an important one because it is the one that you share here and it is very much a tool that we believe is essential so that you can develop a strategic plan in addressing the needs of local governments. As a representative of local government, I think I would be remiss if I didn't say that we often need help in financing capital improvements and cuts to capital improvements will have a dramatic impact on the ability of local governments to meet those needs.

But that being said, I think it is important that, when you look at the need for a capital budget, it is for the strategic purpose that

[1] As of June 30, 1994.

it offers, and a national capital budget would give local governments and regions of this country the ability to integrate their strategic plans with the plans of the Federal Government in a way that right now we don't have available and it is something that we think is seriously needed.

In New York City, we have had a separate expense and capital budget for many years. It was the fiscal crisis that forced us to address the need to deal with those two documents in a serious way, and what the capital budget provides us with the opportunity for the purchase of property, for the purchase of infrastructure needs for which there is a long-term benefit, and there is a strict standard by which we allow items to come into our capital budget, and that is called PPUs.

There must be a period of probable usefulness of more than 5 years and those standards are determined by both State legislation, local legislation, and the advice of bond counsel, and it is an important standard that I think you may want to consider introducing into any legislation that comes forward.

The city of New York essentially has a three-tiered capital budget process. We have a 10-year strategy, which is the long-term vision of where we are going. We have a 4-year strategy which is more up front where you really have to make some real decisions on where your resources will be dedicated. Then there is an annual capital budget for which you must appropriate money. The payments for that come out of an annual commitment plan, which is of a significant magnitude in the city of New York, approximately $4 billion a year that we commit to capital needs.

In the preparation of that document, there is significant input from local communities, from city agencies, and from the consideration of resources that are available to fund all the needs that exist in New York City. New York City is a little bit bigger than Fairfax County. Our overall budget approaches $33 billion on the expense side and annually $5–$4.5 billion on the capital side. And we in the city of New York have found it, as I said, as an important tool and believe that the Federal Government should seriously think of incorporating that as a budgeting tool into the national budget.

Thank you.

[The prepared statement of Mr. McMahon follows:]

PREPARED STATEMENT OF THOMAS L. MCMAHON, DIRECTOR, FINANCE DIVISION, NEW YORK CITY COUNCIL

Good afternoon Mr. Chairman. My name is Thomas L. McMahon and I am the Director of the Finance Division of the City Council of New York. I would like to thank the Chairman for inviting testimony on the creation of a federal capital budget. I believe that the separation of capital expenditures from current operating expenses will improve the federal budget process, and promote a long term capital strategy that will help to rebuild the country's badly deteriorated infrastructure.

While the federal government has not had a balanced budget since 1969 [1], in the same time period the rate of increase for public capital stock has declined. Between 1980 and 1990 federal spending on infrastructure fell from 4.7 percent of all federal expenditures to only 2.5 percent, helping to lower the ratio of public to private capital stock from .61 to .44 over the last thirty years.

Many economists believe that there is a positive relationship between the government's investments in infrastructure and the private sectors investment's in the

[1] Although the modest deficit of 1973 might be more accurately termed a balanced budget.

equipment, technology and capital stock[2] needed to promote economic growth. Yet the reduced spending for infrastructure in the last decade has limited the growth potential of the U.S. as a whole and has had an even more devastating impact on local economies.

In New York City the deterioration of the infrastructure, and the economic consequences of this deterioration, are visible to residents and businesses within the City. We provide a graphic example of the way in which economic growth is slowed due to the poor condition of our infrastructure. According to a 1992 Department of Transportation study, road congestion and poor pavement can increase the cost of operating a truck by between 24 to 42 percent. This upward pressure on costs has contributed to the decline of the City's wholesale industry and limited job opportunities for our less skilled residents. It has also contributed to a generally high cost of doing business in New York City which has slowed growth across a variety of local industries. In 1988 the Congressional Budget Office estimated that selective expansion of the highway system in congested, urban areas would have yielded returns of 10 to 20 percent.

Local governments often need help in financing capital improvements (and sometimes need help in financing infrastructure maintenance) so declines in federal spending on infrastructure are of great concern to localities. We believe that the creation of a federal capital budget would aid in developing a long term infrastructure strategy which could integrate the needs of localities within regional and national goals. We also believe that the absence of a federal capital budget has contributed to the nation's and the localities infrastructure deficit.

In New York City we separate the capital budget from the rest of the expense budget and while the City has not had sufficient funds for all the infrastructure improvements needed, we feel that the existence of a capital budget has improved the budget process and helped the City focus on a capital strategy. Our capital budget provides funds for the purchase of property, the construction of facilities, improvements of existing facilities and the purchase and installation of major equipment. The capital budget therefore, functions as an investment plan for the City's infrastructure.

The capital budget is presented by the Mayor to the Council for adoption each year[3] and forms part of a four year capital program[4]. The first year of the program represents spending planned for the upcoming fiscal year, while the remaining three years of the capital program is a projection of the spending necessary to complete each project in the capital budget and to fund new projects anticipated in the following three years. The Charter also requires the preparation of a ten-year capital strategy that is used to describe all facets of the development of the City's capital facilities for the next decade[5].

However, including an item in the capital budget does not guarantee an actual expenditure. The City's capital commitment plan is a measure of what is actually to be spent on capital projects during the course of the fiscal year. Agency targets in the commitment plan represent the actual dollar amounts that are to be spent in the current fiscal year based on a projection of the dollar value of contracts into which the City will enter.

The capital budget process insures that capital projects adopted each year are the final product of a longer capital planning process that begins with a ten-year capital strategy, takes firmer shape when it reaches the four year capital program and crystallizes in the current year capital budget. We believe that the short-term time horizon associated with the annual operating budget is not appropriate for capital planning.

Without a capital budget, spending for current goods and services is mixed-in with spending for long term investments. This creates a timing mismatch between outlays and benefits. Further, the unified budget makes it difficult to evaluate the financial solvency of the federal government because you can not incorporate the values of assets acquired into your understanding of the budget. A capital budget also creates an improved understanding of the budget process among the public that can contribute both to balancing the budget and providing more funds for investment and infrastructure.

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[2] Sharon Erenburg in "The Relationship Between Public and Private Investment" Working Paper No. 85, The Jerome Levy institute, 1993 estimated that each one percentage point increase in public infrastructure expenditure would yield a 0.6 percent increase in private sector equipment investment. The work of David Aschauer and M.I. Nadirie and T.P. Mamuneas have tended to confirm Erenburg's finding.

[3] Charter Section 225(a).

[4] Charter Section 212.

[5] Charter Section 215.

The alternative to a formal capital budget is the back door method of creating a capital budget through the use of more "off-budget" agencies, categories and projects. While this back door approach works toward the goal of correcting the timing mismatch between outlays and benefits it also reduces accountability and does little to improve public understanding.

We believe that New York City has an excellent capital budget process—what we lack is funding. In fiscal year 1995 federal aid will provide New York City with only 5 percent of its capital needs. Further, the budget reductions contemplated in the "Contract With America" will have a negative impact on both the capital and the operating budget of New York City. For example, under provisions found in the Contract With America, The Metropolitan Transit Authority (MTA) will lose $44 million in funding starting in fiscal year 1996, rising to $200 million in fiscal year 2002. If this portion of the Contract becomes part of the federal budget, The MTA will be forced to curtail its' current level of needed capital improvements and, in the long run, pay the higher costs associated with the maintenance of deteriorated tracks and equipment. The Contract will also have a negative impact on the upgrading of sewage treatment facilities and public housing.

We hope that the creation of a federal capital budget will help expand the national capital program and provide assistance to local governments that need to rebuild their infrastructure.

Mr. HORN. Well, thank you very much. I think all of you have given excellent testimony.

Let me just ask you, Mr. McMahon, because I am curious: on the 5-year life standard, do some of the buildings which you put in the capital budget include extensive scientific equipment or computer systems that come with that initial construction of the building?

Mr. MCMAHON. Yes.

Mr. HORN. And if so, do you include those as part of the capital budget?

Mr. MCMAHON. Yes.

Mr. HORN. You are assuming more than a 5-year life?

Mr. MCMAHON. Yes.

Mr. HORN. OK. Because that creates a major problem as to how you sort the equipment that comes with the building to make it functional.

Mr. MCMAHON. Right. As part of the infrastructure that is necessary to maintain that building, we believe that should be part of the budget. And the bonds that are issued associated with that project will reflect the period of usefulness of the asset. So that if the asset only has a 10-year life, the bond that is issued with that would have that 10-year expiration date.

Mr. HORN. OK. Let me call on Chairman Clinger. I will hold my other questions until later.

Mr. CLINGER. Just very briefly, one of the things that I feel a capital budget at the Federal level could be very useful, and it is a planning device, as a planning tool: which would enable us to do the sorts of things you are able to do, which is to take a look 10 years out? What is our needs, 10 years out, 4 years out, I think you said, and then 1 year out?

Recognizing the Federal Government is no longer the provider of all good things, but nevertheless, there still is a need for an interface between the Federal Government and the State government and the local government in terms of infrastructure planning, the fact that the Federal Government does not have a Federal capital budget and, therefore, there tends to be a stop-go kind of funding for a lot of the infrastructure programs, whether it is highways, airports, water and sewer systems, or whatever.

How would it help you if we had a Federal capital budget that you could then use in your own capital budgeting? Isn't your own capital budgeting somewhat inadequate because you can't really take into account or really plan on whatever assistance you are maybe going to receive from the Federal level? Do you want to respond to that?

Mr. McMAHON. I believe that is correct. What we do in the State of New York is make assumptions based upon historical trend and actual annual appropriation. But it is more guesswork, and clearly we recognize that any 10-year plan has to be adjusted over time and we believe that the Federal Government would make those same adjustments that we have made in the city of New York.

Mr. CLINGER. Yes. Ms. Hanley?

Ms. HANLEY. I think it would also be useful for those governments that are part of regional bodies, particularly transit, if we had a plan so that we knew what the transit—the capital transit budget would be so that we know what our local obligation, particularly here in this area in connection with WMATA, what our local obligation would be, and then it would be—it wouldn't be peaks and valleys. It would be more level.

Mr. CLINGER. That is what I mean. It is almost sort of a chaotic situation because the Federal Government changes its mind, reverses policies, does all kinds of things which I think have to be very disruptive in terms of infrastructure development, certainly it seems to me. Ms. Hanley, how did the school board and its bonds interact with the capital program with the board of supervisors?

Ms. HANLEY. Very carefully. I am sorry. In Virginia, school boards are still—are just now being elected but they are still dependent school boards so they are dependent for their funding, both capital and operating, on the governing bodies. So the school boards had the authority to establish a capital program to reach consensus on it and then it became—it is incorporated into the governing body's capital program.

We do have little spurts of disagreement on the size of the school's capital program because of course for a county like Fairfax, that is a majority—that is probably over 50 percent of it, but it is an interaction that takes a lot of public involvement, but in Virginia, school boards are dependent, and so it is part of the—the governing body sells the bonds for the school board as well. The debt service is counted.

Mr. CLINGER. One final question. You have heard a discussion about the definitional problem that you have to deal with, what is the definition, for example, of the city of New York or in the Fairfax County? How do you define capital?

Ms. HANLEY. I want to hear yours first.

Mr. McMAHON. It is the standard that I mentioned, the period of probable usefulness. It has to be more than 5 years and it is——

Mr. CLINGER. Is it pretty much bricks and mortar?

Mr. McMAHON. Yes. Yes.

Mr. CLINGER. You don't get into——

Mr. McMAHON. It is focused on bricks and mortar. Occasionally vehicles slip in, but that is a close call, a vehicle.

Mr. CLINGER. But you don't get into so-called human infrastructure?

Mr. MCMAHON. No.

Mr. CLINGER. OK.

Ms. HANLEY. It has traditionally been that it has turned out to last the life of the bond. In other words, we shouldn't still be paying on the bond when whatever it is is no longer around. And traditionally we have had 30-year bonds. Equipment then is not considered capital.

Mr. CLINGER. You are talking about tangible things?

Ms. HANLEY. Tangible things, yes.

Mr. LEIDINGER. We finance the acquisition of our equipment, either motorized or technological equipment, either with direct purchase or through the use of establishing revolving funds to fund annually an amount estimated to have a sum sufficient to replace it at the end of its useful life.

There are some places in Virginia that allow the issuance of short-term notes, short-term bonds, 5 to 7 years, to provide highly specialized equipment that lasts longer than a police vehicle, but not as long as a jail if you would. For example, a fire truck or a new computer. That might go 5 to 7 years.

So there is some capital debt financing done with using short-term bonds for highly specialized equipment. But as Ms. Hanley said, it is bricks and mortars, it lasts the life of the debt, then it is capital. If it doesn't, it is capital equipment; it is either paid for one way or another out of current cash.

Mr. CLINGER. Right. Thank you all.

Mr. HORN. Representative Maloney.

Mrs. MALONEY. I would like a comment from all of you on how—the structure by which you balance your budget. I know we are hearing a lot about all the cities are balancing their budgets and the States are balancing their budgets, and on long-term investment.

Is that off budget in the balancing or is it just the cost of the interest rates to carry the long-term investment? How do you—I know that on the expense side, you balance it. But how is the capital part part of balancing the budget?

Mr. MCMAHON. In New York City, as you know quite well, we carry the interest and the principal of our debt from the capital budget in the expense budget. The expense budget is required to be balanced under generally accepted accounting principles, which on an annual basis, your revenues have to match your expenses. And it is essentially so the capital budget is a separate—is a separate document with the expense budget, including the principal and debt service payments on that capital program.

Mrs. MALONEY. The same?

Ms. HANLEY. Our capital budget is limited by the amount of debt service that will support it. In other words, our debt service is—our policy is that our debt service should not exceed 10 percent of our general fund budget, not including—I guess not including what the capital costs are, but that our debt service is figured in into the general fund and we must have a balanced budget in Virginia. We are required to.

Mrs. MALONEY. The ability of local governments, I would like to ask Ms. Hanley, to fund capital projects is often dependent upon the opinions of those wonderful credit rating services.

Ms. HANLEY. Yes.

Mrs. MALONEY. And you noted in your testimony, and congratulations, that since 1975, Fairfax County has had a triple A rating from both Standard and Poors and Moody's Investment Services, the Nation's leading rating agencies. You estimate that since 1978, the rating has saved your county $110 million in debt service costs on general obligation balance.

Can you tell us more about the process by which the rating services evaluate your local bond offerings? And I would like to ask Mr. McMahon the same question, and what are your ratings right now?

Ms. HANLEY. I will let Mr. Leidinger go into the process in detail.

Mr. LEIDINGER. First of all, we stay in regular contact with the folks at the rating agencies and we do that on a regular basis. We do that on the telephone. They come to visit us and spend time with us prior to each bond sale we have. We spend probably a day in Fairfax with them discussing the projects included in the bond issue, take them on a tour of the county, helping them appreciate the understanding and dynamics of the credit, if you would, and underlying issues and strengths that are in that credit. They know us very, very well.

We share financial information with them regularly and completely and as financial issues arise, it is not beyond us to pick up the phone and just talk with them and tell them what we are thinking about.

Mrs. MALONEY. Do you believe it is your strict emphasis on capital budgeting that you have that enables you to have this fine rating?

Mr. LEIDINGER. Yes. They are very happy that we have that, and more particularly, since it is self-imposed and it has been self-imposed and maintained over an extended period of time.

Mrs. MALONEY. And could you answer the same question? What is New York City's bond rating now?

Mr. MCMAHON. Well, unfortunately, we don't have as good a bond rating as Fairfax. We are significantly below that, Standard and Poors has us at A-minus, Moody's has us as BBB-plus. Even though we have a rigorous process in New York City, the pressures on the expense side of the budget have given us that rating much lower than we would like to be at.

As the mayor and the city controller who have responsibility for negotiating those ratings with the agencies, although the city council, we also spend time with them and try to comfort them in the fact that we ultimately will do what we can to balance the city's budget, but as you know, there are tremendous pressures on the city's budget from a host of areas, not the least of which is that the city of New York, with 7 million people, we have over a million people on welfare and that cost, which is shared by the local government in New York State, which most States don't. New York State pays 25 percent of the cost of Medicaid, welfare, and other social programs.

So that there is tremendous pressure on the expense side of the budget which I believe has led to the lower rating, although since 1977, we have balanced every year's budget and it is an interesting thing. Rating agencies, you know, they look at city bonds, but as soon as city bonds go out, they get bought, and it is—the last offering was actually oversubscribed.

And so while it is a process that you have to deal with and it is an important process, there are many who believe that perhaps the rating industry, the process by which bonds are rated, should also be looked at.

Mrs. MALONEY. Very briefly, if you could share with the committee members the problems in our budgeting process that led to the crisis and how they were corrected. Maybe that could help us in looking at this capital.

Mr. MCMAHON. As one of the prior witnesses testified, the Beam shuffle, it wasn't a Beam shuffle; it was the Lindsey shuffle and Wagner shuffle and many shuffles before that in the city of New York. There was a history of essentially mixing your capital and expense programs, and so what often happened was that the revenues that were raised for a capital program were used up front to pay the expense side of the budget because there wasn't a clear distinction between the two, and that is fine.

It works perfectly as long as you have cash, and what happened in the fiscal crisis was people saw what was going on. And when the city went to borrow on the capital side, people—the banks said no, that it has to stop, and it did stop and then precipitated a series of reforms which we think have served the city well, looking back over the past 20 years now.

Mrs. MALONEY. Thank you. My time is up.

Mr. HORN. I think that is a convenient place to take a break. We have about 10 minutes in which to get over to vote. If you don't mind waiting, we would like to ask you a few more questions.

Thank you very much. We will be back to you in about 15 minutes.

[Recess.]

Mr. HORN. We can resume the hearing. The hearing is resumed at roughly 3:39 p.m., and the gentleman from Virginia, Mr. Davis, will begin the questioning.

Mr. DAVIS. Mr. Chairman, thank you very much. I have got some questions for each of you.

Mr. Leidinger, let me ask, I know the Fairfax County budget, which I have some familiarity, is a complex document. As I understand it, you have your budget and then you have your debt service as an item in that budget that can't exceed 10 percent under your 10 commandments?

Mr. LEIDINGER. That is correct. Debt service cannot exceed 10 percent of combined general fund disbursements, that is direct county expenditures as well as the amount of money we transfer to the school system each year for its operation.

Mr. DAVIS. But you can use additional county dollars for capital improvements; you just don't go in debt for it?

Mr. LEIDINGER. We do. That is cash pay down, pay-as-you-go.

Mr. DAVIS. What is the current debt roughly of the county? You have a balanced budget but you still have a debt that we service each year. What would the total debt be?

Mr. LEIDINGER. The total debt is around $1 billion.

Mr. DAVIS. What about the trust funds? Can you talk about how we use trust funds at the local level?

Mr. LEIDINGER. Trust funds like enterprise funds for water and sewer?

Mr. DAVIS. Right. Like we are supposed to have at the Federal level for Social Security and the highway trust funds that get into the integrated budget, for planning purposes, get thrown in. Do either one of you want to talk about how you——

Ms. HANLEY. The enterprise funds are separate from our general fund budget. They are self-generating. They pay for themselves, if you will, by either fees or some kind of revenue in terms of sewer is the one that particularly comes to mind. The water authority, there is another one. They are not—those funds are not usable in the general fund. They don't transfer and they are internally—I hate to say internally generated, but they are self-contained and not part of the general fund budget.

Mr. DAVIS. So there is no mixing and matching on that. They just stand there——

Ms. HANLEY. You can't take money out of the—from sewer revenues and pay for human services out of that.

Mr. DAVIS. OK, thank you.

Ms. Hanley, let me ask you if you have any thoughts in terms of the—you have heard the discussion of how you define capital and whether it should be human factors, personal property, real estate. Do you have any thoughts on that? You have worked—you have been on the Metro board here, worked with transportation. You have been on the school board. You have very broad experience.

Ms. HANLEY. I think the 20th century view of capital has been bridges and roads and rails and bricks and mortar, but as we look to the 21st century, the highways are different. They may be information highways and we may have to think about the technology infrastructure in order to be competitive worldwide, particularly in a locality, if the locality is going to be competitive.

And so what we have maybe called equipment under the headline of computer equipment may be broader in the 21st century technology infrastructure, and I think that would appropriately be a capital improvement.

I don't think that we know yet what all that means. I wouldn't propose to know what that will mean in the next 20 or 30 years, but when you are talking about long-term life, those things may have long-term life.

Mr. DAVIS. Objection, thank you.

Ms. HANLEY. Certainly as I mentioned, in transit, that is back the other way, that would—some kind of stability in terms of revenue for that kind of capital would relieve localities of having to make up the difference, particularly in subsidies, if you have some kind of regional arrangement where the localities are on the hook for the capital, and in that case, that comes out of our general—either that is our capital—either we have to plan for it under our capital consideration or we have to make it up out of our general fund.

Mr. DAVIS. OK, thank you.

Mr. McMahon, let me ask you a question. You still have the control board in New York functioning as an oversight now as opposed to—how has that traditionally interacted with your capital budgets?

Mr. McMAHON. The control board, as you know, was established as—during the fiscal crisis as the emergency financial control board in order to monitor city finances, and they didn't approve—they ultimately, during that time period, had approval over the expense and capital budgets adopted by the city, but since it was the expense budget that had the greatest focus, that was where they focused the majority of their energies.

Since the mid 1980's, they have been serving in an advisory capacity monitoring both the expense and capital budgets and commenting on them on a periodic basis.

I think many of their recommendations have been helpful, thoughtful. On the capital budget, they have advocated the need for a written debt policy. They have advocated the need for something that the city has not done in the past, but which is currently being explored, which is pay-as-you-go capital. I know you mentioned in Fairfax they use it and I think it is an important element of any capital program.

In the city, we haven't used it as much as we should. I think it is—the control board has served as an oversight agency and I think generally a thoughtful one.

Mr. DAVIS. OK, thank you. I yield back.

Mr. HORN. Thank you very much.

The gentleman from Illinois, Mr. Flanagan, the vice chairman of the subcommittee.

Mr. FLANAGAN. Good afternoon. I have one large question with a lot of smaller parts attached to it and, Mr. McMahon, in reading through your testimony, I would first like to apologize for not having been here for your oral testimony, but I have read through it and looked through it all.

I would like to ask the question, should the Federal Government finance projects that you discuss, the MTA and the other things involved there, what—I guess for lack of a better term—guarantee is there that the ongoing funding to maintain and operate them would be there? And if not, would such a capital expenditure include operating expenses as well?

Mr. McMAHON. Not necessarily. It depends on what the ultimate goal that you are looking to realize is, articulated by the spending choice that is made. And I think that it is clear that both nationally, regionally, and locally that investments have to be made in infrastructure if this country and our regions and our cities will be able to compete in the economics of the 21st century. So I think the idea—I mean, the investment is necessary to make us competitive.

Mr. FLANAGAN. I understand that. My question continues though. Maybe you can guess where I am going. Why a Federal expenditure? I wrestle with this—I am from Chicago and I wrestle with these problems constantly there where a local authority will come to me and say, I need a handful of millions for this, for that, for the other thing, all of them local need, local necessity, local requirement and sometimes a local good idea. Why out of the Federal pot?

Mr. McMAHON. The Federal Government is responsible for national commerce. Why is there an interstate highway system?

Mr. FLANAGAN. The interstate highway system is not a local bridge across the north branch of the Chicago River. The interstate commerce system is not a downtown transit system. That is not interstate commerce.

Mr. MCMAHON. But that bridge is part of the interstate network.

Mr. FLANAGAN. What is interstate commerce? If we are going to extrapolate it that far, then anything that provides a mode of transportation across a road or pavement somewhere is interstate commerce, then we will just take over the transportation budget here of the Federal Government.

I don't mean to be purposely contrary with you and I am doing this purposely to make a point, and that is, would it not be better to withdraw from projects like these, to withdraw from having to put expenditures into things like this, turn it back to the States and get the Federal Government out of these businesses entirely, consequently having—balancing the budget along the way, providing general economic health and permitting the State revenues to increase proportionately with the decrease of the Federal revenues? Shouldn't that be our long-term goal, to let Illinois or New York, whatever the case may be, to make their own decisions as they need best where they are?

Mr. MCMAHON. Under a very thoughtful strategy for fiscal federalism where each branch of government had responsibilities for those specific charges and those are articulated, I think that would be an excellent approach, but with that would also have to come the release of the tax dollars that are necessary to fund those very important initiatives, and it is a difficult area, difficult question.

I agree with you. I don't think there are easy answers, but at this current point in time, I don't know that local governments have the wherewithal to make the massive investments that are necessary to rebuild the infrastructure of this country and be competitive on their own.

Mr. FLANAGAN. I would tell you on the scale on which you are talking, the Federal Government running hundreds of billions in debt every year, I am not sure that we have the wherewithal at the Federal level with our current structure to be able to do it at all.

The Federal Reserve prints the money and we kind of collect it up and kind of pass it out and with some rhyme or reason occasionally, but I question seriously perpetuating the system that does a job this badly. And maybe some of the other panel members have a comment on that.

Ms. HANLEY. I would be—thinking, for example, of this region where we have WMATA, which is a tri—a multijurisdiction and the only one in the country of three jurisdictions, the District, Virginia, and Maryland, there are certainly some national interests in having the economy of this region be strong. I think there are some national interests, particularly in transportation, of the economic benefits of transportation, whether or not it be just in one particular jurisdiction, or the bridge may be in one area, but a lot of other people may go over it, and I think there are some national interests there in keeping the infrastructure strong so that the economies of our cities and States can be strong.

The other thing that I would say is that, for example, a locality like Fairfax doesn't access income, and because we have no income tax, and so our infrastructure is—you know, our revenue authorities are fairly limited, and if we had to take over the part of the Beltway, for example, that was in Virginia——

Mr. FLANAGAN. No one would suggest that you would take over the Beltway or part of the interstate highway system. That is clearly the Federal Government's responsibility for interstate commerce because the touching is so close, but a footbridge across the north branch of the Chicago River, you have really got to go a long way to convince me that that is something that needs to be done.

However, that is the sort of capital expenditure we are talking about for local transit or necessary regional transit matters and capital infrastructure generally. I am trying to draw a line here and I am more inclined to draw it away from the Federal Government than toward it, and this is where we remain, I think, perhaps philosophically opposed.

Ms. HANLEY. Well, I guess the other question is in transit, you have to balance some other Federal goals, which include clean air.

Mr. FLANAGAN. OK. I yield back.

Thank you, Chair.

Mr. HORN. The gentleman from New Hampshire, Mr. Bass.

Mr. BASS. Thank you very much, Mr. Chairman.

Appreciate your appearance here today and I, like my colleague from Illinois, I regret having not been here for your oral testimony. We had another Government Reform and Oversight Subcommittee hearing.

I come from a State that has a capital budget, the State of New Hampshire, and we also don't have a sales or income tax, and as a former member of the legislature and the New Hampshire State Senate during tough economic times, there has been some temptation to use the capital budget as a mechanism whereby it becomes somewhat easier to balance the budget in a given year.

To what extent do you all feel pressure to utilize the capital budget as a mechanism to make your operation expenditures a little easier to deal with?

Ms. HANLEY. Well, we don't. In other words, what happens is that we don't do those capital expenditures. If the general fund shrinks to the point that the 10 percent debt service exceeds the 10 percent, we put off the sale of bonds. I suppose you could say that there are some human investments that we use the bond funds for if it concerns the design and the construction of a project, but the operation, we do not use capital and bond funds for.

Mr. LEIDINGER. In Fairfax County, approximately 72 percent of our general fund revenues come from property-based taxes, real estate and personal property taxes. So we are fairly sensitive to what happens in the real estate market and the general economy as well.

During the decade of the 1980's, our general fund revenues were growing at an average annual rate of about 12.2 percent. When the recession hit us in 1991, not only did that growth stop, but we lost revenue for the first time in the history of the county, and the board of supervisors took a number of tough actions, as I mentioned this morning, but included among that—those actions were deferring $220 million worth of capital projects that were scheduled to be completed. They simply cut back and cut the suit to fit the cloth, both in the operating budget and the capital budget. There was not an effort to conduct operating activities in the capital program at all, as Ms. Hanley has said.

Mr. BASS. So in effect, you have very strict limits on what you can capitalize and how much capitalization you can undertake in a given period?

Mr. LEIDINGER. That is correct.

Mr. BASS. Thank you very much, Mr. Chairman.

Mr. HORN. Thank you. Let me ask a few questions and then we will have another round. I am curious about how much your status as a member of a governmental entity determines your support for a capital budget? How does that process differ from the process which determines your support for an operational budget?

Are there different standards, different criteria, or is there an overlap in some areas? How do you prioritize those things so you are satisfied that you will get a majority of the board's support?

Ms. HANLEY. I get to go first.

Mr. HORN. Besides putting one project in each Member's district.

Ms. HANLEY. Oh, well you gave my answer. There may not be anything left to say. I guess in Fairfax County, we have a comprehensive plan that is the basis of what—the long-range plan of what kinds of infrastructure we need in terms of fire stations and police stations and that kind of thing, as well as the Judicial Center and all that.

And so that all goes into a—on a list with costs. And the real question becomes, what do you do first? How do you establish which things to do first if there are bonds approved for it? We do most of our—obviously, as we said earlier, most of our capital construction through the sale of general obligation bonds, and so they have to be approved by the electorate in order to do that. So the real discussion is: What do you do first and, yes, there are some standards, and yes, there is a lot of give and take in order to get things on the list first and how you squeeze it all in each year.

It is a different kind of give and take, however, from an annual budget because that is more immediate. We take a little longer range view on the capital budget.

Mr. HORN. How about New York?

Mr. MCMAHON. In the city of New York, it is a process that proceeds on two separate tracks, the expense budget with all the pressures that go there for the next year's expenditures, and the capital budget with more of a long range view, and the linkage is the debt service that is necessary to support the capital budget.

Four years ago, the city of New York went through a charter revision, which is still evolving in many ways, and one of the requirements of that charter was that the—with each capital budget, there be an itemization of the expense pressure that would be needed to maintain that capital asset or to operate that capital asset.

It is something that is required by the charter but hasn't been fully implemented yet and we are still trying—going through the process of developing the mechanism to measure the pressure that would be placed on the expense budget because of the existence of an asset.

And it is a tool that, as I say, is difficult to measure, but once we figure it out, I think it will be a very important tool to link the two, because, ultimately, they are linked.

Mr. HORN. Now, Robert Moses was one of the great czars of public works of New York. He worked, as I remember, for about five decades on behalf of both the Governor of New York, regardless of party, and for the mayor of New York City, regardless of party. Did he operate under that capital budget or did he just have an independent budget that nobody had any control over?

Mr. MCMAHON. Right. Robert Moses is going—there is a bit of revisionism going on in New York City as regards Robert Moses because people are starting to realize that the last major public works project was done under Robert Moses and nothing has been done since.

He used something different. He operated under—the State under a local capital process until he found it wasn't working for them and then he did something, which was to create an authority. And in New York City, he created a number of authorities.

First, at the State level, a parks authority, which enabled them to build Robert Moses Park on the south shore of Long Island, which is—which includes some of the finest beaches, we like to think, in the country, Jones Beach being one of them. And he also created something called the Triborough Bridge and Tunnel Authority which is in New York City and it is separate from the city's capital budget and it is supported by the tolls on the various bridges and tunnels, and that was used to buildup this—the city's infrastructure for bridge and tunnels. And there are other examples of authorities in the city that are separate——

Mr. HORN. Did he create the airport and harbor authorities also?

Mr. MCMAHON. The Port Authority was created by State law before Robert Moses. That was before his time. I think that was in 1925, and they also have a separate operating and capital budget as well, and——

Mrs. MALONEY. Can I ask a question?

Mr. HORN. Sure, please.

Mrs. MALONEY. Were his authorities on budget or off budget?

Mr. MCMAHON. Off budget. So still in New York City, the TBTA is off budget. It is subsumed into part of the overall—the MTA. It is a subsidiary of the MTA and it is off budget.

Mr. HORN. Are the bridge fees pertaining to that authority solely used for maintenance, operation, reconstruction of the bridges, or do they slide into the city budget?

Mr. MCMAHON. They only slide into the mass transit system. They support mass transit in New York City.

Mr. HORN. And did that take a separate action of the city council and the State legislature or the authority board?

Mr. MCMAHON. The State legislature.

Mr. HORN. State legislature?

Mr. MCMAHON. Right. And the initial intent of issuing the bonds was that they would be retired once the bridge was paid for. In most cases, very few tolls have been rescinded because there has been a reissuance of the debt and the proceeds of the tolls have been used to support mass transit.

Mr. HORN. Let me ask you one last question. It has to do with public psychology and employee psychology. In California, as some of you have read, we had a major budget crisis over the last few years where the generally $60 billion State budget had a $15 billion deficit, an amount unheard of in modern times. Before that, we only had a $1 billion deficit in 1983, which we solved within 45 minutes of Governor Deukmejian taking the oath of office through cutting the State budget 2.5 percent for the year. We had gone through half the year, so we had to cut our budget by 5 percent. We did it and that solved that problem.

A little more difficult to solve, is $15 billion, especially since the University of California, the California State University and the California community colleges, three separate statewide entities and boards, all appointed by the Governor, have authority to issue bonds under the State of California. Those bonds go before the voters, and until recently, those bonds for capital projects were approved.

So you find, when you are trying to grapple with a $15 billion deficit as Governor, that you could wipe out the whole traditional State government, corrections, mental health, public health, all the rest, and the three university systems, all that is traditional, and you wouldn't close the gap. In other words, you couldn't get the $15 billion even if you wiped out the whole traditional State government, because it is entitlements that were running the deficit up.

So you face the irony where you had to take huge chunks of personnel out of State government. When people wake up in the morning and they get the pink slip at the end of the day, then they look around them, and here are beautiful facilities being erected, this science building, that psychology building, this jail, this prison, whatever, all of which, funded by bond authority several years before, now appears where people are being led off by the thousands.

Obviously employees wonder why that disconnect is. Well, it is because the capital budget is funded in a different way than the operational budget; in other words, through bonds rather than taxes. Have you had to experience that, and what do you do about it under those circumstances? Nobody in Fairfax County ever has a problem with what the board does?

Mr. DAVIS. The library.

Ms. HANLEY. I was thinking more of the new government center.

Mr. HORN. The Taj Mahal, you mean, for the county executives and board.

Ms. HANLEY. There are times, I guess, when I wish we were a little further away from——

Mr. HORN. The television cameras are not here.

Ms. HANLEY. Small favors. Thank you very much.

That does happen occasionally, but in Fairfax, more when it is funded other ways than by general fund dollars. In fact, the psychology recently in Fairfax is the reverse. We voted for these projects and you haven't built them yet. Why not? Because we supported them and we think they ought to be in place, and you all are just being stingy and just won't do it. And it is harder to explain that the operating funds aren't there and the debt capacity isn't there. That is partly because the debt capacity is tied to the general fund.

The Government Center, of which I spoke, was not a general obligation bond and so that did raise that confusion because the voters hadn't voted on it.

Mr. HORN. Let me ask you on that debt capacity: is that an act of the board or do you have a county charter and that is written into the charter?

Ms. HANLEY. We don't have a county charter. It is the act of the board and we believe that our rating agencies think it is very important that we do that.

Mr. HORN. So if the board changed it, obviously that might well affect your rating?

Ms. HANLEY. Certainly, as well as the rating agencies look for us having some kind of annual capital expenditure within our annual budget.

Mr. LEIDINGER. If I may, while the 10 percent limit on debt service, 10 percent of general disbursements is self-imposed, I don't think the rating agencies would really care if it was 8 percent or 9 or 11 or 12 or 10 so long as it was agreed upon locally and you were consistent with what you did over time.

Mr. HORN. I just ask Mr. McMahon, is the city university of New York budget in your budget, or is that a separate budget?

Mr. MCMAHON. No. The city university budget shows up as part of our budget.

Mr. HORN. They would have that kind of problem I described. If you had cutbacks, shiny buildings are going up, while the faculty is being laid off, how much of a problem is that?

Mr. MCMAHON. It is a significant problem because New York is now facing the same situation that you pointed to in California where, because of tremendous pressures on its budget, it has to cut back on a whole host of areas, including employees in the city university and there are facilities that exist that will have to be closed.

The same situation exists in the Health and Hospitals Corp. in the city of New York where we have created a massive structure now with cutbacks and entitlements in a whole host of areas, that significant downsizing will be needed.

It is a significant problem. I don't know what the answer is. It is probably something that requires—you know, that is—reflects a certain lack of planning or a lack of thought, but going back years ago, there were assumptions that people relied on, erroneously now, but I don't know what the easy answer is.

Mr. HORN. Well, the answer is obviously one thing: That you have to educate your constituency, both your employees and the taxpayers that provide the funds that we are talking about, that two different methods of funding that just happened to come along at different times.

Representative Maloney, do you have some more questions? Anybody on this side have questions?

Mr. DAVIS. If I could just ask one other question?

Mr. HORN. The gentleman from Virginia.

Mr. DAVIS. Basically, as I understand it, to follow up on two questions that the chairman had raised——

Mr. HORN. Please.

Mr. DAVIS [continuing]. That your capital budget is, to a large extent, driven by the fact that 10 percent in Fairfax, or whatever it is in New York, you have a certain amount you are budgeting to capital expenditures through your debt service and that, to a large extent, drives your capital budget. You may have some other operating budget revenues you could put into capital, and that is, I take it, a good financial control.

Ms. HANLEY. Yes.

Mr. MCMAHON. Yes. I mean, our limitation is 10 percent of the average of assessed property over the prior 5 years, and another thing that is driving it in New York City, as I imagine in many of the older cities in this country, is the deterioration of the infrastructure. Our water system is well over 100 years old. The transit system is almost 100 years old and these are all needs that require attention because if you don't make that investment, it will cost you more in the long run.

Mr. DAVIS. The other followup is that when the revenues go down, as the chairman said, you can be left with empty buildings if you don't project out ahead of time. Has it been your experience, as revenues go down, you can go into capital like roads and bridges that don't take people and operating expense and would move in that direction as opposed to libraries and schools which may be more intense, and if there is any comment on that?

Ms. HANLEY. You can if you don't have specific authorization in a bond, certainly. I mean, if you have the flexibility to do those things that don't require that much operating.

Mr. DAVIS. My next question is, I take it both of you are overauthorized, you have plenty of authorization out there and then you can only spend down a certain amount a year?

Ms. HANLEY. I never like to think of myself as being overauthorized, but I guess, yes.

Mr. DAVIS. How about in New York?

Mr. MCMAHON. New York is now bumping up against the State constitutional limit on the amount of debt that it can have issued, and the reason being that there has been a significant drop-off in the value of property in the city of New York, and some people argue that is cyclical and it will come back up, but it is a problem that we are addressing right now by scaling back our capital.

Mr. DAVIS. Fairfax has to have a bond issue for a specific project. To borrow, you need to get the permission of the voters. Does New York City have that? Cities in Virginia don't have that to the same extent.

Mr. MCMAHON. No. It is not—there is no voter approval required for the city of New York general obligation debt issuance. It is essentially approved by the council as part of the annual——

Mr. DAVIS. So you wouldn't have an authorization problem. I guess in Virginia, you would have to be authorized by the voters and then you would spend it down to the extent your budget allows you to. Ms. Hanley?

Ms. HANLEY. Yes, unless you are a city or unless you have some kind of authority or revenue bond situation where you had the revenue stream identified.

Mr. DAVIS. Like for waste water treatment or burning trash?

Ms. HANLEY. Water authority, Metro garages at Vienna.

Mr. DAVIS. You have the revenue stream. Thank you.

Mr. MCMAHON. And I should point out, the State of New York is different in this case because there, in order to issue debt, you need the authorization of the voters. And what Governor Rockefeller did was, he also found creative ways to create authorities that were off budget that got around that mechanism and utilized it to create a number of things that are very attractive in New York but also very expensive.

Mr. DAVIS. Thank you.

Mr. HORN. I thank each of you very much. We have delayed the Virginia contingent long enough to get caught in the rush hour traffic and feel the problems of modern urban capital projects.

Mr. DAVIS. HOV–2 now, though. They are OK.

Mr. HORN. We do thank you for coming. And Mr. McMahon, we deeply appreciate you coming down from New York and sharing your experience with us. It is very important. So thank you all.

And if the last panel will come forward, I would appreciate it. In the meantime, I ask consent that the working papers provided by Mr. Brasher and Ms. Young of the majority staff having to do with the California legislative analysts' definitions of the terms we are discussing, and the excerpts from the California State Administrative Manual and the work of the National Association of State Budget Officers entitled, "Capital Budgeting in the States, Path to Success," as well as an article in Government Finance Review, "Operating Capital Budget Reform in Minnesota, Managing Public Finances Like for Future Matters," be included at the conclusion of today's hearings as part of the hearing record.

Hearing no objection, that is so ordered.

Please be seated. Our first speaker will be Mr. Ted Sheridan, the former Chief Financial Officer of Fairchild. Thank you very much for coming.

STATEMENTS OF TED SHERIDAN, PRESIDENT, SHERIDAN MANAGEMENT CORP., ON BEHALF OF FINANCIAL EXECUTIVES INSTITUTE; AND DAVID CHU, FELLOW, NATIONAL ACADEMY OF PUBLIC ADMINISTRATION, SENIOR FELLOW, RAND CORP.

Mr. SHERIDAN. Good afternoon, I am Ted Sheridan, president, Sheridan Management Corp. and I am a member of the Financial Executives Institute, Committee on Government Liaison. FEI is a professional association of 14,000 chief financial officers, treasurers, and controllers from some 8,000 major corporations throughout the United States and Canada. The committee on government liaison formulates positions on economic and regulatory issues of concern to American business.

Mr. Chairman, we appreciate the opportunity to present the views of FEI before the subcommittee and are always willing to provide our technical assistance to you, the ranking member, and your representative staffs. And I was very pleased to see that Chairman Clinger was here and I have a copy of H.R. 767, which I had not seen before and it appears that is quite germane to these processes. I have read his prior submissions in earlier Congresses.

As to why I am here, I have been a member of this committee of FEI for virtually its entire existence, and the last time I was here, I testified before then-former Chairman Conyers on the CFO Act. I have been involved with various things with GAO, OMB, and Treasury, and worked for the late Malcolm Baldrige in some processes here and others.

In addition to being CEFO of Fairchild Industries, I also held a similar position with AMF for 12 years and I have been involved with this matter in a variety of other contexts, including part of the faculty at Columbia University, where I held a seminar on this matter.

The issue is why capital budgeting and why the private sector over the last 15 years has gone through a wrenching process of reengineering and downsizing and virtually every business has had to reassess its mission, its priorities, and the ability to deliver a required level of goods and services at lower cost and with greater efficiency.

Those of us in the corporate financial community know how critical and painful this process can be. We had to do it because of the official laws of survival in the global marketplace. In this current environment of multibillion dollars deficits, we strongly recommend that the Federal Government emulate wherever possible the private sector experience.

Central to private sector reengineering has been employment of a highly disciplined mission definition and capital allocation process conducted on prescribed cycle schedules. Pivotal to this is the commitment to long-term fixed assets which will drive much of the operating budgets of future years.

The importance of capital budgeting in the private sector cannot be overemphasized. Capital budgets force companies to develop long-term strategies on how to most efficiently accomplish the business objectives and link costs to the fulfillment of that mission. By doing so, it subjects the process to serious analysis for setting priorities and allocating scarce resources.

Given the impact on long-term mission accomplishment and the financial commitments embodied in the capital budget, it's imperative that it be analyzed, approved, and accounted for in a process totally separate from that for current operations. To lump them together as is currently done in the Federal unified budget is to obscure and to frustrate the role it should play.

It must be understood that the presentations accompanying the Federal budgets that break out capital appropriations for fixed assets and other investments are done after the fact and are not separately considered in the decisionmaking process. Doing so makes it virtually impossible to adopt the disciplined approach of the private sector to mission definition and capital allocation.

Capital budgeting forces companies to develop a long-term strategic plan, usually 5 years, to fulfill stated goals and objectives. In developing the strategic plan, companies first determine what their capital asset requirement needs will be to accomplish the mission. Once completed, the costs to fund the capital assets will be calculated.

Determining the ability to fund capital projects requires companies to prioritize projects in order to accomplish the stated objectives and best fulfill the overall mission within funding constraints. In the private sector, analysis using investment criteria such as positive net present value are employed to determine the relative value of completing—competing projects and to make the critical priority decisions.

Once this process is complete and the decision to move ahead with capital investment is made, a system must be put in place that periodically tracks the progress of investments to ensure that the project is meeting its stated objectives.

In the private sector, the financial reporting system is used to monitor the progress of such capital budgets produced on a monthly, quarterly, and annual basis. Safeguards such as periodic audits are performed regularly to ensure accuracy of the financial reporting system and accomplishment of objectives. In condensed form——

Mr. HORN. Let me say that we are going to be running short of time. We do put your whole statement in the record. You don't have to read it, so feel free to just summarize.

Mr. SHERIDAN. Right. The point that I was trying to make and why I would like to finish this very last thought is in a condensed form, these reports are reviewed by board of directors to evaluate the effectiveness of the strategic plan and the underlying capital investments.

The board of directors uses this information as the basis for approving the strategic plan for the ensuing 5 years, where the cycle begins again. We would propose such a process, we, FEI, and this review and approval will be done at the Federal level by the Congress through an oversight committee such as this one.

So we are trying to bring into the cycle an approval process that is very much like the very successful one used within the corporate environment and we feel that this committee is one that could have that oversight under your new charter.

Thank you, I would be pleased to address any questions.

Mr. HORN. Well, I see that you have advocated here a pilot program so why don't you just summarize the idea there.

Mr. SHERIDAN. Well, I spent half an hour with your colleague Chris Shays before this meeting trying to explain these thoughts in less time than you allotted to me, because that's Chris' way and it became clear to me that the enormity of the subject matter, the complexity of the definitions and the means to address it were so, so huge that in our view we would do what we would do in the private sector, is to find relative projects on which we could try out these notions in such a way that they could be given under-the-microscope scrutiny by this committee and others. And we would propose to do that in three areas that we think are relevant within a very narrow definition of assets in the capital budget.

[The prepared statement of Mr. Sheridan follows:]

PREPARED STATEMENT OF TED SHERIDAN, PRESIDENT, SHERIDAN MANAGEMENT CORP., ON BEHALF OF FINANCIAL EXECUTIVES INSTITUTE

Good afternoon, my name is Ted Sheridan. I am President of Sheridan Management Corporation and a member of Financial Executives Institute's (FBI) Committee on Government Liaison. FBI is a professional association of 14,000 chief financial officers, treasurers, and controllers from some 8,000 major corporations throughout the United States and Canada. The Committee on Government Liaison formulates positions on economic and regulatory issues of concern to American businesses.

Mr. Chairman, we appreciate the opportunity to present the views of FBI before this subcommittee and are always willing to provide our technical assistance to you, the Ranking Member Carolyn Maloney and your respective staffs.

Why Capital Budgeting

Over the past 15 years, the private sector has gone through a wrenching process of re-engineering and downsizing. Virtually every business has had to reassess its mission, priorities, and the ability to deliver a required level of goods and services at a lower cost and with greater efficiency. Those of us in the corporate financial community know how critical and painful this process can be. We had to do it because of the efficient laws of survival in the global marketplace. In this current environment of multi-billion dollar deficits, we strongly recommend that the Federal government emulate the private sector experience.

Central to private sector re-engineering has been employment of a highly disciplined mission definition and capital allocation process conducted on a prescribed cycle schedule. Pivotal to this is the commitment to long term fixed assets which will drive much of the operating budgets of future years.

The importance of capital budgeting in the private sector cannot be overemphasized. Capital budgeting forces companies to develop long term strategies on how most efficiently to accomplish their business objectives and to link cost to the fulfillment of that mission. By doing so, it subjects the process to serious analysis for setting priorities and allocating scarce resources.

Given the impact on long term mission accomplishment and the financial commitments embodied in the capital budget it is imperative that it be analyzed, approved and accounted for in a process totally separate from that for current operation. To lump them together as is currently done in the Federal unified budget is to obscure and frustrate the role it should play.

It must be understood that the presentations accompanying the approved Federal budgets that break out capital appropriations for fixed assets and other "investments" are done after the fact and are not separately considered in the decision making process. Doing so makes it virtually impossible to adopt the disciplined approach of the private sector to mission definition and capital allocation.

The Mission Definition & Capital Allocation Cycle

Capital budgeting forces companies to develop a long-term (usually 5 years) strategic plan to fulfill stated goals and objectives. In developing the strategic plan, companies first determine what their capital asset requirement needs will be to accomplish the mission. Once completed, the costs to fund the capital assets will be calculated.

Determining the ability to fund capital projects requires companies to prioritize projects in order to accomplish the stated objectives and best fulfill the overall mission within funding constraints. In the private sector, analysis using investment criteria such as a positive net present value are employed to determine the relative value of competing projects and to make the critical priority decisions.

Once this process is complete and the decision to move ahead with the capital investment is made, a system must be put in place that periodically tracks the progress of the investment to ensure that the project is meeting its stated objectives.

In the private sector, the financial reporting system is used to monitor the progress of such capital projects—produced on a monthly, quarterly, and annual basis. Safeguards such as periodic audits are performed regularly to ensure accuracy of the financial reporting system and accomplishment of objectives.

In condensed form these reports are then reviewed by a board of directors to evaluate the effectiveness of the strategic plan and the underlying capital investments. The board of directors use this information as the basis for approving the strategic plan for the ensuing five years, where the cycle begins again.

If the process is adopted as FBI proposes, this review and approval would be done at the federal level by Congress through oversight committees such as this one.

Definition of Capital Assets

Within the Mission Definition and Capital Allocation process, decisions must be made on the present and future deployment of various categories of capital investment which support mission accomplishment.

To embrace all of the definition of investment applied to all federal programs within the current conceptual framework would obviously overwhelm the effort. FBI has chosen to narrow the definition initially to tangible fixed assets and to address a limited number of program types. This would include:

- Defense system procurement,
- Buildings, equipment and information systems to support agency operations, and

- Government-owned infrastructure projects

We would not include such items as:

- Intangible assets
- Grants to state and local governments
- Revolving funds
- R & D, education and training
- Human Resources
- Social Investment

FEI Recommendations for a Pilot Program

Because of the long term commitments created by the capital budgeting process for fixed assets, it is essential that it be analyzed and justified in a process separate from that used for other forms of federal investment, current operating expenses and discretionary spending.

However, moving to capital budgeting does raise some additional issues. These include violating existing policy and law concerning the appropriation process, the inclusion of depreciation in operating budgets, employment of deficit financing of investments and possible abuses such as deflecting costs between operating and capital accounts!

While recognizing these concerns, FEI believes that it is possible to create a system that would deal effectively with each of these issues. To that end, FEI proposes a pilot program to test the applicability of these systems to discrete federal programs that are representative of three classes of fixed asset investment:

— A weapons system procurement such as the FA 18 E/F
— An information system acquisition such as FTS 2000, and
— A government owned infrastructure project such as power generation

Each project would create and implement a Mission Definition and Capital Allocation program. It would then establish a proposed fixed asset Capital Budget distinct from other investment and spending for the associated department or agency. Following that it would integrate the fixed asset expenditures budget with other appropriate investment and spending relevant to the program. A financial management and control system would be devised with an accompanying reporting and auditing program to be presented to this Subcommittee for oversight approval.

Systems and procedures would be devised and tested to prove their efficacy and their ability to satisfy the concerns expressed by observers. Each of the three programs would then be evaluated for possible broader application and, hopefully, eventual adoption as modified and improved for general use in the Federal budget process.

Conclusion

Mr. Chairman, budget decisions made today have long-term ramifications for the health of the nation's economy. In this environment of sustained budget deficits, making informed budget decisions are more important than ever. That is where capital budgeting can play a vital role. Capital budgets would be an important tool for Congress and the President to have at their disposal as they work toward a more efficiently run government.

To that end, FEI has worked for over 15 years promoting the need for improved financial management practices in the Federal government. Four years have passed since the passage of the Chief Financial Officers Act of 1990. Much has been accomplished, but much remains to be done. We believe the 104th Congress provides some unique opportunities to significantly strengthen the CFO Act. The time is right to get the Federal government's fiscal house in order, and we stand ready to assist you and this Subcommittee to accomplish these long overdue objectives.

Mr Chairman, thank you for this opportunity to appear before the Subcommittee this afternoon. I would be pleased to answer any questions.

Mr. HORN. That is very interesting. You note a weapon system procurement such as FA–18E/F could be included. I suspect that would get shot down as people say, "my heavens, they will hide the whole defense budget in here." An information system acquisition such as FTS 2000, which we will be holding a hearing on, would be very appropriate to include as would a government-owned infrastructure project such as power generation.

So what you are saying is take some gigantic project that has long-term viability similar to the private sector and try to apply these basic principles.

Mr. SHERIDAN. Well, Mr. Chairman, I only suggested the FA–18 because the empennage is built in southern California but that was just a——

Mr. HORN. I don't have any parochial interest so don't worry about that. I just think the general principle of including weapons systems would bother me, frankly. Maybe I could be convinced differently, but I just think it is so liable to mischief by the executive branch that pretty soon we would have the capital budget equal to the operating budget. There is a constitutional provision on weapons anyhow that they need reappropriation every few years, which no other budget has.

So this is immensely helpful.

Let us ask Dr. Chu, now, a fellow of the National Academy of Public Administration and, I guess, still a fellow, at Rand?

Mr. CHU. Yes, sir.

Mr. HORN. We are most grateful for you coming. Again, your statement will go in the record. Please feel free to summarize it and then we will get to the questions the Members have.

Mr. CHU. Thank you. I will summarize it briefly. Let me say it is a great pleasure to be here and to have a chance to offer testimony. I should stress that this is testimony based upon my service on a NAPA panel, although NAPA itself has not taken a position on these matters. My remarks should not be viewed as representing NAPA's institution, nor as representing the organization on whose staff I serve, Rand.

Capital budgeting is obviously a critical issue, one that has long been with us, but one which you know has met considerable resistance over the years at the Federal level. A core conclusion of the panel on which I served was it was important to understand why this idea has not been adopted at the Federal level. In that regard, I believe that our deliberations identified five issues that are useful to consider.

First of all, a question which has already been touched upon repeatedly this afternoon, is the proposed scope of a Federal capital budget. Does it go so far at one extreme to embrace such investments as ideas, which includes the product of research and development software data bases, et cetera, on which the Federal Government expends considerable resources?

Does it include human capital or is it limited to items of physical capital?

And within the physical regime, are we talking principally about items that support private sector activities—roads, bridges, et cetera—or are we also encompassing items that support the government production of services, whether those are health services, veteran's services, postal services through the postal system, defense—the FA–18 example in Mr. Sheridan's pilot list? Are we talking simply about plant here, meaning buildings and their improvement, or are we embracing equipment, as well?

The second major issue, in my judgment, is whether the method of financing the capital investment is important in deciding what we are talking about. Are we restricting the capital account to directly financed items, through appropriations or borrowing?

Do we include items that are financed through tax subsidies?

Do we include items that are financed through credit guarantees, or by government enterprises, which is important activity in the housing sector?

Do we go so far to include items that are required as a result of Federal mandates of one sort or another?

A third major issue, in my judgment, is the question of how we decide the aggregate level of capital investment for the Federal Government. Should it be mechanistically linked, as in the Fairfax County example, to a particular aggregate index like Federal revenues, or should it be determined in some other way, including a tradeoff of consumption versus investment?

A fourth obvious issue, is how any decision about the aggregate level investment should be apportioned among the bodies in the Congress who would make decisions on its specific allocation and on specific projects.

And a final issue, obviously, is the relationship of the capital budget to borrowing limits for the Federal Government as a whole.

As I indicated in my opening comment, capital budgeting presents a difficult but important challenge. If there were easy answers to this challenge, the capital budget idea would have been adopted at the Federal level years ago. The decisions associated with this challenge—with Federal investment—are obviously critical to the country's future, and thus important to us all.

Thank you, Mr. Chairman.

[The prepared statement of Mr. Chu follows:]

PREPARED STATEMENT OF DAVID S.C. CHU, FELLOW, NATIONAL ACADEMY OF PUBLIC ADMINISTRATION

Mr. Chairman and Members of the Subcommittee:

My name is David Chu and I am pleased to testify this afternoon at your invitation on behalf of the National Academy of Public Administration (NAPA). The views expressed are my own and not those of the Academy as an institution. However, they are based on work by a NAPA panel on capital budgeting of which I was a member and associated staff research. The work was done at the request of the Corps of Engineers as part of a major project on the nation's infrastructure strategy. One result of our work was to co-sponser a Capitol Hill Summit conference on Federal Capital Budgeting with the Advisory Commission on Intergovernmental Relations here in the Rayburn building in March of last year.

As you know, the Academy is a Congressionally chartered organization which was formed more than twenty-seven years ago to improve governance and public management. It has a membership of about 400 Academy Fellows who have spent their professional lives actively concerned with government and its problems.

My purpose this afternoon is not to testify on particular legislation although we have seen Chairman Clinger's bill, H.R. 767, which is proposing a capital budget and an operating budget within a unified federal budget. Regardless of the specifics of that bill, which we look forward to studying further, it addresses a problem about which there is general agreement. How should the federal government budget for capital investments especially in periods of fiscal stringency? We believe this is, and should be, a major concern of the Congress and therefore a good choice for investigation and review by this committee.

As you all know, this is not a new subject. Almost 30 years ago, in October 1967, the President's Commission on Budget Concepts stated that:

> The Commission finds little merit in proposals to exclude outlays for capital goods from the total of budget expenditures that is used to compute the budget surplus or deficit. It strongly recommends against a capital budget in this sense.

There has been consistent and strong opposition to a capital budget ever since, strong enough to prevent success of the persistent attempts to incorporate this concept into the federal budget process.

If this Committee and this Congress are to be successful in coming to grips with the capital budgeting problem, a thorough examination needs to be made of the roots of this opposition as well as the many—and there are many—good arguments for capital budgeting. What I wish to do this afternoon is to outline some of the issues that need to be explored in that examination.

Those that favor capital budgets make persuasive arguments:

- Many states and localities are using capital budgeting successfully.
- The use of long range planning and cost benefit analysis which are important to capital investment decisions would be enhanced by a capital budget.
- By clearly identifying expenditures associated with capital, a capital budget would discourage, or eliminate, borrowing for operating expenditures.

Each of these arguments deserves consideration by of the Congress.

In addition there are a number of more technical issues to be explored:

What are the range and boundaries of capital budgeting? There is little question that investment in research and development, and in education and training, are investments in the future of great importance to the nation. They are included as part of federal investment in the President's budget. However, their inclusion in a capital budget would greatly enlarge its potential scope.

It is possible to separate so-called hard capital investment into projects directly enhancing the private sectors long-term productivity (such as roads, and water management facilities) and those required to conduct government managed activities (such as veterans hospitals, postal facilities and federal courthouses and prisons). Would both groups of projects be included in a capital budget?

To what extent would capital equipment programs be part of a capital budget? This includes both military equipment, and civilian equipment such as air traffic control hardware, and some that is in-between, such as the multi-billion dollar global positioning system started to meet a military objective, but now with burgeoning civilian applications.

Federal government financing of capital investment is not all through direct appropriations. The $75 billion subsidy for housing is funded through income tax deductions, so called "tax expenditures". Also, there are multi-billion dollar loan and credit programs for housing delivered through federal departments, corporations, and government sponsored enterprises. While few would argue that these should be part of a capital budget, their role is harder to ignore when considering the role of the federal government in promoting federal investment in future infrastructure.

Within the Congress, the adoption of a capital budget would pose a number of procedural issues in the Congress. I will only mention a few:

- How would decisions be made on the "appropriate" level of investment?
- Would investment allocations be made to congressional committees and, if so, how?
- Would trade-offs be allowed between discretionary spending for investment and mandatory programs that support consumption to permit Congress to shift resources from consumption to investment?

Finally, the relationship of a capital budget to government borrowing needs to be determined. A popular viewpoint is that borrowing would be acceptable for capital investment, but not for operating programs. This is the view of many states in their budget operations. At the moment, federal borrowing is determined by the cash flow needs of the Treasury, without reference to the type of program requiring the funds.

Mr. Chairman, you are undertaking a major task and a difficult one. The concept of capital budgeting wouldn't have been around for more than 30 years without final action if it were easy. But the stakes are high; deciding wisely the level and content of federal capital investment, in the face of many competing demands, is of great importance to the nation's future. We at the Academy will follow your progress with great interest and stand ready to assist you wherever possible.

Thank you for the opportunity to share our views on this important issue.

Mr. HORN. We thank you, Dr. Chu.

Representative Maloney.

Mrs. MALONEY. Well, I think a big issue is how do you define the capital budget. From the other panel, it is very clear on the local government, I guess we have been dealing with it so long, and everyone agrees it is the bridges and the roads and most of the States and cities do.

I would like to ask both of you where would you put defense?

See, in the city and State government in which I served, we didn't have defense and so it was not an area that I even thought about. But it seems to be such quickly changing technologies, not permanent items a lot of times. The minute we finish with the F-15, it is the F-16 and probably next year it will be the F-18.

How do you feel about defense? Would you define that as a capital budget item or an operation budget item?

Mr. CHU. I should emphasize that this is my personal view, and obviously it is a bit biased because I served in the Department of Defense for a number of years. But in my judgment, many of the items—physical items acquired by defense—are the quintessence of capital items. They are long-lived. The Department for many years published a balance sheet, which included a valuation of the capital stock.

There is an obvious problem that Mr. Horn identifies: the controversy associated with and the practical political issues entailed by treating some of these items as capital items. But in my judgment they clearly are, on the simple basis that they are long-lived: they provide services to the country over a long period of time.

From the perspective of Mr. Clinger's bill, if the reason—the principal reason—for capital budgeting is to assist planning, it is ultimately that planning function that such a budget presentation for defense would support. I am struck that especially at the current juncture in history, the sitting Secretary of Defense has signaled that he feels the investment portion of his budget is below the rate that in the steady state would be needed to sustain the structure of the forces the United States currently possesses. So it is a live issue in the planning context in that cabinet department, whether or not we show it as a capital budget item.

Mrs. MALONEY. Thank you.

Mr. SHERIDAN. In that regard, and I concur with your thinking, we should remember that whether the asset—asset purchase or procurement process is motivated by dictates beyond the realm of certain committees, that it should be understood that the $229 billion capital expenditures for capital for the defense procurement are going to take the largest measure and I think they should be very carefully looked at, judged on their merits for their mission support, and be viewed as an important element. To somehow push them off the table, I think would defeat the purpose of budgetary process in the capital area.

Mrs. MALONEY. And Mr. Chu, you mentioned in areas that we would have to look at the degree to which you would be allowed to borrow. Again, it has been tried on State and city levels and they have certain principles that we heard, 10 percent debt service, but how would you see the limits on borrowing for the Federal Government so that you keep some type of control?

Mr. CHU. I think one of the principles that was identified has considerable merit, at least in the long run; whether you follow it from year to year is another matter. That is, the borrowing instrument used should not substantially exceed the life of the item that it supports, nor your ability during that period of time to repay the principal and carry the interest on the debt that is thereby incurred.

Now, the important linking element in all of this, which is touched upon in Mr. Clinger's bill, of course, is the consumption charge. What will show up in the operating budget of the cabinet agency will be the depreciation or the asset consumption charge every year, the drawdown, in some sense, of the life of the equipment. And that is another element, another balance that in my judgment would warrant your attention.

If you are drawing—if you are consuming faster than you are investing, that is a signal that over time—eventually—there will be nothing left in that particular capital stock.

Mrs. MALONEY. Do you care to comment?

Mr. SHERIDAN. There is the notion that because the Federal Government is a sovereign entity that it doesn't have to go before the rating agencies and therefore some of the process of allocating the liabilities to the asset side is not relevant. That is far from truth.

The world capital markets are looking at us just as they use the benchmarks beneath the deutschemark and the yen and when we exceed, whether it is a percentage of benchmark of GDP or consumption or whatever, we are at peril that we are going to put ourselves in a position where our interest costs on this debt will exceed that which it should be. And even though the rating agencies do not necessary give us a double B or a triple A, we should look at this in the same manner and take it with the same degree of seriousness as it if were a firm mandate.

Mrs. MALONEY. Thank you very much. I have no further questions.

Mr. HORN. You raised an interesting point. The State of Virginia, as I recall, prided itself in the twenties and the thirties as the debt-free State. Everything was pay as you go out of the taxes raised that year. Bonds were not floated.

In the State of California, until this last election, the voters would almost always approve a bond authorization for higher education. They approved one for the University of California about 10 years ago. This time the voters went right down the ballot and said no to practically every Statewide bond measure regardless of its bipartisan or nonpartisan basis. Some had absolutely no opposition statement on the ballot, but it didn't matter. The voters said enough is enough. We have a deficit, folks. We are not going to pass the bonds.

Of course, the Federal Government doesn't go to anybody in terms of an actual electorate for their bond authority. They would come to Congress. We finance it in a wide variety of ways compared to the States. I believe that in the States, usually the capital budget is primarily financed by bonds voted by the voters. Obviously part of it can be paid out of the operations budget if the legislature so votes.

But does that in your judgment pose any problems for how the Federal Government approaches this? It is strictly a congressional decision at this point. We don't ask the voters of America to authorize a capital project and retire it by bond.

Mr. SHERIDAN. Well, the process is clearly more cumbersome, but the private sector knows when it is being crowded out of the financial marketplace. It also knows that the benchmark that it pays for its money is predicated on that which the Treasury pays. And if the Treasury pays more, they pay more, whether it is 100 or 150 basis points.

And they recognize that the impact on their own businesses and their own lives and their own adjustable rate mortgages are at stake. We find that they have more difficulty turning down ballots and they fire only every 2 years, but I think that they will speak and have.

Mr. CHU. The observation I would offer on this whole controversy is that, as is obvious to everybody, we are making these decisions now. We are making capital investment decisions now. But we aren't making them—and I think this is the point really in Mr. Clinger's bill—we aren't making them in an organized way, thinking about our choices in some strategic sense. We are also making borrowing decisions now. In essence, all the capital budget notion does—for all the economics that get attached to it—is insist that we try a more organized, more strategic approach to capital investments decisions. It doesn't change the fact that we are already making them.

Mr. HORN. Do you agree with Mr. Sheridan's suggestion that some of the long-term weapons systems would qualify for a capital budget?

Mr. CHU. Yes, sir.

Mr. HORN. You served in the Pentagon?

Mr. CHU. Yes, sir.

Mr. HORN. What did you think objectively——

Mr. CHU. Yes, sir.

Mr. HORN [continuing]. As to the criteria by which the Department of Defense picked and chose between competing projects of a 5, 10, 15-year nature? I am familiar with the C–17. I think that has been in initiation stage, production stage, for 17 or 18 years at this point from the original design.

How did you see that process working? Were there things that you as an expert in this area thought, "good heavens, why don't they apply some common sense and use this as a criteria?" Or are there criterion to separate between these items?

Mr. CHU. I think that the imposition of, or the requirement to submit a capital budget, would do the Department of Defense a great deal of good, because its present budgetary horizon is formally only 6 years into the future. There is a tendency not to look beyond that, and a tendency, in fact, to try to push bills out to the end of that period—if you're really clever, to the 7th year.

And of course as you appreciate, typically it takes at least a year to build an airplane. It takes several years typically to build a large naval war ship. It takes more than 6 years to conceive, design, and develop a major weapons system, C–17 being an excellent case in point.

One of the advantages, it seems to me, of a capital budget, is that it would compel the Department to deal with these issues on a long-term basis, including, ironically, having to think about the operating costs commitments it is making in the future by the capital decisions that it is initiating today.

In my judgment, it would be healthy for the Department. I don't wish to pretend that it would necessarily be enthusiastically received as a notion within that Department, but I think it would bring a very useful, proper long-term perspective to the choices that it must always make.

Mr. HORN. Well, that is an excellent point that you have made, in my humble opinion, because, as you suggest, they put it right outside of where that line was and then they dump the cost on us later and say, "oh, well, you should have known what you were doing when you approved it."

Well, did we not have all of the information at the time and there is no question that we are misled by the Pentagon regardless of administrations, as far as I am concerned. That was just confirmed on my recent walk to the Capitol with a person that is an expert in this area.

Let me give you an example, the V–22, Osprey. It has been in development, production, experiment. One Secretary of Defense is for it. One cancels it. A few years later, another Secretary of Defense wants to restore it.

What do you do in a capital budget situation with that particular project?

Mr. CHU. The first thing you do—and I think that the debate on this would have been substantially helped by a capital budget—is you pay attention to the extant stock of equipment that supports the mission, in this case principally the movement of marine forces from ship to shore. What I think that would have underscored for everyone, and thereby assisted the debate on this issue, is that the present stock is being drawn down very rapidly, much more rapidly than any replacement like the V–22 can possibly sustain. Had a capital account approach been taken, I think that would have given greater support to those in the Department who were worried about the immediate drawdown that was occurring.

Now, I should acknowledge, Mr. Chairman, that I am highly biased commenting on that specific issue, because I was one of those who advised the Secretary to cancel the program.

Mr. HORN. Let me move to a domestic example, HUD, Housing and Urban Development. Its predecessor agency, I think, built Pruitt Igo, a major public housing project in St. Louis.

I don't know if you remember, but a few years ago the evening news showed that whole project, I don't know, 8, 10, 12 stories tall, being blown up by dynamite. It was so bad that nobody knew what to do with it. I remember that project because I was the vice chairman of the U.S. Commission on Civil Rights. I held a hearing in St. Louis in 1970 and we saw that project. It was a disaster then. A decade or more went by before they blew it up.

But I cite that because generally in capital projects there is some estimate of the useful life, as the point was made by you and earlier panels, in order to retire the bonds. You don't issue bonds for a 20-year project that comes apart in 10 years. But if things become so bad that they do not last for the expected duration of the project?

Now, how do we accommodate that in the capital budget idea if the bond authority is the basic way those are being funded? Does that become sort of a whimsical government to the bond holders or what?

Mr. CHU. Of course, as you appreciate, Mr. Chairman, ultimately it is the full faith and credit of the United States that stands behind the bonds. I think this is an example of an unfortunate situation where the capital asset vanishes prematurely, effectively robbing the Federal Government of the base of Federal revenue or services that undergirds its commitment.

In my own judgment, that sort of situation speaks to the inadequacies of the program—limitation—and not necessarily to any flaw in the notion of a capital budget by itself. If systematically one finds that the agency involved is overestimating the life of the assets, then that is something that the agency should be asked to correct. And if it won't, obviously the last—the last opportunity is the Congress imposing a correction on the agency's deliberations.

Mr. HORN. Yes. Mr. Sheridan.

Mr. SHERIDAN. One might also include in the capital budget at the outset the notion of replacement and refurbishment requirements in the future. It was clear that in that project and many that we see not too far from here that that was not allocated at the time and I think that was a shortcoming of the process.

Mr. HORN. I think you are absolutely correct. California does exactly that with major capital outlays separated from minor capital outlay where you could go in, completely redo the building to adapt to modern computer systems, so forth, and take care of equipment replacement.

Governor Reagan personally ordered that change made because until he became Governor, the rule in California was you got your scientific equipment with the initial building but there was no funding formula to ever replace that equipment. So I remember my planning dean came in to me the first few months when I was president. He said, "I have a great idea." He said, "Let's split this campus in two. It would only mean we would need another president, and we could double our formulas and go back and get all the new equipment and everything else that we need that didn't come with the buildings."

And it was just crazy, that type of bureaucratic system. That was pointed out to the Governor. He laughed and said, "This is the stupidest thing I ever heard of," and the Department of Finance finally changed it, but we still have some crazy anomalies.

Let me yield to the gentleman from Illinois, Mr. Flanagan.

Mr. FLANAGAN. Thank you, Mr. Chairman. Thank you, gentlemen, for coming.

Mr. Sheridan, I was very interested as you were talking about capital budgeting in the private sector. And it all seems to be objective oriented. We have a direction that we are going. We know where we want to be in a certain amount of time. We will budget accordingly and we will get there by allocating resources to make that happen and making sure that we have operating expenses to cover as we go along.

Would the government could work that way. There is an enormous fluidity with change of administration, with change of parties as the payers of bills come in and the payers of bills go and the level of priorities, the level of objectives changes enormously through that time.

How does in a business context, for instance, a part of the apocalyptic problem of stock crashing, divisions being sold off and other really horrible things happening in business when you have such a change whether externally or internally imposed, in the context of a capital budget, the fluidity and objectives and how does that play in or out?

Mr. SHERIDAN. Well, in an honest setting, the objectives, the mission statement is clearly recited at the outset and unless there is a reason to change that mission statement, it continues with the asset for its life. And during that period of time, should the mission be diminished, the life either physically or effectively be reduced, then the value of that asset is contracted. I would submit that unless there is some reason within the political process that the objectives for the assets change that they would be still valid.

That is not to say that there would not be changes in mission and changes in objectives over time, but if they are clearly enunciated at the outset and are clearly put forward with the appropriation and with the ongoing requirements, that is one way that you can go back and track and say do we need this asset and is it justified in its current life.

Mr. FLANAGAN. Maybe if I give you a "for instance," I can explain this a little better.

We started I guess about 20 years ago now and will go on until I am old and gray and my children are old and gray digging something in Chicago called the deep tunnel. It is an enormous and wonderful hole in the ground that employs lots of local folks and costs the Federal Government of the United States bazillions annually. The efficacy for that originally was to take storm water from the Chicago area and help out the sewage system. The underlying need for it, it was a wonderful experiment in actually having an unstated role of being shelters in the event of perhaps a nuclear holocaust.

Our objectives have changed there. Chicago is no longer deeply worried about that, but yet the problem goes on because of the inertia it has built up on its own. That would be certainly familiar under the rubric of a capital expenditure, this sort of project, I would imagine, by whatever definition and qualifications by the excellent question raised by Mr. Chu.

If we had such a capital budget in here and we have had a fluidity in objectives, we have a different mission, yet we have an enormous expenditure in this already and, not to mention, an operational cost that is quite high as well, how would business in its experience deal with this problem?

Mr. SHERIDAN. Well, they shut down the Edsel plant and if the product does not sell and if it has no useful means, those assets in the future appropriations and expenditures would be diverted to some other project. It would be written off and you would start with a new slate. That may be more difficult to do within a political environment, but that's what we'd do.

Mr. FLANAGAN. Thank you. I yield back, Mr. Chairman.

Mr. HORN. Thank you. The gentleman from New Hampshire, Mr. Bass.

Mr. BASS. Thank you very much, Mr. Chairman.

A question for you, Mr. Chu. In your testimony you mentioned on page 2 that a thorough examination needs to be made of the roots of this opposition, meaning opposition to capital budget. Could you just briefly list what the roots of this opposition are?

Mr. CHU. I think, as people here are well aware, the executive branch, particularly the Office of Management and Budget, has not been enthused about this concept. It has come up repeatedly over the last several decades. And notwithstanding its widespread use at the State and local level, it's been something that the Federal Government, at least on the executive branch side, has consistently rejected.

In my own judgment, a principal element in the opposition to the idea is the fear that the chairman mentioned: that people would improperly hide, or attempt to solicit support, for operating costs as a capital item. And that, I think, is one of the reasons that the nonphysical investments are so controversial, even if they clearly are long-lived and have an enduring contribution to the productive enterprise of the Nation.

Mr. BASS. Who does the Federal Government borrow from and what is the difference between borrowing for a capital budget and borrowing to balance the operating budget?

Mr. CHU. Well, the Federal Government, of course, as you know, sir, ultimately borrows from two sources: either from our own citizens or from citizens or organizations abroad, setting aside the outright printing of money by the Federal Reserve as a solution to financing the Federal deficit.

Those two sources have different implications for the future economic life of the country. Ultimately, as an economic matter, what counts is the level of Federal borrowing and the implications of the Federal Government consistently running excess of expenditures over revenues.

Mr. BASS. This is my last question. Has anybody ever considered the establishment within a capital budget network of an authority or this committee in oversight capacity or whatever for leasing versus purchasing and setting limits on leasing, so that when we contract to build buildings that don't work or to purchase aircraft that are obsolete before they even get finished or never tested and so forth, have either of you two gentlemen given any thought to this as a mechanism whereby we could provide more flexibility, less risk, and so forth and so on?

Mr. SHERIDAN. Well, in most cases, a lease versus buy for a highly creditworthy entity, the lease will not win simply because you have to pay somebody else to rent their money. There may be some cases where operating leases would have some merit for particular reasons given the obsolescence, such as computer within a certain period of time, but if it is purely a cost-of-money question, it is hard to get a better credit rating than the United States and hence you would be paying more to have the same asset utilized.

Mr. CHU. As I observe this, there have been two principal issues in the use of leases by the Federal Government. One is the one that Mr. Sheridan mentions; can you do better in some financial sense by leasing versus buying? At one point, when agencies didn't have to discount the leases completely up front with the Federal Financing Bank, it was an end run around Federal budgetary limitations. That loophole has been largely closed.

The other issue is a little different, and it revolves around the question of using the lease as a way of involving the private sector in the provision of a service that the Federal Government would otherwise have to provide itself.

Examples include the provision of family housing at Fort Drum, New York, in the Department of Defense, which the Army did wish to undertake on a leasing basis for exactly that reason. The belief was if a lease arrangement—a very long-term lease: 20, 30 years—could be negotiated, then you could have a private sector provider of the housing services, yet with a substantial amount of government control, providing a more efficient and less expensive alternative.

As you know, there have been statutory prohibitions, originating in predecessor versions of this committee, that have precluded the Federal Government from leasing certain items. One of the benefits of leasing is avoiding technological lock-in when you acquire something—computers specifically—whose technological life is much shorter than you would prefer.

Mr. BASS. Thank you very much, Mr. Chairman.

Mr. HORN. Thank you, Mr. Bass.

Let me ask one last question and then we will adjourn. On this leasing and owning situation, it seems to me one of the basic decisions you face relates to the pace of modern technology.

You have a certain expected life on the bricks and mortar, but in terms of those essential basic communication materials that come within—the computer system, the telecommunications switch, whatever—their life is increasingly shorter in terms of 5 years versus 20 or 30 or 40 where you might amortize the bricks and mortar.

Should those items be simply separated out and not put in the capital budget and put more in the operational budget so you would have maybe 95 percent of the project in the capital budget but 5 percent of that basic building would be in the operational budget?

Mr. SHERIDAN. Well, in the private sector, you try to have your short-lived assets expensed if you possibly can, but, of course, there is an income tax motive for that. I think what you can do is take the present value of that asset on a lease basis and put that in your capital budget, but reflect it is going to be a very fast takedown asset and reflect that fact in your operating budget in something akin to a depreciation account, without raising that particular issue which can keep us here for a longer time.

Mr. HORN. Any comment on that?

Mr. CHU. I would agree with the point Mr. Sheridan makes, which is I would not exclude short-lived assets from the capital budget. But I think you have to be realistic about what the life really is going to be. I think you have to be willing, for a capital budget to be useful for planning purposes, to revise estimated lives.

Let's go back to your housing project example. If it turns out the life is only 10 years, not 30, you need to be honest in that capital budget and suddenly show large current consumption charges that reflect the fact its life is coming to an end. And for computers, the life might be only 2 years.

Mr. HORN. Right. They are often obsolete the day you buy them after the long purchasing process. I was thinking when we talked about the 15 to 20 year weapons systems, from design to production to implementation and operation, I often wonder and say how does this ever work? Because when you think where we started the second world war, and granted that we had designs that were coming up in the late 30's, but how did anything ever get built? When you think about what we did in production, it is simply amazing. The productive capacity of this Nation was completely focused on war production and winning the war.

Do you have any wisdom on that? Are we now taking too long on some of these long-term efforts?

Mr. CHU. Maybe we're taking too long, although I am not persuaded that we are actually taking much longer than we ever did. One interesting datum: Of ship designs preferred by the U.S. Navy in World War II, of those ships of such designs whose keels were laid down after Pearl Harbor, not a single one was delivered before VJ Day. So we basically fought the war either with ships that we started producing before the war or with emergency designs—jeep carriers, destroyer escorts, et cetera—the industrial aircraft, I would acknowledge—that we conceived during the course of conflict.

Mr. HORN. Yet merchant ships were built one per day at one point.

Mr. CHU. Right, but of a standardized design, not to, "normal military specifications."

Mr. HORN. Does that have anything to do with the differences between the private sector deciding on a design and the public sector deciding on a design?

Mr. CHU. Some of it does. But some of it also reflects the fact that the military sector, particularly in the cold war period, was constantly trying to push the edges of technology to gain an advantage over its opponent. Whether it is an airplane or it is the Taurus sedan, the history of technologically ambitious projects is they take a long time.

Mr. SHERIDAN. It is worthy of note, however, that even though we have the C–17 and some other issues, the C–5 in a prior era, there have been—there has been the ability to prolong the life of certain fixed assets. Air frames that are aerodynamically exactly the same as they were in the 50's are still flying today. By upgrading the mission requirements based on technology, the changes in F–11 from an earlier era to something that has a totally different mission. So it is possible with careful work to take a long-lived asset and give it as a cap many more lives.

Mr. HORN. There is no question that is true. C–17 is expected to go into 2020, maybe even for my 100th birthday in 2031. I am hoping the C–17 will last that long and we will have 240 or so by that time.

But are there any other questions?

Mrs. MALONEY. If I could, Mr. Chairman, ask one question on depreciation. The Clinger bill has a depreciation in it and he refers to it as the asset consumption charge which is to be financed by the appropriations in the operating budget, allows for depreciation to be based on either historical cost or replacement cost or current value.

I would like both of you to comment on your views on depreciation. Also, with the demise of the Soviet Union would that reduce the defense assets in value if we are to use depreciation?

Mr. SHERIDAN. Depreciation is really an accounting term and it is basically an effort in the private sector to link the profit motives to allocate cost to the same time you are receiving revenue. And, therefore, it is important when you are trying to do, as the FASAB is doing, which is to create commonality with the private sector to accounting measures that are at least comparable. And to that end, they should be applauded.

That should be differentiated from the investment process which is purely cash on cash, at least it is in—so that in the private sector you take account of depreciation, but then you add it back to the process. Depreciation is a meaningful proxy for a diminished life because the other attribute in the accounting sense is that you don't want to carry an asset on your books and then 1 day junk it and have an abrupt kind of spike.

So it has—it has a purpose, but to use depreciation within an operating budget absent real world cash constraints, which would be to look at perhaps pairing it with a liability I think is fraught with some dangers, but it conceptually is not an inappropriate thing.

Mrs. MALONEY. Mr. Chu.

Mr. CHU. I would argue it is a particularly important concept if you are going to apply capital budgets to any agency like Defense, which has an operating focus, because without it there will be a tendency to ignore the rate at which you are actually drawing down your assets.

Now, I grant that physically the asset doesn't disappear 10 percent every year, but it signals to you the fact that now there are 9 years left until it dies or 8 years left, et cetera. And it gives you some sense of the renewal level that you have to maintain in order to provide for the future. It is a signaling device. There has to be a thoughtful accounting way of lining it up with actual cash expenditures, which are a different matter. But its signaling value as a planning tool I think is very significant for a number of Federal agencies.

Mr. SHERIDAN. You raised a second issue and that is the valuation of certain assets, whether they be intangibles of human resources or the value of a weapon system. I think if one examines the mission of the weapons system and it no longer has value, it should go off whatever balance sheet, whether it be one that it kept within a service to say do we have mission support, it should be taken off because it no longer has value. But attributing that value and putting it on a balance sheet for purposes of financial statements, that is a very, very difficult area and one that is sort of a trap for anybody that is an adherent of it.

Mrs. MALONEY. Thank you.

Mr. HORN. Thank you, Mrs. Maloney.

Any further questions?

If not, let me thank Mrs. Maloney for arranging the witness from New York City; Mr. Davis for arranging the witnesses from Fairfax County. Mr. Brasher and Ms. Young of the majority staff for their fine work in preparation for the hearing.

We are grateful to the National Academy of Public Administration for being present here, and we appreciate the expertise that both of you have provided from the various experiences you have had in government.

Since we are continually trying to get any administration to do justice to the Chief Financial Officers Act, I am sure that we will be talking with you, Mr. Sheridan, as to how we could improve that system and are the chief financial officers doing what they ought to be doing? We had an excellent series of hearings last year that Mr. Spratt's subcommittee had, and we intend to pursue that every year until we are all satisfied that the agencies finally have proper financial statements that reflect their activities.

So thank you all for coming. It has been very helpful. We will be reviewing the documents. There might be some questions that I will send to you on behalf of the staff. Mrs. Maloney may well have some questions from her side. And we would like to include all those in the record.

And saying to the reporter that as is our usual procedure, we will put the statement in the record after the individual is introduced unless they read the whole statement. I think only one witness did that and so we won't repeat it if he did it.

But we will get every bit of information you have and you would like to send us we would appreciate it. So thank you again for coming and thanks to the committee for sticking it out until 5 o'clock on Thursday afternoon. We appreciate it. The meeting is adjourned.

[Whereupon, at 4:56 p.m., the subcommittee adjourned, to reconvene subject to the call of the Chair.]

[Additional material submitted for the record follows:]

In addition to *state* facilities, the state has provided substantial funding assistance to local governments for schools, jails, parks, and other facilities. Most of this assistance has come from general obligation bonds and for the most part is not included in the budget act.

Below are key terms often used in the context of state capital outlay budgeting.

Capital Outlay Terms

Terms	Definitions
Capital Outlay	Includes purchases of land and projects involving construction of new facilities or renovation of existing facilities (typically to accommodate program changes).
Major Capital Outlay	Projects having a total cost greater than $250,000. All major projects are identified and budgeted individually in the budget bill.
Minor Capital Outlay	Projects having a total cost less than $250,000. Minor projects are budgeted as a lump sum amount in the budget bill.
Maintenance	Includes normal repair and the replacement of components and equipment so that a facility can continue to function as designed. Maintenance costs are included in state departments' operating budgets.
Special Repairs	Maintenance projects that are required periodically and are above the base level of expenditures needed for routine maintenance. Examples include replacing roofs, painting exteriors, replacing mechanical/electrical equipment, and repaving roads. Costs are also included in operating budgets.
Deferred Maintenance	Maintenance backlog that occurs when routine maintenance is not sustained at an appropriate level and special repair projects are not accomplished when needed.
Phases of Projects	Major capital outlay projects are budgeted in the following phases: (1) preliminary plans—partially completed design documents, (2) working drawings—completed design documents and specifications used for bidding of the construction contract; (3) construction—includes construction contract cost, contingency allowance, quality control testing and inspection, and administrative oversight, (4) equipment—movable equipment that is directly related to the capital outlay project. The cost, complexity, and schedule of a project usually determines whether the project phases are budgeted in one year or over 2-3 years.

Continued

Terms	Definitions
Scope Language	Usually included in the annual supplemental report of the budget act. Describes the scope, schedule, and cost (by phase) of all major capital outlay projects as approved by the Legislature.
State Public Works Board	Three-person board consisting of the Directors of the Departments of Finance, General Services, and Transportation. Responsible for review and approval of (1) state acquisition of land, (2) completed preliminary plans for all major capital outlay projects, and (3) augmentations to capital outlay project appropriations (see below). Three members of the Senate and the Assembly are also appointed to the board in an advisory capacity. The Treasurer and the Controller are also members of the board when the board considers matters related to the issuance of lease-revenue bonds.
Augmentations	The State Public Works Board may approve augmentations to capital outlay projects by up to 20 percent of the amount appropriated by the Legislature. (Augmentations above 20 percent require an additional appropriation by the Legislature.) For augmentations of between 10 percent and 20 percent, the Director of Finance must provide notification of the proposed augmentation to the Chair of the Joint Legislative Budget Committee and the chairs of the fiscal committees in each house at least 20 days prior to Public Works Board approval of the augmentation.

STATE ADMINISTRATIVE MANUAL

CAPITAL OUTLAY

INTRODUCTION (New 9/91) **6501**

The Capital Outlay chapter of the State Administrative Manual has been designed to provide a reference source for policies and procedures relating to the budgeting and administration of capital outlay (construction and acquisition) programs. The chapter is divided into three main parts. The first SAM Section (6500) presents an overview of the terminology and time frames involved plus guidelines to determine what is and what is not applicable to the state's capital outlay program. The second SAM Section (6600) describes the detailed requirements for budgeting of capital projects from the point of assessing departmental facility needs through justification of individual projects including the budget decision process and preparation of the documents involved in the budget process. The third SAM Section (6700) details the requirements of the administrative approval process involved in carrying out the acquisition, planning, design and construction of capital projects. Through this basic arrangement, the reader should be able to find the information necessary for this specific purpose. All other standard budgeting procedures apply.

Subject to annual budget decisions, financing of facilities needs may take several forms such as direct appropriations from various general or special fund revenue sources, through proceeds of general obligation bonds, through leases or lease purchase agreements, or through other forms of debt financing such as revenue bonds or certificates of participation which may be issued by the State Public Works Board. In order for the Governor and the Legislature to determine appropriate financing options necessary to meet the needs for competing government services and capital projects, it is necessary to project the need, the rationale and the impact on support costs well in advance of the need for project funding.

A successful capital outlay program begins with effective facility management and program planning. It is state policy that all capital outlay projects will be based on optimum utilization of existing space and property and well documented workload/population projections. These projects should be carefully conceived and justified to provide cost effective solutions for program delivery; and will be professionally designed and managed to ensure against wastefulness in the expenditure of public funds. Specific appropriation of funds will be based upon defined project scope, estimates of cost and realistic schedules for the respective acquisition, planning, design and construction phases including relevant environmental reviews.

The State Public Works Board, the Department of Finance, and the Department of General Services, through powers and duties defined in various sections of the Government Code, all perform key roles in carrying out authorized capital outlay projects. By statute, the Public Works Board acquires property for the state, may issue debt instruments to construct facilities for the state, must approve the preliminary plans for capital projects prior to allocation of additional funds, and may set reasonable conditions for any project. The Public Works Board ensures that legislatively approved scope and cost of projects are carried out with all due speed and diligence. Within these parameters, certain flexibility to revise the cost and to modify the scope are granted by statute as well, recognizing the basic uncertainty inherent in capital program undertaking. Staff of the Department of Finance, Capital Outlay Unit, serve as staff to the Board for all construction items. The Office of Energy Assessments (OEA) acts as staff to the Board for energy related projects. Staff of the Office of Real Estate and Design Services act as staff to the Board for all real estate related activities and the Office of Project Development and Management (OPDM) and the State Architect (OSA), also in Department of General Services, supervise the design and construction process for most state agencies.

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INTRODUCTION (New 9/91) 6501

This manual addresses the requirements from the perspective of most departments, that is those which must utilize the Department of General Services to carry out capital projects. For those agencies which are exempt (e.g., the Department of Transportation for highway construction and the Department of Water Resources for the State Water Project and the Department of Corrections for its New Prison Construction program), equivalent information and procedures, in substantially the same form, will be required. It is also noted that this manual generally describes and defines requirements for construction projects which follow a routine sequence for staged plan development and single bid package contribution. This manual does not attempt to provide a complete detailing of the administrative requirements when a multi-contracts approach (phased construction contracts) or a fast-track design-build is used.

THE CAPITAL OUTLAY BUDGET (New 9/91) 6510

Departments must anticipate their capital outlay needs at an early stage. Forecasting capital outlay needs shall be based on the department's facility in inventory and the population estimates prepared by the Population Research Unit of the Department of Finance. Capital outlay budgets are zero based each year. There is no base budget such as exists in support and local assistance budgets. Each department shall submit a written Capital Outlay Budget Change Proposal (COBCP) for each project to be considered for inclusion in the capital outlay budget for the forthcoming fiscal year. (See SAM Section 6620, Illustration 1.) In addition, consideration must be given to the requirements of the California Environmental Quality Act (CEQA). A major requirement of the Act is the necessity to prepare an Environmental Document for projects undertaken in whole or in part by any public agency. Information should be made available for the review process indicating the status of the environmental impact review. All major capital outlay proposals must be submitted to the Department of Finance and the Office of Project Development and Management, Department of General Services, by February 1 of each fiscal year.

DISTINCTION BETWEEN STATE OPERATIONS, LOCAL ASSISTANCE AND CAPITAL OUTLAY (New 9/91) 6520

Acquisition of real property; purchase, rental, leasing and construction of facilities and structures; repair, maintenance and or replacement of capital assets; and purchase of fixed and movable equipment is budgeted as either State Operations or Capital Outlay (major vs. minor) depending on circumstances including the cost and purpose. SAM Section 6520, Illustration 1 reflects current policy for the budgeting of these expenses. Generally, repair, maintenance, and systematic replacement (other than structures) are considered a cost of conducting currently authorized business and therefore are budgeted as State Operations. Any real property acquisition or new construction, extension, or betterment (including interior asbestos/remodeling) are appropriately budgeted in capital outlay because they are necessary to accommodate program change. Rental or lease costs of facilities are appropriately budgeted as State Operations costs; however, exercise of a purchase option (i.e., real property acquisition) must be budgeted as capital outlay. It is necessary for leased space to be accounted for in facilities inventories and prospective changes in leased space to be addressed in the context of five-year capital outlay plans. Leased space is an alternative to state ownership and requires a coordinated informed decision as to which approach will be pursued. Fixed and movable equipment necessary for the initial occupancy of a new facility (capital outlay construction project) is appropriately budgeted as capital outlay because, in essence, it completes the project. (See SAM Section 6520, Illustration 1.)

DISTINCTION BETWEEN STATE OPERATIONS AND CAPITAL OUTLAY

	STATE OPERATIONS	CAPITAL OUTLAY	
DESCRIPTION OF PROJECT	OPERATING EXPENSES AND EQUIPMENT	PROJECT LEVEL MINOR PROJECTS	PROJECT LEVEL MAJOR PROJECTS
Construction Projects: New construction, alteration, extension or betterment of existing structure. Estimated to cost..........		$250,000 or less	In excess of $250,000
Repair Projects: Repair and Maintenance projects that continue the usability of a facility at its designed level of services..........	Irrespective of amount		
Equipment Projects: a. Irrespective of time of purchase or estimated cost of equipment if related to a specific construction project..........			Irrespective of amount
b. New equipment to meet program needs and not related to a construction project, and replacement of existing equipment even though the new equipment is to be used in a new facility..........	Irrespective of amount		
Purchase of Land: Including related costs such as condemnation and court costs, legal fees, and title reports etc..........			Irrespective of amount
Rental or Lease Projects	See Discussion		
Purchase Option of Formerly Rented or Leased Space			Irrespective of amount

STATE OPERATIONS INCLUDING SPECIAL REPAIRS (New 9/91) 6521

State Operations includes all equipment items (regardless of amount) that are to replace existing equipment; all equipment not included in the complement necessary for initial operation of a specific construction project; and all repair projects. Such repair projects, regardless of amount, shall be budgeted in the Operating Expenses and Equipment portion of the Summary by Object in the line expense category of "special repairs". Recurring maintenance will be included in the Operating Expenses and Equipment line item of "facilities operations".

Examples of special repair projects include, but are not limited to, repainting a facility; reroofing projects; electrical rewiring; plumbing repairs; dredging of river or stream beds (to restore original flow capacity); replacing old equipment items (air conditioners, carpeting, etc.); and road repairs.

Alterations for the purpose of Section 6.0 of the Budget Act means any modification to existing State-owned space that changes the use of the space as to function, layout, capacity or quality. Typical alterations include demolition of existing partitions and/or construction of new partitions or initial installation of carpeting and movable partitions. Alteration projects should be budgeted as part of the construction program and may be either major or minor projects, but if no funds are provided in Capital Outlay, State Operations funds may be used within the guidelines of Section 6.0 of the Budget Act.

LOCAL ASSISTANCE (New 9/91) 6522

Grants to local agencies for the operation, maintenance, and acquisition or development of facilities are budgeted as Local Assistance. Local Assistance projects must be for non-State owned facilities (local entity retains ownership after completion of project).

CAPITAL OUTLAY INCLUDING MINOR CAPITAL OUTLAY (New 9/91) 6523

Capital Outlay includes purchases of land and costs related thereto, including capital outlay planning and administrative costs, court costs, condemnation costs, legal fees, title fees, etc., and construction projects, including preliminary planning, working drawings, and equipment related to a construction project regardless of cost or timing. Construction projects include new construction, alteration, and extension or betterment of existing structures. Capital Outlay projects must be for State-owned properties and facilities and must improve the facility beyond its present use or designed levels.

Minor Capital Outlay projects are budgeted as Capital Outlay and are composed of construction projects whose estimated cost is $250,000 or less. The dollar limitation on Minor Capital Outlay is adjusted when necessary by the Department of Finance. State acquisition projects, regardless of amount, are funded in major Capital Outlay.

BUDGET PREPARATION AND ENACTMENT TIMETABLE (New 9/91) 6530

In order to assist departments in planning their capital outlay budget work, the following schedule is provided. This timetable should be adhered to by departments so that analysis and processing of agency requests may be done in an orderly manner, and to meet overall statewide deadlines. It should be noted that initial requests shall be submitted 18 months prior to the budget year for which funding is requested. Dates listed for submissions by departments are those by which the action should be received by the Department of Finance (DOF), the Legislative Analyst's Office (LAO), and the Office of Project Development and Management (OPDM), as appropriate. Submission earlier than required will be appreciated and will assist the operations of the Capital Outlay Unit of the Department of Finance.

(Continued)

Introduction

Background

Research efforts of the National Association of State Budget Officers have focused primarily on operating budgets. Paul Timmreck, while serving as President during 1990-91, initiated this project to provide budget offices with useful information on capital budgeting. This report represents an initial effort to provide comparative analysis on capital budgeting practices by the states. Although this report does not result in one "model capital process," its objective is to highlight desirable practices that can be used by all states.

Part One

Part One summarizes the results from the survey sent to all states in 1991. The survey covers an array of topics including defining capital expenditures, the capital budgeting process, estimating costs, setting priorities, managing assets, financing projects, and managing debt. Good practices are highlighted at the end of each section.

Part Two

Part Two reviews various issues common to all states and illustrates their impact through the use of specific state examples. The topics covered in this part include protecting maintenance funds in a world of competing demands and the strengths and weaknesses in states' capital budgeting processes. States included in the case studies represent a diversity of approaches in capital budgeting and financing.

Summary

Good Practices In Capital Budgeting

- Establish a clear definition of expenditures within the capital budget.
- Define maintenance expenditures and provide for adequate funding of maintenance in statute.
- Include specific operating costs for each capital project.
- Ensure that effective legislative involvement occurs throughout the capital budgeting process.
- Strengthen the review of the years beyond the budget year in long-range capital plans.
- Identify the criteria used in selecting capital projects.
- Define all program outcomes for capital investments.
- Evaluate cost estimating methods to measure their validity.
- Establish a tracking system to keep projects on schedule and within budget.
- Define the factors to consider in decisions to own or lease.
- Develop a clear debt policy.
- Review cost-benefit comparisons for private sector participation in capital projects.
- Maintain an updated inventory system of capital assets.

Capital Budgeting In the States

Section 1

Defining Capital Expenditures and Protecting Maintenance Funds: Tables 1-3

Almost all states define the types of expenditures allowed in capital budgets. As Table 1 shows, most definitions are broad and include such items as construction, improvements, land acquisition, site improvements, and major renovations. Some definitions specify the anticipated useful life of a project while others include certain equipment purchases. Table 2 shows that most states include capital planning activities within their capital budgets. About half the states have a minimum expenditure requirement for their capital budgets. The minimums range from a low of $1,000 to a high of $250,000 with $25,000 being the most frequent minimum for capital budget expenditures.

Treatment of maintenance expenditures in capital budgets also varies across states as illustrated in Table 3. In about half the states, maintenance is included in the operating budget. Other states, including Alaska, Colorado, and Ohio, differentiate between deferred maintenance as a capital expenditure and ongoing maintenance as an operating expenditure. Other approaches used by states include appropriating a reserve maintenance fund in Virginia, authorizing a formula for building renewal funds in Arizona, and appropriating a portion of a building's value for maintenance in Idaho.

Good Practices

- **Establish a clear definition of expenditures within the capital budget.**
  In developing or refining capital expenditure definitions, states should consider the implications of minimum requirements and types of expenditures such as equipment and planning studies. Certain activities, such as leasing, may fall within the operating budget though be viewed as debt by rating agencies in their credit analysis.

- **Define maintenance expenditures and provide for adequate funding of maintenance in statute.**
  Maintenance funds are often sacrificed for budget balancing purposes. Some approaches to preserving maintenance funds look good in theory, but not in practice. States use approaches such as budgeting a percentage of the building valuation for critical maintenance as in Idaho and conducting an annual inventory of maintenance needs in Florida. A more detailed account of how a few states attempt to preserve maintenance funds is discussed in Section 1 of the case studies in this report.

Table 1
Defining Capital Expenditures

State	How Do You Define Capital Expenditures?
Alabama	Renovations, repairs, major maintenance, new construction, land purchases, and equipment
Alaska	Asset with an anticipated life exceeding one year and a cost exceeding $25,000
Arizona	Building renewal, land acquisition, infrastructure, and capital projects.
Arkansas	No specific definition.
California	Facilities improvements. Includes related planning and fixed equipment costs
Colorado	Purchase of land; purchase, construction or demolition of buildings, purchase and installation of equipment
Connecticut	Expenditures that result in acquisition or additions to fixed assets.
Delaware	Includes major equipment acquisitions if at least 10 years.
Florida	Real property, including additions, replacements, major repairs, and renovations which extends useful life
Georgia	Purchases of land, construction of new facility, replacement/major renovation, and site improvements
Hawaii	Permanent, non-recurring expenditures on new, or improvements to existing facilities
Idaho	Construction, remodeling, and maintenance of buildings and other structures
Illinois	Repair, maintenance, renovation, remodeling, rehabilitation of existing facilities; construction of new facilities
Indiana	Construction, rehabilitation, repair, purchase and sale of land, equipment, and grants to municipalities
Iowa	Construction, renovation, or improvement of buildings or grounds exceeding $50,000
Kansas	New construction, remodeling, razing, rehabilitation, and repair.
Kentucky	Capital construction above $200,000 and major equipment above $50,000.
Louisiana	Acquiring land, buildings, equipment or for permanent improvement.
Maine	Renovations, repairs, major maintenance, new construction, land purchases and equipment
Maryland	Acquisitions with a 15 year life, excluding vehicles and supplies
Massachusetts	No response.
Michigan	Planning, acquisition, construction of buildings and equipment and remodeling, repair
Minnesota	Acquisition, construction, original furnishings and equipment, renovations, and major repair
Mississippi	Includes planning, design, land/building acquisition, demolition, new construction, furnishings, equipment
Missouri	Includes construction, acquisition of real property, demolition, restoration, rehabilitation, equipment purchase
Montana	Building and construction defined in statute
Nebraska	No specific definition.
Nevada	No response.
New Hampshire	Assets with useful life of 5 years and cost exceeding $30,000.
New Jersey	Acquisition of land, construction, repairs, equipment above $50,000, long-term leases
New Mexico	Renovation and repairs, new construction, land acquisition, vehicles, and equipment
New York	Acquisition, construction, demolition of fixed asset, major repair/renovation, preliminary studies and equipment
North Carolina	Renovations, major repairs, deferred maintenance, new construction, land, and major equipment.
North Dakota	No specific definition.
Ohio	Renovations, new construction, land purchases and equipment
Oklahoma	Purchase of land and buildings. Construction or major repair, major purchase of equipment
Oregon	Improvements which prolong the life or add value to the property
Pennsylvania	Construction, renovations, improvements, equipment, furnishings, land acquisition. Estimated life above 5 yr
Rhode Island	Construction, renovation, repair, rehabilitation, land acquisition, buildings and equipment
South Carolina	Capital expenditures over $25,000 according to GAAP definition
South Dakota	No specific definition.
Tennessee	Renovation, maintenance of certain size, additions, new facilities.
Texas	Renovation, major repairs, new construction, land, equipment purchases.
Utah	Long-term asset costing more than $1,000
Vermont	New construction, land acquisition, major maintenance and repairs above $25,000
Virginia	Real property acquisition, improvements of $250,000+, new construction of $250,000+, stand alone equipment
Washington	Design, construction, renovation, and acquisition of long-term assets.
West Virginia	Includes buildings and/or land with appropriation in effect for 3 years.
Wisconsin	Includes land, buildings, facilities, equipment, as well as remodeling, reconstruction, and maintenance
Wyoming	New construction, acquisition of land, reconstruction, major improvements above $10,000 for 10 years
DC	Permanent improvement to a fixed asset with useful life exceeding 3 years

Table 2
Capital Versus Operating Budgets

State	Capital Planning in Capital Budget	Minimum Size For Capital Budget	Definition For Capital
Alabama	N	N	Y
Alaska	Y	$25,000	Y
Arizona	N	N	Y
Arkansas	N	N	N
California	Y	N	Y
Colorado	Y	Over capital outlay limit	Y
Connecticut	Y	N	Y
Delaware	Y	N	Y
Florida	Y	N	Y
Georgia	Y	N	Y
Hawaii	Y	N	Y
Idaho	Y	$15,000	Y
Illinois	N	$25,000	Y
Indiana	N	N	Y
Iowa	Y	$25,000	Y
Kansas	N	N	Y
Kentucky	Y	N	Y
Louisiana	Y	$50,000	Y
Maine	N	N	Y
Maryland	N	$100,000	Y
Massachusetts	No response	No response	No response
Michigan	Y	$50,000	Y
Minnesota	N	N	Y
Mississippi	Y	$150,000	Y
Missouri	Y	Repair $2500	Y
Montana	Y	$25,000	Y
Nebraska	Y	N	N
Nevada	No response	No response	No response
New Hampshire	Y	$30,000	Y
New Jersey	Y	$50,000	Y
New Mexico	Y	$100,000	Y
New York	Y	N	Y
North Carolina	Y	$50,000	Y
North Dakota	Y	N	N
Ohio	Y	N	Y
Oklahoma	N	N	Y
Oregon	Y	Construct $100,000	Y
Pennsylvania	Y	$100,000	Y
Rhode Island	N	N	Y
South Carolina	Y	$25,000	Y
South Dakota	N	N	N
Tennessee	Y	Maint $100,000	Y
Texas	Y	N	Y
Utah	Y	$1,000	Y
Vermont	Y	$25,000	Y
Virginia	Y/N	N	Y
Washington	Y	N	Y
West Virginia	N	N	Y
Wisconsin	Y	$5,000	Y
Wyoming	Y	Y	Y
DC	Y	$250,000	Y
	Y = 35	Y = [illegible]	Y = 45

Table 3
Treatment of Maintenance

State	How Is Maintenance Treated In The Capital Budget?
Alabama	Renovation and repair are capital items, maintenance is operating.
Alaska	Renovation, repair, deferred maintenance are capital items; general maintenance is operating.
Arizona	Routine maintenance excluded. Building renewal funds appropriated by formula in statute.
Arkansas	Treated like any other request.
California	In operating budget.
Colorado	Deferred maintenance in capital, routine maintenance in operating.
Connecticut	In operating budget.
Delaware	Deferred building maintenance addressed.
Florida	An annual inventory of state-owned buildings conducted to determine maintenance need.
Georgia	Included if relatively substantial cost, not recurring, and increases useful life.
Hawaii	In operating budget.
Idaho	Critical maintenance budgeted at 1% of building valuation.
Illinois	In operating budget.
Indiana	In operating budget.
Iowa	Deferred maintenance in capital.
Kansas	Largely financed from dedicated funds.
Kentucky	Minor maintenance below $200,000 funded from pool of state funds.
Louisiana	In operating budget.
Maine	Included in operating budget.
Maryland	Included if over $100,000, 15 year life.
Massachusetts	No response.
Michigan	Lump sum maintenance appropriation.
Minnesota	Major maintenance in capital budget, recurring maintenance in operating budget.
Mississippi	Maintenance projects generally not recommended.
Missouri	Ongoing maintenance to preserve a facility in operating; other maintenance & repair above minimum in capital.
Montana	Major maintenance included.
Nebraska	Renovation and repair are capital items, maintenance is operating.
Nevada	No response.
New Hampshire	Deferred maintenance in capital, usual maintenance in operating budget.
New Jersey	Maintenance above $50,000 in capital.
New Mexico	In operating budget. In future, may plan to fund preventive maintenance in capital.
New York	In operating budget.
North Carolina	In operating budget.
North Dakota	In operating budget.
Ohio	Deferred maintenance in capital; routine maintenance in operating.
Oklahoma	In operating budget.
Oregon	Routine maintenance excluded.
Pennsylvania	In operating budget.
Rhode Island	In operating budget.
South Carolina	According to need.
South Dakota	In operating budget.
Tennessee	Major maintenance above $50,000 included.
Texas	In operating budget.
Utah	In operating budget.
Vermont	Major maintenance and repair in capital, general maintenance in operating budget.
Virginia	Maintenance reserve appropriation provided.
Washington	Renovation and major repairs are capital items, maintenance is operating.
West Virginia	In operating budget.
Wisconsin	Funding provided.
Wyoming	In operating budget.
DC	N/A

Section 2

Organization of the Capital Planning Process: Tables 4-6

The capital budgeting process usually starts with budget instructions issued to agencies. The time-line from the initial instructions until the appropriation varies from six months to two years, with an average time-line of about one year. As Table 4 shows, in addition to state agencies, some states also allow non-profit agencies, boards and commissions, and elected officials to make requests for capital projects. States are about evenly divided between having a separate capital document and combining capital and operating expenditures in one document. The types of documents vary across states with project descriptions, multi-year planning documents, and portions of the operating budget serving as capital documents.

With the many actors involved in the capital process, some states - more than one-third - have established joint legislative boards or commissions to oversee the process as shown in Table 5. Some boards are established with specific missions, such as developing and implementing a long-range planning process as in Kentucky.

Capital planning in most states is a multi-year process. Table 5 shows that in about two-thirds of the states, the capital budget extends from three to ten years, with five years the most frequent time-span for capital plans. In about half the states with long range capital budgets, the budgets are passed into law. In most cases, the long-range budget is amended through annual appropriations. Often the budget office provides an overall coordinating role for the long-range plan. Although many states have long-range plans, estimates for the out-year costs provide a general trend for the project and are not as detailed as the current year estimate.

The coordination of the capital and operating budget is a significant feature of the capital budgeting process. Table 6 demonstrates that coordination occurs in many states by including the impact on the operating budget as part of every capital request. Budget analysts provide a key role in coordinating operating and capital budgets. Other approaches to coordinating operating and capital budgets include a program planning process in higher education used in Colorado and a strategic planning process that fosters communication between those involved in the operating and capital budgeting decisions in Delaware.

Good Practices

- **Include specific operating costs for each capital project.**
  Although most states require that operating costs accompany capital project requests, there should be an enforcement mechanism that requires agencies to develop operating cost estimates over several years. The agencies' operating budget request should reflect the impact of the capital projects over the several year period.

- **Ensure that effective legislative involvement occurs throughout the capital budgeting process.**
  Some states have established specific oversight boards to help foster communication between the legislative and executive branches. In other states, such as Maryland, state officials informally maintain good communication channels with the legislature.

- **Strengthen the review of the years beyond the budget year in long-range capital plans.**
  Although most states have long-range capital plans, the years beyond the budget year are often scrutinized much less than the budget year. More scrutiny of long-range costs would help to assess the financial commitments on both the operating and capital budgets.

Table 4
Organization of the Capital Budget

State	Legal Authority	Who Makes Requests	Documents Produced
Alabama	Statute	A	Governor's Executive Budget
Alaska	Statute	A	Project Description and Justification
Arizona	Statute	A,E	Capital Improvement Plan
Arkansas	Appropriations by Agency/Project	A	Biennial Budget Manual
California	Annual Budget Acts	A,E	Budget Change Proposals Budget Estimates
Colorado	Statute	A	Project Request. Prioritized Summary 10 Yr
Connecticut	Statutes, Special & Public Acts	A	Annual Capital Budget
Delaware	State Code	A,E	CIP Project Description, Operating Budget
Florida	Statute	A	Agency Capital Improvement Prg., Gov. Capital Imp Prg
Georgia	State Code	A	Governor's Annual Budget Report, Amended
Hawaii	Revised Statutes	A,E	Multi-Yr Program Financial Plan, Executive Budget
Idaho	State Code	A	6 Yr. Plan Produced by Division of Public Works
Illinois	Appropriations & Bond Auth. Bills	A,B,E	Capital Budget
Indiana	Statute	A,H	State Budget Committee Recommendations
Iowa	State Code	A	Operating Budget
Kansas	No requirement for Governor	A	Governor's Budget Report
Kentucky	State Revised Statutes	A	Executive Branch Budget
Louisiana	Statute	A,E	Capital Outlay Act and 5 yr Budget Plan
Maine	Annual Budget Acts	A	Capital Budget
Maryland	State Law and Appropriations	A,E,P	Budget & 5 Yr Capital Improvement Program
Massachusetts	No response	No response	No response
Michigan	Annual Appropriations	A,H	Annual Budget Document
Minnesota	Statute	A,H,E	Capital Budget Recommendations
Mississippi	No response	A	Governor's 5 yr. Capital Improvement Plan
Missouri	Statute	A	Governor's Executive Budget
Montana	State Code	A,H	Capital Construction Program, Major Maintenance Plan
Nebraska	Statute	A,H	Governor's Executive Budget
Nevada	No response	No response	No response
New Hampshire	Statute	A	Governor's Executive Budget
New Jersey	State Budget Law	A,P	Governor's Budget Rec & Capital Improvement Plan
New Mexico	Statute	A,E,H	Capital Improvement Plan and Forms
New York	State Finance Law	A,PA	Capital Projects Bill, 5 Yr Capital Plan
North Carolina	Appropriation	A	Capital Improvement Document
North Dakota	Agency's appropriation	A	Capital Construction Form
Ohio	Statute	A,E,P	Governor's 6 Year Capital Improvement Plan
Oklahoma	Statute	A	State Finance Forms
Oregon	Legislative	A	Budget Overview, 6-Yr Plan, Project Description
Pennsylvania	Constitution	A	Governor's Executive Budget
Rhode Island	Statute	A	Capital Development Budget/Operating Budget
South Carolina	No overall authority	A	Annual Permanent Improvement Plans
South Dakota	Individual bills	A	No capital budget
Tennessee	Division of Budget	A	Budget, Project Description, Project Summary
Texas	Part of appropriations process	A	Budget Requests-Construction Schedules
Utah	Statute	A	Budget Documents, 5 Yr Plan
Vermont	Statute	A	Capital Budget Recommendations
Virginia	Appropriation Act	A	Budget Bill & Budget Document
Washington	Legislature	A	Capital 6 yr Program, Appropriation Bill
West Virginia	Statute/Case by case	A	No response
Wisconsin	Statute	A	Capital Budget Recommendations
Wyoming	Statute	A	Capital Outlay Budget Request
DC	Home Rule Act	A,E	Capital Budget & Capital Improvement Plan

Key: A = Agencies B = Boards E = Elected Officials H = Higher Education P = Private Organizations PA = Public Authorities

Table 5
Organization of Capital Budget: Part 2

State	Joint Boards for Capital Review	Time-Line for Capital Process	Span of Long-Range Capital Budget
Alabama	N	No response	N
Alaska	N	10 months	6 years
Arizona	N	1 1/3 years	5 years
Arkansas	N	6 months	N
California	Y	1 1/2 years	5 years
Colorado	Y	1 year	3 years
Connecticut	Y	1 year	N
Delaware	N	1 year	3 years
Florida	N	1 year	5 years
Georgia	N	1 year	3 years
Hawaii	N	9-10 months	6 years
Idaho	Y	8 months	6 years
Illinois	N	1 year	5 years
Indiana	Y	10-12 months	N
Iowa	N	1 year	5 years
Kansas	Y	1 year	5 years
Kentucky	Y	8 months	N
Louisiana	N	1 year	5 years
Maine	Y	10 months	5 years
Maryland	Y	9 months	5 years
Massachusetts	No response	No response	No response
Michigan	Y	9 months	5 years
Minnesota	N	6 months	5 years
Mississippi	N	9 months	5 years
Missouri	Y	1 year+	N
Montana	N	1 year	6 years
Nebraska	N	No response	N
Nevada	No response	No response	No response
New Hampshire	Y	9 months	6 years
New Jersey	Y	1 1/3 years	7 years
New Mexico	Y	9 months-1 year	5 years
New York	N	10 months	5 years
North Carolina	N	1 1/2 years	N
North Dakota	N	1 year	N
Ohio	N	1 year	6 years
Oklahoma	N	14 months	3-5 years
Oregon	Y	1 1/2 years	N
Pennsylvania	N	10 months	5 years
Rhode Island	N	No response	6 years
South Carolina	Y	Determined by Legislature	N
South Dakota	N	N/A	N
Tennessee	Y	1 year	5 years
Texas	N	2 years	N
Utah	Y	1 1/2 years	5 years
Vermont	N	6 months	5-10 years
Virginia	N	1 1/2 years	N
Washington	N	1 year+	6 years
West Virginia	N	1 year	N
Wisconsin	Y	1 1/2 years	4 years
Wyoming	Y	10 months	N
DC	N	1 1/2 years	6 years
	Y=20		

Table 6
Capital Budgeting Coordinated with Operating

State	How Is Capital Budgeting Coordinated With The Operating Budget?
Alabama	Combined in one appropriation bill.
Alaska	Combined in one appropriation bill.
Arizona	Capital project requests must include impact on operating budget.
Arkansas	Agency anticipates impact on operating budget from capital requests.
California	Through verbal communication, sharing of plans, and system data reports.
Colorado	Higher education has program planning process that links operating budget to capital.
Connecticut	Through analysis by budget and capital analysts
Delaware	Strategic planning process serves in promoting communication
Florida	Plans include impact of capital project on operating budget.
Georgia	Developed simultaneously; included in one appropriation bill.
Hawaii	Capital projects include impact on operating costs.
Idaho	By governor's budget analyst.
Illinois	Through budget office instructions and cooperation of budget analysts.
Indiana	Combined in one appropriation bill.
Iowa	Both operating and capital developed simultaneously; impact of operations taken into account.
Kansas	Budget analyst review of capital request includes impact on operating budget.
Kentucky	Prepared simultaneously with operating budget.
Louisiana	Budget analysts review capital budget requests
Maine	Same process as operating budget except for General Fund and Highway Bond Projects
Maryland	Through capital/operating coordinator. Impact on operating budget part of capital budget presentation
Massachusetts	No response.
Michigan	Component of total budget process.
Minnesota	Capital requests must include impact on operating budget.
Mississippi	Match capital recommendations to agency's operating mission; project change in operating costs
Missouri	Capital budget analyst coordinates analysis with operating budget analyst.
Montana	Budget office reviews capital projects and coordinates with operating
Nebraska	Capital projects include impact on operating costs.
Nevada	No response.
New Hampshire	Budget Office reviews capital projects and coordinates with operating.
New Jersey	Through staff interaction and by management review
New Mexico	Capital budget includes operating budget impacts and operating budget references capital projects
New York	Capital budget requests must include impact on operating costs.
North Carolina	Through capital and operating budget analysts
North Dakota	In the same budget, different line items.
Ohio	Capital bill is one year after the budget bill. Analysts review capital request for impact on operating budget
Oklahoma	Estimated operating costs calculated.
Oregon	Capital budgeting is mostly independent and reviewed after the operating budget.
Pennsylvania	Capital and operating budgets are both developed by the Office of the Budget.
Rhode Island	Agencies must include impact on operating
South Carolina	Capital plans include 5 year operating expenditures
South Dakota	Bond payments included in operating budget
Tennessee	Architectural staff meets with budget analysts and departments to review capital and operating
Texas	Part of the operating budget.
Utah	Through Office of Planning and Budget
Vermont	Developed at the same time; impact from capital projects must be included in operating budget
Virginia	Developed at same time. Capital requests must include impact on operating budget.
Washington	Debt service part of operating budget, otherwise separate
West Virginia	No response.
Wisconsin	Periodic review with budget office and facilities management
Wyoming	Operating and/or maintenance expenses referenced in capital request.
DC	Agency directors request projects in support of long term operating plans.

Section 3

Capital Project Selection, Cost Estimating, and Project Tracking: Tables 7-13

A central component of the capital budgeting process is establishing priorities within the extensive array of proposed projects. With scarce resources and limits on financing options in many states, establishing a set of priorities is a crucial task. Some states first look at the capacity for financing projects from either debt or cash limits over a several year time period and then set priorities.

As Table 7 shows, more than one-third of the states set priorities on a functional basis, such as higher education, natural resources, and local government assistance. Other states use an approach based on emergency, legal, and health reasons. Priorities are ranked by categories such as health and safety, critical maintenance, improvements, and new construction in states such as Virginia, New Hampshire, and Montana. Arizona specifies the use of a formal ranking system to establish priorities in addition to viewing the projects within the political and economic context.

Other approaches to setting priorities include approving projects with a cost savings component as presented in Table 8. When projects are approved with a cost-savings component, often the monitoring of the cost savings is informal. About two-thirds of the states include emergency requests within the capital budget process.

After establishing priorities, states are interested in ensuring that program objectives are met through the project requests. Table 9 shows how some states formalize the review through audits and written justifications, such as in New Jersey, while other reviews are ongoing though less formal.

In carrying out the priorities established in the capital plan, a successful outcome often rests upon the accuracy of cost estimates. Table 10 illustrates the variety of methods states use to develop cost estimates. Architects, engineers, and consultants often provide cost data. In most cases, either the requesting agency or a general services or public works agency is responsible for the review and/or development of the estimates. Techniques include value engineering, life-cycle cost analysis, construction and material indices, and square footage estimates. Almost all states use cost standards according to a particular type of building and space utilization standards to estimate costs as displayed in Table 11. In about half the states, cost options and life-cycle costs are used in cost estimating.

Table 12 shows that in most states future operating costs are projected and often compared to current operating expenses. Projected future costs, however, do not necessarily have any claim on future appropriations.

Table 13 presents the variety of methods states use to track projects once they are underway. Monitoring during the process occurs in the budget office as well as in agencies. Some states, such as Kentucky and Virginia, require an annual or semi-annual progress report for legislative review. A formal tracking system as part of the accounting system is being developed in New Jersey. Other states have a decentralized tracking system within the specific agency overseeing the project.

Good Practices

- **Identify the criteria used in selecting capital projects.**
  States often determine their needs on a functional basis such as higher education and aid to localities. While the functional approach is used for needs assessment over time, emergency or health and safety criteria often determine immediate project selection. States should have some method to integrate needs assessment with project selection. What constitutes an emergency or health reason should be clearly defined. In reviewing the process for project selection, states should assess how actual project selection compares to the priority list.

- **Define all program outcomes for capital investments.**
  Reviews of project requests often do not explicitly link the program objective to the project in question. Projects may be approved that meet financial criteria, but do not meet the objectives of the program.

- **Evaluate cost estimating methods to measure their validity.**
  Even though the expertise for estimating methods is often with the architects and engineers outside of the budget department, budget analysts should be able to understand the underlying assumptions and methods used in the cost estimates in order to thoroughly review project requests.

- **Establish a tracking system to keep projects on schedule and within budget.**
  The tracking system should be ongoing and should serve as an early warning device for projects that are exceeding projections for both cost and time.

Table 7
Setting Project Priorities

State	Do You Set Priorities on a Functional Basis?
Alabama	Needs assessment.
Alaska	Functional areas.
Arizona	Based on an evaluation system
Arkansas	Prioritized by law and then according to need
California	Urgency- fire & life safety code violations, health issues.
Colorado	Needs assessment, project by project
Connecticut	Functional areas.
Delaware	Functional areas, gubernatorial issues funding availability.
Florida	Functional areas.
Georgia	Functional areas.
Hawaii	Functional areas.
Idaho	According to need.
Illinois	No.
Indiana	Project by project basis.
Iowa	Functional areas.
Kansas	Within dedicated funds for each functional area
Kentucky	Life safety projects and maintenance receive priority over new construction.
Louisiana	Functional areas.
Maine	According to need.
Maryland	Functional areas.
Massachusetts	No response.
Michigan	Functional areas.
Minnesota	Project by project in the context of review guidelines
Mississippi	Functional areas.
Missouri	Each project evaluated on merits. Agencies with dedicated funds have more leeway.
Montana	Health & safety, critical maintenance, general maintenance, renovations, improvements, new construction
Nebraska	Agencies and universities set priorities
Nevada	No response.
New Hampshire	Priority categories are health and safety, critical maintenance, maintenance, and new construction
New Jersey	Functional areas. Agencies set priorities in requests. Governor's policies used as guideline
New Mexico	Priorities based on urgency - life & safety and critical maintenance.
New York	Budget Division analysis of critical needs
North Carolina	Budget office analysis and review, governor
North Dakota	By budget office.
Ohio	Urgency, life-health-safety projects, rehabilitation, new construction, depending on funding availability
Oklahoma	Functional areas and by legislatively determined priorities
Oregon	Functional areas.
Pennsylvania	Functional areas.
Rhode Island	Functional areas, health and safety, and policy staff input.
South Carolina	Project by project or immediate need
South Dakota	No response.
Tennessee	Project by project, prior years' funding and planning considered.
Texas	Requesting agency sets priorities within its request. Legislature determines priorities between agencies
Utah	No.
Vermont	Assess based on merit, financial returns, and statutory mandates
Virginia	Major repairs, legal/judicial mandates, life safety codes, improvements, new construction, expansions
Washington	Functional areas. Historical spending and/or identified needs.
West Virginia	No response.
Wisconsin	Evaluation of needs.
Wyoming	Perceived need.
DC	Functional areas.

Table 8
Project Characteristics

State	Approve Projects with a Cost Savings Component	Separate Planning & Construction	Include Emergency Requests in Capital Budget
Alabama	N	N	N
Alaska	Y	Varies	Y
Arizona	Y	Y	Y
Arkansas	N	Y	N
California	Y	Y	N
Colorado	Y	Sometimes	Y
Connecticut	Y	Y	Y
Delaware	Y	Y	Y/Life,safety
Florida	N	Sometimes	N
Georgia	Y	Usually	Y
Hawaii	Y	Y	Y
Idaho	N	Y	Y
Illinois	Y	Often	Seldom
Indiana	Y	Y	Y
Iowa	N	Y	N
Kansas	Y	Y	Y
Kentucky	Y	Sometimes	Y
Louisiana	Y	Y	Y
Maine	Y	Y	Y
Maryland	Y	Y	Y
Massachusetts	No response	No response	No response
Michigan	N	Y	Y
Minnesota	Y	Y	Y
Mississippi	Usually	N	Y
Missouri	Y	Sometimes	Y
Montana	Y	Y	Y
Nebraska	N	N	N
Nevada	No response	No response	No response
New Hampshire	No response	No response	No response
New Jersey	Y	Y	Y
New Mexico	Y	Y	Y
New York	Y	Y	Y
North Carolina	Y	Y	Y
North Dakota	N	N	N
Ohio	Y	Sometimes	Y
Oklahoma	Y	Y	Y
Oregon	N	Y	N
Pennsylvania	Y	N	N
Rhode Island	Y	Y	N
South Carolina	Y	Y	Y
South Dakota	N/A	Often	N/A
Tennessee	Y	Y	Y
Texas	Y	N	N
Utah	N	Y	Y/Consultants
Vermont	Y	Y	Y
Virginia	N	Y	Y
Washington	N	Y (Major projects)	Y
West Virginia	N	N	N
Wisconsin	Y	Y	Y
Wyoming	Y	Y	Y
DC	Y	Y	Y
	Y = 33	Y = 32	Y = 34

Table 9
Program Objectives Met Through Project Requests

State	How Do You Ensure That Program Objectives Are Met Through Project Requests?
Alabama	There is no formal process in place.
Alaska	No process currently exists for measurement.
Arizona	Administration Department analyzes project requests in terms of program objectives and fiscal impact
Arkansas	Monitoring by Office of the Budget.
California	Through management coordination and communication.
Colorado	There is no formal process in place.
Connecticut	Through agency reports after construction.
Delaware	No response.
Florida	Through a review of release requests
Georgia	Budget analysts screen requests.
Hawaii	Budget and Finance analyzes request and evaluates project.
Idaho	First planning phase determines program needs.
Illinois	Bureau of Budget review.
Indiana	Varies with project.
Iowa	Monitored by departments.
Kansas	Budget analysts make sure that program objectives are met.
Kentucky	Require written justification.
Louisiana	Budget analysts review requests
Maine	Department of Administration and Control Projects.
Maryland	Review and analysis by the Department of Budget and Fiscal Planning
Massachusetts	No response.
Michigan	A project program statement is reviewed before architecture plans are initiated.
Minnesota	No formal process exists.
Mississippi	By performing two separate reviews per account.
Missouri	Requests must explain how program objectives are met. Requests and objectives are thoroughly reviewed
Montana	Arch. & Eng. reviews and prioritizes requests; budget office reviews; and Gov. recommends action to Leg
Nebraska	No formal process, but Budget Office conducts analysis as needed.
Nevada	No response.
New Hampshire	Budget Office review.
New Jersey	Budget office conducts analysis, audits, studies
New Mexico	Analyst reviews requests. Agencies starting to implement management system through goals and objectives
New York	Through annual budget request-budget recommendation process by budget staff.
North Carolina	Office of State Budget and Management reviews and analyzes requests.
North Dakota	No response.
Ohio	Office of Budget and Management and legislative reviews.
Oklahoma	No response.
Oregon	No response.
Pennsylvania	No response.
Rhode Island	Budget analysts and policy staff review
South Carolina	Review by engineers, Legislative Council, State Reorg. Commission, and agency's internal auditors
South Dakota	No response.
Tennessee	Through team and committee work
Texas	Legislative Budget Office reviews analyses
Utah	Through analysis.
Vermont	No formal process.
Virginia	No formal process exists.
Washington	Review by program analysts and technical budget staff
West Virginia	No response.
Wisconsin	Review by program analysts.
Wyoming	Through informal assessment.
DC	Project objectives are matched with long-term comprehensive plan objectives during evaluation

Table 10
Estimating Project Cost

State	How Do You Estimate The Cost Of Capital Projects?
Alabama	By agencies with assistance of architects and engineers.
Alaska	Based upon past history and/or engineering estimates.
Arizona	Agencies prepare estimates and Facility Management Division verifies costs using reports and standards.
Arkansas	Cost estimates submitted by agencies and reviewed by Building Services Agency and Budget Office.
California	Cost estimates based on time and materials and are updated after preliminary plans and drawings.
Colorado	Usually square foot estimates with percentages for fees, contingency etc.
Connecticut	Cost estimates are prepared by the Department of Public Works and the requesting agency.
Delaware	Estimated both as one-time appropriation and phased in based on size/unique aspects of project.
Florida	Determined by agency based on national figures and revised by recommendations by Dept. General Serv
Georgia	Estimates prepared by agencies, by business managers or architects/engineers depending on project
Hawaii	By user agency.
Idaho	Estimates from agency staff often from a study prepared by architect prior to budget request.
Illinois	Central construction agency makes estimates.
Indiana	Primarily by entities submitting project requests.
Iowa	Quote from outside source.
Kansas	By agencies, architects and Division of Architectural Services using construction and material indices
Kentucky	Division of Engineering projects most costs.
Louisiana	By staff architects and engineers.
Maine	By staff and Department of Administration architects and engineers.
Maryland	Department of General Services reviews and modifies agency estimate based on comparable projects
Massachusetts	No response.
Michigan	As a function of average square foot costs in the planning phase based on arch. planning documents
Minnesota	Requesting agency either in-house or by consultants
Mississippi	By using standard industry finance procedures
Missouri	Agency engineers and architects use standard industry estimating procedures. Div of Design & Construct reviews
Montana	Cost guides generally provide the cost basis. Estimates vary from unit costs to square foot costs
Nebraska	By agencies, with assistance of consultants if necessary
Nevada	No response.
New Hampshire	Governor selects projects to be formally estimated
New Jersey	Most agencies develop estimates with Division of Building and Construction or through own staff
New Mexico	By agencies, assisted by cost estimators, architects, and engineers.
New York	Design-construction agencies provide preliminary estimates based on surveys and review of facilities
North Carolina	Office of State Construction estimates must accompany all requests.
North Dakota	Agencies prepare estimates with architects and engineers
Ohio	Initially by agencies with input from Division of Public Works and architects.
Oklahoma	Initially by agencies, potential vendors, architects, engineers. Reviewed by construct staff and State Finance
Oregon	By consultant professional cost estimators
Pennsylvania	Using agencies use various methods such as cost standards and agency architects/engineers staff.
Rhode Island	Most agencies develop estimates through own staff
South Carolina	By agency with assistance of architects and engineers
South Dakota	By architectural and engineering estimates of project
Tennessee	By departments, consultants, capital projects and Finance and Administration staff.
Texas	Requesting agencies submit project analyses to legislative and executive budget offices.
Utah	Professional consultants project costs.
Vermont	By state engineers and consultant engineers
Virginia	Requesting agency develops the estimate and Departments of Budget and General Services review it
Washington	Life cycle cost analysis/value engineering basis for estimates/professional estimators.
West Virginia	Architects/engineers, consultants and specialists prepare estimates.
Wisconsin	Estimates based on historical data on past projects. national estimating guides.
Wyoming	Estimates prepared both in-house and externally
DC	By cost estimators and the Department of Public Works

Table 11
Cost Estimating Methods
What Are The Methods Used To Estimate Costs?

Methods Used:

State	Cost Standards Building Type	Space Utilization Standards	Cost Options	Life-Cycle Costs
Alabama	Y	Y	Y	Y
Alaska	Y	Y	Y	Y
Arizona	Y	Y	N	Y
Arkansas	Agencies may use	Agencies may use	Agencies may use	N
California	Y	Y	Y	Y
Colorado	N	Y	Sometimes	Required/Not Enforced
Connecticut	Y	Y	Y	Y
Delaware	Y	Y	Y	Y
Florida	Y	Y	N	Y
Georgia	Y	Y	Sometimes	Y
Hawaii	Y	Y	N	N
Idaho	Y	Y	N	Y
Illinois	Y	Y	Sometimes	Y
Indiana	N	Y	Y	N
Iowa	Y	Y	Y	N
Kansas	N	Y	Y	Y
Kentucky	Y	Y	N	N
Louisiana	Y	Y	Y	Y
Maine	Y	Y	Y	Y
Maryland	Y	Y	Y	N
Massachusetts	No response	No response	No response	No response
Michigan	Y	Y	Y	Y
Minnesota	N	N	N	N
Mississippi	Y	Y	Y	N
Missouri	Y	Y	Y	Y
Montana	Y	N	N	N
Nebraska	Y	N	N	N
Nevada	No response	No response	No response	No response
New Hampshire	Y	Y	Y	Y
New Jersey	Y	Y	Y	N
New Mexico	Y	Y	Sometimes	Sometimes
New York	Y	Y	Y	N
North Carolina	Y	Y	Y	Y
North Dakota	Agencies may use	Agencies may use	Usually not	N
Ohio	Y	Y	Sometimes	N
Oklahoma	Y	Y	Y	YN
Oregon	Y	Y	Y	Y
Pennsylvania	Y	Y	Y	Sometimes
Rhode Island	N	Y	N	N
South Carolina	N	N	N	Y
South Dakota	N/A	Y	N/A	N/A
Tennessee	Y	Y	Y	Y
Texas	Y	Y	Y	Y
Utah	Y	Y	Y	Y
Vermont	Y	Y	Y	N
Virginia	Y	Y	Y	Y
Washington	N	Y	N	Y
West Virginia	N	N	N	N
Wisconsin	Y	Y	Y	Y
Wyoming	Y	Y	Y	N
DC	Y	Y	Y	N
	Y = 38	Y = 42	Y = 29	Y = 25

Table 12
Cost Estimating Methods: Part 2
What Are The Methods Used To Estimate Costs?

State	Project Future Operating Costs	Claims on Future Appropriations
Alabama	N	Y
Alaska	Y	Y
Arizona	N	N
Arkansas	N	N
California	Y	Y
Colorado	Y	Y
Connecticut	Y	N
Delaware	Y	Y
Florida	Y	N
Georgia	Y	Y
Hawaii	Y	Y
Idaho	N	N
Illinois	Y	N
Indiana	Y	N
Iowa	Y	N
Kansas	Y	Y
Kentucky	Y	N
Louisiana	Y	Y
Maine	Y	Y
Maryland	Y	Y
Massachusetts	No response	No response
Michigan	Y	Y
Minnesota	Y	N
Mississippi	Y	Y
Missouri	Y	Y
Montana	Y	N
Nebraska	N	N
Nevada	No response	No response
New Hampshire	Y	Y
New Jersey	Y	Y
New Mexico	Y	N
New York	Y	N
North Carolina	Y	N
North Dakota	Y	N
Ohio	Y	N
Oklahoma	Y	N
Oregon	Y	Y
Pennsylvania	Y	N
Rhode Island	Y	N
South Carolina	Y	N
South Dakota	N A	N
Tennessee	Y	N
Texas	Y	N
Utah	Y	N
Vermont	Y	N
Virginia	Y	N
Washington	Y	N
West Virginia	Y	N
Wisconsin	Y	Y
Wyoming	Y	N
DC	Y	Y
	Y = 43	Y = 19

Table 13
Formal Reporting System To Track Capital Projects

State	Do You Have A Formal Reporting System To Track Capital Projects?
Alabama	No formal system.
Alaska	Agencies and the budget office complete a capital authorization status report.
Arizona	Projects reviewed by legislature.
Arkansas	No formal system.
California	State Public Works Board and Joint Legislative Budget Committee.
Colorado	Dept. of Administration reviews some contracts and verifies fund availability.
Connecticut	No formal system.
Delaware	Development Office/Dept. of Adm. Services approves expenditures, construction, and monitors progress
Florida	Governor's Budget Office and agency provide an annual analysis on progress of project at various phases
Georgia	Each agency has tracking process
Hawaii	Planning, design, and project coordinator branches of agency.
Idaho	Division of Public Works tracks projects.
Illinois	No formal system.
Indiana	Entity receiving appropriations has major tracking responsibility. Public Works Division also tracks projects
Iowa	Agencies gather information and Legislative Capital Projects Committee reviews it.
Kansas	Governor's budget report includes descriptions of all projects. Architectural Services tracks all projects
Kentucky	Governor's Office for Policy and Management prepares annual report for legislature.
Louisiana	Office of Facility Planning and Control oversees project.
Maine	Agencies and Department of Administration track projects.
Maryland	General services and budget office update database.
Massachusetts	No response.
Michigan	Department of Management and Budget reviews architectural plans, monitors appropriations.
Minnesota	Division of Building and Construction prepares quarterly status reports.
Mississippi	Bureau of Buildings tracks projects.
Missouri	Computerized information system provides information on each project.
Montana	Architecture and Engineering administers all projects; budget office tracks appropriations.
Nebraska	Quarterly status reports are prepared.
Nevada	No response.
New Hampshire	Agencies prepare status reports.
New Jersey	A formal project tracking system is being developed.
New Mexico	Capital project monitoring system tracks funds expended and progress to date on a semi-annual basis
New York	The design-construction agencies monitor design and construction, the client agency reviews.
North Carolina	Office of State Budget and Management and State Construction oversee fiscal and quality assurance.
North Dakota	No formal system.
Ohio	Office of Budget and Management with State Controlling Board approve all releases of capital funds
Oklahoma	Office of Public Affairs and Office of State Finance administer funds and reports.
Oregon	Management by agency, design review by Capitol Planning Commission.
Pennsylvania	Office of the Budget maintains a status report.
Rhode Island	Building Code Commission and departments track progress.
South Carolina	State Engineers Office assist in bidding, planning and approval.
South Dakota	State Engineers Office and Commissioner of Administration monitor projects.
Tennessee	Project management and monitoring by Capital Projects Management and Finance and Administration
Texas	Requesting agency oversees the project.
Utah	Div. of Facilities Construction and Mngt., Div. of Water Resources, and Dept. of Transportation track projects
Vermont	Department of State Buildings tracks costs
Virginia	Agency and Dept. of General Services prepare a progress report on semi-annual basis for legislature
Washington	Executive and legislature review, reporting system in development.
West Virginia	No formal system.
Wisconsin	Division of State Facilities Management.
Wyoming	No formal system.
DC	Implementer tracks status, user does site visits, financial officer executes budget action and financing

Section 4

Capital Financing: Tables 14-17

After priorities are established, states look at how to finance a project. States' financing options are often dependent upon legal limits on debt levels or the ability to incur debt. Other restrictions include scarcity of general revenues as well as policy decisions to maintain certain debt levels in light of bond ratings.

As Table 14 shows, states often look at the amount of general fund resources available for projects through an analysis of funding availability. In some cases capital allocation is derived from the total revenues available less operating requirements. Due to severe fiscal constraints, some states have virtually eliminated the use of general funds for capital projects in recent years.

For states that have an option to debt finance, the issue of whether to fund a project through cash or bonds arises. Table 14 illustrates how decisions on project financing depend on such factors as funding availability, the size of the project, the type and life of the project, tax laws, and the likelihood of voter approval for the project.

Another financing decision states face is whether to own or lease a facility. Most of the states that have a policy regarding this decision compare the life-cycle costs of the two options in deciding whether to own or to lease. Most states do not explicitly consider the impact on the local property tax base in the decision.

In addition to general obligation bonds, states also include revenue bonds in the regular capital budget process. From a debt perspective, coordinating various debt issues would provide a state with a better picture of total debt. For states that debt finance, there is often the need to finance a project on an interim basis until the bonds can be issued. Table 15 shows that about half the states use treasury loans as an interim form of financing. Other interim financing options used by the states include special funds, pooled investments in California, bond anticipation notes, and master note financing in Kentucky.

In funding capital projects through debt financing, debt service expense becomes a fixed cost in the operating budget and, if excessive, can limit future options. States build discipline into their debt financing decisions through such means as user fee financing whenever possible as shown in

Table 16. About half the states have the users of approved facilities participate in paying for debt service. Some states require private sector participation in certain capital projects. The types of projects most likely to have private sector participation include economic development projects and build-to-suit projects with an option to buy. About half the states compare debt service expense with the net operating impact and changes in revenues and expenditures of the projects funded.

States make decisions on the amount of general funds to allocate for debt service based on available revenues as well as statutory/constitutional debt limits. As Table 17 shows, about two-thirds of the states have limits on the amount of debt service or authorized debt. The limits vary across states, with a range from no general obligation debt to fifteen percent of available revenues for debt service. Limits on authorized debt also range from no allowable debt to a dollar amount such as $500,000 or percentage of income or revenues. Other limits are waived with the requisite voter approval. Limits on revenue bonds are less frequent and when they exist, the limits tend to be dependent on various issuing authorities. As an approach to setting targets for debt, about half of the states start the capital budget process with amounts based on funding sources such as total general obligation bonds, total debt service appropriation, and total cash appropriation for capital projects.

Good Practices

- **Define the factors to consider in decisions of whether to own or lease.**
  Factors to consider include life-cycle costs and the impact on local property taxes.

- **Develop a clear debt policy.**
  With the trend towards more of state expenditures in the entitlement or mandatory category, states limit their flexibility when debt service exceeds a comfortable portion of their operating budget. The debt service limits states set for themselves should be viewed in light of anticipated overall growth in the states' revenues.

- **Review cost-benefit comparisons for private sector participation in capital projects.**
  Opportunities to involve the private sector would help target the specific benefits and costs of a project.

Table 14
Project Financing

State	Amount of General Fund Dollars Used	Use of Bonds Vs. Cash	Policy Own Vs. Lease
Alabama	Economic and political considerations	Project size	Y
Alaska	Available revenue minus operating	Nature of project, availability of funding	Y
Arizona	Economic and political considerations	Constitutional limit	Y
Arkansas	Financing structure, mechanism in law	Legal provisions, availability of bond finance	Y
California	Statute/constitutional limits	Potential for voter approval, asset life, cash	Y
Colorado	Transfers from general fund in statute	Legislation	N
Connecticut	No response	Size of request	Y
Delaware	Economic conditions, funds available	Federal tax laws, project scope, private involvement	Y
Florida	At least 5% of general fund growth	Type of project	Y
Georgia	Projected revenue minus operating	No set policy	N
Hawaii	Availability of funds	Nature of project, available funds, debt limits	N
Idaho	Surplus funds when available	Need, political appeal, available cash	N
Illinois	Prior years, condition revenues	Bondability guidelines	Y
Indiana	Type of project and availability of funds	Availability of funds, statutory authority	N
Iowa	Governor's recommendation	Governor's recommendation	N
Kansas	Debt service commit, stat transfer highways	Availability of funds, benefit spread	N
Kentucky	Relative need versus dollars available	Available cash, debt ceiling, life-cycle of project	N
Louisiana	Little general fund used	Expected life of project	N
Maine	Debt service commitment	Size of project	N
Maryland	Availability of funds, type of project	Availability of funds, project type	N
Massachusetts	No response	No response	No response
Michigan	Project size-under $5 million	Project size	N
Minnesota	Judgement call	Bondability constraints	N
Mississippi	No general fund	All projects use bonds	Y
Missouri	Financial health of state/other priorities	Available funds/amount of state debt	N
Montana	No general fund/Leg. may add general fund	Size of project	N
Nebraska	Availability of funds, project type	Availability of funds, project type	N
Nevada	No response	No response	No response
New Hampshire	Debt service only	Economic situation, life of project	Y
New Jersey	Consider mandated costs and revenue proj.	Cost, size, purpose of project	N
New Mexico	Availability of funds	In process of review	N
New York	General fund "last in" source	Type of project	N
North Carolina	Projected general fund balance	Revenues produced and leg. approved G.O. bonds	N
North Dakota	Needs vs. funds	Availability of funds	N
Ohio	Funds available, type of project	Project type and size	N
Oklahoma	Funds available	Amount of project, project type	N
Oregon	No response	Cash availability	Y
Pennsylvania	Projects usually financed with bonds	Special fund agencies with dedicated revenues	N
Rhode Island	Funds available	Most projects bond financed	N
South Carolina	Allowable debt service	Availability of funds	N
South Dakota	N/A	Cash availability	Y
Tennessee	Cash available after operating	Cash availability	Y
Texas	Legislative priorities	Legislative priorities	Y
Utah	Executive decision	Executive decision	Y
Vermont	Rarely use general funds	Bonding guidelines and tax laws	N
Virginia	Judgement call	Financial feasibility, availability of revenues	N
Washington	Funds available	Funding source	N
West Virginia	Estimated cost	Legislative authorization	N
Wisconsin	Priorities of Governor, Legislature, & Comm.	Building commission action	Y
Wyoming	Gubernatorial/legislative priorities	Availability of funds	N
DC	Repairs not qualifying for bonds	Type of project	Y
			Y = 18

Table 15
Project Financing: Part 2

State	Use Of Treasury Loans	Include Revenue Bonds In Capital Process	Interim Financing Methods
Alabama	N	Y	N
Alaska	Y	Y	General fund
Arizona	N	N	N
Arkansas	N	Y	N
California	Y	Y	Planning funds,pooled invest
Colorado	Y	Y	N
Connecticut	Y	Y	Bond Anticipation Notes
Delaware	No response	N	Local school funds
Florida	N	Y	General fund, special taxes/Education
Georgia	N	Y	N
Hawaii	Y	Y	Treasury loans/BANs
Idaho	Y	Y	Permanent Building Fund/GA
Illinois	N	N	N
Indiana	N	N	N
Iowa	N	Y	Internal funds
Kansas	Y	Y	N
Kentucky	Y	Y	Master note financing/adv. recei
Louisiana	Y	Y	Loans
Maine	Y	Y	Bond Anticipation Notes
Maryland	Y	Y	Adv funds consol. bond proceeds
Massachusetts	No response	No response	No response
Michigan	Y	Y	General fund
Minnesota	Y	N	N
Mississippi	N	N	N
Missouri	N	Y	N
Montana	N	Y	Cash
Nebraska	N	Y	N
Nevada	No response	No response	No response
New Hampshire	N	Y	General fund
New Jersey	Y	N	N
New Mexico	N	Y	N
New York	Y	Y	Tax. rate loan, commercial paper
North Carolina	N	Y	N
North Dakota	N	N	N
Ohio	N	Y	N
Oklahoma	N	Y	N
Oregon	N	Y	Internal loans
Pennsylvania	N	N	Bond Anticipation Notes
Rhode Island	Y	N	Bond Anticipation Notes/general fund
South Carolina	Y	Y	Bond Anticipation Notes
South Dakota	N/A	N/A	N/A
Tennessee	Y	Y	N
Texas	N	Y	N
Utah	Y	Y	Cash flow Treasurer
Vermont	Y	N	Bond Anticipation Notes/general fund
Virginia	Y	Y	Being developed
Washington	N	Y	N
West Virginia	Y	Y	Treasury loans, notes
Wisconsin	Y	Y	N
Wyoming	N	Y	N
D.C.	Y	N	General fund pooled cash
	Y=24	Y=36	

Table 16
Debt Service

State	Users Pay Debt Service	Compare Debt Service to Revenues & Expend.	User Fee Financing	Private Sector Participation
Alabama	Sometimes	Y/N	Sometimes	Y/N
Alaska	Y	N	Y	Y
Arizona	Y	Y	Y	N
Arkansas	Y	N	Y	N
California	Y	Y	Y	Y
Colorado	Y	No response	Y	Y
Connecticut	N	No response	Y	Y/N
Delaware	Y	Y	Y	N
Florida	Y	N	Y	N
Georgia	N	N	Sometimes	N
Hawaii	Y	Y	Y	Y
Idaho	Sometimes	Y	Sometimes	N
Illinois	N	Y/N	Y	N
Indiana	N	Y	N	N
Iowa	Y	Y	Y	N
Kansas	Y	N	Y	N
Kentucky	Y	N	Y	Y
Louisiana	Sometimes	N	Y	N
Maine	Sometimes	Y	Sometimes	N
Maryland	N	N	Y	Sometimes
Massachusetts	No response	No response	No response	No response
Michigan	Y	N	Y	N
Minnesota	Sometimes	Y	Sometimes	Sometimes
Mississippi	Y	Y	Y	N
Missouri	N	Y	N	N
Montana	Sometimes	Y	Y	Sometimes
Nebraska	Y	N	Y	N
Nevada	No response	No response	No response	No response
New Hampshire	Y	Y	Y	Y
New Jersey	N	N	N	N
New Mexico	N	N	N	N
New York	N	N	N	N
North Carolina	N	N	Y	N
North Dakota	Y	N	Y	Y
Ohio	N	N	N	Sometimes
Oklahoma	Y	Y	Y	Y
Oregon	Y	Y	Y	N
Pennsylvania	N	N	N	N
Rhode Island	N	Y	Y	N
South Carolina	Y	Y	Y	N
South Dakota	Project by project	Project by project	Project by project	Project by project
Tennessee	Y	Y	Y	Y
Texas	N	Y	Y	N
Utah	N	Y	Y	N
Vermont	Y	Y	N	Sometimes
Virginia	Y	Y	Y	N
Washington	Y	N	Y	N
West Virginia	Y	Y	Y	N
Wisconsin	Y	Y	Y	N
Wyoming	Y	Y	Y	N
DC	N	Y	N	Y
	Y=26	Y=26	Y=34	Y=10

Table 17
Debt Management

State	Policy to Limit Debt Service	Policy to Limit Authorized Debt	Moody's G.O. Rating
Alabama	N	N	Aa
Alaska	Based on oil revenues	N	Aa
Arizona	N	G.O. debt limit of $350,000	No G.O. debt
Arkansas	N	N	Aa
California	N	N	Aaa
Colorado	No general obligation debt allowed	No G.O. debt allowed	No G.O. debt
Connecticut	N	N	Aa
Delaware	15% of general fund	5% of revenue	Aa
Florida	N	50% of tax revenue preceding 2 yr.	Aa
Georgia	Y	Y	Aaa
Hawaii	15% of revenues	Y	Aa
Idaho	N	N	No G.O. debt
Illinois	N	N	Aa1
Indiana	N	No. G.O. debt allowed	No G.O. debt
Iowa	N	G.O. bond limit of $250,000	No G.O. debt
Kansas	N	$1 million limit w/o voters	No G.O. debt
Kentucky	N	G.O. bonds $500,000	Aa
Louisiana	10% of 3 yr. av revenues Bond & Redempt Fund	2 times 3 yr. av. bond revenues & redempt. funds	Baa1
Maine	N	N/General Fund\$150 million on revenue bonds	Aa1
Maryland	8% of available revenues	G.O. debt at 3.2% of income	Aaa
Massachusetts	No response	No response	Baa
Michigan	N	Cap on bonds	A1
Minnesota	3% of general fund unrestricted receipts	N	Aa
Mississippi	5-8%	1.5 times lg. revenue preceding 4 yr.	Aa
Missouri	N	State constitution and statute	Aaa
Montana	N	N	Aa
Nebraska	N	N	No G.O. debt
Nevada	No response	No response	Aa
New Hampshire	N-Informal	10% of general fund revenue	Aa
New Jersey	N	N/G.O. Y/Revenues based on issuing authority	Aaa
New Mexico	1% of taxable property subject to property tax	Y	Aa
New York	N	Statutory limits G.O. bonds	A
North Carolina	N	Voter approval	Aaa
North Dakota	N	N	Aa
Ohio	5% of annual general fund expenditures	Legislative approval	Aa
Oklahoma	N	N	Aa
Oregon	N	Determined by Treasurer/Legislature	Aa
Pennsylvania	N	N	A1
Rhode Island	N	G.O. bonds must be approved by voters	Aa
South Carolina	5% of prior year's revenues	Function of debt service	Aaa
South Dakota	N/A	N/A	No G.O. debt
Tennessee	Y	150% of revenues from previous year	Aaa
Texas	N	No response	Aa
Utah	N	Based on total assessed value of property	Aaa
Vermont	N	Debt Affordability Committee reviews debt	Aa
Virginia	N	1.15% times average annual revenues	Aaa
Washington	7% of revenues	Legislative approval	Aa
West Virginia	N	N	A1
Wisconsin	3 to 4% of revenues	Y	Aa
Wyoming	1% of assessed value of taxable property	1% of assessed value of taxable property	No G.O. debt
DC	14%	N	Baa

Source: Moody's Municipal Credit Report, November 12, 1991.

Section 5

Asset Management: Tables 18-19

States often use inventory systems to track the status of existing capital assets. As Table 18 shows, almost all states maintain a data base inventory for capital assets. In about one-third of the states, the inventory systems assess the condition of facilities, while about two-thirds of the states use building maintenance standards. The frequency of updating data bases ranges from continuously to every three years.

Some states charge rent to departments in order to finance maintenance and improvements to facilities. In about two-thirds of the states, departments are charged rent and the rent is used for building maintenance. Other funding mechanisms available for maintenance include building renewal funds, dedicated building funds, maintenance reserves, and revolving funds in addition to general funds as shown in Table 19. In about two-thirds of the states the current priority in appropriations is for maintenance rather than new construction.

Good Practices

- **Maintain an updated inventory system of capital assets.**
  States should review the adequacy of the information and include the condition of the facilities.

Table 18
Asset Management

State	Data Base Inventory	How Often Data Updated	Priority Between Maint & New Facilities	Charge Rent To Departments
Alabama	N	N/A	Based on need	Y
Alaska	Y	Now current	Maintenance	N
Arizona	Y	Yearly	Maintenance	Y
Arkansas	Y	Kept by Bldg Services	Based on need	Y
California	Y	Ongoing	Maintenance	Y
Colorado	N	N/A	Project by project	N
Connecticut	Y	Yearly	Maintenance	N
Delaware	Y	Yearly	Maintenance	N
Florida	Y	Yearly	Maintenance	Y
Georgia	N	N/A	New buildings	Y
Hawaii	Y	Continuous	Within available funds	N
Idaho	Y	Yearly	Maintenance	Y
Illinois	Y	Constant	Half appropriation	N
Indiana	Y	Ongoing	Depends	N
Iowa	N	N/A	New buildings	N
Kansas	Y	Yearly	Maintenance	Y
Kentucky	Y	Continuous	Maintenance	Y
Louisiana	Y	No response	Maintenance	Y
Maine	Y	Yearly	Maintenance	Other than general fund
Maryland	N	Every 3 yr	Depends	Y
Massachusetts	No response	No response	No response	No response
Michigan	Y	Depends on staff	Maintenance	Y
Minnesota	N	N/A	New construction	Y/N
Mississippi	Y	Every 2 yr.	Depends on future impact	Y
Missouri	Y	Yearly	Maintenance	Y
Montana	Y	No response	Maintenance	Y
Nebraska	N	N/A	Based on need	Y
Nevada	No response	No response	No response	No response
New Hampshire	N	N/A	Maintenance	Y
New Jersey	Y	Periodically	Maintenance	N
New Mexico	Y	No response	Based on need	N
New York	Y	Every 2 yr	Maintenance	Y
North Carolina	Y	Every 3 yr.	Depends	N
North Dakota	Y	Yearly	Maintenance	Y
Ohio	Y	Yearly	Maintenance	Other than general fund
Oklahoma	Y	Yearly	No response	Y
Oregon	Y	Being developed	Maintenance	Y
Pennsylvania	Y	Yearly	Not established	N
Rhode Island	Y	Developing/Continuous	Based on need	Y
South Carolina	Y	As needed	Depends	Y
South Dakota	Y	No response	Maintenance	Y
Tennessee	Y	In process	No response	Y
Texas	Y	Continuous	Maintenance	N
Utah	Y	Yearly	Maintenance	Y
Vermont	N	N/A	Need based	Other than general fund
Virginia	Y	No response	Maintenance	Y
Washington	N	N/A	New construction	Depends
West Virginia	N	N/A	Equal	Y
Wisconsin	Y	Yearly	Maintenance	Y
Wyoming	Y	Monthly	Maintenance	N
DC	Y	N/A	Maintenance	N
	Y=38			Y=29

Table 19
Asset Management: Part 2

State	Other Mechanisms For Maintenance
Alabama	Budget & revolving funds through rent
Alaska	N
Arizona	Building renewal funds
Arkansas	Y
California	N
Colorado	N
Connecticut	N
Delaware	N
Florida	General fund
Georgia	Continuation and improvement funds
Hawaii	Hospital, airport
Idaho	Operating budget
Illinois	N
Indiana	Y
Iowa	N
Kansas	Dedicated Building Funds
Kentucky	General fund
Louisiana	Operating budget
Maine	Operating budget, Dedicated Build. Funds
Maryland	N
Massachusetts	No response
Michigan	N
Minnesota	Pooled account for asset preservation
Mississippi	Y
Missouri	N
Montana	Operating budget
Nebraska	N
Nevada	No response
New Hampshire	Operating budget
New Jersey	N
New Mexico	Operating budget
New York	N
North Carolina	N
North Dakota	N
Ohio	Operating budget
Oklahoma	Y
Oregon	N
Pennsylvania	N
Rhode Island	N
South Carolina	N
South Dakota	General fund and other appropriations
Tennessee	Revolving fund through rent
Texas	N
Utah	N
Vermont	N
Virginia	Maintenance reserve
Washington	General fund
West Virginia	N
Wisconsin	Y
Wyoming	N
DC	N

Case Studies in Selected States

Section 1

Defining Capital Expenditures and Protecting Maintenance Funds

- **Question: How do you define or breakout your categories of capital expenditures (e.g., renovation, maintenance, construction, planning)? What do you include as "capital" expenditures? Are you satisfied with your definition? Why or why not?**

Arizona

There are two types of capital appropriations. The first is a statutorily prescribed "building renewal" formula and the other type covers all other appropriations in our Capital Outlay Act. "Building renewal" is defined in A.R.S. 41-790 to mean:

Major activities that involve the repair or reworking of a building, including the upgrading of systems which result in maintaining a building's expected useful life. Building renewal does not include new construction, landscaping and area beautification, infrastructure replacement or repairs, routine maintenance, new paving resurfacing of an area that was not capitalized as part of the original cost of the building, or demolition and removal of a building.

The other type of capital appropriation includes renovation projects, major systems replacement, design and/ or engineering fees, land acquisition, and new construction.

Operating budget agencies may expend resources for items related to capital facilities. Minor renovations, relocations, remodeling, paving, general maintenance, statewide capital planning and inspections, and emergency infrastructure repairs are usually expended against the operating budget.

Since legislative enactment of the building renewal formula in 1986, the formula has never been fully funded. For example, while the total state general fund appropriation in the Capital Outlay Act for FY1992 is $4 0 million, the general funds "building renewal" formula allocation alone is targeted to be $22.9 million. Accordingly, there are both insufficient general fund appropriations to finance capital projects and no clear definition of capital projects (other than building renewal).

Indiana	Capital budgets include preventive maintenance, repair and rehabilitation, and construction. Preventive maintenance is defined as expenditures for the normal/routine upkeep of existing structures. Repair and rehabilitation refers to infrequent upkeep or upgrading existing structures which may result in a change in the function of an asset. Construction refers to expenditures resulting in a new fixed asset.
Kansas	There are four main capital improvement categories: rehabilitation and repair, remodeling, new construction, and razing. Debt service, regardless of the nature of the project, is treated as a separate category. Rehabilitation and repair includes all maintenance (major and emergency), restoration, replacement of fixed equipment, energy conservation, code compliance, re-roofing, and program requirements. Remodeling includes all major projects that substantially change the structure and use of existing facilities. New construction includes all new construction and building additions. Razing includes the demolition of existing facilities. Debt service, consistent with GAAP accounting principles, includes only the principal portion of the debt service payment for a project.
Rhode Island	Maintenance is defined as all repair and renovation activities that do not alter the asset's original purpose or expected useful life, while capital is defined as all activities associated with construction. Capital includes renovations and repairs which alter the asset's original intended use or useful life.

- **Question: Most budget officials recognize the need for repair and maintenance activities. Often, however, funds get diverted to other operating expenses or to remodeling, renovations, or construction projects. Have you addressed this issue in your state? To what effect?**

Arizona	Many of our facilities have structural and mechanical problems which cannot be addressed due to the lack of renewal and maintenance funds. To a large extent, preventive maintenance is not done on a routine basis. All of our available funds are used to fix problems once they become emergencies. The "building renewal" formula was an attempt to address the concerns of budget officials and facility managers in the area of maintenance and repair, however, funds were not provided. The state's facility managers have done an outstanding job in fixing the building inventory on "less than shoestring budgets" in the last five years.

Indiana

The necessity to improve the method for determining funding levels for repair and rehabilitation led the Higher Education Commission, the State Budget Agency, and public institutions, with the support of the General Assembly, to study the condition of facilities and alternative public policies towards improving the conditions. A number of funding formulas used in other states were evaluated and changes were made in the way in which Indiana's public institutions report facilities inventory data to the Commission. The formula recommended for use in Indiana public higher education derives from Michigan's formula. The basic premises are as follows:

- The formula should be based on construction costs;
- The formula should reflect current year building valuation;
- The formula should recognize that as a general policy fewer resources should be directed to building renewal than the cost of building replacement;
- The formula should recognize that older buildings require proportionately more renewal funds than younger buildings and;
- The formula should reflect the effects of building renewal projects already accomplished.

Kansas

The definition for rehabilitation still has some "gray" areas as to whether this type of work should be included in capital improvements or the operating budget. For example, maintenance undertaken by the Department of Transportation, whether done with in-house staff or by contract, is reported in the operating budget, whereas maintenance for other agencies is reported as a capital improvement. There does not appear to be any overriding concerns about the definition of maintenance.

Maintenance funds are protected for certain facilities through the use of dedicated sources of revenue derived from a property tax levy. Universities, state hospitals, state mental retardation institutions, youth centers, the School for the Visually Handicapped, and the School for the Deaf are included. In some years, correctional facilities have shared in the levy for state hospitals and related facilities, but now they have a dedicated portion of lottery and racing receipts. The Governor proposed to the 1991 legislature to dedicate another portion of lottery and racing receipts to a new fund, named the General Facilities Building Fund, to provide a stable source of financing for facilities belonging to other agencies such as the Department of Administration, Department of Agriculture, Adjutant General, Department of Wildlife and Parks, State Fair, Kansas Bureau of Investigation, and Insurance Department.

Rhode Island

Repairs and renovations have usually been in the capital budget, with only minor repairs and preventive maintenance financed in the operating budget. This policy resulted in postponing many repairs until they approached crisis proportions. Repairs at this stage became more costly and diverted attention from establishing an ongoing inventory of repair needs. Furthermore, with bond funds being project specific, the state did not have the capacity to address emerging maintenance problems. Instead, items would generally be placed on hold for a subsequent bond issue.

In recognition of this problem, asset protection legislation was enacted that dedicated a portion of lottery receipts for asset protection activities. While reserving operating revenues for ongoing asset protection was a giant step forward, two issues plagued the program: (1) the lack of an inventory on the general condition of state assets precluded any needs evaluation process; and (2) the pressure to include remodelling which exceeded normal asset protection as an eligible activity. The asset protection program, which took effect July 1, 1986, survived until FY 1991 when, with a $250 million state deficit, the reserved funding for asset protection was suspended.

Coincidentally, this state was in the midst of the FY 1991-2 biennial capital budget process. In recognition of both asset protection requirements identified by agencies in their capital budget requests and the suspension of asset protection funding over the two ensuring years, a $19.5 million two-year bonded asset protection program was presented to and approved by the voters in November 1990. As opposed to previous bonded maintenance, this issue is not project specific and therefore provides flexibility to intervene in unanticipated, priority situations.

At this juncture, maintenance/asset protection activities will continue to be proposed for bonding. Accordingly, state agencies are required to identify their current and projected asset protection needs as a distinct element of the FY 1993-4 biennial capital budget. Along with setting priorities, maintenance needs must be identified as: (1) backlog requirements - needs as of FY 1992 and, (2) prospective requirements - needs projected yearly from FY 1993 to FY 1997.

In summary, in an attempt to provide a continuous stream of operating funds for repair and renovations, statutory language was established specifying the proportion of receipts to be available for asset protection. This statutory language has been suspended, and to fill the financing void asset protection has been financed with general obligation bonds.

Section 2

Organization of the Capital Planning Process

- **Summary**

A capital budget begins with the state budget office preparing guidelines, forms, instructions, and procedures that are then provided to the individual state agencies to complete. State agencies request the capital improvement and construction budget for their agencies. Whether the capital budget is for only the budget period or if it is a six to ten year plan, the list of capital needs is generated at the state agency level. Generally speaking, a capital budget is done separately from the operating budget. Some states, however, submit both the operating and capital budget to the legislature at the same time while others actually submit the two budgets to the legislature at different times.

Capital budgets include both renovations to existing buildings and new construction. New construction and improvements to existing buildings are usually all part of the same priority listing. Some states require agencies to plan fifteen years down the road although a shorter plan is actually submitted to the state budget office. Generally, state's with annual sessions look at needs five years down the road; those with biennial budgets look at three biennia or six years total.

In states where substantial planning is done, long-range plans do guide future years significantly. In states where documentation for the years outside the budget process is minimal, plans generally do not guide the future. States with well-established capital budgets require thorough documentation on the program need of the building, the use of the building, size, and structure.

Some of the elements that make capital budgets work include a clear understanding of the philosophy and the principles that are the framework of a capital budget. Without a clear understanding of the principles, the process becomes haphazard and much more political. Thorough documentation, planning, and needs analysis are a must. This includes taking a tough stance on requiring agencies to document the need for the project. Expertise on capital construction is also needed. Whether the expertise of engineers, architects, and cost estimators is a part of the budget office, part of a general services department, or contracted out, it is a necessary element of success. The expertise to evaluate projects and set priorities for the capital budget must be available to the budget office

Finally, the states most satisfied with their capital budgeting process have some method of keeping legislatures informed on the capital budget needs of the state. Some states have a formal committee made up of individuals who are in charge of financing projects, supervising construction of projects, or budgeting for the state. Committees include both the executive branch and legislative branch. States that have a committee in place report that it lends credibility to the capital budget process, it tends to take politics out of the decision making process, and that it is perceived as a fair and equitable approach for setting capital priorities for the state. In states that did not have a formal committee or commission to evaluate the capital budget, the budget office or the person in charge of the capital budget always kept key legislators informed.

- **Question: How does your state generate a list of capital improvements and capital construction needs?**

Kansas	Statute requires agencies to submit five-year facilities plans each year, encompassing the forthcoming budget year and four succeeding budget years.
Maryland	Agencies submit requests for consideration. The capital budgeting process runs parallel to the budget process but is separate from it. Forms are provided to the agencies to make their requests.
Minnesota	State agencies submit their requests on capital needs. The capital budget guidelines, forms, and procedures are sent to the state agencies by the budget office. The capital budget is a separate document from the operating budget and it is presented to the legislature at a separate time. In fact, the budget office is attempting to change the timing of the operations and capital budgets so that one year of the biennium, (the first year) operating budgets would be passed by the legislature and the second year of the biennium (when only minor changes need to be made to the operating budgets), the capital budget would be passed. The state of Minnesota is on a biennial budget system but its legislature does meet every year. When both budgets are considered during the same legislative session, the capital budget does not receive a thorough hearing. Doing the capital budget on the off year of the operating budget would allow legislators the opportunity to do site visits. In research conducted, about half the states did capital budgets and operating budgets at the same time and the other half did them at different times.

Virginia	A list of capital projects is generated by soliciting request forms from all state agencies and institutions of higher education.

- **Question: Are capital improvements to existing buildings separated from new construction needs?**

Maryland	Major renovations are handled the same as new construction. A separate facility renewal item in the capital budget handles projects between $100,000 and $1.000,000.
Minnesota	Improvements and new construction needs compete for the same capital expenditure dollars.
Virginia	They are evaluated in the same manner based on the programmatic merit. Renovations compete with new construction for funding in the same plan.

- **Question: How does your state approach multi-year planning for major capital improvements and new construction?**

Maryland	The agency's request includes its needs or anticipated needs over the next five years. The plan the agency submits reflects the way it would like to see renovations and new construction handled for their agency. That may not necessarily be what the Capital Budget Office recommends; some projects may be moved up, some may be moved back.
Minnesota	While state agencies do submit a six-year plan, the out-years (those years beyond the actual budgeting period), are really only "wish" lists and are not based on solid needs and thorough analysis.
Virginia	Agencies are required to be thinking of construction and renovation plans ten to fifteen years hence, though they submit a six-year plan to the state budget office. The state of Virginia is on a biennial budget, so the six-year plan covers three biennia. Although the plans beyond six years are not submitted to the budget office, budget analysts visit each agency and talk about what the agency is looking at seven to fifteen years down the road. Every two years the six-year plan is updated by the state agency.

• **Question: How much do your long-range plans guide future years?**

Kansas	The plans submitted are generally a guide to the future; however, the scope and cost of projects will change significantly from the time they first appear in the plan to the time a decision is made to fund them.
Maryland	About 70 percent of the requests anticipated for the second year of the five-year plan will actually be part of the budget process the following year. The other 30 percent could change for reasons such as delays in design or other types of delays for scheduled building or renovations; discovery of new needs; requests for projects that had been turned down by the legislature and are requested again; or perhaps the legislature had appropriated planning funds for a project that was not in the five-year plan for the budget year. If the legislature appropriated planning funds, then the capital project would be scheduled sooner.
Minnesota	Those years that are not actually in the budget itself do not have the same level of documentation and needs analysis as occurs in the budget year.
Virginia	Plans are constantly being updated because of changing needs. In fact, the program is in a state of flux right now, because Virginia has always operated its capital construction budget on a pay-as-you-go basis. The state has done no borrowing for buildings since 1978, with the exception of revenue producing types of projects in higher education and a few prison sites through the Public Building Authority. As a general rule, renovations and new construction have been done completely on a cash basis. Because there was no need for debt financing, there was not a great deal of emphasis on the six-year plan. However, beginning with its next biennium, the state is looking at a six-year debt financing instrument in order to manage capital renovations and new construction. There is not much detail beyond the current two years. Beyond two years, agencies aggregate the number of square footage and apply a general cost per square foot. Virginia requires by statute that a preplanning study precede any construction. Generally, the preplanning study is funded in the biennium prior to construction. If the legislature did not fund the preplanning study, the department that wants to build during the next biennium needs to find the money on its own to do the study. The preplanning study actually means that about 20 percent of the planning is done, and the agency is ready to move into the design phase. The preplanning study results in a much more accurate estimate.

- **Question: What are the elements in your process that make it work?**

Kansas	The system works primarily because of the working relationships of the participants and not because any specific set of procedures are followed. It is uncertain to what extent the system needs to be made more formal. As discussed elsewhere, the review of projects in greater depth probably is of more concern.
Maryland	The process needs to begin with the debt affordability process. There is a Debt Affordability Committee that has built up credibility over time and determines how much bonding can be expected in the next five years. The State takes the five-year plan seriously. In other words, it sticks to it unless there is a compelling reason to deviate from it. The Governor backs the long-range plan which gives the plan additional integrity. The state requires agencies to document the proposed project - what it is for, how big it is, why it is needed; descriptions and justifications are required, even for those not scheduled to be built for five years. By the time the project moves up to the year it might be built, there should be a full program description, including architectural specifications and other justification to ensure that it is indeed a necessary renovation or construction project. By the time it is moving into being on line as a project, everyone should have a clear idea of the project needs. Enough work needs to have been done by the state agency so a very accurate cost estimate can be made.
Minnesota	There is a need to distinguish between the political aspects of capital budgeting and the managerial aspects of capital budgeting. In the state of Minnesota, a 60 percent majority vote is required in order to bond. Since it is very rare for one party to control a 60 percent majority in both the House and Senate, projects are traded for votes. Therefore, it is very difficult to take politics out of the capital budget. However, the budget office is considering an approach to get more background information on capital projects by requiring that a study be done before a project can be considered. Analysis of what the facility is needed for, who it would be used by, and its function would allow for more equity and less politics in the decision process. The Executive Branch is increasing its attention on preserving existing capital assets outside the politics of the bonding bill.

Virginia

A substantial amount of planning goes into a project before it becomes part of the Governor's recommendation and is submitted to the legislature. That planning is done at the program level to determine how that particular renovation or construction would serve the needs of the clients and what the project will cost.

The Department of Planning and Budget is responsible for putting together all the Governor's recommendations for a budget, including capital construction. The Department of General Services is the agency that is responsible for cost estimating. The two departments work very closely together to coordinate and project costs that are then included in any budget recommendation.

Virginia is in a state of flux. Before, the cost of estimating and budget analysis was based more on how much it would cost to build a particular building requested by an agency. The analysis is moving to a more analytical approach. The first determination will be if the building is needed; and if a building is needed, what type of building would be most suitable rather than focusing on cost estimates for whatever type of building had been requested.

There are a number of budget sections; for example, one on education, one on human services, and one on general government. The budget analysts who deal with the operations of the department within their section also deal with the capital budget. The education analyst, for example, would coordinate all the capital construction projects that were in education budgets. Budget analysts can call on the Department of General Services for expertise in the technical issues about the project. Once each section has prepared its capital construction list, the budget analysts recommend statewide priorities.

- **Question: What are the elements you would like to change?**

Maryland

Rapid growth and changes have made the development of a long-range plan for prison and juvenile facilities difficult. There has been improvement, however, in projecting needs in the corrections area.

One improvement to the process would be to make a more critical analysis of the projects planned for four and five years out, rather than waiting until the projects are in the budget year. More justification in the plan at an earlier stage would improve the plan and would minimize the changes.

Minnesota

The state of Minnesota is looking at a major revamping of its capital budgeting to include several things:

- 1) better information in all six years of the plan, and
- 2) de-politicizing the capital budget process, or at least forcing a more thorough review.

Virginia

The budget office is very involved in the execution, the actual construction, and monitoring construction and should perhaps try to play a less prominent role. In higher education, certified engineers and architects on the teaching staff now have oversight of managing project construction. Most state agencies and institutions however, do not have that expertise, so it falls to the budget office to be involved in the execution of projects. The budget office is attempting, however, to designate and disperse that type of responsibility to the state agencies whenever possible.

- **Question: What advice would you give to a state that has never done a capital budget? How would you recommend they proceed to organize a capital budget, and what steps do you recommend a state take to do its first capital budget?**

Maryland

One suggestion is the need to educate agencies into the capital budgeting culture. Agencies tend to be more absorbed in their immediate budget needs rather than taking time to plan five years out. Agencies really need to plan; they must think about the missions of the agency, the overall view of the agency, and their needs. Agencies must explain in great detail, in nontechnical language, why a request is needed, who will benefit from it, and how it will be utilized.

Staffing is very important. It is difficult for the budget staff, who are concerned with operating budgets in the short-term, to be concerned also with capital budgeting in the long-term. A state needs an adequate staff dedicated to reviewing capital projects, who have the best interests of the state as a whole in mind.

Minnesota

One recommendation is to have a clear philosophy, a very clear definition and understanding of the principles on which a state's capital budget is based. Without guidelines or general principles, making decisions can be quite difficult. Another suggestion is clearly defining what is a capital improvement versus what is a maintenance type expenditure which should appear in the operating line item. Without a clear definition of what should be bonded, it may be easy to build up debt for ongoing operating expenses.

The guidelines may in fact restrain bonding; for example, the guideline in Minnesota is that no more than 3 percent of the general fund can be used for debt service. However, guidelines make one stop and think about prioritizing projects and getting the most for the money. Another suggestion is to gain an understanding of how the legislature is going to process the capital budget. Knowing how the legislature will deal with a capital budget means one can plan to meet the information needs of the legislature.

Virginia

One suggestion is to separate the financing phase and the construction phase because they are not similar; totally different expertise is needed in both areas.

- **Question: Do you have an oversight committee?**

Maryland

The state of Maryland does not have a review board. It has budget hearings where an agency has an opportunity to explain its capital budget request, and generally the legislative staff is there. On occasion, there is a legislator present, but that is fairly rare. The Deputy Budget Secretary for Capital Programs puts a lot of effort into informally keeping key legislators abreast of capital budgeting needs. During the legislative session when projects and budgets are making their way through the budget process, there is daily contact with the legislators. The legislature tends to focus mainly on the budget year requests rather than the years beyond the budget when making its decisions.

Minnesota

The state of Minnesota does not have an oversight committee, but the legislature is considering establishing a joint committee where both political parties and the legislative and executive branches would be represented. This committee could set out the basic parameters to follow in the capital budget and provide oversight to the capital budget process.

Virginia

Virginia does not have an oversight committee. The previous Governor had a cabinet level committee to review various capital outlay requests, but that no longer exists. That committee was made up of the Secretary of Finance, Secretary of Education, Secretary of Health and Human Services, and three others appointed by the Governor. There were no legislators on this particular oversight committee. The committee was chaired by the Governor's Chief of Staff.

The oversight committee can be useful in helping to iron out questions of equity. When the budget office makes its recommendations, it generally looks at setting priorities based on absolute program needs, while the legislature tends to focus more on specific districts. When the oversight committee was optional, it helped to structure the Governor's recommendations so that it did meet program needs, but also equitably dispersed funds to localities. An oversight committee may allow the state to benefit from a more diversified view, rather than the straight budget analyst view of program needs.

Section 3

Capital Project Selection

- **Question: How do you establish priorities for selecting capital projects?**

Kansas

Agencies are required, as part of the submission of their five-year facilities plans, to indicate the priority of projects based on safety considerations, adherence to program requirements, conformance with codes, and so forth. There are few formal guidelines or definitions that agencies are directed to follow. On the negative side, the depth of analysis is not as great as it should be because of time considerations and the complexity of cost estimates and benefit/cost evaluations. On the positive side, the process generally produces rational results, and with a few exceptions, has not been a source of discord among project selectors. The experience of the agency representatives who develop requests helps to make the process work.

Virginia

- **Overview**

The process for selecting capital outlay projects for funding takes about twenty months. In December of even-numbered years, the Department of Planning and Budget provides agencies with instructions for developing their capital budget proposals. It is not until July of the following even-numbered year that projects receive funding.

Agencies submit their capital budget proposals to the Department of Planning and Budget in February of odd-number years. The capital budget proposal sets forth the agency's capital project needs in priority order and relates these needs to the agency's programs and services. The proposal consists of three parts — a six year plan, a maintenance reserve plan and individual capital project requests.

- **Six Year Plan**
  The six year plan covers a period of three biennia (currently: 1992-94, 1994-96, 1996-98). This listing summarizes the agency's needs for the next three biennia in priority order within each biennia.

- **Maintenance Reserve Plan**
  The maintenance reserve plan identifies all maintenance projects, regardless of anticipated funding source, for the biennium. Maintenance projects cost between $25,000 and $500,000 and are aimed at maintaining or extending the useful life of an existing facility. They are not intended to enhance, upgrade or otherwise improve plant, property or equipment, unless such work is incidental to the main purpose of the project.

  The maintenance reserve review has two steps. The first step is for the Department of General Services to validate that requested projects meet the criteria for maintenance reserve projects, as previously specified. At this step, the Department of Planning and Budget only provides input on an exception basis, after the Department of General Services' determination of valid maintenance projects.

  The second step is to develop funding recommendations for maintenance reserve accounts. Agencies' maintenance reserve needs are almost always greater than the amount of funds available and in some cases, these needs exceed the agency's ability to effectively address them within a given biennium. Therefore, maintenance reserve funding is usually allocated by formula. The Department of Planning and Budget is responsible for developing the maintenance reserve funding allocations for non-higher education agencies, while the State Council for Higher Education in Virginia is responsible for the institutions of higher education.

  Final maintenance reserve funding recommendations are based on these formula allocations and on the input of the individual budget sections in the Department of Planning and Budget. In some cases, adjustments are made to the formula allocations to take unique needs into consideration. In addition, individual projects are prioritized within the maintenance reserve plan so that agencies can stay within funding constraints.

- **Capital Project Request**

A capital project request must be prepared for each project listed in the first biennium of the six year plan, except the maintenance reserve plan. The primary purpose of this request it to provide a carefully reasoned explanation of activities. It must also provide a description of the project. Finally, the request must contain an estimated cost and the anticipated impact the completed project will have on the agency's operating budget.

Between February and April of each odd-numbered year, the Governor's Secretaries and the Department of Planning and Budget conduct a preliminary review of the major capital project requests. A major capital project is:

- New construction or acquisition of a facility larger than 20,000 square feet or costing greater than $1 million or;
- Improvements to existing facilities costing more than $500,000.

The preliminary review identifies those major projects that are considered to have merit without consideration of a source of funding. For a project to be considered as having merit it must meet one of the following criteria.

- First Priority: Requests for major repairs to existing structures that are necessary for the continued use of the facility and that are not normally considered in Maintenance Reserve.
- Second Priority: Requests associated with legal or judicial mandates requiring new construction or requests to supplement projects under construction.
- Third Priority. Requests associated with standards and certification requirements of existing facilities (e.g., life safety code requirements, space guidelines deficiencies).
- Fourth Priority: Requests associated with improvements to existing facilities (renovations, restorations, relocations).
- Fifth Priority: Request associated with new construction that are in accordance with the mission and service delivery functions of the requesting agency

- **Preplanning Studies**
  For major projects determined to have merit as a result of the preliminary review, preplanning studies must be prepared. In these cases, the information contained in the capital project request justified the need for the project and provided an initial estimate of the project's cost. The preplanning study presents more detailed architectural, engineering and technical information associated with the project, confirms the technical feasibility of the project and refines the project's cost. Agencies may use up to $50,000 from operating expense appropriations to fund a preplanning study.

  Agencies prepare preplanning studies between April and September of odd-numbered years and submit them to the Department of General Services. By November, the Department of General Services reviews the preplanning studies and provides recommendations to the Department of Planning and Budget on the technical aspects of the project (including a revised cost estimate).

  Once the major projects have been reviewed for programmatic and technical merit, the Governor's Secretaries and the Department of Planning and Budget conduct a similar preliminary review on the projects of lesser magnitude between April and September. The same criteria for determining merit is applied to these projects.

- **Final Decisions**
  The next part of the review process is to combine the two categories of projects into a single priority listing: within each Secretarial area and statewide. From this comprehensive listing, projects with top priority will be selected for funding in the 1992-94 biennium. Less urgent projects will become the foundation for the development of the six-year capital outlay plan for 1994-2000. The priority categories used to make the preliminary decisions are also used for this determination. In addition, the urgency of the project (from the statewide policy perspective) is considered.

  Once the programmatic and technical review is complete, the next stage in the development of a capital budget is to establish criteria for how the various types of projects will be financed. Virginia traditionally has financed capital projects on a pay-as-you-go basis. This funding method has created competition for resources between the operating and capital budgets. As a result, limited funding has been available for capital projects and has restricted funding to only the most urgently needed projects.

Section 4

Capital Financing

- **Summary**

There is a diverse range in how states finance capital projects. This section focuses on two questions. How does a state determine the overall size of its capital budget (particularly the bond-funded capital program)? How does a state decide which fund source to use for a particular project (particularly bond proceeds versus current revenues)?

Some states have very formal and sophisticated processes for deciding on a total level of debt. In others, debt authorization is less formal. Two or three states are looking at ways to implement debt management systems. Some states, like Virginia, are contemplating an expanded general obligation (G.O.) bond program and states like Illinois are reigning in debt authorizations. In general, states that actively manage their debt seem to look to debt service as a proportion of revenues, debt outstanding per capita, and debt outstanding as a proportion of personal income as measures of debt capacity.

In some states, dedicated revenues provide an important source of capital funds. This has an important effect on the capital budget process. Projects eligible for dedicated funds are then considered separately from (and often preferentially to) projects that have to compete for non-dedicated funds. States are more nearly uniform in how they allocate cash for capital spending. When cash is available, it tends to be used for smaller and shorter-lived projects, and for maintenance and renovation projects.

There is much variation in the sorts of costs that states allow for bond funds. Many states have strict bondability requirements, with criteria relating to the nature of the expense, the life of the project, and the amount. In other states, guidelines are less formal, or virtually non-existent.

- **Question: How is the overall size of the capital budget determined? Is there any process for determining the amount of G.O. debt, revenue debt, and operating funds to be authorized?**

California

Historically, capital funding in California has proceeded on an ad-hoc basis. Bond authorizations must be approved by the voters; they may get on the ballot through the legislative process or by initiative. Typically, bond issues are proposed for a variety of projects such as higher education, health care, housing, child care, and prisons.

The state has a Special Account for Capital Outlays (SAFCO) which is funded from offshore oil royalties. This account is used to fund "one time" capital expenditures such as upgrades to aging state hospitals, flood control, and water projects. The account is not generally used for general state facilities such as universities and prisons. A modest amount of general funds is budgeted for deferred maintenance and small capital projects under $500,000. The state has a wide variety of special funds available for capital expenditures.

In addition, California has a lease revenue bond program. Higher education facilities, prisons, state office buildings, and courts are financed by revenue bonds, backed up by lease payments of the using agencies. The state does not consider these obligations part of its debt burden, since rental would have to be paid whether it is being paid to the state or to a private landlord. Authorizations of lease revenue bonds require legislative approval, but do not go before the voters. Projects are budgeted on an ad-hoc basis, and the total program is generally much smaller than the general obligation (G.O.) bond program.

In 1990, nearly $10 billion in G.O. bond issues appeared on the ballot, about one-third of it through initiative. Although only $900 million for school construction passed, this level of proposals caused some alarm within the legislature and the administration. As a result, the Department of Finance has prepared a ten-year study of capital resources and needs. The study proposes a ten-year capital spending plan limiting debt service to 5 percent of general funds. Taking other available revenues into account, this resulted in a recommended $50 billion program over the ten years. In tandem with this recommendation is a proposal to transfer responsibility for $10 billion of school and jail construction to local governments.

Kentucky

Kentucky's capital program is financed from current revenues and revenue debt of special authorities. The state has not issued state general obligation debt since 1965 (the constitution gives the state G.O debt authority, but requires any authorization of G.O. debt over $500,000 to go to the voters). The cash-funded portion of the capital budget increases incrementally from year to year as part of the biennual budget process. It is used primarily to finance maintenance, renovations, and small projects.

The overall amount of revenue debt to be authorized is based on a "semi-formal" process. The State Economist (who heads the Office of Financial Management and Economic Analysis), estimates the state's capacity for new debt. The estimate is based on projected revenues over the repayment period. The same office approves and manages the debt issuances of the various authorities, and therefore acts as the central control agency.

Agencies request projects for the biennium which are analyzed and the most worthy are included in the recommended budget and assigned a fund source. Kentucky law requires line-item budgeting of projects over $200,000. There are no lump-sum appropriations and funds may not be transferred from one project to another once funds are appropriated.

Some of the authorities have caps on the overall amount of debt they may authorize, but these caps generally are not the operative constraints. In the event they become problematic, legislation to raise the cap is generally successful.

The operative limit on the size of the capital budget is the estimate of overall capacity for new debt and the availability of other revenues.

Illinois

Illinois' capital budget is funded primarily from two sources: G.O. bonds and "Build Illinois" sales tax revenue bonds.

The Governor annually recommends a level of new G.O. debt. In making this recommendation, the Governor considers measures of debt burden (debt outstanding per capita, debt service as a share of general fund appropriations, and G.O. debt outstanding as a share of state personal income), rating agency perspectives, and the state's overall fiscal position. Ultimately, the recommended level is a judgement involving subjective, political, and fiscal considerations.

The "Build Illinois" program was enacted in 1985. Bonds are issued each year based on cash flow projections. Illinois also authorizes about $70 million annually in a revenue bond program for local civic centers. The bonds are backed by state general funds and are subject to appropriation.

Kansas

Financing is decided by project on the basis of cash available, the urgency of completion, the reliability of the revenue source for debt service, the estimated useful life of the facility, the extent to which it adds to the financial liability of the state, and the long-term effect it has on the budget.

Decisions whether to lease or purchase are made mostly on the basis of long-term cost comparisons. Recent decisions have been made to purchase facilities that for some years had been leased. The rising cost of continuing the lease simply made it financially prudent to consider purchase of the facilities.

Maryland

Maryland has a formal process established in law for setting the amount of G.O. debt to be authorized each year. The law establishes a Capital Debt Affordability Committee, chaired by the State Treasurer and including the Comptroller, the Budget Secretary, the Transportation Secretary, and a public member.

In making its determinations, the Committee strives to account for the same factors used by rating agencies in determining the state's bond rating. In particular, the Committee seeks to keep state tax-support debt outstanding under 3.2 percent of state personal income and to keep debt service under 8 percent of available revenues.

State tax-supported debt in Maryland includes G.O. debt, revenue bond debt of the Department of Transportation, the Maryland Stadium Authority, and capital leases. Until recently, the debt affordability process took the planned level of transportation revenue debt and other types of tax-supported debt as a "given," and G.O. debt was planned within the remaining capacity. More recently there has been concern about the transportation program and other calls on state resources "crowding out" the traditional G.O. bond program.

The amount recommended by the Committee becomes the ceiling for the Governor's proposed budget and for the General Assembly's authorization.

State general funds are used for items where the use of tax-exempt funds are restricted by federal tax laws. This principally means loan programs for housing, economic development, and certain environmental loan funds. If funds are available, general funds also are used for state construction projects and capital grants in exactly the same way as bond proceeds. The amount depends entirely on the amount available in the annual budget process. The state strives to use annual surpluses and other "one-time" revenues for capital projects and other "one-time" expenditures.

Non tax-supported revenue debt (primarily in higher education, environmental programs, and other loan programs) are budgeted and issued according to the need and capacity of the issuing agency.

There is a central reporting process for the Treasurer and the budget department to keep track of agency revenue debt.

Virginia

Historically, Virginia has financed capital spending on a pay-as-you-go basis. Biennial budgets through 1989 have generally included $125 million to $200 million in capital spending, with the specific amount depending on the availability of funds and the competition with other initiatives as part of the regular budget process.

Since 1989, lottery revenues have been earmarked for capital projects. State law required these lottery receipts to be allocated as they were received: the budget could not anticipate lottery revenues. As a result, budgets have included some general funds for maintenance reserve and critical infrastructure projects. Other projects were placed on a prioritized list, and were funded in priority order as lottery revenues materialized.

In the recent downturn, lottery funds were diverted to support the commonwealth's operating budget, resulting in the cancellation of capital projects. This experience has led the Department of Planning and Budget to study the commonwealth's capital needs and resources.

The study calculated debt capacity for Virginia by looking at debt service per capita and as a percentage of personal income. These ratios were compared with the same measures for other AAA rated states. Based on the results of this study, the Governor has now committed to a six-year capital plan.

The Commonwealth also has a Virginia Public Building Authority which finances state office buildings and new prison construction. The Authority's revenue bonds are backed up by the lease payments of the using agencies. Projects financed through the authority are budgeted on a project-by-project basis. The Authority's debt ceiling is increased by the legislature for each new project.

Washington

Washington limits G.O. debt to the level where debt service (excluding debt service supported by project revenues) equals 7 percent of general funds. The Office of Financial Management conducts a study of projected debt service over the life of state bonds, to calculate the amount of bonds that may be authorized each year. In addition to the debt-financed program, some capital spending is financed from dedicated revenues. For example, K-12 school construction is financed from timber receipts.

The state makes extensive use of capital leases and certificates of participation as alternative financing mechanisms. The state organizes and manages the financing of equipment and real property through a master lease purchase acquisition program. Lease development for privately owned buildings with leases exceeding five years or have a purchase option are evaluated in the capital budget request. Lease development projects are funded from operating funds only.

- **Question: Often states have to make decisions on whether to finance a project from operating funds or bond proceeds. What guidelines or practices do you use to make these decisions. Do you have specific bondability guidelines that you use in your state?**

California

Cash is frequently used for projects if there is a dedicated fund source, and for deferred maintenance and small projects. California uses bonds for costs associated with projects with a twenty-year useful life or longer. Associated costs may include planning, administrative expenses, equipment and start-up costs. (Note: legislation is pending to limit administrative costs financed by bonds to 2 percent of the project. The Administration opposes this legislation due to the cost that would be shifted to the operating budget).

Financing by the Lease Revenue Bond Prog-am is generally limited to construction costs.

Kansas

There are no specific bondability guidelines in the state. The authority to finance projects through bonds issued by the Kansas Development Finance Authority is an integral part of the budget process, from the Governor's recommendation through legislative approval, followed by a specific request from the Secretary of Administration. For all practical purposes, Kansas is not a state that issues general obligation bonds, although local units of government can issue them.

Kentucky

In Kentucky, cash is generally used for small projects (under $200,000) and maintenance and renovation projects. Debt is used to finance large projects (including major renovations), and projects that produce a revenue stream. In the case of particular projects and particular years, the decision to finance with cash or bonds will depend in part on the availability of funds.

Illinois	Illinois appropriates a small amount of general funds for short-lived projects. Bondability guidelines require bond-funded projects to have a useful life at least equal to the life of the bond (15-20 years), to increase the value of a property, and to cost at least $25,000. Bond funds are used for acquisition, construction, design, and new equipment.
Maryland	The decision to use current revenues or bond proceeds depends mostly on the availability of general funds in a given year. If general funds are available, the state strives to use current revenues for facility renewal and capital maintenance, capital equipment, and smaller projects. The state adheres strictly to bondability guidelines which are intended to assure that assets purchased with bond proceeds have a useful life equal to at least the 15-year life of the bonds.
Virginia	Virginia has traditionally relied on current revenues for most capital spending. The capital plan is just now being formulated so it is too early to know the exact magnitude of the dollars involved. However, the overall size of the plan will surely consider Virginia's debt capacity and ability to issue tax supported debt.
Washington	Washington currently has no guidelines or criteria for the use of bond funds. Bond proceeds are sometimes used for salaries and small projects (i.e. in the thousands of dollars).

Section 5

Asset Management

- **Summary**
  Maintenance of facilities is a difficult issue. Buildings are often constructed with limited budgets and have materials and systems that demand considerable attention and resources. Maintenance needs are often in competition for funds otherwise needed to meet an agency's mission. Determining the right amount of funds to be dedicated to maintenance of facilities is made even more difficult by the lack of information regarding the size and quantity of space owned and leased by state agencies, not to mention issues of age, condition, and maintenance history.

  States have attempted to identify needs by:

- Establishing separate capital and maintenance requests in the budget process.

- Developing dedicated resources to support maintenance.

- Using formulas to establish permanent renovation pools and setting up special appropriations to maintain, repair, and replace roofs, and for heating and air conditioning systems.

- Placing responsibility for maintenance outside of the state by leasing space.

In the overall maintenance program there is the need to establish a list of projects with legitimate cost estimates and a reasonable schedule including realistic priorities. Maintenance needs based on facts are more easily appropriated, whereas programs rooted in ratios, historical expenditure patterns, educated guesses, and similar subjective processes are often left without funds.

The failure to understand the total assets and condition of property can be traced to two primary causes:

- Asset information is collected for financial/accounting purposes and not for budgeting purposes.

- In an attempt to centralize the process, efforts are made to standardize a system that cannot meet the legitimate and different needs of agencies. For example, higher education facilities are analyzed for their ability to provide adequate education and lab space and may not relate to mechanical or equipment or circulation space. Department of Corrections may need extremely detailed maintenance programs to facilitate performing maintenance through the use of untrained inmate labor.

The key to successful maintenance programs is to identify common elements of information that all systems should provide, gather only that information electronically from agency capital management programs on a periodic basis, and let the agencies move forward to procure systems or use common systems in a way that facilitates their individual needs. What is needed is to find more efficient ways to identify maintenance needs, establish costs, and evaluate priorities first at an agency level and then at a statewide level. Armed with this data, capital analysts can equitably evaluate how to allocate available resources.

- **Question: How do you keep up to date on your state's capital assets? How does the information help you to maintain your state's capital stock?**

Arizona

Arizona has a maintenance program that uses a formula to provide the amount needed on maintenance each year. The Facilities and Management Division uses the *Sherman-Durgess Program* designed by two professors in Michigan.

Input for the computer program is the age, size, and replacement value of the facility. This information is run through a formula. The output is the amount that should be spent on maintenance each year, approximately 1 percent of the replacement value.

This program was installed in 1985. In 1991, the formula showed a need to appropriate $6.8 million, though $807,000 was appropriated.

California

California uses a basic preventive maintenance computer program. The program has been in use for two years in Sacramento and for one year in both Los Angeles and San Diego. Additional capital asset inventory information was added in order to maintain a centralized capital asset inventory. It took three years to develop and to input the information for this centralized system. Though some information on the system is not currently needed, the information could be used for maintenance in the future.

Once data was centralized, the program became insufficient and is now being modified to meet the state's needs.

Idaho

Idaho has a centralized maintenance system. Officials in the Public Works Division do not recommend designing your own system since there are many available vendors.

The capital asset inventory consists of The Bureau of Risk management computerized list of replacement values of all the state facilities and is not used for budgeting or capital management.

Illinois

Illinois implements a two-stage program to provide funding for maintenance and renovation work. Essentially, projects less than $25,000 are funded by agencies in separate appropriations in the operating budget and larger projects are funded by the capital budget.

Although there are safeguards within a budget to protect maintenance funds (a restriction to move no more than 2 percent of any line item to another appropriation) maintenance funds continue to be a target during budget cutting exercises. Priorities are set by agencies and the actual list of projects is determined by the capital budget office with help from public works professionals.

The Illinois inventory data is not being used to manage maintenance or to assist in the development of the capital budget, as was the original intention.

Kansas

Capital asset management varies in this state. Some agencies, such as the Board of Regents for the Universities and the Department of Transportation, have well-developed inventory systems. Others are not well developed.

The type of information maintained by the Regents institutions allows them, by means of a formula adopted from the State of Indiana, to determine an appropriate amount of funds for maintenance that would preserve the useful life of a facility to a predetermined age. The system, after several years of development, never has been completely implemented.

Wisconsin

Wisconsin has a computerized maintenance program and several other programs for maintenance. Agencies evaluation of their facilities showed that preventive maintenance was needed. Funds were appropriated for agencies/institutions to help them train in preventive maintenance.

Wisconsin has three other programs. First, there are two engineers in the division who work strictly with roof maintenance in the spring and the fall. The engineers use a checkbook to pay for minor projects. Second, there is one person who only does masonry inspections.

The third program is a road program that costs $1 million a year. This program is for preventive road maintenance and includes patching sidewalks and roads. The state bought the patching equipment and uses inmate labor.

Operating and Capital Budget Reform in Minnesota: Managing Public Finances Like the Future Matters

Minnesota's performance budgeting clearly relates the budget to the citizen's needs and to well-defined statewide policy objectives developed within a public process. A scoring system uses critical and strategic criteria to measure the need for and urgency of each capital budget request.

By Laura M. King

Editor's note: Each year the Government Finance Officers Association awards its prestigious Award for Excellence to recognize outstanding contributions in the field of government finance. This article describes the 1994 winning entry in the budgeting and financial planning policies and procedures category.

When Governor Arne H. Carlson first took office four years ago, he inherited the worst financial crisis in Minnesota's history. In order to forge a lasting solution to the state's chronic fiscal problems, Governor Carlson directed that operating and capital budgeting reforms be enacted to ensure accountability and long-term planning.

The governor understands that the public does not look upon government as a model of efficiency. Citizens believe that state and local government is distant and unresponsive to their needs. To address this problem, Minnesota developed a performance-based budget and reporting system with a focus on effectiveness and accountability of state services.

The new performance-based budget and reporting system is based on three principles: 1) government must be driven by the public's goals and mission rather than government's rules and regulations, 2) the taxpayer will pay for results rather than efforts and 3) government must be able to measure and communicate progress toward both goals and results.

Significant reform also was introduced into the capital budgeting process. A six-year planning horizon was initiated for projects to encourage long-range planning, specific criteria for project ranking were introduced to provide an objective analytical context for decisions, and an inventory of fixed assets is being developed. All of the capital budget planning now occurs within the context of six-year, debt management guidelines and planning.

Performance Reporting

Performance budgeting was introduced in Minnesota's 1994-95 biennial budget. The immediate goal was heightened management and legislative awareness of the concepts of program outcome definition and measurement. The longer-term goal would have funding decisions based on agreed-upon expected outcomes and results rather than on historical efforts and good intentions.

The movement toward citizen-oriented financial statements which improve both the readability and understanding of state budget materials has guided recent efforts. The concept of performance budgeting was woven through Minnesota's 1994-95 executive budget process and budget documents. The object was to clearly relate the budget to real citizens' needs and well-defined statewide policy objectives developed within a public process.

The key to success rests with the commitment of the governor and legislature to articulate program policy objectives and agree upon outcome measurements of success. State agencies now are required to define the results they will accomplish and are held accountable by elected officials and the public for their performance.

Historically, government has done a poor job of measuring results. It does an excellent job of measuring how much activity occurs—how much money is spent, how many forms are filed, how many reports are prepared, how many permits are issued. But government is less successful at measuring the results of those activities and efforts—whether they resulted in a safer or cleaner environment or a better life for Minnesota's citizens.

It is not a matter of how hard government tries but whether it makes a difference. Focusing on outcomes will enable action and elimination of things that have marginal value in order to concentrate resources on activities known to make a difference.

The state's performance budget and reporting process had two primary objectives, both based fundamentally on

MINNESOTA'S PERFORMANCE REPORTING PROGRAM KEY COMPONENTS

- Commitment of governor and legislature
- Improved communications
- Redesign of budget presentation
- Training and assistance for agencies
- Annual agency performance reports
- Audits of performance reports

PERFORMANCE TERMS

Program goals **are the general end toward which agencies direct their activities. They are broad statements describing a desired outcome for an agency or its programs. A goal addresses issues by stating policy intention. They are both qualitative and quantifiable but not quantified. Goals should address the agency's mission, its actions and its priorities.**

Objectives **are clear targets for specific action. In contrast to goals which are broad, general statements of long-range purpose, objectives are specific, quantified and time-based statements of accomplishment or outcome. Objectives should be derived directly from the agency's stated goals which imply a priority for resource allocation.**

Performance measures **provide a quantifiable assessment of outcomes, outputs, efficiency or cost-effectiveness. Outcome measures express desired future results. They provide a means for comparing actual with intended impacts. Outputs, efficiency and cost-effectiveness measures all relate to the cost of achieving the outcome. An outcome measure advances the objectives and goals. The other three types provide cost benchmarks.**

improved communication skills. Foremost was to describe the budget in terms that emphasized the link between state dollars and direct services in a fashion that both the legislature and the general public could easily understand. This information is then used to communicate important budget decisions, improve the quality of information available in the legislative process, and provide the framework for improved government accountability and continuous performance reporting.

Both detailed and summary-level budget presentations have been redesigned to deemphasize accounting and micromanagement of state agencies' operations. In the place of detailed accounting information, relation to statewide goals, measurement of results and productivity measures have been emphasized.

Development of the state's first performance budget involved a massive, concentrated effort by all state agencies. Rather than gradually phase in the new program over several years, Minnesota decided on the Big Bang approach. Concerned that a phased approach would subject different agencies to different sets of rules for budget review, and that the project would lose momentum during the transition, Minnesota elected to bring every agency on line at the same time with the expectation that refinements would be necessary during future years.

To assist agencies with developing and improving their performance measures, the department of finance developed a simple guide. Intensive training and assistance also was provided throughout the process. More than 800 outcome indicators and 1,000 efficiency measures were adopted in the detailed agency budget plans so that Minnesotans will know if they are getting their money's worth from their tax dollars.

There are two basic steps involved in performance measurement:

- define specific objectives for agency activities from the perspective of the customers being served and
- establish clear standards to measure progress toward meeting the objectives.

The definition of clear activity objectives is the single most important step in the performance measurement process. As the Cheshire Cat said to Alice: "If you don't much care where you go ... then it doesn't really matter which way you go."

Objectives are not merely descriptions of activities. "To minimize fatal accidents" is not an acceptable objective. Objectives are quantifiable statements of intended results. This is an acceptable objective: "To decrease the number of fatal accidents per passenger mile traveled by 5 percent during the next year."

Performance measures provide a quantifiable assessment of outcomes, outputs, efficiency or cost-effectiveness. Each is useful if conceived, designed and applied properly. Shared vocabulary is key to successful application—decide early and repeat often what each term means in the organization. Measures are by definition quantifiable and directly related to state objectives. Each type has a different focus in the time series; outcomes look to the future while the others measure history.

IMPROVED COMMUNICATIONS

- **Financial statements are citizen-oriented**
- **Budget links state dollars to direct services**
- **Legislature receives high-quality information**
- **Framework provided for continuous government accountability**

Minnesota's legislature endorsed the results-oriented approach of the governor's budget presented in January 1993. As part of the implementation of the 1994-95 adopted budget, legislation was formally enacted requiring preparation of annual performance reports by 20 of the state's largest agencies.

In a cooperative role, Minnesota's legislative auditor will evaluate agency performance reports for reasonableness and validity of information and data. The performance reports will be completed by September 1 of each year to complement the state's budget cycle. In this manner, performance information will be available on a regular, published basis prior to the beginning of each annual legislative session.

As part of the new system, agencies are required to develop annual performance reports for their operations in advance of their budget submittals. Reports are mandated to be user friendly and must include

- descriptions of how their customer base is expected to change;
- simple, declarative statements of the agency mission, goals and objectives; and
- benchmarks for accomplishment that are specific enough so citizens can measure annual progress.

Adoption of Minnesota's first performance budget represents the beginning of a long-term evolutionary process. The major payoff will come in future years, when policy officials will have the necessary information to effectively assess progress toward a shared set of goals. Performance reporting indicates that the state is listening to the people's priorities and is supporting their priorities with measurable goals and budget objectives. Performance reporting means that Minnesotans can hold their government accountable for the results they want.

These efforts reflect citizens' desires for government to become less rules-oriented and more results-oriented. Minnesota's performance budgeting effort is intended to move government into a more flexible arena. It aims at reforming the way state government does business in order to enhance accountability. The reforms introduced in the capital budget process also focused on the need to improve the state's financial management within a strategic planning framework.

Capital Budget Reform

The goal of the capital budget process is to make informed investment decisions according to a fair, open and objective process and to effectively manage both physical and financial assets.

In the past, Minnesota's capital budgeting process was characterized by dueling wish lists and little project analysis. The governor and legislative leaders vowed to change this situation in order to improve the public's confidence in state government, and policy official's confidence that professional analysis would win out over lobbying.

A central element of capital budget reform is to provide greater emphasis on strategic planning over a six-year planning horizon. Agencies must clearly identify their roles and responsibilities, long-range strategic plans and six-year capital budget plans, and then satisfactorily link their capital requests to their strategic plans. This disciplined process allows more intelligent investment decisions to be made after consideration of requests in their strategic context and on the basis of uniform and systematic project planning data.

In addition, the department of finance developed a computerized debt capacity model that tracks multiyear requests and helps manage capital decisions within the state's debt capacity at all points in the six-year cycle. This ensures consistent funding levels across many years and eliminates sharp peaks in capital budget authorizations which might otherwise lock the state into unfavorable cash flows and long-term debt service commitments, thus consuming financing capacity in future years.

In combination with a six-year debt capacity model, agency strategic planning produces rolling long-term plans. Based on their strategic plans, agencies present requests for a six-year period. Action on some items is requested in the immediate biennium. Other projects are merely identified for consideration in the out years. All requests, however, are plugged into the debt capacity model which predicts future debt service and available bonding capacity within the six-year time frame.

Over time, the long-term plans are updated. Projects not funded in one biennium can be reconsidered in a future biennium, along with new requests.

The concept of a sequential series of predesign, design and construction appropriations was first introduced in the 1994 session. The idea is to spend a little for predesign activities before spending more for design and before spending a considerable sum for construction. Agencies are expected to sequence their requests over multiple biennia in this manner. By small investment in the front-end of a project through this leveraging technique, decision makers receive substantial information early in the life of a project before committing substantial resources.

Other significant improvements include the comprehensive assessment of the condition and suitability of existing capital assets before committing resources for the acquisition of new ones and the introduction of scoring criteria to evaluate agency requests on a statewide basis. More accurate project cost estimates are provided, and the long-term consequences of capital budget decisions on agency operating budgets are carefully examined, as well.

Improved cost estimating not only applies to capital expenditures but to operating costs, as well. All capital requests must be presented with full identification of anticipated cost impacts on agency operating budgets. These estimates are known as "facility notes" and serve as the basis for subsequent operating budget adjustments if the capital project is approved.

Exhibit 1
CAPITAL PROJECT SCORING CRITERIA

Criteria	Ratings	Values	Maximum score
I. Critical			
Critical life-safety emergency	Y/N	700/0	700
Critical legal liability	Y/N	700/0	700
Prior commitment	Y/N	700/0	700
Maximum critical score			700
II. Strategic			
Strategic linkage	0/1/2/3	0/40/80/120	120
Life-safety concerns	0/1/2/3	0/35/70/105	105
Customer services/statewide significance	0/1/2/3	0/35/70/105	105
Agency priority	1-4 quartile	25/50/75/100	100
User and nonstate financing	0-100%	0-100	100
Asset preservation	0/1/2/3	0/20/40/60	60
Operating savings or efficiencies	0/1/2/3	0/20/40/60	60
Contained in statewide six-year plan	Y/N	50/0	50
Maximum strategic score			700
Maximum score (all criteria)			700

REDESIGN OF BUDGET PRESENTATIONS

New focus
Relation to statewide goals
Measurement of results
Productivity measures

Deemphasis
Accounting
Micromanagement

Each capital budget request is scored by a team from the departments of finance and administration. The 1994 session was the first time scoring was incorporated into the state's capital budget. The scoring system is designed to measure both the overall need for the project and the relative urgency for an immediate appropriation.

Scoring is based on statewide criteria that are grouped into one of two categories—critical or strategic, as depicted in Exhibit 1. Critical criteria determine if the project is urgent, unavoidable and requires action in the current legislative session. Life-safety emergencies, legal liability and binding commitments fall into this category. A project evaluated by one of the critical criteria receives a score of 700, the maximum possible score.

Strategic criteria measure each project's strategic need and value to the state. For example, how closely is the project linked to the agency's strategic mission? What is the statewide significance of the project? Strategic criteria also evaluate the amount of nonstate financing brought to the project, operating savings achieved and whether the project reduces achieved and whether the project reduces the state's deferred maintenance needs. Variable scoring is used for these criteria, with [illegible]

THE MINNESOTA FY1996-2001 CAPITAL BUDGET PROCESS

January 1995	The capital budget instruction manual is issued and distributed to agencies.
May 1995	Preliminary agency capital budget requests are due to the department of finance.
June 1995	Preliminary agency capital budget requests are forwarded to the legislature.
June-September 1995	The departments of finance and administration screen requests, provide preliminary project scoring and meet with affected agencies to provide relevant feedback. Legislative site tours begin.
October 1995	Final agency capital budget requests are due to the department of finance.
November 1995	Departments of finance and administration complete final review and scoring of agency requests. State revenue and debt capacity forecasts are issued.
February 1996	Governor submits FY1996-2001 Strategic Capital Budget Plan to the legislature.
May 1996	Legislature adopts and the governor approves the 1996 bonding bill.

being the maximum possible score, as it was for the critical group.

The positive results of the state's capital budget reform effort were clearly demonstrated for the first time in the 1994 legislative session. Agency requests were substantially improved through the new system. Project costs were prepared in a more rigorous manner. The objective ranking system was used to identify critical capital budget decisions, resources were committed to the most important critical investments, and the opportunity costs of committing scarce resources to the wrong projects were avoided. Linkage of the financial effects of capital decisions on agency operating budgets also were fully integrated into the decision-making process.

Millions of dollars were saved through use of the new process, and millions more are being spent better than using the traditional approaches to capital project allocations of the past. Overall, the new process has substantially improved the information available to the governor and legislature for making capital project decisions and has thus improved the state's allocation of capital resources.

The general concepts employed in Minnesota's capital budget process are transferable to any state or local government. The application of Minnesota's approach addresses removing consideration of capital projects from the one-shot political arena and the pork-barrel decision-making process commonly associated with capital budgets. The ranking criteria used to evaluate projects across agencies and the database structure for the facility inventory may be used in any jurisdiction.

Multiyear Horizons

Capital and operating budget reforms adopted in Minnesota in the past four years have significantly advanced the state's financial management. Both efforts have multiyear horizons which encourage decision making on behalf of tomorrow's taxpayers as well as today's. Operating and capital budgets now are debated on the basis of priorities articulated and adopted by the executive and legislative branches. The processes have been redesigned so that reporting on the results of efforts to achieve the adopted priorities will be a routine part of each year's legislative session and provide the basis for additional financial support. ❑

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PREPARED STATEMENT OF THE NATIONAL SOCIETY OF PROFESSIONAL ENGINEERS

The National Society of Professional Engineers (NSPE) wishes to express serious concern regarding the United States' current process used for financing and planning for its growing infrastructure needs. Funds available for expansion and for continued maintenance of infrastructure are very limited. The present method of financing these projects is complex and fragmented. The traditional "pork barrel" approach to infrastructure funding contributes to an already disorganized government decision-making process, resulting in a loss of public confidence.

NSPE urges Congress to enact legislation that would require the Executive branch to create an annual Capital Budget as part of its annual budget submission to the Congress. This Capital Budget would provide the basic information on which infrastructure needs should be addressed by both the Executive and Legislative branches.

The Capital Budget should include:

I. an estimate of aggregate capital investments (construction and rehabilitation) required to provide specific levels of service over specific periods of time;

II. an estimate of aggregate operation and maintenance investment requirements (for purposes of preparing an operation and maintenance budget);

III. the identification of sources of financing and investment priorities;

IV. a presentation of how proposed annual capital expenditures would relate to the nation's long-term needs; and

V. a five-year investment plan.

NSPE believes that the establishment of a Capital Budget must be a high priority for the federal government. Use of a Capital Budget will ensure appropriate use of trust fund accounts, aid Congress and the Executive Branch in establishing infrastructure investment priorities, and improve public confidence in the budget process.

Many state and local governments already utilize capital budgeting procedures to finance public works construction, physical plant development, and land acquisition. Capital budgets permit state and local governments to demonstrate that the borrowing of funds for infrastructure investment will accrue benefits for the public over long periods of time.

NSPE urges the Federal government to look to those jurisdictions for guidance in setting up a Federal capital budget. Furthermore, because the states and localities play major roles in infrastructure financing, the Society urges those jurisdictions which do not utilize formal capital budgeting procedures to adopt such practices.

In an era of scarce public resources and a compelling need for renewal of our deteriorating infrastructure, capital budgeting must become a high priority item on the national agenda. Establishing a Capital Budget will enable the Federal government to more accurately plan and account for costs associated with investing in our nation's physical infrastructure. In addition, the use of a Capital Budget will aid in setting government priorities and improving public confidence in the process.

NSPE was founded in 1934 and represents 70,000 engineers in the United States and abroad in 535 local chapters and 54 state and territorial societies. NSPE is a broad-based interdisciplinary society representing all technical disciplines and all areas of engineering practice, including government, industry, education, private practice, and construction.

NSPE appreciates the opportunity to express its' views on establishing a Federal capital budget and looks forward to working with Congress and the Administration on this important issue.

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