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Budget Issues: Capital Budgeting for the Federal Government

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PREFACE

The federal deficit is widely viewed as the nation's number one fiscal problem, but the cash-based, unified budget used by the federal government is a seriously deficient tool to reduce that deficit. It counts all borrowings, whether for operating expenses or capital investments, toward the deficit. The term deficit, however, implies a depletion in resources. This does not occur when the government borrows to acquire capital investments, since such investments yield a flow of benefits in future years. Borrowings for capital investments are better thought of as "capital financing" rather than as contributing to a "deficit."

Drawing a distinction between "capital financing" and operating "deficits" will provide the President and the Congress a sounder approach to deficit reduction, correct a budget bias against capital project initiatives, more accurately report the costs of the federal government's direct loan programs, help focus public attention on the nation's physical infrastructure needs, and provide a direct link with agency and governmentwide financial statements.

GAO proposes restructuring the current unified budget to include an operating and a capital component within the budget. This exposure draft sets forth a conceptual framework for a restructured budget. The restructured budget would identify the revenues, investments, and "capital financing" needs for capital investments, and it would clearly distinguish them from current operating amounts and "deficits." We also propose that the Balanced Budget and Emergency Deficit Control Act of 1985 (Gramm-Rudman-Hollings) be amended to establish separate targets for capital financing, the operating deficit, and total financing requirements from the public.

Since February 1985, when GAO issued Managing the Cost of Government: Building an Effective Financial Management Structure (GAO/AFMD-85-35), which summarized the federal government's problems in financial management, including the federal budget structure, we have been actively studying, evaluating, and discussing the need for comprehensive budget reform. We believe our capital budgeting proposal would immediately improve the federal budget decisionmaking and control processes.

Our proposal, however, is only part of a broader GAO study of budget restructuring needs, which also includes the treatment of trust funds and enterprise activities. We will report separately on this work. In the near future, we will also issue a summary report on our capital budgeting, trust fund, and enterprise studies.

At this time, we would like to invite comments on our proposal from interested parties, including individuals, professional associations, academia, public interest groups, and all levels of government. We ask that you submit your comments within 45 days of receipt of this draft.

If you have any questions, please contact James L. Kirkman, Associate Director, at (202) 275-9573 or Charles W. Culkin, Jr., Deputy Associate Director, at (202) 275-1984. Your comments should be sent to the U.S. General Accounting Office, Accounting and Financial Management Division, 441 G Street, NW, Room 6820, Washington, DC 20548.

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The federal deficit is widely viewed as the number one fiscal problem facing the nation today. The federal government can no longer act as if it has unlimited financial resources. The nation is faced with a fundamental policy decision: how much to spend on governmental programs and services and how to pay for them.

As a decisionmaking tool, the budget should be comprehensive and portray federal programs and amounts in a way that is useful to officials and the public. Unfortunately, the current cash-based, unified budget, although largely comprehensive, is seriously deficient in its usefulness as a tool in making sound fiscal choices. Its usefulness would be greatly enhanced if it were modified to distinguish between capital investments and operating expenses.

Problems With Current Budget Structure

The current budget structure focuses attention exclusively on a single surplus or a deficit total. The reported number--a $150.4 billion deficit for fiscal year 1987--is widely viewed as the key indicator of how well the federal government is doing in its fiscal policy. While it is important to have a single number for fiscal policy purposes, an exclusive focus on such a number is misleading and hampers budget decisionmaking. This approach has two major problems.

First, the exclusive focus on a single, cash-based total leads to unsound deficit reduction strategies. States distinguish between debt incurred for capital investments and debt incurred for operating expenses, and they focus upon the latter in their balanced budget requirements. In contrast, the President and the Congress have no choice under the present budget structure but to apply deficit reduction efforts broadly to aggregate debt totals. For example, the Balanced Budget and Emergency Deficit Control Act of 1985 (Gramm-Rudman-Hollings) calls for deficit targets that apply equally to capital and operating programs. This is because the budget makes no systematic distinction between outlays for capital investments and those for current operations, or between the portion of the debt related to capital investments versus that for operating activities.

This single-number focus of federal deficit reduction efforts is based upon a highly questionable premise: all outlays and debt are the same, whether for capital investments or operating expenses. This is not the case. Capital outlays do not immediately reduce the resource base of the government the way outlays for current operations do, because they represent asset exchanges. When outlays are made and related debts are incurred to acquire assets, whether they are buildings or loans, they produce future streams of benefits to the government in terms of a cash return or by providing facilities to carry out government operations. Therefore, debt incurred to finance capital investments should be thought of as "capital financing" rather than as a contributor to the "deficit."

Failure to recognize the critical distinction between "capital financing" and operating "deficits" leads to efforts to reduce all borrowings to zero. This could be procyclical. Also, under such an approach, officials cannot readily discuss and set in public policy the needed balance between spending for short-term consumption needs (operating expenses) and long-term infrastructure and productivity enhancing needs (capital investments).

Second, under the current, cash-based budget, there is a budget bias against capital programs, which could lead to uneconomical decisions. Under present budget scorekeeping rules, a $10 million outlay to construct a building (a capital investment) in a given year contributes to the year's deficit the same as a $10 million outlay for vehicle or airplane fuel costs (an operating expense). This scorekeeping practice "front-end loads" the costs shown in the budget for the acquisition, since the project will have sizable start-up cash payments. Such a capital project is also at a disadvantage during budget deliberations when competing with an alternative means of acquiring the use of a building that would have lower front-end costs, such as leasing, but which has significantly higher long-term costs.

This could result in decisionmakers selecting the leasing option even though it would entail larger, long-term costs without the sizable benefit of eventual ownership. In a sense, it requires a capital asset to have a 1-year payback to be able to compete equally with current operating programs, a clear manifestation of the budget's focus on short-term thinking.

The costs of direct loan programs are similarly distorted because of the current budget's cash-flow orientation. A portfolio of $100 million in new direct loan outlays counts toward the deficit the same as $100 million in grants, even though the $100 million in direct loans does not represent $100 million in costs. This cash-flow treatment does not recognize that the government, in making these loans, receives a financial asset (the note promising future repayments), and that at least a portion of the loan outlays will be repaid in the future. This omission makes direct loan programs seem more costly (in outlay terms) in their early years, but it gives the opposite impression in later years when loan repayments are netted against new disbursements for calculating reported (net) loan outlays.

A capital budget would eliminate these and other deficiencies.

Benefits of Capital Budgeting

A capital budget would provide the President and the Congress a sounder basis for targeting areas for deficit reduction. For example, Gramm-Rudman-Hollings targets could be established for the (1) "capital financing" requirements of the capital component of the budget, (2) "operating deficit" of the operating component of the budget, and (3) "total financing requirements from the public" of the budget. This would eliminate a weakness in the existing law that requires all borrowings, even those for capital investments, to be reduced to zero by fiscal year 1993. It would also increase comparability between federal and state budgeting practices and results.

In addition to providing a clearer picture of the composition of federal debt, **a capital budget would correct a budget bias against**

physical capital investments. This would be done by distributing outlays in budget reporting over the useful life of the capital investment. Each year's amount would be reported as an asset consumption charge (depreciation) in the operating budget.

Similarly, **a capital budget would more accurately report the costs of the federal government's direct loan programs.** The estimated subsidy costs of these loans would be reported in the operating budget, while the direct loan disbursements, less the subsidy costs incurred in making those loans, would be reported in the capital budget. The principal repayments received on the loans would be reported as capital budget revenues. This treatment would put direct loan programs on a comparable basis with grant program costs.

A capital budget also would help focus public attention on the nation's physical infrastructure needs. Federal, state, and local governments have invested billions of dollars in physical capital investments--highways, bridges, water and sewer systems, airports, buildings, and the like. Many of these structures are deteriorating. A capital budgeting approach would help highlight the problem--new investments would be compared to capital consumption amounts--and encourage replacement planning.

Finally, **a capital budget would provide a direct link with agency and governmentwide financial statements.** These statements would include balance sheets as well as revenue and expenditure statements. This would enable officials to focus on the impact that budgetary decisions have on the government's assets, liabilities, and overall financial condition.

GAO's Capital Budget Proposal

GAO proposes restructuring the current unified budget by requiring an operating and a capital budget within the unified budget. The restructured budget would identify the revenues, investments, and "capital financing" needs for federal capital investment activities, and it would clearly distinguish them from current operating amounts and the "operating deficit." Operating and capital amounts would also be provided for each budget function, agency, and program. In cases where a single program involves both capital and noncapital items, it would include account-level schedules that report total program costs. Further, our proposal would require that the Balanced Budget and Emergency Deficit Control Act of 1985 be amended to establish separate targets for capital financing, the operating deficit, and total financing requirements from the public.

The capital budgeting proposal in this document is only a conceptual framework. It does not address matters such as the classification of consumable inventories and stockpiles, the calculation of credit subsidies for federal credit programs, or specific alternatives for financing capital projects. These matters would have to be addressed prior to implementing a capital budget.

We believe that capital budgeting within the context of the unified budget would substantially improve the federal budget decisionmaking and control processes. It would represent an important step toward building a modern and effective financial management structure for the federal government.

This report has three major sections. The first section discusses our capital budget proposal. The next two sections discuss the benefits of capital budgeting and the arguments against capital budgeting, respectively. In addition, an appendix presents sample formats of how some restructured budget tables would look.

Report Separately on Capital and Operating Amounts Within Unified Budget

GAO proposes restructuring the current unified budget by requiring an operating and a capital component within the unified budget. Tables 1 and 2 illustrate, respectively, at a summary level, the current unified budget and the basic concepts of our restructured unified budget. Both budgets reflect the $150.4 billion total cash deficit for fiscal year 1987.

As table 2 shows, our restructured budget would differ from the current budget (table 1) in that it would contain both an operating budget and a capital budget with each reflecting revenues and expenses. The operating budget's "operating surplus/deficit" and the capital budget's "net capital financing requirements" would result in a single budget number referred to as "total financing requirements from the public." This total would be consistent with the total now defined by the current unified budget as the "cash surplus/deficit."

Under our proposal, amounts received from the public, or nonfederal sources, which are currently offset against gross outlays, would be treated differently. Such amounts, currently termed "proprietary receipts" and "offsetting collections," are not reported as "budget receipts." Rather, they are netted against gross outlays to produce the (net) outlay totals in the budget. In effect, these receipts and collections are "buried" in the outlay totals. In fiscal year 1987, these receipts and collections totaled $158.1 billion, and they included such amounts as loan repayments received by federal lending agencies; medicare premiums; sales of government assets, products, and services; and rent and royalties from outer continental shelf leases.

Table 1: Current Unified Budget for the U.S. Government

	Actual 1987	Estimate 1988	Estimate 1989
	---(dollars in billions)--		
Receipts			
General taxes and receipts	$ 527.1	$ 550.2	$ 581.9
Earmarked taxes and receipts	327.1	359.0	382.8
Total receipts	854.2	909.2	964.7
Outlays			
Civil functions	584.0	622.6	648.4
Defense functions	282.0	285.4	294.0
Interest on debt	138.6	147.9	151.8
Total outlays	1004.6	1055.9	1094.2
Cash surplus/deficit(-)	$-150.4	$-146.7	$-129.5

Table 2: GAO's Restructured Unified Budget for the U.S. Government

	Actual 1987	Estimate 1988	Estimate 1989
	---(dollars in billions)--		
Operating Budget			
Operating revenues	$ 957.8	$1020.3	$1085.0
Operating expenses	1004.0	1071.4	1117.7
Cash surplus/deficit(-)	-46.2	-51.1	-32.7
Asset consumption charge	-50.0	-51.3	-52.0
Operating surplus/deficit(-)	-96.2	-102.4	-84.7
Capital Budget			
Capital revenues	56.7	61.6	50.1
Capital investments	160.9	157.2	146.9
Capital financing requirements	-104.2	-95.6	-96.8
Asset consumption charge	50.0	51.3	52.0
Net capital financing requirements	-54.2	-44.3	-44.8
Total financing requirements from the public	$-150.4	$-146.7	$-129.5

GAO has recommended against netting such amounts against gross outlays on the grounds that the resultant outlay totals understate the true level of federal outlays.[1] Under our proposal, these amounts would not be netted against gross disbursements for purposes of calculating operating expenses and capital investments. Rather, they would be reported as budget receipts. This results in expense and investment figures in table 2 (restructured budget) which are larger than the outlays reported in table 1 (current budget). Throughout this report, our restructured budget amounts reflect this new approach. Such an approach does not, however, change the "bottom line," that is, the financing requirements from the public.

We should note that because of our approach and the quality of existing data on capital expenditures and asset consumption charges (depreciation), we had to make several assumptions in developing the numbers. Therefore, we would emphasize that the numbers in all the tables in this report are approximations for illustrative purposes only. Appendix II discusses the methodology that we used in developing our budget numbers.

Operating Component of Restructured Budget

The operating component of the restructured budget, as illustrated in table 3, would report all operating revenues and expenses for programs and activities that are not classified as capital investments. The revenues would include general taxes; payroll and other earmarked taxes; and fees, royalties, and other earnings. As for expenses, they would include the costs of civil and defense functions, the interest on the national debt, and the subsidy costs the government incurs in making direct and guaranteed loans.

Most expenses in the operating budget would represent cash disbursements to the public. One noncash amount that we would add is

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[1] Federal Budget Outlay Estimates: A Growing Problem (GAO/PAD-79-20, February 9, 1979) and Federal Budget Totals Are Understated Because of Current Practices (GAO/PAD-81-22, December 31, 1980).

Table 3: Operating Component of Restructured Unified Budget

	Actual 1987	Estimate 1988	Estimate 1989
	-----(dollars in billions)----		
Operating Budget			
Operating revenues			
General taxes	$ 498.4	$ 521.8	$ 552.7
Payroll and other earmarked taxes	304.6	333.1	356.1
Fees, royalties, and other earnings	154.8	165.4	176.2
Total operating revenues	957.8	1020.3	1085.0
Operating expenses			
Civil functions	$ 643.0	$ 696.5	$ 729.9
Defense functions	199.7	205.1	214.4
Interest on debt	160.3	168.5	171.9
Credit subsidy costs	1.0	1.3	1.5
Total operating expenses	1004.0	1071.4	1117.7
Cash surplus/deficit(-)	-46.2	-51.1	-32.7
Asset consumption charge	-50.0	-51.3	-52.0
Operating surplus/deficit(-)	$ -96.2	$-102.4	$ -84.7

an "asset consumption charge" which represents the consumption of the federal government's physical assets. The current budget does not include an asset consumption charge. It therefore misstates the true cost of operating the government.

Adding the noncash asset consumption charge to the operating budget would eliminate this omission and add a major noncash cost incurred each year that is not now reflected by reported cash outlays. There are other possible noncash entries, such as reporting the annual accrued liabilities for pension programs, which, if included, would also increase reported operating expenses. We have not included these noncash amounts in our operating budget at this time because our proposed operating budget is designed mainly to distinguish between operating expenses and capital investments. Therefore, we have only added noncash operating expenses for capital investments. We are, however, reviewing the issue of accrued liabilities, and we may propose their inclusion in our restructured operating budget.

In sum, the operating component of our restructured budget would reflect the annual costs of the government's physical capital investments, as well as the cash outlays for other current programs and activities. An operating surplus/deficit would be reported based on these revenues and expenses.

Capital Component of Restructured Budget

The capital component of the restructured budget, as illustrated in table 4, would report both capital revenues and capital investments; these amounts would represent cash revenues and disbursements. Capital revenues would include user fees, excise taxes, and similar amounts which are earmarked by law to finance physical and financial capital investments. Capital revenues would also include most loan principal repayments and interest paid by the Treasury on securities held by the capital trust funds.

Capital investments would include disbursements for physical assets and financial assets. Physical assets would include tangible assets, that is, assets which cost $25,000 or more and provide economic benefits for more than 2

Table 4: Capital Component of Restructured Unified Budget

	Actual 1987	Estimate 1988	Estimate 1989
	-----(dollars in billions)----		
Capital Budget			
Capital revenues			
Loan receipts	$ 37.6	$ 40.9	$ 28.9
Other capital receipts	19.1	20.7	21.2
Total capital revenues	56.7	61.6	50.1
Capital investments			
Financial asset disbursements, less subsidy costs	$ 34.2	$ 33.2	$ 26.2
Physical asset additions	126.7	124.0	120.7
Total capital investments	160.9	157.2	146.9
Capital financing requirements	-104.2	-95.6	-96.8
Asset consumption charge	50.0	51.3	52.0
Net capital financing requirements	$ -54.2	$-44.3	$-44.8

years. Financial assets would include legal instruments such as federal direct loans, less any estimated net costs the government incurs in making the loans. The loan balance reported would represent a financial capital investment by the government, similar to a physical capital investment. Just as the government acquires a fixed asset, such as a building, in exchange for a physical capital disbursement, it also acquires a financial asset, such as a note receivable, in exchange for a disbursement of cash. The next section--"Definition of Capital Assets"--details our description of capital assets.

The amount by which capital investments exceed capital revenues would be reported as "capital financing requirements." From this total, the noncash "asset consumption charge" amount would be subtracted to produce "net capital financing requirements." This adjustment is made to reflect the "financing" of expenditures for physical assets by the current year's asset consumption charge. Under our approach, amounts for the asset consumption costs would be made available in the operating budget and credited to the capital budget.

After making the asset consumption charge adjustment, the resultant net capital financing amount would represent the portion of capital financing that supports capital expansion rather than simply capital replacement. A zero amount would mean that no new borrowings were necessary for capital expansion. The term "net capital financing requirements" is used instead of "capital deficit" in order to reflect the fact that the government is borrowing to finance a capital asset which has value and will produce a future stream of benefits.

It is important to recognize the distinction between an "operating deficit" and "net capital financing requirements." Under current budget reporting practices, the "deficit" is essentially defined as the difference between total outlays and receipts. It represents an increase in the federal debt to the public, regardless of the kinds of outlays financed by the debt.

As currently defined, the deficit provides one measure of the federal government's aggregate involvement in the economy and the financial markets. As an indicator of the federal government's financial health, however, its focus on borrowings is misleading because it fails to recognize that at least a part of the debt incurred results in an increase in federal assets. Our proposal corrects this misconception by distinguishing between borrowings which are used to finance operating costs (operating deficit) and borrowings which are used to finance the acquisition of capital assets (net capital financing requirements).

Definition of Capital Assets

How to define the items that would be included in the capital component of the budget has been the focus of much debate. Over 20 years ago, for example, the last presidential commission on budget concepts expressed concerns about how to define capital assets. In its October 1967 Report of the President's Commission on Budget Concepts, the commission discussed the "difficult accounting problems" involved in defining capital. The commission stated that under a capital budgeting approach, "proponents of new spending programs would be tempted to stretch the capital budget rules on inclusion."

In order to ensure that only the appropriate items are included, we believe it is critical to have a narrow and disciplined view of what would be classified as capital. Under our proposal, we would define capital assets as being of two types--physical assets and financial assets.[2]

We would define physical assets as assets with the following characteristics: (1) they have

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[2]OMB data show that, in fiscal year 1987, federal outlays for major physical investments ranged from $105.7 billion for acquiring federally-owned assets, to $126.7 billion if one also includes grants-in-aid to states and local entities in support of their capital projects. In addition, federal direct loan disbursements amounted to $34.2 billion. In total, these capital investments represented about 16 percent of total federal outlays in fiscal year 1987.

form and substance, that is, they are tangible, (2) their ownership resides or will reside in the public domain,[3] (3) they typically provide services or benefits, including for national defense and security, for more than 2 years, and (4) they cost $25,000 or more. Such assets would include, but would not be limited to, the following: roadways and bridges; airports and airway facilities; mass transportation systems; waste water treatment and related facilities; water resource projects; medical facilities; resource recovery facilities; public buildings; space and communication facilities and equipment; railroads; defense facilities; military hardware; and strategic petroleum reserves and mineral stockpiles. Also, assets acquired by capital leases as well as leasehold improvements would be included. This definition excludes consumables such as inventories and spare parts. We are currently reviewing the issues surrounding inventories and stockpiles held by the federal government and will be reporting later this year on how they should be treated under our capital budgeting proposal.

Financial assets, as we define them, would include principally notes and loans receivable as well as any legal instruments, such as bonds

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[3]The federal government assists state and local governments by providing significant investments in infrastructure assets, most notably the interstate highway system and waterways, which are located on state and local property, but are generally available to the public at large. GAO's position is that such assets are federal assets if the costs are paid with federal funds (equity interest) and the infrastructure assets are part of the general public domain, rather than being clearly owned by another party. Also, such assets should be depreciated, where applicable, over their useful lives. Conversely, infrastructure investments (capital grants) in projects or assets that are clearly owned by and benefit a single party or group and are not generally available to the public at large should not be capitalized by the federal government.

and other securities held by the federal government.

In defining capital assets, we did not include investments in nontangible assets. These would include investments in "human capital," such as education and training or investments in research and development. Like investments in physical or financial assets, these investments are different from other operating expenditures because they also result in future benefits to society. However, we believe that there are practical differences between tangible and nontangible investments which warrant excluding the nontangible investments from our definition of capital. These include (1) inconsistencies with other financial reporting practices, (2) difficulties in delineating the boundaries of human capital activities, and (3) the difficulty of measuring the future value and useful life of nontangible investments.

Accounting-standard-setting organizations in both the public and private sector--GAO, Government Accounting Standards Board, Financial Accounting Standards Board, American Institute of Certified Public Accountants, and the Department of the Treasury--identify tangibility as a common characteristic of capital investments. Guidance provided by these organizations is currently applied across federal, state, and local governments and the private sector. In addition, the Federal Capital Investment Program Information Act (Public Law 98-501) defines capital investments as physical assets.

Another reason for excluding nontangible items is that by making a clear and distinct break between tangible and nontangible investments, we add clarity to the budget system and minimize the possibility for misclassifying noncapital items as capital. This would eliminate pressures to include other less tangible items in the capital budget and lead to improved public perceptions of the entire process.

Besides maintaining consistency with current financial reporting practices, another important factor in favor of excluding nontangible investments is the degree of uncertainty which would result from including them. For purposes of determining the value of government assets in policy analysis and financial statements, the nature of tangible investments is that they can be more accurately measured than nontangible investments. When attempting to allocate capital costs over time, useful life calculations for depreciation are more finite for tangible than nontangible investments.

Excluding nontangible investments from the capital portion of the budget does not reflect a belief that these investments are of lesser importance to the nation or to the individuals that they serve. Human resource programs and research and development activities both result in future benefits to society which may in fact outweigh those provided by more tangible investments. Given the importance of these programs and activities, we believe an expanded special analysis section in the budget would provide the detail decisionmakers need to make informed decisions about such assets. For example, the summary information on federal investments in research and development and education, which is now contained in Special Analysis D in the budget, could be expanded to provide more in-depth information on where these funds are being spent.

We acknowledge that our definition of capital assets is a general one. Good definitional standards need to be established in order to distinguish between capital investments and operating expenses. Further, it is not only crucial to establish good definitional standards, but also to monitor, through an independent evaluation, how those standards are applied. As such, our capital budgeting proposal would require that 31 U.S.C. 1112 be amended to require that (1) the Comptroller General, in cooperation with the Secretary of the Treasury, the Director of the Office of Management and Budget, and the Director of the Congressional Budget Office, establish criteria, principles, and standards for determining the content of the operating and capital budgets and (2) the Comptroller General review the implementation of these criteria, principles, and standards, as he deems necessary, to determine whether actual and proposed appropriations, revenues, and expenditures presented in the capital budget represent activities, functions, and programs which support the acquisition, construction, or rehabilitation of capital assets.

The usefulness of the current unified budget would be greatly enhanced if its structure were modified to include a capital budget and an operating budget. This proposed capital budget would provide the President and the Congress with a sounder basis for targeting areas for deficit reduction, correct a budget bias against physical capital investments, more accurately report the costs of the government's direct loan programs, help focus public attention on the nation's physical infrastructure needs, and provide a direct link with agency and governmentwide financial statements.

Provides a Sounder Basis for Deficit Reduction

The current budget structure focuses attention exclusively on a single surplus or deficit total--a $150.4 billion deficit in fiscal year 1987. It does not make a systematic distinction between receipts and outlays for capital investments and those for current operations, or between the portion of the debt related to capital investments versus operating activities. As a result, the President and the Congress have no choice but to apply deficit reduction efforts broadly without systematic consideration of capital and operating needs. For example, Gramm-Rudman-Hollings deficit targets apply equally to capital and operating programs, which unnecessarily restricts the debt control options available to federal lawmakers. In this regard, the federal government is clearly out of sync with state governments.

At the state level, 37 states have reported that they have a distinct capital budget whereby the capital and current operations amounts are reported separately either within an overall budget or as separate budgets.[4] Thirty-four states require their governments to execute balanced budgets, and most of these states target their balancing requirements to

[4] Budget Issues: Capital Budgeting Practices in the States (GAO/AFMD-86-63FS, July 15, 1986).

their operating budgets only.[5] Expenditures for capital investments are not counted as operating expenses, but rather as a means of financing capital development. Debt financing is utilized for their capital projects, subject to separate state debt limitations. Further, the states control their debt by requiring that their annual debt service costs be included in budgets which are subject to balanced budget requirements.

In contrast, the single-number focus of federal deficit reduction efforts is based upon the highly questionable premise that all outlays and debt are the same, whether for capital investments or operating expenses. This is not the case. Capital outlays do not immediately reduce the resource base of the government the way outlays for current operations do, because they represent asset exchanges. When outlays are made and related debts are incurred to acquire assets, whether these assets are buildings or loans, they produce future streams of benefits to the government through a cash return or by providing facilities to carry out government operations. Therefore, debt incurred to finance capital investments should be thought of as "capital financing" rather than as a contributor to the "deficit."

Failure to recognize the critical distinction between "capital financing" and operating "deficits" leads to efforts to reduce all borrowings to zero. This could be procyclical. Also, under the current budgetary approach, officials cannot readily discuss and set in public policy the needed balance between spending for short-term consumption needs (operating expenses) and long-term infrastructure and productivity enhancing needs (capital investments). Further, it makes it difficult to compare federal and state budgeting practices and results.

A capital budget would give the President and the Congress a sounder basis for targeting areas for deficit reduction. For example, Gramm-Rudman-Hollings targets could be

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[5] Budget Issues: State Balanced Budget Practices (GAO/AFMD-86-22BR, December 10, 1985).

established for the (1) "capital financing" requirements of the capital component of the budget, (2) "operating deficit" of the operating component of the budget, and (3) "total financing requirements from the public" of the budget. This would eliminate a weakness in the existing law where all borrowings, even those for capital investments, would be reduced to zero by fiscal year 1993. To correct this weakness, our capital budgeting proposal would require that the Balanced Budget and Emergency Deficit Control Act of 1985 be amended to establish separate targets for capital financing, the operating deficit, and total financing requirements from the public.

Eliminates Disincentives Toward Capital

Under the current budget scorekeeping rules, physical capital investments in a given year are treated as if they were costs incurred in that year. For example, a $10 million outlay to construct a building (a capital investment) contributes to the year's deficit the same as a $10 million outlay for vehicle or airplane fuel costs (an operating expense). This scorekeeping practice "front-end loads" the costs shown in the budget for the acquisition, since the project will have sizable start-up cash payments.

During budget deliberations, such a project is at a disadvantage. It must compete with an alternative means of acquiring the use of a building that would have lower front-end costs, such as leasing, but which has significantly higher long-term costs. This could result in decisionmakers selecting the leasing option even though it would entail larger, long-term costs. More importantly, it could result in the project not being approved because of its initial effect on the budget even though the long-term benefits would outweigh the costs. In a sense, it artificially requires a capital asset to have a 1-year payback to be able to compete equally with current operating programs, a clear manifestation of the budget's focus on short-range thinking.

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

The Balanced Budget and Emergency Deficit Control Act of 1985, however, placed the Postal Service back on-budget. As a result, its capital investment program was cut back drastically in the Omnibus Budget Reconciliation Act of 1987. In February 1988, the Postmaster General expressed his frustration when he stated the following: "Under the government's cash-basis accounting budget, a postal dollar invested in capital assets is given the same effect as a dollar in operating losses. No one can reasonably expect a self-supporting enterprise as pervasive as the Postal Service to do well if its service-improvement efforts and capital-modernization plans can be canceled in midstream whenever the latest reading on the government's overall bottom line looks bleaker than forecast."

Capital budgets used in the private sector deal with this budget bias by using a different scorekeeping approach. When companies make capital investments, they do not charge the investments against their current operating budget. Only an amount which reflects the annual consumption of the investments--known as an asset consumption charge, or depreciation--is reported as a cost in the operating budget.

Our proposal would use a similar approach. Capital expenditures would be distributed over the useful life of the capital investment. Thus, the amount reflecting each year's cost of using existing federal assets would be reported as an asset consumption charge in the current operating budget. Because of their long-term benefit stream, it is appropriate to annualize the costs of capital investments over the fiscal periods receiving the benefits. This would put capital investment amounts on a comparable basis with current operation amounts and eliminate the current budget bias against capital projects.

More Accurately Reports Costs of Federal Direct Loans

Similarly, a capital budget would more accurately report the costs of the federal government's direct loan programs, a subject much debated during the past few years. Under the current budget, the budget does not identify the costs of direct loan programs--it records the cash flow of loan outlays and repayments only. For example, a portfolio of $100 million in new direct loan outlays counts the same as $100 million in grants, even though the $100 million in direct loans does not necessarily represent $100 million in costs. This cash-flow treatment does not recognize that the government, in making these loans, receives a financial asset (the note promising future repayments) and that at least a portion of the loan outlays will be repaid in the future. This omission makes direct loan programs seem more costly (in outlay terms) in their early years. An opposite effect develops in later years when loan repayments flow back to the programs. The repayments are netted against new outlays and may result in understating of the new outlays. Further, this omission also leads to using loan sales as a way to "reduce" the deficit.

Our capital budgeting approach would overcome these distortions by reporting in the current operations portion of the budget the estimated subsidy costs of direct loan programs. Direct loan disbursements, less the subsidy costs incurred in making those direct loans, would be reflected in the capital portion of the budget. The principal repayments received on the loans would be reported as capital budget revenues. This would put the financial costs of direct loan program costs on a more comparable basis with those of grant programs.

This budgetary treatment of direct loan programs is in line with recommendations in the 1967 Report of the President's Commission on Budget Concepts. The commission recommended that summary budget schedules identify direct loans on the basis of their unsubsidized values separately from other expenditures. In addition, the commission recommended that the subsidy elements be specifically disclosed in the expenditure account of the budget "since such subsidies are much more like grants than loans."

Focuses Attention on Nation's Physical Infrastructure

With the increased pressure on the federal budget and the ongoing debate about the federal government's relationships with other levels of the public sector and the private sector, the way in which the federal government, states, and localities plan, budget, and protect the public capital investments needed for the future takes on added significance. Federal, state, and local governments have invested hundreds of billions of dollars in physical capital investments--highways, bridges, water and sewer systems, airports, buildings, and the like. Despite this huge investment, many important physical items are deteriorating. Billions more are needed to repair or replace these assets, causing widespread concern about ways to finance their repair and rehabilitation. A capital budget would help highlight the problem--new investments could be compared to capital consumption amounts--and encourage replacement planning.

Begins Providing a Link to Financial Statements

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

A capital budget would provide a useful complement to the financial statements. Together, the two would provide enhanced information on the government's assets, liabilities, and operations by linking past results with future plans. The financial statements would provide a snapshot of the cumulative results of the past capital acquisitions adjusted for usage, while the capital budget would show the planned activities.

ARGUMENTS AGAINST CAPITAL BUDGETING

Arguments have also been made against implementing a capital budget at the federal level. Examples include obscuring the aggregate defict problem, favoring capital projects, and increasing opportunities for budget gimmicks. On the surface, many appear to have merit. Upon closer examination, however, it becomes evident that the arguments are based on misconceptions about capital budgeting. Some of the arguments are not applicable to our capital budget proposal. The remaining arguments are addressed by our proposal. Some of the more popular arguments, along with our views, are presented below.

Obscures the Aggregate Deficit Problem

Some argue that a capital budget could obscure the aggregate deficit problem by redirecting attention to operating deficits. This would happen if the federal government does what many states do--set balanced budget requirements on the operating amounts while minimizing such controls on capital amounts.

It is argued that no real difference exists between a deficit incurred for capital purposes and a deficit incurred for operating purposes. Both produce borrowing requirements which affect the credit markets in a like manner. The effects on "crowding out" credit available for private sector purposes as well as on interest rates are the same. Critics argue that, at a time when aggregate debt levels are a matter of great concern to the Congress and the public both, adopting a capital budgeting approach that could deflect attention from the overall deficit problem is not an appropriate measure.

The argument on obscuring the deficit has two counter-arguments. First, implementing the capital budgeting concept, as presented in this proposal, is not designed to take attention away from the aggregate borrowing levels of the government. Its main purpose is to provide useful information on the debt's composition and allow decisionmakers to make informed and potentially more discriminating decisions about debt control. When attempting to control debt, it is desirable for decisionmakers to know about the differing implications of operating versus capital debt.

By retaining the unified budget totals, our proposal not only provides additional information on debt financing for capital and operating components, but also continues to report information on the federal government's total financing requirements from the public (an amount equal to the current budget's deficit figure). In the same vein, our capital budgeting proposal addresses two major concerns raised in the October 1967 Report of the President's Commission on Budget Concepts--the impact on credit markets of government borrowing for capital items and the government's ability to raise taxes in inflationary periods if the operating budget is balanced. Since our proposal is designed to maintain the budget's unified focus, officials could continue to assess the impact that the total level of government borrowing is having on the private sector's credit markets and interest rates. Further, our capital budgeting proposal does not suggest avoiding tax increases in inflationary periods when the operating budget is in balance. Our proposal is neutral on which fiscal policy should be followed. It merely increases the options available to the President and the Congress.

Second, we would maintain that an important distinction does indeed exist between debt incurred for operating expenses and debt incurred for capital investments. When the federal government borrows to cover operating costs, it does not receive a finite asset in return for its increased debt. On the other hand, when the federal government borrows to finance its capital acquisitions, it receives an asset, which has value, in return for its increased debt. Debt incurred for capital investments does not diminish the federal government's asset base in the same way as debt incurred for operating activities because capital borrowings lead to an increase in the government's or nation's capital assets. This is an important distinction especially in times when the national and international financing communities are concerned about the government's fiscal health.

Favors Brick and Mortar Type Programs

Some argue that a capital budget could produce a budget bias in favor of "brick and mortar" programs, such as roads, bridges, airports, medical facilities, and military hardware. In its October 1967 Report of the President's Commission on Budget Concepts, the commission stated that ". . . a further very persuasive argument against a capital budget is that it is likely to distort decisions about the allocation of resources. It would tend to promote the priority of expenditures for 'brick and mortar' type projects relative to other federal programs for which benefits could not be capitalized (including health, education, manpower training, and other investments in human resources)--even when there is no clear evidence that such a shift in relative priorities would in fact be appropriate."

We do not think that a capital budget would cause a preference for "brick and mortar" programs, or tangible investments, but rather that it would partly remove a currently strong bias against these programs. As we discussed earlier--in our section on "Eliminate Disincentives Toward Capital"--the current treatment recognizes all outlays for capital in a given year as budget costs for that year, even though the capital asset that is acquired is not used up in that year. This "tags" capital projects in budget documents with overstated initial costs. A capital budgeting approach, which distributes capital costs over the years of use, would correct this current bias, not create a bias in favor of capital.

Also, as we discussed earlier--in our section on Definition of Capital Assets--we believe that there are practical differences between tangible and nontangible investments which warrant excluding nontangible investments from our definition of capital. More importantly, under our proposal, there would continue to be congressional budget process decisions on functional totals (with capital and operating breakdowns). Thus, decisions on overall budget priorities, for example, defense versus human resources, would likely continue to be the primary force driving the budget. Similarly, there is no reason to believe that the program priorities seen under Gramm-Rudman-Hollings would change a capital budgeting approach. If

Gramm-Rudman-Hollings' priorities were applied within a capital budgeting framework, many operating programs would continue to benefit from Gramm-Rudman-Hollings cutback exemptions, such as entitlements, while many capital programs would continue to be cut.

Also, we should point out that not all investments under a capital budgeting approach would be brick and mortar programs. Under our proposal, the capital component of the budget would include capital investments in facilities which support health, education, manpower training, research and development, and other health and human resource activities. In addition, direct federal loans, which totaled $34.2 billion in fiscal year 1987, would be included in our capital budget.

Shifts Focus Away From Programs

A related concern that is sometimes expressed is that a capital budget would shift the focus of the budget away from broad program and policy questions of how resources will be allocated to narrower questions of public capital investment and how such investment is to be financed. Furthermore, for programs that are not wholly capital or operating, a capital budget would separate the capital amounts from operating amounts and obscure how the programs work as a whole. The question becomes: How could a programmatic focus be maintained if the capital part of the program was covered in the capital section of the budget, while the related operating part was covered in a different section of the budget?

Our proposal is designed specifically to avoid this problem by maintaining the current aggregate, functional, and programmatic presentations of the current unified budget, modified by operating and capital breakdowns within each such category. Congressional budget reviews and decisions could address operating versus capital allocations, and, at the same time, programmatic and functional allocations within the operating and capital budgets. Budget resolution controls would not stop at the operating and capital totals, but would also address functional breakdowns to maintain an overall programmatic orientation.

Similarly, at the budget account level, sub-accounts for operating and capital would be employed for a single program with both types of expenditures. These sub-accounts would then be combined to provide aggregate information for each budget account. Table I.3 in appendix I illustrates our restructured program and financing table.

Constrains Countercyclical Fiscal Policy

Some opponents of a capital budget argue that a budget with capital assets financed by long-term debt could constrain fiscal policies intended to counter short-term fluctuations in the economy (countercyclical fiscal policy). Extensive debt financing could put constraints on fiscal policy because acquisition decisions would be made with a long-term investment strategy in mind, independent of short-term changes in the economy.

The credibility of this argument centers on two assumptions: (1) that capital expenditures would be reported and funded within a totally separate capital budget with decisions on debt financing of capital made independent of the fiscal needs of the economy as a whole and (2) that capital projects must be financed through the issuance of separate debt. There is no reason, however, why either of these should occur under our capital budgeting proposal.

Under our proposal, both operating and capital amounts would be reported within the context of the unified budget. Therefore, the budget's current unified focus would be maintained and greater attention could be given to the operating and capital components. Under this approach, overall spending levels, as well as spending for operating and capital activities, would be considered and adjusted to meet countercyclical fiscal policy. Thus, fiscal policy options would be broadened, not lessened, under our proposal.

Further, our proposal contains no technical requirement restricting the financing of capital assets to long-term debt. Our proposal only requires that special and earmarked taxes designated by law for capital programs be treated as capital receipts in the capital budget. The extent to which capital expenditures are financed through debt is left up to the discretion of the Congress.

Increases Opportunities for Budget Gimmicks

Some observers argue that capital budgeting would lead to more "budget gimmicks." New opportunities would be created for adjusting the numbers to make them appear as though they are meeting certain targets or policy objectives.

In the 1970's, for example, noncapital amounts were incorrectly classified as capital amounts in New York City. The same misclassification could occur at the federal level.

We agree that these are potential problems, but they can be prevented by developing adequate safeguards. As we discussed earlier in our section, "Definition of Capital Assets," definitional standards need to be established and agreed to by all parties in order to distinguish between capital investments and operating expenses. In addition, it is not only crucial to establish good definitional standards, but also to monitor, through audit oversight, how those standards are applied. This would minimize the chances of officials misclassifying operating amounts as capital amounts.

Assumes Financial Base Is Similar to a State or Private Corporation

Others contend that a capital budget would make sense only if the federal government were like a state or private corporation. When compared to the federal government, states and private corporations have relatively limited resources and responsibilities, thus leading them to limit their borrowings to areas that seem guaranteed to preserve or enhance their financial condition over several years. States with limited financial bases (narrow tax bases and no power to create money) are conscious of their bond ratings and the need to borrow mainly in areas that produce tangible, long-term benefits (capital). Likewise, private corporations prefer to borrow mainly for capital expansion and modernization. Such borrowings are collateralized and can be liquidated by asset sales or through increased profits over several years.

According to this line of argument, these factors do not apply to the federal government.

Its ability to print money and raise taxes provide it a virtually unlimited financial base, unlike states and private corporations. Thus, there is no reason to distinguish between borrowing for capital and noncapital purposes. In any case, these observers argue, it is wrong to think of many of the government's capital investments as producing long-term benefits for the government or having asset sale value in the market place. This is particularly true of defense items, which absorb operation and maintenance costs over several years and do not generate additional revenues. Furthermore, who would buy a missile silo or ammunition storage facility?

We do not agree with these criticisms. The federal government has large financial resources; however, they are not unlimited. We believe that the federal government must still be concerned about the composition of its debt. During the past few years, the level of debt and annual deficits incurred by the United States and other countries has had a substantial impact on financial markets, interest rates, and these countries' ability to attract domestic and foreign investors. It is important for the federal government to exercise stewardship over its financial resources and exercise care in incurring debt. This stewardship is especially important when domestic and foreign financial markets are unsettled by the government's deficits and debt levels.

We agree that the federal government is not like a private corporation, and it should not be treated as one. Our proposal treats the federal government as what it is--a governmental entity. However, just like private corporations, it is important that the federal government provide financial data on both the debt it is incurring and the assets it is acquiring. By clearly distinguishing between debt incurred for operating versus capital expenditures, private corporations have a clear picture of their current financial position. However, the federal government fails to make this distinction and, in failing to do so, the government ends up with federal budgetary data which does not accurately reflect its current financial condition.

A capital budget would provide a clear distinction at the federal level, just as is now provided by most states and private corporations, between debt incurred for capital investments and debt incurred for current activities. This would prompt decisionmakers to consider the trade-offs between incurring debt to finance current expenses versus debt to finance long-term investment needs. This extended time horizon of budget analysis would reduce somewhat the likelihood of decisions with adverse long-term financial consequences.

Adds Complexity to the Budget Process

Finally, it is said that a capital budget would significantly complicate an already complex and time-consuming budget process. This concern stems from the perception that a capital budget would be completely separate from the operating budget. However, if capital budgeting is implemented in the form we propose--and within the unified budget--then this would not be true.

This does not mean that some increase in complexity is not associated with our proposal. However, it is important to recognize that the budget, properly presented, consists of more than just one deficit number. We believe that the value and importance of the additional information provided under our proposal will more than outweigh any modest increases in complexity. Indeed, the new structure should help simplify budget debate and actions by providing a more meaningful breakdown of the budget's total.

Within the executive branch, our proposal would require changes in how information is presented in the President's budget. Information currently provided by agency, appropriation account, and budget function would continue to be reported. However, there would be a clear identification of the appropriation accounts, or parts of accounts, that are for capital purposes, and there would be new summary tables showing the capital and operating breakdowns within each agency and budget function.

On the congressional side, the main effect would be on the budget resolutions and related actions. Current functional categories--defense, housing, etc.--would be broken down into capital and noncapital sections, and the resolutions' aggregate totals would have capital and noncapital components. This treatment also could carry through to affect the way budget deficit targets are set in legislation such as the Gramm-Rudman-Hollings legislation. As we discussed in our section, "Provide a Sounder Basis for Deficit Reduction," our proposal would require that the Balanced Budget and Emergency Control Act of 1985 be amended to establish targets for capital financing, the operating deficit, and total financing requirements from the public.

APPENDIX I: A NEW STRUCTURE FOR THE FEDERAL BUDGET-- SAMPLE FORMATS

GAO's capital budgeting proposal is designed to restructure the way information is currently presented in the President's budget and budget appendix so as to distinguish between operating and capital activities. In the budget, this restructuring would result in the reporting of operating and capital amounts in the budget's summary tables and listing of accounts. In the budget appendix, the account-level "program and financing" tables would be expanded to display, within each appropriation account, the program and financing amounts for operating and capital activities.

Tables I.1 through I.3 present sample formats of how some restructured budget and budget appendix tables would look. These tables are presented for discussion purposes only to show how the current budget tables and budget appendix tables would be affected by the restructuring. The numbers in the tables are approximations for illustrative purposes only. Appendix II describes how we developed the numbers.

Budget Summary Tables

The President's budget currently contains summary tables showing governmentwide receipts, outlays, and the resulting surplus or deficit. Other summary tables provide data in total and by agency and function on budget authority and outlays. Under our proposal, several of these budget summary tables would be revised to include information on both operating and capital activities.

The restructured budget format would present the lead summary tables in terms of an operating budget, a capital budget, and a unified budget total, as illustrated in table I.1 and (in greater detail) table I.2.

Table I.1: **Restructured Unified Budget Summary Table**

	Actual 1987	Estimate 1988	Estimate 1989
	----(dollars in billions)----		
Operating Budget			
Operating revenues	$ 957.8	$1020.3	$1085.0
Operating expenses	1004.0	1071.4	1117.7
Cash surplus/deficit(-)	-46.2	-51.1	-32.7
Asset consumption charge	-50.0	-51.3	-52.0
Operating surplus/deficit(-)	-96.2	-102.4	-84.7
Capital Budget			
Capital revenues	$ 56.7	$ 61.6	$ 50.1
Capital investments	160.9	157.2	146.9
Capital financing requirements	-104.2	-95.6	-96.8
Asset consumption charge	50.0	51.3	52.0
Net capital financing requirements	-54.2	-44.3	-44.8
Total financing requirements from the public	$-150.4	$-146.7	$-129.5

Table I.2: New Budget Summary Table

	Actual 1987	Estimate 1988	Estimate 1989
	----(dollars in billions)----		
Operating Budget			
Operating revenues			
General taxes	$ 498.4	$ 521.8	$ 552.7
Payroll and other earmarked taxes	304.6	333.1	356.1
Fee, royalties, and other earnings	154.8	165.4	176.2
Total operating revenues	957.8	1020.3	1085.0
Operating expenses			
Civil functions	643.0	696.5	729.9
Defense functions	199.7	205.1	214.4
Interest on debt	160.3	168.5	171.9
Credit subsidy costs	1.0	1.3	1.5
Total operating expenses	1004.0	1071.4	1117.7
Cash surplus/deficit(-)	-46.2	-51.1	-32.7
Asset consumption charge	-50.0	-51.3	-52.0
Operating surplus/deficit(-)	-96.2	-102.4	-84.7
Capital Budget			
Capital revenues			
Loan receipts	$ 37.6	$ 40.9	$ 28.9
Other capital receipts	19.1	20.7	21.2
Total capital revenues	56.7	61.6	50.1
Capital investments			
Financial asset disbursements, less subsidy costs	34.2	33.2	26.2
Physical asset additions	126.7	124.0	120.7
Total capital investments	160.9	157.2	146.9
Capital financing requirements	-104.2	-95.6	-96.8
Asset consumption charge	50.0	51.3	52.0
Net capital financing requirements	-54.2	-44.3	-44.8
Total financing requirements from the public	$-150.4	$-146.7	$-129.5

The operating budget would consist of operating revenues, operating expenses, and operating surplus/deficit(-) as described below.

--Operating revenues would include receipts not earmarked by law for capital programs, including amounts not now treated as receipts, but rather as offsets to outlays for calculating reported (net) outlays. The intent is to add clarity by reporting all revenues on the revenue side of the budget.

--Operating expenses would include the gross outlays to the public from noncapital activities.

--Cash surplus/deficit(-) would be the difference between operating revenues and expenses.

--Asset consumption charge would represent the year's depreciation of physical capital assets. It is a noncash expense.

--Operating surplus/deficit(-) would be the total of the cash surplus/deficit and capital consumption charge amounts.

The capital budget would consist of capital revenues, capital investments, and capital financing requirements, as described below.

--Capital revenues would be the receipts dedicated by law to capital assets, both physical and financial. These would include, for example, gasoline excise tax revenues earmarked for the Highway Trust Fund and repayments of principal on federal loans extended to farmers, businessmen, and others. Capital revenues would also include the interest revenues from the dedicated capital trust funds.

--Capital investments would include the outlays for physical and financial assets.

--Capital financing requirements would represent the amount that capital investments exceed capital revenues.

--<u>Asset consumption charge</u> would represent an adjustment made against the capital financing requirements amount to reflect the "financing" of expenditures for physical assets by the current year's capital consumption charge.

--<u>Net capital financing requirements</u> from the public would represent the amount by which capital financing requirements exceed the capital consumption charge.

--<u>Total financing requirements from the public</u> would represent the total of the operating budget's operating surplus/deficit and the capital budget's net capital financing requirements.

Under our proposal, there would be other budget summary tables showing operating and capital amounts. These tables would report, by agency and budget function, operating and capital breakdowns of information on budget authority and outlays. This would essentially involve reformatting existing budget summary tables. In addition, our proposal would add a new summary table to show the noncash outlays for capital consumption charges by budget function and subfunction.

Budget by Agency and Account

The President's budget currently reports, within the "budget by agency and account" tables, information on budget authority and outlays in total, by agency, by fund type, and by appropriation account within an agency. Our proposal would require that this information continue to be reported for each agency and appropriation account as well as for the overall budget total, but subtotals would be reported within each of these levels for operating and capital amounts. The operating data would include amounts for credit subsidy costs.

Program and Financing Table

The appropriation accounts represent the building blocks for the entire federal budget. Detailed information for each individual appropriation account is reported in a "program and financing" table. These tables are found in the budget appendix and provide the most detailed level of program information in the budget. If the capital budgeting proposal presented here is going to lead to substantial improvements in financial management, then it must, as part of the annual appropriation process, focus congressional attention on the allocation of resources between operating and capital activities at the federal level.

Under our capital budgeting proposal, there would be a separate account or sub-account for each operating program and similar treatment for each capital program. When it is desirable to keep the operating and capital parts of a single program intact, these amounts could be reported first in an overall program and financing table, and then in separate, back-to-back, program and financing tables. This format would provide the appropriation committees with information, in one section of the budget appendix, on total program amounts broken down by operating and capital activities. Table I.3 illustrates a restructured account having operating and capital components. It is important to note that this table's data would be reported in summary form and by operating and capital activities. Such reporting will facilitate the usefulness and accessibility of the budget data.

Under our restructured program and financing table, both the summary and operating components would have a line for an asset consumption charge--a noncash item. While the asset consumption charge does not represent cash disbursements to the public, it does represent an operating cost and the amount made available to the capital budget to finance capital investments, and it is, therefore, reported in the program and financing tables. As table I.3 illustrates, it is reported as an activity which does not require an increase in obligations and cash outlays. The asset consumption charge could be treated as a form of budget authority.

Finally, table I.3 reports offsetting collections from nonfederal sources differently than in the current budget. Under current reporting practices, offsetting collections from nonfederal sources, as well as those from other federal funds, are netted against an account's total obligations and outlays for purposes of calculating reported outlays. The result is that the outlay amounts reported for an individual appropriation account are net of offsetting collections from both federal and nonfederal sources.

GAO has long taken the position that it is appropriate to report outlays net of offsetting collections from federal sources. This is one way of preventing the double-counting of the same disbursements. However, we have recommended against the netting of offsetting collections from nonfederal sources against total outlays for calculating reported outlays on the grounds that the resulting net outlay understates the true value of federal outlays to the public.

In table I.3, offsetting collections, for purposes of calculating budget authority, are treated just as they are now--as a source of funding. Thus, the requested amount of budget authority is reduced by offsetting collections from both federal and nonfederal sources. We believe this is how they should be treated because all offsetting collections represent a source of revenues to a particular program.

For purposes of calculating reported outlays, however, offsetting collections from nonfederal sources, under our proposal, are not netted against outlays. This is reflected in table I.3 under the section "Relation of Obligations to Outlays." To compute the 1987 "obligations incurred, net federal funds" entry ($53.2), only the offsetting collections from the federal funds figure ($-18.4) has been netted against total obligations ($71.6).

Our approach results in a 1987 reported outlay figure ($67.0) which is larger than what would be reported under current practices by the amount of offsetting collections from the nonfederal sources ($10.3). By treating offsetting collections in this manner, outlay numbers reported throughout the budget would be on a gross--not a net--basis. Our approach, however, would not change the reported surplus or deficit because the offsetting collections from nonfederal sources would be added to those amounts currently reported as budget receipts. The tables and numbers in this exposure draft were developed using our gross basis.

Table I.3: Restructured Program and Financing Table

ACCOUNT A - SUMMARY
36-0844-403

	Actual 1987	Estimate 1988	Estimate 1989
	-----(dollars in millions)----		
PROGRAM BY ACTIVITY:			
Activity A	$ 25.7	$ 27.1	$ 33.9
Activity B	45.9	49.2	47.3
Total obligations	71.6	76.3	81.2
FINANCING:			
Offsetting collections			
Federal funds	-18.4	-16.3	-17.9
Nonfederal sources	-10.3	-11.2	-10.7
Unobligated balances			
Start of year	-11.3	-17.6	-18.2
End of year	17.6	18.2	17.4
Budget authority	$ 49.2	$ 49.4	$ 51.6
RELATION OF OBLIGATIONS TO OUTLAYS:			
Obligations incurred, net federal funds	$ 53.2	$ 60.0	$ 63.3
Obligated balance, start of year	102.8	89.0	91.2
Obligated balance, end of year	-89.0	-91.2	-86.3
Outlays	$ 67.0	$ 57.8	$ 68.2
Capital consumption charge	$ 4.6	$ 4.8	$ 5.0

ACCOUNT A - OPERATING PROGRAM
36-0844-403-OP

	Actual 1987	Estimate 1988	Estimate 1989
	-----(dollars in millions)----		
PROGRAM BY ACTIVITY:			
Activity A	$ 5.2	$ 5.7	$ 11.5
Activity B	20.4	22.6	19.7
Total obligations	25.6	28.3	31.2
FINANCING:			
Offsetting collections			
Federal funds	-13.8	-11.5	-12.9
Nonfederal sources	-5.1	-7.0	-5.9
Unobligated balance			
Start of year	-3.1	-8.2	-11.0
End of year	8.2	11.0	9.3
Budget authority	$ 11.8	$ 12.6	$ 10.7
RELATION OF OBLIGATIONS TO OUTLAYS:			
Obligations incurred, net federal funds	$ 11.8	$ 16.8	$ 18.3
Obligation balance, start of year	34.0	8.4	8.1
Obligation balance, end of year	-8.4	-8.1	-18.1
Outlays	$37.4	$ 17.1	$ 8.3
Capital consumption charge	$ 4.6	$ 4.8	$ 5.0

ACCOUNT A - CAPITAL PROGRAM
36-0844-403-CP

	Actual 1987	Estimate 1988	Estimate 1989
	-----(dollars in millions)----		
PROGRAM BY ACTIVITY:			
Activity A	$ 20.5	$ 21.4	$ 22.4
Activity B	25.5	26.6	27.6
Total obligations	46.0	48.0	50.0
FINANCING:			
Offsetting collections			
Federal funds	-4.6	-4.8	-5.0
Nonfederal sources	-5.2	-4.2	-4.8
Unobligated balance			
Start of year	-8.2	-9.4	-7.2
End of year	9.4	7.2	8.1
Budget authority	$ 37.4	$ 36.8	$ 41.1
RELATION OF OBLIGATIONS TO OUTLAYS:			
Obligations incurred, net federal funds	$ 41.4	$ 43.2	$ 45.0
Obligation balance, start of year	68.8	80.6	83.1
Obligation balance, end of year	-80.6	-83.1	-68.2
Outlays	$ 29.6	$ 40.7	$ 59.9

APPENDIX II:
METHODOLOGY USED
FOR DEVELOPING
BUDGET NUMBERS

In developing the budget numbers reported throughout this exposure draft, we started with fiscal year 1987 actual amounts and fiscal year 1988 and 1989 estimates as reported in the Budget of the United States Government, Fiscal Year 1989. We reclassified the amounts between an operating budget and a capital budget to reflect our capital budgeting proposal. Tables 2, 3, 4, I.1, and I.2 illustrate our reclassified numbers. For table I.3, we developed the numbers for illustrative purposes only; they are not actual or estimated numbers from the federal budget.

The methodology that we used in reclassifying the numbers is discussed below under two sections--operating budget and capital budget. The explanation is for fiscal year 1987. However, we used the same methodology in developing the fiscal year 1988 and 1989 numbers. All numbers are in billions of dollars.

Operating Budget

Total operating revenues ($957.8) were derived by taking revenues as reported in the budget ($854.2), and then performing the following calculations:

--Adding proprietary receipts from the public ($35.5) and offsetting collections from nonfederal sources ($122.6).

--Subtracting offsetting collections from nonfederal sources for direct loan principal repayments ($37.6). These collections are reported as revenues (loan receipts) in the capital budget.

--Subtracting excise taxes collected ($16.9) for the Highway Trust Fund, Airport and Airway Trust Fund, Hazardous Substance Superfund, and Aquatic Resource Trust Fund (capital trust funds). These taxes are reported as revenues (other capital revenues) in the capital budget.

The total operating revenues were then split into the following categories:

--general taxes ($498.4) include the actual tax revenues credited to Treasury's general fund receipt accounts,

--payroll and other earmarked taxes ($304.6) include the actual tax revenues credited to Treasury's special and trust fund receipt accounts, and

--fees, royalties, and other earning ($154.8) were derived by adding offsetting collections from nonfederal sources ($122.6), proprietary receipts from the public ($35.5), and non-tax revenues credited to Treasury's general, special, and trust fund receipt accounts ($34.3), then subtracting those portions of the offsetting collections from nonfederal sources credited to the capital budget ($37.6).

Total operating expenses ($1,004.0) were derived by taking outlays as reported in the budget ($1,004.6), and then performing the following calculations:

--Adding offsetting collections from nonfederal sources ($122.6) and proprietary receipts from the public ($35.5). The current outlay number reported in the budget is net of these two amounts.

--Adding interest paid to the capital trust funds by the federal government ($2.2). Under the current budget, federal payments to trust funds are treated as intragovernmental transfers, and they are netted against outlays. In our restructured budget, they are treated as amounts flowing from the operating budget to the capital budget. They are treated as outlays in the operating budget and revenues to the capital budget.

--Subtracting capital investment outlays ($160.9). These capital investment outlays are reported in the capital budget.

Total operating expenses were then split into the following categories:

--Defense functions ($199.7) were derived by taking the national defense budget function (050) amount ($282.0) and (1) adding offsetting collections from nonfederal sources ($6.7) and proprietary receipts from the public ($0.8) (the national defense outlay currently reported in the budget is net of these two amounts) and (2) subtracting investment outlays made for national defense ($89.8) (these outlays are included in the capital budget).

--Civil functions ($643.0) are total operating expenses ($1,004.0) minus defense functions ($199.7), interest on debt ($160.3), and credit subsidy costs ($1.0).

--Interest on debt ($160.3) is interest on the public debt ($195.3) minus interest paid to trust funds in budget functions 902 and 903 ($35.0). As is done in the current budget, we also offset interest paid to federal trust funds against interest on the public debt.

--Credit subsidy costs ($1.0) is the estimated subsidy cost reported for the first year by OMB in its recent credit reform proposal package.

--Asset consumption charge ($50.0) represents a rough estimate of the annual depreciation on federal assets. The Department of the Treasury's Consolidated Financial Statements of the United States Government, Fiscal Year 1986--Prototype reported $35 billion for depreciation in 1986 and $40 billion in 1985. OMB reported $22.6 billion for fiscal year 1987. However, the figure was in constant 1982 dollars, and it excluded capital expenditures for defense. We did our own calculation using special Analysis D data. Assuming a 20-year life and using the straight line method of depreciation, we calculated $60.5 billion for depreciation in fiscal year 1987. Given the quality of the data and the assumptions made regarding asset life and depreciation method, we decided that $50.0 billion was a reasonable estimate.

Capital Budget

<u>Capital revenues</u> ($56.7) were derived from the following:

--Loan receipts ($37.6) are offsetting collections from nonfederal sources, which, under current budget practices, are offset against direct loan disbursements to arrive at direct loan outlays. They consist mainly of repayments and prepayments of principal, repayments on defaulted loans, and proceeds from loan asset sales. In reporting only those offsetting collections from nonfederal sources, which are offset against direct loans as capital revenues, we assumed that all remaining offsetting collections from nonfederal sources ($85.0) were related to operating-type activities. However, there could have been cases where these collections came from an activity which we would classify as capital and treat as capital revenues. The current budget, however, does not allow us to make this fine a distinction. Therefore, we chose to report these collections as operating revenues. To the extent our assumption is wrong, we would be underreporting capital revenues.

--Other capital revenues ($19.1) are the excise taxes collected ($16.9) for the Highway Trust Fund, Airport and Airway Trust Fund, Hazardous Substance Superfund, and the Aquatic Resource Trust Fund and the interest paid to the above trust funds by the federal government ($2.2).

<u>Capital investments</u> ($160.9) were derived from the following:

--Financial asset disbursements ($34.2) are direct loan disbursements ($35.2) minus credit subsidy costs ($1.0).

--Physical asset additions ($126.7) are those amounts reported as physical assets in Special Analysis D. In using these numbers, we assumed that they accurately reflected the federal government's annual physical capital investments. However, we had to make two qualifications. First, an ongoing GAO review on the quality of Special Analysis D data has revealed some inconsistencies both within and across agencies as to what is being reported as capital investments versus operating expenditures. Second, OMB's definition of physical investments differs from our capital budgeting definition. OMB uses a 1-year life and no dollar threshold, we use a 2-year life and a $25,000 threshold. Despite these differences, the Special Analysis D data is the only information available on the federal government's physical investments. Thus, we had no choice but to accept the data as the best estimate of the federal government's annual physical capital investments.

The following terms are used in this report.

Appropriation account	A summary account established in the Department of the Treasury for each appropriation and/or fund showing transactions to such accounts.
Asset consumption charge	GAO's capital budgeting proposal uses this term to denote depreciation. See depreciation.
Balanced budget	A budget in which receipts are equal to or greater than outlays.
Brick and mortar	An expression used to describe physical or tangible assets.
Budget deficit	The amount by which the government's budget outlays exceed its budget receipts for a given fiscal year.
Budget function classification	A system of classifying budget resources by function so that budget authority and outlays of budget and off-budget federal entities, loan guarantees, and tax expenditures can be related in terms of national needs being addressed.
Budget gimmick	A expression used to describe various techniques used to circumvent the normal budget process.
Budget receipts	Collections from the public and from payments by participants in certain social insurance programs. These collections consist primarily of tax receipts and social insurance premiums, but also include gifts, receipts from court fines, certain licenses, and deposits of earnings by the Federal Reserve System. Budget receipts are compared with budget outlays in calculating the budget surplus or deficit.
Budget surplus	The amount by which the government's budget receipts exceed its budget outlays for a given fiscal year.

Capital assets GAO's capital budgeting proposal defines capital assets, or capital investments, as physical assets and financial assets, but it excludes consumable inventories. See capital investments, financial assets, and physical assets.

Capital budget In GAO's capital budgeting proposal, the capital budget of the unified budget segregates capital revenues and capital investments from the operating budget's revenues and expenses. Capital revenues and capital investments are excluded from calculations of the operating budget's surplus or deficit, but the operating budget is charged for depreciation.

Capital financing requirements In GAO's capital budgeting proposal, capital financing requirements represent the amount by which capital investments exceed capital revenues. See capital investments and capital revenues.

Capital investments In GAO's capital budgeting proposal, capital investments include physical assets and financial assets, but they exclude consumable inventories. See physical assets and financial assets.

Capital revenues In GAO's capital budgeting proposal, this term includes taxes, user fees, and similar amounts which are earmarked by law to finance physical and financial assets. It also includes most loan principal repayments.

Civil function In GAO's capital budgeting proposal, the civil function amounts shown in the tables include the total of all budget functions except national defense (050) and interest on debt.

Countercyclical Actions aimed at smoothing out swings in economic policy. Countercyclical actions may take the form of monetary and fiscal policy.

Credit subsidy costs In GAO's capital budgeting proposal, credit subsidy costs--such as interest and default costs--are the losses incurred by the government as a result of its direct and guaranteed loan programs.

Defense function In GAO's capital budgeting proposal, the defense function amount shown in the tables includes the total of the national defense budget function. (050).

Depreciation The systematic and rational allocation of the costs of equipment and buildings (having a life of more than 2 years) over their useful lives. To match costs with related revenues in measuring income or determining the costs of carrying out program activities, it reflects the use of the asset(s) during specific operating periods.

Payroll and Other Earmarked taxes Taxes whose revenues are dedicated by law to specific programs. They include such taxes as social insurance taxes, customs duties, unemployment insurance taxes, and gasoline taxes.

Entitlements Legislation that requires the payment of benefits to any person or unit of government that meets the eligibility requirements established by such law.

Expenditures With respect to the provisions of the Antideficiency Act (31 U.S.C. 665) and the Congressional Budget and Impoundment Control Act of 1974 (Public Law 93-344, 31 U.S.C. 1301, note), the term expenditures has the same definition as outlays. See outlays.

Expenses In GAO's capital budgeting proposal, expenses represent the cost of the federal government's operations. They include outlays for civil functions, defense functions, interest on debt, credit subsidy costs, and capital consumption charges.

Fees, royalties, and other earnings In GAO's capital budgeting proposal, other revenues are amounts received from nonfederal sources that are of a business-type or market-oriented nature. They include both proprietary receipts from the public and offsetting collections from nonfederal sources, such receipts as rents and royalties on the outer continental shelf, sales or rentals of government products and services, military sales, and medicare premiums. Also included are non-tax budget receipts such as court fines, custom duties, gifts etc. See budget receipts.

Financial assets In GAO's capital budgeting proposal, financial assets include any legal instrument such as bonds, notes, and other securities held by the federal government.

General taxes Taxes whose revenues are not dedicated to specific programs. They include individual and corporate income taxes.

Interest on debt In GAO's capital budgeting proposal, the interest on debt shown in the tables represents the interest on the public debt, less interest received by both on-budget and off-budget trust funds.

Net capital financing requirements In GAO's capital budgeting proposal, net capital financing requirements represent the amount by which capital financing requirements exceed capital consumption charge. See capital financing requirements and asset consumption charge.

Off-budget entities The budget authority, outlays, and receipts of certain federal entities that have been excluded from budget totals under provisions of law. Although the fiscal activities of these entities are not reflected in budget totals, that are included in calculations of the deficit made under Gramm-Rudman-Hollings law.

Offsetting collections from nonfederal sources Collections from transactions with the public that are of a business-type or market-oriented nature. Under current budget procedures, they are offset against both budget authority and outlays at the appropriation account level. In GAO's capital budgeting proposal, these collections are counted as either capital revenues in the capital budget or other revenues in the operating budget.

Operating budget In GAO's capital budgeting proposal, the operating budget consists of all revenues and operating expenses for programs and activities that are not classified as capital investments.

Outlays Payments made (through the issuance of checks, disbursement of cash, or electronic funds transfer) to liquidate obligations.

Physical assets In GAO's capital budgeting proposal, physical assets are assets with form and substance (tangible), whose ownership resides or will reside in the public domain, which typically provide services or benefits, including for national defense and security, for more than 2 years, and which cost $25,000 or more.

Proprietary receipts from the public Collections from the public as the result of business-type or market-oriented activities. Under current budget procedures, they are offset against budget authority and outlays at the agency and functional total level. In GAO's capital budgeting proposal, these collections are counted as other revenues in the operating budget.

Revenues In GAO's capital budgeting proposal, revenues are collections received (by cash, check, or electronic funds transfer) for public use. They include general taxes, earmarked taxes, and other revenues.

Scorekeeping Procedures for tracking and reporting on the status of budgetary actions, including tabulations and reports on actions affecting budget authority, receipts, outlays, the surplus or deficit, and the public debt limit.

Sequestration The cancellation (or withholding) of budgetary resources pursuant to Gramm-Rudman-Hollings. Once cancelled, sequestered funds are no longer available for obligation or expenditure.

Total financing requirements from the public In GAO's capital budgeting proposal, total financing requirements from the public represents the total of the operating budget's operating surplus/deficit and the capital budget's net capital financing requirements.

Unified budget The present form of the federal government's budget in which receipts and outlays from both federal funds and trust funds are consolidated.

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