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Budget Structure

Providing an Investment Focus
in the Federal Budget

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Mr. Chairman and Members of the Committee and Subcommittee:

I am pleased to be here today to discuss how the budget process could be used to bring about a greater focus on long-term economic growth. The nation's economic future depends in large part upon today's budget and investment decisions. However, trends in economic investment have not been encouraging. First, the pool of net national savings available to finance investment has been shrinking since the 1970s, from an average during that decade of 7.8 percent to only 2.3 percent of net national product in the first half of the 1990s. Second, the level of gross private domestic investment as a percent of gross domestic product (GDP) has fallen since the 1970s, from an annual average of 17.0 percent in the 1970s to an average of 14.0 percent for 1990-1994. And third, many of our trading partners have significantly higher levels of investment. In 1993, the United States ranked 19th in gross fixed capital formation among the 25 nations in the Organization for Economic Cooperation and Development and second to last among G-7 nations. Unless these trends are reversed, future generations will face slower growth in their living standards.

One of the most important federal influences on investment is the budget deficit, which absorbs large pools of private savings that would otherwise be available for domestic investment. The surest way of increasing national savings and investment is to reduce the huge levels of federal dissaving by eliminating the deficit. In a report issued in April 1995,¹ we stated that moving from a deficit to a balanced budget is essential to improving national savings, private investment, and long-term economic growth. In that report, we indicated that achieving a balanced budget by 2002, as contemplated in the budget resolution conference agreement, would increase per capita GDP in 2025 by an estimated 34 percent compared to a "no action" fiscal policy path.

Not only is the overall level of the deficit important to future economic growth, but the type of spending also matters. Federal spending can be divided into two categories based on its economic effect—consumption spending having a short-term economic impact and investment spending intended to have a positive effect on long-term private sector economic growth. Well-chosen federal investment programs can promote an environment conducive to investment and long-term growth in ways that the market alone cannot provide. Programs supporting efficient public infrastructure, an educated workforce, and expanded technological innovation can make important contributions to private sector growth. In the process of cutting the deficit to increase private investment,

¹The Deficit and the Economy: An Update of Long-Term Simulations (GAO/AIMD/OCE-95-119, April 26, 1995). See also Budget Policy: Prompt Action Necessary To Avert Long-Term Damage to the Economy (GAO/OCG-92-2, June 5, 1992) and Budget Policy: Long-Term Implications of the Deficit (GAO/T-OCG-93-6).

the Congress can strive to ensure that a greater share of the remaining federal spending is focused on effective long-term investment programs.

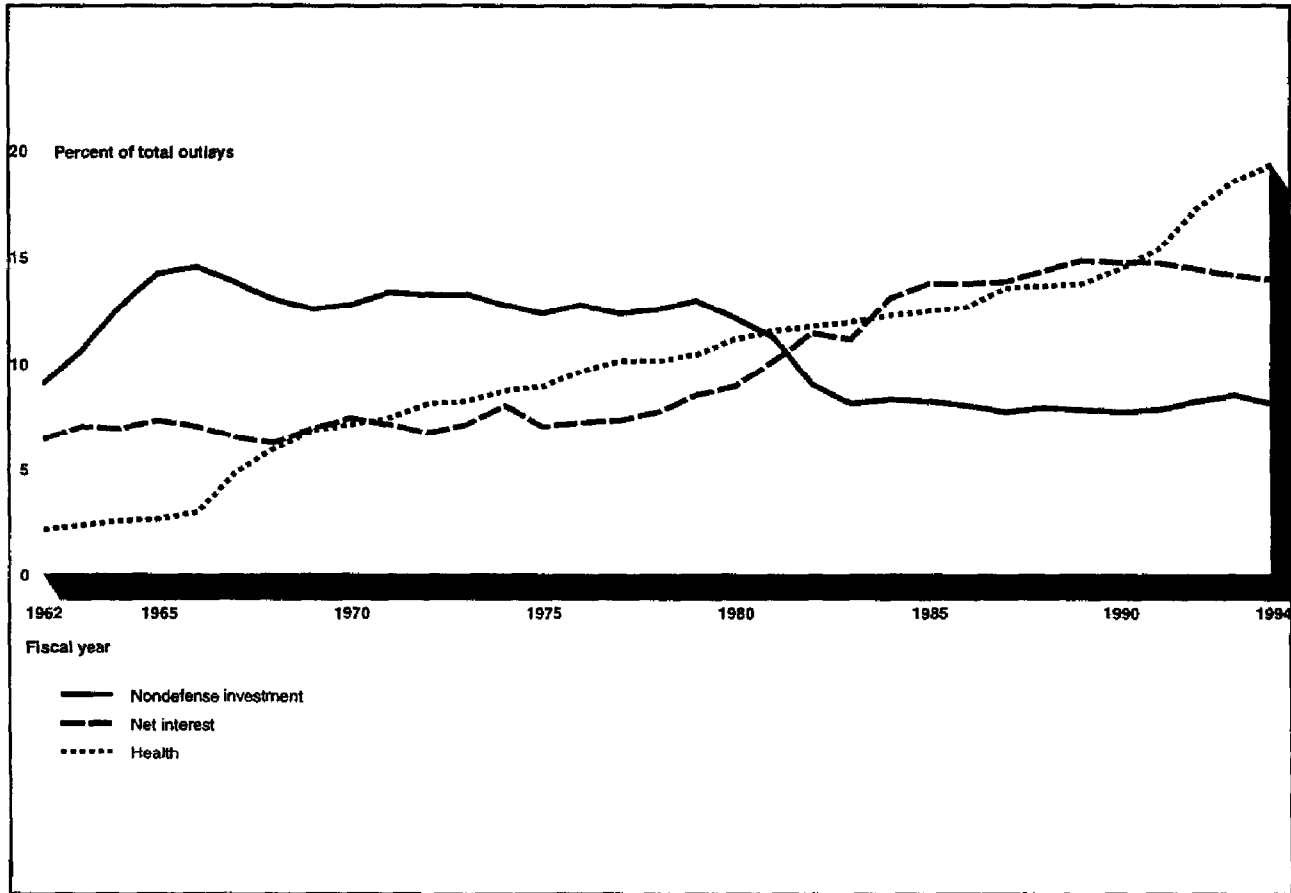
The current budget process does not prompt the executive branch or the Congress to make explicit decisions about the appropriate mix of spending for current consumption and spending for long-term investment. Appropriations subcommittees provide funding by department and agency in appropriation accounts that do not distinguish between investment and consumption spending. The budget process tends to view a dollar spent on short-term consumption the same as a dollar spent on capital investment. However, some have argued that the budget process actually favors consumption over investment because the cost of both must be scored up-front even though most of the benefits from investment programs accrue in the future.

Alternative budget presentations which accompany the President's budgets provide some supplemental information to congressional decisionmakers but are not part of the formal budget process. These presentations have had little effect on the level of investment undertaken by the government. They are not used in executive budget formulation but are merely assembled after executive budget decisions have been made. Nor have they been part of the congressional budget process.

The level of investment spending as a proportion of total government spending has declined significantly over the last few decades since its peak in 1966. Part of this trend may be explained by the rise in interest payments and consumption spending for federal health programs. As shown in figure 1, in 1966, nondefense investment as defined by the Office of Management and Budget (OMB)² made up 14.5 percent of total outlays. Although there were modest ups and downs over the intervening years, by 1994 nondefense investment had fallen to only 8.1 percent of federal outlays. During the same period, interest payments on the federal debt had doubled from 7.0 percent to 13.9 percent of outlays, and the share of total outlays devoted to health care had grown over sixfold from 2.9 percent to 19.3 percent. As a percentage of GDP as well, federal nondefense investment has fallen from 2.7 percent in 1980 to 1.8 percent in 1994. It is worthwhile to note that the investment trends we see here are not a result of any explicit strategy or set of national priorities. Instead they represent the accumulated results of many individual budget decisions regarding hundreds of programs.

²OMB's definition of investment includes not only human capital activities and research and development, but also all physical investment that yields benefits largely in the future. Unlike GAO's categorization of investment in this testimony, it includes spending for such activities as construction of federal office buildings and acquisition of park lands.

Figure 1: Federal Nondefense Investment, Health, and Net Interest Outlays



Source: Budget of the U.S. Government.

RECOGNIZING INVESTMENT IN THE FEDERAL BUDGET

Currently, the federal unified budget focuses policymakers' attention on the impact of federal cash borrowing in the economy. Such a focus is critical to understanding how federal budgetary decisions in the aggregate affect the business cycle in the short term as well as understanding potential consequences for longer-term economic output. However, the unified budget does not differentiate between spending that is intended to produce long-term benefits and consumption spending that is primarily for short-term benefit.

To address this issue, proposals have frequently been made to create a capital budget that separates revenues and outlays for long-lived physical assets from the rest of the budget (that is, the operating budget). Many proposals for federal capital budgeting

go beyond being a mere display of capital purchases; they typically include an associated depreciation component for capital assets which is charged to the annual operating budget. In addition, they commonly envision special budgetary treatment for capital by requiring balanced operating budgets while allowing deficit financing of capital.

Capital budgeting of this nature presents several problems however. First, many of the assets that we would define as investment, including research and development and human capital activities, do not lend themselves to depreciation. In previous work,³ we found virtually no sources that identified methods by which these types of investments could reasonably be depreciated for federal accounting or budgeting purposes. Even for physical capital, many of the assets that are important to the future economic growth of the nation, such as highways and other public infrastructure, are generally not owned by the federal government and are, therefore, not appropriate for the federal government to depreciate; no organization we know of depreciates assets it does not own or control. Second, depreciation--even of physical assets--would undermine budgetary control of expenditures by not recognizing the full cost of an asset at the time a decision is made to acquire it. Third, permitting deficit financing of investment may conflict with the overarching goal of increasing national investment by eliminating the deficit.

Thus, a traditional capital budget would not be a workable approach to recognizing the unique role of the federal government in promoting long-term investment. Instead, we believe that incorporating an investment component within the discretionary caps would be an appropriate and practical approach to supplement the unified budget's focus on macroeconomic issues. An investment component would direct attention to the trade-offs between consumption and investment but within the overall fiscal discipline established by the caps. Policymakers would have a new tool for setting priorities between the short-term and the long-term and an added impetus to evaluate investments against each other in trying to select the most effective investment.

If an investment component within the budget is to be implemented, it is important to decide what activities should be regarded as investment. There are many possible definitions. The definition used for budgetary purposes depends on the purpose that an investment component is expected to serve. Because we believe that the need to enhance the nation's long-term productive capacity is among the most pressing needs facing the country today, we have suggested that investment be defined as federal

³See Budget Issues: Incorporating an Investment Component in the Federal Budget (GAO/AIMD-94-40, November 9, 1993) and Budget Issues: The Role of Depreciation in Budgeting for Certain Federal Investments (GAO/AIMD-95-34, February 1995).

spending, either direct or through grants, that is specifically intended to enhance the private sector's long-term productivity.⁴

Under this concept, the investment component would include grants for physical infrastructure, spending for research and development, and human capital activities, such as education and training, which are directly intended to increase private sector productivity. It could also include spending for some federally owned physical capital that is viewed as having a direct bearing on long-term economic growth, such as water projects, air traffic control systems, and construction of research and development facilities. Federal spending of this type, when economically justified, tends to lower the private sector cost of producing and delivering goods and services, and thereby increases the future productive capacity of the economy.

Our concept of investment spending would not include spending on other federally owned physical assets, such as federal office buildings and military weapons systems, which are not specifically intended to promote long-term private sector economic growth but instead are primarily used in federal operations or to carry out unique federal missions. Such expenditures may improve the efficiency of government agency operations or create jobs in the short term in particular regions of the country; however, they do not have the direct purpose of raising private sector productivity.

Mr. Chairman, we recognize that the Congress may choose to define this category in other ways which may highlight other spending that has long-term benefits. For example, one category might include federal spending on physical infrastructure, whether through grants or direct federal programs. Such spending can yield long-term benefits to the operations and efficiency of the economy and considering them apart from other consumption spending may be useful.

However it is defined, a separate investment component could be beneficial, as long as it adequately encompasses spending that reflects the long-term interests of the federal government. An excessively narrow definition might lead policymakers to overlook the long-term benefits of programs that are excluded and force them to compete with other consumption programs for funding. However, an excessively broad definition undermines the value of creating the distinction in the first place because it fails to provide policymakers with an adequate focus. Striking the correct balance is crucial for making the investment component a useful policy tool.

⁴See Federal Budget: Choosing Public Investment Programs (GAO/AIMD-93-25, July 23, 1993) and Transition Series: Investment (GAO/OCG-93-2TR, December 1992).

IMPLEMENTING AN INVESTMENT FOCUS IN THE BUDGET

Defining investment is only one of a series of issues to be considered in establishing an investment focus in the budget process. A mechanism for focusing decision-making on the appropriate allocation of resources between consumption and investment would also need to be established. Mr. Chairman, we believe that investment spending can best be considered formally in the budget process by establishing targets for investment within the discretionary spending caps--a framework first established in the Budget Enforcement Act of 1990 (BEA). Since we believe that the primary budgetary objective should be to reduce the deficit, a declining unified budget deficit path should be established first. Then, within that path, a target for investment spending could be established to shift the spending mix toward relatively more investment. One approach would be for the Congress to decide on an investment target in the budget resolution which would then be observed in subsequent funding decisions by congressional committees. These committees could evaluate individual investment programs to determine which competing investments should be selected within the overall target. Our previous work provides an example of the kind of framework and questions policymakers can use in evaluating various projects.⁵

Setting an investment target would require policymakers to evaluate the current level of investment spending and would encourage a conscious decision about an appropriate overall level of investment. Given the way the budget process now operates, however, a number of implementation questions would be raised by deciding to set a target for investment. These questions include the following.

- How would this target be defined and should it specify accounts or portions of accounts to be included?
- How can a decision be made on an appropriate level of investment and how can we be assured that only worthwhile projects are funded?
- Within the current budget enforcement framework, would separate floors as well as caps be necessary to assure a minimum level of investment?
- Would trade-offs be allowed between discretionary spending for investment and mandatory programs that support consumption to permit the Congress to shift resources from consumption to investment?
- How would investment and noninvestment activities be allocated to congressional committees?

⁵Federal Budget: Choosing Public Investment Programs (GAO/AIMD-93-25, July 23, 1993).

These are important and difficult questions and the answers could change over time. Nevertheless, we believe workable answers and procedures can be found. Defining investment can prompt controversy, but the temptation to expand this category would be less than under a traditional capital budget that allows for deficit financing of investment. Once agreement is reached, the Congress can turn its attention to developing enforcement and oversight mechanisms that will preserve the integrity and effectiveness of the investment targets.

I should make clear that it would be difficult for the Congress and the administration to shift the portion of federal spending devoted to investment without some increased flexibility to make trade-offs between the discretionary and the pay-as-you-go (PAYGO) portions of the budget. Federal spending on OMB-defined investment already totals roughly half of all domestic discretionary spending. However, BEA does not allow the flexibility to offset increases in discretionary spending for investment with savings on the PAYGO side of the budget. The Congress would need to address how to achieve these trade-offs without destroying the existing controls in BEA.

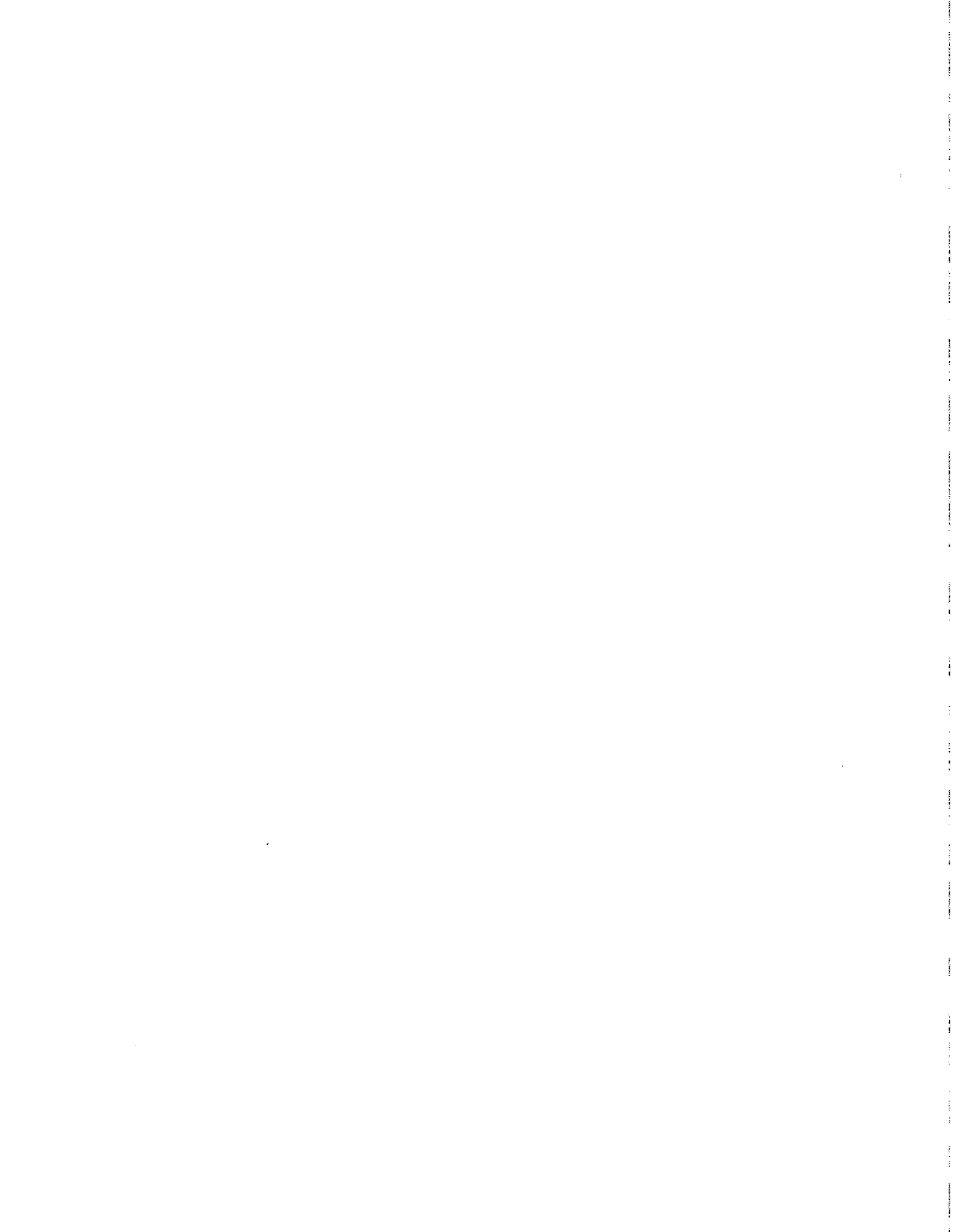
CONCLUSION

Mr. Chairman, we share your concern about investment and long-term economic growth in the United States and the role that budget decisions play in promoting growth. The most important contributions the federal government can make to a healthy and growing economy are (1) reducing the federal deficit and (2) making wise decisions on investments that will foster long-term economic growth. However, the current budget structure does not facilitate decision-making on activities intended to promote long-term economic growth.

We believe that the creation of an investment component in the federal budget could help the Congress and the President make more informed decisions regarding federal spending on consumption versus investments for the future. Separate targets for investment spending within the existing discretionary spending caps could be established to ensure that investment is considered formally in the budget process. Recognizing the importance of the deficit to long-term economic growth, such a component could be established within the context of a unified budget framework that leads to a balanced unified budget over an appropriate period. Although there are a number of implementation issues that would need to be resolved, we believe that working solutions can be found, and we would be pleased to assist the Committee on these matters.

This concludes my statement. I would be happy to answer questions that you or Members of the Committee may have at this time.

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