United States General Accounting Office

GAO

Fact Sheet for the Honorable William F. Clinger, Jr., House of Representatives

March 1989

BUDGET ISSUES

Capital Budget Information for the Fiscal Year 1990 Budget Resolution

GAO

United States
General Accounting Office
Washington, D.C. 20548

Accounting and Financial
Management Division

B-223368

March 31, 1989

The Honorable William F. Clinger, Jr.
House of Representatives

Dear Mr. Clinger:

This report responds to your February 1, 1989, request for our assistance in developing a capital budget proposal which you could pursue as part of the Budget Resolution for Fiscal Year 1990. Specifically, you requested that we provide language for the budget resolution which would include a fiscal year 1988 summary-level budget table with capital and operating components and a fiscal year 1988 outlay table with capital and operating components by budget function. In addition, you requested explanatory material on capital budgeting for possible inclusion in the House Budget Committee report.

Appendix I provides the language for the budget resolution and the accompanying two capital budget tables. Appendix II provides explanatory material on capital budgeting for the budget resolution's committee report. Most of the information for appendix II was obtained from our July 1988 exposure draft, Budget Issues: Capital Budgeting for the Federal Government (GAO/AFMD-88-44). Appendix III discusses the methodology used for developing the two capital budget tables, and appendix IV lists the major GAO contributors to this report.

As agreed with your office, unless you publicly announce the contents of this report earlier, we will not distribute it until 30 days from the date of this report. At that time, we will send copies to the Director, Office of Management and Budget; the Director, Congressional Budget Office; the Secretary of the Treasury; the Chairman, Council of Economic Advisors; and other interested parties.

I hope this information will be helpful to you in your efforts to incorporate the capital budget concept into the budget resolution. Please let us know if we can be of further assistance.

Sincerely yours,

James L. Kirkman

James L. Kirkman
Director, Budget Issues

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ABBREVIATION

OMB Office of Management and Budget

LANGUAGE FOR BUDGET RESOLUTION ON CAPITAL BUDGETING

Section____. Capital Budget

For purposes of information, the Congress provides the following tables which illustrate a restructured unified budget with operating and capital components for fiscal year 1988.

(a) Top-level summary (outlays in billions of dollars)

	Actual 1988
Operating Budget	
Operating revenues	
General taxes	$ 519.5
Payroll and other earmarked taxes	335.0
Fees, royalties, and earnings	36.0
Total operating revenues	890.5
Operating expenses	
Civil functions	599.9
Defense functions	219.3
Interest on debt	151.7
Asset consumption charge	50.0
Credit subsidy costs	
Direct loans	1.0
Loan guarantees	8.7
Total operating expenses	1,030.6
Operating surplus/deficit(-)	-140.1
Capital Budget	
Capital revenues	18.4
Capital investments	
Financial asset disbursements, less subsidy costs	-13.8
Physical asset additions	105.9
Total capital investments	92.1
Asset consumption charge	-50.0
Net capital investments	42.1
Capital financing requirements	-23.7
Items Not Affecting Funds	
Loan guarantee subsidy costs	8.7
Unified budget financing requirements	$ -155.1

(b) Functional categories (outlays in millions of dollars)

	Actual 1988
National Defense (050)	
Operating	$ 219,342
Capital	71,019
Total	290,361
International Affairs (150)	
Operating	12,914
Capital	-2,443
Total	10,471
General Science, Space, and Technology (250)	
Operating	8,443
Capital	2,398
Total	10,841
Energy (270)	
Operating	-975
Capital	3,272
Total	2,297
Natural Resources and Environment (300)	
Operating	5,502
Capital	9,104
Total	14,606
Agriculture (350)	
Operating	31,974
Capital	-14,764
Total	17,210
Commerce and Housing (370)	
Operating	15,183
Capital	3,625
Total	18,808
Transportation (400)	
Operating	9,150
Capital	18,122
Total	27,272
Community and Regional Development (450)	
Operating	6,267
Capital	-973
Total	5,294

Education, Training, Employment, and Social Services (500)	
Operating	31,563
Capital	375
Total	31,938
Health (550)	
Operating	44,285
Capital	205
Total	44,490
Medicare (570)	
Operating	78,878
Capital	0
Total	78,878
Income Security (600)	
Operating	129,335
Capital	-3
Total	129,332
Social Security (650)	
Operating	219,341
Capital	0
Total	219,341
Veterans Benefits and Services (700)	
Operating	27,183
Capital	2,245
Total	29,428
Administration of Justice (750)	
Operating	9,069
Capital	154
Total	9,223
General Government (800)	
Operating	8,704
Capital	770
Total	9,474
Central Federal Credit Activities (870)	
Operating	0
Capital	0
Total	0
Net Interest (900)	
Operating	151,748
Capital	0
Total	151,748

Allowances (920)	
Operating	0
Capital	0
Total	0
Undistributed Offsetting Receipts (950)	
Operating	-36,967
Capital	0
Total	-36,967
Summary of Outlays by Budget Function	
Operating	970,939
Capital	93,106
Total	$1,064,045

EXPLANATORY MATERIAL ON CAPITAL BUDGETING FOR HOUSE BUDGET COMMITTEE REPORT

All of us, at one time or another, have heard the term "capital budget." Many state and local governments require them and most major businesses have them. Furthermore, whenever the topic of federal budget reform comes up, capital budgeting always seems to be mentioned. Politically, there is a certain amount of attractiveness in the term itself.

Some fundamental questions, however, must be answered in any serious consideration of a capital budget at the federal level, such as: what is a capital budget and what effect would a federal capital budget have on the current executive budget formulation and implementation process, the congressional budget process and budget priority-setting, the legislative process, and the formulation of national fiscal and monetary policies?

Over the past year or so, various committees of the Congress have been looking at these issues. Their focus has been on learning about capital budgeting. Consistent with this approach, we are providing, for informational purposes only, a restructured unified budget with operating and capital components for fiscal year 1988. It is an attempt to show what a federal capital budget might look like. It should be noted, however, what this is not: it does not require or provide for a capital budget; it does not change or create a law; and it does not include numbers which are binding. It simply discusses and illustrates the conceptual framework of a capital budget for the federal government.

EXPLANATION OF CAPITAL BUDGET SECTION

The restructured budget presented contains 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 "capital financing requirements," less "items not affecting funds," results in a single budget number referred to as "unified budget financing requirements." This total is consistent with the total now defined in the current unified budget as the "surplus/deficit."

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

Most expenses in the operating budget represent cash disbursements to the public. However, two other costs are added that are not cash disbursements to the public. The first cost is an "asset consumption charge," which represents the consumption of the federal government's physical assets; the current unified budget does not include an asset consumption charge. The asset consumption amount is appropriated in the operating budget and credited to the capital budget.

The second nondisbursement amount is the loan guarantee subsidy costs associated with the budget year's new loan guarantees. The subsidy costs--payments, net of recoveries, that the government makes to lenders when federally-insured borrowers default on payments--generally do not represent cash payments in the budget year in which the guarantees are authorized. Most defaults, as well as the subsequent federal payments, occur in future years. Since these costs are not currently reflected in the budget when the loan guarantees are authorized, it appears that these guarantees are cost free.

By including loan guarantee subsidy costs in the operating budget (and requiring appropriations for these amounts when the guarantee authority is approved), the bias in favor of loan guarantees over other forms of federal assistance, such as direct loans or grants, is eliminated.[1] As illustrated, the loan guarantee subsidy costs are subtracted from the total of the operating budget's "operating surplus/deficit" and the capital budget's "capital financing requirements" to reflect the "unified budget financing requirements."

In sum, the operating component of a restructured budget reflects the annual costs of the government's use of its physical capital investments and the subsidy costs associated with the budget year's credit activities, as well as the cash outlays for other current programs and activities. An operating surplus/deficit is reported based on these revenues and expenses.

1The restructured unified budget concept would also require that the prospective subsidy costs associated with the budget year's direct loans be appropriated and included in the operating budget. However, unlike the loan guarantees, these items in the operating budget would be on a cash basis. The appropriated subsidy amounts, combined with the borrowings for the unsubsidized loan portion, would be used to make direct loan payments to federal borrowers. (See Budget Issues: Budgetary Treatment of Federal Credit Programs, GAO/AFMD-89-42, for a further explanation.)

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

Capital investments include disbursements for physical and financial assets. Physical assets include tangible assets which cost $100,000 or more and provide economic benefits for more than 2 years. Financial assets include legal instruments, such as federal direct loans, less any subsidy costs the government incurs in making the loans. The loan balance reported represents 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 cash, it also acquires a financial asset, such as a note receivable, in exchange for a disbursement of cash.

In defining capital assets, investments in "human capital," such as education and training, and investments in research and development are not included. These investments are excluded because of the current difficulties involved in defining and measuring them, such as delineating the boundaries of human capital activities and measuring the future value and useful life of human capital and other intangible investments. This important issue requires further study.

From the capital investments total, the "asset consumption charge" amount is subtracted to produce "net capital investments." This adjustment is made to reflect the means of financing part of the year's costs of acquiring new physical assets. In effect, the asset consumption charge finances part of the replacement costs of physical capital investments. The resulting net capital investments' amount represents the portion of capital investments which is capital expansion rather than simply capital replacement.

The amount by which net capital investments exceed capital revenues is reported as "capital financing requirements." The term "capital financing requirements" is used instead of "capital deficit" in order to reflect the fact that the government is financing a capital asset which has value and will produce in the future a stream of benefits.

THE PROS AND CONS OF A CAPITAL BUDGET

There are proponents for and opponents against the use of a capital budget by the federal government. Each side makes a persuasive case for its position.

The proponents believe the usefulness of the current unified budget would be greatly enhanced if its structure were modified to include a capital budget as well as an operating budget. A capital budget would provide the Congress and the President 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) "unified budget financing requirements." This would eliminate a weakness in the existing law that requires increased borrowings from the public to finance expenditures, even those for capital investments, to be reduced to zero by fiscal year 1993.

In addition to providing a clearer picture of the composition of federal expenditures, a capital budget would correct a budget bias against physical capital investments 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 credit programs. The estimated subsidy costs of direct loans and loan guarantees would be reported in the operating budget. 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. For loan guarantees, there would be no entry in the capital budget because the financial asset backed by the guarantee is not owned by the government.

A capital budget would also help focus public attention on the nation's physical infrastructural 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 asset consumption amounts--and encourage replacement planning.

Finally, the proponents believe that 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.

On the other hand, some opponents of capital budgeting at the federal level 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.

Opponents also 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."

A related concern of opponents 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.

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. Extensive debt financing could put constraints on fiscal policy because acquisition decisions would be made with long-term investment strategies in mind, independent of short-term changes in the economy.

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

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.

Finally, opponents say that a capital budget would significantly complicate an already complex and time-consuming budget process. This concern stems from the belief that the capital budget would be completely separate from the operating budget.

IMPLEMENTING A CAPITAL BUDGET

Restructuring the current unified budget to include capital and operating components would be a major change in the federal budget process. An extensive overhaul cannot be accomplished in a short period of time. Many unanswered questions must be addressed if capital budgeting is ever to be effectively implemented in the federal government, such as defining human capital and research and development investments and determining specific alternatives for financing capital projects.

METHODOLOGY USED FOR DEVELOPING RESTRUCTURED UNIFIED BUDGET NUMBERS

In developing the restructured unified budget numbers illustrated in appendix I, we used the fiscal year 1988 actual amounts as reported in the Budget of the United States Government, Fiscal Year 1990. We reclassified the amounts as operating expenses and capital investments to reflect the restructured unified budget. The methodology that we used in reclassifying the numbers in the two tables in appendix I is discussed below under two sections--top-level summary table and functional category table. All numbers are in billions.

TOP-LEVEL SUMMARY TABLE

Operating Budget

Total operating revenues ($890.5) were derived by taking revenues as reported in the budget ($908.9) and then subtracting excise taxes collected ($18.4) 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 (capital revenues) in the capital budget.

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

-- general taxes ($519.5) include the actual tax revenues credited to the Department of the Treasury's general fund receipt accounts;

-- payroll and other earmarked taxes ($335.0) include the actual tax revenues credited to Treasury's special and trust fund receipt accounts; and

-- fees, royalties, and other earnings ($36.0) were derived by adding nontax revenues credited to Treasury's general, special, and trust fund receipt accounts.

Total operating expenses ($1,030.6) were derived by taking outlays as reported in the budget ($1,064.0) and then performing the following calculations:

-- Adding the estimated annual consumption charge ($50.0) on federal assets. 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. The Office of Management and Budget (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.

-- Adding the estimated direct loan subsidy cost ($1.0) and the loan guarantee subsidy cost ($8.7)--a noncash expense--reported for the first year by OMB in its credit reform proposal, which was included in its fiscal year 1989 budget.

-- Subtracting capital investment outlays ($93.1). These capital investment outlays are reported in the capital budget.

Total operating expenses were then split into the following categories:

-- Civil functions ($599.9) are total operating expenses ($1,030.6) minus defense functions ($219.3), interest on debt ($151.7), asset consumption charge ($50.0), and credit subsidy costs ($9.7).

-- Defense functions ($219.3) are the national defense budget function (050) amount ($290.4) minus the investment outlays made for national defense ($71.1). (These outlays are included in the capital budget.)

-- Interest on debt ($151.7) is interest on the public debt ($214.0) minus interest paid to trust funds in budget functions 902, 903, and 908 ($62.3).

-- Credit subsidy costs ($1.0 for direct loans and $8.7 for loan guarantees) are the estimated subsidy costs reported for the first year by OMB in its credit reform proposal, which was included in its fiscal year 1989 budget.

-- Asset consumption charge ($50.0) represents our estimate of the annual depreciation on federal assets.

Capital Budget

Capital revenues ($18.4) are the excise taxes collected for the Highway Trust Fund, Airport and Airway Trust Fund, Hazardous

Substance Superfund, Aquatic Resource Trust Fund, Inland Waterways Trust Fund, Leaking Underground Storage Trust Fund, and the Post-Closure Liability Trust Fund.

Capital investments ($92.1) were derived by adding the following:

-- Financial asset disbursements ($-13.8), which are direct loan disbursements ($33.7) minus loan receipts ($46.5) and credit subsidy costs for direct loans ($1.0).

-- Physical asset additions ($105.9), which are those amounts reported as physical assets in Special Analysis D ($124.8) minus the amounts allocated for human capital ($3.1), certain defense spending for ammunition and missiles ($14.8), and other physical assets ($1.0). 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, while we use a 2-year life and a $100,000 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.

FUNCTIONAL CATEGORY TABLE

Operating Budget

Total operating expenses ($970.9) were derived by taking outlays by function as reported in the budget ($1,064.0) and then performing the following calculations:

-- Adding to the appropriate budget function that function's amount of total loan receipts ($46.5). Loan receipts are reported in the capital budget.

-- Subtracting from each appropriate budget function its amount of total capital investments ($139.6). Capital investments are reported in the capital budget.

Capital Budget

Total capital investments ($93.1) were derived by taking total capital investments by function ($139.6) and subtracting from the appropriate budget function that function's total loan receipts ($46.5).

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