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Budget Reform for the Federal Government

Statement of
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Committee on Governmental Affairs
United States Senate

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Mr. Chairman and Members of the Committee:

I am pleased to have this opportunity to discuss important budget reform issues with you today. We are all aware of the Congress' frustration with the budget process. My concern is that the Congress' frustration will lead to a proliferation of proposals for mechanistic and possibly unrealistic budget approaches. I would prefer instead to find ways to improve the vitality of the normal legislative process in the budget area. I will outline four kinds of changes today that we think could help in that regard.

First, the congressional budget process needs to be streamlined. Changes are needed to help the Congress complete its budgeting tasks on time and still have adequate time for oversight and other legislative activities. Later in my statement, I will be discussing various proposals for streamlining the process, including biennial budgeting and proposals for strengthening leadership structures and procedures.

Second, the budget itself should be restructured. We are proposing a new "four-part" budget structure which would differentiate between operating expenses and capital investments and between trust and non-trust funds. This new structure would permit decisionmakers to consider the relative merits of spending for short-term consumption versus spending for long-term capital investments, thus providing a more complete and sounder basis for deficit reduction actions. Such a structure would also "unmask" the degree to which trust fund surpluses serve to hold down the reported unified budget deficit.

Third, there should be better budget reporting of certain costs. We propose congressional "up-front" appropriations for credit program subsidy costs and appropriations to fund the liabilities of federal civilian employee retirement programs, similar to what is now done for military retirement programs. Also, we suggest an accrual based recording of the outlays for payroll and certain entitlement programs in order to minimize opportunities to manipulate payment dates and to report misleading budget "savings."

Finally, the budget numbers should be upgraded. We propose steps to upgrade the numbers in the budget by using more realistic economic assumptions and upgrading agency financial management systems.

Before I discuss these issues in more detail, however, I would like to take a few minutes to address the federal government's current budget problems. The most pressing of these is the current imbalance between revenues and outlays--or the annual deficit.

CURRENT BUDGET PROBLEMS

The number one fiscal problem facing the nation today is the federal budget deficit and how to reduce it. We as a nation are faced with making fundamental policy decisions regarding how much we are going to spend on governmental programs and services and how we are going to pay for them. For 19 consecutive years, there has been an imbalance between the annual revenues flowing into the federal government and the amount spent on government programs and services. During the 1960's, deficit spending was kept close to 1 percent of the Gross National Product (GNP), except for fiscal year 1968--the height of the Vietnam War--when it reached 3 percent. In the 1970's, however, we began to see substantial increases in our annual deficits--reaching 3 or 4 percent of the GNP by the mid-1970's and then jumping to 5 or 6 percent by the mid-1980's. This represents a substantial increase since 1969. In nominal dollar terms, this growth has been just as staggering. During the early 1960's, the deficit stayed well below $8 billion. In the mid-1970's, it climbed above $50 billion, and it reached a all-time high of $221 billion in 1986.

Until recently, the investors who bought U.S. government securities were largely foreign insurance companies, pension funds, and wealthy investors. As the value of the dollar fell, however, these traditional sources of foreign credit declined, and foreign central banks started buying more U.S. securities to help prop up the value of the dollar. This has cost central banks in Europe and Japan a lot of money, and it is not something they will be willing to do forever.

I am also convinced that the large budget deficits are directly related to the dramatic growth in this country's foreign trade deficit. In 4 short years, from 1984 to 1987, we went from being a creditor nation to being the world's largest debtor nation. It is hard to get exact figures, but a good guess is that we owe foreign investors at least $400 billion more than they owe us.

If not corrected, this situation holds great danger for the future. With some major exceptions, many Americans are living fairly well. The problem is we are living well by borrowing the output of other countries' financial institutions and factories. At some point in the future, however, we will have to pay it back by consuming less as a nation. We will all feel it then in the form of a relatively lower standard of living.

In an effort to reduce the budget deficit, the Balanced Budget and Emergency Deficit Control Act of 1985 (Gramm-Rudman-Hollings) was enacted. The idea of the original legislation was that we would reduce the deficit incrementally from $221 billion in fiscal year 1986 to zero in fiscal year 1991.

By fiscal year 1987, we had made some headway in reducing the deficit--a reported $150.4 billion or 3.4 percent of the GNP. It would have been higher except that the 1986 tax reform law "front loaded" revenue in the early years of its implementation, and this revenue was counted against the deficit. By last fall, however, it was clear that we would not reach the original goal of $108 billion for fiscal year 1988, set by Gramm-Rudman-Hollings, so the Congress decided to change and stretch out the targets. The new deficit reduction targets, as set forth in the Balanced Budget and Emergency Deficit Control Reaffirmation Act of 1987, are $144 billion for fiscal year 1988, falling to zero by fiscal year 1993. I want to stress that these are only targets. We must continue to make tough decisions on both the revenue and spending sides of the budget if we are to realize these targets.

A closer look at the programs that make up the budget gives some indication of the difficulty of making those decisions. Entitlement programs alone comprise over 46 percent of the estimated outlays for the fiscal year 1989 budget, while interest on the national debt represents another 14 percent. In fact, annual net interest is actually $22 billion greater than fiscal year 1989's projected deficit. Defense uses another 27 percent of the budget. This leaves 13 percent of the budget. As a result, even if Defense spending is held steady or reduced somewhat, there is not much left to cut.

The November 1987 Congressional-White House "budget summit" agreement, which set broad budget targets for fiscal years 1988 and 1989, showed that difficult revenue and spending decisions can be made if the top elected leaders from the legislative and executive branches are determined to make them. It was also an example of macro-level biennial budgeting. Although agreement was reached on cutting the deficit, which was an accomplishment, I believe the financial markets and the public are expecting more than short-term actions on the deficit. They are looking for more discipline and accountability in how we manage the government's financial resources.

Unfortunately, the budget process is not working as well as it should. One concern that I have is that the administration and the Congress seemingly are increasingly using "budget gimmicks" and "quick fixes" to reduce the deficit. Often these actions have no real effect on the deficit and can even be counterproductive in the long run. The practice of slipping paydays and conducting loan asset sales are two cases in point.

The Department of Defense (DOD) shifted military service retirement payments from September 30, 1984, to October 1, 1984, which resulted in a fiscal year 1984 budget "savings" of nearly $1.5 billion. However, the savings were lost in fiscal year 1985 because DOD made 13 retirement payments rather than the normal 12. Similarly, in fiscal year 1987, the Congress directed DOD to slip its payday from September 30, 1987 to October 1, 1987, which helped reduce the deficit by about $1 billion for fiscal year 1987. However, no real savings were achieved because the liability to make the payments had already occurred.

The use of loan asset sales as a means of reducing the deficit is also of questionable merit. Sales of existing loans in effect shift future loan repayments to the year of sale. Although cash receipts are therefore increased in the year of the sale, such sales do not create additional cash receipts over time above the revenues that would have been received through loan repayments if the loan had not been sold. In fact, if the sale or prepayment of existing loans yields net sales proceeds or prepayment amounts less than the present value to the government of future loan repayments, budget deficits over the long term will increase.

I believe we are all beginning to see indications of the Congress' increased frustration with the budget process. Members increasingly complain that they spend too much time on budget matters, fail to meet budget calendar deadlines, are forced to deal with overly complex omnibus spending bills, and fail to make sufficient progress in reducing the deficit. Our concern is that the Congress' frustration will lead to a proliferation of proposals for mechanistic and possibly unrealistic approaches to budgeting. These could include rigid formula limitations on budgetary outcomes, such as a constitutional amendment limiting spending growth or requiring a balanced budget. The government took a step in this direction with enactment of the Gramm-Rudman-Hollings legislation--an acknowledgment that the normal budget process was not working well and that something was needed to force greater budgetary discipline. Perhaps Gramm-Rudman-Hollings helped us get the deficit down to $150 billion, but it concerns me that the government had to resort to this kind of approach. I would like to find alternative ways of improving the vitality and efficiency of the normal legislative process in the budget area.

We need to be realistic, however, in what we can accomplish. I do not think that we can devise new procedures that will completely overcome the delays and inefficiencies of the current budget process. To a large extent, the difficulties our elected officials experience in reaching consensus on budget matters reflects underlying divisions and uncertainties in the American public about policy choices and priorities. Nevertheless, I think that there are changes that could help. To the extent that we can make the budget process and documents less complex and more understandable, we will have taken a step forward.

Hopefully, the newly established National Economic Commission (NEC) also will address this matter. The last major reforms of the budget process were in 1969 and 1974. It is time to make a fundamental reexamination of the usefulness of the current budget. I would hope that the NEC deliberations and hearings such as these here today will provide the groundwork for major budget reform.

Mr. Chairman, I believe that we can improve budgeting in four ways: streamlining the budget process, restructuring the budget, improving the budget reporting of costs, and upgrading the quality of budget numbers. These should not be seen as "solutions" to our budget deficit problems, but rather as steps that can help our policymakers in making decisions and in taking action on the budget and the deficit.

The remainder of my statement will address our proposals in these four areas.

STREAMLINING THE CONGRESSIONAL BUDGET PROCESS

I think that most of you would agree that the congressional budget process needs to be streamlined. I share concerns that the process is taking up too much time and producing disappointing results.

Budgeting Takes Up Considerable Time

While it is difficult to prove the point with statistics, I have the sense that budget-related activities are probably taking up too much committee and floor time, even considering the unusually difficult decisions that have to be made these days to get the deficit under control. A Congressional Quarterly study showed that the percentage of budget-related roll-calls in the Senate increased from an average of 43 percent in the 1955 to 1975 period to an average of 60 percent over the 1980 to 1985 period. These figures indicate an increase in budget-related roll-calls. An equally important trend, which such figures cannot easily reflect, is an apparent increase in congressional frustration levels at the cumbersome and time-consuming budget process. It is significant, I think, that several of the Senators who announced their intent to retire from the Senate within the past year have cited such concerns as having influenced their decisions to step down.

I would suggest that, in addition to basic divisions in the public and the Congress over policy choices and priorities, there are other factors contributing to the budget problems. One is that each chamber's procedures--time-honored and valuable in many ways--have seemingly become burdened of late by excessive layering and duplication on budget-related matters. Instead of thinking of a single budget process, it would be more accurate today to think of six spending-related processes involving different leadership structures, immense coordination problems, a long line of congressional "veto" points, and numerous revisited decisions. I am referring to the annual functions performed by the authorizing, appropriations, and budget committees, plus the added activities related to the periodic debt ceiling extension, the annual Gramm-Rudman-Hollings process, and, one could add, the late 1987 budget summit between the Congress and the White House. It is hard for me to see how any congressional leadership could expedite budget-related actions under such circumstances.

I also sense that another factor contributing to the budget workload is a certain lack of discipline in the procedures. In this regard, I would mention the non-binding nature of the budget resolutions, the lack of Senate restrictions on non-germane amendments, the incomplete budget resolution enforcement provisions, and the ease with which enforcement provisions may be waived. These features keep "flexibility" in the procedures, but at a high price. They invite revisitings of issues and make the budget process vulnerable to extraneous and time-consuming delays. I think that this gives members of the Congress a feeling that the budget process is out of control and never-ending.

Missed Deadlines and Related Matters

Disappointing results in terms of missed deadlines and the kinds of budget packages delivered for final action compound the problem. The missed deadline matter is a familiar theme, as you know Mr. Chairman. It has been pointed out several times over the years since enactment of the Congressional Budget and Impoundment Control Act of 1974, that the only fiscal year for which all appropriations bills were enacted before the start of the new fiscal year was 1977.

This did not present a major problem in the 1970's. Whenever appropriations were late, a continuing resolution was enacted on time, or agencies continued to operate and incur obligations until appropriations were passed. The Attorney General's opinions of 1980 and 1981, which stated that the Anti-Deficiency Act precluded agencies from operating in absence of appropriations, changed all that. In more recent years, however, there have been two new disturbing developments.

First, the continuing resolutions themselves have not always been enacted on time, leading to partial shut-downs in governmental operations. There were late continuing resolutions in fiscal years 1980, 1982, 1983, and 1984, with resultant funding gaps, extra costs, and, most of all, heightened concern about the way we do business in the nation's capital. Second, the continuing resolutions have been increasingly expanded in scope to the point where the ones for fiscal years 1987 and 1988 were omnibus bills covering all agencies. The final 2,100-page resolution for 1988 was enacted 3 months into the fiscal year after only a few hours of debate, reminiscent of the way omnibus budget reconciliation was first used for fiscal year 1982. Such procedures shortcut deliberations and, I think, weaken the legislative process. Omnibus continuing resolutions also place practical restrictions upon the President's veto options.

Numerous proposals have been put forward to address these kinds of problems and to improve the congressional and executive budget processes. I would like to address the more prominent of these, beginning with biennial budgeting proposals.

Biennial Budgeting

Some members of the Congress have proposed biennial budgeting as a way to streamline the budget process and free up time for more oversight and authorizing activities. At this time, there are nine biennial bills being considered--three in the Senate and six in the House. The Senate bills are the Ford-Roth Biennial Budget Bill; S. 832, introduced by Senator Domenici; and S. 1362, introduced by Senator Kassebaum. Generally, the Senate and House bills are similar in several respects. They require the President to submit a 2-year budget, the Congress to adopt a single 2-year budget resolution, and the Congress to enact 2-year appropriation bills. Differences between the proposals occur mainly in the timetable of actions needed to implement the 2-year cycle by the Congress.

The three Senate bills and House bills H. R. 1558 and 2733 would require the Congress to finalize the 2-year budget and appropriations during the first session of each Congress, with the biennium beginning October 1 of that session (the odd-numbered year). Under these proposals, the second session would be devoted to oversight activities or authorizing legislation, plus any adjustments needed to the budget and appropriations for the current biennium. Under the remaining House bills--H. R.'s 22, 33, 777, and 805--congressional budget-related activities would be spread over both sessions of each Congress, with the biennium beginning October 1 of the second session (the even-numbered year).

I believe that biennial budgeting warrants consideration as a possible means of reducing congressional budget workload and allowing more time for oversight and other legislative activities. I would prefer an approach that concentrates budget activity in the first year of each Congress and oversight in the second session. This method offers the advantage of allowing difficult budget votes to come in a non-election year, and it allows budgets to be adopted during the first year of a new

Congress and a new President's term. I also see merit in requiring a single budget resolution with a provision for amending it if the need arises.

In discussing the advantages and disadvantages of biennial budgeting, it is helpful to consider the experiences of the 50 states, since both annual and biennial budgeting have been practiced at the state level for many years. These experiences can be useful to decisionmakers as they consider the various biennial proposals. In July 1987, we issued a report to the House Budget Committee containing the results of our survey of trends and experiences in state governments with biennial budgeting.[1]

We reported that more states practice annual budgeting than biennial budgeting--31 states to 19 states, respectively. Of the 19 states that currently have biennial budgeting, 7 have legislatures that meet biennially and therefore cannot have an annual cycle. Furthermore, we found that the trend has been in favor of annual budgeting. During the past 20 years, 15 states changed their budget cycles, with 12 switching to annual budgeting and 3 to biennial.

Most states with biennial budgets report that they spend

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[1]Budget Issues: Current Status and Recent Trends of State Biennial and Annual Budgeting (GAO/AFMD-87-53FS, July 15, 1987).

less time on budgeting in the off-year, but indicate that the budget forecasts are less reliable because they cover a longer period of time. The most commonly cited results of changing to an annual budget cycle are improved revenue and spending forecasts and increased time spent on budget activities.

I would like to caution that while biennial budgeting could allow for more oversight and other legislative activities, it does have some potential drawbacks. It could lessen congressional influence or control over program and spending matters. There would be fewer scheduled opportunities to affect agency programs and budgets through the budget and appropriation processes. Since this nation's beginning, annual appropriations have been a basic means of exerting and enforcing congressional policy. A 2-year appropriation cycle could change that control. In addition, it is unclear how enacting 2-year budgets and appropriations would affect the Congress' flexibility to make annual changes in program funding levels in response to an ever changing economic, social, and political environment.

I should add that the potential benefits of biennial budgeting may not be fully realized in the current budget environment. In these times of budget uncertainty and changing deficit reduction goals and procedures, biennial appropriations could experience significant off-year adjustments in the form of rescissions, supplementals, or sequestrations. These actions could, in effect, turn the off-year into another appropriation year with nearly the same work and funding uncertainty.

In my view, these potential problems are not serious enough to negate the possible benefits to be realized from implementing a biennial budget. However, the Congress should be aware of them as it considers the pros and cons of moving to a biennial budget. Also, I believe that the Congress should proceed cautiously on the implementation of a 2-year budget cycle. If adopted, it should probably be tried first on a selective basis.

The Congress has already made some moves towards a 2-year budget cycle. In the fiscal year 1986 Defense Authorization Act, the Department of Defense (DOD) was directed by the Congress to submit a biennial budget for fiscal years 1988 and 1989 and every 2 years thereafter. DOD submitted a 2-year budget for fiscal years 1988 and 1989. However, the authorization committees chose not to approve a full 2-year budget, and the appropriation committees did not provide appropriations for the second year. There apparently were three reasons why the Congress did not provide a 2-year budget. First, the DOD submissions were above the Gramm-Rudman-Hollings deficit reduction targets. Second, there were concerns that a 2-year budget would lessen the Congress' ability to make annual adjustments to the DOD budget. Third, questions were raised over the accuracy of the DOD budget estimates, especially the second-year estimates. I believe that

DOD officials are rethinking their support for biennial budgeting, partly due to a perceived lack of congressional support, and partly because of some problems encountered in the department itself. We are now looking at the DOD experience and will report more fully on it in the near future.

Along these same lines, the Balanced Budget and Emergency Deficit Control Reaffirmation Act of 1987 included a section stating that it was the sense of the Congress that the Congress should undertake an experiment of 2-year budgeting for selected agencies and accounts. The appropriate committees were directed to develop an implementation plan, which also called for an evaluation of the experiment at its conclusion.

I believe that good candidates for this experiment would be organizations with operations and programs which are relatively stable and which have no obvious impediments to the effective testing of the pilot biennial budgeting. Impediments could include activities such as a major reorganization taking place or major changes under way in financial management systems. On this note, GAO recently reported favorably on the testing of a biennial budgeting cycle for the Forest Service, but we recommended that the testing not begin until other budgeting system changes proposed by the Forest Service are completed.

I would also observe that the November 1987 Congressional-White House budget summit agreement was in some ways an application of the biennial budgeting concept. Top leaders from the Congress and the executive branch came together and produced a 2-year agreement on macro budget levels. If it works, this approach may be a way to resolve some of our existing budget process problems.

Other Major Budget Reform Proposals

Several of the Senate and House biennial bills also contain other provisions to streamline or otherwise improve the congressional budget process. Many of those provisions, along with other bills and reform proposals, would address the key problems I outlined earlier in this statement. The ones that I think offer the most promise for lasting improvement are the ones which would enact some kind of permanent continuing resolution, and which would develop more coordinated or integrated leadership approaches.

I think that it is particularly important, Mr. Chairman, to devise leadership procedures and structures to reduce the layering, fragmentation, and duplication that now seems so apparent. Senators Kassebaum and Inouye's S. Res. 260 proposal would require major changes in the structure of existing committees. Senator Domenici, appearing before the Committee on

Rules and Administration last month, proposed the creation of a Joint Committee on the Budget to be patterned after the former Joint Atomic Energy Committee. It would appear that the basic idea of such a joint committee would be to institutionalize the informal, joint approach seen last fall in the "budget summit" talks.

I do not know whether major changes are needed in the committee structure, but I think that it is important to get the elected leadership and chairmen of the major committees working together in a more concerted manner. Such an effort could go a long way toward overcoming many of the budget workload and timing problems we have noted.

Some participants in the congressional budget process have suggested that the Congressional Budget and Impoundment Control Act of 1974 be amended to replace the concurrent budget resolutions requirement with a joint budget resolution requiring presidential signature, so as to minimize later inter-branch disagreements and delays. The November 1987 Congressional-White House budget agreement was a step in this direction. A joint resolution approach, however, would raise its own set of problems. It could raise balance of power questions, since the President would become a more direct participant in the congressional decisionmaking process and, depending on how quickly agreement could be reached on the budget resolution, this participation on the President's part could either accelerate or delay the whole process. On balance, I believe that more executive-legislative negotiations leading to agreements on budget aggregates, such as occurred in the November 1987 budget summit, would be an important step in the right direction.

IMPROVING THE BUDGET STRUCTURE

I also think that it is time for us to restructure the federal budget. It has been 20 years since the last major reform, when the government's administrative and trust funds were merged into one unified budget. This was the principal recommendation of the 1967 President's Commission on Budget Concepts. The development of a unified budget was unquestionably a step forward, and it should be preserved in any new reforms we undertake.

However, although the current cash-based unified budget largely meets the criterion of being comprehensive, it is severely deficient in its usefulness. Its focus on a single cash-based surplus or deficit total, with no distinction made between investment and noninvestment expenditures, leads to unsound deficit reduction strategies, a budget bias against capital investments, and a distortion of credit program costs. It also masks trust and non-trust (federal) fund fiscal relationships.

These problems partly explain the periodic efforts to remove certain federal programs from the budget. The targeted programs have mainly included capital intensive programs, credit programs, and major trust fund programs.

I believe that the incentives to remove certain programs from the budget would be eliminated or lessened significantly if the current budget's structure were modified to reflect a "four-part" budget approach distinguishing between operating expenses and capital investments, and trust and non-trust (federal) funds. Such an approach would provide budget subtotals for each of these amounts. In addition, deficit reduction targets, such as those in the Gramm-Rudman-Hollings law, would be reformulated around each of the new subtotals. Mr. Chairman, attachments I and II of my statement illustrate our "four-part" budget. I should note, however, that because of our innovative approach and the quality of existing data, we had to make several assumptions. Therefore, I would emphasize that the numbers are approximations for illustrative purposes only.

Let me explain, Mr. Chairman, why I think this new budget structure would help. My comments are directed toward what we see as the budget's underlying problem--its exclusive focus on a single surplus or deficit number.

A Single Surplus or Deficit Total Does Not Show Capital Versus Operating Results

Many state officials and private sector executives plan and conduct their activities employing budgets that distinguish between capital investments and operating expenses. At the state level, 37 states have reported that they have distinct capital and operating budgets. In contrast, the federal budget makes no systematic distinction between capital investments and operating expenses. This failure to do so makes it difficult for the Congress to determine how much debt should be incurred each year to finance investments and how much should be used to cover operating expenses.

This is a serious weakness. It can lead to unsound deficit control strategies and to a budget bias against capital programs.

Unsound Deficit Control Strategies

By recent count, 34 states are required by their constitutions or by statute to execute balanced budgets, and most of these states apply these requirements only to their operating budgets. Expenditures for capital investments are not necessarily counted as operating expenses but rather as means of financing capital development. Debt financing and other revenues are utilized for the states' capital projects, subject to separate debt limitations. The liabilities incurred (debt) are offset by new assets of roughly equal value (the capital acquisition), thereby preserving the states' financial resources.

In contrast, the single-number focus of federal deficit reduction efforts does not recognize the different debt uses for capital investments and operating expenses. Because they represent asset exchanges, capital outlays and debt do not immediately reduce the resource base of the government the way current outlays do. When outlays are made and debt is incurred to acquire assets, whether for physical assets, such as buildings, or for financial assets, such as loans, they produce a stream of future benefits to the government. For example, an acquired building provides facilities to carry out government operations over several years, and an acquired loan note provides a cash return. Therefore, debt incurred to finance capital investment is best thought of as capital financing rather than a deficit.

Failure to recognize the critical distinction between capital financing and operating deficits leads to efforts to reduce all borrowing to zero. Such efforts ignore the importance of making conscious budget policy choices about the relative importance of current consumption versus long-term infrastructure needs.

With a capital budget approach, officials could focus upon sounder and more realistic options. They could 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). As a result, they could establish deficit targets for operating activities, financing targets for capital activities, and total financing targets for fiscal policy purposes.

Budget Bias Against Capital Programs

Under the present budget rules, a $50 million outlay to construct part of a hydroelectric plant (a capital investment) in a given year contributes to the year's deficit just as a $10 million outlay for vehicle or airplane fuel costs (an operating expense) does. However, the full $50 million for the hydroelectric plant is not a true cost for that year in that $50 million in federal assets have not been used up. Instead, there has been an asset exchange: $50 million in cash is exchanged for a $50 million facility.

The current procedure of "telescoping" the budget recognition of physical acquisition costs into the early years of construction and cash outlays makes a proposed new start appear more costly, on a yearly basis, than it really is. This creates a budget bias against capital investment initiatives, which could lead to uneconomical decisions. For example, decisionmakers might decide to forgo the construction of a building because of the sizable initial cash outlays that would be reflected in the budget and choose instead another option for space acquisition--leasing--with lower initial budget impact but higher, long-term costs.

A capital budget would improve cost comparability and thereby reduce the existing budget disincentive for physical capital acquisitions. Under capital budgeting, project costs would be "de-telescoped" and distributed over the useful life of the project for purposes of reporting yearly amounts in the operating expenses budget. The amount so reported each year could be identified as an asset consumption charge.

This would not reduce the budget disclosure of actual cash disbursements in a given year. These would be reported in the capital budget part.

Cost comparability of federal credit programs vis-a-vis other programs would also be improved. This issue is similar to the problem now facing physical capital investments. The budget now recognizes the cost of $25 million in new loans as being $25 million at the time of their disbursement, even though much of the loan will be repaid. In effect, this treatment overstates the costs of loan programs in their early years, when disbursements exceed repayments. An opposite effect occurs in later years when loan repayments flow back to the programs. The repayments are netted against new outlays to reporting budget outlays. The budget would thus report "negative outlays" for a year if repayments exceed disbursements.

This distortion of the true costs of credit programs could be corrected under a capital budgeting approach. Subsidy costs would be calculated, showing how much the government loses on given loan programs. The loss amount would essentially reflect any unfavorable interest rate spread, if the government borrowing rate is higher than the lending rate, plus any default losses. The calculated subsidy cost for each year's loans would be reported as an operating expense for the year, and the cash disbursements would be reported as a capital investment.

A Single Surplus or Deficit Total Does Not Distinguish Between Trust and Non-Trust Fund Amounts

Another major area of concern relates to trust funds. Since fiscal year 1969, the budget's annual surplus or deficit has reflected the combined results of trust and non-trust receipts and outlays. This has led to two kinds of problems.

First, proponents of some major trust fund programs, such as the Highway Trust Fund program, have stated that including the trust fund amounts in the budget's totals has prompted the Congress and the President to "misuse" those funds to reduce the reported budget deficit. They charge that officials restrict trust fund outlays while maintaining the tax levels, thereby creating annual trust fund surpluses that are included in the budget's totals and thus lower the reported deficit. It is held that this breaks an understanding or implied agreement underlying the original tax enactment--that is, that the tax revenues would be used for certain program purposes.

Second, observers have pointed out that including the trust fund amounts in budgetary totals has served to "mask" important fiscal relationships and trends. The trust funds' surpluses, when combined with the non-trust accounts' deficits, produce a total that hides the severe deficit on the non-trust fund side of the government's operations. For example, the $150.4 billion total deficit for fiscal year 1987 does not reveal the fact that the deficit for all non-trust accounts was a much higher $223.1 billion, offset in the totals by a $72.7 billion trust fund surplus. Similarly, although the Congressional Budget Office (CBO) projects a declining total deficit through fiscal year 1993, it also projects a growing non-trust fund deficit. Overall decline is caused by the rapid buildup in annual trust fund surpluses.

The masking effect has received considerable attention in recent weeks as writers discuss the implications of the Social Security trust funds' growing balances. The annual balances--that is, annual payroll tax revenues in excess of annual benefit payments--have grown significantly since the 1983 Social Security amendments. The surpluses of these and other trust funds are required by law to be invested in U.S. Treasury securities, thereby financing the debt incurred for the non-trust fund activities of the government. Some argue that an increasing reliance on trust fund surpluses to finance operating deficits means, in effect, an increasing reliance upon the regressive taxes financing some large trust funds as a means of financing general government operations.

Current projections are that the Social Security trust funds will begin to run annual deficits in the first quarter of the 21st century, requiring the funds' administrators to redeem their Treasury securities to obtain the cash needed for benefit payments. This need not present a problem to the Department of the Treasury, provided there is a sound fiscal balance between the trust and non-trust sides of governmental operations. For example, when the securities are redeemed, if the government is borrowing heavily to finance a large non-trust fund deficit, there could be economic reasons for avoiding significant new borrowings to redeem the securities. In that case, the funds to redeem the securities could be raised through new taxes or spending cuts, but both of these approaches could present problems as well. Unfortunately, the current structure of budget information, with its focus upon a single surplus or deficit total, does not facilitate the kind of analyses needed to ensure a proper fiscal relationship between trust and non-trust operations. A new set of budget subtotals, for trust and non-trust operations, would address this masking problem.

Distinguishing between trust and non-trust amounts would resolve the masking problem. Budgetary information structured along these lines would clearly disclose the trends in both parts. It would also be important to show the intragovernmental flow of amounts between the trust and non-trust parts.

As for the issue of misusing trust funds to help balance the budget, the new set of totals proposed herein would not, in themselves, resolve the issue, but would provide better disclosure of how some trust funds are in fact being used for fiscal, rather than programmatic, purposes.

IMPROVING THE BUDGET'S REPORTING OF COSTS

Mr. Chairman, I also believe that we need to improve on the budget's current reporting of information on program costs. The current budget treatment of credit programs, pension programs, and programs in which the government uses its noncash assets in lieu of cash to obtain something of value to the government provides misleading cost information.

The Subsidy Costs of Credit Programs Are Not Accurately Reported in the Budget

As I noted previously, the current budgetary treatment of credit programs--that is, direct loans and guaranteed loans--does not accurately report the costs of these programs. Furthermore, the budget does not identify the subsidy costs up front--i.e. when new credit activities are being considered--so that they can be compared to other programs when budgeting decisions are being made. For many years, GAO has advocated changes in the budget treatment of credit programs to address these problems. We believe that the subsidy costs of credit programs should be identified and appropriated annually when the government makes new direct and guaranteed loans. We would combine this new budget treatment of credit programs with our proposed restructured four-part budget.

The Office of Management and Budget (OMB) has recently developed a credit reform proposal which would require that credit subsidies be appropriated for each budget year's new direct and guaranteed loans. We disagree, however, with the way OMB proposes to calculate the amount of the credit subsidy.

OMB would measure the subsidy using a "benefit to the borrower" approach. Under this approach, the subsidy is measured in terms of the economic benefits the borrower receives by obtaining a loan from the government rather than in the private sector. OMB's approach could produce a larger reported subsidy amount than our "cost to the government" approach, because the OMB method would include some costs which would never be reflected in federal budget outlays, such as higher private sector costs of funds and risk premiums in excess of default risk estimates.

The approach which we prefer measures the subsidy in terms of future cash outlays which will impact on budget totals. The subsidy is measured in terms of the costs--interest subsidies and default costs--the government will incur as a result of its decision to issue the loan. It is calculated by taking the difference between (1) the present value of the future principal and interest payments discounted at the government's long-term interest rate and (2) the money loaned out.

Conceptually, GAO favors the cost approach as the more accurate and appropriate budgetary cost measure. We do not endorse introducing costs into the budget which do not reflect the government's cost.

The Budget Fails To Report the Future Cost of Today's Commitments

I am also concerned over the budget's failure to report the future cost of today's commitments. The current cash-based budget reporting provides incomplete cost information on some major future liabilities because it does not include them in the budget totals reviewed by the Congress. The federal government incurs certain liabilities, such as future pension payments, which may not be liquidated (funds disbursed) by cash outlays until long after the liability has been incurred. In such cases, the cash-based budget does not always recognize the liability. For example, as of September 30, 1986, the unfunded liability of the Civil Service Retirement System (CSRS) was nearly $544 billion. This is the fund's accumulated unfunded liability for future retirement benefits (already earned by current employees and their survivors) which has not been included in budget estimates over the years and which has not been appropriated by the Congress.

Showing the full cost of the CSRS pension plan in the budget would allow the Congress to better consider it on a comparable basis with other government programs. To show the full annual cost of the CSRS pension plan, budget authority should be recorded in each agency's budget to fund the annual accrued liability of employee benefits such as is done for the Federal Employees' Retirement System. In addition, budget authority should be provided to fund all pension funds' unfunded liabilities based on dynamic economic assumptions over a number of years, similar to what is now being done for military retirement.

The federal government also has a number of programs, such as federal employee payroll and certain entitlement programs, which incur liabilities and/or make payments to liquidate (disburse funds) the liabilities on a regular schedule. Since the budget currently focuses on cash outlays, opportunities exist to manipulate outlay levels for such programs by shifting payment dates by a day or two from one fiscal year to another. Because of the size of these payments, changing the payment date could cause a deficit fluctuation of billions of dollars in a given year. For example, in fiscal year 1987, the Department of Defense (DOD) delayed its payday by one day to the succeeding fiscal year, resulting in a fiscal year 1987 budget "savings" of nearly $1 billion. However, no real "savings" were achieved because the liability to make the payment had already occurred.

By accruing outlays in the budget for the liability incurred in each fiscal year to make payments for payroll and entitlement programs having regular payment schedules, these programs would not be candidates for budget gimmicks. Such gimmicks, as delaying a cash payment from one fiscal year to the next, do not result in a true reduction in outlays, and they should not be used to aid the administration and the Congress in meeting deficit reduction goals.

The Use of Noncash Assets To Finance Government Programs Should Be Reported in the Budget

Currently, the budget's totals exclude the costs of some programs with authority to make purchases by giving a seller credits, or something other than money, instead of paying the seller with cash. Governmentwide, agencies have identified 27 accounts which they interpret as having such authority. For example, during fiscal years 1986 through 1989, the Commodity Credit Corporation (CCC) has planned to issue $28 billion worth of "commodity certificates" as payments to farmers participating in various farm support programs. Farmers can use the certificates to repay loans, exchange them for commodities in CCC's inventory, turn them in to CCC for cash, or sell them to someone else who in turn can sell or exchange them. The costs of using the commodities in this manner are not included in the budget's totals.

We believe the budget should include the use of noncash assets to finance programs. During the past year, we have studied the budgetary treatment of CCC's commodity certificates in detail. As a result of our study, we are considering various ways to include in budgetary totals the full amount of resources--cash and noncash--devoted to the program. While commodity certificates are but one of the 27 programs authorized to use this type of financing, many of the other 26 programs could also be included in the budget. We will be reporting soon on the results of our study.

UPGRADING THE BUDGET'S NUMBERS

We also believe, Mr. Chairman, that the timeliness, consistency, and accuracy of the budget numbers should be improved. This is not a new problem, but one that has taken on new importance as the Congress and the administration attempt to address the deficit. I think we can make progress on this numbers problem in at least two areas. First, we should consider ways of improving the economic and spending projections put forth in various budget documents. This will not be easy because legitimate differences of opinion exist on such matters. Nevertheless, I am convinced that we can do better.

I would say that a starting point for achieving better economic and spending estimates would be for officials to base their estimates more on stable economic and financial patterns and less upon optimistic policy and economic goals. There has been a persistent pattern of overly-optimistic budget assumptions and projections, and the trend may be continuing. For example, the recently passed House and Senate budget resolutions for fiscal year 1989 contained an estimated deficit of about $134 billion, which was based on OMB's economic assumptions which are considered very optimistic by many observers. The less optimistic CBO economic assumptions, however, placed the "baseline" deficit in 1989 at $176 billion. The revised Gramm-Rudman-Hollings law, however, mandates that OMB projections prevail, so we have set for ourselves a "rosy scenario" for meeting the target in 1989. This raises questions about the usefulness of the numbers, particularly since the projections of many private forecasters are consistently less optimistic.

A second area of needed improvement would be upgrading agency financial management systems. The financial management processes and systems that support federal policymaking, including budgeting, have not kept pace with the needs of the Congress and the executive branch. When budgeting decisions are based on questionable data from antiquated financial management systems, budgeting problems are compounded. For example, inconsistent practices regarding the treatment of administrative costs may result in the inability to accurately report to the Congress on the implementation of Gramm-Rudman-Hollings. We have been unable to identify how agencies allocated budget cuts between service and administrative operations because some agencies do not identify administrative costs, apply differing criteria, or inconsistently apply criteria in allocating costs to program administration accounts.

Improvements in agency financial management systems would greatly improve the budget numbers. As I stated before your committee last year, Mr. Chairman, the foundation for successful financial reform requires:

-- a legislative mandate to ensure continuity and stability of reform issues,

-- a central position and office established in law to plan, implement, and oversee the reform effort and to provide continuous central leadership,

-- corresponding leadership in executive branch departments, agencies, and bureaus, and

-- a long-range governmentwide plan, developed by the central leadership, for improving and operating federal financial management systems.

One final note on the numbers. We think that the discipline and integrity of the budget numbers would also be helped if more federal agencies prepared audited financial statements. Many statement amounts find their way into the budget, and our GAO financial audits have turned up countless discrepancies and problems with these reported amounts. Continued auditing efforts along these lines should have beneficial effects for the budget.

This concludes my prepared statement, Mr. Chairman. I would be happy to respond to any questions you or members of the Committee may have.

FOUR-PART BUDGET APPROACH
TOP-LEVEL SUMMARY
FISCAL YEAR 1987

	Total funds	Federal funds	Trust funds
	---(dollars	in billions)---	
Operating Budget			
Revenues	$ 957.8	$ 627.2	$330.6
Expenses	1001.8	625.3	376.5
Cash surplus/deficit(-) before interfund transfers	-44.0	1.9	-45.9
Interfund transfers	-2.2	-117.2	115.0
Cash surplus/deficit(-) after interfund transfers	-46.2	-115.3	69.1
Asset consumption charge	-50.0	-50.0	a
Operating surplus/deficit(-)	-96.2	-165.3	69.1
Capital Budget			
Revenues	$ 54.5	$ 37.4	$ 17.1
Investments	160.9	145.3	15.6
Capital financing requirements	-106.4	-107.9	1.5
Interfund transfers	2.2	-	2.2
Capital financing requirements after interfund transfers	-104.2	-107.9	3.7
Asset consumption charge b	50.0	50.0	a
Net capital financing requirements	-54.2	-57.9	3.7
Total Financing Requirements	$-150.4	$-223.2	$ 72.8

a There are asset consumption charges applicable to trust funds, but we could not ascertain those amounts.

b Asset consumption charges could be used as a basis to finance debt used to acquire physical assets.

FOUR-PART BUDGET APPROACH
OPERATING COMPONENT
FISCAL YEAR 1987

	Total funds	Federal funds	Trust funds
	---(dollars	in billions)---	
Operating Budget			
Revenues			
General taxes and fees			
Individual income taxes	$ 392.6	$ 392.6	$ -
Corporation income taxes	83.7	83.7	-
Miscellaneous taxes and fees	50.8	50.8	-
Total general taxes and fees	527.1	527.1	-
Earmarked taxes and fees			
Soc. security and railroad retire.	273.0	-	273.0
Unemployment insurance taxes	25.6	-	25.6
Civil service retire.(employee share)	4.7	-	4.7
Customs duties and other receipts	6.9	5.7	1.2
Total earmarked taxes and fees	310.2	5.7	304.5
Other revenues	120.5	94.4	26.1
Total revenues	957.8	627.2	330.6
Expenses			
Social security	204.8	-	204.8
Defense	199.8	199.4	0.4
Interest on debt	160.3	160.3	-
Income security	135.1	62.1	73.0
Medicare	81.6	-	81.6
Health	42.5	39.9	2.6
Veterans benefits	30.9	29.0	1.9
Other	145.8	133.6	12.2
Credit subsidy costs	1.0	1.0	-
Total expenses	1001.8	625.3	376.5
Cash surplus/deficit(-) before interfund transfers	-44.0	1.9	-45.9
Interfund transfers			
Interest paid to trust funds	-2.2	-35.0	32.8
Fed. employee retire.(employer share)	-	-30.6	30.6
Supplementary medical insurance	-	-20.3	20.3
Civilian supplementary ret. contrib.	-	-16.2	16.2
Military retirement	-	-10.5	10.5
Other	-	-4.6	4.6
Total interfund transfers	-2.2	-117.2	115.0
Cash surplus/deficit(-) after interfund transfers	-46.2	-115.3	69.1
Asset consumption charge	-50.0	-50.0	a
Operating Surplus/Deficit(-)	$ -96.2	$-165.3	$ 69.1

FOUR-PART BUDGET APPROACH
CAPITAL COMPONENT
FISCAL YEAR 1987

	Total funds	Federal funds	Trust funds
	---(dollars	in billions)---	
Capital Budget			
Revenues			
Loan receipts	$ 37.6	$ 37.4	$ 0.2
Other capital receipts	16.9	-	16.9
Total revenues	54.5	37.4	17.1
Investments			
Financial asset disbursements, less subsidy costs	34.2	34.0	0.2
Physical asset additions			
Direct federal programs-civil	16.1	14.7	1.4
Direct federal programs-defense	89.6	89.6	-
Grants-in-aid	21.0	7.0	14.0
Total physical asset additions	126.7	111.3	15.4
Total investments	160.9	145.3	15.6
Capital financing requirements	-106.4	-107.9	1.5
Interfund transfers	2.2	-	2.2
Capital financing requirements after interfund transfers	-104.2	-107.9	3.7
Asset consumption charge	50.0	50.0	a
Net Capital Financing Requirements	$ -54.2	$ -57.9	$ 3.7

a There are asset consumption charges applicable to trust funds, but we could not ascertain those amounts.