149285

United States General Accounting Office

GAO

Testimony

Before the Subcommittee on Economic Development
Committee on Public Works and Transportation
House of Representatives

For Release on Delivery
Expected at
9:30 a.m.
Wednesday,
May 26, 1993

BUDGET POLICY

Federal Capital Budgeting

Statement of Paul L. Posner
Director, Budget Issues
Accounting and Financial Management Division

149285

057333 / 149285

GAO/T-AFMD-93-7

Mr. Chairman and Members of the Subcommittee:

I am pleased to be here today to discuss proposals to establish a federal capital budget. Two bills before this Subcommittee, H.R. 1050 and H.R. 1182, focus on the important distinction between federal outlays for capital investment and for consumption. The increased interest in changing the budget structure to focus on programs that promote long-term economic benefits is a positive development. Last July I testified before another committee on similar proposed legislation and discussed the need to consider the investment implications of federal budget decisions as we attempt to get our fiscal house in order by reducing the federal deficit.

The nation's long-term economic future depends in large part upon today's budget and investment decisions. However, trends in economic investment are not promising--the overall level of private economic investment stands at its lowest levels in three decades. Moreover, our trading partners have significantly higher levels of investment. In 1990, the United States ranked last in gross fixed capital formation among the 24 nations in the Organization for Economic Cooperation and Development. Failure to reverse these trends will doom future generations to a stagnant standard of living and undermine U.S. competitiveness in the world economy.

Because the deficit absorbs private savings otherwise available for domestic investment, it exerts the single most important federal influence on investment. The surest way to increase national savings and investment would be to reduce this unprecedented level of federal dissaving by eliminating the deficit. In a report issued in June 1992, we stated that moving from a deficit to a budget surplus is essential to improving national savings, private investment, and long-term economic growth--vital actions needed to help the next generation of workers support a larger number of retirees.[1] Moreover, we concluded that we have no choice but to deal with the deficits because failure to take action will result in deficits rising to 20 percent of gross national product (GNP), due primarily to rising health, retirement, and the associated interest costs.

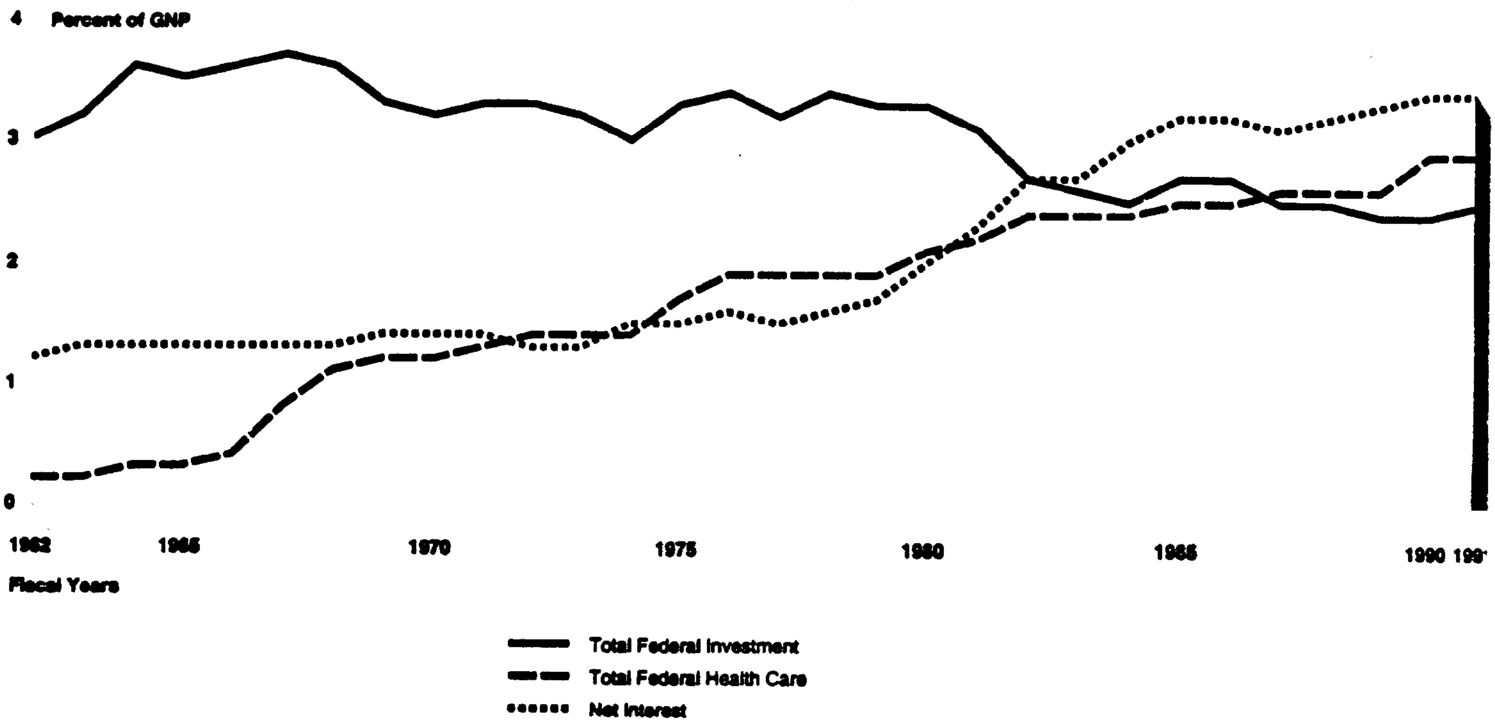
In addition to deficit reduction, well-chosen federal programs can also promote an environment conducive to investment and long-term growth in ways that the market alone cannot provide. Programs supporting efficient public infrastructure, an educated work force, and expanded technological innovation can make important contributions. Indeed, it would be unfortunate if, in the process of cutting the deficit to increase private investment, the government reduced effective federal investment programs as well.

---

[1]Budget Policy: Prompt Action Necessary to Avert Long-Term Damage to the Economy (GAO/OCG-92-2, June 5, 1992).

Recent budget trends are not encouraging for either the deficit or federal investment programs. The growing portion of the budget absorbed by interest payments and consumption programs, particularly health, has squeezed the discretionary sector of the budget, which is the source of federal investment funds. Figure 1 shows that federal outlays for investment programs declined as a share of GNP between 1980 and 1984 and have remained relatively stable at the lower level since then. During the 1980s, both federal health spending and net interest payments on the national debt surpassed the federal share of GNP for public investment.

Figure 1: Federal Investment, Health and Net Interest Outlays (1962-1991)



Source: Budget of the U.S. Government

These trends in the investment share of the budget did not result from an explicit strategy or set of national priorities. Instead, they represent the accumulated results of many individual budget decisions regarding dozens of programs. The budget is not currently structured to promote explicit consideration of the composition of spending for investment and consumption. Both of the bills before this Subcommittee recognize that the current budget structure does not adequately meet the needs of decisionmakers and an informed public since it makes no distinction between current consumption and investment decisions that carry longer term economic benefits.

For several years, we have advocated better planning and budgeting for capital investments to provide a clearer picture of the composition of federal expenditures and to help focus public attention on the nation's investment needs. We still believe that the budget must promote consideration of the longer term impact of capital investment decisions. However, our recent work on investment and long-term economic growth has shifted our focus from a physical capital budget to a broader investment component comprised of programs and activities intended to directly improve the prospects for higher long-term rates of national productivity.

I would now like to talk about what capital budgets are, how they have traditionally been used, and our current position on investment and capital budgeting.

WHAT IS A CAPITAL BUDGET?

A capital budget segregates capital revenues and outlays from an operating budget's revenues and outlays. Although definitions of what constitutes a capital investment may differ, traditional capital budgets normally define capital assets narrowly as tangible assets of a specific dollar value that are intended for long-term use or possession, are relatively permanent in nature, and are not intended for resale.

Most state and local governments have had considerable experience with capital budgeting. In our 1986 report on states' capital budgeting practices,[2] 37 of 45 states responding to a questionnaire indicated that they have a distinct capital budget reporting capital amounts separately. Frequently, the states' capital items are separated from the operating budget because most states have a legal requirement to balance operating budgets. State governments often issue long-term debt for capital investments in the form of earmarked bonds and generally do not include depreciation of capital assets in their budgets.

Business enterprises have capital budgets that show large capital outlays scheduled to be made in future years, the proposed means to finance them, and their expected benefits. The purpose of these budgets is to help evaluate the need for and costs of acquiring and financing long-lived assets. For financial reporting purposes, businesses charge depreciation in order to (1) allocate proportionately the investment costs of depreciable assets to each accounting period during which the asset is used in the production of goods and services and (2) recognize the decline of service potential.

---

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

Unlike state and local governments and business enterprises, the federal government has had no experience using a capital budget. Its unified cash-based budget treats outlays for capital and operating activities the same. Federal debt is undertaken for general purposes of the government rather than for specific projects or activities.

GAO'S CAPITAL AND INVESTMENT COMPONENTS

Currently, the federal unified budget focuses policymakers' attention on the impact of federal cash borrowing on 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 potential consequences for longer term economic output. However, the unified budget does not highlight the different impact that various types of spending would have on the long-term potential output of the economy. Federal spending for well chosen investment programs most likely increases the future capacity of the economy, compared to an equivalent amount of spending for consumption programs.

By recognizing the different impact of various types of federal spending, an investment focus within the budget would provide a valuable supplement to the unified budget's concentration on macroeconomic issues by directing attention to the consequences of choices within the budget for long-term economic growth. Policymakers would then have a new tool for deciding investment and consumption priorities within the budget as well as prioritizing programs within the investment sector.

Having established the need for such an investment focus is only the first step down a long path toward defining and implementing such a concept in budgetary terms. Mr. Chairman, there is no single "right" way to define capital for budgeting purposes. The point is that the budget should highlight for policymakers the group of programs that they consider to have long-term benefits warranting their attention.

For example, states focus on physical capital in their capital budgets, and not on research and development, because the latter cannot be contained within a state. Individuals move from state to state and research results can be used without regard to state boundaries. The federal government is different in this respect since its research and development investments, for the most part, remain within and benefit the country. Accordingly, the scope of a federal capital budget should be broader to encompass the types of programs we undertake that have an impact on long-term economic growth--principally spending on research and development and education and training as well as some physical capital.

The investment budget focus we have in mind includes spending on activities that enhance long-term productivity, regardless of whether they are tangible or intangible, and focuses on investments for the benefit of the economy as a whole, not just the federal government.

Under this concept, a federal investment budget would include grants for physical capital, spending for research and development, and human capital activities, such as education and training, which are intended to increase productivity. It would also include spending for some federally owned physical capital, such as construction of research and development facilities, water projects, and air traffic control systems having a direct bearing on long-term economic growth. Unlike traditional capital budgets, however, an investment budget would not include spending on physical assets, such as federal office buildings and military weapon systems, which are primarily used to carry out federal agency missions. Such expenditures may improve the efficiency of government agency operations and create jobs in the short term in particular regions of the country; however they do not generally improve the economy's longer term productive capacity.

Our approach does not preclude the use of more traditional capital budgeting concepts for spending on federal operations, such as the acquisition of office buildings or financial management systems. In fact, we can see some advantages. Such a budget presentation would put capital investment in government operations on a comparable basis with spending to support current operations. Moreover, other changes not requiring a formal capital budget could help put internal federal operations for capital-type expenditures on a more businesslike basis. For example, greater use of revolving fund concepts to finance internal agency capital purchases could promote greater agency attention to their costs and benefits. However, the need for policymakers to develop a long-range economic perspective on their budgetary decisions argues for a separate focus in the budget on those investment programs having a long-term impact on the potential productive capacity of the economy.

Budgeteers have expressed a concern about investment or capital budgeting potentially elevating the programs covered to the status of sacred cows, thus providing an incentive to distort the definition of investment to include programs which have only tangential long-term economic benefits. This is a legitimate concern that surrounds any effort to make meaningful distinctions in the budget. However, controversial definitional issues can be resolved, as the 1990 Budget Enforcement Act proved in defining mandatory programs. To develop and enforce a definition of investment, the executive and legislative branches would need to reach a similar agreement. Furthermore, we believe that vigilant oversight is vital to avoid abuses; periodic audits of the implementation of investment budgeting would help prevent such abuses. Controversy over the definition will likely escalate if the investment category receives any type of favorable budget treatment, including some of the features I will discuss next.

USING AN INVESTMENT COMPONENT IN BUDGETING

Definitional issues are only one of a series of decisions that need to be considered in developing a capital or investment budget. Other issues include determining how to use such budgetary information in (1) making resource allocation decisions about the overall size of federal borrowing and the deficit and (2) allocating federal resources among competing budgetary claims.

I would like to discuss four alternative approaches for using an investment component to make budget decisions and helping the government focus on long-term economic growth:

-- display federal spending as investment or noninvestment based on established criteria applied to the activity's intent;

-- include depreciation of investment activities in the budget;

-- permit deficit financing of the investment activities; and

-- establish annual investment targets agreed upon by the Congress and the administration.

The approaches are not mutually exclusive. They are presented separately in order to discuss their potential effectiveness as vehicles to focus on the investment consequences of budgetary decisions. Among the issues to be considered are the potential problems each approach could cause for budgetary control and the conduct of overall fiscal policy.

Display Investment Activities

In this approach, the President's budget presentation would categorize and display spending and revenue as investment or non-investment based on established criteria applied to the activity's intent. The Office of Management and Budget classifies all spending in federal budget accounts as investment or noninvestment using character classification codes after executive budget decisions have been made. This coding structure, if used in executive branch budget formulation, could be used as a starting point to identify investment activities in the budget based on any agreed-upon definition of investment.

For many years, an alternative budget presentation or special analysis that distinguishes between spending for investment and spending for current operations accompanied the President's budget.

Special Analysis D, "Investment, Operating, and Other Outlays,"[3] was included in the special analyses budget document from the 1950s through the 1990 budget presentation. Beginning with the 1991 budget, alternative budget presentations on physical and other capital replaced Special Analysis D. A collection of summary tables, "Federal Investment Outlays," is included in the fiscal year 1994 budget.[4] These presentations included as investment major defense and nondefense spending for physical capital, research and development, and conduct of education and training. The displays distinguish between national defense and nondefense investment outlays and between grants to state and local governments and direct federal investment outlays.

However, none of these alternative presentations has been used in budget formulation and none has been part of the formal budget process. The presentation is assembled after executive budget formulation decisions have been made. Further, these have not presented the entire budget so that investment can be viewed in the context of all federal spending. Nevertheless, such a display could prove to be useful in providing additional information for the congressional decisionmaker.

Depreciate Investments

Depreciating investments has some theoretical advantages but many unresolved practical problems in definition and implementation. Depreciating investments in the federal budget would place the costs recorded in the budget for assets intended to yield long-term benefits on an equal footing with operating expenditures. Normally, appropriations and outlays are recorded on a cash basis in the federal budget, which tends to front-load the costs of programs intended to produce long-term benefits. Some argue that this large initial commitment of resources, and the resulting additions to the current-year deficit, make investments unattractive compared to other types of spending, especially under the existing budget process with its spending caps.

Corporations use depreciation to allocate costs over an asset's useful life for financial reporting purposes. Depreciation could be used in the federal budget in a similar manner to distribute outlays over the useful life of the investment and incrementally add outlays to the deficit. An advantage of depreciation is that

---

[3]The title of Special Analysis D changed over the years. It has also been called "Federal Investment and Operating Outlays" and "Federal Investment Outlays."

[4]This presentation is different than the budget section "Investment Proposals," which is a list of appropriation accounts by agency for which the administration is seeking increased levels of funds.

it reflects the cost of goods or services in the period that they are used or consumed. Depreciation could, therefore, assist in measuring cost for future planning and allocation. It would also ensure that the operating budget appropriately recognizes the annual consumption of capital budget outlays.

There are problems, however, with using depreciation in the federal budget. The reported deficit would be lower than actual cash borrowing needs because outlays would not be reported on a cash basis. Spending decisions might be based on questionable data due to the arbitrary nature of depreciation schedules. Such schedules have not been established for the many unique assets government supports, and it is not difficult to imagine the kinds of controversies their use for budgetary scorekeeping purposes could engender. Investments in human capital would be particularly difficult to depreciate. If only physical capital were depreciated, however, it would receive a more favorable budget treatment than human capital.

Both bills before this Subcommittee require the recording of depreciation in the operating budget through an asset consumption charge, defined as the systematic and rational allocation of the annual cost (historical, replacement, or current value) of a physical asset. The asset consumption charge would allocate annual capital costs to the operating budget. The bills do not specify whether the full amount of budget authority for the capital investment's full price would be appropriated upfront or whether it would be appropriated incrementally over the life of the asset.

Many budgeteers have raised the concern that unless the full amount of budget authority is appropriated upfront, the ability to control decisions at the point when total resources are being committed to a particular use is relinquished. From a broad public policy standpoint, it is probably desirable that decisions on capital programs incorporate the full future cost commitment entailed by such programs. In 1990, the Congress moved credit programs in this direction by passing the Credit Reform Act, which required up-front appropriation of the full accrued subsidy costs for the life of the loan or loan guarantee.

Currently, the law requires agencies to have budget authority before they can obligate or spend funds on any item. Underlying budget concepts embodied in appropriations law would have to be changed to permit agencies to incur obligations for the total price of an investment while only having budget authority for 1 year's depreciation of the investment.

Alternatively, budget authority for the investment's full price could be provided upfront (as is currently done) and also provided for depreciation. The amount provided for depreciation would be charged against operating budgets and could be used for either asset maintenance or replacement. Controls would need to be established to ensure that the budget authority was accumulated and used for that purpose rather than for general operations.

Using depreciation in budgeting is meant to remove what some believe to be a bias against capital investments--the requirement for full up-front funding for such investments. However, the ability to deficit finance capital, as in H.R. 1182, would give capital spending an advantage over noninvestment spending since the operating budget is required to balance eventually. Combining depreciation with deficit financing would give capital spending a double advantage.

The Federal Accounting Standards Advisory Board (FASAB) will be addressing the appropriate use of depreciation for federal accounting purposes. It is not clear what types of investment, if any, would be depreciated for accounting purposes. If depreciation concepts are to be used in budgeting, it would be desirable that they be developed in concert with accounting concepts.

Deficit Finance Investments

This approach would permit borrowing to finance investment activities, as in H.R. 1182. In a traditional capital budget, capital is financed primarily through long-term borrowing. The majority of state governments have some form of a capital budget. States use a combination of short-term and long-term debt to finance capital expenditures. Long-term debt, however, is the most frequently used debt financing tool for capital assets. Some advocates of intergenerational equity (which calls for spreading the costs fairly among the generations receiving benefits) argue that capital items, which are used for many years, should be financed by borrowing. In theory, the term of the borrowing should coincide with the life of the capital asset and, as a project generates services over a number of years, the services would be paid for by the generation benefitting from them. In practice, however, states finance capital projects through a combination of current revenues and debt financing and certain states do not link the financing method and borrowing maturity to a capital asset or its useful life.

As I observed at the outset of this testimony, eliminating the deficit and actually bringing about a budgetary surplus over the next decade constitutes the most important federal contribution to enhancing national investment and long-term growth. Permitting deficit financing of investment might increase federal investment, but the federal deficit could well be larger, thus counteracting the budget balancing goal and actually reducing long-term levels of investment in the national economy. Further, in the short run, permitting deficits to finance capital could hamper the federal government's ability to control inflation through fiscal policy--a responsibility states do not have.

Deficit financing of investment would create another problem for the integrity of any budget process. If investments can be deficit financed while other types of activities cannot, there would be significant incentives to try to categorize other activities as investment. Unlike the rest of the budget, activities categorized as investment would not be subject to the same degree of pressure to reduce the deficit.

We do not support H.R. 1182's requirement that the budget's operating component be eventually balanced while capital investment spending be deficit financed. Instead, we believe the trade-off between investment and noninvestment activities should be determined within overall fiscal policies and established deficit reduction targets. As I said earlier, the surest way to increase investment is to increase savings, and the surest way to increase savings is to decrease the deficit.

Establish Investment Targets

The Budget Enforcement Act of 1990 (BEA) established a set of caps on discretionary spending as part of the budget control regime. Investment spending could be considered formally in the budget process by establishing similar aggregate targets for investment. Since we believe that the primary budgetary objective should be to reduce the deficit, a declining unified budget deficit path should be determined first. Then, within that path, a target for investment spending could be established to shift the spending mix to include more investment. Policymakers could evaluate individual investment programs to determine which competing investments should be selected within the overall target.

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 is now controlled, however, a number of implementation questions would be raised by deciding to increase investment spending. These questions include the following:

-- On what basis can a conscious 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 (that is, targets), as well as caps be necessary?

-- How would investment and noninvestment activities be allocated to congressional committees?

-- Would trade-offs be allowed between discretionary spending for investment and mandatory programs that support consumption or only within the discretionary category?

In our view, this approach has the advantage of focusing budget decisionmakers on the overall level of investment supported in the budget without losing sight of the unified budget deficit's impact on the economy. It also has the advantage of building on the current congressional budget process as the framework for making decisions.

CHOOSING FEDERAL INVESTMENT

Regardless of how the budget is structured to display federal investment, it will be important to choose those investments wisely. At the request of Senator Bradley, we have been developing a framework for selecting federal investment programs that could assist the Congress in making investment decisions.

Ideally, policymakers should have access to measures of relative rates of return from federal investment programs in allocating resources among programs. However, such data are scarce and additional research is needed to develop more and better information on the economic effects of various types of investment proposals. Nevertheless, a few well considered questions may help congressional decisionmakers assess the relative worth of competing investments.

Is the investment worth making? Potential economic returns may determine whether to embark on a plan for increased federal investment. In seeking the "best" federal investment, however, decisionmakers should consider not only estimated returns, but also whether the proposal truly addresses a public need and whether the federal government is the right entity to address that need. Questions about whether the private sector or other levels of government should be expected to make such an investment would be pertinent. Alternative approaches to meeting the perceived public need should be considered before rushing to address the problem with federal outlays. For example, some analysts have suggested that charging airlines landing fees based on time of day rather than aircraft weight could help reduce congestion at airports, possibly alleviating the need for expensive new airports.

Is the investment program well designed? Even the best potential investment program can be rendered ineffective by poor design. Decisionmakers should consider design issues to promote effective program delivery, including (1) coordination with state and local governments and other federal policies and (2) targeting of funds to areas with greatest needs. For example, until recently, federal highway policy encouraged new highway construction and major repairs, but prohibited the use of federal funds for preventative maintenance even though preventative maintenance could prove cost effective. Policymakers need to be aware of the possibility that the states and localities could use federal investment funds to supplant their own spending. Studies have suggested that even the prospect of additional federal grant funds can prompt states and localities to reduce their planned spending, which ironically could trigger a decline in total overall public spending for the funded activity.

How can the investment program's results be evaluated? Whether the federal government has indeed selected good investments can, of course, only be known after the investments have been made. But it will be important to future federal investment to consider how investments selected today might be evaluated tomorrow and to begin to collect the information necessary for that evaluation. Too much of the information decisionmakers need to assess potential investments is unavailable. As a result, the federal government's current investments are continued without any evidence that they are good investments. Program evaluation is always important, but if investment were to be favored through a restructured budget, evaluation of the investments' success would become even more critical.

CONCLUSIONS

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 that 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 economic growth. The current budget structure, with its focus on short-term goals, does not meet these needs.

If we are to increase long-term economic growth, the budget must be structured to focus on long-term decision-making. A federal investment budget component could help the Congress and the President make better informed decisions regarding federal spending on consumption versus investments for the future. Recognizing the importance of the deficit to long-term growth, however, such a component should be established within the context of a unified budget framework seeking to reduce the deficit over an appropriate period. Establishing investment targets in the congressional budget resolution would be a useful and feasible way to implement this concept.

I commend the Subcommittee for bringing the budget structure issue forward for public debate. Debate on the bills before you today may begin moving the budget toward a recognition of the contribution of public investment to our economy.

Mr. Chairman, this concludes my remarks. I would be happy to answer any questions that you or Members of the Subcommittee may have at this time.

(935124)

Ordering Information

The first copy of each GAO report and testimony is free. Additional copies are $2 each. Orders should be sent to the following address, accompanied by a check or money order made out to the Superintendent of Documents, when necessary. Orders for 100 or more copies to be mailed to a single address are discounted 25 percent.

Orders by mail:

U.S. General Accounting Office
P.O. Box 6015
Gaithersburg, MD 20884-6015

or visit:

Room 1000
700 4th St. NW (corner of 4th and G Sts. NW)
U.S. General Accounting Office
Washington, DC

Orders may also be placed by calling (202) 512-6000
or by using fax number (301) 258-4066.

PRINTED ON RECYCLED PAPER

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

Official Business
Penalty for Private Use $300

First-Class Mail
Postage & Fees Paid
GAO
Permit No. G100