United States General Accounting Office

GAO

Testimony

Before the Subcommittee on Legislation and National Security
Committee on Government Operations
House of Representatives

Release on Delivery
ected at
00 a.m.
esday,
vember 9, 1993

BUDGET POLICY

Investment Budgeting for the Federal Government

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

058501 / 150288

Mr. Chairman and Members of the Subcommittee:

I am pleased to be here today to discuss federal capital budgeting. In addition to testifying before the Subcommittee this morning, we are providing our report on incorporating an investment component in the federal budget. The report discusses in greater detail many of the issues that I am about to present to the Subcommittee.

Capital budgeting proposals for the federal government are usually advanced as a way to differentiate between spending for the long-term and spending for current operations. Analogies are made both to the private sector and to state budgets. In looking at proposals for a federal capital budget, however, it is important not only to examine these analogies but also to recognize several different aspects of this spending for the long-term versus the short-term as it relates to the federal budget.

The federal budget can be seen both as the budget of an operating entity--the federal government--and as the document through which the federal government expresses its role as the government of a nation. These two roles present different issues.

As an operating entity, the government must be able to make expenditures that increase internal efficiency and maximize the use of scarce resources. For example, the government must make decisions concerning whether to lease or purchase an office building, or whether the increased efficiency provided by the purchase of a computer system will result in benefits greater than cost. Current budget rules are thought to skew these choices. Important as this issue is, however, there is another focus of concern about capital or investment budgeting.

Much debate--and my discussion today--deals with the role of government investment in the long-term productive capacity of the economy. The spending and revenue policies of the federal government affect both the short-term and the long-term economic health of the nation. We believe that increasing attention must be paid to how the federal budget affects the latter; the budget should help policymakers focus on the longer-term impact of budget decisions. In particular, we need to improve our ability to distinguish between those federal programs that increase long-term economic growth and those that primarily support current consumption.

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--private economic investment's share of GDP stands at its lowest levels in three decades. Moreover, our major trading partners have significantly higher levels of investment. Failure to reverse these trends will doom future generations to a relative decline in their standard of living.

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 reducing 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. We said that these are vital actions 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 now because failure to take action could result in deficits rising to 20 percent of gross national product (GNP) by the year 2020, due primarily to rising health, retirement, and the associated interest costs.

In addition to deficit reduction, well-chosen federal investment 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 such as transportation systems, 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. Recent budget trends have not been encouraging for either the deficit or federal investment programs.

COMPOSITION OF THE BUDGET

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 most federal investment funds. Federal outlays for investment programs (physical capital, research and development, and education) 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.

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 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 promote longer term economic benefits.

---

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

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 direct 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.

WHAT IS AN INVESTMENT COMPONENT?

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. 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.

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.

Business enterprises have capital budgets that show large physical 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.

In our 1986 report on states' capital budgeting practices,[2] 37 of 45 states responding to a questionnaire indicated that they had a distinct capital budget which reported 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.

For the federal level, 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. Like the states, such a budget would include some federal investments in physical capital. But the scope of a federal investment budget should be broader to encompass the types of programs we undertake that are intended to have an impact on long-term economic growth--principally spending on research and development (R&D) and education and training as well as some physical capital. Since states often cannot capture the benefits from R&D or job training, the federal government has assumed a major leadership role in these areas.

Under this concept, a federal investment budget would include grants for physical capital and spending for R&D and human capital activities, such as education and training, which are directly intended to increase private sector 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 operations and create jobs in the short term in particular regions of the country; however, they do not directly increase the private sector's longer term productive capacity.

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

---

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

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 reviews of the implementation of investment budgeting would help to do so. Controversy over the definition will likely escalate if the investment category receives any type of favorable budget treatment.

USING AN INVESTMENT COMPONENT IN BUDGETING

Definitional issues are only one of a series of decisions that need to be considered in developing an 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;

-- include depreciation of investment activities in the budget;

-- permit deficit financing of 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 currently 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 distinguished 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, these presentations are used only to provide supplemental data. 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, the current presentations do not include the entire budget so that spending for investment can be compared with spending for consumption. Nevertheless, such a display could prove to be useful in providing additional information for the congressional decisionmaker. In addition to displaying investment outlays as they relate to total federal spending, other additions to the investment information presented in the budget could be useful in evaluating total public investment. For example, the display could include information on investment effectiveness; tax expenditures related to investment; deferred maintenance; and historical information about federal, state, and local spending on investment.

<u>Depreciate Investments</u>

This approach would report the total up-front cost of investments in a capital portion of the budget and the annual depreciation in an operating portion of the budget. Thus, this would spread the investment costs over the life of the investment, and the operating budget would reflect the cost of goods or services in the period that they are used or consumed.

---

[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.

Depreciation has been a long accepted part of accounting in business organizations. Under business accounting practices, depreciation is the allocation of the costs, less salvage value, of fixed assets, including equipment, buildings, and other structures, over their useful lives. It is recorded in a business organization's financial statements to reflect the use of assets during specific operating periods in order to match costs with related revenues in measuring income and to determine the organization's profit or loss, its federal tax liability, and the depreciated value of the asset.

State governments neither budget for depreciation nor charge their operating budgets with depreciation. They often use separate capital and operating budgets because they are legally required to balance their operating budgets. Most charge the operating budget with debt service--principal and interest--when bonds are sold to finance the capital.

Depreciation is not currently used in the federal budget, but capital budget advocates argue for its use. Appropriations and outlays are normally recorded on a cash basis in the budget; thus, the costs of programs intended to produce future benefits are recorded up front. Capital budget advocates argue that this large up-front commitment of resources, and the resulting additions to total spending, make investments unattractive spending decisions compared to other types of spending, especially under the current budget process with its spending caps.[5]

Depreciation is not a practical alternative for the Congress and the administration to use in making decisions on the appropriate level of spending intended to enhance the nation's long-term economic growth for several reasons. Currently, the law requires agencies to have budget authority before they can obligate or spend funds on any item. Unless the full amount of budget authority is required to be appropriated up front, the ability to control decisions when total resources are being committed is reduced. Appropriating only depreciation, which reflects only a fraction of the total cost of an investment, raises this control issue.

In addition to the fund control issue is the difficulty of determining an appropriate depreciation amount. Investments in human capital would be particularly difficult to depreciate because of the difficulties in measuring the future value and useful life of human capital. Also, depreciation schedules are often somewhat arbitrary; thus, including depreciation in the budget could result in spending decisions being based on questionable data. Questions have also arisen over the issue of the federal government

[5]Given the Budget Enforcement Act discretionary budget caps, if resources are committed up front for capital items, spending for alternative discretionary items is squeezed out.

allocating depreciation for physical assets such as highways that are financed with federal funds but are owned by state and local governments.

Depreciation could be useful if the purpose of creating an investment budget component is to make decisions about spending which has future benefits to the government as an operating entity. For example, greater use of revolving fund concepts--including depreciation as part of a user charge--to finance internal agency capital purchases could promote greater agency attention to their costs and benefits.

The Federal Accounting Standards Advisory Board (FASAB) is addressing the appropriate use of depreciation for federal accounting purposes. It is not clear what types of spending, 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.

<u>Deficit Finance Investments</u>

This approach would permit borrowing to finance investment. In a traditional capital budget, capital is often financed 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, but some 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 reducing the level of private investment in the national economy. Further, in the short run, permitting deficits to finance capital could hamper the federal government's ability to counteract the business cycle 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 the other activities as investment.

Establish Investment Targets

The Budget Enforcement Act of 1990 (BEA) established a set of caps on discretionary spending as part of the budget control process. Investment spending could be considered formally in the budget process by establishing similar aggregate targets for investment within the overall caps. 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, an issue I will discuss very shortly, 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 investments wisely. We have developed a framework for selecting federal investment programs that could assist the Congress in making investment decisions.[6]

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 Program Designed to Produce Long-Term Economic Growth?

Identifying federal programs that increase private sector labor productivity and economic growth is an important step in devising a federal investment strategy. This is best demonstrated by estimating national economic returns, but calculating those returns is often difficult because of the lack of reliable data. In practice, certain types of public investment programs--infrastructure, human capital, and research and development--have been found to increase productivity. In evaluating an investment program, it is important to ensure that the program increases overall national economic growth and that its primary effect is not just to redistribute economic benefits from one region or sector to another.

Is the Program Worth Implementing?

Not all investment programs are equally valuable. Some programs will contribute more than others to increased productivity and economic growth or other national needs. One must estimate the program's net benefits to the nation's economy and how quickly the benefits and costs accrue. One also needs to define the problem as explicitly as possible to identify the program best suited to deal with the problem and whether alternatives have been considered. In addition, one must determine whether the problem requires government intervention and at which level--federal, state, or local.

---

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

Is the Investment Program Well-designed?

An investment program may effectively address a well-defined problem but still fail to contribute to private sector output and economic growth because of design flaws. One must determine if the program can work as designed and whether the program is properly targeted to the areas or populations where the highest net benefits can be achieved. One must determine also if factors outside the program will hinder its success and whether it is properly coordinated with other federal programs and those of state and local governments.

How Should the Program Be Evaluated After Implementation?

Even if investment programs are worthwhile and well-designed, success is never guaranteed. Priorities and external conditions may change so that even a well-conceived program, over time, may have disappointing outcomes. To improve the federal government's ability to invest wisely in the future, more must be learned about public investments already made. It is therefore important that all public investment programs include, at the time of their implementation, provisions for evaluating program outcomes.

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 could be a useful and feasible way to implement this concept.

This Subcommittee has selected an excellent issue 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.

(935128)

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.

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