

**FEDERAL CAPITAL INVESTMENT AND
THE BALANCED BUDGET AMENDMENT:
THE PROS AND CONS OF A
FEDERAL CAPITAL BUDGET**



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Preface

Unlike the states and many local governments, the federal government does not have a separate capital budget. In the recent past, when policy makers and policy analysts debated whether the federal government *should* balance its budget, capital budgeting was an important element of the debate: States typically are required to balance only their operating budgets, while borrowing for capital purposes, and some argue the federal government should follow that model. Even in the current budget surplus environment, the issues are relevant, since they bear on *which* budget (if any) should remain in surplus.

The President's Commission to Study Capital Budgeting issued its final report earlier this year, and argued that the federal budget process has significant weaknesses, and that "capital spending in particular is inefficiently allocated among projects." The Commission did not, however, endorse a "simplistic version of the capital budget" and argued instead for a broader examination of the federal budget process.

This study examines the debate over requiring the federal government to produce a capital budget. It is adapted from work initially prepared for a joint project of the Brookings Institution and the Rockefeller Institute of Government intended to foster an open and informed debate on proposed constitutional amendments to require a balanced federal budget. The project was funded by the Carnegie Corporation of New York, the Ford Foundation, the Pew Charitable Trusts, and the Rockefeller Foundation. The opinions expressed in this paper are those of the authors, and do not necessarily reflect opinions of the Rockefeller Institute of Government or the organizations that funded this work.

The study argues that state and federal budgeting practices differ because their respective functions differ. State and local

governments spend a greater proportion of their budgets on capital items like schools and fire stations. Federal expenditure is increasingly dominated by transfer payments, especially entitlement spending. Moreover unlike state budgets, the federal budget is partly designed to be a counter-cyclical policy tool. For comparison purposes, the study briefly surveys the role of capital budgeting among the states, almost all of which are constitutionally required to produce balanced operating budgets.

The paper argues that the politics of the federal budget process raise a caution flag. A federal capital budget would likely be used less as an analytical device and more as an action rule. If history is any guide, this can easily lead to much wasteful, pork-barrel spending all under the guise of "investment." The authors conclude that Congress would be better served by exercising more judicious oversight of agency spending than by adopting a global capital budget.

The recent federal budget surplus has re-ignited the debate over federal entitlement spending. Most of the proposals in effect shift financing of entitlements to general revenues and away from payroll taxes. This represents a significant shift in the structure of federal finance that has thus far gone largely ignored. Paradoxically, the fact that the federal government now enjoys a surplus does not render the question of federal capital budgeting moot. The heart of the question revolves around the politics of the budgeting process. Financial tools (like capital budgets) may be used as instruments of policy analysis or as political ammunition (or both). The disappearance (for now) of the federal budget deficit does not mean the disappearance of budget politics. To the extent that the capital budget concept may enter these political debates, this study should prove useful.

The authors wish to thank Don Boyd, Steve Finkler, and, especially, Dall Forsythe for their helpful comments and advice. Any errors of course are our responsibility.

Introduction

Capital budgets are used to plan and account for investments in equipment that will be used to produce benefits for years to come. Virtually all large businesses use capital budgets, or capital budgeting techniques, in their strategic planning. The fifty states and large municipal governments use them as well for planning the acquisition and financing of large assets, like schools and roads, that are to be used in providing local services. Because the benefits of these assets accrue over time, but the up-front costs are large, businesses and local governments generally finance these investments by borrowing, so that the costs associated with the project are spread out over its useful life.

Unlike the states, the federal government has no formal capital budget. It does not have an overall capital investment policy. It does not employ an analysis of its sources and uses of funds that cuts across agencies and programs. Nevertheless, the federal government has had the implicit authority to resort to deficit finance to fund its operations. Over the last forty years the federal government has done so with gusto, so much so that outstanding publicly held federal debt amounts to about \$3.8 trillion.¹

In an effort to rein in deficit financing by the federal government, numerous proposals for a balanced budget rule, including a balanced budget amendment, have been introduced in the Congress. One of the concerns that has arisen with respect to a balanced budget amendment is the prospect of the federal government facing increased difficulty financing the acquisition of capital goods and other long-term investments by borrowing. This has provoked concern among some fiscal policy analysts that the federal government's budget will be increasingly biased in favor of current consumption and against long-term investments in public infrastructure and human capital that will be needed both to produce services for future generations, and to augment the United

1 U.S. General Accounting Office, "The Economic and Budget Outlook: An Update," September 1997.

States competitive position in the global economy. A possible remedy that has been suggested for dealing with this potential problem is for the federal government to adopt a capital budget. In fact, during the 1995 Congressional debate over the balanced budget, several amendments to this effect were introduced in both the House and Senate. None were accepted.

The heart of the debate over proposals for a federal capital budget relates to the role that a federal capital budget would play if federal budgeting were constrained by a balanced budget rule. A capital budget could simply serve the function of providing more information to decision makers regarding the costs and benefits associated with competing policy choices. On the other hand, capital budgeting may imply an action rule mandating federal spending when the projected benefits of a proposal exceed the cost of borrowing needed to finance it. But, ultimately, the advisability of adopting some form of federal capital budget does not hinge solely on economic theory. It also depends on the political realities of the federal budget process and the manner in which capital budgeting would likely be implemented. Capital budgeting is a tool, not an end in itself. But the tools of decision making can sometimes determine the substance of policy.

One way to see this is to look at the process Congress adopted to implement closing military bases around the country. Congress knew that some bases had to be closed. But individually, Congressmen have powerful incentives to preserve military bases in their home districts. So while in theory most agreed that some bases should be closed, Congress could not, or would not, agree on the politically difficult question of *which ones*. In order to get around this problem, Congress created a base closing commission that would recommend many bases for closure. Congress would then vote on whether to accept the commission's recommendations *in toto*. By diffusing the responsibility for bad news, this procedure allowed the political process to move forward to achieve the desired result (more base closings). Just as with base closings, the question of capital budgeting must take into account not only sound principles of public finance, but also the process of policy

implementation. It is this interplay of economic theory and political reality in capital budgeting that is the focus of this working paper.

The Federal Budget: Role and Structure

The federal government's budget serves many different functions, which is one of the reasons it is structured the way it is. One of the primary functions of the federal budget is to serve as a counter-cyclical economic policy tool. In theory, the federal government attempts to dampen cyclical swings in the economy by increased spending during slack periods and reduced spending during boom times. In addition to its counter-cyclical role in the business cycle, the federal budget acts as a counterweight to state budgets as well. State fiscal policy in the aggregate is inherently pro-cyclical given the balanced budget constraints under which the states operate, although there is probably sufficient wiggle room to attenuate this tendency. Nevertheless, the federal government can offset the states by intentionally running deficits in the conduct of macro-economic fiscal policy. In an accounting sense, the deficits or surpluses the federal government runs are the residual of fiscal policy. What really matters in economic terms is whether the deficits (or surpluses) are structural or cyclical. That, rather than the merits of any single program, is a key consideration in determining the appropriate level of borrowing to finance the federal government.

The structure of the federal budget, and the rules governing its formulation and adoption, have an important impact on the final outcome. Budget rules matter. One of the most important factors to consider in contemplating the federal budget is that it is essentially a cash budget. Capital spending, social insurance outlays, and operating expenses are treated the same. On the revenue side of the ledger, the same logic prevails. Income taxes, payroll taxes, user fees, and proceeds from bond sales are treated as current revenue. The budget makes no distinction between capital investments and operating expenses. At higher (politically visible) levels of

aggregation the budget does not highlight the use of Social Security and other trust fund surpluses for operating purposes. It does not identify totals for activities established to be primarily self-financing like the Post Office.² In addition, because the current budget structure treats all expenditures the same, the federal budget does not highlight the differences between spending for current consumption and long-term investment.³

The federal government operates within a “unified budget structure.” All revenues and outlays are considered part of the current budget for “scoring purposes.” Budget scoring refers to the rules under which the federal government estimates and reports expected revenues and expenses for the fiscal year. Because all revenues and expenses are considered the same by the scoring process, deficits in one program or expenditure type can be offset or masked by surpluses in others. Consequently, under the unified reporting structure, the fact that the federal budget is either in surplus or deficit for any given fiscal year is often devoid of any analytic meaning. For instance, the federal budget for fiscal year 1998 will turn out to have been very close to being “in balance.” The Social Security Trust Fund, which is nothing more than an accounting fiction, will have continued to amass a surplus while the rest of the budget remains in deficit. So by that measure, the Social Security system is financing the federal government’s current operating deficit. But that is just for now, because if present trends hold, the Social Security system will begin to fall into deficit around the year 2012. So to refer to the unified budget as being “in balance” really doesn’t say very much.

In order to introduce some analytic clarity into the budget, some have suggested that the United States adopt a full-fledged separate capital account in which public infrastructure investments are aggregated and depreciated.⁴ A truly separate capital

2 U.S. General Accounting Office, “Restructuring the Federal Budget “The Capital Component” (AFMD-89-52, August 1989).

3 U.S. General Accounting Office “Budget Trends: Federal Investment Outlays, Fiscal Years 1981-2002,” GAO/AIMD-97-88, p. 4

4 A referee has pointed out that depreciation and capital budgeting are two separate issues.

budget would require a drastic overhaul of the entire federal budget structure as well as the whole budget process, complicating an already complicated and cumbersome process. The United States General Accounting Office (GAO) has suggested an incremental approach to the capital budgeting issue designed to remedy shortfalls in current unified budget practices, without the necessity of a complete overhaul of the federal budget process. For simplicity's sake, we will discuss the case for a federal capital budget in terms of the GAO proposal.

The GAO recommended in 1983, and later again in 1989, that the Congress adopt a change in accounting procedures so that the unified budget would be re-sectioned to include information on aggregate levels of investment spending across agency lines to better elucidate the broad policy implications of federal spending.⁵ Under this proposal, operating and capital appropriations would be reported for each budget function, agency, and program. It would represent a conceptual budgetary framework, not the kind of detailed implementation plan a full-fledged capital budget implies.

The impetus behind the GAO's proposal is a desire to provide information to clarify policy choices. In theory, a re-sectioning of the budget would affect the budget formulation process within the Executive branch and facilitate a more careful analysis of policy options.⁶ Moreover, Congress could look at the budget and get a broad sense of the federal government's overall investment posture by comparing capital and operating outlays. Congress could then use the information if it so desired to set national investment policy in terms of aggregate federal investment targets.

In its 1989 proposal the GAO reformulated the 1988 federal budget presentation to show how it would look if were re-sectioned in the manner suggested by the GAO. The first table

5 U.S. General Accounting Office, "Pros and Cons of a Separate Capital Budget for the Federal Government," GAO/PAD-83-1, September 22, 1983, Appendix III, p. 27.

6 *Ibid.* pp. 12-20.

illustrates the surplus/deficit position of the major components of the federal budget.

	<i>Total (Billions)</i>	<i>General (Billions)</i>	<i>Trust (Billions)</i>	<i>Enterprise (Billions)</i>
Operating Surplus / Deficit	\$-131	\$-248	\$124	\$-7
Capital financing requirements	\$-24	\$-23	\$2	\$-3
Unified budget financing requirements	\$-155	\$-271	\$126	\$-10
Source: GAO (AFMD-89-52, August 1989).				

The table illustrates that a federal trust fund surplus was more than offset by deficits in both the general and enterprise funds. The net result was a unified financing requirement of \$155 billion for fiscal year 1988.

Table 2 is the GAO's example of how the federal government reported its unified budget for fiscal years 1987 and 1988, which essentially is the current system.

	<i>Actual 1987</i>	<i>Actual 1988</i>
<i>Receipts</i>		
General Taxes & Receipts	\$527	\$549
Earmarked Taxes & Receipts	327	360
Total Receipts	\$854	\$909
<i>Outlays</i>		
Civil Functions	\$584	290
Defense Functions	282	290
Interest on Debt	138	152
Total Outlays	1,0004	1,064
Surplus/Deficit (-)	\$-150	\$-155
Source: GAO (AFMD-89-52, August 1989)		

Table 3 shows the federal budget as if it were re-sectioned according to the GAO proposal.⁷

Table 3 GAO Proposed Federal Budget Presentation (In \$ Billions)		
	<i>Actual 1987</i>	<i>Actual 1988</i>
<i>Operating Budget</i>		
Operating Revenues	\$958	\$1,013
Operating Expenses	1,073	1,144
Operating surplus/deficit (-)	\$-155	\$-131
<i>Capital Budget</i>		
Capital Revenues	\$57	\$67
Capital Investments	142	141
Asset Consumption Charge	-50	-50
Net Capital Investments	92	91
Capital financing requirements	\$-35	\$-24
Unified budget financing requirements	\$-150	\$-155
Source: GAO (AFMD-89-52, August 1989)		

The re-sectioning of the budget, illustrated by Table 3, shows at a glance how much expenditure is going for capital investment, and how much is going for operating expenses. The unified federal budget deficit is \$155 billion for 1988. The federal government had \$141 billion in outlays for new capital investments, but consumed \$50 billion of the existing capital stock, for a net new addition to the federal capital stock of \$91 billion. The existing capital stock generated \$67 billion in revenues, so the financing requirement for net new capital was the difference, which amounted to \$24 billion in 1988. Since the total unified deficit for 1988 totaled \$155 billion, the remaining \$131 billion represented operating expenditure.

7 The GAO's proposal treats amounts received from the public differently than the current budget, which offsets them against gross outlays. Consequently gross receipts and expenditure in Tables 2 and 3 are not the same, but the unified financing requirements are.

As these tables illustrate, the re-sectioned federal budget highlights the portion of the budget going for investment. Thus, it could simply function as an information device. Or, it could be used as a mechanism for targeting investment levels. It could also serve as a tool for defining borrowing limits. Congress could, for example, limit new borrowing to the amount needed for net new capital investment. In a situation similar to the 1988 case illustrated by the tables above, borrowing could be restricted to \$24 billion, which represents net new capital investment. Congress would then have to raise another \$131 billion in revenue, cut operating expenditure \$131 billion, or some combination of both.

At this point, in order to put a proposal for federal capital budgeting in perspective, it is useful to take a brief, comparative look at the capital budgeting practices of businesses and especially state and local governments.

Business and State Capital Budgeting Practices

Accounting practices are primarily designed to perform two functions. The first is to present a clear picture of the financial condition of an entity to those outside the organization. The second is to provide a tool for management and political decision making. Capital budgeting typically falls into the second category.

Capital budgets are concerned with accounting for the expenses and revenues associated with long-term capital investments. Not only do capital budgets serve as a tool for analyzing capital investments, they can be integrated with the operating budget. For instance, at the municipal level, the direct costs of building a new school or library would be in the capital budget, but the salary of additional personnel would be included in the operating budget. Because the focus is not on capital projects per se, but as a means of accomplishing programmatic objectives, state governments tend to frame policy discussions with respect to the general fund, rather than all the funds represented in their budget presentations.⁸

8 Axelrod, Donald, *Budgeting for Modern Government*, 2nd ed. (New York: St. Martin's Press, 1995), p. 125.

Virtually all large businesses have separate capital accounts in which they develop plans for large-scale capital investments that will provide benefits in the future. They estimate the present value of those expected benefits, and they make plans to finance those investments either internally from cash flow, or externally by debt issuance. Comparing the present value of expected future benefits with alternative investments (traditionally by cost-benefit analysis) provides a mechanism for project evaluation and investment decision making.

State and local governments use capital budgets in a somewhat similar but not identical fashion. Capital budgets are used to plan the acquisition and financing of capital items used in the conduct of the government's business. As a general rule, however, state and local governments do not use the same strict accounting rules businesses do. One of the main distinctions is that, unlike business, governments do not depreciate their capital stock. They do not publish business style balance sheets listing assets and liabilities. Obviously, sub-national government units do not need to depreciate for tax purposes. But tracking and control purposes are also served by accounting systems irrespective of tax considerations.

Using modified accrual as the basis of accounting, states do not show fixed assets on their balance sheets the way businesses do. As soon as fixed assets are acquired they are treated as expenditures. For reporting purposes fixed assets are generally shown in the General Fixed Asset Group. Even then, some infrastructure — such as roads, bridges, and sewer systems — may not be shown at all.⁹ For comparison purposes, the interested reader is invited to examine the income and balance sheet presentations of the state of New Jersey and virtually any publicly held company. Data are readily available on the World Wide Web.¹⁰

9 Finkler, Steven A., *Financial Management for Public, Health, and Not-for-Profit Organizations*, 1998. See Chapters 11 through 13, especially Appendix 11-A, Chapter 11, page 64.

10 New Jersey publishes budget and financial data at: <http://www.state.nj.us/treasury/omb/2000bud/cafr/finstats.pdf>. Most publicly held companies publish their financial data on the World Wide Web as well. General Electric publishes financial data at: <http://www.ge.com/investor/finance.htm>.

All fifty state constitutions contain severe constraints on borrowing. Ten state constitutions do not allow any debt whatsoever, except for emergencies. Eleven impose rigid borrowing requirements. Nineteen require direct voter approval for going into debt, or increasing debt limits. Ten more require super-majorities or other devices to restrain borrowing. All are required to maintain balanced operating budgets. As a result, capital budgets have performed a critical function for state and local governments, providing them with a mechanism for separating long-term investments from operating expenses, thereby allowing them to seek debt financing (with varying degrees of difficulty) for the acquisition of capital assets. But, as we noted earlier, while balanced budget constraints are used to limit state spending and borrowing, the states do not have the same economic responsibilities as the federal government.

Because of the inherent substantive differences in the economic roles played by the states and the federal government, state and local capital spending plans are far more likely to be project specific. Moreover, the processes by which local capital spending decisions are made are different from those of the federal government. Very large capital projects requiring substantial borrowing — such as environmental reclamation projects in a state, or a new school house in a town — are often put to the voters directly in the form of referenda authorizing the issuance of bonds for the specific purpose of funding that project. Furthermore, the decision to fund state-level investment by issuance of bonds is often driven by tax considerations. A state with a large population of high-income residents will be more likely to finance in the municipal bond market because the implicit federal tax subsidy is greater than that received by a state with fewer high-bracket taxpayers.¹¹

11 Because bonds issued by state and local governments are generally exempt from federal as well as state income taxes, the tax saving enjoyed by municipal bond holders represents an implicit federal subsidy. The higher the taxpayer's marginal tax rate, the greater the subsidy. A state with a large proportion of high-bracket taxpayers therefore has a powerful incentive to finance a large segment of its expenditure by debt issuance because the implicit federal tax subsidy allows it to export a portion of its tax bill.

Many of the reasons that states use capital budgeting are simply not applicable to the federal government. First, unlike the states, the federal government does not need a capital budget to maintain access to the capital markets. It has first call on funding in the capital markets by virtue of the fact that it can simply monetize its borrowing needs if necessary. Second, its future borrowing power will not be affected by any one deal. The magnitude of the outstanding debt is such that even if the budget were in balance, the federal government would probably have to sell about \$4 billion on the average work day just to roll over the outstanding debt. Moreover, secondary market trading in Treasury securities generally exceeds \$150 billion on the average trading day. Third, the federal government is not subject to the same solvency criteria state and local governments are subject to. While the federal government could in theory be charged an interest rate premium in the market place, as a practical matter it is likely to borrow at a discount relative to other national governments as long as the dollar remains the world's reserve currency.

In short, the federal government may make the political decision to place borrowing constraints on itself with a balanced budget amendment, but externally imposed market discipline is unlikely to be affected by the adoption of a capital budget *ceteris paribus*. The experience of the states in many respects is largely irrelevant to the question of whether the federal government should adopt a capital budget. The unique position of the national government in the federal system, and the functions for which capital budgets are typically employed are likely to be the determinative factors in the decision.

Capital Budget Functions

Donald Axelrod has suggested that capital budgets serve six specific functions which we will now discuss.¹²

12 Axelrod, Donald, *Budgeting for Modern Government*, p. 116.

1. Comprehensive Planning

Comprehensive Planning involves determining the economic and social needs of a jurisdiction, defining goals, objectives, and targets for the public sector, proposing programs and policies to accomplish those objectives, and recommendations for financing those initiatives. The capital budget is part of the overall planning process especially with respect to the financing of public sector investment.¹³ These plans vary in complexity and scope among state and municipal governments in the United States. In general, at the federal level, proponents of comprehensive planning in the United States have concentrated their efforts in forming a national industrial policy. However, at the federal level, industrial planning has encountered strong philosophical resistance. Consequently, the federal government has chosen to fund basic research, preferring to let the business of picking winners and losers remain in the private sector.

2. Functional Planning

Functional plans are smaller scale, dealing with specific functions and programs. They typically analyze programs, and set performance targets over a multi-year period. For instance, a functional plan would typically be used to deal with large functions or programs like prison or school construction. In addition, a functional plan would be used to set priorities on programs and capital projects and to estimate probable costs.¹⁴

3. Multi-Year Planning

Multi-year capital investment programs are the link between comprehensive and functional plans. The comprehensive plan pulls together the functional plans and coordinates them into an action plan. The capital investment program establishes the framework for the government's investment priorities, and its fiscal policy choices, thereby directly influencing the capital budget. As of 1995,

¹³ Ibid., p. 108.

¹⁴ Ibid., p. 108-109.

twenty-nine states prepared rolling, long-range capital plans and budgets extending at least five years.¹⁵ These plans are “rolling” in the sense that they are (or can be) continually updated and adjusted as time passes and situations change.

4. Project Selection

The capital budget is a tool used in the selection of investment projects. Factors considered in the selection of projects include: 1) condition of existing facilities, and 2) additional needs generated by growth, deterioration, or both. The usual criteria for selection is some form of cost-benefit, or cost-effectiveness analysis.

5. Financial Planning/Management

The capital budget is used in financial planning 1) to estimate revenues and expenses associated with capital projects; 2) to determine the best way to finance selected projects; and 3) to assess issues of intergenerational equity. Intergenerational equity can best be thought of in terms of fairness between generations. Each generation has an obligation to treat future generations equitably. It can be plausibly argued that the main difference between financing by current taxation and debt issuance is the timing of the ultimate tax bill. The normative prescription would argue that the current generation should tax itself for what it will consume, leaving both what it did not consume and that portion of the cost to future generations. If, for instance, a town were to build a new school house, the benefits of the physical plant would be enjoyed by future generations. Therefore, the town should borrow some of the cost of building the school as a way of spreading the costs over the generations that will benefit from it.¹⁶

¹⁵ Ibid. 109-110

¹⁶ There is however another school of thought known as Barro-Ricardian Equivalence that maintains that government fiscal policy is largely irrelevant because individuals take steps to offset the intergenerational effects of government debt policy. See Harvey S. Rosen, *Public Finance*, 4th ed. (Chicago: Richard D. Irwin, Inc., 1995), p. 469-71.

6. Integration of Investing and Financing Activities.

It is through a capital budget that projects can be analyzed both in terms of their merits and their impact on the financial condition of the entity. Moreover, the linkage of policy, planning, and financing is a crucial step in the successful execution of a workable capital investment strategy. It is this linkage that ties the elements of the plan together so that the program can focus on achieving long-term policy goals. Successful implementation will require a good operational definition of what truly constitutes capital investment. That definition is critical, and is the subject to which we now turn.

Defining Federal Investment

A good operational definition of capital investment for budgeting purposes is a crucial element in the development of a capital budget. The sometimes loose and interchangeable use of terms like “capital” and “investment” have often served to blur rather than clarify the whole idea of what a capital budget would actually look like in practice. At one extreme, some definitions of capital investment are limited to investments in permanent, tangible infrastructure. At the other extreme, any investment in human capital such as education and training would be included.

John Mikesell categorizes capital budgets in terms of three criteria. He says that a capital budget “focuses decisions, facilitates financial planning, and regularizes the provision of projects that (1) have a long life (ten or fifteen years at a minimum), 2) have a high price tag relative to the resources of the governing unit, and (3) are non-recurrent” [i.e. they are intermittent].¹⁷ The GAO has a somewhat more expansive definition. They define federal investment as “...federal spending, either direct or through grants, specifically intended to enhance the private sector’s long-term productivity. This definition includes spending on (1) some

¹⁷ Mikesell, John L. *Fiscal Administration: Analysis and Applications for the Public Sector* (Pacific Grove, CA: Brooks/Cole Publishing, 1991), p. 167.

intangible activities, such as research and development (R&D), (2) human capital designed to increase worker productivity, particularly education and training, and (3) physical assets to improve infrastructure, such as highways, bridges, and air traffic control systems.”¹⁸ The Office of Management and Budget (OMB) takes a narrower point of view. OMB says “that Capital assets are land, structures, equipment, and intellectual property, including software, that are used by the Federal Government and have an estimated useful life of two years or more. Capital assets exclude items acquired for resale in the ordinary course of operations or held for the purpose of physical consumption such as operating materials and supplies.”¹⁹

In its discussion of capital and its annualized counterpart, investment, the President’s Commission to Study Capital Budgeting declined to settle on a single definition of capital, preferring to elucidate the differences among different types of capital spending. The Commission noted that capital spending could be differentiated by function. For instance, spending on physical plant, R&D, and training (human capital) could all be considered capital spending. The Commission also distinguished between *federal* capital and *national* capital. In the Commission report, federal capital refers to only those assets that belong to the federal government (like buildings). National capital includes all government spending aimed at delivering long-term benefits to the nation.²⁰

Clearly, the easier it is to define an item as a capital investment, the easier it is to balance the operating budget. Consistency would seem to be the key. But ultimately the choice of definition is itself a policy decision, and is not insulated from the political process.

18 Source: GAO/AIMD-97-88, Federal Investment Outlays, Fiscal Years 1981-2002 (Letter report, 05/21/1997).

19 OMB Circular No. A-11, 1997, “Planning, Budgeting, and Acquisition of Capital Assets,” 300.4 Definitions, p. 294.

20 Report of the President’s Commission to Study Capital Budgeting, <http://www.whitehouse.gov/pscsb>, pp. 9-10.

Trends in Federal Spending

Not all types of governmental activities will or should be financed alike. Changes in federal responsibilities and priorities will have a bearing on the strategies and structures used to fund different types of current and prospective federal activities. Trends in the composition of federal expenditure will reflect the relative importance of federal capital expenditure. The trend in federal expenditure, as Table 4 shows, is increasingly in the direction of consumption rather than capital outlays. Moreover these programs encourage consumption through income transfers.

In 1971, Social Security, Medicare, and Medicaid accounted for a 21.2 percent share of the federal budget. By 1995, they accounted for 38.1 percent. Similarly, in 1971 these three programs consumed 4.2 percent of Gross Domestic Product (GDP). By 1995 they consumed 8.3 percent. During this time total federal outlays increased from 20 percent of GDP to 21.7%. In short, during the last twenty-five years federal spending has been driven by transfer payments.

Table 4				
Shifting Priorities in the Federal Budget				
<i>Outlay Category</i>	<i>Percent of GDP</i>	<i>Percent of GDP</i>	<i>Budget Share</i>	<i>Budget Share</i>
Year	1971	1995	1971	1995
Mandatory Outlays	6.9	10.6	34.7	48.8
Social Security	3.3	4.8	16.7	21.9
Medicare	0.6	2.2	2.9	10.3
Medicaid	0.3	1.3	1.6	5.9
Other	2.7	2.3	13.5	10.7
Discretionary Outlays	11.7	7.8	58.3	35.9
Defense	7.5	3.9	37.6	18
International	0.4	0.3	1.8	1.3
Domestic	3.8	3.6	18.9	16.6
Interest Outlays	1.4	3.3	7.0	15.3
Total Outlays	20.0	21.7	100.0	100.0
Source: U.S. General Accounting Office "Budget Trends: Federal Investment Outlays, Fiscal Years 1981-2002" (Letter Report, 05/21/97, GAO/AIMD-97-88).				

The determination of trends in federal investment spending, however, depends on the choice of definition. Measured as a percentage of current dollar GDP, the trend in federal investment spending is lower. This must by definition be true if the driving force behind federal spending is consumption programs. The GAO points out that “The President’s policy estimates of what we [the GAO] have categorized as investment spending for fiscal year 1998 amount to \$148.6 billion, or 7.2 percent of total outlays and 1.8 percent of GDP, part of a continuing downward trend. Actual total federal outlays for investment as a share of total outlays decreased from a high of 10.4 percent in 1981 to 7.8 percent in 1996. While investment rose in some years, the overall trend was down. Investment outlays for fiscal years 1997 to 2002 are projected to continue this downward trend by steadily declining from 7.4 percent to 6.6 percent of total outlays.”²¹ However, if federal investment outlays are converted to constant dollars, “Investment spending in estimated constant dollar outlays increased slightly from the 1980s to the mid-1990s, with a gradual decline through 2002.”^{22,23}

The composition of federal investment spending in constant dollars, as defined by the GAO, has shown shifting patterns. Investments in physical capital remained steady from 1981 through 1995, and is projected to trail off slightly until 2002. After showing increases from 1980 through 1990, Research and Development drops off gradually. Education and training have shown steady growth from 1981 that is projected to continue through 2002.²⁴

Ninety-six percent of federal investment outlays from 1981 projected through 2002, measured in constant dollars, is contained in seven budget functions. According to the GAO, “Two of those functions, Education and Training, and Health, show a

21 U.S. General Accounting Office “Budget Trends: Federal Investment Outlays, Fiscal Years 1981-2002 (Letter Report, 05/21/97, GAO/AIMD-97-88).

22 Ibid.

23 In response to a referee’s query we would like to note that we relied more extensively on the GAO rather than OMB or other agencies on the theory that the GAO was less likely to have a vested interest in the debate.

24 Ibid.

general increase over the period. The General Science function shows an increase to the mid-1990s and then levels off. The National Defense and Transportation functions show increases followed by declines in the 1990s and through 2002. Investment spending in the Natural Resources and Environment and Energy functions show a continued downward trend from the 1980s through 2002.”²⁵

The composition of total federal spending has shifted dramatically over the last twenty-five years, as federal spending patterns began to reflect changes in federal priorities. Over this time only outlays for human services and interest payments have increased budget shares. Outlays for defense, economic affairs, natural resources, and central government operations have had their budget shares reduced. Moreover the change in federal outlays reflects a change in the federal activity away from providing goods and services to principally providing payments to individuals.²⁶

In summary, broadly defined inflation-adjusted federal capital spending has increased over the last forty years as shown in Table 5, but the composition of outlays has shifted decisively in favor of expenditure for human capital development, especially in Education and Training and Health Care.

<i>Year</i>	<i>Billions \$1992</i>			<i>% of Total Outlays</i>		
	<i>Total</i>	<i>Defense</i>	<i>Non-Defense</i>	<i>Total</i>	<i>Defense</i>	<i>Non-Defense</i>
1965	138.6	72.0	66.6	32.2	18.0	14.2
1975	156.9	62.3	94.7	20.9	8.6	12.3
1985	216.9	121.7	95.2	19.7	11.5	8.2
1995	218.7	91.2	127.5	15.4	6.4	8.9

Source: Budget for FY 1998 Historical Tables

25 Ibid.

26 Ibid.

When analyzing budget data, it is important to consider that constructing budgets and establishing priorities is not merely a question of mechanically collecting information, analyzing costs and benefits, and making decisions “by the numbers.” The choices made reflect political preferences as well as economic analysis. And the rules governing the decision process can have an important impact not only on how those decisions are made, but also on what decisions are made. Accordingly, we now turn our attention to the political framework within which budget decisions are made.

The Political Context of Budgeting

Budgeting is inherently political. Scarce resources must be allocated to achieve competing priorities, goals, and policies. Budgeting provides a framework in which these allocation decisions are made. Within the budgetary framework, goals are determined, priorities are set, and policies are put in place and evaluated. The procedure is fraught with conflict every step of the way. It represents more than just the technical and financial aspects of policy. It is at the heart of democratic politics.²⁷

The same can be said about the debate over adopting a federal capital budget. The adoption of a federal capital budget within the context of a balanced budget can be construed as 1) a technical adjustment to the budget to convey more information; 2) an escape hatch to get around budget balancing requirements; or 3) an action rule to target a specified level of capital investment. The decision to adopt a capital budget is itself a policy choice and is an integral part of the political process. So is the definition of what constitutes a federal capital investment, and the purposes for which a capital budget would be employed. With that in mind, we will consider the pros and cons of federal capital budgeting not as an abstract exercise, but in the context of the rough and tumble of budgetary politics.

27 Axelrod, Donald *Budgeting for Modern Government*, pp. 1-12

The Pros of Federal Capital Budgeting

Proponents of a federal capital budget make three main arguments in its favor. First, the federal government's budget process creates perverse incentives for consumption at the expense of investment. A federal capital budget would change the incentive structure in such a way that Congress would no longer unduly favor consumption over investment. Second, because of the fragmentary nature of the budget's presentation and adoption, Congress lacks sufficient information to properly assess the federal government's investment posture. A capital budget would provide Congress with the information necessary to make more informed choices. Third, the Congress could use a capital budget as a budget enforcement tool so as to limit federal borrowing to the amounts needed to finance capital investment, while balancing the operating budget. This would have the additional advantage of imposing budget discipline while still allowing flexibility. Moreover, the federal government could shift the timing of capital outlays if necessary in order to maintain fiscal policy as an effective counter-cyclical policy tool.

The budget process is driven by Congressional subcommittees that appropriate by agency or department. As a result the focus of appropriators is on an agency's yearly budget numbers. Agency funding is provided in appropriations accounts that do not distinguish between investment and consumption spending. Consequently, not enough attention is given to the mix between long-term and short-term needs.²⁸ The budget process does not prompt either the executive or legislative branches to make explicit decisions about the appropriate mix of consumption and investment spending in the budget. Although the documentation that accompanies the President's budget provides some information on investment, this is not part of the formal budget process. The investment/consumption debate is not one of the organizing themes of federal budget debates.²⁹

28 U.S. General Accounting Office, "Testimony 7/11/96," GAO/T-AIMD-96-129.

29 Ibid.

Proponents claim that the lack of a capital budget systematically penalizes capital investment because the political incentives embedded in the budgeting process are such that Congress is most likely to fund popular consumption-based programs whose impact is felt right away. The benefits that come from capital investment take time to be felt. Moreover, the benefits are spread out unevenly over time; the benefits are “lumpy.” But the costs associated with those benefits are often large, and have to be paid up front. This, proponents claim, is a source of perverse incentives in the budget. Even though capital investment has large if lumpy benefits, the short-term orientation of the yearly (operating) budget cycle influences Congress to systematically under invest in public infrastructure in favor of the more politically popular consumption-based programs.

Intergenerational Equity

The government has an obligation to promote intergenerational as well as horizontal and vertical equity. Each generation should bear its fair share of the costs and benefits of development. But the systematic bias in favor of consumption and against investment in the current budget process implies that the current generation is consuming too much, and doing so at the expense of future generations. This would be the case even if the operating budget were to be in technical balance because in the absence of a capital budget, the depreciation of the federal capital stock would simply be disguised, and succeeding generations would be left with a reduced capital base.

The federal government has the responsibility to conduct policies designed to smooth out the business cycle to the extent possible. One of the more volatile cyclical areas of the economy is private capital investment, which typically falls off during recessions, with attendant multiplier effects. A multi-year federal capital budget could be a useful tool in the conduct of counter-cyclical economic policy in two ways. First, it could help smooth out the business cycle by maintaining a steady, predictable long-term

federal investment posture. Second, federal capital spending could be speeded up to bolster demand during periods of economic slack. That would provide a degree of economic stimulus which would help mitigate economic downturns.

In general, the federal government should strive to maximize the efficiency with which it uses taxpayer (and future taxpayer) dollars. A capital budget helps accomplish this in two ways. First, capital budgeting presents decision makers with tools that can be used to evaluate the optimal mix of inputs (land, labor, and capital) in determining the best manner in which to produce needed goods or services. Second, a capital budget integrated into the current unified budget would tell lawmakers how the agencies are allocating appropriated funds in order to accomplish their missions. Further, it would allow Congress, if it so desired, to order changes in the input mix, or to target what it considered appropriate levels or ratios of investment expenditure to operational spending.

Finally, a capital budget can be an effective tool for expenditure control. In a balanced budget environment, if debt financing were limited to funding capital improvements and short-term cyclical deficits, consumption spending would be limited by tax revenues. Any additional spending would be restricted to investment spending. More investment in the consumption/investment ratio would provide for a more efficient government in the long run, thus reducing future revenue demand. An effective partitioning of the capital and operating segments of the budget would make Congressional oversight of agency performance easier, and would increase the visibility and accountability of agency decision making. Congress would then find it easier to impose some budget discipline on the agencies.

In summary, a federal capital budget would provide Congress with the information it needs to make informed decisions about the federal governments aggregate investment stance. It would serve to draw attention to, and organize the budget debate around, the mix between consumption and investment. It would provide a link between federal financing and investing activities.

As a result, Congress would be in a position to link borrowing with investing, while still balancing the operating budget, thus preserving the needs of intergenerational equity.

The Cons of a Federal Capital Budget

Opposition to the adoption of a federal capital budget comes from those who argue first, and most importantly, that it is a Trojan horse designed to destroy the budget discipline a balanced budget policy would impose and that it would encourage more undesirable federal borrowing; and second, it will not achieve the objectives proponents claim, and may make things considerably worse.

Perverse Incentives

Many proponents of federal capital budgeting suggest that the lack of a formal capital budget in the federal government creates a perverse incentive for the federal government to emphasize current consumption at the expense of investment. However it is a fallacy to suggest that government budgeting processes at the national level *accidentally* favor consumption at the expense of investment. They do so by design. In theory, the national government should run deficits when the economy is slack in order to stimulate demand, and run offsetting surpluses during expansions. This sounds symmetric; all it appears to do is extend the budgetary time frame. But symmetry in theory is not symmetry in application. It is naïve to assume that politicians will create surpluses as willingly as deficits. It is elementary that politicians like to spend, but do not like to tax.³⁰ Moreover, underlying this entire macro-budgetary framework is the Keynesian premise that market economies necessarily suffer from insufficient levels of effective demand. There is a built-in bias in favor of deficit spending for the purpose of stimu-

30 Buchanan, James M. and Wagner, R.E., "From Private Preferences to Public Philosophy: The Development of Public Choice," in *Constitutional Economics* (Oxford, UK and Cambridge, MA: Basil Blackwell Ltd.), 1991, p. 42.

lating demand.³¹ Increasing current consumption through income transfers is one method of accomplishing this.

A good example of the Congressional propensity to spend but not tax under the cover of capital investment was provided by the Advisory Commission on Intergovernmental Relations. The Commission sponsored a symposium on Federal Capital Budgeting in 1994 at the request of Representatives Bob Wise (D-WV) and Bill Clinger (R- PA). Representative Wise argued then that a capital budget was needed to finance investment in an era of deficits because “You can’t raise taxes sufficiently to reduce the deficit or balance the budget. You can’t cut the budget enough to reduce it.”³² Five years later of course, the argument in Congress is what to do with the projected trillion dollar *surplus*.

Capital Budget as a Policy Tool

It is argued that Congress has insufficient information to properly focus its attention on the nation’s capital investment needs. A capital budget would provide that information. This confuses the idea of a national investment strategy with policy analysis and program evaluation. First, it is not at all clear that public infrastructure needs are best determined at the national level. It is almost certainly the case that central targeting of public infrastructure needs would lead to greater federal control of state level policy and planning for public infrastructure. Second, at the agency level, federal agency executives provide the various Congressional committees with information relative to their capital needs and the decision making processes they used to assess those needs. But not all agencies are the same. The appropriate mix of capital and other resources needed to accomplish an agency’s mission will vary widely from agency to agency. There is no reason to suppose that the use of capital resources by the Defense Department, the Social Security Administration, and the Justice Department is compara-

31 Buchanan, James M. and Wagner, R.E., “The Consequences of Mr. Keynes,” in *Constitutional Economics*, pp 95-96 and 99.

32 Intergovernmental Perspective, *Federal Capital Budgeting* 20, 2, Spring 1994, p. 9.

ble.³³ Nor is there any reason to assume that Congress would be in a position to reallocate the capital budget among agencies in such a way that would promote more efficient usage.

Consider the response to the brief experiment with the line item veto. The line item veto was supposed to be a tool to be used by the President to impose rationality and discipline on the budget, rather than allowing it to be dominated by petty local concerns. It did not, however, stop the horse trading among Congressmen to protect their districts from its application. *The Wall Street Journal* reported that in response to line item veto threats, "In last minute deals yesterday on cuts from the Agriculture Department budget, a \$7 million grant for the University of Mississippi was salvaged at the expense of \$900,000 for an insect-research lab in the state. Sen. Barbara Mikulski (D., Md.) recently gave up a space-telescope project, for which a former aide had lobbied to save aviation-equipment funds for a contractor, AAI, in her own state."³⁴ Hardly a model of efficient capital allocation.

Capital Budgets as Bargaining Chips

There is every reason to expect that the same log rolling that takes place in the operations budget will take place in the capital budget. In fact, it is likely to begin almost immediately as Congress defines exactly what constitutes an investment eligible for inclusion in the capital budget. As we discussed earlier, this is much easier said than done. The problem is not merely a technical issue. It goes to the heart of policy. The more flexible the rule, the less likely it will provide either the information or the discipline that defines its function. On the other hand, the more rigid the rule, the more likely it is to be honored in the breach, or generously "re-interpreted" by the bureaucracy or future Congresses. Examples of this type of thing are common. The Reagan Administration, for example, once

33 See Discussion of the Draft GAO Report, "Pros and Cons of a Separate Capital Budget for the Federal Government: Appendix VI," Carey P. Modlin, Assistant Director for Budget Review. August 31, 1992

34 Rogers, David "Line Item veto was Supposed to Strengthen..." *The Wall Street Journal*, November 21, 1997, p. A24.

attempted to have ketchup redefined as a vegetable, and the Clinton Administration to this day insists on referring to Ameri-Corp workers as “paid volunteers.” The use of this technique has become so successful that *The New York Times*, for instance, reported on November 30, 1997, that “The Ameri-Corps program, which was created in 1993, rewards volunteers with a \$4,725 grant to finance their education.”³⁵

The experience of New York is instructive in this regard. In the 1970s New York City’s manipulation of its capital budget was such that by 1975, items that ordinarily would have gone into the operating budget constituted over 50 percent of the capital budget and were a major factor in precipitating the City’s financial crisis. The capital budget was transformed into an extension of the operating budget enabling New York City to evade legal borrowing requirements so that it could continue to spend itself into near bankruptcy. There is every reason to suppose that Congress, like New York City, would use a capital budget as an escape hatch to evade the discipline a balanced budget amendment is meant to impose.

As Accounting Devices

It is often claimed that the federal budget overstates the deficit. All federal expenditure is not “spending” for consumption. Some of the federal budget is used to acquire assets which will produce benefits for years to come. What really matters is the consolidated financial position of the federal government, not just one year’s deficit number. A proper accounting procedure would take account of this by charging only net capital consumption to the current year.

There is much to be said for this. Unfortunately, it leads down a road that few are willing to travel. In order to do this, the federal government could publish a balance sheet listing its assets and liabilities, including the present value of promised future

³⁵ *The New York Times*, “Clinton Seeks to Extend National Service Programs,” November 30, 1997.

entitlement benefits. This is a course of action that has not been adopted by any government anywhere. Alternatively, in the unified budget, the federal government could report the change in the present value of future liabilities. Given current projections on the cost of entitlements, this would undoubtedly show the consumption component of the budget to be much higher, and the federal budget to be in much worse shape than current reporting requirements indicate. In his testimony to the House of Representatives during the balanced budget debate, Richard Vedder, professor of economics at Howard University responding to a question on federal capital budgets, made a similar point. He said:

“In a perfect world, I think perhaps you would have a separate capital budget. On the other hand, in a perfect world, in your accounting system you would depreciate your assets that you already have, your infrastructure, and count that as a current expenditure. Even if you didn’t make a cash outlay of that money, you would set that money aside for depreciation, amounting to tens of billions. And, the same is true with Social Security: our unfunded Social Security liabilities grow each year. We would, in a perfect world, budget that. We are not doing perfect accounting. In a perfect world we would do these things.”³⁶

As Action Rules

It is critically important to define just what it is that a capital budget is supposed to do. While it is preferable to have more information to guide decision making, a capital budget is meant to do more than just convey information. It is a rule of action. Dr. Charles Schultze made this point when he testified before the House during the Balanced Budget amendment debate. He said “... mainly when people use the term ‘capital budget’ they mean a rule of action that you balance the operating budget, but it is all right to borrow for capital outlays.”³⁷

36 Testimony before the House of Representatives, Committee on the Budget, Washington, DC, February 5, 1997.

37 Ibid.

The important thing to consider here is the competition for investment capital. If private savings are relatively low, as they are in the United States, federal borrowing for capital investment may merely displace private investment. On the other hand, if federal investment is financed through taxation rather than debt issuance, those federal investments will reduce private consumption. Total investment outlays in the economy, both public and private, will be greater than they would have been had the federal government resorted to borrowing. Johnathan Rach, in *Demosclerosis*, makes much the same point. He says that "If government were running deficits to finance productive investments — roads and bridges, say — this wouldn't be a problem. But the deficits haven't financed investment. Since the early 1960s, federal long-term investments (excluding defense) have run at about 2 percent of the gross national product; but short-term benefits, as defined by the government itself, rose from 6 percent of GNP in the early 1960s to more than double that percentage in 1992. So the worst is really true: Budget deficits are being used exclusively to finance consumption."³⁸

Whatever Happened to the Plan?

There appears to be a naïve belief that because the capital budget specifies a certain plan of action, that is what will actually happen. The experience of the Department of Defense (DoD) may be instructive here.

In 1994 Congress became concerned about apparent discrepancies between the Defense Business Operations Fund (DBOF) capital budget and actual capital asset spending. The DBOF is no minor operation. It has assets valued at \$126 billion, and had 1995 revenue of \$77 billion, making the fund equivalent to one of the world's largest corporations.³⁹ Its 1994 capital budget

38 Rauch, Johnathan, *Demosclerosis* (New York, NY: Times Books, 1995), pp. 149-150.

39 U.S. General Accounting Office, *Defense Budget Capital Asset Projects Undergo Significant Change Between Approval and Execution*, GAO/NSIAD-95-20, December 1994, p. 3.

was \$1.8 billion.⁴⁰ The GAO found that the DoD had significant problems carrying out its capital budget. In the projects the GAO visited, they found that in 1993, 86 percent of the projects were canceled. In 1994, 65 percent were.⁴¹ Moreover, they reported that at six of the sites they visited, if a project was postponed or canceled, officials usually substituted for it with another project.⁴² There is no particular reason to suspect that the Defense Department is all that different from the other agencies.

Summary and Conclusion

Capital budgets are tools used in the planning and execution of projects with large up-front costs. The benefits of these projects are generally spread out over time, so capital projects are usually financed by borrowing. This enables both costs and benefits to be distributed fairly over time. The federal government has no formal capital budget, but has been able to finance freely in the capital markets. However, a balanced budget amendment with no provision for a capital budget, and therefore borrowing capability, might hinder the federal government's ability to efficiently and equitably finance future service provision.

The President's Commission on Capital Budgeting concludes that there is insufficient evidence to objectively determine whether the current federal budget process leads to bias (in either direction) in the federal government's total capital spending.⁴³ We agree. The Commission also concludes that shortcomings in the federal budget processes have led, and continue to lead to resource allocation that is less than ideal.⁴⁴ Again, we agree.

While in theory it is preferable to have the information that a capital budget would (in theory) provide in order to inform policy choices, in the final analysis it is crucial to anticipate how

40 Ibid.

41 Ibid., p. 2.

42 Ibid., p. 5.

43 President's Commission on Capital Budgeting, p. 45.

44 Ibid.

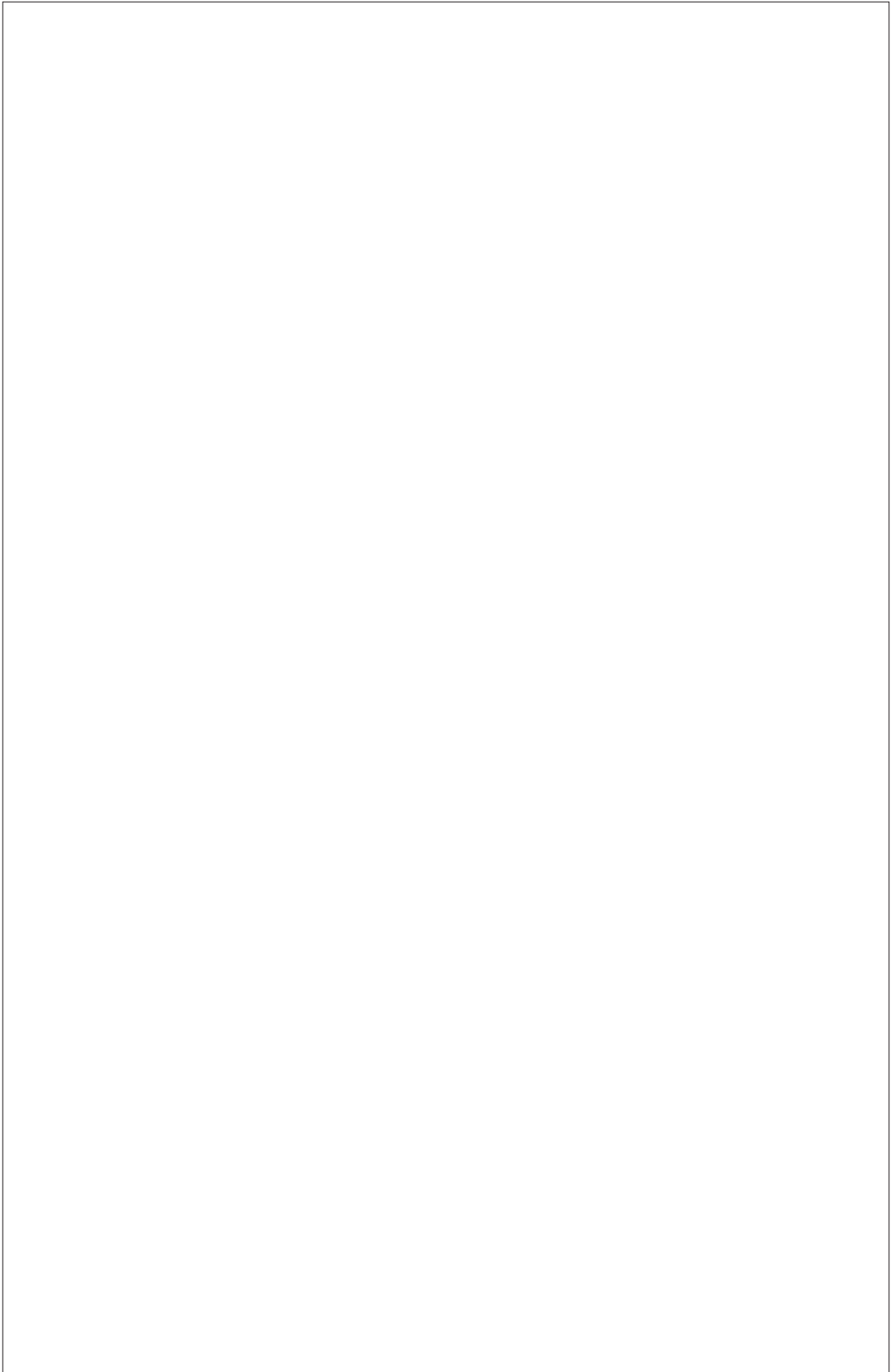
capital budgeting would work in practice. And how capital budgeting would work is inextricably tied in to budgetary politics. Here the evidence is not encouraging. If current and past practice is any guide, a capital budget would very likely be construed as an action rule, rather than as an information device. Further, Congress would almost certainly adopt a very broad definition of what constituted "investment" eligible for inclusion in the capital budget. As a result, federal capital budgeting would likely lead to increased levels of federal expenditure and borrowing, and not necessarily for projects that truly constitute social investments that would provide net benefits on the margin.

The federal budget is now increasingly driven by transfer payments and entitlements, aptly called the third rail of American politics. These entitlements are driving federal consumption expenditure, not the absence of a formal capital budget. A formal capital budget which created implicit borrowing authority would in all probability make the situation worse. Because the domestic savings rate is so low, federal capital market borrowing mostly displaces private sector borrowing. Federal borrowing finances federal consumption spending. If the federal government wanted to increase aggregate investment in the economy, the best way for it to do so would be for the federal government to *reduce*, not increase, its borrowing. We therefore conclude that the federal government should not adopt a formal capital budget as part of the overall federal budget structure.

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