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CONGRESSIONAL BUDGETING
ALTERNATIVE APPROACHES TO THE FEDERAL BUDGET

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ABSTRACT

The Federal budget today is viewed principally on a cash basis that measures priorities mainly by how much Congress spends on them in the present. It does not contain a systematic means of applying measures of program and agency performance to budgetary decisions. It does not comprehensively evaluate the full range of policies employed to achieve national goals. It does not distinguish between spending for immediate consumption and spending with longer-term benefits. Its process begins by assuming the legitimacy of the previous year's spending levels rather than forcing Congress to justify programs in each budget cycle.

In developing a new budget process, therefore, it is useful to examine mechanisms that might address some of these shortcomings. The following discussion considers several of them.

INTRODUCTION

In developing a new congressional budget process, it is worth considering alternative perspectives that can help inform legislators' decisions about fiscal priorities and policies. One example is examining how to link performance measures to the allocation of resources. Another is capital investments, which are currently accounted for in the same way as immediate consumption spending. There are other examples as well.

The discussion below considers some of these options. Whether or not they should become part of the congressional budget process is for elected lawmakers to determine. Examining them, however, can shed light on fiscal policymaking for the Federal Government.

PERFORMANCE-BASED BUDGETING

As Used by State Governments

Performance-based budgeting started in the States in the 1970s as an innovative way to examine how agencies were using public funds. It is an attempt to quantify and measure the success of agencies and programs. "This means moving away from funding an activity or program and instead focusing on funding the outcome desired by the government."[1]

Nearly all the States have experimented with some form of performance budgeting, with varying success, but all were seeking to improve performance, control costs, and focus finite resources on the most effective programs. Legislators or governors (the latter by executive order) required agencies to establish measurable outcomes in terms of their missions and objectives. The policymakers could then judge the agencies' success against these measurable outputs.

In 2013, the National Association of State Budget Officers [NASBO] conducted a survey in which 44 percent of respondents said their States used some form of performance budgeting, sometimes in concert with another method such as traditional line-item budgeting.[2] One study using data from 1970 through 1997 indicates performance-based budgeting reduced State spending by 1.3 percent as a share of State income and per capita spending by approximately 2 percentage points. Magnitudes vary among States depending on the specific procedures used and the duration of performance budgeting.[3]

Nevertheless, a serious criticism of performance-based budgeting says agencies may set outcome criteria too low, thereby underperforming their potential but still meeting

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[1] Maurice P. McTigue, QSO, *Budget Process Reform: Utilizing Performance Information to Produce Better Outcomes*, statement to the Committee on the Budget, U.S. House of Representatives, 6 July 2006.
[2] Elaine S. Povich, "'Performance-Based Budgeting' Takes Off in States," Governing.com, 28 August 2014: http://www.governing.com/news/headlines/performance-based-budgeting-fad-Takes-off-in-states.html.
[3] W. Mark Crain and J. O'Roark, "The impact of performance-based budgeting on state fiscal performance," *Economics of Governance*, 2004: https://ideas.repec.org/a/spr/ecogov/v5y2004i2p167-186.html#author.

policymakers' expectations.[4] A second caveat is that some spending may actually increase with the use of performance budgeting, as high-performing programs receive greater funding even as poor performers are cut. There is also the possibility of new programs being created because of the reduced cost of old programs.[5] In a study NASBO conducted in 2014, the organization cautioned that performance budgeting is a tool, not a silver bullet, and requires a high level leadership and agency buy-in to succeed. NASBO further concluded a statutory framework provides greater continuity in performance budgeting than executive actions.[6]

Texas and Minnesota are often cited as models for best practices in performance budgeting, but former Texas Budget Director Wayne R. Roberts cautions it is "not a panacea for making tough choices. Every line item has a powerful constituency. There are no accidents in budgets."[7] Put another way, performance budgeting may provide useful information about whether government programs are efficient or effective. It cannot, however, judge whether agencies or programs should exist, or what priority they should hold among a government's activities.

The Federal Experience

As part of its "Reinventing Government" initiative, the Clinton Administration introduced a form of performance budgeting for Federal agencies with the Government Performance and Results Act [GPRA] of 1993. The law requires agencies to develop mission statements and strategic plans with annual performance goals; to provide brief descriptions of how the goals are to be met and verified; and to prepare annual performance reports.[8]

In 2000, the Mercatus Center at George Mason University studied Federal vocational training programs using GPRA information and developed an analytic framework for identifying which programs accomplish their intended goals. The study concluded the performance budgeting framework was flexible enough to accommodate diverse values and judgments about policy priorities. It further stated calculations used in performance budgeting do not make decisions automatic, but they do give policymakers a clearer understanding of the effects of their decisions.[9] "[C]hanged procedures will not, on their own, improve budget decision-making if the legislature does not change its practices as well. But better budget processes that more starkly demonstrate the options available to appropriators – and the consequences of each of the options – may well change the incentives for appropriators."[10]

The law was updated with the GPRA Modernization Act [GPRAMA] of 2010, signed by President Obama in 2011.[11] The update more closely aligns reporting with presidential

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[4] Ibid, p. 168.
[5] Ibid, p. 180.
[6] National Association of State Budget Officers, *Investing in Results*, Summer 2014: http://www.nasbo.org/sites/default/files/pdf/NASBO%20Investing%20in%20Results.pdf.
[7] Ibid.
[8] Ibid.
[9] Jerry Ellig and Maurice P. McTigue, *Putting a Price on Performance: A Demonstration Study of Outcome-Based Scrutiny*, the Mercatus Center at George Mason University, 2000, p. 12.
[10] McTigue, op. cit.
[11] Public Law 111-352, 111th Congress.

terms and presidential budget proposals, and gives the administration's Office of Management and Budget [OMB] a stronger role in the process. It explicitly calls for consultations with Congress and requires the reporting to be available on the Internet. The law also provides Congress and outside stakeholders an opportunity to influence the manner and content of agency and OMB goal setting and then assess their performance.[12]

The Government Accountability Office [GAO] finds implementation of GPRAMA has been uneven across the Federal Government, with some agencies improving their performance but with much work still to be done. The challenges, according to GAO, are:

- Performance information must be useful and used by agency managers;
- The Executive Branch needs to address cross-cutting (cross-agency) issues;
- Agencies struggle to link individual and agency performance to results;
- OMB and agencies have not clearly communicated reliable and complete financial and performance results.[13]

Lessons from the States and Other Countries

Different States and countries have had varying experiences with performance-based budgeting, but the following is a short list of common results or lessons learned. States examined were Washington, Iowa, Virginia, Nevada, Oregon, Texas, Minnesota, Alabama, Connecticut, Colorado, North Carolina, Illinois, and Utah.[14] Countries studied were Canada, the United Kingdom, Australia, and Denmark.[15]

- Agency buy-in from senior managers is key to the successful implementation of performance budgeting, because elected officials and political appointees are transient.
- Leadership matters. Top leaders must actively participate in implementing performance budgeting to ensure agencies will actually use the information developed to inform funding and management decisions.
- Spending should be aligned with core government functions. That requires a detailed understanding of the relationship between resources expended and results achieved at the program level.
- A common framework is crucial for application of government-wide, results-based management.

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[12] Congressional Research Service, *Changes to the Government Performance and Results Act: Overview of the New Framework of Products and Processes*, 29 February 2012, p. 1.
[13] Government Accountability Office, *Implementation of GPRA Modernization Act Has Yielded Mixed Progress in Addressing Pressing Governance Challenges*, 30 September 2015: http://www.gao.gov/products/GAO-15-819.
[14] National Association of State Budget Officers, op. cit., pp. 6-16.
[15] Organisation for Economic Co-Operation and Development, *Performance Budgeting in OECD Countries*, 2007: https://www.bmf.gv.at/budget/haushaltsrechtsreform/OECD_Studie_Performance_Budgeting.pdf?5b0ube.

- Performance budgeting requires clear expectations, regular evaluation and reassessment in light of experience, and public accountability.

- A systematic approach to program reviews – regularly scheduled – is essential for integrating performance information in the budget process.

- There must be a clear link between program outcomes and results for performance information to be useful in budgeting.

- Agencies or departments should not be penalized automatically for failing to meet outcome goals because external factors may have a significant impact on the outcome.

- Incentives matter. If agencies are allowed to keep savings they identify and redirect the funds, they have a greater incentive to collect and use data about the efficiency and effectiveness of their programs.

PORTFOLIO BUDGETING

The Portfolio Concept

Under the current budget process, spending decisions are organized by individual agencies, programs, congressional committees, or budget "function" categories, not in terms of comprehensive national goals and priorities whose underlying programs cut across these groups. Critics argue the current arrangement is piecemeal and fragmented, and inherently favors the short-term and incremental. The effect is "little change and inadequate focus on national priorities or how to achieve them more efficiently."[16] For instance, there are roughly four dozen different Federal job training programs across several agencies, creating "a labyrinth of bureaucracy that consistently fails to produce substantial numbers of job placements."[17] While some populations, such as veterans, may benefit from programs targeted to their specific needs, most job-training programs are overlapping and duplicative.

Portfolio budgeting would look at the entire range of programs and seek better fiscal strategies for achieving their aims. It proposes restructuring the budget process to focus on strategic priorities that "look broadly across a range of closely related programs, tax provisions, and regulatory policies affecting common policy goals."[18] This is distinct from current budgeting practices, which focus primarily on Federal spending only.

"[T]he current process for developing the budget – because it is biased toward marginal, short-term changes and familiar policies and is piecemeal, fragmented, and stove-piped – is often blind to major shifts in the Nation's economy and social structure. The result: it misses bigger, strategic options that could produce breakthrough gains in how resources could be used to achieve national goals. This is why it would be helpful to add a

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[16] F. Stevens Redburn and Paul L. Posner, *Portfolio Budgeting: How a New Approach to the Budget Could Yield Better Decisions*, The Brookings Institution, September 2015.
[17] Committee on the Budget, U.S. House of Representatives, Report on the Concurrent Resolution on the Budget – Fiscal Year 2017 (H. Con. Res. 125, Report 114-470).
[18] Redburn and Posner, op. cit.

'portfolio budgeting' approach to the current process. This would make room in the process for selective, deeper consideration each year of a few important policy objectives that cut across agency, program, and committee jurisdictions."[19]

By taking into account all aspects of policy, the portfolio budgeting method would allow policymakers to evaluate programs and fiscal strategies more comprehensively. "Each year, for each selected policy objective, the full portfolio of spending, tax provisions, and other policies addressed to each selected goal would be compared with alternative strategies that use resources very differently with the aim of finding a new strategy to achieve a better result at lower cost. . . . This approach is designed to identify breakthrough gains in the productive use of resources."[20]

Portfolio budgeting calls for a two-track system. The administration and Congress would continue to formulate budgets in some areas using the current budget process. They would apply the portfolio budgeting method for a select few major policy objectives each year, allowing an in-depth focus and analysis on the selected portfolios.

The portfolio process would follow this sequence:

- Selecting national priorities and goals, or portfolios;

- "Identifying the set of federal policies, spending programs, regulations, tax preferences, and other activities that constitutes the relevant *policy portfolio* for analysis and budgeting"; [21]

- Assessing the collective effects of programs and considering alternative policies and whether they could yield better results at a lower cost.

An Illustration

Consider Federal fiscal policy toward higher education. The Federal Government subsidizes the costs of tuition, books, fees, and other college expenses through loans, grants, and tax provisions. The goals of these policies and programs, which have a budget of more than $100 billion a year,[22] are to expand access to higher education, make college more affordable, and achieve and maintain the country's economic competitiveness by maintaining an educated workforce.

The portfolio budgeting approach would involve Congress in examining the entire education portfolio – cross-cutting committee jurisdictions and particular pieces of legislation – and asking questions about the effectiveness of the programs in relation to stated goals and the Federal Government's return on the investment. Then alternative approaches to achieving these goals in higher education could be analyzed to see if they produce a better return on Federal spending and actually meet the needs of the students served.

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[19] F. Stevens Redburn, statement to the Committee on the Budget, U.S. House of Representatives, 6 July 2006.
[20] Ibid.
[21] Redburn and Posner, op. cit.
[22] Ibid, p. 2.

Pros and Cons

One fundamental benefit of the portfolio approach is that it would lead to re-evaluating the major categories of government fiscal policies, and perhaps reassessing whether government should be involved in so many things with so many programs.

An important consideration, however, is who would choose and create the portfolios, which would have a significant impact on setting the long-term policy agenda. The administration, by its nature and institutional structure, would appear to be well-suited for this task. On the other hand, establishing the portfolios would be an influential instrument for setting the national policy agenda. This is Congress's constitutional role, on which presidents over the past century have increasingly encroached. It may be more appropriate, therefore, for Congress to develop the portfolios, even if it requires expanding its own institutions such as the Congressional Budget Office [CBO].

Another risk lies in the portfolios' inclusion of both spending and tax provisions (known as "tax expenditures"). This would increase the temptation to treat tax provisions as identical to spending, so that eliminating a tax "expenditure" – a revenue increase – would be viewed as a spending reduction to offset higher spending elsewhere in the portfolio. This would be an out-and-out "tax and spend" result.

CAPITAL BUDGETING

What Is Capital Budgeting?

Capital budgeting is a system in which the expense associated with acquiring an asset is apportioned over the entire useful lifetime of the asset, rather than all at once when the initial acquisition occurs. For example, the expense of acquiring a new building would be reflected in the budget as something equivalent to an annual mortgage payment or a depreciation charge, and it would recur until the useful life of the asset was fully depleted. In a non-capital budgeting system, such as what is now used in the Federal budget, the entire cost of the building would be recognized in the year it is acquired, and no subsequent expense would be recognized over the remaining years of the building's useful life.

How Capital Assets Are Defined

Capital assets are defined broadly as those with a useful lifetime of more than one year, and usually at least two years.[23] Typical capital assets include things such as land, structures, and equipment; these are classified as physical capital. Capital assets may also include intellectual property such as patents, or long-term agreements such as exclusive rights to broadcast programming or distribution of a product. Some analysts suggest capital assets should also include less tangible items that are believed to produce long-term benefits, such as spending on research and development, education, job training, wellness, and intervention programs. Capital assets do not include items acquired for resale or in the ordinary use in operations such as materials and supplies.

[23] The Office of Management and Budget has set two years as the minimum useful lifetime for capital assets for agency budget planning purposes. See Capital Planning Guide V 3.0, Supplement to Office of Management and Budget Circular A-11, p. 2.

How Congress Budgets for Capital

Congress does not have a capital budget – at least not one that resembles practices in the States and several other countries. While Congress does appropriate funds for capital assets, there is no unifying congressional budget strategy on the amount of resources that should be dedicated for long-term purposes, and no authoritative definition of what a capital asset is. Further, the current cash-based budget rules that charge "up front" for appropriations involving capital are unlike any system used outside the Federal Government.

Because the congressional budget recognizes all capital costs "up front," it does not include future repayment of debt principal as a budgetary cost. This is done to avoid double-counting the cost of acquiring a capital asset; it must be recognized either all "up front" or all over time.

Figure 1

Table 18–1. COMPOSITION OF FEDERAL INVESTMENT OUTLAYS
(In billions of dollars)

Federal Investment	Actual 2015	Estimate 2016	Estimate 2017
Major public physical capital investment:			
Direct Federal:			
National defense	108.9	110.8	109.7
Nondefense	40.3	42.5	39.4
Subtotal, direct major public physical capital investment	149.2	153.3	149.1
Grants to State and local governments	77.2	78.0	85.3
Subtotal, major public physical capital investment	226.4	231.3	234.4
Conduct of research and development:			
National defense	70.7	71.7	78.9
Nondefense	61.3	63.8	67.8
Subtotal, conduct of research and development	132.1	135.5	146.7
Conduct of education and training:			
Grants to State and local governments	55.9	60.3	59.3
Direct Federal	74.7	63.9	55.3
Subtotal, conduct of education and training	130.7	124.2	114.6
Total, major Federal investment outlays	**489.2**	**491.0**	**495.6**

Despite a lack of information on overall capital spending at the congressional stage of the budget process, OMB provides some useful information about government-wide "investments" (see Figure 1 above, reproduced from OMB's fiscal year 2017 *Analytical Perspectives*) which it defines to include the following:

- Spending on physical capital;
- Grants to States for capital-related spending (mostly transportation); research and development;
- Education and training.

According to OMB, the Federal Government spent $489 billion on such investments in fiscal year 2015 – about 13 percent of the overall Federal budget that year.

Is Congressional Budgeting Biased Against Capital Spending?

Some believe the entirely "up front" recognition of capital expenses in the congressional budget creates a bias against capital spending – one that would be ameliorated by distributing costs over the useful life of the asset. This bias is most acute for capital items funded with discretionary appropriations – which funds the majority of capital spending – because they are constrained by fixed statutory spending limits. Within the context of constrained discretionary appropriations, anything that causes a spending spike – such as capital-intensive acquisitions – are at a disadvantage vis-à-vis routine spending for operations expenses, which are recurring and typically smooth from year to year.

Current budget rules also may be causing greater-than-necessary spending for acquiring capital assets. This results from agencies' and authorizing committees' heavy preference for operating leases instead of capital leases or outright purchases for physical assets. Under current budget rules, operating leases are scored only for the cost of annual lease payments, whereas capital leases and outright purchases are scored for the full lifetime cost of the lease or purchase. Operating leases are a much more expensive option if the true intention of the agency is to remain in one location for a long period of time.

The Benefits of Capital Budgeting

An explicit capital budget could eliminate the perceived bias mentioned above toward funding capital-intensive projects. It would have the virtue of aligning the recognition of expenses in the Federal budget to the point in time when the benefits of the asset are actually consumed. It would also address an issue of fairness – the notion that future generations should help pay the costs of assets from which they benefit. Critics argue that future generations already do pay for the costs of acquiring capital assets, assuming they are financed with new borrowing, because repayment of principal and interest occurs in the future. Nevertheless, as mentioned above, principal repayments are not recognized as a budget expense under current budget rules; only interest is. Another potential benefit of a capital budget would be that it would better engage the Congress in thinking about an overall, government-wide capital planning strategy, rather than continuing with no overall plan and making capital decisions in isolation.

Depending on its implementation, capital budgeting can also lead to better management of capital assets among agencies. One real-world example was New Zealand's decision to include a "cost of capital" charge in the budgets for its agencies. This reform created incentives for New Zealand's agencies to dispose of unused and underused capital so that budgetary resources could be put to better use.

A capital budget might also bring Congress closer to achieving a balanced budget – though the definition of balance would differ from the current cash-based standard. Most States in the U.S. and other countries that have capital budgets define a balanced budget to mean a balanced "operating budget"; their capital budgets are separate and might or might not be balanced. If the Federal Government had implemented a capital budget and used OMB's definition of investments – which is admittedly broad – the results in fiscal year 2015 would have been an operating surplus of $57 billion rather than a deficit of $432 billion. Note the actual fiscal year 2015 *cash deficit* of $432 billion is the same, regardless of whether one employed a cash-based or capital budgeting-based system.

The Risks of Capital Budgeting

One of the main risks associated with capital budgeting would be an expansion or "loosening" of the definition of capital assets. Proponents of higher spending would be tempted to get more programs classified as "investments" to receive favorable budgetary treatment. The concept of long-term benefits – a central requirement of capital assets – is somewhat subjective; one could argue nearly all Federal spending somehow generates a long-term benefit. Social programs that deal with intervention and welfare assistance are prime examples of spending that could bestow long-term, albeit highly uncertain, benefits. Most entities that use capital budgeting exclude social programs.

Another risk is that capital budgeting can lead to increased borrowing, especially if there is an expectation that all capital assets should be financed with debt. Although capital spending can be financed from general or dedicated revenue sources rather than debt – the Federal Highway Trust Fund is one example – the question of future generations paying their fair share for benefits tends to sway the argument of how to finance capital assets toward using new borrowing. Changing the treatment of capital assets in the Federal budget would likely further complicate an already overly complex system.

What Other Countries Are Doing

Countries that have adopted capital budgets generally have done so as part of a larger shift from budgeting on a cash basis to an accrual basis.[24] The following describes two prominent examples – New Zealand and Australia – along with several examples of countries that abstained from accounting for capital spending on an accrual basis.

NEW ZEALAND

New Zealand is roughly the same area (land size) as Colorado, and it is home to 4.5 million people[25] – several hundred thousand more than Los Angeles.[26] In 1984, a reform-oriented government was elected, and it set about correcting various problems plaguing the country. This included seeking ways of improving how capital resources were used. Additionally, the government sought to improve the performance of the public sector and make more informed spending decisions. One problem was that spending decisions were not connected explicitly to stated, or expected, outcomes. The government established Purchase Agreements to try to connect the two. In the Purchase Agreements, what was expected from the spending– the defined outcome – was expressly laid out, making it easier to hold agencies accountable and force various programs to compete with one another.

In addition, Parliament committees began overseeing all programs in their respective jurisdictions. For example, the Education and Science Committee began directly overseeing all education programs, and it could determine which were working and

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[24] Congressional Budget Office, *Capital Budgeting*, May 2008, p. 11: https://www.cbo.gov/sites/default/files/110th-congress-2007-2008/reports/05-08-capital.pdf.
[25] The World Bank, database on New Zealand, http://data.worldbank.org/country/new-zealand, accessed 29 June 2016.
[26] See U.S. Census Bureau, 21 May 2015: http://www.census.gov/newsroom/press-releases/2015/cb15-89.html.

which were not. Then the Parliament's appropriators had the necessary information to shift how they allocated resources.[27] Key here is that the legislature, which has the authority to make spending decisions, was empowered and also required to take program performance into account.

Figure 2

Key Dates in New Zealand Public Finance

- 1989: The Public Finance Act 1989 specified requirements for accrual budgeting and financial reporting by departments. Government departments began to report in accordance with accrual accounting. Whole-of-government flows (for example, taxes and transfer payments) were still budgeted and forecast on a cash basis.

- December 1991: New Zealand became one of the first governments in the world to prepare consolidated financial statements on an accrual basis.

- 1994: The Fiscal Responsibility Act 1994 required accrual-based budgeted and actual information at the whole-of-government level. The government's first accrual-based fiscal forecasts based on Generally Accepted Accounting Principles were published in June 2004.

Source: Table copied from A Guide to the Public Finance Act, Treasury of New Zealand[28]

In this shift to output-based budgeting, New Zealand also shifted to accrual budgeting. The key legislation related to this shift is the Public Finance Act, passed in 1989 and amended in 2004.[29] Subsequent acts, shown in Figure 2 above, built upon the Public Finance Act, as the country began implementing accrual budgeting.

Output-based budgeting in New Zealand has similarities with performance- or evidence-based budgeting. It involves the purchasing of outputs, or specified goals (see discussion above), from government departments or outside sources, such as the private sector, if an activity has been contracted out to a non-government entity. The departments are then responsible for both operations and capital spending, which are considered inputs.

Accrual budgeting benefits both the New Zealand Parliament and the government departments. Departments can make informed decisions about how to deploy capital spending. For example, for one department it might make more sense to rent an office building than purchase the building to house its employees, or vice versa. The practice also gives the Parliament information about how departments are using capital resources, so lawmakers can decide how much to give to them in the future. The Parliament is able

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[27] Maurice P. McTigue, "Can Budget Process Reforms Produce Better Budget Outcomes?" the Mercatus Center at George Mason University, testimony before the Committee on the Budget, U.S. Senate, 12 April 2016: http://mercatus.org/sites/default/files/McTigue-Senate-Budget-Committee-Testimony-v1.pdf.
[28] Ibid, p. 8.
[29] Treasury of New Zealand, *A Guide to the Public Finance Act*, August 2005: http://www.treasury.govt.nz/publications/guidance/publicfinance/pfaguide/02.htm.

to keep tabs on whether or not a department is overcommitting itself and unable to keep its capital assets functioning properly.

AUSTRALIA

Effective in the 1999-2000 budget year, Australia – home to more than 23.4 million people[30] – shifted from cash to accrual budgeting. It also began to display its agencies' financial statements using accrual accounting rather than the previously used cash accounting.[31] The government also required its agencies to produce Portfolio Budget Statements specifying both the outcomes they expected and the outputs they would produce. Put another way, the agencies must say what benefit they expect to provide to the public and what specific items will result from their spending. Interestingly, the Australian Parliament cites in its primer on the budget that the new way of presenting agency budgets was not transparent – at least not initially – even though that was a goal. The first budget in 1999-2000 provided little information, and only in subsequent years did the quality and quantity of the information improve.[32]

The new method does have other flaws. For example, if agencies' outcomes are vague or are not connected to more general, national goals, they are less effective and less meaningful. Outcome statements are sometimes subjective, as in "producing a better national transportation network." A more meaningful statement would be "increased mobility and reduced traffic congestion, measured in part by shorter commuting times and fewer accidents." As part of its budget process, Australia also requires each agency to produce statements showing operations, assets and liabilities, cash flow, and capital information. In particular, the assets and liabilities statement is used to get a picture of those things Australia owns that will provide future benefits and those liabilities, or obligations, that Australia must pay or, in the case of services, provide. The capital statement tells the government what kinds of assets the agencies are purchasing and how capital funds will be used.

OTHER COUNTRIES

Not all countries who have weighed the benefits and costs of adopting accrual-based budgeting chose to follow through with the switch. Norway and Sweden, for example, chose not to change and instead continued with their practice of cash-based budgeting. Their rationale was that they could maintain more control over spending on capital activities through cash-based rather than accrual budgeting.[33]

This decision is not unfounded. In addition to the risks of capital budgeting described previously, a country considering the switch would be wise to estimate whether capital budgeting would yield the spending outcomes they desired. One question would be whether the country wants to incur additional debt to finance capital activities, and what limits on borrowing it might impose.

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[30] The World Bank, database on Australia, http://data.worldbank.org/country/australia, accessed 29 June 2016.
[31] Parliament of Australia, *Budget Guide*: http://www.aph.gov.au/About_Parliament/Parliamentary_Departments/Parliamentary_Library/Publications_Archive/archive/BudgetGuide#Where%20to%20Start.
[32] Ibid.
[33] Congressional Budget Office, *Capital Budgeting*, May 2008, p. 12: https://www.cbo.gov/sites/default/files/110th-congress-2007-2008/reports/05-08-capital.pdf.

Other countries that ultimately retired their separate capital budgets are Denmark, Finland, and the Netherlands.

Lessons from the States

As in New Zealand and Australia, capital budgeting in the States offers a useful guide for connecting broader goals of government with specific capital spending. How States define capital budgeting is important to consider. According to the NASBO: "[T]here is no uniform definition of capital expenditures across states or a single guideline regarding the optimum financing strategy for capital projects."[34]

Nevertheless, some common characteristics do arise in what are considered capital projects. "[T]hey are a nonrecurring expense for a physical asset that has a long-term life. Most states include construction, land acquisition, major renovations and repairs, major items of equipment, information technology systems, and funds or grants to local agencies of a capital nature."[35] Specific examples from various States include the following:

- Georgia defines capital spending as "the budgeting of the State's General Obligation Bonds and the expenditure of the bond proceeds for capital projects."[36]

- Kansas considers activities including new construction, remodeling, razing, acquisition, and the principal and debt service for a capital spending to be eligible capital expenses.[37]

- Other States list land acquisition, equipment, information technology, easements, vehicles and machinery, infrastructure, major renovations, and furnishings.

- Some States, such as Oregon and New Hampshire, require the item to have a useful life of a certain length, whether one year, five years, or even 20 years. Additionally, States may set cost thresholds for certain capital items – $500 in Ohio, at least $50,000 for furnishing and equipment in New Jersey, and major maintenance and repairs costing more than $250,000 in Vermont.

- All 50 States include capital construction in their definition, and all but three count land or site acquisitions. About half the States require the expenditure to be non-recurring, and half also require the asset to be physical in nature.

Looking at capital expenditures by program area is also useful. "Most capital spending by states is concentrated in two areas: transportation and higher education. Transportation accounted for over 63 percent, and higher education accounted for 12 percent of state

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[34] National Association of State Budget Officers, *Capital Budgeting in the States*, Spring 2014, http://www.nasbo.org/sites/default/files/pdf/Capital%20Budgeting%20in%20the%20States.pdf.
[35] John T. Hicks, *Capital Budgeting in the States*, statement before the Committee on the Budget, U.S. House of Representatives, 6 July 2016.
[36] National Association of State Budget Officers, op. cit., Table 2, p. 8.
[37] Ibid.

capital spending in fiscal year 2015."[38] No States consider corrections activities to be capital, while 19 consider transportation as such.[39]

The source of the definition of capital expenditures also varies among States. In Arkansas, the definition can be found in the State constitution, regulations, code, and statute. In Kentucky, the definition is solely in statute.[40] It is worth noting that intangibles, such as education and other human capital spending, are not considered as capital expenditures. By limiting the definition, States guard against understating the cost of spending on intangible activities for which it is difficult to measure any depreciation costs or life-cycle benefits.

A key to States' use of capital budgets is connecting them to a regular planning process related to long-term capital goals. Many States have found success in having a central planning agency manage capital projects. For some States, the job falls to their budget offices; in others it is in the Department of Finance or Administration. For other States, though, this activity is done at individual agencies. To be successful, States also have to connect their capital and operating budgets. They need to be able to know the budgetary effects of different capital projects to record them on their operating budgets, both in the current year and several years out.

Another important consideration is who is able to request capital spending in the States. In all 50 States, the agencies can make such a request, and in all but three, institutions of higher education can. In only eight States are private organizations eligible.[41]

When recording the budget transaction for capital expenditures, States focus on the costs and do not record any net benefits, which are difficult to define. Benefits, especially if they can be measured, certainly could be considered as part of States' capital planning. It is also important to note that States budget for the debt service arising from capital spending. Interestingly, States often book debt service as an operating expense and fund it out of general revenues. Sometimes a dedicated tax or fee is used to pay the debt service. To illustrate the point: 47 States use general revenues to pay debt service on capital costs, and 40 use specific taxes and fees. Similarly, 29 States use capital project-generated revenue, if it is available.[42] Further, to ensure they can cover the debt service, many States have established limitations on how much debt they can issue. Thirty-eight States have constitutional, statutory, or policy limits on total general obligation debt. These legal limitations augment natural constraints on States' borrowing from the municipal bond market and how much general revenue is available, as two examples.[43]

Incorporating Elements of Capital Budgeting Into the U.S. Federal Budget

Adopting a separate capital budget presents significant challenges. President Johnson's budget concepts commission recommended against capital budgeting, saying in part: "In

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[38] Hicks, op. cit.
[39] National Association of State Budget Officers, op. cit., Table 5, p. 14.
[40] Ibid, Table 1, p. 7.
[41] Ibid, Table 17, p. 47.
[42] Ibid, Table 36, p. 99.
[43] Ibid, p. 83.

periods of inflationary pressure the appearance of a balanced budget, with capital expenditures excluded, might pose a psychological barrier to adequate taxation. In any event, proponents of new spending programs would be tempted to stretch the capital budget rules on inclusion, so that the immediate impact of the program in increasing the current deficit, or reducing the current surplus, would be less, and the program itself therefore less visible."[44]

Nevertheless, other capital-budget-related mechanisms or features could be incorporated into a reformed budget process. One approach could be to "charge" agencies for the cost of their capital assets each year, to encourage them to dispose of unused capital. U.S. Federal agencies have little incentive to liquidate capital assets, such as unused or underused land, equipment, or buildings. Scorekeeping rules contribute to the dilemma (in certain cases land disposition may be scored as costing, rather than saving, money), but in any case agencies are not motivated through budget means to relinquish assets they are not using.

In New Zealand, the government made it a priority to dispose of such assets. Any funds spent on maintaining a vacant building or on equipment that will not be used for the foreseeable future cannot be spent on acquiring or maintaining useful capital assets. These foregone benefits are one reason to give agencies incentives to clean house. The inherent misuse of taxpayer resources is another. New Zealand set up capital charges that function like a dividend. The agencies are fully funded for the assets they are using, but not for those they are not using. For example, a hypothetical agency may have assets it is using that require $100 million to be kept current. Yet it has other assets it is not using that cost $10 million to maintain annually. The agency would be funded for the gross quantity of assets being used – $100 million – but would have to pay for the assets it was not using. Thus it has the incentive to liquidate those unused assets in a timely way to avoid paying for them.

Another option would be for Congress to devise criteria to evaluate one instance of capital spending relative to another, even if the capital activities are dissimilar. One way would be to determine an activity's rate of return, which could inform appropriations. Defining the rate of return could be difficult and politicized, but if done correctly it could make it more difficult and less attractive for Congress to fund capital activities of low value. Key to this approach would be making the rate of return criteria transparent. For example, one measure of defense or homeland security capital spending's rate of return would be how well it reduces risk and harm to the public. For transportation capital spending, it could be the decrease in traffic congestion or the increase in mobility in metropolitan areas and downtown urban cores. Various factors in each area's rate of return would be weighted differently. Then different defense, homeland security, or transportation programs/activities could be compared; Congress would have the information and could abandon unproductive activities while funding successful ones.

It would be important to clearly connect the information about capital spending's rate of return to the appropriations process. One option would be to require appropriators to explain in their supporting documents what they expect to get for the spending. The next year, they could examine whether that goal was met or not. Connecting the two would also enable better congressional oversight. Under today's practice of Federal

[44] *Report of the President's Commission on Budget Concepts*, October 1967.

appropriations, the decision to spend is public, but the answer to the question of "why" spend on certain capital activities often is not visible.

Still another approach to getting better value for capital spending is to devise ways to hold the government accountable for its capability, or competence, in a given spending area. If it is not maintaining its capability or performing a service cost-effectively, then it could look to contracting out or otherwise getting out of a certain area altogether. Further, the appropriations process could be altered to require the committee to demonstrate it has used such performance information when appropriating funds. New Zealand made a widespread effort to seek competitive bids for government activities. The results were especially dramatic in the size of the civil service. For example, the Department of Transportation went from having 5,600 employees to having 53; the Forest Service went from 17,000 employees to 17; and the Ministry of Works went from 28,000 employees to one. While those individuals no longer had civil service jobs, the need for their skills still existed in the private sector.[45]

ZERO-BASED BUDGETING

Zero-based budgeting is a method of decision-making that requires each line item in a budget to be justified, considered, and approved during each budget cycle. Put simply, it requires each budget to be built from a "base of zero." This system is the opposite of incremental budgeting, in which only *new* budgetary items are considered and everything already approved in prior budgets becomes part of a permanent spending "baseline" that is automatically approved without new justification. Critics of incremental, "baseline" budgeting point out that automatically approving a certain baseline of spending does not adequately control costs or provide incentives for oversight.

While it is true that baseline concepts play a large role in the congressional budget process, it is also true that all discretionary appropriations are built, strictly speaking, from a zero-base starting point. Furthermore, the Congressional Budget Office scores all appropriations acts assuming a base of zero. On the other hand, CBO's baseline spending projections assume the current discretionary spending level, and then project it forward with built-in increases for inflation. For "direct" or "mandatory" spending, however, the budget does not start with a zero base. Indeed, all spending for such programs is permanent or subject only to occasional sunset dates, allowing them to operate as if a permanent baseline governed their behavior. Spending for these programs is subject to justification only when it is originally authorized or reauthorized. This contributes to the automatic and uncontrolled nature of this spending.

President Carter attempted to introduce zero-based budgeting in the late 1970s. By 1978 the Office of Management and Budget had developed procedures for using it,[46] but it was never implemented. Seventeen States have experimented with the concept. Florida and Oklahoma abandoned it. In the States, zero-based reviews are primarily an Executive Branch responsibility.[47]

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[45] From a lecture by the Honorable Maurice P. McTigue, adapted for "Rolling Back Government: Lessons from New Zealand," *Imprimis*, Volume 33, Number 4, April 2004: https://imprimis.hillsdale.edu/rolling-back-government-lessons-from-new-zealand/.
[46] National Conference of State Legislatures, *Fiscal Brief: Zero-Base Budgeting in the States*, January 2012.
[47] Ibid.

CONCLUSION

In constructing a new congressional budget process, it is clearly worth considering options outside current structures. These might include incorporating performance measures of programs and agencies; evaluating the full range of policies employed to achieve national goals; distinguishing between operating and capital expenditures; and assuming a zero base as a starting point for spending decisions, to force a more rigorous demand for justifying programs. Policymakers may or may not choose to adopt such practices. Nevertheless, evaluating the practice of budgeting can illuminate limitations of today's procedures and inform decisions about what a restructured budget process should include.

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