INVESTMENT BUDGETING IN FOREIGN, STATE AND LOCAL GOVERNMENTS

JOINT HEARING

BEFORE THE

COMMITTEE ON GOVERNMENT REFORM AND OVERSIGHT

AND THE

SUBCOMMITTEE ON GOVERNMENT MANAGEMENT, INFORMATION, AND TECHNOLOGY

OF THE

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INVESTMENT BUDGETING IN FOREIGN, STATE AND LOCAL GOVERNMENTS

THURSDAY, JUNE 29, 1995

HOUSE OF REPRESENTATIVES, COMMITTEE ON GOVERNMENT REFORM AND OVERSIGHT, JOINT WITH THEIR SUBCOMMITTEE ON GOVERNMENT MANAGEMENT, INFORMATION, AND TECHNOLOGY QUIT

Washington, DC.

The committee and subcommittee met, pursuant to notice, at 10:10 a.m., in room 2154, Rayburn House Office Building, Hon. William Clinger (chairman of the full committee) presiding.

Present from full committee: Representatives Clinger, Chrysler, and Norton.

Present from subcommittee: Horn, Bass, Maloney, Mascara, and Wise.

Full committee staff present: Monty Tripp, professional staff member; and Cheri Tillett, assistant chief clerk.

Subcommittee staff present: J. Russell George, staff director; Mark Brasher, professional staff member; Andrew G. Richardson, clerk; and Matt Pinkus, minority professional staff member.

Mr. CLINGER. The Committee on Government Reform and Oversight will come to order. I would like to begin the hearing by expressing my great appreciation to subcommittee chairman, Steve Horn, for co-chairing this hearing on an issue that I have long supported, and that is a Federal capital budget. Given the current fiscal constraints, budgeting that places greater emphasis on the twin towers of government responsibility, fiscal responsibility and long-term economic growth is needed today more than ever before.

Under our existing system, unfortunately, no distinction is made between investment spending and spending for short-term consumption and basic government services. Instead, all spending is lumped together, thereby diluting and obscuring the beneficial nature of the Federal Government's investment in necessary infrastructure. By comparison, a capital budget would separate investment revenue and outlays from basic operational revenue and outlays; thus enhancing the budget's role as a policy tool.

By improving accounting, reporting, control and fiscal priority setting, an investment oriented budget affirms both that capital is a limited resource, and that capital expenditure should be a part of a coherent, long-term plan to meet our country's infrastructure needs. An investment budget is useful on several different levels. In terms of government function, an investment budget would focus more attention on our Nation's deteriorating infrastructure, and

force more efficient decisionmaking on public investment initiatives.

Importantly, it also thoroughly explains to the public the connection between government investment and the return or future benefit of this investment. And finally, an investment oriented budget promotes intergenerational equity by saddling future generations with debts solely, or assets that have future tangible benefit. Some skeptics would have us believe that an investment budget would serve merely as a gimmick; that unnecessary government spending would continue under the moniker of capital investment; that there would be all kinds of game playing going on to try to get items put under the umbrella of the capital budget.

I would disagree with those skeptics. Investment budgeting provides us the sort of specific information on spending priorities that doesn't exist in our present inefficient system. And I would argue on the contrary, that it would be significantly more difficult to slide through unnecessary spending when our budget process specifically addresses only two fundamental and distinct economic activities—spending on assets and spending on operations.

So as a strong advocate of the budget process reform, I would encourage all of our members to listen carefully to today's distinguished speakers, and join me in an effort to change the way the Federal budget is calculated. At this time, I would like to ask the co-chair of this hearing, Mr. Horn, if he would have an opening statement.

[The prepared statement of Hon. William F. Clinger, Jr., follows:]

PREPARED STATEMENT OF HON. WILLIAM F. CLINGER, JR., A REPRESENTATIVE IN CONGRESS FROM THE STATE OF PENNSYLVANIA

The hearing will come to order.

I would like to begin by thanking Subcommittee Chairman Steve Horn for co-chairing this hearing on an issue I have long supported—that is a federal capital budget.

Given current fiscal constraints, budgeting that places greater emphasis on the twin towers of government responsibility—fiscal responsibility and long-term economic growth—is needed today more than ever before. Under our existing system, unfortunately, no distinction is made between investment spending and spending for short-term consumption and basic government services. Instead, all spending is lumped together, thereby diluting and obscuring the beneficial nature of the federal government's investment in necessary infrastructure.

By comparison, a capital budget would separate investment revenue and outlays from basic operational revenue and outlays, thus enhancing the budget's role as a policy tool. By improving accounting, reporting, control and fiscal priority-setting, an investment-oriented budget affirms both that capital is a limited resource and that capital expenditure should be a part of a coherent long-term plan to meet our country's infrastructure needs.

An investment budget is useful on several different levels. In terms of government function, an investment budget would focus more attention on our nation's deteriorating infrastructure and force more efficient decisionmaking on public investment initiatives. Importantly, it also thoroughly explains to the public the connection between government investment and the return or future benefit of this investment. Finally, an investment-oriented budget promotes intergenerational equity by saddling future generations with debt solely for assets that have future tangible benefits.

Some skeptics would have us believe that an investment budget would serve merely a gimmick; that unnecessary government spending would continue under the moniker of "capital investment." I disagree. Investment budgeting provides us the sort of specific information on spending priorities that doesn't exist in our present inefficient system. I would argue that it will be significantly more difficult to slide through unnecessary spending when our budget process specifically addresses only

two fundamental and distinct economic activities—spending on assets and spending on operations.

As a strong advocate of budget process reform, I encourage all our members to listen carefully to today's distinguished speakers and join me in an effort to change the way the federal budget is calculated.

Mr. HORN. Mr. Chairman, if I might, I'd just as soon put it in as if read, and we can get on with the business.

[The prepared statement of Hon. Stephen Horn follows:]

PREPARED STATEMENT OF HON. STEPHEN HORN, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF CALIFORNIA

Thank you, Mr. Chairman. Some of us remember after the Second World War, when the first Hoover Commission on reorganizing the Federal Government recommended adopting capital budgeting. From time to time since then we have heard similar proposals.

Foreign governments have used various capital budget mechanisms to improve performance. State and local governments and private corporations in the last 50 years have used the techniques of investment budgeting to their advantage. It is ironic that processes which the Federal Government proposed a half century ago are now being proven by other nations and governments. As a planning tool, investment or capital budgeting focuses decision-makers' attention on plant-and-equipment and infrastructure needs that compete for scarce resources. Competing long-term requirements are arranged in priority order as part of the annual budget planning process.

The Federal Government has so far declined to use this valuable decision-making aid. The President's Budget relegates investment planning to a few appendices, almost as an afterthought. Congress needs a place in the budgeting process to make explicit choices on the level of capital investment. If we are to improve government performance, we need to do better by showing proposed spending by capital investment accounts, as well as for short-term consumption, or current goods and services. In addition, we need a clear distinction in the budget between operating outlays, normally expended in the current year, and investment outlays, which produce a "timed-release" benefit over many years.

Today we will hear from John Wood, the Ambassador from New Zealand; Ed Rendell, Mayor of the City of Philadelphia; and Paul Posner of the General Accounting Office. I look forward to the learned testimony of our witnesses.

Mr. CLINGER. Thank you very much, Mr. Chairman; and now I'm pleased to recognize the ranking member of the subcommittee, Mrs. Maloney.

Mrs. MALONEY. Thank you, Mr. Chairman, and I, likewise, would like to have my opening statement submitted to the record as read. I'm very anxious to hear what Ambassador Wood has to say. I strongly support a capital budget. It's the form of budgeting under which we worked effectively and well in New York City and New York State—having an expense budget and a capital budget to plan for the future and to repair and restore infrastructure. I thank you for your leadership on this issue, and for bringing such a distinguished panel here today. Thank you.

[The prepared statements of Hon. Carolyn B. Maloney, Hon. Charles F. Bass, Hon. Robert E. Wise, Jr., and Hon. Frank Mascara follow:]

PREPARED STATEMENT OF HON. CAROLYN B. MALONEY, A REPRESENTATIVE IN CONGRESS FROM THE STATE NEW YORK

Thank you Mr. Chairman. This is our second hearing on the topic of capital budgeting and I commend the Chairman for his diligence in this area. It is always useful to examine the operation of the budget process and look for constructive improvements. I look forward to the testimony of our witnesses, who bring the diverse experiences of national and local governments to our hearing.

Local governments operate under serious fiscal constraints, especially in the current climate of decreasing Federal resources. State and local governments cannot

print money and incur debt the same way that the Federal government can and must therefore rely on their own resources. We can all learn from the hard choices they have to make.

I am sympathetic to the idea of establishing a more explicit capital budget on the Federal level—indeed I am a proud cosponsor of Mr. Wise's bill which would do just that. Capital budgeting will work if it is designed to help Congress and President make choices which increase long-term national productivity and our stock of national assets. It can aid us in setting priorities and choosing between competing capital assets chasing scarce funds.

A capital budget is a tool which can be used to help us make difficult choices within the national budget. We have allowed our national infrastructure to decay and have not planned adequately for the future needs of the nation. Congress has too often chosen the quick fix, in preference to some of the major decisions we should make about our highways, rail systems, bridges and aviation systems.

Chairman Clinger, Congressman Wise and others should be commended for introducing legislation which would apply capital budgeting at the Federal level. They have helped to focus our attention on an important national problem. However, questions remain. The most compelling of these is just exactly how one defines the capital budget. As a decision-making tool, capital budgeting will not work if it is used as a gimmick to shelter too much of the budget from the hard fiscal choices we must all make. Including most of the old budget under a new name will help no one. Most of us would agree that things like roads, bridges, mass transport and computer technology should be included under a capital budget. I am skeptical however about including such items as defense and weapons systems.

I believe that a well-defined and properly implemented capital budget would be a useful tool in helping us all plan better for the future. I look forward to today's testimony. Thank you Mr. Chairman.

Prepared Statement of Hon. Charles F. Bass, a Representative in Congress From the State of New Hampshire

I would like to thank both Chairman Clinger and Chairman Horn for holding this joint hearing today on investment budgeting. As a member of both the Government Management Subcommittee and the Budget Committee, I am very interested in the implications of applying a capital budget or a unified budget to the Federal budget.

The Government Management Subcommittee has already held a hearing on this topic. During that hearing, I noted that the State of New Hampshire utilized a capital budget. As a member of the legislature, I had the opportunity to become familiar with both the strengths and the weaknesses of this approach, at least insofar as it related to a relatively small state's budget. From this experience, I can conclude that we need to examine capital budgeting very carefully before we decide whether it would be a help or a hindrance to our own budget efforts.

Capital budgeting clearly has worked successfully in many instances. I would cite the experience of Fairfax County as an example, to which our colleague on the full committee, Mr. Davis, certainly can attest. However, for our purposes, it would perhaps be more appropriate to examine the implementation of a capital budget on a national government scale. New Zealand has instituted such a budget, and we are honored to have Ambassador John Wood here today to educate us on that country's experience.

Let me again stress that this is a very important hearing. We have an opportunity here to draw some extremely valuable lessons that we may very well apply in the coming years. Our witnesses have been very gracious in agreeing to appear before us today, and I look forward to their testimony.

I thank the Chairman.

Prepared Statement of Hon. Robert E. Wise, Jr., a Representative in Congress From the State of West Virginia

Mr. Chairman, Members of the Committee, I would like to thank you for holding this hearing today. As you know, I have long been a supporter of capital budgeting. Earlier this Congress I sponsored an amendment to balance the federal budget using a capital budget and for several years Chairman Clinger and I have worked on legislation to establish a capital budget which highlights investment over consumption spending.

As a veteran of six years of service on the House Budget Committee, I have come to believe that many of the budget problems facing this Congress, particularly the shift in recent years from public investment toward consumption spending, have as

much to do with the budget process as with decisions made—or not made—by the Congress.

Perhaps the greatest, and to me the most mystifying, problem with the current system is the fact that the federal government's unified budget makes no distinction between money spent on investments and money spent for consumption. Highways, federal salaries, health benefits and foreign aid, which are all examples of federal programs that are paid for through taxes and borrowing, are all accounted for in basically the same way. But all borrowing is not created equal. Borrowing for physical infrastructure can be justified if it pays for itself in the long-run by increasing the nation's wealth and capacity for future economic expansion. Borrowing to meet the day-to-day expenses of government cannot.

Both Chairman Clinger and I have introduced legislation that would divide the federal unified budget into an operating budget and a capital budget. Under our bills the operating budget would include all programs that meet the immediate obligations of running the government. The capital budget would include long-term, tangible investments in infrastructure. This legislation would direct the operating budget to be balanced but would allow the federal government to borrow money for certain investments in infrastructure that increase the national wealth and contribute to economic growth. Money borrowed for those infrastructure investments would be paid back over the life of the road, bridge, sewer system or other infrastructure investment.

The concept of a federal capital budget is not new. The budget was expanded in the 1950s to include information on investment spending. Reform in the 1980s required even more investment information in the unified budget. Many other industrialized countries employ a capital budget, and businesses and most state and local governments have investment budgets that separate long-term capital investments from year-to-year operating costs. Individuals and groups as diverse as former OMB Director Richard Darman, the General Accounting Office and the Progressive Policy Institute have endorsed distinguishing between investment and consumption spending in the budget. As a recent GAO report on the harmful effects of the deficit points out, "a new [budget] decision-making framework is needed, one in which the choice between consumption and investment spending is highlighted throughout the decision process, rather than being displayed for information purposes after the fact."

Businesses know the difference between borrowing to consume and borrowing to invest. Borrowing is a smart move when the money is used to finance productive investments that help a business modernize its equipment, expand and become more profitable. But borrowing money to pay salaries or executive bonuses or to send employees to expensive conferences rather than to modernize would be foolish.

I believe the federal government should make this same distinction in its budget. By borrowing for current expenses the government is asking future generations of taxpayers to pay for the cost of running the government today. But borrowing to invest is different. If the government passes part of the cost of building a road to future taxpayers, it also gives them something in return—a new highway that will encourage economic development, facilitate commerce and increase economic growth for years to come.

Instituting a capital budget would force policy makers to decide whether or not each investment is worth borrowing money to finance. In addition, the public would benefit from knowing that the government's current costs are being paid for and that any borrowing is for investments in the future rather than paying for the present and saddling future generations with bad debt.

All of us agree that the U.S. must make investments that are critical to future economic growth but that the budget deficit must also be reduced. Rather than going from crisis to crisis, the federal government should have an institutionalized system of long-term investment planning. Adopting a federal capital budget would provide such a mechanism.

Mr. Chairman, Members of the Committee, this is a time of fundamental change in the way government serves the people. In order to be more responsive to taxpayers' needs and more responsible with taxpayers' money, I believe the federal government should reform its budgeting to distinguish between consumption and investment. Adopting a capital budget would begin to effect this critical change and I hope you will seriously examine and ultimately endorse this important budget reform.

PREPARED STATEMENT OF HON. FRANK MASCARA, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF PENNSYLVANIA

Good morning Mr. Chairman. It is good to be here this morning. I know it must be Thursday if this is the third Government Reform and Oversight hearing I have attended this week.

All kidding aside, I am pleased that you have decided to hold another hearing on capital budgeting. I concur with the assessment that it is important to refocus on the possibility of requiring a capitol budget for the federal government at this time when there is distinct possibility the 1974 Budget Act will be revised.

As an accountant and a former county commissioner, I have a lot of experience with capital budgets. I stand with those who feel this kind of budget is a natural for the federal government, and, as a result, I am an enthusiastic cosponsor of Mr. Wise's capital budgeting bill.

I support this effort for two important reasons.

First I think it will help refocus our nation's spending priorities on improvements in the country's infrastructure and other long-term investments rather than concentrating on immediate consumption and operating funds.

My friends on the other side of the aisle who keep talking about long-term investment should share this view.

Moreover, Congressman Wise and I come from districts that are crying out for additional infrastructure investments. In our part of the world, new infusions of money for roads, water and sewer lines, and corps of engineer projects spell economic development.

Equally important, are the statistics which show the nation's infrastructure as a whole is falling apart and in need of billions of dollars of repair and replacement. A crumbling infrastructure reduces productivity. We cannot as a nation continue to grow and proposer without facing and correcting this serious deficiency. A capital budget would help move us in that direction.

Second, I also believe a capital budget would help put our Country's fiscal house into better perspective. Battleships, monuments, and federal buildings throughout the land are long lasting assets and should be considered as such in the budget. It makes no sense to only view them as expenditures that add to the deficit without on the other hand counting their long-term value and worth.

Finally, I want to personally welcome Mayor Rendell, my good friend from Philadelphia, who will testify here this morning about the efforts of the U.S. Advisory Commission on Intergovernmental Relations to promote capital budgeting. Welcome Ed.

I truly look forward to the testimony that will be presented and am sure it will be very interesting and enlightening.

Thank you Mr. Chairman.

Mr. CLINGER. Thank you, Mrs. Maloney, and without objection, both the statements of Mr. Horn and Mrs. Maloney will be entered in the record. I'm sorry, also Mr. Wise's—forgive me, I'm a little punchy and not quite picking up everything that's going on this morning. Now I'm very pleased to welcome our first panel, and delighted to have him with us today, because of the exciting things that have been going on in his country of New Zealand.

I've had an opportunity to hear Ambassador Wood speak about some of the very exciting and innovative things that have been happening in the Government of New Zealand, and delighted that he was able to come here this morning and share his insights and experiences with us. So, Ambassador Wood, we're glad to have you with us, and if you'll proceed.

STATEMENTS OF JOHN WOOD, AMBASSADOR OF NEW ZEALAND, ACCOMPANIED BY ANDREW RAE, EXECUTIVE DIRECTOR'S ASSISTANT, WORLD BANK; AND TONY DALE, HARKNESS FELLOW, ON LEAVE AS BUDGET DIRECTOR, NEW ZEALAND TREASURY

Mr. WOOD. Thank you very much, Mr. Chairman. I'm afraid that the most exciting thing that happened in New Zealand recently

was that we lost the World Rugby Cup final. So that was a little depressing to our economy, I think.

Mr. CLINGER. But you won the other one.

Mr. WOOD. We won the other one. First of all, if I could introduce, please, two officials from the New Zealand Treasury, who are with me here this morning; and I'm going to defer to their expertise, which greatly exceeds my own on our subject for discussion. First of all, Mr. Tony Dale, who's present in the United States on a Harkness scholarship, and who was formerly budget director in the New Zealand Treasury; and Mr. Andrew Rae, who is at present working in our executive director's office at the World Bank. Mr. Rae was previously in the social policy and government services branch of the New Zealand Treasury.

Mr. Chairman, the last decade has seen extensive reform of the New Zealand public sector. This has been part of a reform process that has affected every major sector of the New Zealand economy, and one which the OECD has termed the most comprehensive set of reforms undertaken by any member of the OECD. And it was in 1984, at the time the reforms commenced, that our economy was in particularly bad shape.

The national debt was approaching Third World proportions. The government was involved in practically everything about 60 percent of our economy—running everything from telecommunications to oil exploration. The economy was barely growing. In fact, the only thing that was growing was unemployment. Our reform started in the financial sector, and then moved on to agriculture, where we removed all subsidies. And then we moved to reform the public sector.

An important part of reforming the public sector was significantly changing the budgeting, accounting, and management systems of the New Zealand Government. Mr. Chairman, in my written testimony, I've outlined in some detail the nature of those changes. They commenced in 1988, and have now been in place long enough for us to begin to realize some of the benefits, and for independent commentators to assess the results.

But let me briefly summarize the reforms for the committee. The key features of our new public sector management system in New Zealand are, first, a change to the appointment and assessment processes for departmental—or, in your terms, agency—heads. Second, a change in the way we define, measure, and report departmental performance. Third, the delegation of input control to departments or agencies themselves. And fourth, a change in the way we define, measure, and report the fiscal performance of government as a whole.

Under our new system, departmental chief executives—and I think the name is important, these are no longer called secretaries; they are chief executives. They're appointed for limited terms, on performance based contracts. They negotiate annual agreements with their cabinet minister, which specify the performance expected of the chief executive. The annual agreements define performance in terms of the things the chief executive can be held accountable to deliver.

We focus on outputs, that is, goods and services, rather than outcomes. Let me give you a specific example. It may be government

policy, it may be an outcome for the government to seek a reduction in death tolls on our roads. The outputs that the police will be held responsible for may be the number of police road patrols, the number and quality of driver education programs and so on. This distinction is important in terms of real accountability.

In our experience, the move to an output control system has allowed the near total delegation of input control to chief executives. Chief executives now control personnel levels, rates of remuneration within their agency, and the mix of labor, capital, and various operating items. Previously, these were controlled by central government departments like the Treasury and the State Services Commission.

These reforms were accompanied by changes in the budget and accounting systems. A major objective of the government was to obtain greater transparency in order to determine the real costs of particular activities undertaken by government agencies. A major change was the adoption of accrual accounting. Unlike cash accounting, which only reports cash-flows, the accrual method also measures the full cost of an agency's operations for the year.

These costs can then be allocated to outputs to establish the true cost of government programs. A second advantage of the accrual accounting basis is that it reports the assets and liabilities of government departments. And I can tell you that when this system was first introduced, there were some nasty shocks. Among them was a $7 billion unfunded liability under the government employee pension scheme.

This, together with the accumulated operating losses, contributed to a negative net worth position. In fact, in 1992–1993, the New Zealand's Government overall net worth was negative $7.7 billion New Zealand dollars. We had vaguely apprehended for some years that our government was in plain terms bankrupt, and we were now able to prove it. I'm pleased to say, however, that in the latest financial year, the position has improved to a negative $3.3 billion New Zealand dollars; and by June next year, we expect the New Zealand's Government net worth to be positive—probably for the first time in a long time.

Despite initial skepticism from departments, ministers and commentators, accrual accounting is now widely considered to be an important element of our financial management reforms. It provides much better information on departmental, and the whole of the government's, financial performance. No one in my country is advocating return to cash accounting. And a number of other countries, notably the United Kingdom, are following New Zealand's lead.

The adoption of accrual based budgeting and accounting has changed the way our expenditure is recognized, and the way the deficit—or, I'm happy to say, for the last 2 years—surplus, in the case of the New Zealand Government, is calculated. Now, a key feature in the accrual measure is that it distinguishes between operating and capital flows.

Operating, or non-capital flows, are reported in an operating statement, while capital flows are reflected in a balance sheet. Operating and capital cash-flows are separately reported in a statement of cash-flows. Examples of these three statements for the

New Zealand Government as a whole are attached to my written testimony. And it's important to note that similar statements are prepared for each government agency.

The advantage of the operating/capital distinction is that the resulting surplus or deficit measurement provides a much better indication of the underlying fiscal position. The operating result is not masked by large, often one off, capital flows, such as those resulting from the privatization of government trading activities. For this reason, even under our old cash based budgeting system, we had removed all financial capital transactions from our deficit measure.

However, this was only a rough operating capital proxy, and the accrual based system has now provided us with a much better measure. Just as economists use more than one indicator to monitor economic performance—for example, growth, inflation, and unemployment—we now have a series of indicators to measure the government's financial performance. These provide a richer suite of information about the fiscal position and medium-term trends.

In my written testimony, I've gone into some detail on the definition of operating expenditure, vis a vis capital expenditure. Clearly, in splitting these two, it is important to define what is to be included in capital. New Zealand uses the definition provided by generally accepted accounting practice, which is essentially all assets and liabilities of the government.

We do not consider expenditure on human capital, education, private sector research and development, to be capital expenditure. While it can be argued that these expenditures are investment, they do not generate an asset for the government; and hence, we regard them as operating expenses. A second feature of the New Zealand system is the delegation of most capital expenditure decisions to agencies themselves.

When we moved to the new system, each department identified and valued all of their assets and liabilities; thereby establishing their opening balance sheet positions. This in turn, determined the capital base for the department. Under our new system, departments or agencies do not require an appropriation or even ministerial approval to buy and sell assets within that capital base. This freedom is quite extensive.

For example, my ministry can sell a car and use the proceeds to buy another vehicle or a computer or land or furniture. Alternatively, we can reduce our working capital, and use the proceeds to buy a physical asset or vice versa. How has it worked in practice? Initially, there were fears in some quarters that government agencies might abuse this newfound freedom by investing unwisely. This has not proved to be so.

By trusting managers, while at the same time monitoring overall asset levels—something we were quite unable to do previously—we have found that managers have rationalized sensibly, selling surplus assets to upgrade computer equipment, for example. I know in the case of my own ministry—the Ministry of Foreign Affairs and Trade—that we, in times gone by, instinctively resisted suggestions by central control departments, such as the Treasury, that we should sell overseas properties, for the very good reason that there was no incentive to us as an agency for us to do so.

However, since we have had the freedom to manage these capital assets ourselves, and to buy and sell within a capital agreed based, we have made many rationalizations of our property holdings of our own volition. My ministry's head office building in Wellington, for example, is owned by private investors out of Singapore. Incidentally, they're much better landlords than the New Zealand Government ever used to be.

What happens if a department runs short of working capital, or is unable to finance asset purchases from within its existing balance sheet? In this case, it must seek a capital injection from the government; and to be successful, it must justify its bid on the basis, and I'm quoting, "of a sound business case." The criteria for such cases are set out in my written testimony.

This business case must be presented in the context of a medium-term strategic business plan, which focuses on the demand for the agency's outputs, and the efficiency of the agency's operations in their entirety. Having to present a sound business case provides a real discipline on agencies to justify their requests. In our last budget round, for example, a number of agencies withdrew bids for capital injection that they would otherwise have made because, in effect, they were unable to meet the criteria for a sound business case.

A third feature of the New Zealand system is that we recognize the cost and consumption of capital in the budget and accounting systems. Capital—even that raised by a government through taxes—has a cost. As a means of encouraging agencies to recognize this opportunity cost, each agency is levied a capital charge, which they are required to pay to the Treasury twice a year. The charge is calculated as a percentage of the department's capital base.

This creates an incentive for agencies to minimize the existing capital base. A number of departments, agencies have even reduced their capital by improving their collection of debts and ensuring they don't pay bills until they are due. As with all other expenses, agencies are required to allocate their capital charge across their outputs. It is thus reflected in the cost of the outputs purchased by the government and appropriated by Parliament.

Now, the capital charge has been controversial, but its impact has been positive. And independent study conducted by Price Waterhouse concluded that the charge has been very successful in making explicit to agency managers the cost of owning assets, and that there is sufficient evidence to state unequivocally that the concept has been successful. Let me give you a small example of the capital charge at work from my own experience here in Washington.

At our Ambassador's residence, the foreign ministry owns a number of paintings by New Zealand painters, which were purchased 20 years ago for a relatively modest sum. They have now appreciated to the point where their capital value is several hundred thousand dollars. Now I'm faced with a situation that I have to pay a twice yearly capital charge on that capital value to the New Zealand Treasury.

So that kind of sharpens my decisionmaking. What am I going to do—am I going to go on paying the capital charge, or do I ship the paintings back to New Zealand and sell them at auction and

buy some cheaper paintings and the ministry gets to keep the proceeds. So, similarly, we don't own the Ambassador's motor vehicle here in Washington any longer, because I'd have capital tied up in that and I'd have to pay the capital charge. So we lease our motor vehicle.

So those are the sort of practical micro decisions that are forced upon you by the existence of the capital charge. Departmental managers constantly face this sort of issue in regard to all their agency's capital assets. At the beginning of each budget cycle, the New Zealand Government is required to publish a budget policy statement, setting out the fiscal parameters and budget policies for the forthcoming budgets.

While similar in nature to a U.S. budget resolution, the budget policy statement is required to establish fiscal parameters for the following variables, over a 3-year period—operating balance deficit or surplus; operating revenues; debt net worth; or the net balance sheet position. The distinction between operating and capital funds means that all capital expenditure has to be financed from within the balance sheet.

This means that new capital can only be funded by either running cash reserves or increasing debt. Thus, in order to set debt and net worth parameters, the government has to decide how much new capital investment it will undertake, and how it will finance that investment. Mr. Chairman, let me summarize briefly.

The New Zealand budgeting and accounting systems use accrual, rather than cash, accounting. In this system, capital flows are distinguished from operating flows, and excluded from the measure of the government's deficit or surplus. A capital transaction is defined as one that generates an asset for the government, in contrast to the country as a whole. All other transactions are treated as operating expenditure, and included in the deficit surplus calculation.

Detailed capital expenditure decisions are mostly delegated to agencies which are free to buy and sell assets within their capital base. If they need additional capital, they must seek a capital injection from the government. And to be successful in their bid, they must present a sound business case. The cost and consumption of capital is included in the cost of outputs and detailed middle operations, but not explicitly appropriated. Thank you very much, Mr. Chairman.

[The prepared statement of Mr. Wood follows:]

PREPARED STATEMENT OF JOHN WOOD, AMBASSADOR OF NEW ZEALAND

INTRODUCTION

Thank you Mr Chairman for the opportunity to take part in this hearing.

As you know the last decade has seen extensive reform of the New Zealand public sector. This has included significant change to the budgeting, accounting and management systems of the New Zealand government. In my testimony today I would like to outline the main aspects of these reforms. In doing so I will focus particularly on the aspects of our system that impact capital planning and budgeting processes.

OVERVIEW OF PUBLIC SECTOR MANAGEMENT REFORM

Reform of the core departmental financial management system began in 1988. It was designed to fundamentally redefine the nature of the accountability relationship between a government Minister and his or her department. It also sought to improve the incentives on departmental managers to respond to the government's policy priorities.

The key features of the new public sector management system are:

- a change to the appointment and assessment processes for department heads
- a change in the way we define, measure and report departmental performance
- the delegation of input control to departments
- a change in the way we define, measure and report the fiscal performance of the government as a whole.

Under our new system departmental chief executives are appointed on limited-term, performance based contracts. They negotiate annual agreements with their Minister which specify the performance expected of the chief executive. These "performance agreements" are used as the basis for assessing the chief executive's performance at the end of the year.

The annual agreements define performance in terms of the things the chief executive can be held accountable to deliver: outputs (goods and services) rather than outcomes. In addition the agreements recognize that as well as being a purchase of a department's outputs the government is also owner and that good "ownership performance" is a second key dimension of chief executive performance.

The move to an output control system has allowed the near total delegation of input control to chief executives. These delegations include control over personnel levels, rates of remuneration, and the mix of labour, capital and various operating items.

These reforms were accompanied by changes to the budgeting and accounting systems. A major change was the adoption of accrual accounting. Unlike cash accounting, which only reports cash flows, the accrual method also measures the full cost of a department's operations for the year. These costs can then be allocated to outputs to establish the true cost of government programs. A second advantage of the accrual basis is that it reports the assets and liabilities of the department.

Despite initial scepticism from departments, ministers and commentators, accrual accounting is now widely considered to be an important element of our financial management reforms. It provides much better information on departmental and whole-of-government financial performance. No-one is advocating a return to cash accounting and a number of other countries, notably the United Kingdom, are following New Zealand's lead.

SEPARATING OPERATING AND CAPITAL FLOWS

A Better Deficit Surplus Measure

The adoption of accrual-based budgeting and accounting has changed the way expenditure is recognised and the way the deficit/surplus is calculated.

A key feature of the accrual method is that it distinguishes between operating and capital flows. Operating (non-capital) flows are reported in an operating statement while capital flows are reflected in a balance sheet. Operating and capital cash flows are separately reported in a statement of cash flows. Examples of these three statements for the government as a whole are attached. Similar statements are prepared for each department and agency.

The new deficit surplus measure comes from the bottom of the operating statement. Important aspects of this measure are:

- it includes all revenues to be earned by the government in that year, regardless of whether the cash is projected to be received or not
- it includes all expenses to be incurred by the government in that year, regardless of whether cash is projected to be paid out or not
- it excludes all flows relating to the purchase or sale of assets and liabilities
- it includes the operating results of all government departments and agencies including government owned companies and semi-autonomous organizations (ie it is a unified budget).

The advantage of the operating/capital distinction is that the resulting surplus/deficit measure provides a much better indication of the underlying fiscal position. The operating result is not masked by large, often one-off, capital flows.

For this reason, even under our old cash based budgeting system we had removed all financial capital transactions from our deficit measure. However, this was only a rough operating/capital proxy and the accrual based system is now providing us with a much better measure.

Notwithstanding the better deficit surplus measure, all expenditures, be they operating or capital in nature, need to be financed. The cash flow statement provides financiers and financial markets with this information. In this way we have separate measures of the true cost of running the government for the year (the surplus/deficit from the operating statements) and the financing implications of this (from

the cash flow statement). As in the business world, these two measures provide different information for different purposes.

Thus just as economists use more than one indicator to monitor economic performance (for example, growth, inflation, unemployment), we now have a series of indicators to measure the government's financial performance. These provide a richer suite of information about the fiscal position and medium term trends.

Defining Capital

An operating/capital split makes it important to clearly define what is to be included in "capital". We use the definition provided by generally accepted accounting practice which is essentially all assets and liabilities of the government.

On the asset side this means:

- investment/divestment of capital in government departments, government-owned companies' or other organizations partly or wholly owned by the government
- the purchase/sale of physical assets that will be owned by the government
- the creation, purchase or sale of intangible assets (such as computer databases and intellectual property rights) that will be owned by the government.

We do not consider expenditure on human capital, education, private sector research and development to be capital expenditure. While it can be argued that these expenditures are an investment, they do not generate an asset for government. If we were doing a budget or set of national accounts for the country as a whole then we might consider treating these items as capital expenditure because it could be argued that they create an asset for the country. However, no asset is created for the government and hence we regard them as operating expenses.

Similarly grants (in cash or kind) to private individuals, organizations or institutions are accounted for as an operating expense unless the government obtains some ownership rights in return. In most situations this is not the case.

While this approach provides a relatively tight capital definition it does not mean that all operating expenses should be viewed equally. For example, in the recent Budget the Government identified priority expenditure areas including education, health and research and development. In this way it is focussing its operating expenditure in the areas of greatest return to the country as a whole.

DELEGATION OF CAPITAL DECISIONS TO DEPARTMENTS

Delegation within a Capital Base

A second feature of the New Zealand system is the delegation of most capital expenditure decisions to departments.

When we moved to the new system each department identified and valued all of their assets and liabilities, thereby establishing their opening balance sheet positions. This in turn determined the capital base for the department. Under our system, departments do not require an appropriation or even Ministerial approval to buy and sell assets within that capital base.

This freedom is quite extensive. For example, a department can sell a car and use the proceeds to buy another car or a computer or land or furniture. Alternatively they can reduce their working capital and use the proceeds to buy a physical asset or vice versa.

In making these capital decisions departments are restricted by:

- the level of their existing capital base
- a prohibition on departmental borrowing
- the requirements to deliver specified and agreed outputs

The later restriction ensures that a department does not dispose of an asset that it requires to produce its outputs. In this way we have delegated input control and replaced it with controls over what outputs are produced and the size of the capital base.

Initially there were fears in some quarters that departments might abuse this new found freedom by investing unwisely. This has not proved to be so. By trusting managers while at the same time monitoring overall asset levels (something we were unable to do previously) we have found that managers have rationalized sensibly—selling surplus assets to upgrade computer equipment for instance.

Capital Injections into Departments: A Sound Business Case

If a department runs short of working capital or is unable to finance asset purchases from within its existing balance sheet, it must seek a capital injection from the government. To be successful it must justify its bid on the basis of "a sound business case".

As part of this business case the department must (among other things) identify:

- the nature and expected life of the investment
- how the proposal is consistent with the Government's strategy and with the department's core business
- the financial flows attributable to the proposal
- the relevant non-tangible benefits and costs
- the financial return to the Government

Furthermore this business case must be presented in the context of a medium term strategic business plan which focusses on the demand for the departments' outputs and the efficiency of the departments' operations in their entirety. This is not simply an accounting exercise; it is a means of matching long-term strategy with operational planning. It does this by treating assets as future productive capacity not a sunk cost.

The "sound business case" approach provides a discipline on departments to justify their requests. I understand that in the last budget round it encouraged a number of departments to withdraw bids they otherwise would have made.

The approach also provides Ministers with analytical information on which to base capital injection decisions.

OPERATING IMPACTS

A third feature of the New Zealand system is that we recognize the cost and consumption of capital in the budget and accounting systems.

The Cost of Capital: The Capital Charge

Capital, even that raised by a government through taxes or borrowing, has a cost. As a means of encouraging departments to recognize this opportunity cost, each department is levied a "capital charge" which they are required to pay to the Treasury twice a year.

The charge is calculated as a percentage of a department's capital base. The larger the base the higher the charge. Conversely, the lower the base the lower the charge. This creates an incentive for departments to minimize their existing capital base.

As with all other expenses, departments are required to allocate the capital charge across their outputs. It is thus reflected in the cost of the outputs purchased by the government, and appropriated by Parliament.

At the whole of government level, the charge is eliminated out and only the (accrual) cost of external financing is reflected in the deficit/surplus.

Although the capital charge has been a little controversial, its impact has been positive. An independent study conducted by Price Waterhouse concluded that the charge has been very successful in making explicit to departmental managers the costs of owning assets and that there is sufficient evidence to state unequivocally that the concept has been successful.

Capital Consumption: Depreciation

The operating statement of each department is required to include the depreciation cost associated with their assets. This has a number of advantages, among them the fact that departments can no longer run down their assets by not maintaining or replacing them. If they do so the immediate reduction in value is obvious from the balance sheet.

Depreciation is aggregated into the various categories of expenditure reported in the operating statement of the government as a whole. The deficit/surplus thus includes the consumption of capital for the year (along with all other non-cash expenses).

While departments and the government as a whole record depreciation as a separate line item, for budgetary purposes departments are required to allocate all their costs across their outputs. This includes depreciation and other non-cash costs.

Furthermore, appropriations are made on an output basis (the maximum accrual amount to be spent in producing each output) rather than on the basis of input line items. As a result, depreciation is not explicitly appropriated. Its inclusion in the cost of outputs means that it is implicitly appropriated, however.

CROWN ASSETS

A fourth distinction relates to what we call "Crown assets". These are assets over which departments do not have full purchase/disposal control. Examples include national parks and historic buildings.

Crown assets are separated from departmental assets and recorded on the Crown (or government) balance sheet rather than on a departmental balance sheet. Departments act as agents for the government in the management of these assets but have

no authority to buy or sell them. Those decisions are made directly by Ministers on the basis of cost-benefit analyses.

CAPITAL DECISIONS IN THE NON-DEPARTMENTAL SECTORS

In addition to departments there are also a large number of government-owned companies and semi-autonomous government agencies in New Zealand. These typically operate under the same type of system as government departments:

- they are free to manage their assets as they see fit within their capital base
- if they want more capital they must justify a capital injection on the basis of a sound business case.

The government-owned companies and some of the other agencies also have the power to borrow in their own name from the financial markets. This generally only occurs when they are operating in a competitive environment and are therefore subject to the efficiency disciplines of the private sector. The government does not guarantee this debt and this helps ensure that financial markets keep an oversight on their performance.

CAPITAL AND THE BUDGET PROCESS

Implicit Capital Budget

At the beginning of each budget cycle, the New Zealand Government is required to publish a Budget Policy Statement setting out the fiscal parameters and broad policy priorities for the forthcoming budget. While similar in nature to a US Budget Resolution, the Budget Policy Statement is required to establish fiscal parameters for the following variables over a three-year period:

- operating expenses
- operating balance (deficit/surplus)
- operating revenues
- debt
- net worth (net balance sheet position)

While there is no explicit requirement to establish a capital budget (an amount to be spent on capital investment) such a limit is implicit in these variables.

The operating/capital distinction means that all capital expenditure has to be financed from within the balance sheet. This means new capital can only be funded by either running cash reserves or increasing debt. Thus in order to set debt and net worth parameters the Government has to decide how much new capital investment it will undertake and how it will finance that investment.

Capital Investment Decisions

At the detailed level the decision-making process is relatively simple. As the budget process progresses Ministers decide which individual capital investment decisions to support in the light of their capital constraint.

Because detailed capital decisions are mostly delegated to departments and other agencies, these capital budgetary decisions consist of choosing between:

- investment of new capital into departments
- investment of new capital into government-owned companies and semi-autonomous government agencies
- the purchase or development of Crown assets.

The first two categories have "sound business case" information to support them and this provides an analytical basis to make this decision. The latter usually are supported by cost-benefit analyses.

SUMMARY

The New Zealand budgeting and accounting systems use accrual rather than cash accounting. In this system capital flows are distinguished from operating flows and excluded from the measure of the government's deficit or surplus.

A capital transaction is defined as one that generates an asset for the government, in contrast to the country as a whole. All other transactions are treated as operating expenditure and included in the deficit/surplus calculation.

Detailed capital expenditure are mostly delegated to departments who are free to buy and sell assets within their capital base. If they need additional capital they must seek a capital injection from the Government. To be successful they must present a sound business case.

Ministerial capital decision-making consists of determining the level of capital injections into departments, government-owned companies or semi-autonomous government agencies. They also make decisions about the purchase or development of Crown assets—assets of the government which are not controlled by agencies.

The cost and consumption of capital is included in the cost of outputs and departmental operations but not explicitly appropriated.

This ends my prepared testimony.

Mr. CLINGER. Thank you very much, Mr. Ambassador. We really appreciate your testimony, and I'll have some questions. But I first of all want to recognize the co-chairman of this hearing, Mr. Horn.

Mr. HORN. Thank you very much, Mr. Chairman. Mr. Ambassador, I enjoyed your summary today, just as I enjoyed your address at Leesburg, which got all of my colleagues out of their chairs not just to exercise, but to applaud your presentation. And I'm delighted you have two experts with you today. Mr. Dale, we had the pleasure of having you testify before the subcommittee.

One of the things that bothers a lot of people in the United States when you talk about a capital budget is that it looks like government is using the capital budget to get around the "regular" budgeting process in the sense that they take large projects, or even smaller ones out of the regular operational budget line, and handle them in a seemingly different way.

Now, I realize one doesn't have to handle them that way. But when I heard you say computers would be part of the capital budget, and now even paintings, which would have value and all, I wonder, is there an agreed upon minimum length of life for an object before it is considered eligible for the capital budget? And then I'd like to go back to how do we deal with those perceptions. But I think I need a definitional term as to how New Zealand handles that.

Mr. DALE. Essentially, it has to meet the accounting definition of an asset in terms of life, that's essentially longer than a year. So it has a life of more than 12 months.

Mr. HORN. More than 1 year?

Mr. DALE. Yes.

Mr. HORN. Or did you say 4 months?

Mr. DALE. No, 12 months.

Mr. HORN. OK, so that's the basic minimum for qualifying as a capital item.

Mr. DALE. That's correct.

Mr. HORN. OK. Have the New Zealand people, because of this capital budget, felt, that the government is putting one over on us? Or is it as obvious in consideration as your operational budget?

Mr. DALE. The latter. What the distinction has done is made government decisionmaking much more transparent. It's now much more obvious where the government is spending money on day to day housekeeping type operations, or whether it's actually investing in assets that will contribute to future wealth. So there's no sense at all that there's some hidden game going on here.

It has made it much more transparent. The financial markets very much like the separation, because they can see what the underlying operating position of the government is. And second, the media, the politicians, and the public more generally, find that the distinction helps them understand what the real position of the government is in a fiscal, financial sense.

Mr. WOOD. I think in terms of public perceptions, if I could just say, it's no longer possible, for example, to finance operating expenditure out of the disposal of capital assets and get away with

it through some accounting sleight of hand. That kind of transparency has now been injected into it. That sort of practice was not entirely unknown in my country in the past.

You couldn't obscure what was being done in the new system. So I think to that extent, public perceptions would be very positive. They understand capital assets and the importance of those assets to them, and they can find out what happens to the assets.

Mr. HORN. In the United States, operational budgets are generally supported by revenues derived by taxation. Sometimes they're supported by bonds, which is not considered a good practice. But if you're into capital projects in the United States—dams, highways, ones with fairly long life that you can advertise—generally they're funded by bonds at the State level.

How does that work in New Zealand, in terms of different financial instruments or sources for different types of projects or budget operations?

Mr. DALE. Unlike the United States, we don't link bond instruments to specific projects. Both operating and capital expenditure is funded out of general bonds, general debt raising, plus taxation. So we don't have a one on one link. What the changes mean for us, though, is we've been able to identify exactly the nature of the financing need for capital purposes. So we've been able to split out how much of debt raising is for paying for the groceries, and how much is an investment; and that's been very helpful.

Mr. HORN. Let's take the overall New Zealand budget. Is one operational, and the other capital? What's the definition to divide the budget?

Mr. DALE. Well there are essentially three aspects to the budget. One is the operating expenditure, which is measured on an accrual accounting basis. So it includes non-cash expenses of the government as well. The second is the balance sheet. And the third is the cash-flows, which is the financing. So we look at all three aspects as part of the budget process.

Mr. HORN. Now, would you use those same three aspects on the capital aspects of the budget?

Mr. DALE. The capital budget is really about how the government wants to structure its balance sheet, and then how it's going to finance that structure into the cash-flow. So essentially, we would look at the balance sheet and the cash-flow impact on that.

Mr. HORN. So in New Zealand, your cash-flow, which is derived primarily from taxes, could be supplemented with customs fees, or whatever. Presumably those funds are fungible, and can be used on either the capital projects or the non-capital projects; is that correct?

Mr. DALE. That's correct. That's the financing source.

Mr. HORN. Yes. So, well, that's interesting. Now, that's where, in this country, I suspect there would be a feeling that we're trying to put something over on them if it wasn't that obvious. And some people are thinking of separate budget cycles, in a way——

Mr. DALE. Right.

Mr. HORN [continuing]. For capital versus operational. Operational comes up annually, although in some of our States, it's a 2-year budget. Some people would like the Federal Government to go to a 2-year budget and so forth. So these arguments go on. But

on the capital side, one could say that you would have that every year or every other year. And you're planning forward on major investments of the society—be it buildings or what not.

Now, when you said computers, what immediately came to mind was that there's a very short life for some computers, with the advances in technology. And I would worry, in this country—and I have worried, because I sat on the California Educational Facilities Authority, which approved the backing of bonds for private colleges and universities to undertake expansion of their facilities, academic facilities, primarily.

But once in a while, they'd have computers in there. When you're talking about a 20-year project on the physical facility, or a 40-year project, and you throw the computers in that are outdated the day you buy them, in terms of the generation of technology, some of us would say we've got a real problem in terms of the income stream there. Because you're going to have to replace those computers many times in the life of that physical building.

I just wondered if any problems like that pop up in the decision-making on the capital side in New Zealand.

Mr. DALE. Two comments. First of all, on the financing side, we separately identify the amount of cash that will be used for capital purposes there, the general taxation amounts that are coming in. We can simply identify that. So we can see the differences over time. But the real reason we haven't had a problem is because of the use of accrual accounting. Because accrual accounting separates out the financing issues, the cash-flow issues, from the consumption of the asset.

So what happens is, like, take a computer. Let's say it has a 3-year life. When we purchase that computer, it finds its way onto the balance sheet as an asset. And then in each year, one-third of the value is written off and charged against the deficit. So the deficit, which is an accrual measure actually reflects the usage of that computer, and its running down in value.

So you have that operating measure as a reflection of future cash-flow needs. This is basically sufficient transparency in the system to overcome the concerns that you're raising. Now, the United States, in your situation, where you're in a cash accounting environment, I think you need to think about alternative mechanisms to deal with what you're talking about. We use accrual accounting to deal with that issue.

Mr. HORN. Thank you, Mr. Chairman. I have other questions for later.

Mr. CLINGER. Thank you very much, Mr. Horn. And now I'm pleased to recognize a gentleman who is a champion of capital budgeting, and has introduced legislation. He's been a long-time, strong advocate for capital budgeting, the gentleman from West Virginia.

Mr. WISE. Well, I appreciate that very much, Mr. Chairman, and I appreciate the chance to work with you. And I have to be honest, after last night, you've watched me depreciating before your very eyes. I'll never tell that everybody up here has the same tie on they had on yesterday. Mr. Ambassador, thank you very much for being here. Mr. Clinger, who's been the real tireless champion of this

issue, and I have had the chance to be involved in a lot of these meetings.

It's delightful to run across someone at the national level, the Federal level, who's employing capital budgeting and can testify to it. I have a couple of brief questions. One is, I note with interest that you refer—in your definition of capital budgeting—to a distinction between investments which generate an asset for government, and that qualifies as a capital expenditure; and those which create an asset for, "the country," which does not qualify as a capital expenditure.

And you treat the latter, for the country, as an operating expense. I guess my question is, where is the distinction? And I would specifically ask this—in the Federal system here, where the Federal Government puts up 80 percent of the cost of a mile of highway; the State puts up 20 percent. Would that be considered an asset for the—and we would argue, I think, I would argue, and I think I can speak for others, that that should qualify as a capital expenditure.

But I'm just curious, under the New Zealand system, is that an asset for the country or for the government?

Mr. DALE. In New Zealand, the highways are an asset of the government. The government almost fully funds national highways, and they are regarded as an asset of the government, and they're on the government's balance sheet.

Mr. WISE. Does the Federal Government, as well, make grants for water and sewer systems and other forms of infrastructure?

Mr. DALE. Not really, not in the way you do here. But the government does, for example, provide grants for research and development by private sector organizations. And we do not regard that as an asset of the government, because the resulting research is not owned by the government; it's owned by the private sector. So we treat that as an expenditure.

Mr. WISE. What about a government building—I assume would be a capital expenditure; is that correct?

Mr. DALE. That's correct.

Mr. WISE. What about military items, and particularly those that have a life beyond immediate consumption—an airplane, a naval ship?

Mr. DALE. That's a very good issue. In New Zealand we treat military items, other than ammunition, as an asset, and we have them on our balance sheet. Interestingly, the system of national accounts that the United Nations uses, which is also an accrual accounting system, requires all military equipment to be expensed in the year in which it's purchased, not to treat it as an asset.

Now, in New Zealand, we have not employed that practice. We do treat them as an asset, and that is because it is reasonably rare for a piece of New Zealand military equipment to be destroyed in combat. They more often than not just depreciate over time and with use. So we feel that our military equipment is more in the nature of a normal asset. Clearly, in many cases in the United States, that is not the case.

Mr. WISE. Yes, I guess, could it be looked at in the same context as, say, an expensive piece of police equipment. You hope it's never used, but at the same time, it's necessary for the overall security

to preserve the integrity of not only the government, but also perhaps to safeguard the economy? As I know you know, that's a long running debate that takes place in this country—if you're going to have capital budgeting, and if you do, what goes in it?

I think another question I would have is, on page 5 there's discussion, you talk about a capital charge. Could you discuss what that is and how it works?

Mr. DALE. The capital charge is conceptually like a dividend or interest payment that each agency pays to the Treasury, on behalf of the government. And what it really is, is a device to help agencies recognize the cost of the capital that they have invested in them. Most departments find no difficulty in recognizing that labor has a cost, because they're paying salaries every week.

But once they get—and under the old system, once they got their capital—it was essentially free thereafter. And if they had buildings that were empty or cars that weren't used, it didn't have any impact. This capital charge actually levies them a fee for the amount of their net asset position.

Mr. WISE. Well, I understand in terms of what the Ambassador was describing as far as the paintings go, but how do you handle a capital charge on a piece of highway?

Mr. DALE. Good question. One of the things that's in the written testimony, but we didn't discuss previously is, we do make a distinction between assets that the department controls and those that the department doesn't control. And the capital charge is only levied on the former category—those that the department controls. Now, the highways are not a departmental asset. They are reported separately, and so there's no charge on them.

And the reason we do that is because the Ministry of Transport does not have ultimate control over the roading. That's an important distinction.

Mr. WISE. Thank you very much.

Mr. WOOD. I wonder if I could just add a comment to the answer to your first question. And that was to do with the distinction between an asset from the point of view of the country as a whole, and an asset from the point of view of the government. I think it was felt, in the New Zealand context, that you were not going to make sensible investment decisions, at least at the government agency level, if you argued for those investment decisions from the point of view of the overall economic good.

And you had to get a bit more rigorous than that in that you had to make investment decisions based on whether or not an asset was created which was owned by the government, and if so, what exactly that asset was and what its value was, rather than just advancing general propositions that this would be good for the economy as a whole or it would be good for the country as a whole.

And that's why you may recall I said that some forms of expenditure, such as education, which are perfectly justified in terms of the general well being of the country, are not treated as the creation of an asset owned by the government.

Mr. WISE. Thank you, and I would assume another reason, as well as the area that Mr. Horn got into, which is so that no one can charge abuse of the accounting system, trying to lump everything under the capital budget side. Thank you very much.

Mr. CLINGER. Yes, that really was following up on something I wanted to ask you about—give an example of what was an asset of the country. And I think what you've said is it would be that, but would not have a specific value, but more of a sort of generic sense of well being for the country, as I understand it. Education would be considered an asset of the country, for example.

Mr. DALE. Education is a very good example.

Mr. CLINGER. One of the problems we grope with here, and I think you addressed that, Ambassador, in your testimony, was the definitional problem. How do you define, and who makes those determinations? And just to clarify, as I understand it, the asset of the government is basically bricks and mortar. In other words, it's physical assets, limited to physical assets, but includes military. Is that correct?

Mr. DALE. That's correct. It is essentially things that you can touch, although there are some intangible assets, such as computer data bases that are included. But essentially, we use the same rules that the private sector uses in compiling a balance sheet for a company.

Mr. CLINGER. We talk a lot here about pork barrel projects, and politicians are always being criticized for engaging in pork barrel investments and that sort of thing. One of the attributes, I think, that a capital budget can bring to it is a little more discipline in the way that we go about funding and selecting and determining what projects need to be done.

How is a decision made, for example, under your system, what highways get funded or what city gets a new airport or an extension of an airport? How are those decisions made?

Mr. DALE. As I alluded to earlier, there are essentially two categories of assets—those that are managed by the agency and the full responsibility of the agency. In those cases, the decisions are purely the agencies'. The government's decision is really how much investment it wants to make in the agency in total, and then the mix of assets is the department's responsibility. The legislature has no involvement in that at all.

There's a second group of assets, which are what we call Crown assets. They are managed by agencies on behalf of the government. And the legislature and the ministers make decisions about those assets. And that includes roads. But what has also happened in New Zealand is we have set up some organizational arrangements where the detailed decisionmaking about which road is built or fixed is actually made by an independent commission, like the base closure type approach.

So the government and the legislature decide how much to spend on building new roads or maintaining existing roads. And this independent commission then determines exactly which roads will be built or maintained. And they do so using a very sophisticated benefit cost system, a cost ratio system, the highways. So it's quite independent from a political process.

Mr. CLINGER. You emphasized, I think, that by going to an accrual basis of accounting and basically separating capital from operating expenses that has engendered a greater degree of transparency. Could you amplify on that a little bit?

Mr. DALE. OK. We get it in a number of ways, but for example, what accrual accounting does is recognize the wearing out of assets. So each year, we value the roads, the national highway system. And if those roads have not been maintained properly within the year, then their value will have decreased. So for starters——

Mr. CLINGER. Let me interrupt there. How do you determine, or who determines the depreciation schedule for these?

Mr. DALE. Essentially, highway engineers.

Mr. CLINGER. OK.

Mr. DALE. So, for a start, we get a pretty neutral measure of capital consumption and the wearing out of assets. So if asset replacement or maintenance has been foregone, then that becomes quite transparent. And we've seen that, for example, in the education system where school buildings, which are all owned by the Federal Government, were not being well maintained. You could see that became very, very obvious.

Conversely, if significant additional expenditure has been spent on roads or schools or whatever to broaden or extend the highway system, then that also becomes very obvious. You can see the stock and what's changing in the stock. The third real benefit of this is what's reported is the actual resource use for the year, not a cash-flow. And this has a number of benefits. First of all, it means that manipulation of the cash position during the year is essentially eliminated from the deficit measure.

We used to have systems where, if you're running out of money, you didn't post any checks in the last month, to keep the deficit under control. Well, now, that doesn't make any difference. If you've incurred the expense, whether you've actually paid for it makes no difference at all. So you get a more accurate measure like that. Second, the deficit measure picks up non-cash expenses that were incurred that year, but for which the cash-flow won't happen for several years' time.

A good example here is the employee pension liability that the Ambassador mentioned. The reason we ended up with a $7 billion deficit in the government employees pension scheme is because for a number of years under our cash system, we had traded off wage increases for increases in pension liability; in a cash system, the increase in pension benefits doesn't show up until the people retire.

Now under our new system, it shows up immediately in the year in which you incur it. So it kind of has the same benefit that credit reform has had in this country.

Mr. CLINGER. Thank you, thank you very much. Mr. Horn.

Mr. HORN. I yield to Mr. Chrysler.

Mr. CLINGER. Do you have any questions Mr. Chrysler?

Mr. CHRYSLER. No.

Mr. HORN. Mr. Ambassador and your colleagues, we'll submit a number of these questions perhaps to you and Mr. Dale. If you would help us on them, they don't require heavy answers, but I don't think there's time to go through all of them. But I do want to mention a few in the personnel area. If chief executives do not attain the level of performance specified in their contracts and agreed to by them, what happens?

Mr. WOOD. The contract is a short-term one, and it doesn't have a renewal clause in it.

Mr. HORN. What's the general length of the contract?

Mr. WOOD. That is quite often confidential to the position. My own contract here, as Ambassador, is for 4 years. A chief executive officer's contract would typically be for 5 years, with regular performance reviews.

Mr. HORN. Now, we've read a lot about the president of the Bank of New Zealand. It would be the equivalent of our Federal Reserve—really, your central monetary system, central bank. If he can keep the inflation rate under 2 percent, he's paid rather well. How long term an appointment is that?

Mr. WOOD. I don't know what term that his appointments are, but I'm pleased you mentioned that, because in fact, the lead item in our news sheet from New Zealand today is a revelation that inflation, because of an unusually heavy increase in the price of fruit and vegetables in New Zealand, inflation has spiked at about 2.3 percent, which exceeds, for the first time in several years, the 2 percent limit for inflation, which the Governor of the Reserve Bank is bound to observe.

And the debate is whether he would be asked to resign or not as a result. And the minister has said that, in the circumstances, his inclination is not to hold him responsible for the performance of the fruit and vegetable sector in the New Zealand economy. But on the other hand, the option is there.

Mr. HORN. He won't be picking right now in the Gala apple orchard. We all buy them—fine apple products. Since I grew up on a ranch, I know a good apple when I see it. Right now, they're coming from New Zealand. Has the control over the personnel levels been delegated to the chief executives in all the ministries, or is there a centralized personnel system still?

Mr. WOOD. It's delegated authority.

Mr. HORN. How far down does it go?

Mr. DALE. Authority is based in the chief executive of each department. They are the employing authority. They can set the terms and conditions of employment for their department, including wage rates and anything else.

Mr. HORN. If you had major capital projects involved under that type of department, such as we have with our Bureau of Reclamation or our Army Corps of Engineers, where is the responsibility for that project? I mean, does it rest ultimately with the minister as the chief executive, or does it get down into the field in different parts of New Zealand where there might be a regional director or whatever you would call your equivalent of that?

Mr. DALE. In a formal sense, it rests with the chief executive, but in every department, the chief executive will then have a delegation process within his or her department.

Mr. HORN. So there is real grass roots authority over personnel?

Mr. DALE. Certainly. Essentially what most departments will do is, for each of the line managers all the way down the chain, establish an operating and capital budget for each small operating unit.

Mr. HORN. Are there any of the resources used to fund the capital budget that fund personnel related to the operation of the capital projects in that budget, or is there a strict separation?

Mr. DALE. Strict separation.

Mr. HORN. What organization is responsible for enforcing adherence to accounting and reporting standards that are applicable to the New Zealand Government?

Mr. DALE. Essentially two—the Treasury in the budgetary context, and the Auditor General does a comprehensive audit of each agency each year on a financial basis, and ensures that the split has been maintained. And the Ambassador just mentioned that, of course, the parliamentary committees also examine the budgetary reports and the annual reports each year, and examine that split also.

Mr. HORN. My last question is, in your opinion, can the concept of a cash-flow statement that distinguishes operating from capital cash-flows be adopted by the United States without an accompanying move to the full accrual accounting?

Mr. DALE. I think that, yes, in a cash-flow sense, you can separate out operating from capital cash-flows. We had done that in New Zealand prior to our reforms.

Mr. HORN. Very good. Thank you, Mr. Chairman, and thank all of you.

Mr. CHRYSLER. Mr. Chairman.

Mr. CLINGER. Yes, Mr. Chrysler, the gentleman from Michigan.

Mr. CHRYSLER. If I could just comment on Mr. Wood. The government of New Zealand has just gone through quite a restructuring in the last several years; is that correct?

Mr. WOOD. Yes, we have. We've gotten rid of a number of government agencies. I think my recollection is that 21 government agencies in total have been—are no longer part of the government. I mean, they've been gotten rid of in a number of ways. Some have been gotten rid of altogether. But for the most part, they've been privatized, they've been sold to private sector.

Mr. CHRYSLER. Mr. Chairman, we may want to bring someone from his organization back for a future hearing. I just wanted to bring that to your attention. Thank you.

Mr. CLINGER. Your Excellency, we thank you and your colleagues very much for being with us this morning, and for your very helpful testimony. And we really welcome it very much; it's very useful to us.

Mr. WOOD. Thank you very much. It's been a great pleasure to be here.

Mr. CLINGER. Thank you. I'm now very pleased to ask a fellow Pennsylvanian and a good friend, the mayor of Philadelphia, Ed Rendell, whose stewardship of the city of Brotherly Love has been remarkable. He's been a great mayor and a great Pennsylvanian. We're glad to have him with us. Mayor, we have a practice in this committee of swearing in all U.S. witnesses that do not have any objection to that.

Mr. RENDELL. Surely, none whatsoever.

Mr. CLINGER. If you would stand and we'll give you the oath.

[Witness sworn.]

Mr. CLINGER. Again, welcome, Mayor Rendell. We're very pleased to have you with us, and we thank you very much for coming and sharing with us your experiences in the city of Philadelphia.

STATEMENT OF EDWARD G. RENDELL, MAYOR, CITY OF PHILADELPHIA

Mr. RENDELL. Good morning, Mr. Chairman and members of the committee. It is my pleasure to be here not just representing myself and the city of Philadelphia, but representing the Advisory Commission on Intergovernmental Relations, of which I am a member, appointed by President Bush. And the Advisory Commission on Intergovernmental Relations, ACIR as it's known, in my belief, has done probably the best comprehensive work on the issue of a Federal capital budget that has been done.

And I have great interest in this field. As I think the members of this committee know, from 1991 through 1993, ACIR, in cooperation with the Army Corps of Engineers, did a very comprehensive study on what we call high performance public works and new Federal infrastructure and investment strategy for America. I think this has already been handed to the committee. I would ask that it be made part of the record. It is a tremendous document in terms of the control issue.

And Congressman Horn and Congressman Clinger both refer to how do we make sure that there are proper evaluative controls and constraints on the Federal capital budget process so this doesn't become a runaway, out of control, give away, pork barrel type program, which creates a lack of public confidence. This document, I think, talks about—the key to it is high performance public works. And it talks about building ways of doing that. It's relatively short for that long body of work, and I would commend it to you for your reading.

Second, as I think Congressman Clinger, Congressman Wise know, ACIR conducted, in 1994, a day-long summit on the Federal capital budget. I think both Congressmen had the occasion to speak to the summit. And that report is included in the Intergovernmental Perspective, a magazine published by ACIR. And for those of you who weren't there, I would also commend this to your reading. And I'd like that also to be introduced as part of the record.

Let me just say, parenthetically, we don't get paid for being on ACIR. All it means is four trips to Washington a year. I make enough trips to Washington a year, so there's nothing in it other than the fact that I believe intergovernmental relationships—particularly with what this Congress is doing—are ever increasingly important. And I know this isn't the correct forum, but I will say that I am told a House committee eliminated the funding for ACIR for the coming budget year.

And in my judgment, that would be tragic. It would save me four trips to Washington, but it would be tragic because it is one of the few bodies in our government that's capable of doing these type of long-range studies. On the issue of Federal capital budget, let me just make a couple of quick points that are covered by the report. I won't belabor them.

No. 1, although it is true that every local government and State government, almost every one of us have a capital budget, the report recognizes and discusses fairly thoroughly, why you just can't implant our capital budget system onto the Federal Government. There are differences. There are differences in the way you approach your budget, we approach ours. There are conceptual dif-

ferences, as well as pragmatic differences, and we understand that. But we still believe that a Federal capital budget could work for our government.

And in terms of constraints, there are a tremendous amount of constraints that are placed on a properly run capital budget. No. 1, there is the constraint of the marketplace itself. We know when we are out of control, when our capital budget is exceeding spending limits, because the marketplace tells us we can't borrow. The city of Philadelphia, as Representative Clinger knows very well, went through a half-decade of horrible fiscal problems.

And in the year before I became mayor, we literally had no capital budget because the marketplace refused to lend us money because of our overall fiscal problems. Your ability to borrow coincides and is coordinated with your overall debt limit; what the marketplace believes an appropriate debt limit is; what you can sustain in debt service payments. So there's a built in control, a marketplace control in a capital budget system to begin with.

Second, I think one of you talked about the issue of discipline. And I think there is more discipline in a capital budget than in a unified budget like the Federal Government has. Because we are required by law, the city of Philadelphia is required to not only file a yearly capital budget, but we have to file a 5-year capital improvement program. And in some jurisdictions, that can go to as much as 20 years out.

So it forces you to make a careful examination of what your real and legitimate capital needs are. Now, if you look at the SIP, as opposed to the individual yearly capital budgets, there's some deviation. I'm not going to tell you that the SIP is adhered to 100 percent of the time. There is some deviation, but I would say that deviation is no more than 10 to 15 percent. So you're forced to do long-term planning. You're forced to look at your needs in a comprehensive way.

You're forced to make judgments and prioritizations. And you better be careful; you better be sure that these things get done and get done well, because capital dollars, as I will talk about in a second, are extraordinarily scarce these days. Second, there can be and should be sound criteria in place for evaluating requests. It actually adds, it makes an improved basis for decisionmaking. I think one of you used the term, present a sound business case.

And I think we really do that. When our departments come in and ask for capital requests, we really hold them to a very, very high test. Is it needed; will it work; will it achieve the goal; can we sustain it in our operating budget? All those criteria are applied. And I think you do get a sound process that produces good results. Now, is there a need for a Federal capital budget? Absolutely.

I think that in many areas, our Nation's infrastructure is flat out crumbling; it is disintegrating literally right before our eyes. And I would say that those are mostly rural and urban areas. In suburban areas, the infrastructure is far newer and therefore not nearly in as need of desperate repair. But there, in many suburban areas, infrastructure cannot accommodate growth. There simply aren't enough dollars to accommodate the necessary growth in suburban area.

So I think a Federal capital budget would be one of the few items that the Congress could do that would have widespread urban, rural, and suburban support. This is one issue where cities, rural areas, and suburbs would all agree—maybe for different reasons, but we would all agree. To give you an example of—and I know anecdotal examples have limited benefits, but you all remember not this past winter, but the winter of 1994, how brutally cold that was in the Northeast.

In the city of Philadelphia, and I'm sure it was much the case here in Washington, we had about 40 days of 20-degree or below weather strung together. Many ice storms during those 40 days. And then, on the 41st and 42nd day, our temperature went up to 70 degrees, which was wonderful for the citizenry to get out and enjoy 70-degree weather, but horrible for our infrastructure. Fifty-eight water mains broke in 24 hours in the city of Philadelphia, causing us to lose a quarter of a billion gallons of water.

We repaired those 58 as fast as we could, using every contractor as well as our own city work force. And the city work force reported to me that about a quarter of those mains had been laid in the 19th century. We don't have any mains or sewer pipes laid with the new technology that's been developed in the last 6 or 7 years. We simply don't have any of them.

I was saying before my testimony that the one case you can make for the one area where we as a Nation have done a fairly decent job in protecting our infrastructure is in roads. But then I qualify that, and that's in highways, not in streets. I'm not here often enough in Washington to comment on the caliber of your streets, but my guess is—someone's nodding their head—my guess is, they're every bit as bad as the streets are in Philadelphia, New York, and Cleveland—streets that are disgraceful.

I mean, this is the United States of America, and our streets in our major cities are disgraceful. Our highway system and road system, our burgeoning suburbs—simply disgraceful. If you've ever been in Sarasota, FL, or anywhere in the Gulf Coast of Florida, you simply can't get around because we can't develop our infrastructure in areas that are growth areas fast enough. We have an enormously serious problem. And look at it from the perspective of a city, and I'm sure this is true for hard hit rural areas as well.

The city of Philadelphia, in fiscal crisis, literally spent, according to an evaluation by the Pennsylvania Economy League, 45 percent in its capital budget of what was necessary to properly maintain the assets, facilities, and infrastructure that we have. With our fiscal recovery, we are up to 61 percent. And it's good news that we're up to 61 percent, but we are still 40 percent under funded to properly maintain the facilities and infrastructure we have.

That's not talking about new infrastructure. If we need a new wastewater treatment plant, or we need a new tertiary treatment plant for drinking water or things like that, that's new investment. There are no dollars available for new investment, because we're at a 61 percent level, and we're doing well now. And we're at a 61 percent level. This is a desperately important issue for all of the Nation.

In fact, I don't know how many of you remember—I know you get a ton of mail, so my feelings would not be hurt if none of you

remember this. But on March 22nd, I sent every member of the Congress a letter. I'd like to pass you up a copy, in case somehow you misplaced my letter. The copy I'm sending is addressed to Congressman Fattah, one of our Philadelphia Congressmen, but each of you received a personalized copy of this.

In it, I talk about, in part, a Federal capital budget. But what I talk about is, I think, even more important. And all of the questions you asked the good folks from New Zealand were very important, and they were good, technical questions. But ladies and gentlemen, if I can say one thing to you, and I don't get the opportunity too much, everyone in the country understands and supports the need for deficit reduction.

And I don't think there's an American who would disagree that we need to balance the budget. There would be disagreement as to how fast; there would be disagreement as to how. But all of us understand that that's got to be the No. 1 priority for Washington, DC. And we applaud Democrats and Republicans alike, applaud the Congress' effort to try to take a serious and responsible look at those questions.

However, there are problems afoot in our country, which I think every one of you are aware, that cannot wait 7 years or 10 years to be addressed. There are people in hard hit areas, urban and rural areas, that cannot wait for the deficit to be eliminated, for the budget to be balanced, for us to give them help. These people need to see our economy regenerated in many different areas of the country. While we are balancing the budget, we have to find a way to do substantive repairs to our Nation's infrastructure, and to create economic development.

One of the best things about a capital budget—when we were going through my first 2 years in Philadelphia, when we were cutting and cutting and changing the way government operated, and there was some real short-term pain going through that process, we could regenerate our economy and give hope to people because of capital spending. It was a very important thing emotionally, as well as substantively for our economy, because people saw government doing things.

And at a time when you are going to be forced to cut domestic discretionary spending, and some of it I would have no quarrel with. Some of it ought to be cut. Some of the cuts I think are potentially dangerous. But at a time when you're doing that, if we can, at the same time, in a coordinated fashion, undertake a massive infrastructure repair program—that, by the way, puts millions of people back to work—most of the countries in the Far East are spending billions and billions of dollars to repair their infrastructure.

The side benefit is that it puts millions of people back to work, and not in $5.50-an hour jobs, not in make work government programs, but in real jobs. I think that this is so important to our country. There's no issue right now that's as important. We have to get people back to work. If we're going to cut people off of welfare, we have to have real employment alternatives. We can't just play a charade and say welfare reform means getting people off of welfare.

Because you may get them off your welfare rolls, but if you don't do anything for them, they're going to be in my homeless shelters. And what have we done? We've just shifted the tax burden from the Federal level to the local level. That hasn't accomplished anything. We're talking about human beings. And unless we can give them job opportunities, job training first, and job opportunities, even more important than job training, there isn't going to be a very pleasant American out there. There isn't going to be an America that any of us want to be proud of.

So I think whether you call it—in my letter I say that the infrastructure investment program can be financed through a Federal capital budget. But it could also be financed by a trust fund. And I know your main area of concentration today is the Federal capital budget. And myself and ACIR would love to see you do that. But it could also be done by an infrastructure investment fund.

We have a highway trust fund. There's no reason we could have an infrastructure investment trust fund. It's important to keep our highways up, but unless we keep our wastewater systems, our sewer systems, our water systems up, our streets and our roads, this country is in big, big trouble. So I commend you for your efforts, and I know that in many ways I am preaching to the congregation that's already committed to this, but I cannot tell you how important this is.

This is not just a technical hearing on accounting principles and cash-flows and things like that. This is one of the single most important things we can do for the United States of America. Let's fix this country's infrastructure. We need to do that. If we were a totally healthy economy, totally health country, we still need to fix our infrastructure. But second, let's use it as an opportunity to generate economy and put people back to work.

No more important issue. While you're doing the broad and overriding budget balancing, you cannot forget generating economic development; you cannot forget things as fundamental as this Nation's infrastructure. I know many of you travel abroad and have the opportunity to travel abroad, and you see cities in other countries. And when you compare some of the spending that goes on in other countries for their cities—the Seoul, Koreas, and places like that—it is embarrassing. It is flat out embarrassing.

We need this. We commend the committee for doing it. Federal capital budgeting is certainly an acceptable way to do it. I think it will add discipline. The long-range planning that comes with a capital budget I think is a plus. And I think the Nation would applaud it. This Nation wants its infrastructure repaired; this Nation wants real, good, private sector jobs created. Thank you.

[The prepared statement of Mr. Rendell follows:]

PREPARED STATEMENT OF EDWARD RENDELL, MAYOR, CITY OF PHILADELPHIA

Mr. Chairman and members of the Committee, I am Edward G. Rendell, Mayor of the City of Philadelphia, Pennsylvania. It is a pleasure for me to represent the U.S. Advisory Commission on Intergovernmental Relations today on the important topic of Federal capital budgeting.

Let me be clear, at the outset, that the Commission is in full support of capital budgeting by the Federal government. ACIR has recommended specifically that:

> The President should . . . establish a public works investment section in the President's budget.

The Congress should . . . revise the Congressional budget and appropriations processes to recognize and effectively respond to the President's investment budget.

These capital budgeting recommendations are part of a larger set of recommendations for ensuring higher quality public works investments and more cost-effective maintenance of existing facilities.

These recommendations grew out of the Commission's 1991-1993 project with the U.S. Army Corps of Engineers to develop a "Federal infrastructure strategy," as called for in a line-item appropriation to the Corps. The report of that project was developed in consultation with a wide variety of Federal, State, and local officials—including Congressional and Executive agency staffs—as well as representatives of the private sector. With your permission, I will submit a copy of the ACIR report for inclusion in the record of this hearing.

The President responded to the Commission's recommendations by establishing infrastructure investment principles that all Federal agencies have been directed to use in justifying their budget submissions to OMB (Executive Order 12893, January 27, 1994). The President also expanded the "Federal Investment Spending and Capital Budgeting" section in the Analytical Perspectives volume of the Fiscal Year 1996 Budget. That document presents information required by the Federal Capital Investment Program Information Act of 1984. I believe that these are two important steps in the evolution toward a Federal capital budget.

We hope that the Congress also will respond positively to the Commission's recommendations by enacting capital budgeting legislation this year.

We are pleased that Congressman Clinger and others have reintroduced such legislation in this Congress. It is becoming increasingly urgent as the debate over balancing the Federal budget becomes more serious.

ACIR was privileged last year to present a day-long Capitol Hill Summit on Federal Capital Budgeting at the request of Congressmen Clinger and Wise. At that Summit—which was attended by more than 100 Congressional and agency staffers, and others—we learned:

- The many reasons why the Federal government does not, but should, use a capital budget, and
- Some of the ways in which this almost universally accepted concept in State and local government might have to be modified for use by the Federal government.

I would like to share those lessons with you as I answer the three questions you asked ACIR to address in this hearing.

Question 1. How do capital budgets work at the State and local levels?

State and local governments use capital budgeting as an essential mechanism for planning and managing the funding of long-term investments in public works facilities and purchases of equipment for which borrowing is appropriate because of the benefits expected in the future. This mechanism is essential to State and local governments because they must balance their operating budgets every year, and the capital budget provides their only vehicle for justifying long-term borrowing.

Many of the projects that appear in State and local capital budgets are paid for over multiple years, and the adopted annual capital budget generally is part of the jurisdiction's CIP. The CIP is a multi-year program of projects that shows how expenditures are projected to be paid-out over a five- or six-year period. It provides the basis for projecting future borrowing and debt service needs.

The capital budget is linked to the annual operating budget by the need to pay debt service. State or local bonds sold to pay for capital investments may be either revenue bonds (paid off by dedicated revenues generated by the investment) or general obligation bonds (paid by appropriations from the general funds of the state or local government as adopted in the annual operating budget). Operating and maintenance expenses for new facilities and equipment appear and are authorized in the annual operating budget.

The financial discipline that limits State and local borrowing is supplied by a combination of the government's need to rely on the private bond market for borrowed capital, and the requirement that their annual budgets be in balance. When a State or local government nears the limits of borrowing what it can be expected to pay back easily—or begins to miss payments—its bond rating goes down, its interest rates go up, and its access to private money declines or disappears.

The Federal government does not finance its debt this way. When it runs short of cash, for whatever reason, it simply raises the debt limit and goes on borrowing. Thus, it does not have the same compelling reason as State and local governments to use a capital budget.

To the contrary, the guiding Federal budget concept has been the unified budget, which is designed to produce a bottom-line, cash-basis figure on annual outlays, which shows the Federal government's effect on the national economy. This concept was formalized in the 1967 report of the President's Commission on Budget Concepts, and is still operative. The focus is on questions of macro-economics and counter cyclical Federal fiscal policy, rather than on financing sound long-term investments.

We believe it is time to introduce more return-on-investment analysis into the Federal budget, and capital budgeting is an important means of doing that.

Question 2. What is the impact of investment planning on resource allocation?

It is difficult to answer this question definitively because we have no survey of the actual impact of State and local capital budgeting. However, the primary intent of that type of budgeting is that it will effectively translate a thoroughly researched and deliberated physical development plan into a financial plan for orderly provision of the physical infrastructure needed to support the development plan. Thus, in the best of all worlds, capital budgeting should begin with a politically adopted long-range (often 20-year) physical and economic development plan that provides the basis for the five-year capital improvements program and, finally, the annual capital budget (which actually authorizes spending).

The most sophisticated form of investment planning practiced has been by Federal agencies responsible for water resources. They have justified their construction projects using benefit-cost analyses to show the long-term value of their proposed projects to the national and regional economies. These analyses provided the model for the infrastructure investment principles set forth in the ACIR report and Executive Order 12893.

We are aware, however, that the practice of investment planning by the Federal, State, and local governments often does not follow all these good intentions. Furthermore, even when the proper planning and investment analyses are done, the capital budget may reflect other factors, such as political preferences and the influence of individual political officials, that may sometimes result in the inclusion of investments that have not been fully analyzed.

ACIR found that the best practices of investment planning and analysis have the potential to markedly improve the rate-of-return that could be expected from future infrastructure investments. It is particularly urgent to promote their more widespread use at this time of declining investment in the nation's public works.

America must find ways to derive greater benefit from every scarce infrastructure dollar invested, and ACIR believes that capital budgeting, supported by our recommended planning and investment analysis tools, offers an important opportunity to move in this direction. The House Transportation Appropriations Subcommittee took an important step in that direction in the 103rd Congress when it established criteria for screening proposed funding requests to help ensure their programmatic and economic soundness. I hope this step will be followed by other steps in the same direction.

Question 3. What are the advantages and disadvantages that might be envisioned from the adoption of a Federal unified capital/operating budget?

Advantages

Orderly Funding of Infrastructure. Long-term capital investments need continuity of funding to support multi-year planning, construction, operation, and maintenance. Capital budgeting provides a framework for that continuity and policy commitment.

Improved Basis for Decisionmaking. Capital budgeting, coupled with return-on-investment analysis and reliable measures of program performance, could provide an understandable basis for setting Federal spending priorities—a feature that is now largely lacking in the Federal budget. Investments that have met the criteria for program and economic soundness are likely to present better choices than projects that have not been subjected to such analysis.

Fiscal Discipline. Long-term capital investments can be evaluated systematically to show future benefits as a basis for justifying Federal borrowing. Federal expenditures not justified in this manner, could be required to be paid from current revenues.

Helping to Balance the Nation's Economy. Public works projects that are planned and ready to implement provide an opportunity for modulating the rate of Federal spending to help offset the cyclical swings of the nation's economy.

Disadvantages and Ways to Minimize Them

Difficulties with the Unified Budget Concept. Opponents of Federal capital budgeting stress the Federal government's need to focus most clearly on the bottom line cash basis effect of Federal spending on the economy. Acceptable Federal capital budgeting, therefore, would need to preserve a macro-economic focus—a feature that is not of concern in State and local capital budgeting. Federal counter-cyclical spending policies obviously would affect the rate of Federal capital spending more directly than State and local capital spending.

Deficit Reduction Difficulties. A capital budget would tend to justify borrowing at a time when the Federal government is attempting to stop borrowing. In the current balanced budget climate, it is also feared that the capital budget would give an unfair advantage to capital spending, encourage increased spending for this special class of programs, make it harder to meet other pressing needs in the Federal budget, create pressures to identify many other classes of spending as "investments" (e.g., human resources and research programs, and/or establish a bias for construction and against proper funding for operation and maintenance of existing facilities.

To mitigate these concerns, the Federal capital budget would have to be (1) limited in scope, (2) integrated programmatically and economically into the whole Federal budget, without building arbitrary fire walls between spending categories, and (3) linked to the annual balanced budget by incorporating required debt service, as is done in balanced state and local budgets. In addition, care should be taken to balance capital investments with their associated operating and maintenance expenses.

Whether capital budgeting would lead to deficit spending is a separate issue. The capital budget could be put on a pay-as-you-go basis like any other budget, if that is required for the good of the economy in any given year. The capital budget would help ensure that the investments programmed in it would yield sound prospects for delivering future benefits, and would justify borrowing if that decision is made.

Increased Complexity. Pulling capital investments out for separate analysis and still integrating their effects with other parts of the budget would introduce some additional complexity. However, that complexity would be offset by greater understanding of the positive programmatic and economic effects of those investments.

Inappropriate Tool. State and local capital budgeting is designed to schedule the financing of specific projects. A Federal capital budget would do this for some directly specified projects (such as Federal buildings and earmarked highways), but most Federal capital investment is in the form of Federal-aid programs under which the project selections are made by the grant recipients. Opponents of Federal capital budgeting argue that it is inappropriate for budgeting these types of expenditures.

To respond to this argument, Federal capital budgeting should be structured differently than the typical State and local capital budget. Programmatic performance and benefits would have to be reported on some summary basis yet to be developed. The Government Performance and Results Act of 1993 points the way toward this new type of budgeting.

CONCLUSION

In conclusion, it is my view that objections to Federal capital budgeting can be overcome. Certainly, Federal capital budgeting will look different than its State and local counterparts, but it can provide benefits that the nation sorely needs to maintain its leadership in world trade and environmental protection, and to provide all Americans with more livable and more functional communities.

Thank you for this opportunity to address you today. I would be happy to answer any questions you may have.

Mr. CLINGER. Thank you very much, Mayor Rendell. And let me just say I share your concern about ACIR, because I think with the fact that we are really in the process of redefining what the Federal relationships are between Federal, State, and local governments, and that is a centerpiece, really, of what this Congress is going to be all about, we need all the help we can get in assistance in that.

I have a particular interest because of the unfunded mandates legislation, Title I of that legislation, that requires review of existing unfunded mandates, and an evaluation of which ones should stay, and which ones should go. So it is a real concern.

Mr. RENDELL. And we abide by that bill. ACIR has been given the mandate to conduct that study.

Mr. CLINGER. That's correct.

Mr. RENDELL. There's now a move afoot to shift it to the CBO.

Mr. CLINGER. OMB.

Mr. RENDELL. OMB, I'm sorry. And I will tell you, if you shift it to the OMB, you will not get the same type of impartial analysis that you would get from ACIR. For example, one of my biggest problems is when a mandate comes down, let's say, from EPA. EPA does the cost analysis. Well, EPA told us in Philadelphia, that a tertiary treatment plant for our water system would cost us $50 million to construct.

The city of Phoenix had constructed one 6 months before, and in a State where they don't use union labor, it cost the city of Phoenix over $100 million. We estimated it would cost us $140 million, and EPA gave us an estimate of $50 million. If you look at the history of EPA cost analysis, way off the mark. I mean, incredibly off the mark. And when you ask part of the government itself to do a cost benefit ratio analysis, way off the mark.

It's much better to have a group like us, which has some people from the Federal Government—as you know, four people from the administration, four people from the Congress, but also includes four mayors, four Governors, and four members of State legislatures, and a very independent and very capable staff.

Mr. CLINGER. One of the things that I think I have always been interested in trying to pursue the capital budget for is because I think that without a capital budget, you're not aware of the shrinkage that goes on in terms of infrastructure investment. Infrastructure doesn't have a real constituency out there. I mean, it has constituencies, but it doesn't have the burning urgency of some of our other demands.

And it's been my observation over time that where there becomes a crunch, and we're now in those kinds of crunch decision times, infrastructure usually is the one that suffers. In other words, we usually tend to favor those things that have a more visible, human face to them. And I think the capital budget would at least identify for us, to show us that that is in fact shrinking.

Mr. RENDELL. I think there's no question about it. I think the only infrastructure program that has a real vocal constituency are highways.

Mr. CLINGER. Right.

Mr. RENDELL. And that, coincidentally, probably the only infrastructure that the Federal Government at least comes close to adequately funding or adequately providing match funding for. There's not a whole lot of people out there banging on the doors for wastewater treatment plants. And yet we have to have them.

Mr. CLINGER. Right.

Mr. RENDELL. And it is an enormous expenditure for us. You're absolutely right. And it's interesting, as mayor, of course I pore over the operating budget, but I pore over the capital budget because in some ways, where Philadelphia will be 5 years from now—let's assume I'm reelected and I'll be here for 5 more years. When I walk out of that office—we have a two term limit, when I walk out of that office in January of the year 2000, it may be more influ-

enced or as much influenced by that capital budget, my 5-year plan, as it is by my operating budget, which also we have a 5-year requirement for operating budget.

Not 5-year budgeting, we must submit a 5-year plan as well as the yearly budget. So I think there's no question. It forces you to do just what you say. It forces you to examine where you're going. Where are we going to be down the pike? The problem with doing capital investment as you do it now, and there are some times when you are terrific in funding needed projects.

But it is a little bit on a catch as catch can, sort of off the cuff basis. And nobody thinks of where we want to be, and nobody takes a look at the Nation as a whole. Where are we? Where are we on very important issues? And it has not served the Nation well at all.

Mr. CLINGER. I have yet to find a Director of the Office of Management and Budget or, indeed, a chairman of the Congressional Budget Office who thinks well of capital budgeting. And I think the reason for that is because they view it as an attempt to fence off a whole area of resource spending that goes on, and prevent them from adjusting that in some way. Have you found that that's a problem in working in capital budgeting at the city level?

I mean, are there those that keep trying to put more under the fence or behind the fence to——

Mr. RENDELL. Well, sure, there's a running battle of—in local governments, it's usually the other way. It's trying to slip some operating budget expenses into the capital budget. Because for us, the capital budget, as long as you can handle the debt service, it's an easier thing to do. So there's a running battle, and you have to be watchful of that. There's no question about it. But again, I think the key is high performance public works.

If you set up standards, if you set up a real cost benefit analysis and then real criteria and real evaluation—is the project needed; does it fit into our long-range goals; does this jurisdiction have a good track record at producing on time, on budget projects? I mean, you could set up all sorts of criteria that could very easily manage it better than what you do now, clearly better than what you do now.

Because now when you give money for what would be termed as a capital expenditure, there's very little oversight and there's very little preplanning. And it doesn't fit into a broad overall plan. The beauty of the capital budget is, I have to sit down and I have to say, OK, I'd love to do a whole lot for recreation centers because our recreation centers are in real disrepair, and it's something that really is important to the kids in the city.

But at the same time, over here, I've got major street reconstruction. And I have to sit down and weigh and prioritize all those demands. I mean, just like you do in the operating budget. But you don't do it in the operating budget for capital investment. That sort of gets thrown in at the last second, and there's no overview. And where do I want our rec centers to be? Am I going to build new rec centers?

One of the problems in the city of Philadelphia was they kept building new rec centers whenever a community group of 30 got together. And then we didn't have operating money to deal with the day to day operations of the rec centers. It really forces a type of

good, critical analysis. And I don't understand what the fear is. Because if the criteria are there, if you hold people to high standards, I think if you give a jurisdiction money and it goes way over budget and this and that, I think this should be a mechanism for punishing that jurisdiction and rewarding others that use their capital dollars wisely.

Mr. CLINGER. Mr. Wise.

Mr. WISE. Thank you very much, and thank you, Mayor, it's encouraging. Incidentally, thank you, I appreciate your—and I know Chairman Clinger will, too—remembering that ACIR day-long event. We considered that a real victory. It was the first time we'd ever been able to have people for a full day on capital budgeting. We knew our time was coming. We were able to keep a roomful for at least 8 hours. People were enthusiastic.

Mr. RENDELL. Well, I wasn't a speaker, just because I wanted to hear.

Mr. WISE. Well, one day, we're still going to get to my dream, which is to have that demonstration where thousands march upon with Capitol with signs saying, "Cap Budgeting Now." And I know you're going to lead it, Mayor, you're that kind of personality.

Mr. RENDELL. Absolutely, absolutely.

Mr. WISE. A couple of quick questions. You mentioned a trust fund, and you're correct, it's an attempt by Congress to have a separate fund for highways and airports. But one of the frustrations here, and I know by Chairman Shuster of the Transportation and Infrastructure Committee and Ranking Member Mineta, is that the trust fund often gets hedged for deficit reduction as well, not for the purposes for which the money was intended.

And so that's why many of us, while we'd like to see the trust fund go off budget, I don't think that's going to happen. Capital budgeting seems to be another way to deal with it.

Mr. RENDELL. And it's obviously safer, because it's almost—you can slip a little in, but it's really hard. It's much—someone used the term "fire wall." It's a much clearer fire wall than a trust fund is.

Mr. WISE. The question I did want to ask you is, how would you handle depreciation, or do you handle depreciation on a capital budget in a government budget?

Mr. RENDELL. In a government budget? I mean, we build it in. It depends on the asset itself. It depends on the life span of the asset. We do that very much similar to what the—were you here for the testimony of the New Zealanders?

Mr. WISE. Yes.

Mr. RENDELL. Very much the same way as they do it.

Mr. WISE. I've been struck—but you're able to define and to estimate, I assume, in useful lives and period of time. I'm struck by those who seem to think that it's some kind of impossible task for the Federal Government to do that, when every city and State and business has to do that.

Mr. RENDELL. Well, I think the best example is even business. Business does it on an absolute yearly basis, and they have very little trouble doing it. We have very little trouble doing it, as well. Again, there's a lack of confidence here in being able to do things that are elemental to us; and it is surprising to us.

Mr. WISE. Yes, and I think you refer in your letter to signing a task to the IRS. This Congress thinks nothing of sending over to the IRS, define this and go out and raise money accordingly. And yet when you come to this area to assigning useful lives to assets. And I might note, Mr. Chairman, that you'd referred to—one of your questions dealt with CBO and OMB. I've noticed since I've been here, a bipartisan unanimity among CBO directors and OMB directors about capital budgeting.

Somehow, what is standard budgeting and accounting process everywhere else, and also where they got their degrees from, once they entered these hallowed halls and offices, automatically becomes anathema.

Mr. RENDELL. And no one has ever suggested, for example that we do away with our capital budget. No one has ever suggested that.

Mr. WISE. But thank you. I think that it really means a lot to have your testimony and your energy and leadership on this. And we're getting to that day.

Mr. CLINGER. Now I'd like to recognize my colleague from Western Pennsylvania, Mr. Mascara, for 5 minutes.

Mr. MASCARA. Good. Thank you very much, Mr. Chairman. And I'd like to welcome my friend from Philadelphia, and you're one of my heroes, doing a tremendous job in Philadelphia. You indeed are preaching to the choir. As an accountant and former county commissioner, as you well know, for a lot of years, I had a capital budget. I financed that capital budget. I had a surplus, and when I needed some money, it was there. And you couldn't touch it.

That was, you weren't going to take anything out of that capital budget to finance current operations. I just wouldn't let that happen. So I have a lot of experience in capital budgets. And I have joined enthusiastically, as a co-sponsor, with Congressman Wise on the capital budgeting bill. This needs to be done. As an accountant in my former life also, it amazed me that if we bought an aircraft carrier—and I don't know what that costs, $500 million. And when it was built, we paid for it, and that was it.

If it had a life of 40 years, I wanted to charge it off over a 40-year period; one-fortieth each year. So if we do a capital budget and if we do a balance sheet—and I don't know whether that's possible or not—and we add up our assets, our liabilities, and we subtract the two, we'd come up with a net worth. I just wonder how much of the $4.7 trillion that we're in the hole, we're really not in the hole.

But we really don't know what we own. We know what we owe for the most part, but we don't know what we own. You mentioned an infrastructure investment trust fund. That's excellent. And as Congressman Wise pointed out, the highway trust fund has been abused over the years. It's sitting there to mask a deficit. People throughout this country are crying for some of those funds. I did, as a county commissioner, in attempting to build the Mon-Fayette Expressway.

That is a highway, but we also build sewers, and water projects, and try to get water to people that do not have water. But, if we have an infrastructure investment trust fund, then I suggest that we not abuse it and that the law states that we can't abuse it; that

it has to be used for infrastructure. Last time I looked, there were tens of billions of dollars in the highway trust fund. And that's one of the reasons I joined with Congressman Shuster to take that off of the unified budget so there would be no abuses.

I'm disappointed that Congressman Wise thinks that won't fly. But I'm hoping that it flies. I think we need to act responsibly. And the word, trust fund, really is an oxymoron. Where I come from, if you misuse a trust fund, you go to jail. But I guess we do that often down here in DC and get away with it. But I'm glad to see you here, and you've answered most of my questions. I see that perhaps we should take your lead and proceed with the formation of a capital budget.

Mr. RENDELL. Congressman, just a quick comment. I remember in January 1992, President Bush outlined a plan to regenerate the economy. As you will all recall, the economy was the big issue in 1992. It wasn't deficit so much, but it was the economy. And one of the things he said he was going to do was he was going to fast track spending from the highway trust fund. And even though, as the mayor of a city, a highway trust fund is not right up there. I would rather see mass transit; I would rather see Amtrak; I would rather see a lot of things.

But I said, bravo, because not only are we going to spend it, we're going to put people back to work. If you spent the highway trust fund—I know you couldn't do it, but let's assume you could—in the next 18 months, do you know how many Americans you'd put back to work? Do you know how much juice you would put back into the economy? And that's what we ought to be doing with infrastructure, highways, everything.

We ought to repair this country; inject some real activity into the economy; and put people back to work.

Mr. MASCARA. I agree. In fact, the Mon-Fayette Expressway runs through my district, from the West Virginia border to the city of Pittsburgh. It runs about 62 miles; $1.5 billion project that will put some 10,000 people to work building this massive highway. And there's projections of tens of thousands of jobs over 10 or 20 years that that would create. So we need to put that money to work. And I concur with you, and I thank you for giving your time, Mayor, to come here and present your testimony.

Mr. CLINGER. Thank you, Mr. Mascara. Mayor, thank you very much for your very helpful testimony and for your leadership. And we've got them all——

Mr. RENDELL. And you have the high performance?

Mr. CLINGER. Got that one, as well.

Mr. RENDELL. Good. Thanks again, I appreciate it.

Mr. CLINGER. Thank you, Mayor. I'm now pleased to call to the witness table, Mr. Paul Posner, Director of Budget Issues, Accounting and Information Management Division of the U.S. General Accounting Office. Mr. Posner, if you would——

Mr. POSNER. May I bring my two colleagues up here with me?

Mr. CLINGER. Yes, you have colleagues we can introduce in a moment.

[Witness sworn.]

Mr. CLINGER. You may proceed to give your statement, introduce your colleagues.

STATEMENTS OF PAUL POSNER, DIRECTOR OF BUDGET ISSUES, ACCOUNTING AND INFORMATION MANAGEMENT DIVISION, U.S. GENERAL ACCOUNTING OFFICE, ACCOMPANIED BY BERNARD MYERS, SENIOR EVALUATOR; AND CHRISTINE BONHAM, ASSISTANT DIRECTOR

Mr. POSNER. Yes, I will. Thank you, Mr. Chairman. I'd like to introduce, on my right, Christine Bonham, who's an Assistant Director with our budget issues group; and on my left, Bernard Myers, who's been doing a lot of work on investment and capital in the budget. I'd also like my statement to be placed in the record, and deliver a summary of it here. As you know, Mr. Chairman, GAO has shared concerns over the years on several very important issues.

One is the importance of improving our long-term economic future, and the role played by both public and private investment in that. And second, the budget process itself, and the need to make more discriminating distinctions on the character of spending within that process. With regard to investment, the trends are not favorable. As many of you know, the national savings rates are at a significant low level, compared to the past 30 years.

We are now significantly behind our trading partners in most OECD nations, with regard to the level of gross fixed capital formation. And these kinds of trends, if they're continued, do not bode well for a future where we have a demographic shift facing us, where we have a very large number of retirees that are going to have to be supported by a smaller work force.

Now, if that smaller work force is not to face prohibitive tax rates, we have to have a long-term economy that's going to be significantly larger than present projections suggest. Now, what's the Federal role in all this? Well, there's two roles that we see. One is, the surest way to do something about promoting the longer term growth of this long-term economy is to promote private investment.

And the surest way the Federal Government can do that is to eliminate the deficit and perhaps even move to a budget surplus. We finished a report in April for Chairman Kasich and Chairman Domenici on the Senate side on these long-term trends in the deficit. And what we found is, if we do nothing, the trends in Social Security and health are going to cause the deficit to balloon to 20 percent of GDP in the next 25 years.

That's basically assuming everything else stays the same, except for those two programs and interest on the debt. Conversely, we used an economic model. We found if we do a balanced budget by 2002, you get a significant boost to long-term GDP per capita. It grows by 34 percent by the year 2025 if we do something about this deficit and don't let these trends get out of control. So that's the first thing, deficit reduction.

The second thing, as you've been noting over the years, is the type of spending matters within the budget. Well chosen investment can improve long-term productivity and improve the potential for GDP to grow more. And that's in three major areas. One is the infrastructure, whether it's highways, transit, airports, water projects, if they're well chosen and effective. Two is research and development—the way we improve the stock of new technology and innovation in this economy.

We can do that through the budget. And three is human capital with effective programs that improve the skills of our people and our work force. Ideally, we want to do both. We want to reduce the deficit; to promote private investment; and we want to shift toward well chosen public investment within the budget. In some sense, it is counter productive to do one at the expense of the other; counter productive to increase private investment by reducing the deficit at the expense of well chosen public investment.

Conversely, it's also possibly counter productive to increase effective public investment by increasing the deficit at the risk of private investment. What does the current budget process look like, with regard to these twin goals? We are moving to address, as you very well know, the deficit, with the conference report on the budget resolution.

But with regard to the composition of spending, we have no current process that prompts Congress as a body to consider the composition of spending between investment and consumption. All spending is the same, regardless of its long-term benefits. Now, we have in our printed statement a graph that shows the consequences of some of these trends; that over the past 20 years, public investment, as a share of the budget, has decreased, has been overtaken by mandatory spending for health, by interest in the budget and other things.

So the key question for the Federal Government is how do we develop a process that is tailored to promote both of these Federal roles, private investment and public investment, and respects both of those roles and respects the unique role the Federal Government in the investment area? In other words, unlike State and local governments, we don't own assets, by and large, within the infrastructure area. We don't own capital assets, to a great extent.

We subsidize others to help them afford to pay for those assets. Now, in this regard, traditional capital budgets, in our view, are not well suited to respond to these unique Federal roles. And by traditional capital budgets, I mean a capital budget that would balance the operating budget and permit deficit financing of capital, which is what many State and local governments do. I mean a budget that would have a capital budget that is financed by depreciation that's booked on the operating side.

So what you really appropriate and control is the annual depreciation costs. Deficit financing of capital doesn't respect the important role of the government as steward for the overall economy. While deficit financing of capital could promote more capital, it could also threaten, again, the private investment that the deficit has such an important role to play in.

It could also distort budget definitions within the budget. It would tilt the table so much toward capital, that the temptation to define things as investment that really aren't properly categorized in that would be very significant.

Depreciation is a concept that is very appropriate for certain things, but I'm afraid not for budgeting at this point. Depreciation is an approach where you spread costs over a period of time to be commensurate with the benefits of those kinds of investments.

It is an approach that is very appropriate for financial statements, for matching expenses to income, to determine the price of

products, to determine profitability of a corporation. And it's an approach that really was developed because of the allegation that the Federal Government has these large, lumpy projects that we have to fund that involve up front costs and long-term benefits.

In fact, when we look at most of the infrastructure that we fund, the human capital we fund, the R&D that we fund, Federal Government doesn't own most of those assets. Federal Government owns only 12 percent of the total investments that we define as Federal public investment, according to the Office of Management and Budget. Again, most of what we do are grants and subsidies.

And these subsidies are not lumpy and they're not large. They don't typically involve, like the space station, for example, large up front investments. They typically involve a steady stream of payments to the State and local governments. So depreciation as a concept is not really well suited to the unique role the Federal Government plays in these areas.

It also has some downsides. If you really only are going to pay attention to the annual depreciated amount of your investments, which is the advantage that advocates say you could have, then you threaten some very important principles, like budget control. You want to make sure that you do in fact recognize the full up front costs of what you're getting into at the time you make the commitment. That's the only time you can control the commitment.

There are also some problems in valuation of useful lives for some of these things, particularly for human capital and R&D, which are areas that we think are important for investment. And it's significant that the Federal Accounting Standards Board, which is now promulgating standards for the Federal Government, is not including infrastructure as a depreciable asset to be booked on the balance sheets of the Federal Government.

So, given that, those traditional approaches don't seem well suited to either our role or the challenges we face in both promoting private and public investment. What does? Well, we feel that an investment component, operating within the discretionary caps, is a more appropriate way to encourage the kinds of public investment that you want without jeopardizing some of the other goals that we think are important at the Federal level.

One we see is, the investment component would prompt a full congressional consideration on a macro basis of how much investment we want to have in our budget in a given year. In other words, rather than have the amount of investment bubble up from thousands of individual decisions made in other committees, Congress would have an opportunity to weigh in on that very important issue for the long-term economy.

But you would do it within the overall fiscal discipline established by the caps. And I think our track record with the discretionary caps has been very good over the past 5 or 6 years. What this would do is, it would shift the debate toward public investment within an overall fiscal constraint, without bogging us down in endless debates about how you would depreciate assets; how you would book these kinds of costs over time, and employ an army of accountants in the process.

Now, how you define this component, whether it's considered investment that includes infrastructure, R&D, and human capital;

whether it's just focused on infrastructure, is obviously a decision for Congress to make, and you're going to have to weigh some issues in that. But as a mechanism, I think it has a lot to offer us here at the present time at the Federal level.

Now, there are implementation issues involved. Congress would have to decide, once it agrees on a component, how it's going to enforce that through the appropriations process. I think that these are workable issues. It would have to obviously decide how it's going to define such a component. It may even want to permit cuts on some of the PAYGO programs, which essentially fund primarily consumption kinds of activities, to be used to finance investment on the discretionary side.

These are the kinds of issues that we're confident can be worked out. And I think what you've had in the past is that people concerned about the definitions feel that they are insurmountable and we ought to throw the whole baby out with the bathwater. In my view, as long as you're not tilting the table too much—and this is what having the component established within the caps does, it provides an overall discipline—I think the temptation to distort the definitions is limited.

And I think the process could be made to work. And we would be glad to continue to work with this committee on such a process. Thank you.

[The prepared statement of Mr. Posner follows:]

PREPARED STATEMENT OF PAUL POSNER, DIRECTOR OF BUDGET ISSUES, ACCOUNTING AND INFORMATION MANAGEMENT DIVISION, U.S. GENERAL ACCOUNTING OFFICE

Mr. Chairman and Members of the Committee:

I am pleased to be here today to discuss how the budget process could be used to bring about a greater focus on long-term economic growth. The nation's economic future depends in large part upon today's budget and investment decisions. However, trends in economic investment have not been encouraging. First, the pool of net national savings available to finance investment has been shrinking since the 1970s, from an average during that decade of 7.8 percent to only 2.3 percent of net national product in the first half of the 1990s. Second, the level of gross private domestic investment as a percent of gross domestic product (GDP) has fallen since the 1970s, from an annual average of 17.0 percent in the 1970s to an average of 14.0 percent for 1990-1994. And third, many of our trading partners have significantly higher levels of investment. In 1993, the United States ranked 19th in gross fixed capital formation among the 25 nations in the Organization for Economic Cooperation and Development and second to last among G-7 nations. Unless these trends are reversed, future generations will face slower growth in their living standards.

One of the most important federal influences on investment is the budget deficit, which absorbs large pools of private savings that would otherwise be available for domestic investment. The surest way of increasing national savings and investment is to reduce the huge levels of federal dissaving by eliminating the deficit. In a report issued in April 1995,[1] we stated that moving from a deficit to a balanced budget is essential to improving national savings, private investment, and long-term economic growth. In that report, we indicated that achieving a balanced budget by 2002, as contemplated in the budget resolution conference agreement, would increase per capita GDP in 2025 by an estimated 34 percent compared to a "no action" fiscal policy path.

Not only is the overall level of the deficit important to future economic growth, but the type of spending also matters. Federal spending can be divided into two categories based on its economic effect—consumption spending having a short-term economic impact and investment spending intended to have a positive effect on long-

[1] The Deficit and the Economy: An Update of Long-Term Simulations (GAO/AIMD/OCE-95-119, April 26, 1995). See also Budget Policy: Prompt Action Necessary To Avert Long-Term Damage to the Economy (GAO/OCG-92-2, June 5, 1992) and Budget Policy: Long-Term Implications of the Deficit (GAO/T-OCG-93-6).

term private sector economic growth. Well-chosen federal investment programs can promote an environment conducive to investment and long-term growth in ways that the market alone cannot provide. Programs supporting efficient public infrastructure, an educated workforce, and expanded technological innovation can make important contributions to private sector growth. In the process of cutting the deficit to increase private investment, the Congress can strive to ensure that a greater share of the remaining federal spending is focused on effective long-term investment programs.

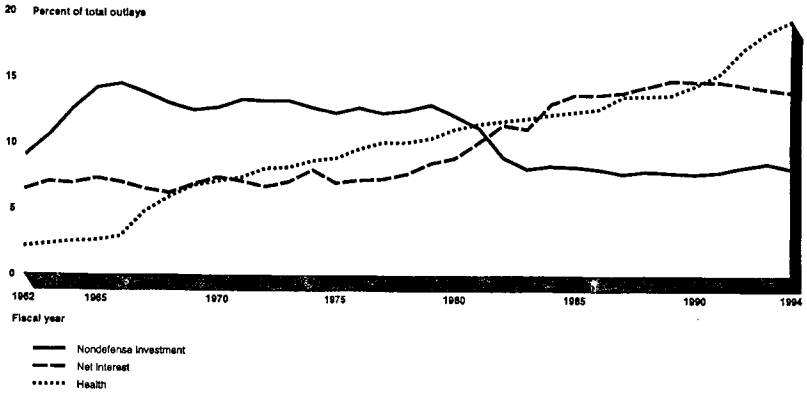
The current budget process does not prompt the executive branch or the Congress to make explicit decisions about the appropriate mix of spending for current consumption and spending for long-term investment. Appropriations subcommittees provide funding by department and agency in appropriation accounts that do not distinguish between investment and consumption spending. The budget process tends to view a dollar spent on short-term consumption the same as a dollar spent on capital investment. However, some have argued that the budget process actually favors consumption over investment because the cost of both must be scored upfront even though most of the benefits from investment programs accrue in the future.

Alternative budget presentations which accompany the President's budgets provide some supplemental information to congressional decisionmakers but are not part of the formal budget process. These presentations have had little effect on the level of investment undertaken by the government. They are not used in executive budget formulation but are merely assembled after executive budget decisions have been made. Nor have they been part of the congressional budget process.

The level of investment spending as a proportion of total government spending has declined significantly over the last few decades since its peak in 1966. Part of this trend may be explained by the rise in interest payments and consumption spending for federal health programs. As shown in figure 1, in 1966, nondefense investment as defined by the Office of Management and Budget (OMB)[2] made up 14.5 percent of total outlays. Although there were modest ups and downs over the intervening years, by 1994 nondefense investment had fallen to only 8.1 percent of federal outlays. During the same period, interest payments on the federal debt had doubled from 7.0 percent to 13.9 percent of outlays, and the share of total outlays devoted to health care had grown over sixfold from 2.9 percent to 19.3 percent. As a percentage of GDP as well, federal nondefense investment has fallen from 2.7 percent in 1980 to 1.8 percent in 1994. It is worthwhile to note that the investment trends we see here are not a result of any explicit strategy or set of national priorities. Instead they represent the accumulated results of many individual budget decisions regarding hundreds of programs.

[2] OMB's definition of investment includes not only human capital activities and research and development, but also all physical investment that yields benefits largely in the future. Unlike GAO's categorization of investment in this testimony, it includes spending for such activities as construction of federal office buildings and acquisition of park lands.

FIGURE 1: FEDERAL NONDEFENSE INVESTMENT, HEALTH, AND NET INTEREST OUTLAYS



Source: Budget of the U.S. Government.

RECOGNIZING INVESTMENT IN THE FEDERAL BUDGET

Currently, the federal unified budget focuses policymakers' attention on the impact of federal cash borrowing in the economy. Such a focus is critical to understanding how federal budgetary decisions in the aggregate affect the business cycle in the short term as well as understanding potential consequences for longer-term economic output. However, the unified budget does not differentiate between spending that is intended to produce long-term benefits and consumption spending that is primarily for short-term benefit.

To address this issue, proposals have frequently been made to create a capital budget that separates revenues and outlays for long-lived physical assets from the rest of the budget (that is, the operating budget). Many proposals for federal capital budgeting go beyond being a mere display of capital purchases; they typically include an associated depreciation component for capital assets which is charged to the annual operating budget. In addition, they commonly envision special budgetary treatment for capital by requiring balanced operating budgets while allowing deficit financing of capital.

Capital budgeting of this nature presents several problems however. First, many of the assets that we would define as investment, including research and development and human capital activities, do not lend themselves to depreciation. In previous work,[3] we found virtually no sources that identified methods by which these types of investments could reasonably be depreciated for federal accounting or budgeting purposes. Even for physical capital, many of the assets that are important to the future economic growth of the nation, such as highways and other public infrastructure, are generally not owned by the federal government and are, therefore, not appropriate for the federal government to depreciate; no organization we know of depreciates assets it does not own or control. Second, depreciation—even of physical assets—would undermine budgetary control of expenditures by not recognizing the full cost of an asset at the time a decision is made to acquire it. Third, permitting deficit financing of investment may conflict with the overarching goal of increasing national investment by eliminating the deficit.

Thus, a traditional capital budget would not be a workable approach to recognizing the unique role of the federal government in promoting long-term investment.

Instead, we believe that incorporating an investment component within the discretionary caps would be an appropriate and practical approach to supplement the unified budget's focus on macroeconomic issues. An investment component would direct attention to the trade-offs between consumption and investment but within the

[3] See Budget Issues: Incorporating an Investment Component in the Federal Budget (GAO/AIMD-94-40, November 9, 1993) and Budget Issues: The Role of Depreciation in Budgeting for Certain Federal Investments (GAO/AIMD-95-34, February 1995).

overall fiscal discipline established by the caps. Policymakers would have a new tool for setting priorities between the short-term and the long-term and an added impetus to evaluate investments against each other in trying to select the most effective investment.

If an investment component within the budget is to be implemented, it is important to decide what activities should be regarded as investment. There are many possible definitions. The definition used for budgetary purposes depends on the purpose that an investment component is expected to serve. Because we believe that the need to enhance the nation's long-term productive capacity is among the most pressing needs facing the country today, we have suggested that investment be defined as federal spending, either direct or through grants, that is specifically intended to enhance the private sector's long-term productivity.[4]

Under this concept, the investment component would include grants for physical infrastructure, spending for research and development, and human capital activities, such as education and training, which are directly intended to increase private sector productivity. It could also include spending for some federally owned physical capital that is viewed as having a direct bearing on long-term economic growth, such as water projects, air traffic control systems, and construction of research and development facilities. Federal spending of this type, when economically justified, tends to lower the private sector cost of producing and delivering goods and services, and thereby increases the future productive capacity of the economy.

Our concept of investment spending would not include spending on other federally owned physical assets, such as federal office buildings and military weapons systems, which are not specifically intended to promote long-term private sector economic growth but instead are primarily used in federal operations or to carry out unique federal missions. Such expenditures may improve the efficiency of government agency operations or create jobs in the short term in particular regions of the country; however, they do not have the direct purpose of raising private sector productivity.

Mr. Chairman, we recognize that the Congress may choose to define this category in other ways which may highlight other spending that has long-term benefits. For example, one category might include federal spending on physical infrastructure, whether through grants or direct federal programs. Such spending can yield long-term benefits to the operations and efficiency of the economy and considering them apart from other consumption spending may be useful.

However it is defined, a separate investment component could be beneficial, as long as it adequately encompasses spending that reflects the long-term interests of the federal government. An excessively narrow definition might lead policymakers to overlook the long-term benefits of programs that are excluded and force them to compete with other consumption programs for funding. However, an excessively broad definition undermines the value of creating the distinction in the first place because it fails to provide policymakers with an adequate focus. Striking the correct balance is crucial for making the investment component a useful policy tool.

Defining investment is only one of a series of issues to be considered in establishing an investment focus in the budget process. A mechanism for focusing decision-making on the appropriate allocation of resources between consumption and investment would also need to be established. Mr. Chairman, we believe that investment spending can best be considered formally in the budget process by establishing targets for investment within the discretionary spending caps—a framework first established in the Budget Enforcement Act of 1990 (BEA). Since we believe that the primary budgetary objective should be to reduce the deficit, a declining unified budget deficit path should be established first. Then, within that path, a target for investment spending could be established to shift the spending mix toward relatively more investment. One approach would be for the Congress to decide on an investment target in the budget resolution which would then be observed in subsequent funding decisions by congressional committees. These committees could evaluate individual investment programs to determine which competing investments should be selected within the overall target. Our previous work provides an example of the kind of framework and questions policymakers can use in evaluating various projects.[5]

Setting an investment target would require policymakers to evaluate the current level of investment spending and would encourage a conscious decision about an appropriate overall level of investment. Given the way the budget process now oper-

[4] See Federal Budget: Choosing Public Investment Programs (GAO/AIMD-93-25, July 23, 1993) and Transition Series: Investment (GAO/OCG-93-2TR, December 1992).

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

ates, however, a number of implementation questions would be raised by deciding to set a target for investment. These questions include the following.

- How would this target be defined and should it specify accounts or portions of accounts to be included?
- How can a decision be made on an appropriate level of investment and how can we be assured that only worthwhile projects are funded?
- Within the current budget enforcement framework, would separate floors as well as caps be necessary to assure a minimum level of investment?
- Would trade-offs be allowed between discretionary spending for investment and mandatory programs that support consumption to permit the Congress to shift resources from consumption to investment?
- How would investment and noninvestment activities be allocated to congressional committees?

These are important and difficult questions and the answers could change over time. Nevertheless, we believe workable answers and procedures can be found. Defining investment can prompt controversy, but the temptation to expand this category would be less than under a traditional capital budget that allows for deficit financing of investment. Once agreement is reached, the Congress can turn its attention to developing enforcement and oversight mechanisms that will preserve the integrity and effectiveness of the investment targets.

I should make clear that it would be difficult for the Congress and the administration to shift the portion of federal spending devoted to investment without some increased flexibility to make trade-offs between the discretionary and the pay-as-you-go (PAYGO) portions of the budget. Federal spending on OMB-defined investment already totals roughly half of all domestic discretionary spending. However, BEA does not allow the flexibility to offset increases in discretionary spending for investment with savings on the PAYGO side of the budget. The Congress would need to address how to achieve these trade-offs without destroying the existing controls in BEA.

CONCLUSION

Mr. Chairman, we share your concern about investment and long-term economic growth in the United States and the role that budget decisions play in promoting growth. The most important contributions the federal government can make to a healthy and growing economy are (1) reducing the federal deficit and (2) making wise decisions on investments that will foster long-term economic growth. However, the current budget structure does not facilitate decision-making on activities intended to promote long-term economic growth.

We believe that the creation of an investment component in the federal budget could help the Congress and the President make more informed decisions regarding federal spending on consumption versus investments for the future. Separate targets for investment spending within the existing discretionary spending caps could be established to ensure that investment is considered formally in the budget process. Recognizing the importance of the deficit to long-term economic growth, such a component could be established within the context of a unified budget framework that leads to a balanced unified budget over an appropriate period. Although there are a number of implementation issues that would need to be resolved, we believe that working solutions can be found, and we would be pleased to assist the Committee on these matters.

This concludes my statement. I would be happy to answer questions that you or Members of the Committee may have at this time.

Mr. HORN [presiding]. We thank you. I now yield to the gentleman from Pennsylvania, Mr. Mascara, for questions.

Mr. MASCARA. Thank you very much, Mr. Chairman. Thank you, Mr. Posner, for those very enlightening remarks. I appreciate much of what you said. I just wonder, you used a figure of only about 12 percent would really qualify for what? I mean, as a real capital investment?

Mr. POSNER. What I meant by that was, of the total amount of the Federal spending we would define as investment, the domestic infrastructure, the human capital kinds of programs, and research and development. According to the Office of Management and Budget, it's about $120 billion for fiscal 94. The Federal Government owns about 12 percent of that.

In other words, we don't own highways, the airports, the mass transit facilities. We do own water projects, to some extent, and that kind of thing. But by and large, as you know, we have a third party government in some sense—we use others to implement public business.

Mr. MASCARA. That's discouraging news. We're looking at forming a capital budget. If what you say is correct, if there's only 12 percent of what we spend that we could call a real capital budget item, then perhaps we're going off in the wrong direction. I, as a county commissioner, was involved with NACO, the National Association of Counties, and as a former accountant, am certainly familiar with FASB. And I was involved with NACO as a member of the committee that structured GASB, the Governmental Accounting Standards Board.

And I was wondering whether or not we should look to GASBE for some help, or for some assistance, or consult with them to see. Because I think we're in trouble in this country because we fail to use good accounting practices. And if what you say is true, then there's an admission by all of us, and if we accept that, that perhaps we can't look to the accounting business for some help in structuring something that would make a lot of sense for us as it relates to the capital budget.

That's awful discouraging, and I'm going to go away discouraged today.

Mr. POSNER. I hope that's not the case, because I think you have to tailor accounting principles to the Federal role. And if you're familiar with the Federal Accounting Standards Board, as chaired by Elmer Stocks, former Controller General, they have been in the process, the past 2 years, doing just that. So, for example, there are some assets which they call property, plant and equipment—things like Federal office buildings, computer systems, that would get depreciated on a balance sheet.

But things like highways, things like airports, that we don't own, that we are pursuing in our role as custodian for the economy, rather than as an owner of assets, those kinds of things, they would have a separate kind of report that would discuss the value of that. But they would not articulate it through the balance sheet.

Mr. MASCARA. I understand that, because working with the Regional Planning Commission in Pittsburgh, in building highways, we had 80–20 ratios, we had 50–50. So I understand what you're saying with regards to not being able to capitalize a contribution to a State or to a county. Thank you, Mr. Posner. Thank you, Mr. Chairman.

Mr. HORN. OK. I unfortunately had to leave for another subcommittee hearing for a time, so I haven't heard all of the informal interchange. But let me ask you a few questions for the record, and then we'll follow them up, as you're usually very gracious in answering them, and get them in the record at this point.

How much have we gone into the definition of capital and capital investment? Did we pursue that to the best of your ability? I want to make sure we've got all the thinking in the record. And I wondered, in the preparation of this report, as well as your statement, have we analyzed what the States are doing in this area? Are there

comparison charts and matrixes around, so we get a feel for definitional terms as they've evolved over the years with the States?

Mr. POSNER. Well, we have articulated the definition of investment that we think is primarily economically driven, essentially. It's those activities and infrastructure, human capital, research and development that appear to have the most direct relationship to long-term growth, to the factors that impact on productivity, which is how we improve the potential of the economy to grow.

Obviously, there are other definitions out there. You've got roughly $104 billion for that set that we've talked about. There's an additional roughly $20 billion, is it $20 billion, Bernard?

Mr. MYERS. Approximately $13 billion.

Mr. POSNER. $13 billion for fixed assets that the Federal Government owns, by way of the office buildings, the physical capital we use to undertake Federal missions. The GSA office buildings don't have a direct relationship with the economy in 2025, but they nevertheless are important to the way we carry out the public's business, as are information systems for IRS and that kind of thing.

So there's a separate category there that people should care about. This of course also doesn't include the defense side. So that's another category that, again, doesn't have, in most cases, except for the basic research, a direct relationship with long-term growth. But nevertheless, it's important for people concerned about that mission. So those are some categories.

And I think we have building blocks for you to work with, essentially, and decide. Now, the one thing about extrapolating from the State and local side is, of course, there are several differences. One is, there are national missions, as you well know, that State and local governments typically don't get involved with research and development, for example.

They have a different set up in the sense that they own and manage these assets, and we generally subsidize assets. And then we also have the role for the stewardship of the whole economy that they don't have. So that's why the unified budget is important to maintain, from a Federal standpoint, as a kind of statement of how the Federal Government impacts the whole economy, compared to the State and local governments, which use, as you know, use more fund accounting principles in their budgets.

Mr. HORN. Why does it matter if it's unified or split up into operational and capital, just as a start? I mean, all you have to do is add the numbers.

Mr. POSNER. As a matter of presentation, you can do that. What's important is that for your fiscal policy decisions, you consider the unified budget. But you're right. As a matter of fact, we have argued for different kinds of presentations, because sometimes the unified budget alone obscures important considerations. And that's why we want—we're talking about this investment component.

Because if you just consider a pure unified budget as the basis for making decisions, all spending looks alike. And that's clearly not the case.

Mr. HORN. Well, you're exactly correct. And private enterprise is a good example of that. We've had tremendous drops in research investment by American corporations in the last few years. That is going to substantially hurt this Nation over the next 10 to 20

years, because that's when that investment is realized. But it needs to be nursed and nurtured if you're going to be successful.

So it seems to me, when we're talking the capital outlay aspect, there's both pluses and minuses, politically, in having a separate capital budget. One is, it sticks out there like a sore thumb, and people will say, why are you doing that? On the other hand, when you take your approach of looking at the economy, which is certainly a reasonable approach, you would really be presenting a needs list that is not necessarily in touch with fiscal reality.

But it could be long-term; it could be, this is what we'll do in this 5-year period and so forth. And obviously, you would update that. You would prioritize that, based on certain criteria. In the California State University system, which I guess has the biggest construction in the State of California, along with the University of California, we have a priority list.

And you are to strictly proceed through the executive branch clearance process of the Governor, and the Department of Finance, the equivalent of the Office of Management and Budget at the Federal level, into the legislative clearance process, which includes the joint budget committee of the legislature, which would be much like some of the authorizing committees here. But then it would go to an authorizing committee in each house.

It would go to the Ways and Means Committee in the Assembly of California. It would go to the Senate Committee on Finance. And that moves through as part of the budget, but it is clearly separable. It doesn't come up at a different time, they're acting on them both. But it's clearly identified. It is a capital budget. It's based on priorities in terms of education, and it moves through with your budget.

But it's a different set of dynamics as to how things get there, versus a broad operational budget where you couldn't find it at the State level if your life depended on it. But that's aggregated budgeting, simply as we have in the Federal Government. And it is sent back down the pyramid on the same basis. So what I'm thinking here is, I'd like to know what other States are doing when they analyze these investments, if you will, which are buildings of all sorts that learning takes place in.

And that's a fairly good investment in our society. If you want to move over to dams and rivers and harbors and all the rest of it, States do have priority lists for those. And that's what determines where you allocate scarce resources, namely the taxpayers' taxes or revenue, or bond revenue, which means they have to vote it. We haven't had to do that at the Federal level, where citizens actually vote on a capital program.

What we have had, though, is certainly an executive equivalent, which is, we can issue bonds, too, in this government, and we do.

Mr. POSNER. Yes. I would say, just to add to what you said, that this investment component is a probably necessary, but not sufficient condition, to get a lot of important decisionmaking to go on that doesn't go on now. And you're referring to kind of a planning and prioritization process. I just might note for the record that OMB has kicked off such a process for the small portion which we call fixed assets. Last year, they had agencies for the first time submit 5-year plans that tried to project their capital needs.

Essentially it was the first time we've done this at the Federal level. And they actually had a directors' review session that, for the first time, at least talked about capital in the budget in a unified sense. They have some discussion in their budget presentation about the outcome of that. We're kind of looking at that right now, as a matter of fact, to understand to what extent did that prompt the kind of priority setting that you're talking about; and what criteria were used; and what innovative financing techniques have been used?

Because when you look at things like computers and office buildings where there are big up front costs with long-term benefits, there are some things that we could do by way of looking at best practices, whether at the States or perhaps other Federal agencies, to promote that kind of thing.

Mr. HORN. Well, California is 25 to 40 years ahead of the Federal Government in this area. The priority system does work. And obviously, with aggregate incremental budgeting, you're talking about that starting at the lowest level of an organization, and working its way up. In our case, it's now, I think, 21 campuses, and sifting through a central headquarters which prepares the budget, clears it with the Governor, presents it to the legislature.

The Governor can cut it, add to it, do what he wants with it, as the chief executive of the State. But it has worked, and what it has done is end the pork barrel type things that we read about in the national government and also the State Government in that, when you followed that process, here's the formula, in a way, for how many square feet you get for how many students taught and so forth and so on.

You have a utilization factor. You have a need factor, based on expansion. And if somebody goes around that, the Governor can easily veto it back by his line item veto; and Governors of California have done exactly that. So you don't find, in California, the type of stuff you see coming out of the Congress, where somebody gets a high paid lobbying firm and works that building project or whatever clear through the Congress.

It's lost somewhere in the huge Federal budget, because it is all over the place. It's very hard to find these things unless you're in on the committee and the subcommittee. So it seems to me, there are a few lessons to be learned there. But my own interest is more on the fiscal side, where I think we have less knowledge, and we could depend on the New Zealands and the different States in the Union as to what type of debt service in relation to the operating budget; how do you put a value on the assets for which you're responsible and all this.

Any guidance GAO can provide or we use in the American law division, or you using it, since we're all part of the same legislative branch, to search these laws and policies, would be immensely helpful to this committee. We're going to move on this, and we need to have a very thorough understanding of what is going on here.

I wonder if the gentleman from Pennsylvania has more questions?

Mr. MASCARA. Well, after I've gone over 30 hours with no sleep, I'm not excited about prolonging my agony. But I do have one question, Mr. Chairman, as relates to New Zealand. Ambassador Wood

talked about how New Zealand does not consider human capital, education, and private sector research and development to be capital expenditures. New Zealand also makes a distinction between investments which generate an asset for government, which would qualify as a capital expenditure, and those which create an asset for the country, which would not qualify as a capital expenditure.

Instead, they treat the latter as an operating expense. And I just wonder whether you, Mr. Posner, could elaborate on your view of the distinction between those two.

Mr. POSNER. I think it's a very valid distinction. But it would be very different in our country, versus New Zealand. Because remember, New Zealand essentially is not a Federal system. And so the government has a lot more assets and infrastructure that they're responsible for—the Federal national government. We don't do much as a Federal Government with regard to the domestic productivity agenda of this country.

And therefore, we have a lot more that we collectively care about that New Zealand, I think, would define as national rather than governmental kinds of assets. As I say, I think the distinction, though, is a good one, analytically; that there are some things at the Federal level that we own, are responsible for maintaining. The office buildings, computer systems, even some of the large things like the space shuttle, that you really could use some more traditional capital analysis techniques and those kinds of things for.

But the majority, again, of things that matter for the long-term productivity of the economy are things that are not governmentally owned assets, and that's why you need to think about different concepts to capture that.

Mr. MASCARA. So because they're not a Federal system, then they would have more creation of national assets than we have.

Mr. POSNER. I think that's correct. Chris, do you want to respond. You know a little bit more.

Ms. BONHAM. They own their highway system, for example, whereas our States primarily own the highway system here. I would like to comment a little bit now——

Mr. HORN. Excuse me, I'd like to pursue that a bit, if I might. The States own it in the sense that they bought the right of way. Is that what we mean by owning?

Ms. BONHAM. Yes.

Mr. HORN. Because the Federal Government has contributed, on the interstates, 90 percent; is that not the figure for the interstate highway system?

Mr. POSNER. That's correct.

Mr. HORN. The States contribute 10 percent. Then you have the maintenance situation. We might say, on this whole situation, people always sort of fixate themselves on the capital investment figure. It is a minor figure, compared to the operational figure that is related to that capital asset. That is where the real money is. Capital investment is a very minor stake in buildings, highways, everything else.

But you've got to maintain them; you've got to repair them, et cetera. That's where the money really goes.

Ms. BONHAM. What I wanted to add, though, was about what FASAB, the Federal Accounting Standards Advisory Board, is

doing with regard to these asset like things that we don't own—the highways, the R&D, the human capital—that would not be on the balance sheet of the Federal Government. They are recognizing that these are, in effect assets, that this is asset-like spending.

And in recognizing that, they will be requiring some new types of reports in the financial statements that would at least report what we have spent over some period of time, going back, say, 10 years, to recognize that the government is investing in the country. And there is some requirement to try to link some outcome measure to this. So you would look at R&D spending, and then also have a report that says, and this is what we've gotten for it.

You could look at human capital spending and try to make some connection. Just to recognize that this is of an asset-like nature, even though it isn't on the balance sheet. And they would not depreciate it, would not depreciate highways. But they would carry information on the spending that the Federal Government does on these highways in the financial statements.

Mr. HORN. What thought has been given to research investments by the Federal Government not only as to the direct payment, but to the overhead payment? What degree of investment is that? Universities since the Second World War have been built by very skillful manipulation of overhead costs, which have provided new science buildings, new technology buildings, all sorts of buildings.

And while the Federal Government doesn't own them, in essence they've subsidized their construction.

Ms. BONHAM. Right. And if we have made grant contributions to do that, that would be picked up in the financial statement reporting that is envisioned by FASAB.

Mr. HORN. Are you saying we're getting prepared, somewhere in this vast Federal bureaucracy, an actual balance sheet financial statement?

Ms. BONHAM. Well, as a matter of fact, the Treasury has been doing a consolidated financial statement for the Federal Government for a number of years. It's not audited yet, because the underlying accounting systems aren't strong enough to sustain audits in all cases. But there is a legislatively mandated date, I think, of 1997 to have an audited consolidated statement for the Federal Government.

Many agencies now do financial statements that are audited. GAO audits some; the IGs audit some of them. They provide an additional perspective beyond what you see in the budget to decisionmakers. Accrual basis data are reported in these financial statements. And there are balance sheets and there are operating costs reported.

Mr. HORN. Well, I know. And I add, along with my colleague Chris Cox and John Spratt, the unpleasant task of listening to them as they present what I have thought are absolutely—well, I don't know how to put it—absolutely incomplete, shall we say, balance sheets at this point. And we've looked at those. I think Chris made the comment last year to the IRS that if a corporation had presented that to you, they'd probably be in jail.

And that's what they're presenting to the Congress. And the reason I'm interested in it is, we're holding a hearing on this very subject——

Ms. BONHAM. And we're testifying, I think.

Mr. HORN. I'm sure you are. Here we have the Pentagon can't even find $15 billion, and GAO doesn't know it's missing. It seems to me we've got real problems in the Federal Government, where it just seems to drift it around and out of the system. So I think the Members of the Congress have major concerns about how can anybody account for anything fiscally in the executive branch.

Ms. BONHAM. Right, yes.

Mr. HORN. They're really behind. Corporations would be indicted for the way they operate the place. That's why I'm fascinated when you tell me the Treasury has something that's a consolidated statement.

Ms. BONHAM. It's not audited, though.

Mr. HORN. Not audited. It's not realistic either.

Ms. BONHAM. No, but there are requirements for it to be audited on this century.

Mr. HORN. Good.

Mr. POSNER. A realistic performance measure.

Mr. HORN. Since the House of Representatives is undergoing the first audit since 1788, when they elected the first Congress, why, I'm glad the executive branch is coming along, too. It's depressing when one thinks about it.

Mr. MASCARA. Mr. Chairman, I'd just like to comment to the young lady about the system of accounting. I think what you're referring to is a modified accrual accounting system. Because when I became the controller of Washington County, I implemented that. And then we finally went to a full accrual system—probably one of the first in the State, and maybe one of the first in the country.

And it certainly helped us when we went to the market for borrowing, because we did have a full accrual accounting system. I think what you're referring to in the consolidated statement is that, one, it was unaudited, and two, that it's a modified one.

Ms. BONHAM. Yes, that's true. We do not accrue revenues, for example. So it is a modified accrual system. It's what the States would call a modified accrual system.

Mr. MASCARA. And hopefully someday we'll have a good balance sheet in the Federal Government.

Mr. POSNER. Well, Congressman Mascara, if I could just interject. You may have pointed to one of the reasons why our accounting systems aren't up to snuff. You, at the local level, have to go to the bond market and sell your obligations, and you have to satisfy investors. We generally don't have that discipline. And so far, we haven't had that discipline.

Mr. MASCARA. We're not required at the local level, but my accounting background dictated that I do that. And two, the county benefited by getting a lower interest rate, because we had a full accrual accounting system.

Mr. POSNER. Exactly.

Mr. HORN. Along that line, has GAO got a position on the Federal Government going to accrual accounting?

Mr. POSNER. Well, I can have Chris, who's been working very closely with FASAB, and she will have something to add to this. I think when you say accrual accounting, are you talking about in the budget?

Mr. HORN. As recommended by the Hoover Commission in 1949. Am I not correct they recommended accrual accounting?

Ms. BONHAM. For the budget or for——

Mr. HORN. Well, I'm willing to start anywhere; I'm a reasonable guy. I mean, where do you want to start?

Ms. BONHAM. FASAB standards call for an accrual basis for the Federal Government. They will be calling for accruals where they can be made. You may in fact call it modified accrual. I think still we're having problems even thinking about accruing revenue, for example. But the underlying concept for their standards is accrual based reporting.

That's different from what is done in the budget. There are some areas in the budget now that are on an accrual basis. Credit reform put credit programs on an accrual basis. Some of the Federal employee pensions are on an accrual basis for budget authority. But most of the budget is cash based. And that is primarily driven by the great concern for the deficit, and a desire to have a number that represents the borrowing needs of the government.

To the extent that you depart from an accrual basis, the deficit number departs from the borrowing needs of the government. That does not mean that the government could not do a separate cash-flow statement.

Mr. HORN. Right.

Ms. BONHAM. But that's not how we do it right now.

Mr. POSNER. Basically, when you look at the budget—and we'll be talking about this when we come up to your next hearing—most of the budget payments for grants and salaries is pretty close to what you get with an accrual system. But where you really care is where the timing is off; where cash doesn't give you the right signals, like with deposit insurance when the system was broke long before it was broke on a cash basis; or when you're making commitments where cash doesn't capture the full nature of the commitment.

And so we're exploring, for example, whether you should change the way we budget for insurance programs, like PBGC right now has a cash surplus. But that's even though the accounting statements show significant deficits. And economic analysis shows even more daunting problems in the future. And so you want to—what we've always felt is that you look selectively at areas where cash doesn't make sense to give the right signals to decisionmakers.

Mr. HORN. Well, we thank you. The staff might be sending you some questions, which, if you could answer them, I think they're very simple to answer, as long as you have a policy on that. If you'll let us know, because it would be helpful in preparation for that other hearing, if we could integrate some of the thinking here on these various topics. So I thank you all for coming from the General Accounting Office. We appreciate all you do for the Congress.

Let me thank the staff that participated in preparing this hearing. For the full committee, the joint venture, Monty Tripp professional staff member; Ed Amorosi, the director of communications; and Cheri Tillett, the assistant chief clerk. For the subcommittee, Russell George, the staff director; Mark Brasher, the professional staff member; and I think Anna Young was also involved with this

hearing; Andrew Richardson, the clerk; Tony Polzak, the LEGIS fellow.

And for the minority staff, Matt Pinkus is the primary one, is there anyone else? David McMillen, OK. The majority staff will wake up and get that right in the future hearings, I assure you; and the reporter, Marianne Nash—thank you, Marianne, we appreciate it. So with that, this hearing is adjourned. Thank you for coming.

[Whereupon, at 12:20 p.m., the hearing was adjourned, subject to the call of the Chair.]