Federal Capital Budgeting: Evaluating the Current Budgetary Treatment of Capital Spending by the U.S. Federal Government

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Research Questions & Summary

1. What is a capital budget and why does the federal government not have one?
2. How does the current budgetary treatment of capital spending affect decision-making?
3. Would an alternative treatment of capital spending at the federal level promote better outcomes?

This project addresses each of these questions. It explains how capital spending at the federal level is part of the unified budget, accounted for on a cash-basis, and why this matters for decision-making. The analysis compares this treatment to how other entities, such as state and local governments and the private sector, budget for capital. It evaluates the federal budgetary treatment of capital and examines alternative ways to budget for capital spending and whether they might lead to better or worse outcomes. Alternatives considered include dramatic reforms such as implementing a separate federal budget accounted for on a full-accrual basis or a non-budgetary capital acquisition fund (CAF), as well as more modest reforms including on-budget CAFs, strengthened requirements for deferred maintenance reporting, and greater use of retrospective analysis of capital spending projects.

This analysis finds that the current budgetary treatment of federal capital spending promotes efficiency, accountability, and long-term planning to a certain extent by effectively and transparently matching the decision to undertake a capital project with the total cost of that project over its lifespan. At the same time, the analysis also identifies some drawbacks to the current treatment of capital spending as well. Namely, because benefits of capital spending, by definition, accrue over a long period while the budgetary costs are incurred upfront, this arguably leads to a below-optimal level of capital spending by the federal government. However, this paper concludes that empirical evidence to support this argument remains elusive and recommends adopting more modest, incremental changes to the capital budgeting process to improve outcomes instead of implementing drastic reforms that might lead to even greater distortion and reduced transparency.

Methodology & Sources

This qualitative research and policy analysis draws on previous literature and core budgeting concepts to evaluate and rate the current federal budgetary treatment of capital spending, as well as several alternatives, based on three criteria selected by the author: (1) efficiency, (2) accountability, and (3) long-term planning. Literature sources for this study included the staff papers and final report prepared by the President's Commission to Study Capital Budgeting (PCSCB)(1999), reports on capital budgeting and financing issued by government agencies (CBO, 2008; GAO, 2005), OMB Circular A-11 (2011), guidance materials published by the Federal Accounting Standards Advisory Board (2011) and the Report of the President's Commission on Budget Concepts (1967).

1. What is a Capital Budget and Why Does the Federal Government Not Have One?

Different entities employ distinct approaches to budgeting for capital projects. The table below summarizes how the private sector, state and local governments, and the federal government define "capital," make decisions about which capital projects to pursue, and account for capital spending in their budgets.

	Private Sector	State & Local Governments	Federal Government
Definition of Capital	Physical assets and select intangibles (e.g., intellectual property)	Varies by state, but usually restricted to physical and technological infrastructure; sometimes includes grant monies to localities	Physical assets and intellectual property owned and used by the federal government
Decision-Making Inputs	Market signals; Net present value calculations; financing options available	Formal priority-setting tools; financing options available; legal debt restrictions; decisions entirely separate from operating budget	Mission of the agency; benefit-cost analysis; must make direct tradeoffs with other forms of spending
Budget Accounting	Full accrual basis (depreciation, not purchase price of the asset, counted towards operating budget)	Separate from operating budget (debt service payments, not purchase price of the asset, counted towards operating budget)	Combined with operating expenditures; can finance and budget for "useful segments" of capital project separately; agencies encouraged to use on-budget capital acquisition accounts/funds

Some argue that the federal government should have a separate capital budget like state and local governments and/or treat capital spending similar to the private sector. Following this approach, the government would recognize an asset's annual depreciation, not its purchase cost, as an expense in the operating budget, which would be funded through appropriations, thus replacing the current cash-basis budgeting process for capital assets with an accrual accounting system. However, the federal government has chosen not to adopt a separate budget for capital. The reasons why can be summarized as follows:

1. Technical challenges (e.g., ambiguity on how "capital" ought to be defined)
2. Fear that this approach would lead to increased borrowing
3. Accrual-based accounting is less transparent and more susceptible to manipulation
4. Reluctance to grant special treatment to one form of spending

2. How Does the Current Budgetary Treatment of Capital Spending Affect Decision-making?

	Pros	Cons
Efficiency	Scorekeeping rules help guard against perverse incentives to forego purchasing long-term assets or entering into capital leases No empirical evidence to support argument about bias against capital spending (PCSCB, 1999)	Total cost scored upfront, while benefits accrue over the long-term, which theoretically may distort decision-making against capital projects Decision-makers likely to be particularly averse to the budget spikes created by capital projects when their budget authority is constrained by some type of cap
Accountability	Capital spending is on-budget and thus subject to the appropriations process, which means policymakers are to some extent held accountable to demonstrate success of existing projects and present justification for new projects	Current process does not require federal government to budget for depreciation of assets or deferred maintenance, making it difficult to hold them accountable for proper use and management of assets
Long-Term Planning	Keeping capital spending on-budget means the budget deficit more accurately reflects costs that will be borne by future generations as a result of decisions made today Subject to OMB's benefit-cost assessment requirements Upfront scoring matches the long-term costs of a project with the decision to incur them	If the current budgetary treatment of capital distorts the amount of government spending on capital, this could mean that the government is not investing enough in capital projects that would more than pay for themselves over time, or that it is investing too much in projects that will result in negative net benefits over time.

3. Would an Alternative Treatment of Capital Spending Promote Better Outcomes?

The Criteria-Alternative Matrix below presents the ratings of expected outcomes for each policy option, assigned by the author based on literature review findings and knowledge of budgeting concepts.
Rating scale: (0) Poor; (1) Fair; (2) Good; and (3) Excellent

Alternative	Efficiency	Accountability	Long-Term Planning	Total
Status Quo	1-2	2	2	5.5
Federal Capital Budget (accounted for on an accrual basis like the private sector; outlays scored for depreciation)	1-3	1	1	4
Non-Budgetary Capital Acquisition Fund (CAF) (outlays scored when agency makes rental payments to the fund, corresponding to depreciation rate)	1-3	2	1	5
Incremental Reforms, including an on-budget CAF, tighter reporting standards on deferred maintenance, and greater use of retrospective analysis for capital projects	2	2.5	2.5	7

Conclusion & Further Research

The current budgetary treatment of capital spending to a large extent already supports the budget's ability to promote efficiency, accountability, and long-term planning. Some of the drawbacks to the current treatment might be improved by increasing the use of on-budget CAFs, better financial reporting on deferred maintenance, and more retrospective analysis of capital projects. Given the uncertainty around whether and to what extent the current method used to budget for capital projects distorts policymakers' decision-making, my analysis recommends the federal government refrain from adopting a separate budget for capital or a non-budgetary CAF due to potential loss of transparency and accountability, as well as the importance in the public sector of matching the total long-term costs of a project with the decision to incur those costs. However, further research is recommended to examine empirically whether or not the current budgetary treatment of capital does in fact create a distortion against (or in favor of) capital spending, the results of which could lead to a different policy recommendation.