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WASHINGTON

CABINET AFFAIRS STAFFING MEMORANDUM

Date: September 19, 1983 **Number:** CA168780 **Due By:** ____________

Subject: Cabinet Council on Economic Affairs - September 20, 1983

8:45 A.M. in the Roosevelt Room TOPIC: Budget Process Report

	Action	FYI
ALL CABINET MEMBERS	☐	☐
Vice President	☑	■
State	☑	■
Treasury	☑	■
Defense	☑	■
Attorney General	■	☑
Interior	■	☑
Agriculture	☑	■
Commerce	☑	■
Labor	☑	■
HHS	■	☑
HUD	☑	■
Transportation	☑	■
Energy	■	☑
Education	■	☑
Counsellor	☑	■
OMB	☑	■
CIA	■	☑
UN	■	☑
USTR	☑	■
GSA	■	■
EPA	■	■
OPM	■	■
UA	■	■
SBA	■	■

	Action	FYI
CEA	☑	☐
CEQ	☐	☐
OSTP	☐	☐
____________	☐	☐
____________	☐	☐
____________	☐	☐
Baker	☑	■
Deaver	■	■
Clark	■	☑
Darman *(For WH Staffing)*	☑	■
Harper	☑	■
Jenkins	■	☑
____________	☐	■
____________	☐	■
____________	☐	■
____________	☐	■
____________	☐	■
CCCT/Gunn	☐	■
CCEA/Porter	☑	■
CCFA/	☐	☐
CCHR/Carleson	☐	☐
CCLP/Uhlmann	☐	☐
CCMA/Bledsoe	☐	☐
CCNRE/	☐	☐

REMARKS:

Back to drawing bd.

The Cabinet Council on Economic Affairs will meet on Tuesday, September 20, 1983 at 8:45 A.M. in the Roosevelt Room.

The attached paper is an Executive summary of the full Budget Process report that was distributed last Friday.

RGD
Sugg redef'g ques = instead of accepting congr'l def of cap budg'g, look at it as we would prefer to see it def'd. (DS disagrees)

Regan
Real problem (and root of this debate) is the absence of long-range planning — that is the real ques for disc: should we have long-range plng and if so in what form?

1 change to capital budgeting (from cash budget) would provide no meaningful improvement and, in many areas, would be misleading

2 should incr efforts to bring off-budg items on-budget

3 p 7-8 (internal congr'l pressures)

4 Const'l issues & line item veto via def. of "bill"

DS
Has agreed w/ Congs on an enhanced reporting syst

RETURN TO: ☐ Craig L. Fuller
Assistant to the President
for Cabinet Affairs

☐ Katherine Anderson ■ Don Clarey
☑ Tom Gibson ■ Larry Herbolsheimer
Associate Director

THE WHITE HOUSE

WASHINGTON

September 19, 1983

MEMORANDUM FOR THE CABINET COUNCIL ON ECONOMIC AFFAIRS

FROM: ROGER B. PORTER RBP

SUBJECT: Executive Summary for the September 20 Meeting

Don Moran, chairman of the CCEA Working Group on Budget Process Issues, has prepared the attached executive summary of the longer Working Group report circulated to Council members last Friday.

The Working Group will report to the CCEA at our Tuesday, September 20 meeting. The meeting is scheduled for 8:45 a.m. in the Roosevelt Room.

Attachment

EXECUTIVE OFFICE OF THE PRESIDENT

OFFICE OF MANAGEMENT AND BUDGET

WASHINGTON, D.C. 20503

September 16, 1983

MEMORANDUM FOR: HON. DONALD T. REGAN
Chairman, Pro Tempore
Cabinet Council on Economic Affairs

FROM: Donald W. Moran
Chairman, CCEA Working Group
on Budget Process Issues

SUBJECT: Executive Summary of Draft Study #12

Overview

The Working Group's charter in preparing this study was to focus on the role of the budget as a policy control and accounting tool. While the President's budget has other roles as a fiscal policy blueprint and as a resource allocation mechanism, other studies you have chartered will explore the implications of these roles in a broader context.

Moreover, the Working Group was asked to comment on a number of areas -- from capital budgeting to the Congressional budget process -- that are currently the subject of intense debate by policy practicioners. For this reason, the draft study submitted on September 9 was organized as a series of topical discussions on the major points, rather than as a comprehensive treatise on the broad topic of budget accounting and control mechanisms. These discussions, and any recommendations for further study or decision that flow from them, are summarized in the three sections below.

CAPITAL BUDGETING

Since its inception, the Federal government has kept its books on a strict cash basis. While the budget provides a means for recording and measuring the cash flow consequences of longer term financial commitments, the major control emphasis has been placed on balancing the cash drawer within any fiscal year.

As the Federal government has undertaken ever-broader responsibilities, and as Federal borrowing demands have risen, questions have been raised about the adequacy of simple cash accounting as a mechanism for accurately reflecting the stream of costs and benefits that flows through the budget accounts. In particular, given the heavy involvement of the Federal government in purchasing goods which have many years of useful life, increasing concern has been raised over the years about whether the present annual expensing method adequately reflects the stream of costs associated with Federal undertakings.

This concern has usually been expressed in the form of proposals to establish, within the Federal chart of accounts, a separate capital budget, which would distinguish outlays (and associated revenues or borrowings) for capital goods from outlays for current expenses. While these proposals take many forms, the central thrust has been to adopt a method for expensing capital costs that is conceptually separate and discrete from cash accounting. Most commonly, the notion of depreciation expensing is discussed.

In arguing for such treatment, many proponents appeal to the treatment of capital costs under generally-accepted accounting procedures in the private, for-profit sector, and argue that such treatment more accurately balances the flow of costs with capital consumption. Others point to the example of State and local governments, which generally maintain separate and distinct capital and operating accounts. Beyond questions of accounting theory and practice, capital budgeting proponents note that projects with long-term benefits are often subordinated to projects with short-term payoff in the present system in which all investments are denominated in current-year dollars, regardless of the real discounted present value of their benefits.

ques whether moving to cap. budg structure would be meaningful

The study examines each of these lines of argument in turn.

Private Sector Analogies

The Working Group's study concludes that appeals to treatment comparable to private sector capitalization/depreciation fail to hold water for the following reasons:

Lack of Profit Motive

Depreciation treatment of capital costs allows a better matching of costs and revenues for the purpose of calculating profits. Lacking a profit motive, the Federal government has no compulsion along these lines -- and probably never should.

Quantifying Matching Benefits

In private sector accounting, the returns against which capital costs are depreciated are denominated in dollars and cents, allowing comparison of comparable costs and benefits. By contrast, the Federal government most often invests for vague and unquantifiable benefits for the public at large. Matching precise dollar estimates of costs to vague notions of general benefit adds little or nothing to the analysis of Federal investment decisions.

Capitalization by Ownership

Most proposals call for the Federal budget to capitalize outlays for grants to States and localities that provide investment capital. Yet in such cases, ownership of the physical assets passes out of the control of the Federal government. Under generally accepted accounting principles, private sector grants to, say, hospital building drives are (a) expensed by the grantor and (b) capitalized by the grantee. Hence, there is no private sector analogy to capitalization/depreciation of investments that pass beyond Federal ownership.

Segmenting the Balance Sheet

While the private sector analogy appeals to the notion of an "income statement/balance sheet" treatment of Federal operations, which has considerable intuitive appeal, capitalization of assets alone will not do the job. The other side of the story is accrual of liabilities. Yet the major asset that the Federal government has to back up unfunded liabilities is sovereign powers of taxation, not collateralized physical assets. In this context, looking only at the physical investment portion of the asset side of the ledger could seriously distort Federal investment decisions.

State & Local Practice Analogies

Those with experience in State and local governments often argue that separate budgets for capital spending at the State and local level work by matching the useful life of physical investments to the maturity of financial instruments sold to finance their installation. While this argument has appeal, the study concludes that:

Constitutional Limitations on Debt

The major force driving capital budgeting at the State and local level is the presence of Constitutional limitations on borrowing, not greater sophistication in accounting theory. In the absence of these limits, it is unclear that governments would subject themselves to the discipline of limiting borrowing to the amount needed to finance discrete projects.

Effects on Borrowing Practices

Moreover, given the heavy influence of Federal security issuances on the market for debt of all kinds, it is not at all clear that the maturity structure of Federal debt offerings should be mechanistically determined by a schedule of project financings.

The "Second Class Spending" Problem

Even if the Federal government proposed to circumvent this problem to a degree by continuing to market securities to finance non-capital expenditures, a separate capital budget along State and local lines would create two classes of activities -- tax-financed "non-capital spending" and debt-financed capital spending. As the Congressional enthusiasm for placing favored categories of spending off-budget indicates, there will be strong temptations to encode a fairly expansive definition of "capital". The financial condition of New York City in 1975 is a testimony to the financial direction of such a system.

The Thrust of the Debate

Whatever the merits of the accounting arguments involved, it is the latter temptation that drives most active consideration of capital budgeting initiatives. The prevailing notion informing most actors in the debate is that present accounting treatment forces needed long-term investments to compete in the Federal budget process with outlays for short-term payoffs. Given the assumed bias of the political system toward short-term payoffs, this argument asserts that longer-payoff programs -- notably "needed public investments in infrastructure" -- are dangerously short-changed.

Hence, the thrust of the argument is that the short-run costs of long-run projects should be <u>written down on a depreciation basis</u> in order to make them more appealing vis a vis dollar-for-dollar pricing of current costs.

Setting aside the question of what should fall into such a privileged category, this is a dangerous tendency to install in the Federal budget process. For one of the greatest public goods created by the Federal government is the <u>full faith and credit of the Treasury</u>. Any supposed discipline which attempts to divorce the financial commitments of the Federal government from the short-run income available to it should be viewed with deep suspicion.

The plain fact is that, whatever method the Federal government uses to weigh policy decisions and make resource allocations, the government still requires comprehensive cash accounting, at least in the aggregate, to ensure that spending and revenue policy is made in light of their effects on government cash flow. Depreciation treatment or other expedients cannot make the cash disbursements needed to finance investments go away. In fact, were such approaches installed in the budget in lieu of current cash flow treatment, they would seriously distort, rather than aid, Federal budget policymaking.

Enhanced Capital Planning

An ancillary issue in the capital budgeting debate is the question of whether the Federal government should undertake expanded analysis and planning to better allocate whatever resources it expends in support of "infrastructure" development. Claiming that present knowledge about national needs and Federal efforts is woefully inadequate, capital budgeting exponents call for greatly increased data collection, analysis and reporting requirements designed to deduce the "right" scope and composition of Federal efforts in support of infrastructure development.

The study examines the problems raised by enhanced capital planning in considerable detail. The conclusion it draws is that efforts to divine the "right" amount of infrastructure through Federal central planning have no more intrinsic merit than any other central planning model. Specifically --

- -- Proponents claim that infrastructure needs can be empirically determined through engineering standards and economic analysis. Yet the perceived level of "needs" is in fact the result of a raft of arguable policy judgements about appropriate measures of need.

- -- Proponents infer that the desired level of public investment is manifest in demographic and industrial development trends. Yet the demand for public goods is in fact elastic depending on pricing policies and other cost factors which physical inventories will miss.

- -- While standard policy approaches tend to deduce "needs" in isolation, investment decisions for infrastructure offer substitutes, such as intermodal tradeoffs in transportation, that confound needs determinations based solely on item inventories.

-- In general, isolating capital investments for study misses the fact that non-capital inputs may perform the same or better levels of service at lower cost.

-- Finally, determination of Federal investment on the basis of meeting "unmet needs" ignores the tendency of Federal spending in these areas to displace public and private spending that would take place in the absence of Federal intervention.

In all, the study offers sufficient reason for caution on the part of the Administration in responding to public and Congressional pressure for enhanced attention to "capital budgeting" and "capital needs assessment".

BUDGET PROCESS ISSUES

The second session of the study deals with a wide range of technical and procedural issues raised in discussions of whether changes in the process of Federal budgetmaking are warranted.

The first part of this section analyzes the recommendations recently unveiled by the Committee for Economic Development on changes in the budget process. Essentially, they have recommended:

-- Bringing all off-budget items on-budget;

-- Greater technical coordination between Congressional and Executive Branches with respect to economic assumptions and definitional differences;

-- Enhanced credit controls; and

-- Merged consideration of spending programs and "tax expenditures" reaching the same areas of endeavor.

After examining the on/off-budget question, the study concludes that there is a strong case for increased efforts on the part of the Administration to bring off-budget items on-budget during the next budget cycle. With respect to technical coordination, the study indicates that, while efforts are underway to solve definitional conflicts with the Congress, efforts to integrate economic assumptions and estimating methods could lead to an unacceptable derogation of Executive Branch authority. The study approves of most recommendations of the CED on credit control, but raises difficulties with their proposed treatment of "tax expenditures".

Internal Congressional Procedures

In reviewing recommendations that have been made, by CED and others, about the existing budget process, the study considers a number of expedients, such as multi-year budgeting. In the end, we conclude that the pressure on the present process is driven by the fact that the existing system doesn't mesh well with the legislative machinery needed to actually implement decisions made during the process.

The major problems facing the process at this stage of its development are:

- -- It is viewed as consuming a disproportionate amount of the Congressional calendar each year.
- -- It has come to be the major forum in which symbolic grandstand votes are forced on myriad special interest appeals;
- -- The heavy reliance on reconciliation during 1981 and 1982 is viewed by Congressional authorizing committees as subverting and subordinating the regular legislative process; and
- -- The structure of the Resolution itself -- a scheme of functional categories that bear little relation to the structure of the appropriations process -- makes it ill-suited to effective enforcement.

We conclude that <u>any</u> reform proposal should be judged on whether it alleviates or exacerbates these pressures. For unless some better way is found to make the decisions reached in the budget process translatable into concrete policy action by authorizing and appropriations committees, the hostility felt on both ends of the Mall toward the outcome of the present process may make effective budgeting impossible.

Our study discusses a reform proposal which appears to meet these criteria. It calls for:

- -- Having each Congress adopt, at the beginning of its First Session, a binding four-year budget that would remain in force for <u>both</u> the First and Second Sessions.
- -- Adopting a new functional category scheme that breaks the budget into components that track well with the existing enforcement structure:

- o Entitlements would be separated from discretionary programs.

- o Discretionary spending authority would be allocated en bloc to the Appropriations Committee.

- o Items such as pay increases would be established as a separate element of the resolution.

-- Rather than the current practice of Concurrent Resolutions in which the President has no role, budget resolutions could be converted to Joint Resolutions, which require the President's signature to become effective.

The study concludes that some arrangement along these lines would go a long way toward rendering the budget enforceable. Given a two-year horizon to enact conforming authorizing legislation, the legislative process would be returned to the standing Committees of jurisdiction and existing Congressional power lines, in a situation where aggregate targets would bind all authorizing legislation. Appropriations Committees could shuffle priorities among their various subcommittees each year, and move forward within their own logic to produce annual appropriations bills. Perhaps most importantly, requiring Presidential approval of the biennial product would ensure that the Congress reaches an accommodation with the Executive Branch on broad policy priorities and spending/revenue policy. The result, all told, could be a Federal budget with real legitimacy.

MAJOR CHANGES/CONSTITUTIONAL ISSUES

Going beyond process issues implied in efforts to incrementally reform existing practice, the Working Group was also asked to consider fundamental changes in the way in which power is distributed or restrained in the Federal Government. Two major areas addressed by the study are the question of granting the President line item veto authority, and the questions that need to be answered should the Administration decide to go forward with its own concrete proposal to amend the Constitution to require a balanced budget.

Line Item Veto Authority

Based on a survey of the way in which the forty-three Governors with line-item veto authority are granted their powers, the study identifies a wide range of different powers subsumed under the "item veto" label. In some states, Governors can only veto entire sections of bills; in others, they are empowered to reach into appropriations acts to change specific enumerations. We conclude that the question of what the President is allowed to sever from a bill is the key to the degree of power conferred by legislative veto authority.

One important conclusion of the study is that it is <u>not necessary to amend the Constitution</u> in order to confer line item veto authority on the President. Article I, section 7 of the Constitution requires that "every bill" be presented to the President for his approval or disapproval, but the term "bill" is not further defined. In the past, the Congress has considered, but never had both Houses adopt, legislation which would have defined the term "bill" to mean any section of a piece of legislation enrolled for the President's signature. In effect, this would have permitted the veto, as a discrete act, of any section of a bill that met with the President's disapproval.

Such a grant of authority, of course, could be overridden by subsequent legislation, or could be waived by the Congress in a proviso to individual pieces of legislation. Yet the study concludes that the approach has merit if a decision is made to pursue such a grant of authority during this Administration.

Beyond this question, the study points up the need for further clarification of technical issues prior to any Administration announcement of support for such a grant of authority.

<u>Balanced Budget Amendment</u>

In its concluding section, the study discusses the technical issues that need to be resolved should the Administration decide to put forward its own proposal to amend the Constitution to require a balanced budget.

The discussion highlights the disjunction between spending commitments (in the form of obligations or contracts) and actual revenue and outlay flows. Given the weak interconnection between commitments and disbursements, the major challenge posed to budgetary control under a balanced budget regime will be ensuring the tools needed to guarantee accounting balance in the face of marked changes in circumstances toward the end of each fiscal year.

In assessing methods to cope with this problem, it becomes clear that the choices are a trade-off between:

- -- Escape clauses, which would permit a technical short-term breach of the exact balance requirement in extraordinary circumstances; and

-- Extraordinary spending control or revenue-raising powers granted to the President.

Given the Administration's view that escape clauses are to be held to the absolute minimum, the Administration should move forward to fashion the sort of extraordinary cash management authorities needed to ensure that a balanced budget requirement is technically enforceable. Setting aside the question of extraordinary revenue powers, which are almost certainly undesirable and would, in any event, require amendments to Article I powers of the Congress, the most promising areas of study are:

-- Tying disbursement controls more tightly to the obligation and contracting process early in the year.

-- Line item veto authority for appropriations bills.

-- Broad transfer and impoundment authorities to control within - year obligations; and

-- Defined procedures to control actual cash disbursements in the event of a year-end revenue shortfall.

While all of these issues are more appropriately addressed in enabling legislation than in the Constitution itself, our study makes clear that these questions must be seriously addressed before we can specify a workable Constitutional amendment. Should a decision be made to introduce an Administration proposal, a Working Group should be established to wrestle with these questions immediately thereafter.