A Capital Budget for Public Investment

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A strong and productive economy is the key to meeting our future fiscal challenges, from providing unmet entitlements to reversing our current account deficit. We need therefore to establish budgetary priorities that will make our economy more productive in the future. The government's current pattern of spending, however, does not reflect this imperative. Over the last several decades, the portion of the federal budget going to current consumption has increased, while that devoted to what might legitimately be called public investment has declined. Indeed, the federal budget does not even officially distinguish between spending on productivity-enhancing investment and spending on current consumption.

As a result, the federal government currently does not adequately fund investment in our nation's physical infrastructure or knowledge capital upon which a more productive economy rests.

America Is Falling Behind

From 1950 to 1970, we devoted 3 percent of GDP to spending on infrastructure—roads, bridges, waterways, electrical grids, and other essentials of a modern and competitive economy. Since 1980, we have been spending well less than 2 percent, resulting in a huge accumulated shortfall of needed investment. Not surprisingly, infrastructure bottlenecks—traffic-choked roads, clogged-up ports, uneven broadband access—are undermining our nation's efficiency. The biannual report of the American Society of Civil Engineers offers these and other examples of an inadequate public infrastructure:

> Over a quarter of the nation's bridges are structurally deficient or functionally obsolete.
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> Most of our airports will not be able to accommodate the new jumbo jets scheduled for introduction later this decade or handle the expected growth in the number of small regional jets necessary for commerce for smaller business centers.
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> Nearly 50 percent of the 257 waterway locks operated by the U.S. Army Corps of Engineers are functionally obsolete.
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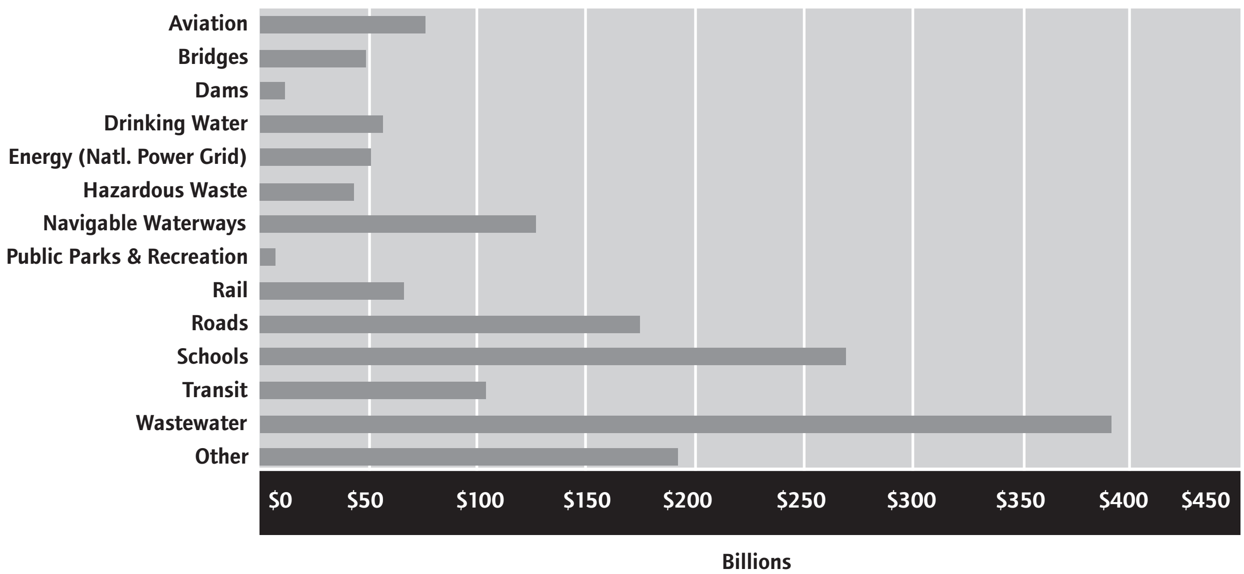
> Poor road conditions cost U.S. motorists \$54 billion a year in automotive repairs and operating costs; these same motorists spend a total of 3.5 billion hours a year stuck in traffic.

We are also now lagging behind in the infrastructure of the information age. Only 33 percent of households have access to broadband, which is increasingly

INFRASTRUCTURE INVESTMENT NEEDED



Source: American Society of Civil Engineers.

critical for successful commerce. The United States now ranks 16th in the world in broadband penetration. And the costs of broadband in the United States are rising relative to those in other countries, putting American-based companies at a disadvantage. U.S. consumers, for example, are forced to pay nearly twice as much as their Japanese counterparts for connections that are 20 times slower.

We have also underinvested in basic science and research and development. Basic science research is important because it makes possible the technological breakthroughs that could revolutionize the economy and the way we live. It is also responsible for the innovation from which American companies derive premium returns on capital. But research and development spending as a share of GDP has declined over the last two decades, as the federal government's support for research and development has shrunk.

Finally, we have not kept up with other countries in the training of skilled workers, particularly scientists and engineers. The United States now graduates fewer engineers per capita than nearly all other advanced industrialized countries. Some American firms are thus beginning to complain about the shortage of skilled workers in some sectors of the economy, forcing them to rely more on outsourcing than they would like. In sum, underinvestment in research and development, a less than world-class infrastructure, and an inadequately trained workforce are acting as a drag on American economic growth and thus on future living standards.

How to Fix the Problem

Correcting this problem by ensuring that public investment is adequately funded in the future will require institutional reform. The United States underinvests in public capital in part because it neither properly accounts for its public capital expenditures nor properly finances them. The U.S. federal government is virtually the only government among the world's advanced industrialized countries not to have a formal capital budget that separates public investment outlays from current consumption expenditures. And unlike state and local governments, which use special purpose bonds to fund specific capital needs, the federal government finances public infrastructure projects out of general government revenues or out of special trust funds, like the Highway Trust Fund. This makes no sense since public investment is different from current government expenditures in both character and economic consequences. Most public investment, especially most public infrastructure projects, should be paid for over the useful life of the investment, and the fact that it earns a return on investment in the form of higher productivity and increased tax revenues should be reflected in how we account for it.

The first step, then, in correcting our public investment deficit would be to establish a formal capital budget. A federal capital budget would not alone correct the problem of chronic underinvestment in public capital. But it would make our government more accountable for its spending priorities and give us the tools to finance public investment in a way that is fiscally responsible. A federal capital budget would separate in a transparent way our nation's public investment from our government's current outlays. Capital budgets are used by private businesses—as well as by most cities and states—because they help management distinguish between ordinary operating expenses that a company routinely incurs during the course of doing business and extraordinary ones that add to a business's capacity to grow and thus should be depreciated over a number of years.

Discipline, Fiscal Responsibility, and Flexibility

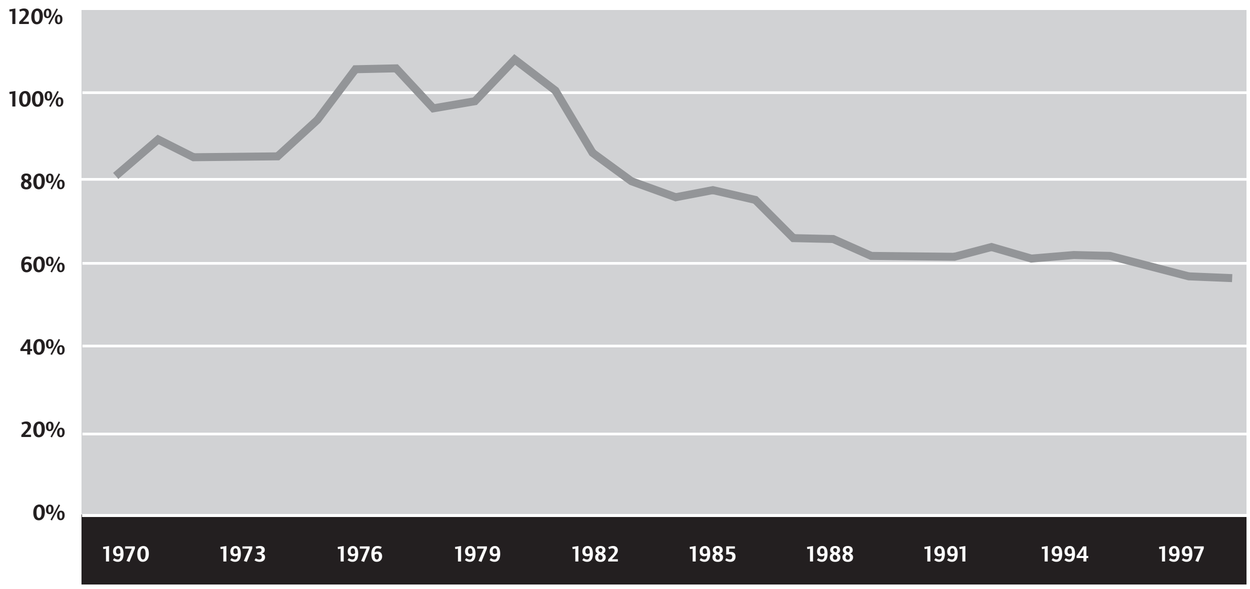
Constructing a capital budget would help improve American government in three ways:

First, it would impose some necessary discipline on the discussion of our nation's budget and public debt. It is now too easy to become alarmed by growing deficits, on the one hand, or too complacent about shrinking deficits, on the other. Because the current budget makes no distinction between consumption and investment, it does not allow us to make intelligent choices about our spending priorities. The introduction of a capital budget would force a different and more productive debate over the budget. Above all, it would enable us more easily to ask the right questions: Spending for what purpose? Borrowing for what purpose? Without a capital budget, we are unable to differentiate good spending from profligate spending, virtuous debt from vicious debt. But with a capital budget, the public discourse would shift the discussion to a much more fruitful discussion of public spending for consumption versus public spending for investment. There will of course still be disagreements about the level of government spending, and the amount of public investment needed, but at least the debate will more likely address the right issues.

Underinvestment in research and development, a world-class infrastructure, and an adequately trained workforce act as drags on U.S. economic growth.

Second, it would allow us to develop a more sophisticated and more useful approach to fiscal responsibility. Today, the notion of fiscal responsibility tends to mean either a balanced budget or a balanced budget over a business cycle. Again, this overly simplistic idea fails to distinguish between the very different nature of capital expenditures and ordinary ones. With a capital budget, it would be easier to develop a consensus over some broad fiscal principles. In general, it would be reasonable to get centrists from both parties to agree that the current expense budget should be balanced over the economic cycle. And based on sound economic principles it would also be reasonable to be able to develop a consensus that a capital budget could be financed in part by government borrowing, which would be paid back over a period of years. Capital outlays would be seen for what they are—net additions to the government's capital stock, which like the capital assets of a company, would be depreciated over their useful life. Thus, with the initiation of a capital budget, additions to the national federal debt would be matched by additions to our national federal assets. Accordingly, the capital budget

FEDERAL SPENDING FOR INFRASTRUCTURE AS A PERCENTAGE OF GROSS DOMESTIC PRODUCT, 1970–98



Source: Congressional Budget Office.

would provide a basic guideline for government borrowing. Any deficit that was incurred beyond the capital budget would need to be justified either as a matter of macroeconomic policy to stimulate the economy or as a matter of a national emergency. And over the years, the greater part of our national debt would gradually become the financial counterpart of our public productive capital, as the late eminent economist Robert Heilbroner suggested.

Third, it would also give us more flexibility for financing needed public investment in our nation's future while helping us maintain fiscal discipline over current expenditures. Today, we try to ensure a certain level of infrastructure spending by using trust funds with dedicated revenue streams, such as the highway and airport trust funds. But while this may ensure that these programs are insulated from budget-cutting pressures, it also ties the government's hands, reducing its ability to finance the optimal level and mix of public investment. Trust funds thus reduce the government's flexibility, and are subject to abuse by powerful political constituencies that can skew government spending. A capital budget would give the government much more flexibility to match government spending with our public investment needs while at the same time ensuring that public investment was adequately funded. It would allow us to reduce federal spending on highways if that was warranted and increase spending on broadband without the current constraints imposed by designated trust funds.

How to Finance a Capital Budget

A capital budget in any given year could be financed by a combination of tax revenues and government borrowing. The exact amount of government borrowing would depend in part on the macroeconomic conditions prevailing at the time and in part on the projections relating to the return on public investment. The other institutional innovation needed to help correct our public investment relates to the way government borrows for purposes of funding government activities.

As in accounting for government expenditures in general, the government currently makes no distinction between borrowing for general current expenditures or for particular investment projects.

But this may not be the best use of the capital markets. State and local governments routinely use special-purpose bonds to finance needed capital improvements and investments, and so should the federal government. Special purpose bonds, for example, could be used for certain new infrastructure improvements and for certain new energy development programs that could pay for themselves over time.

Congress should therefore ask the Treasury Department to develop a new class of 30- to 50-year bonds to finance public infrastructure and other public investment projects. This new class of bonds would technically increase the national debt, but because they would fund public investment projects that would have positive returns for the economy they would not have the same consequences as other deficit spending.

There is a strong case for the introduction of long-term special purpose bonds at this time, given the big backlog of public investment needs and the availability of relatively cheap capital. Issuing long-term bonds for specific designated projects would be a financially wise use of debt because the federal government would be able to take advantage of historically low interest rates to replenish key parts of America's public capital. The higher economic growth rates that would result from these investments in turn would increase tax revenues and expand the country's tax base, reducing the burden of future government programs, including Social Security and Medicare. Thus, the returns on this faster economic growth would far exceed any increased government borrowing costs.

The Heart of Sound Modern Government

Together, these two institutional innovations—a federal capital budget and special purpose long-term bonds—would give policymakers the tools they need to correct America's public investment deficit. The idea of a capital budget is not a new idea. Nor is it a conservative or liberal idea. First proposed by Franklin Roosevelt in 1939, a federal capital budget was seriously considered by both the Johnson and Reagan administrations. The principal objection to the idea over the years has been the fear that capital budgeting would open the door to fiscal profligacy in which spending was redesignated as investment. The idea of capital expenditure, some have argued, is an inherently vague notion subject to political abuse. But this concern can be addressed in a responsible way. In the case of private business, we have been able to develop accounting rules and procedures for determining whether an expenditure is an ordinary expense or a capital investment, and if the latter how quickly it should be depreciated. So we should be able to develop similar rules for government spending. Indeed, the Office of Management and Budget (OMB) already publishes an annual breakdown of what it considers to be public investment. The OMB's methodology, while not flawless, could be a starting point for an expert commission to develop clearer guidelines for capital budgeting.

Just as private firms and most states use capital budgeting, a federal capital budget would separate public investment, which expands our capacity to grow, from current consumption outlays.

The overarching notion guiding whether an expenditure should be included in the capital budget would be similar to the one already used by the OMB in its annual breakdown of government expenses—namely, whether a particular expenditure is a public investment or an ordinary operating expense. On average, as noted earlier, a public investment produces a positive return to the economy and increases future tax revenues as a result of stronger and more sustained economic growth. In general, three major categories of expenditures would meet this criterion of productivity-related investment that would increase future tax receipts: research and development; capital expenditures for infrastructure such as roads and bridges; and education and training. These investments are capital assets, and should be treated as such, and each year in keeping with good accounting principles the interest costs and depreciation expenses relating to these initial capital investments should be written off as part of the normal operating budget. By contrast, most military, health care, and transfer-program spending would be categorized as current consumption. Again, a bipartisan body would need to develop some standard rules for the depreciation of different kinds of public investment, just as we have developed rules for the write-off of research and development by private companies.

Overcoming the opposition to the establishment of a public capital budget will not be easy. But reintroducing the idea in itself would help spur a much needed debate about our nation's spending priorities and about the proper level of government debt. The public investment deficit has received much less attention than the budget deficit, but it threatens our economic future all the same. Properly accounting for what the federal government spends its money on and how it finances government expenditures goes to the very heart of sound modern government. For a nation that considers itself on the cutting edge of international commerce, it is an anomaly of historic proportion that we continue to deny ourselves this indispensable tool of modern capitalism.❖