February 12, 1988

R_X FOR THE AILING FEDERAL BUDGET PROCESS

INTRODUCTION

Item: On February 18, 1988, Ronald Reagan is due to submit to Congress his Fiscal Year 1989 budget. Congress then is supposed to complete work on thirteen appropriations bills by October 1, 1988, when Fiscal Year 1989 begins.

Item: President Reagan submitted his FY 1988 budget in January 1987, projecting a deficit of $107.8 billion, which met the guidelines set by the Gramm-Rudman-Hollings Deficit Reduction Act. In his budget statement, the President threw down the gauntlet to Congress: "In submitting this budget, I am keeping my part of the bargain--and on schedule. I expect Congress to do the same."[1] Congressional Democrats declared the President's budget "dead on arrival."

Item: On October 19, 1987--Black Monday--the Dow Jones Industrial Average plummeted 508 points. The Reagan Administration and Congress rushed to the budget summit table to signal, as they put it, to the world financial markets that a compromise for the 1988 budget could be reached. The negotiators believed that by fashioning a budget agreement, and avoiding automatic spending cuts as called for by Gramm-Rudman-Hollings, they would demonstrate the leadership necessary to calm jittery stock markets. They were wrong on two counts. First, the deficit was not the main cause of the stock market free fall. In fact, the federal deficit had fallen from 5 percent of Gross National Product (GNP) to 3.4 percent of GNP during the 1987 fiscal year. Second, a budget compromise promising $23 billion in new taxes and only $6 billion in unspecified domestic spending cuts--but no specific program reductions--could hardly be described as reassuring to financial markets.

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1. Stephen Gettinger, "Little New in $1 Trillion 1988 Budget Request," *Congressional Quarterly*, January 10, 1987, p. 44.

Rather than embracing the compromise, Wall Street reacted with understandable skepticism, and stocks drifted.[2]

Item: Three days before Christmas, Reagan signed a Continuing Resolution, a catchall spending bill combining the thirteen appropriations measures that Congress had failed to pass as separate spending bills. He also signed the deficit reduction bill referred to as Reconciliation. The spending bill, nearly three months late, called for $604 billion in outlays, the costliest single bill in United States history. For the second year in a row Congress combined all its thirteen regular appropriations bills in one 2,100-page package weighing 30 pounds.

The moral of this sad chronicle: the budget process has broken down. To avoid a repeat of last year's debacle, budget reform is needed politically and technically.

Inaccurate Information. Politically, the President should be granted what 43 governors now possess--a line-item veto. In addition, Congress should pass two separate appropriations bills, thus allowing itself ample opportunity to examine the legislation. Congress also should strongly consider a balanced budget amendment and adoption of biennial budgets.

Technically, Congress and the American people need more accurate information about the budget and the deficit. Current accounting practices for the federal budget do not present an accurate picture for evaluating the government's obligations. Congress needs to adopt the accounting system currently required of all publicly held corporations as well as many state and local governments, known as generally accepted accounting principles (GAAP). Congress also needs a more accurate measure of total public sector borrowing. This should include state and local as well as federal net borrowing.

Without adopting the necessary reforms, Congress and the American people are likely to witness a recurrence of last year's end-of-the-year rush to enact a budget. To avoid the eleventh-hour crunch, reform must take place in Congress.

REFORMING THE BUDGET PROCESS

The 1974 Budget Act created a strict timetable for budget legislation. Its aim was to end the notorious practice of voting on spending bills at the eleventh hour. But since 1982, Congress has not even come close to meeting its own deadline for passing the Budget Resolution, which establishes broad spending and tax guidelines.[3] That "deadline" is April 15; it was May 15 prior to the Gramm-Rudman-Hollings Deficit Reduction Act of 1985. In fact, only once in the past thirteen years has Congress met its self-imposed timetable. Over the past eight years, Congress on

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2. John E. Buttarazzi, "A Spending Freeze, Not New Taxes, Will Solve the Budget Crisis," Heritage Foundation *Executive Memorandum* No. 181, December 1, 1987.

3. Lawrence J. Haas, "If All Else Fails, Reform," *National Journal*, July 4, 1987, pp. 1713-1714.

average has been over two months late in passing the Budget Resolution.[4] Delays in passing the Resolution have resulted in Congress taking bills that should be passed separately and packaging them into larger measures.

This past December, Reagan once again faced an "all or nothing" choice when Congress dropped the mammoth $604 billion catchall appropriations bill on his desk. It was designed to keep dozens of federal agencies, from the entire Department of Defense to small programs benefiting constituents of powerful lawmakers, running through the fiscal year. To keep critical military and domestic programs functioning, Reagan felt forced to agree to millions of dollars of special interest pork. Examples: $500,000 to study whether vegetable oil can be made into ink; $60,000 to establish a Belgian Endive Research Center in Massachusetts; $260,000 for cranberry research; $8 million to build schools for North African Jews living in France; $25 million to build an airport less than twenty miles from Dallas-Fort Worth International Airport that the Federal Aviation Administration does not even want; and $250,000 for pig and exotic plant control at the Haleakala National Park in Hawaii.[5]

Line-Item Veto

Much of this special interest pork-barrel spending could be trimmed if Congress were to give the President the power to veto line items in a spending bill. This would not amount to excessive power for the President. Providing the line-item veto through an amendment to the President's rescission powers would enable the President to rescind individual appropriations items without tearing up the entire bill. The rescission then would stand unless Congress explicitly overrode the veto with a simple majority in each chamber.[6] Lawmakers thus still would have the power to enforce their will through a simple majority; the line-item veto simply would force each member to register his vote openly on each item.

Checks and Balances. Such a change would restore checks and balances to the budget process. Eleventh-hour budgets with last minute funding bills and resolutions have placed the Executive Branch at an increasing disadvantage. Under current law, the President's only recourse is to petition Congress to rescind specific spending on an item, but unless both Houses of Congress approve the rescission by a two-thirds vote within 45 days, the President must spend the funds. In 1986, Congress approved just four of Reagan's 156 rescission requests. Providing the President with line-item veto authority, through an amendment to the rescission process, would improve the executive-legislative balance by strengthening the President's powers to force an up-or-down vote on each item.[7]

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4. Stephen Moore, "Congress's Dirty Dozen: Budget Process Horror Stories," Heritage Foundation *Backgrounder* No. 602, September 10, 1987.

5. Doug Bandow, "The Dirty Secrets of the 1987 Continuing Resolution," Heritage Foundation *Backgrounder* No. 630, February 10, 1988.

6. John M. Palffy, "The Congressional Budget Process," *Mandate for Leadership II*, Stuart M. Butler, Michael Sanera, and W. Bruce Weinrod, eds. (Washington, D.C.: The Heritage Foundation, 1984), p. 397.

7. For more information on the line-item veto, see John Palffy, "Line-Item Veto: Trimming the Pork," Heritage Foundation *Backgrounder* No. 343, April 3, 1984.

The line-item veto also would partially relieve congressmen of local political pressure to "bring home the bacon." Legislators could attach the most parochial, nongermane provisions, yet the President would feel the political heat when he exercised his veto.

Biennial Budgeting

Recent experience indicates that Congress is incapable of completing its budget business within twelve months. Some 22 states use biennial budgeting as an alternative to annual budget wrangling. If Congress were to adopt a two-year budget cycle, it could avoid last minute continuing resolutions.

Under a two-year budget, Congress would enact a Budget Resolution setting out broad tax and spending guidelines during the first year of the congressional session. In contrast to today's Budget Resolution, which is little more than a vague promise, the Resolution under the new arrangement would be a statute requiring the President's signature. The result: spending levels would have to be enforced, or Congress would be breaking the law. Also during the first year, program committees would hold hearings and debates on authorizing legislation to set spending limits for individual programs. Authorizing bills would have to be reported out before the end of the year.[8]

In the second year of the session, under a biennial budget, the primary budgetary task would be for the appropriations committees to report out separate appropriations bills for the President's signature. These bills would set the actual outlays for individual programs.

The budget compromise reached following the stock market crash of October 1987 establishes broad guidelines for deficit reduction over a two-year period. Although a slight improvement over the current process, the agreement still fails to address the central problem--that is, the process itself needs drastic overhaul and a new framework. Biennial budgeting would be an important step toward providing the necessary framework.

Balanced Budget Amendment

Perhaps the most effective political means of injecting discipline into the budget process is to force Congress to spend no more than what it receives in revenue. A constitutional amendment mandating a balanced budget would provide a clear goal for Congress. The Gramm-Rudman-Hollings Deficit Reduction Act calls for annual reductions in the deficit until a balanced budget is reached in 1991. Despite the law's commendable intentions, deficit targets already have been missed; even when targets are met, Congress has done so through accounting gimmicks that achieve success on paper. Examples: payments have been shifted into the next fiscal year, and items have been shifted off the budget.

Stimulated by Reagan tax cuts, government revenues have increased dramatically since 1983, but government spending has grown even faster.

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8. Palffy, *op. cit.*

In fact, after accounting for inflation, spending has increased by 34 percent in real terms since 1981. A constitutional amendment requiring Congress to balance the budget would force Congress not to spend more than it collects. Exceptions could be written into the amendment to provide flexibility during emergencies such as war. A key component of any balanced budget amendment would be inclusion of a tax limitation provision. Since the spending side of the federal ledger consistently outstrips the revenue side (despite the record increases in revenues under the Reagan Administration), a tax limitation rule is needed to prevent Congress from increasing its spending at the expense of American taxpayers.[9]

REFORMING THE GOVERNMENT'S BUDGET ACCOUNTS

The federal government reported a budget deficit for Fiscal Year 1987 of $148 billion. Looking at the figures another way reveals red ink in excess of $300 billion. It is just a matter of how government spending, taxes, and borrowing are measured. After taking full account of the unfunded federal pension liabilities and other programs currently off-budget, the $300 billion-plus looks more realistic.

If a budget is to be useful as a backdrop for economic policy, it must give an accurate and useful description of how the federal government takes in and spends money. The existing system of accounting hides and distorts more than it reveals, leading to bad information and thus bad policy.

No Distinction. The main problem is that the federal government uses a cash-basis budgeting and accounting system for measuring government spending. Under cash accounting, investment expenditures (such as roads or weapons systems) and current expenses (such as interest payments or food stamps) are treated in the same manner, although they have very different implications for the state of government finances. This accounting system differs greatly from the generally accepted accounting principles (GAAP), which are used in the private sector.

Although the cash-basis budget system provides important quantitative information concerning the government's cash flow, it reveals nothing about the qualitative nature of government expenditures.[10] By treating long-term expenditures the same as current expenses, the cash budget does not make proper allowances for future costs. For example, the liabilities of entitlement programs, such as Social Security and Medicare, which obligate the government to pay benefits in the future do not show up on the Treasury's books. Private sector corporations, by contrast, make provisions in their annual budget, so that they are forced to consider future liabilities when planning for the coming year.

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9. For more information concerning a balanced budget amendment, see Daniel J. Mitchell, "Federal Spending in Crisis: The Case for a Tax Limitation/Balanced Budget Constitutional Amendment," Citizens For a Sound Economy.

10. Rep. Joseph Dioguardi (R-NY), "GAAP's Budget Gaps Will Surprise," *The Wall Street Journal*, November 6, 1987, p. 26.

Cash-basis financial reporting, on the other hand, ignores such obligations and allows elected officials to adopt programs and make promises without acknowledging their full costs in the annual budget. This lack of accountability predictably allows legislators to favor today's voters at the expense of tomorrow's taxpayers.[11] Perhaps not surprisingly, nearly all growth in federal government spending as a percentage of GNP since World War II derives from programs that promise future payments. The only major exception is interest payments. Today's budget thus creates tomorrow's liabilities.[12]

The Credit Budget

The area of the budget in need of the greatest accounting reform is the federal credit budget. Despite borrower subsidies, such as below market interest rates, generous grace periods for repayments, and lower collateral requirements than are found in the private credit markets, federal agencies carry loans as assets on their balance sheets at full face value. No responsible private firm would do that--firms make allowances for the likelihood that money they have lent out might not be repaid.

Budgeting for loan guarantees is even more misleading. A loan guarantee is a government promise to pay a private lender, such as a bank, the principal and interest of a loan in the event of borrower default. Examples of such programs are the Guaranteed Student Loan Program and the Small Business Administration's loans. There is a perception that such guarantees cost the Treasury nothing. Thus even though the federal government assumes a liability with a loan guarantee, and will have to make payments on some of those guarantees, the cash budget treats them as costless until a cash payment actually is required because of a borrower default. Only then is it treated as an actual cost item. Contrary to the perception created by the cash budget, loan guarantees are not free. Guarantees are a subsidy, in that they provide borrowers with more favorable terms than would be available in the private market. In 1986, the federal government provided guarantees for $89.6 billion of new loans at an estimated taxpayer subsidy of $10.2 billion.

Additional Payments Later. By not accounting for such future obligations, Congress makes spending plans without recognizing that it will be forced later on to make additional payments. Worse still, when a guaranteed loan does go into default and the government reimburses the lender, the government assumes the loan and records the defaulted loan on its book as an asset at full face value--even though chances of repayment are small.[13]

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11. Arthur Andersen & Co., *Sound Financial Reporting in the U.S. Government*, February 1986, p. 7.

12. Phillip Longman, "How the Government Cooks the Books," *The Washington Monthly*, August 1987, p. 47.

13. For more information concerning credit reform, see John E. Buttarazzi, "Selling the Federal Loan Portfolio," in *Privatization: A Strategy for Taming the Federal Budget* (Washington, D.C.: The Heritage Foundation), p. 73.

How GAAP Would Improve Accountability

GAAP (also known as accrual accounting) records economic obligations and actions as they occur, not when the bills are paid or taxes collected. Thus it credits the budget for assets that the government will have for years to come and puts liabilities on the books at the time they are incurred. For instance, the cost of a new program that will require future federal funding would, under GAAP, be reflected in current accounts. According to GAAP, there would be two budgets, a capital and an operating budget. Capital spending would be placed in the capital budget, and a charge for depreciation and obsolescence of the capital stock as well as current expenses taken onto the operating budget.[14]

A federal capital budget would give a clearer picture of the government's net worth at any time. Spending that builds up assets for the future is fundamentally different from spending on consumption. When a corporation buys $1 million worth of factory equipment, its net worth does not change. It has exchanged one kind of asset (cash) for its equivalent in another asset (equipment). Costs show up later, in the form of depreciation.[15] When the federal government buys $1 million worth of equipment, however, the books only record $1 million in cash outlays, increasing the deficit by $1 million.[16]

Key Reforms Needed. Implementing a capital budget without other key reforms, however, would be a serious mistake. Whereas capital budgeting would allow the federal government to spread out the costs of acquiring assets over several years, it would not account for future liabilities. Only accrual accounting accounts for future obligations. When a corporation promises a future pension, it must record the current value of that pension as a liability. To provide a clear idea of the government's financial standing, the federal government must do the same.[17]

Using generally accepted accounting principles in assembling the federal budget would yield several benefits. Among them:

◆◆ It would put Social Security and other major entitlement costs on a sound accounting basis.

◆◆ It would allow expenditures for long-term assets, such as major weapons systems and highways, to be budgeted in the form of depreciation charges over the years that the assets were in service.

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14. Michael J. Boskin, "Capital Budget Is a Useful Tool," *The Wall Street Journal*, December 2, 1987, p. 28.

15. Depreciation is the systematic allocation of the cost of an asset over its expected economic life or some other period of time for financial reporting purposes.

16. Jonathan Rauch, "A Capital Idea for the Budget," *National Journal*, December 6, 1986, p. 2949.

17. *Ibid.*

◆◆ It would permit the consolidation of reporting by combining the current cash and credit budgets, which would eliminate much confusion about the scope of the U.S. government's operations and its related debt.[18]

Properly executed, GAAP would permit lawmakers to make more informed choices among capital projects. GAAP would clarify the consequences of government actions for elected officials and all Americans.

HOW GAAP WOULD ALTER THE DEFICIT PICTURE

In 1986, Arthur Andersen & Co., one of the nation's leading public accounting firms, estimated U.S. budget deficits from 1974 to 1984 under cash-basis accounting as well as GAAP. The comparison, summarized in Table 1, is startling.

TABLE 1
CASH BASIS ANNUAL DEFICIT vs. GAAP BASIS ANNUAL DEFICIT
(in billions of dollars)

	Cash Basis Annual Deficit			GAAP Basis Annual Deficit		
Year	Nominal	% GNP	1984 $	Nominal	% GNP	1984 $
1974	6.1	0.4	12.2	95.1	6.9	190.4
1975	53.2	3.6	97.7	152.1	10.3	279.4
1976	73.7	4.5	126.4	188.8	11.5	323.7
1977	53.6	2.9	85.9	224.6	12.1	359.8
1978	59.0	2.8	88.4	215.8	10.3	323.2
1979	40.2	1.7	55.5	256.8	10.9	354.9
1980	73.8	2.9	93.5	322.2	12.5	408.3
1981	78.9	2.7	91.3	264.7	9.2	306.3
1982	127.9	4.2	138.5	314.0	10.3	339.9
1983	207.8	6.4	215.6	395.3	12.3	410.1
1984	185.3	5.2	185.3	333.4	9.3	333.4

Source: Arthur Andersen & Co.

In 1984, the cash-basis deficit was $185.3 billion, while the GAAP deficit was a staggering $333.4 billion. The difference is explained largely by the fact that Social Security and other future entitlement obligations are not fully reflected in the cash budget.

The seemingly enormous 1984 GAAP deficit needs to be placed in historical context. Four years earlier, the last full year that Jimmy Carter controlled the budget, the federal GAAP deficit was $408.3 billion or 12.5 percent of GNP. The 1984 GAAP deficit thus was lower than the 1980 deficit. This is obscured because the deficit currently is stated as a cash deficit, which in 1980 stood at $93.5 billion (in 1984 dollars) or half the 1984 deficit figure.

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18. Arthur Andersen & Co., *op. cit.*

The reason for the wide divergence between the GAAP and cash deficits is that, during the 1960s and 1970s, Congress created or expanded such major entitlement programs as Medicare with small immediate outlays but massive obligations for future Congresses and taxpayers. A large portion of the cash deficit appearing during the Reagan Administration, therefore, is caused by the liquidation of liabilities created during the Carter Administration.[19]

Possible New Abuses. Adoption of GAAP would mean that government books would be kept in much the same way as business accounts. There would be a distinction made as to what constitutes current expenses, investments, and liabilities. Although this would be sound from an accounting point of view, there are problems with it. Without proper safeguards to ensure that spending is properly classified, it could expose the federal budget process to new abuses. In particular, the determination of whether outlays are placed on the capital or operating budget could be influenced unduly by political considerations.[20] Advocates of spending programs might press to have their program classified as a capital outlay so that it would not have to be paid for by current taxes and would not count against the deficit.[21] While a hydroelectric plant is clearly an investment that belongs in the capital budget, spending on education may not be. Some would argue that it is an investment in human capital, and as such, should be placed in the capital budget. Some too would argue that welfare spending is an investment in poor Americans and thus is a capital outlay. If these arguments were accepted, large current outlays would be spread out over many budget years, hiding their true impact.

Strict standards thus must be established as to what is a capital expenditure and what is not. One such standard would be to incorporate the Office of Management and Budget's annual assessment of federal capital outlays, which appears as Special Analysis D in a separate volume of the President's annual Budget. Another solution would be to distinguish between investment and operating expenditures according to guidelines set by the Financial Accounting Standards Board. The Board is an independent organization that sets financial accounting and reporting standards for businesses.

NEEDED: A PUBLIC SECTOR BORROWING REQUIREMENT

The American people and their lawmakers are concerned about the size of the federal deficit because it is taken to be a measure of the impact of government borrowing on the private credit markets. A large deficit is assumed to translate into higher borrowing costs in the form of rising interest rates. Yet the deficiencies in the accounting procedures of the government mean that the true scale of government borrowing actually is unknown.

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19. Diogaurdi, *op. cit.*

20. Gregory J. Ballantine, "Does Washington Need a New Set of Books?....That Special Interests Will Abuse," *The Wall Street Journal*, December 2, 1986, p. 28. See also, Stuart M. Butler, "A Capital Federal Budget: An Escape Hatch to Higher Spending," Heritage Foundation *Executive Memorandum*, No. 142, December 23, 1986.

21. Ballantine, *op. cit.*

The picture is further distorted because the federal deficit only measures--inaccurately--the federal sector, not government borrowing at all levels. A more accurate and relevant measure of government borrowing would take into account all public sector activities--net state and local borrowing as well as federal net borrowing. Even without adopting GAAP, the cash-basis budget would be improved significantly by adopting the procedure used in Britain and many other major countries--called a Public Sector Borrowing Requirement (PSBR). This measurement includes not only the national government deficit or surplus, but also the aggregate state and local deficit or surplus.

Table 2 indicates how a U.S. Public Sector Borrowing Requirement, adjusted for state and local budget deficits or surpluses, would compare with reported federal deficits for the past five years.

TABLE 2
The Public Sector Borrowing Requirement (PSBR)
(in billions of dollars)

	1983	**1984**	**1985**	**1986**
Current Federal Cash Deficits	-207.8	-185.3	-212.3	-220.7
State and Local Surpluses	56.4	70.2	62.5	62.5
Net Adjusted Deficit (PSBR)	-151.4	-115.1	-149.8	-156.7

By law, states and localities must invest their surpluses in Treasury bills, notes, and bonds. Thus nearly a third of the published deficit is the federal government channeling cash through block grants to lower levels, which promptly invest it back with Uncle Sam. This is similar to the Department of Defense running a deficit and the Department of Education running a surplus but only including the Defense deficit in the overall deficit figure. This type of double counting has no net impact on the private credit market.

CONCLUSION

Ronald Reagan's FY 1989 budget will trigger intense discussion about the deficit, spending priorities, and the budget process itself. Policy decisions will have to be made. But before lawmakers can make wise decisions, Congress and the Administration need to know clearly how large the deficit actually is. For this, the federal government requires an accounting system that measures accurately what the government must pay for now and what it will owe in the future. The use of generally accepted accounting principles would provide such a system.

Once policy makers get a clear picture of the true size of the deficit, they must be given the tools and rules necessary to shape deficit reduction policies and a

mechanism to enforce their agreement. This means a line-item veto for the Executive Branch, adherence to established laws such as the Gramm-Rudman-Hollings Deficit Reduction Act, a new budget act that would provide Congress with the necessary time to consider all spending requests properly, and an amendment requiring that Congress not spend more than it takes in.

Christmas Showdown. In his 1988 State of the Union Message, Reagan said what all of Washington knows: "The budget process has broken down, it needs a drastic overhaul. With each ensuing year, the spectacle before the American people is the same:...budget deadlines delayed or missed completely, monstrous continuing resolutions that pack hundreds of billions of dollars worth of federal spending into one bill--and a Federal Government on the brink of default."

The President vividly described the gargantuan size of the reconciliation bill and continuing resolution as "43 pounds of paper and ink." Should Congress again wrap all its appropriations and other legislative business in one package, it must confront a presidential threat not to sign it. With proper reforms, Congress and the President would be able to avoid this showdown next Christmas.

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