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# Resource Allocation: Impediments and Distortions

The question before us today is whether the rules of thumb and categories we have explicitly and implicitly established for resource allocation are appropriate and aligned with our overarching fiscal, programmatic, and political goals. Do they establish incentives to prompt consideration of the kinds of trade-offs that are necessary to achieve these goals? Or do they create distortions and constrain resource allocations and trade-offs that undermine these goals?

Ideally, a budget process should facilitate informed trade-offs among competing objectives, programs, and tools of government. Congressman Charles Stenholm best described the competition that the congressional budget process was intended to inspire: "This process will require many tough choices as priorities are set among worthy programs. But essentially, all programs will be together in the same boat, competing for priority status as we seek to determine how best to allocate the revenues coming into the U.S. Treasury."

## Norms

Given that budgeting inherently involves choosing among competing claims for scarce resources, resource allocation is essentially a political task. Having said this, there are more reasonable and less demanding tests for the resource allocation process. As a general rule, it is healthy for programs and other claims to compete openly against common criteria.

Ideally, important political, economic, and programmatic questions should be raised when considering competing claims in the budget. Key questions include:

- Which goals and programs are most important to the nation?
- Which programs and policies show the greatest effectiveness in achieving these goals?
- Which programs offer greatest efficiency in achieving goals at least cost?
- Which programs are considered to best achieve goals of fairness and equity in the distribution of benefits and costs?

The competition and comparison of claims occurs on a number of levels. Overall priorities among broad areas or missions, such as defense and nondefense discretionary spending, are at times the focus of high-level budget deliberations. More routinely, appropriations committees and federal agencies alike must make choices among competing programs and administrative bureaus for resources. From time to time, policymakers consider the relative efficacy of competing tools of government, such as grants, loans, and changes in the tax code, to assess which has greatest promise in achieving policy goals.

It is difficult to articulate a set of standards for resource allocation for all time. Yet, we can suggest certain benchmarks that such a process should aim for:

- Including all significant costs for each program or activity in the budget, both short- and longer-term;
- Fostering competition among all significant related programs and activities;
- Ensuring that programs have comparable information on costs and performance;
- Permitting trade-offs across the various programs and categories in the budget where appropriate; and
- Providing for periodic reconsideration of existing programs and claims

**Limiting choices**

Budgetary officials and scholars alike have long recognized that it is impossible to comprehensively trade off all claims against each other. Broad program areas lack a common denominator to permit rational comparison between battleships and relief for the poor. The trade-offs are too numerous and complex, and the politics too difficult.

Budget processes and structures, in effect, create rules and categories that facilitate choices by segmenting choices by certain categories, for instance program area, tool, or agency. In many cases, we use incremental principles to focus attention on the changes at the margin, rather than the base of programs. We typically focus trade-offs on programs or activities within a single agency rather than comparing with other similar programs across the entire government. In some cases, we constrain trade-offs based on the nature of the revenue supporting the program, with earmarked revenues devoted to spending programs benefitting contributors. In other cases, trade-offs are constrained based on committee jurisdictions, with tax expenditures being considered by the revenue committees notwithstanding their functional equivalence with related spending programs. Decision-making rules and budget scoring conventions also can influence and possibly bias the resource allocation process.

We have identified eight areas where the rules, short cuts, and institutional boundaries significantly distort resource allocation trade-offs. We think that these constraints produce budgetary decisions that can compromise overall fiscal goals as well as our major national priorities. Specifically, the areas include:

- Tax versus programmatic expenditures;
- Mandatory vs. discretionary spending;
- Capital expenditures;
- Long-term commitments for insurance;

- Treatment of trust funds;
- Treatment of user fees;
- Appropriations account structure; and
- Base vs. incremental spending

We suggest that these areas contribute to systemic resource allocation problems in the budget process:

- Limited trade-offs between related programs that have different budgetary classifications (tax expenditures, mandatory, and discretionary spending) but similar missions;
- Locking in final priorities over the long term;
- Underinvestment relative to other priorities;
- Understatement of costs for major government commitments;
- Choice of overly costly strategies for financing assets; and
- Weakening of periodic review and deliberation over major spending and revenue programs.

Today, we will concentrate on three areas: mandatory vs. discretionary spending, tax expenditures, and capital expenditures.

## Bias of mandatory over discretionary spending

**Background**

An ongoing problem has been the proliferation of mandatory programs that could be more logically funded through annual appropriations. Last year's farm bill continued a long-standing practice of providing mandatory funding for certain agricultural research programs through annual appropriations. In 2005, the House majority leader and the chairman of the House Energy and Commerce Committee created two new mandatory energy programs without any compelling rationale as to why they should not be funded through the give-and-take of the annual appropriations process.

**Existing controls on mandatory programs.** One of the stated reasons for creating the congressional budget process in the mid-1970s was to stem the tide of "backdoor spending." To that end, the budget resolution was created to, in part, impose limits on the amount an authorizing committee could increase mandatory spending. These spending levels are now enforced through points of order. Another point of order was added to block measures increasing entitlement spending during certain points of the budget cycle. Additionally, the budget resolution can direct authorizing committees to report legislation reducing entitlement spending. Finally, the original budget act set up a special process for the appropriations committees to act on bills that created new entitlements.

Congress has successfully used the threat of a point of order to enforce the budget resolution's limits on new entitlement spending. Still, additional mandatory programs are created every year. The importance of the allocations has declined with the advent of the [pay-as you go (PAYGO) rule in the House and Senate. The PAYGO rule effectively catches all bills that would have previously breached the committee's allocations. Other rules prohibiting increases in mandatory spending were generally ineffective.

Another layer of mandatory controls was imposed in 1985 and continued through 2002 when statutory limits were imposed on budget deficits and later on new and expanded entitlements. Under both methods, a breach of the limit triggered automatic reductions in a small group of mandatory programs.

**Forms of mandatory spending.** As a general matter, mandatory spending is spending that is provided outside the annual appropriations process. The largest category is entitlement programs that provide funding to recipients who meet certain eligibility requirements, on the basis of certain formulas set forth in the underlying law establishing the program. But this discussion will focus on programs that are mostly not entitlements but are simply funded through legislation other than an appropriations bill. These programs often have all the characteristics of discretionary programs but have been funded in other measures.

**Incentives for bypassing appropriations.** There are at least three reasons policymakers choose to bypass the appropriations process when establishing new programs:

- *Secure and multi-year/permanent funding*. Unlike discretionary programs that must compete for funding annually, mandatory programs have guaranteed funding on a multi-year or permanent basis. Usually these programs are guaranteed funding unless the authorizing committee targets the program for savings to offset another initiative, or the committee is directed to achieve savings in the initiative, or the committee is directed by the budget resolution to achieve savings through a reconciliation bill.

- *Congressional rules & jurisdiction*. Discretionary and mandatory spending are controlled by separate committees and through separate legislative vehicles. The authorizing committees have little incentive to establish discretionary programs in the authorizing bills because then they lose control over the programs' funding levels since any future funding will be set by the appropriations committees in the appropriations bills. The appropriations committees have little incentive to fund these new programs because they compete for the same pool of resources as other discretionary programs.

- *Congressional patrons*. Programs tend to be created by the committees that most support them. Proponents of new programs may seek an entitlement status for their program in an authorizing bill since the authorizing committees may be more sympathetic.

**Adverse effects.** The impact of backdoor spending on making it more difficult to gain control over these programs and their long-term fiscal effects has been well documented. Other effects have not received a significant amount of attention in the budget process.

- *Absence of competition*. A program granted multi-year funding does not need to compete with other programs that have either different or similar objectives.

- *Less oversight.* Since mandatory funding is provided regardless of performance, the agencies may be less responsive to congressional oversight.

- *Fragmentation in policy setting.* With policy effectively being split between the appropriations and authorizing committees, in addition to the tax-writing committees, policymaking is fragmented. Multiple programs and tax expenditures may have similar but not entirely complementary objectives.

- *"Sticky" spending levels*. Congress obviously has less ability to shape fiscal policy when, to achieve a fiscal target, it must change an existing program to achieve savings rather than merely decrease a program's funding level.

- *Fiscal implications of automatic growth*. Medicare, Medicaid, and other entitlement programs are increasing at a faster rate than the economy. Over the long term, mandatory spending will increasingly crowd out other discretionary priorities, consume an increasing share of the economy, and require higher levels of taxation or debt financing.

**Potential rationale for mandatory funding**. There are some legitimate justifications for bypassing appropriations beyond the simple expediency of securing non-competitive funding.

- *Retirement planning.* Workers pay into Social Security and federal retirement programs believing they will receive a specified benefit when they retire or become disabled. These workers have presumably based their long-term savings decisions on the assumption they will receive future benefits and would not be able to adjust easily if the benefits were reduced.

- *Contractual obligations (actual or implied).* The federal government sometimes enters into binding contractual obligations that may justify mandatory spending.

- *Constitutional requirements*. Some obligations have constitutional foundations, such as the lifetime tenure of Article III judges and the need to provide restitution in the event of a judgment against the United States. These salaries and payments out of the Federal Claims and Judgment account are presumably treated as mandatory for these reasons

- *Economic stabilization programs*. Certain entitlements such as unemployment insurance were specifically created to provide benefits during economic downtowns and experience an increase aggregate demand during these periods. If these payments were subject to annual appropriations, Congress might not fund these programs with the necessary appropriations when they are most needed if they have to compete with other perceived more-urgent needs or if the government was operating under a fixed expenditure limit.

- *Treaty obligations*. U.S. obligations required under treaties might reasonably be considered mandatory and, for this reason, Budget Enforcement Act expressly exempted them from sequestration

**Potential remedies**. A range of options has been suggested to stem the proliferation of mandatory programs, increase the ability to make trade-offs between mandatory and discretionary programs, and increase the control of mandatory spending, including:

- *Mandatory-to-discretionary amendments in the budget resolution*. The budget resolution could permit amendments moving funding from the mandatory to the discretionary side of the budget (accompanied by the appropriate allocations and reconciliation instructions).

- *Food stamps model*. Mandatory programs could be restructured to retain basic features of an entitlement, while subjecting program obligations to the appropriated level. The food stamp program has this feature. While participation is basically determined by its eligibility requirements and benefits are allocated by formula, the law authorizing the program expressly requires that benefits are to be reduced *pro rata* if appropriations are insufficient to cover the entire eligible population.

- *Discretionary allocation/cap adjustments*. Authorizing committees are reluctant to include their new programs in the appropriations process if they are not assured the programs will receive sufficient appropriations. The appropriations committees are similarly disinclined to provide the necessary appropriations for new programs if that decreases the amount of appropriations available for their own favored programs. One possible solution is providing an automatic increase to the appropriations committees' allocations if they provide sufficient appropriations for the new programs *and* the authorizers have previously offset the new program in an authorizing bill.

- *Sunsetting*. Additional existing programs or all new and expanded programs could be sunset, as many discretionary programs and mandatory programs authorized by the farm bill already are. Such a requirement could be coupled with procedures to facilitate transfers from the mandatory to the discretionary side of the budget.

## Tax Expenditures

Tax expenditures are typically established separately from related spending programs in the budget, giving rise to potential for fragmentation, duplication, and overlap. In areas ranging from low-income housing to higher education, subsidies are provided separately through the tax code and through grants, credits, and other spending programs. Powerful incentives reinforce the consideration of tax expenditures on separate tracks from related spending. Tax expenditures, moreover, suffer from long-standing performance and accountability weaknesses that can undercut their ability to effectively promote program goals.

**Background**

Tax expenditures have grown to rival total discretionary spending in magnitude. Tax expenditures consist of exclusions, deductions, credits, and deferrals that reduce taxes owed for specific activities. Tax expenditures are generally defined as reductions in taxes paid by individuals and corporations relative to a comprehensive "normal" income tax.

The number of tax expenditures more than doubled from 1974 to 158 in 2006. According to the Congressional Research Service, the revenue lost in 2006 was $945 billion, or almost 70 percent of income taxes paid that year. Tax expenditures are present in most budget functions. The largest tax expenditures reported by Office of Management and Budget for FY 2009 include:

- Health-care contributions by employers - $168 billion
- Mortgage interest deduction - $100 billion
- 401(k) deferrals - $51 billion
- Charitable deductions - $47 billion
- Accelerated depreciation - $44 billion

**Reasons**

The separation of tax and spending programs has deep-seated roots:

- Revenue committees jealously guard their prerogative to use the tax code to enact social policy;

- Tax expenditures give proponents the ability to both create new benefits and tax cuts at the same time;

- Tax expenditures are alluring because they feature less administrative overhead and controls; and

- Tax expenditures are subject to less periodic scrutiny by either OMB or Congress. Like other mandatory programs, once enacted, they elude the periodic review or oversight in the budget process, unless they contain sunset provisions.

PAYGO, when applied, does promote some deliberation by requiring new tax expenditures to be offset by other tax changes or reductions in mandatory programs. However, for the most part, tax expenditures are considered in the frame of tax policy rather than in the context of their programmatic goals. The most important effort to grapple with existing tax expenditures occurred as part of the 1986 tax reform, where tax subsidies were reduced in exchange for lower rates. The tax code generally does not come into play when corresponding reforms are undertaken in major spending programs, such as welfare reform in 1996.

The separate consideration of tax expenditures in Congress has its parallels in the executive branch. The Department of the Treasury has responsibility for oversight and control, and OMB generally does not include tax expenditures in the budget formulation process or in its director's reviews. OMB performance initiatives under the Government Performance and Results Act (GPRA) and the Program Rating Assessment Tool (PART) have also generally excluded tax expenditures. This isolation carries through to the agencies. The low-income housing tax credit, for instance, does not show up in HUD's performance plan or in the PART reviews for HUD, even though it is the largest single source of financing for low-income housing construction today.

**Effects**

There is no process that forces Congress to compare the relative merits of using tax expenditures over related spending programs and tools. Rather, each congressional committee is free to adopt multiple programs addressing the same goals, as long as it can secure enough votes.

Tax expenditures can contribute to mission fragmentation and program overlap with related discretionary and mandatory spending programs. This, in turn, creates the potential for duplication and service gaps. Tax expenditures actually exceed federal mandatory and discretionary outlays for three budget functions – energy, commerce and housing credit, and general government – and for major shares in other functions such as health care and education.

One powerful example of mission fragmentation is the higher education area, where the federal government helps students and families save and pay for the costs of postsecondary education through tax expenditures, grants, loans, and guarantees. Indeed, since the 1990s, the federal government has offered multiple tax incentives, including the nonrefundable Lifetime Learning and HOPE tax credits, deductions for qualifying post-secondary expenses and interest on student loans, and two tax-preferred ways to save for future education expenses. Government Accountability Office has found that the welter of benefit programs can offset one another in unpredictable ways and confuse families seeking to make the best use of federal assistance.[1] [i]

There are clearly cases where tax expenditures may be the most efficacious strategy to deliver public goods. For example, this tool may be the most cost-effective way to influence the spending behavior of large numbers of taxpayers for such purposes as donating to charitable organizations – a spending program is likely to be more expensive and burdensome.

However, tax expenditures have generally been prone to characteristic shortfalls in effectiveness and targeting. They are generally highly prone to substitution by providing taxpayers with benefits for activities they would do anyway. When they do affect behavior, they have the potential, according to many economists, to reduce the efficiency of markets by tilting investment toward tax-preferred activities and may undermine broader policy goals. Two prominent examples are housing and health care, where costs are undoubtedly higher due to the tax subsidies provided through tax deductions and exclusions. Tax deductions and exclusions are regressive in that they are more valuable to those in higher tax brackets and typically provide no benefit to the one quarter of lower-income Americans who pay no income tax.

**Potential remedies**

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Ideally, the budget process should encourage trade-offs between tax expenditures and related spending programs. However, fragmentation of congressional committees makes it difficult for Congress to provide more comprehensive review of tax expenditures in the budget process. Envisioning how this might take place illustrates the difficulties.

**Suggested congressional alternatives**. Congress could examine the following options:

- *Reconciliation*. The expedited procedures for reconciliation could be tapped to weed out unjustifiable tax expenditures. The budget resolution would specify reduction targets to revenue committees for focusing on selected tax expenditures that can parallel reduction targets provided to authorization committees with comparable programs, potentially stimulating collaboration across the committees.

- *Coordinated Reviews*. Select several major crosscutting programs, including tax expenditures, to review each year. The relevant committees could be required to bring forward revisions to existing programs in their jurisdictions for consolidated action by the budget committees or leadership task force. This is similar to the process that the government of the Netherlands does annually in their interdepartmental review of selected crosscutting programs.

- *Allocation /Cap Adjustments*. To encourage trade-offs between tax expenditures and discretionary programs, the discretionary spending caps could be increased commensurate with reductions taken in tax expenditures. Potential objections by beneficiaries of these programs could be mitigated if Congress allocated the necessary increased discretionary spending for similar purposes as the reduction in related tax programs.

**Suggested executive actions**. These may prove more feasible. GAO has suggested that:

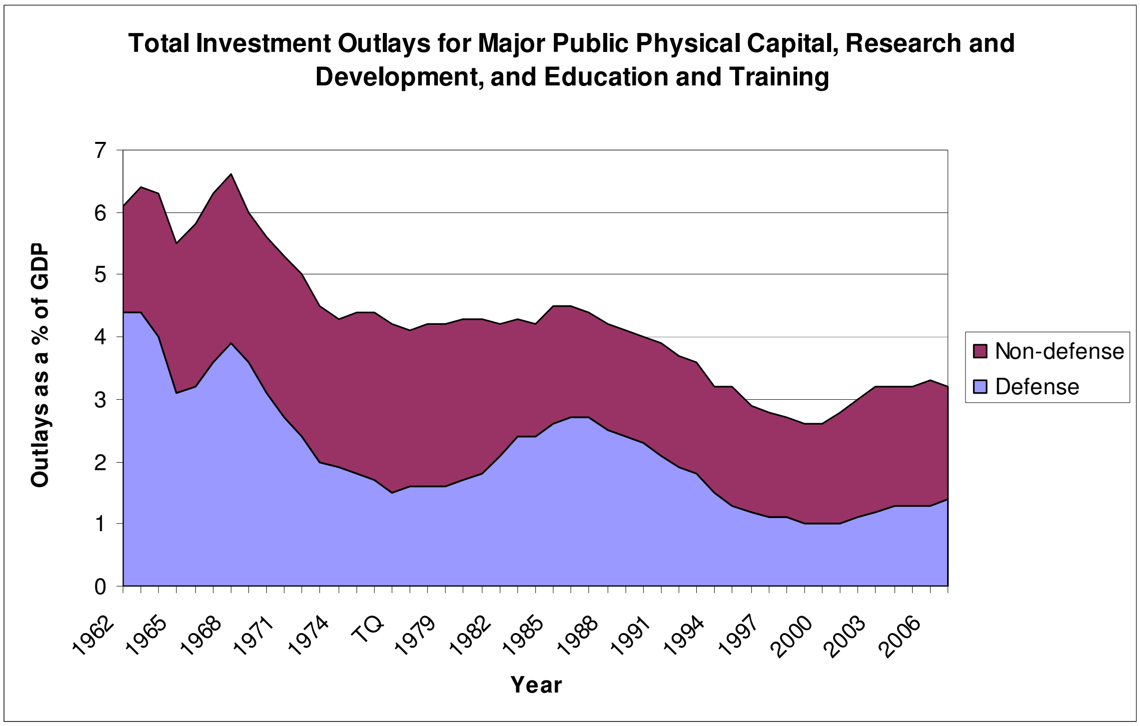
- OMB review tax expenditures routinely as part of the budget formulation process.
- tax expenditures be covered in executive performance planning and assessment programs such as GPRA and PART.
- tax expenditures be displayed in the budget alongside related spending programs by function in the president's budget and end-of-year reports.

## Capital Expenditures

Public capital investment plays a central role in promoting a strong and growing economy for any nation. Well-chosen investments in transportation, water resources, energy generation, and other public facilities can ensure that the economy can effectively move goods, people, and services, as well as generate and transmit power efficiently. Moreover, infrastructure is often essential to the achievement of broader governmental and social objectives, including education, environmental protection, or national defense.

## Background

Spending for broad public investments has grown in constant dollars from 1962 to 2007 from $137 billion to $363 billion. As a share of GDP, however, federal public investment has been cut in half, from over 6 percent to 3 percent, during this period. The balance between defense and nondefense has shifted over these years, with non-defense investment now exceeding that for defense, as illustrated in the following chart.




Of the total investment spending portfolio, physical capital projects present special challenges due to the potential mismatch between the large required up-front costs and the longer-term benefits of capital projects and facilities. Of the nearly $430 billion in federal investment outlays in FY2007, $138 billion was spent for construction of new facilities, acquisition of equipment, and land purchases – all activities with high up-front costs and longer-term benefits. An additional $130 billion was spent on research and development activities with potentially high up-front expenditures for such activities as advanced weapons procurement. The rest of the federal investment portfolio supports grants and human capital programs that do not present the same spiking problems as physical capital.

Federal budgeting for capital observes unified budget and up-front funding principles. Unlike many state and local governments, the federal government has a unified budget that facilitates the federal budget's role in affecting the broader economy through fiscal policy. The federal budget requires that the full budget authority for capital investments be recognized and budgeted for up-front so that Congress is accountable for the full costs of long-term assets when the irrevocable commitment of government resources is made.

**Concerns**

There are two sets of contradictory concerns about the allocation of federal resources for capital expenditures. Some are concerned that the budget allocates insufficient funding for capital compared with other claims due to the high initial costs for these projects. Others are concerned that elevating capital to a special category with different budgetary treatment would potentially undercut unified budgeting and prevent policymakers from making informed trade-offs between capital and noncapital investments.

**Advocates of capital budgeting**

Advocates of capital programs and federal agencies alike complain that the up-front funding requirement biases budgets against capital expenditures due to the spikes in budgets that such large expenditures entail. They argue that unified cash-based budgets fail to match the costs with the benefits delivered over many years by these assets.

Those who want to increase infrastructure through national investment have championed the adoption of a federal capital budget. A federal capital budget would spread the costs over the useful life of projects based on either depreciation or bond financing dedicated to the project, similar to how state and local governments undertake these projects. This approach would ease the alleged bias against capital. These proposals also typically envision a separate part of the budget for capital projects. While some proponents suggest that the capital budget be separately financed, most nations with capital budgets fold the capital portion into the unified budget.

**Opponents of capital budgeting**

This capital budgeting model, however, may not be workable in a federal context for three reasons:

- Unlike state and local governments, the federal government does not own most of the infrastructure it subsidizes. Accounting rules do not permit capitalization of assets if they are not owned by the entity.

- The spreading of costs over many years would complicate the exercise of federal fiscal policy by disconnecting the budget accounting for capital from the economic impact of raising cash for the project in the near term.

- A capital budget would not force decision-makers to be responsible for the full costs at the same time they are, in effect, taking credit for the full benefits of the projects. This mismatch of benefits and costs may lower incentives to deliberate on and compare specific capital projects.

- Separate budgetary treatment of capital might prevent policymakers from making informed trade-offs between capital and noncapital strategies for satisfying public goals.

**Capital Budgeting Through the Back Door: Agency Practices**

While OMB Circular A-11 appropriately requires agencies to obtain up-front budget authority for the entire costs of capital acquisitions, this principle appears often to be observed by many agencies only in the breach. Concerned that these rules constitute a bias against capital investments by creating funding spikes, agencies have pursued a growing range of strategies to acquire assets, all of which compromise up-front control and often constitute more costly approaches to obtaining capital services:

- *Incremental funding*. In a survey of key domestic agencies by GAO in 2000, most agencies indicated that they budgeted for capital projects on an incremental basis. While agencies acknowledged that incremental funding made them vulnerable to funding interruptions and project delays, in the short term this approach allowed them to fit more projects under their budget ceilings.

- *Operating leases*. GSA has concluded that operating leases are the most expensive way to obtain office buildings and other fixed assets for long-term purposes, when compared to purchase, construction or lease-purchase. However, because OMB scoring rules call for up-front funding for the latter options, agencies resort to more expensive leases because they can be funded with an agency's annual budgets. GAO has suggested a change to the scoring of operating leases that fail OMB's test for capital leasing – those leases supporting long-term space requirements should also be scored on a net present value over the useful life of the building.

- *Public-private partnerships*. An emerging practice in state and local governments and several agencies is using private firms in the financing of land, space, or other facilities. The private firm then can recoup its capital investment by charging the agency to lease back the facility or land or can charge the general public through user fees. By sidestepping up-front control and authorization, these public-private partnerships (PPPs) can compromise accountability and control. The private sector can bring efficiency gains to projects and has incentives to complete projects on time and below budget since it assumes the risks of overruns. However, these partnerships will yield net gains compared to public ownership only if these gains exceed the higher costs of financing that the private sector must pay to borrow funds. In a study of PPPs in Organization for Economic Cooperation and Development nations, most nations were drawn to these partnerships primarily because they could avoid committing funds up-front and thereby, create an appearance that their deficits were lower than they really were over the long term.

**Potential remedies**

The widespread and persistent "work-arounds" used by many agencies suggest that current capital asset budgeting rules are problematic for the operations of agencies. Any potential options should ease the spiking budget problem but also retain the accountability that arises from the up-front commitment of government resources. Options include:

- *Investment component*. An investment component could be carved out of the discretionary portion of the federal budget that would contain the various infrastructure as well as human capital and research and development programs that promise long-term gains for the nation. As it decides on the overall cap on discretionary spending to guide its appropriations decisions for the fiscal year, Congress could also separately vote and track an overall level of investment or infrastructure that it expects to be funded for that year. Such a reform would prompt a healthy annual debate on the level of investment or infrastructure while preserving both up-front funding and unified budget principles.[ii]

- *Funding of useful stand-alone segments*. OMB guidance enables agencies to break capital projects down into more affordable segments that can stand the test of delivering a service on their own, such as acquiring several boats in a larger buy of boats for the Coast Guard.

- *Capital acquisition accounts*. Larger agencies that purchase a consistently large stream of capital every year may be able to use a fund to aggregate contributions from bureaus to budget for selected projects each year. This has the advantage of preserving up-front funding while spreading costs each year among bureaus and programs. Some agencies already take advantage of working capital funds and other similar strategies in conjunction with their appropriations committees.

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[i] U.S. Government Accountability Office, *Student Aid and Postsecondary Tax Preferences: Limited Research Exists on Effectiveness of Tools to Assist Students and Families Through Title IV Student Aid and Tax Preferences,* GAO-05-684 (Washington, D.C.: July 29, 2005).

[ii] U.S. Government Accountability Office, *Providing an Investment Focus in the Federal Budget* (Washington, D.C.: GAO, June 29, 1995) GAO-AIMD-95-178.