Testimony Of

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On

"Capital Budgeting in the States"

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Chairman Price, Ranking Member Van Hollen, and members of the Budget Committee, thank you for inviting me to discuss the topic of capital budgeting in the states. My name is John Hicks. I am the Executive Director of the National Association of State Budget Officers (NASBO). For over 70 years, NASBO has been the professional membership organization for state budget and finance officers. As chief financial advisors to our nation's governors, NASBO members are influential decision makers in state government. They guide their states in analysis of budget options and formation of sound public policy.

I am here today to talk about capital budgeting in state governments. As this Committee considers alternate approaches to federal budgeting, capital budgeting has been a frequent subject. The issues around adopting a capital budget at the federal level have been examined and studied in the past, particularly the Commission on Budget Concepts for the Federal Government in 1967, the Report of the President's Commission to Study Capital Budgeting in 1999, and the Congressional Budget Office paper to this very Committee on capital budgeting issued in 2008.

In my testimony, I will focus on the developments in capital budgeting in the 50 states, summarize the general practices and primary elements of their capital budgeting processes, and comment on the purposes and benefits of capital budgeting to the states. My remarks will draw heavily on the NASBO publication, *Capital Budgeting in the States*, Spring 2014.

Capital Budgets in States' Budget Processes

All states have some form of a capital budgeting process. Capital spending has consistently represented six percent of total state spending over the last 20 years. Most states distinctly separate their capital budget from their operating budget. Other states incorporate their capital budget items within their overall operating budget. In both cases, governors propose and state legislatures adopt their operating and capital budgets concurrently in almost all states. There are a few exceptions where states adopt their capital budget in a separate year from their operating budget. States' balanced budget requirements recognize that the portion of their capital budgets funded by debt is accounted for by budgeting the annual debt service costs in their operating budget. What distinguishes capital budgeting within the states' overall budget process is the variety of decision support processes that take place prior to the appropriation actions.

Why Do States Have Capital Budgeting?

Why do states have a capital budget with an additional set of special review processes? They assist states in considering the inherent differences between capital and operating expenses. Capital spending reflects high-dollar, nonrecurring outlays on physical assets that have a long-term life. Because states own much of the capital assets created, there is a long-term commitment that commonly must be supported on an ongoing basis through future operating budgets. Because capital projects are expensive with long-term consequences, the capital budgeting process provides a mechanism for governors and state legislatures to subject them to intense review as to their priority, propriety and funding source. These significant resource commitments require extensive planning, substantial upfront financing, technical knowledge and sometimes cooperation across jurisdictions and levels of government. Capital budgeting incorporates review processes that take into account the large scope and long-term nature of this type of public spending.

Characteristics of State Capital Budgets

State capital budgets generally consist of the appropriated amount for capital items or projects and their associated sources of financing. These approvals span more than one fiscal year usually until the project is complete. The specific definitions for what is included in the capital budget are determined by states' laws.

The common characteristics of the items included in a capital budget are that they are a nonrecurring expense for a physical asset that has a long-term life. Most states include construction, land acquisition, major renovations and repairs, major items of equipment, information technology systems, and funds or grants to local agencies of a capital nature. States will usually have a minimum dollar threshold for an item to be included in the capital budget. The most numerous items contained in capital plan, capital budget requests, and the adopted capital budget are those that maintain the states' existing infrastructure and preserves the state's previous major investment in capital assets. Routine maintenance for physical assets is typically included in the operating budget. States usually budget the full amount of a capital project's expected costs upfront in their capital budgets. This provides financial certainty to the project and does not depend on future capital budgets to ensure the project's completion. At times, states will initially finance the design of a capital project in one budget, but that does not assure its construction or acquisition funding in the next budget cycle. States do not budget for depreciation or incorporate education and training or research and development; issues that have been examined and debated when considering capital budgeting for the federal government.

While there are differences among the states as to what is included and excluded in their capital budgets, the more salient issue is that each state has set up its own budget rules to organize the decision-making process for approving capital spending. The budget rules for requesting, recommending and appropriating capital budget items have different characteristics than those for operating budgets. Budget enforcement and budget execution rules for capital projects also have different elements than operating budgets.

The different nature of capital budget decisions has led to the adoption of a process with different budget rules. Capital budgeting decisions involve choosing from a lengthy list of non-recurring projects rather than deciding on the incremental or decremental amount of a program or on starting a new program in the operating budget. The total size of a capital budget varies more from one budget cycle to the next more than does the operating budget.

Which Areas of State Government Receive Capital Investments

The functional composition of state government capital budgets include the same program areas as states' operating budgets do, but are concentrated where those program areas have the largest physical plant. Most capital spending by states is concentrated in two areas: transportation and higher education. Transportation accounted for over 63 percent, and higher education accounted for 12 percent of state capital spending in fiscal year 2015.[1] Despite the dollar concentration on transportation and higher education, state capital budgets include a wide variety of other items. Some examples are psychiatric hospitals, correctional facilities, state parks, dams, veterans' nursing homes, and national guard armories. States vary significantly in the area of capital grants and funding to local governments and special districts, including participation in funding elementary and secondary school buildings, and drinking water and wastewater infrastructure.

Sources of Funds in States' Capital Budgets

The financing sources for states' capital budgets are similar to their operating budgets. Over the last twenty years, on average, 72 percent of state capital spending has been financed with current revenues or pay-as you go, and 28 percent from bond proceeds. Of the current revenues, 39 percent come from special revenue funds, the largest portions are from dedicated taxes and fees for transportation and tuition and fees for higher education; 28 percent from federal funds, and 5 percent from the states' general fund. In each budget cycle, budgetary choices are made by states on the amount of current revenues to be devoted to the capital budget instead of the operating budget. The most notable difference between capital and operating budget sources of funds is the use of bond proceeds, or borrowing. Some states have also identified capital-specific financing sources to fund high-dollar asset preservation, repairs and maintenance needs. In recent years, public-private partnerships have become more prevalent as a mechanism for the acquisition of infrastructure, especially in the transportation arena.

Borrowing in States' Capital Budgets

Most states have constraints on the amount of debt they can or are willing to incur. State debt is almost exclusively devoted to capital spending; associating the long-term benefits of a capital asset by spreading its costs over a span of years. That span of years is typically no more than the expected life of the asset. Issuing bonds also provides states with a budgetary smoothing device. Payment of the debt service for the bonds is included with states' operating budgets, often at a consistent annual amount over the term of the bonds. States utilize a number of constraining devices in deciding the level of debt to be budgeted. From NASBO's most recent publication on state capital budgeting, 38 states have a constitutional, statutory, or policy limit on total general obligation debt (debt that provides the full faith and credit of the state), 25 states have a constitutional, statutory, or policy limit on general obligation debt service, and 20 states have additional debt affordability criteria, which often looks at all appropriation supported debt, not just general obligation debt.[2] The bond market and bond rating agencies provide additional elements of spending discipline on the amount of debt states incur for capital purposes. Even in the current low interest rate environment, states remain cautious about incurring debt for capital projects

Capital Planning Processes in States – More Science than Art

States use extensive capital budget planning processes to assist them in choosing among a lengthy set of alternative capital spending choices. In our most recent survey, 43 states reported that they develop a multi-year capital improvement planning process for every budget cycle. The average time horizon is five years, ranging from two to ten years. States have reported that these capital improvement plans play a critical role in informing capital budgeting decisions. This planning process is commonly coordinated by a central government agency and often the capital improvement plan will identify or rank capital projects after reviewing an extensive amount of information provided through the process. Significant efforts are made at assessing the condition of existing capital assets, measuring its capacity against forecasted service levels, and relating to state strategic and programmatic plans. Some states incorporate a joint executive/legislative review board as a component of their capital planning process, raising awareness for all of the decision-makers in the budget process. Over time, capital planning in states has incorporated a number of reform-minded public administration practices that has improved and advanced the quality of the technical and financial analysis.

Among the most important features of state capital budgeting processes is examining the impact of capital spending on future operating budgets. Nearly all states report that capital budget requests contain information estimating the fiscal impact on future operating budgets. A common refrain in states is that it costs more to operate a prison than to build it.

Summary on the Benefits of Capital Budgeting to States

States use the capital budgeting process to provide greater analysis of long-term financial investments, to provide a focused process for some of the states' most expensive spending items, and to recognize how different the capital budget choices are from the operating budget. It incorporates a long-term planning process that supports both the short-term capital investment decisions and their longstanding operating budget consequences. Capital budgets provide full, upfront financing certainty to capital spending items designed to not rely on future budget cycle decisions. Through the capital budget process, governors and state legislatures exert focused control over these spending choices and establish rules to assure their budget enforcement. A capital budgeting process brings better attention to the condition of capital assets and to the adequacy of maintaining them. In most states, the capital budget is a part of a unified budget addressing both the current operations of government and its long-term investments.

[1] National Association of State Budget Officers, *State Expenditure Report (Fiscal 2013-2015 Data)*, November 2015.

[2] National Association of State Budget Officers, *Capital Budgeting in the States*, Spring 2014.

State Capital Spending - 25-Year History

FIGURE 18:
CAPITAL EXPENDITURES BY TYPE, FISCAL 1991 TO 2015

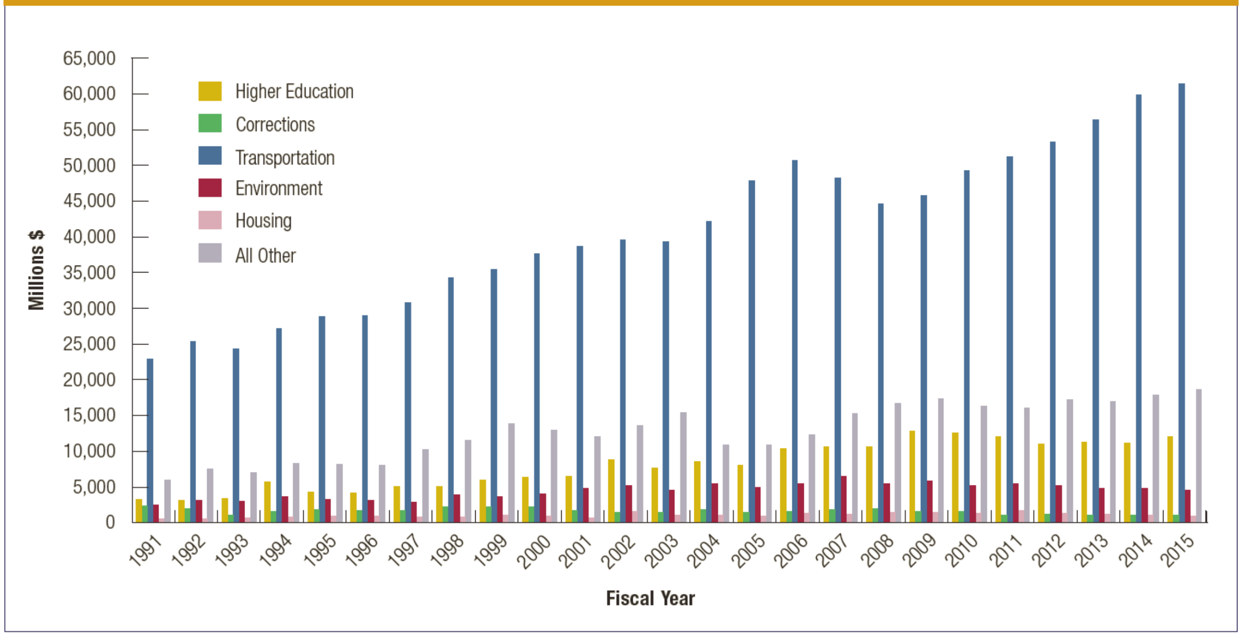
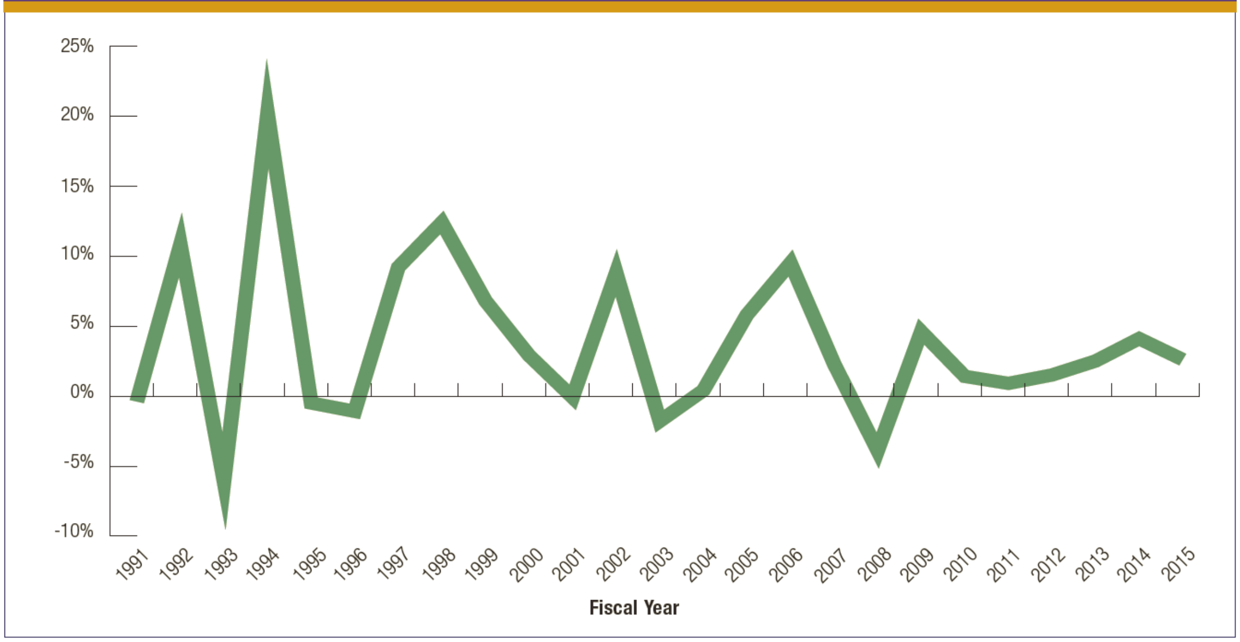


FIGURE 19:
ANNUAL PERCENTAGE CHANGE IN TOTAL CAPITAL EXPENDITURES



Source: National Association of State Budget Officers, *State Expenditure Report (Fiscal 2013-2015 Data)*, November 2015.