

# **CAPITAL BUDGETS: THEORY AND PRACTICE**

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## **Introduction:**

Capital budgets in governments have multiple objectives – as instruments of compensatory fiscal policy, as windows on the networth of public bodies, and as vehicles of development, particularly in the area of economic infrastructure through greater reliance on debt than on the conventional sources of financing, viz. Taxation. Governments in the past have introduced them to serve these objectives, singly or collectively, depending on the context. In some cases, more attention was paid to capital budgets as a way of reducing deficits on the current account. Notwithstanding the seeming virtues of capital budgets, opinions continue to be divided, as they have been during the last seven decades, about their utility in governments. In the present context, where several industrial countries are having budgetary surpluses and are using them to reduce levels of public debt, there is little incentive to revive the debate about the need for capital budgets. Elsewhere, in the developing world, however, where many governments continue to live on the edge of financial instability, there is a continuing debate about capital budgets and their equivalents. Experience shows that in the absence of properly organized capital budgets, there had been a proliferation of borrowing avenues, or resort to borrowing without due consideration of the sustainability aspects (or intergenerational equity), an inadequate maintenance of assets and an overall poor management and performance of major projects. It is arguable whether this could have been prevented by the establishment of capital budgets. Moreover, for the countries that continue to depend on debt finance as a major instrument of budgetary resources, the issue arises whether capital budgets promote an improved process of decision making and an overall management culture that permits continuing attention to the government's networth. For both these reasons, it is important to revisit the debate about capital budgets. More specifically, it is important to consider whether capital budgets provide an improved framework for resource allocation, utilization and resource use accounting and whether they will contribute to a restraint in the growth of expenditure, or whether they will prove to be too soft a constraint in the management of debt financed outlays. To answer these issues, it is necessary to review the evolution and content of capital budgets.

This chapter is divided into two parts. Part I is devoted to a brief discussion of the evolution of capital budgets from thirties to date and the different considerations that influenced it. This is followed by a delineation of the contents of capital budgets – capital budget planning, capital budget formulation and capital budget implementation.<sup>1</sup> Part II is devoted to a discussion of country practices, and ebb and tide of the debate about the need for capital budgets, and concludes with a discussion of the above leading issues.

## I

### **Evolution**

Although the conceptual framework of a capital budget had not undergone major change during the years, there are six discernible stages in which its various aspects had come to be reviewed as integral parts of the overall debate of the applicability of the system to governments. In order to have a proper perspective, it is instructive to consider these stages briefly. The first stage is the depression years during which efforts were devoted to designing ways that would promote recovery. The then prevailing public philosophy did not favor public borrowing for financing government outlays except during national emergencies such as wars. Borrowing, once initiated, it was believed, would prove to be an attractive option for policy makers to finance ordinary outlays. To resist this temptation, and with a view to creating a favorable lobby, Sweden decided to introduce a capital budget which was to be funded by public borrowing and which was to be used primarily to finance the creation of durable and self-financing assets that would also contribute to expanded networth equivalent to the amount of borrowing. The capital budget so launched, which was also called investment budget, found extended application, in the following years, in other Nordic countries. To facilitate the implementation of capital budget, a system of extended grants that went beyond a fiscal year, was established. The second stage reflects a different background

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<sup>1</sup> It may be noted that most of the available literature, which any way is limited, excludes any discussion of capital budget implementation. In governments, actions speak louder than intentions and aspirations and are judged, both by the financial and political markets, by the results achieved.

that provided an impetus for the application of capital budgets to government transactions. During the late thirties, the colonial government of undivided India introduced a capital budget, more to reduce a revenue deficit by shifting some items of expenditures from a current to a capital budget. It was believed that a burgeoning budget deficit did not reflect well on the creditworthiness of a colonial government and the introduction of a dual budget-system provided a convenient approach that would reduce revenue or current account deficits while providing a rationale for borrowing. The third stage refers to the growing importance attached to capital budgets as a vehicle of development plans. The countries that were becoming independent since the late forties recognized that the inherited budget system did not properly serve their needs of development. Partly influenced by the Soviet model of central planning, many developing countries formulated massive five-year plans and capital budgets were conceived to be the primary vehicle of economic development. Where capital budgets did not exist, a variant known since then as development budget came to be introduced. The fourth stage reflects the growing influence of economists on the allocation of resources in government. With a view to ensuring a more efficient and rational allocation, quantitative appraisal techniques, which hitherto were applied to multi-purpose river valley projects, came to be applied on a wider scale during the sixties. These techniques established a trend for a more rigorous application of investment appraisal and to detailed financial planning. This feature, which was common to all government transactions, whether of a program or a project variety, came to be a condition precedent for inclusion of projects in the capital or its equivalent budget. During the fifth stage, there was a revival of the issue of the need for a capital budget in government, particularly in the United States. Along with the growing application of quantitative techniques, there was also a view during the whole decade of sixties, that the introduction of a capital budget could be advantageous. But this view did not gain much support, as a President's commission, which went into budget concepts in the United States, believed that a capital budget could lead to greater outlays on brick and mortar and that as a result the current outlays could suffer. Having rejected the capital budget, the commission advocated the introduction of accrual accounting (as distinct from an accrual budgeting) in government accounts. The introduction of accrual accounting, which any way did not make any progress in the United States until the early

nineties, would have meant the division of accounts into ordinary and investment. In the event, such accounts were intended more for information than as a basis for budgeting. Meanwhile, however, there was a development which cast more serious doubts about the need for capital budgets. Sweden, which made pioneering efforts in the thirties, undertook a review of its budget system in the early seventies, and found that excessive focus on capital budgets would need to be tempered by a recognition that the overall credibility and credit worthiness of government depended more on the macro-economic policy stance and less on the networth of government. While the application of capital budgets for quasi-commercial transactions was necessary, it was not to be considered as a main basis for the borrowing program. This shift in emphasis contributed to a decline in the fortunes of capital budgets until the late eighties, when it came to be revived in a different form. By the late eighties, there was a recognition that the management of government finances required radical approaches and this radical approach consisted in the application of accrual accounting. During this sixth stage, followed partly by the experience of Australia and New Zealand, there was a renewed plea for the introduction of accrual budgeting and accounting. This found an echo in the United States where it was held that the absence of a distinction between investment and ordinary or current outlays led to unintended neglect of the infrastructure or accumulated assets. If proper asset maintenance (which was as important as asset creation) was to be ensured then a division of outlays into current and capital was needed as a part of day to day budget management.

### **Capital Budget: Conceptual Framework:**

Although the corporate practices provided the basic inspiration, it was recognized from the beginning that the nature and rationale of capital budgets would be different in the public bodies. Apart from the basic distinction arising from the profit motive, the structure of a government and the diversity of purposes sought to be served were different. Unlike the corporate sector, an entity in government may not have separate assets and frequently the power to borrow may be limited. The power to borrow and the assets created belonged to the whole government. In addition, the government may not engage in direct asset creation but may frequently transfer the

borrowed resources to its more specialized agencies including state owned enterprises to create the assets. The more important differences lay in the rationale for capital budgets in governments. From the point of financing, it was to explore the alternative to taxation, to engage in borrowing that had a potential to bring about a better distribution of the government services among taxpayers and beneficiaries. Borrowing also could contribute to a better distribution between consumption and investment although there were clearly limits on the extent of borrowing. Moreover, investments by governments tend to be lumpy in the years in which they are incurred, contributing in turn to uneven revenue mobilization measures and tax revisions to match the growth in expenditures. While capital expenditures necessarily tend to be unevenly spread, reflecting in large part, the projects to be financed, properly organized and financed, they had the potential of bringing out a more smooth tax and revenue regime. From an accounting point of view, capital budgets would have depreciation provisions and capital charge reflecting the life of the asset over its life span rather than the fiscal year in which expenditures were incurred on its acquisition or completion. Finally, from the point of view of overall financial credibility, capital budgets forced a more rigorous examination of the impact of expenditures and to the extent that they resulted in corresponding assets, the networth of government was assured permitting it to maintain its credit worthiness in the market.

### **Structure of a capital budget**

The structure of the capital budget that evolved from the application of the preceding considerations is illustrated in Table 1. Contrary to the general belief, a capital budget has also an extensive portfolio that goes beyond borrowing although depending on the situation, it may be the most importance source. In principle, taxes levied on property, although paid from current income, are considered to be levies on capital and are included in capital receipts. In some countries, income from natural resources (including oil) may be earmarked for capital projects and are therefore included in receipts. In countries with development plans, surpluses from the current

**Table 1**

**Structure of a Capital Budget: An Illustration**

Receipts	Expenditures
<p>I. Estate and Death Duties Taxes and Property Earmarked Revenues for Capital Projects</p> <p>II. Surpluses from the Current Account</p> <p>III. Proceeds of Borrowing:</p> <ul style="list-style-type: none"> <li>• Domestic</li> <li>• Trust and Captive Accounts maintained by government</li> <li>• External</li> </ul> <p>Repayment of Loans</p> <p>IV. Depreciation Allowances</p> <p>V. Sales of Property`</p> <ul style="list-style-type: none"> <li>• Regular</li> <li>• Privatization Proceeds</li> </ul> <p>VI. Capital Grants</p> <p>Total</p>	<p>I. Acquisition of existing Assets*</p> <ul style="list-style-type: none"> <li>• Plant, Property and Equipment</li> <li>• Financial</li> </ul> <p>II. Acquisition of new Assets*</p> <ul style="list-style-type: none"> <li>• Plant, Property and Equipments</li> <li>• Financial (Other than Capital transfers)</li> </ul> <p>III. Capital transfers</p> <ul style="list-style-type: none"> <li>• Transfers to other levels of Government@</li> <li>• Transfers to State owned enterprises.</li> </ul> <p>IV. Repayment of Loans</p>

\* Contention categories such as outlays on social capital are not included here.

~ Do not include revaluation profits

& May include jointly financed projects

@ May include non-remunerative projects and some loans.

budget (relatively less during recent years due to the significant growth in current outlays) are yet another source of receipts. Depreciation allowances represent, in accounting parlance, a contra or a balancing entry in that these allowances which are charged to the current account are treated as capital receipts. Charging depreciation allowances would have the short-term impact of contributing to an increased current account deficit (or reduced surplus) and to an overall higher deficit but this has to be tempered by a recognition that depreciation allowances are not, in many cases, maintained on a cash basis, and are more in the nature of a book entry. The receipts section includes capital transfers from external sources and proceeds from the sale of property, and privatization.

The determination of capital expenditure is, however, a more complex area. The first issue that arises is – what are capital expenditures and how are they to be determined? This area represents some common, and some different elements in the approaches of accountants and economists. From an accounting point of view, outlays incurred on the acquisition, fabrication of an asset or a transfer leading to the creation or acquisition of an assets, are included in the capital budget for so long as they meet three criteria, viz., (i) that they are used in the production or supply of goods and services (productivity criterion), (ii) that their life extends beyond a fiscal year (longevity criterion) and (iii) that they are not intended for resale in the ordinary course of operations. The approaches of economists first make a distinction between outlays on self-financing and self-liquidating projects. Although both are included in a capital budget as they are funded from borrowing, self-financing projects refer to those that have the potential to service their future interest payments, while self-liquidating projects are those that have the potential to service both interest and principal repayment. A distinction is also made between acquisition of existing assets and those that will be created a new, and, in the process, a bridge is also built with the national income accounts. Productivity and longevity or durability considerations are common to both economists and accountants. Unlike the accounting approach, however, the approach of economists plays more emphasis on the self-liquidating nature of the activity as an

additional feature of assets. Further, from an economist's perspective, certain activities of a unique nature (e.g., defence) are treated as consumption expenditures even if they technically contribute to assets and thus to capital formation. The accounting approach makes no such distinctions.<sup>2</sup> The applicability of durability also poses problems in that government acquires several items of equipment for day to day use, that have an expanded life span beyond an year, but are not treated as capital expenditures as they do not meet the reproduction criterion. In practice, governments follow a form of case law to determine which of the items are to be included. It is quite likely, however, that initial expectations about the criteria may not fulfilled later. In such situations, the non-remunerative projects may be written off through the current account.

### **Resource allocation**

The first and major part of public financial planning, regardless of the existence of a capital budget relates to the determination of resources to be allocated. The criteria for this purpose, need to be rigorous and applied consistently. The costs and benefits associated with government policies, programs and projects need to be identified in detail and evaluated as these costs imply real opportunities foregone. Although capital budget planning was not an essential component of capital budgets during their initial stages of application, largely reflecting the relative lack of required techniques at the time, over the years, there has been a growth of these methodologies and their application has come to be an accepted integral part of governmental financial planning. More specifically, such planning enables a public determination of the optimal level of public stock, the determination of public receipts between debt and taxes (and the implicit need to keep the ratio of debt to GDP at a constant level, to the extent possible) and the role of compensatory fiscal policy. The last element requires the determination of the directions in which amounts are to be spent, if recession is to be addressed, and the possible reductions in outlays if persistent inflation is the problem. Financial planning is therefore essential to determine the economy wide policies and strategies and the sector development approaches.

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<sup>2</sup> This could lead to peculiar applications. Computer technology including software are treated, despite their extremely short life, as capital expenditures.

In order to arrive at decisions, techniques ranging from straightforward discounted cash flows to sophisticated technical, economic, financial, social, institutional and environmental analysis are applied. (These techniques have been discussed in the proceeding chapters). The application of these techniques has been considerably facilitated by the fact that capital projects are financed by institutional lenders who insist on the completion of these detailed studies as essential first steps leading to the financing of the projects. A view is periodically advanced to the effect that the pursuit and application of capital financial planning does not require the existence or operation of a budget. While this is indeed true, it also needs to be recognised that the existence of a capital budget, while facilitating planning has also the potential of making such planning an ingrained habit and a part of the overall discipline. Governments depend on their fiscal machinery to make financial planning possible and capital budgets facilitate that process. Furthermore, in a context of preparation of medium term fiscal plans, rolling medium term expenditure plans and associated approaches, capital financial planning becomes not a remote art, but a day to day practice. Accrual budgeting, when introduced, facilitates these aspects through its built in feature of the separation of current and capital or investment budgets.

The exercise of capital financial planning also permits an opportunity to focus on other aspects, including risk assessment. Some of the routine issues that are faced by governments in this regard are illustrated, in brief, in Table 2. Of particular importance is the area of risk assessment – an area which is taken up by governments in the thirteenth hour, when the crisis is at the doorstep. Capital financial planning needs to go beyond the project level, to the sector level, and, ultimately, to the overall level of the national economy, to anticipate changes in the economic parameters and to internalise them in decision making.

**Resource utilisation:**

This phase refers to the implementation of the capital budget and the steps, as well as the issues that arise through these steps are described in Table 2. From the standpoint of financial discipline, three aspects merit explicit recognition.

**Table 2**  
**Issues in the Management of Capital Budgets**

Functional Area:	Issues
<p><b>Resource Planning and Allocation</b></p> <p>I. Project and Investment Appraisal</p> <ul style="list-style-type: none"> <li>• Need to apply uniform and consistent guidelines</li> </ul> <p>II. Funding Arrangements</p> <ul style="list-style-type: none"> <li>• Centralised borrowing</li> <li>• Decentralised and Market based borrowing</li> </ul> <p>IV Budget Formulation</p> <ul style="list-style-type: none"> <li>• Medium term rolling plans</li> <li>• Annual estimates to be based on contracted costs and to allow for inflation</li> <li>• Domestic currency expenditures to be fully provided for</li> <li>• Contingent liability and associated risk management should be an integral part of budgetary decision making.</li> </ul>	<ul style="list-style-type: none"> <li>• Some techniques may be qualitatively deficient, may lend themselves to manipulation and may become `design studies' intended to support decisions already taken.</li> <li>• Centralised borrowing which leads to resource fungibility and the loss of project identify (except where funded by external resources) may not promote the needed sense of financial responsibility.</li> <li>• Absence of regulated and co-ordinated borrowing among levels of government and governmental units could contribute to competitive borrowing, crowding out, higher costs and to over-heating of the economy.</li> <li>• Could contribute to budgetary rigidity and the management of austerity programs, when needed would be rendered difficult.</li> <li>• Full adjustment for inflation, apart from contributing to budgetary problems does not promote financial responsibility.</li> <li>• This part of project outlays is dependent on the budgetary position and frequently full funding may not be provided. Underfunding leads to project delays.</li> <li>• In practice most systems are not adequately geared for this purpose. Some countries have initiated efforts to pass legislation and associated regulations in this regard.</li> </ul>

<ul style="list-style-type: none"> <li>• Consider the scope for compensatory fiscal action</li> </ul> <p>Risk assessment</p> <ul style="list-style-type: none"> <li>• Approaches to expenditure management</li> </ul> <p><b>Resource Utilisation</b></p> <p>III. Budget Implementation</p> <ul style="list-style-type: none"> <li>• Release of funds</li> <li>• Underfunding</li> </ul>	<ul style="list-style-type: none"> <li>• The need for compensatory fiscal action and the magnitude of adjustment are determined as a part of this exercise. In some countries (e.g., Japan) compensatory fiscal action (stimulus packages) may be taken throughout a fiscal year and a sense of supplementary budgets may be approved. In most developing countries, however, capital (or its equivalent) outlays are generally severely curtailed in order to reduce the overall size of the budget deficit. When this drop is not compensated through increases in private investment there may be reduced growth of GDP.</li> <li>• Changes in interest and exchange rates have serious implications for the financing of self-financing and liquidating projects. In several cases, these costs may be borne by the general budget and the project costs may remain unchanged. These transactions need to be transparent.</li> <li>• During this phase, the key variable that is constantly kept in view, particularly during the last two decades, is the overall size of the budget deficit. The size of this deficit remains unaffected by any ill-guided attempts to manipulate items from the current to capital budget.</li> <li>• Major capital projects have their own seasonality of expenditure flows and each project may have its own distinctive requirements. In general, therefore, funding and associated budgetary authority are released in conformity with project requirements and implementation schedule.</li> <li>• It is a common experience that projects are underfunded in that even the amounts estimated in the budget may not be released. This is in addition to the budget compression in allocation at the initial stage of budget preparation. In particular, domestic counterpart outlays may be reduced in the context of a resource shortfall: where projects are financed through earmarked funds, this experience may be escaped.</li> </ul>
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These relate to Underfunding, cost escalation and year-end unspent amounts. Notwithstanding all the care taken in the formulation of financial plan and budgets, governments are confronted with sudden revenue shortfalls during the fiscal year. A typical response in such situation has been to underfund the projects and programs. Underfunding, however, is a false choice, often contributing to considerable cost escalations, that later pose formidable problems for cost recovery. Many an experience also reveals that the completed cost of projects is considerably different, not merely due to underfunding, but due to a variety of factors affecting the construction and operations of projects. To minimise such variations, techniques such as Critical Path Method, Project Evaluation and Review Techniques, are applied. Their impact, however, may not be substantial to overcome the inherent problems of design of the project. Year-end unspent amount reflects, in a way, the leakages in the financial control system. Some countries have been endeavouring to permit carryovers to the following years, an approach that illustrates a way of living with the problem, than avoiding it. If these procedural issues are not recognised and addressed, they have the potential of affecting the outcome and contributing major differences between budgetary intent and outcome.

### **Resource use Accounting and Financial Reporting**

The traditional basis of government accounting has been the cash basis, which does not permit the preparation of a balance sheet showing the assets and liabilities of government. To that extent, it does not illustrate the networth of government that is one of the principal corner stone of capital budgets. To resolve this problem, the alternative approach of accrual accounting has been advocated. Accrual accounting involves three existing features, and the possibility of an additional feature. The three existing features relate to the – (a) shifting of the recording basis from cash to commitment (regardless of when the payment is made), (b) separation of financial activities into current and capital, with full depreciation allowances that permit the allocation of costs over the period of the life of an asset rather than recording the expenses when they are incurred, and (c) preparation of financial statements that are in conformity with Generally Accepted Accounting Principles. The statements include a balance sheet, an operating statement, statement of cash flows, statement of

borrowings, a statement of commitments and a statement of contingent liabilities. These statements illustrate the networth and provide the basis for the decision of the investing public. The additional feature relates to the application of Activity Based costing that will permit the internal management to identify the factors contributing to cost increases and the possible ways for addressing such increases.

Experience shows that accrual accounting remains for many governments, a goal that is yet to be achieved.

## **Evaluation**

The concluding stage of financial operations refers to evaluation which seeks to learn the lessons of experience. Completed projects and programs are evaluated to ascertain whether they could have been completed at lesser cost, whether more could have been obtained for the moneys spent, and more significant, whether the intended benefits have accrued and if not, whether any different incentive structures could yield a different outcome. More specifically, for the capital budgets, it illustrates whether the loan funded projects have the potential of being remunerative and self-financing, and whether the non-remunerative parts have to be written off from the current budget shifting the burden to the taxpayer. Experience shows that while considerable progress has been made in the evaluation of completed projects, particularly where they are funded externally, progress remains to be made in the transfer of non-remunerative parts to the current budgets.

## **II**

### **Current Practices:**

The practices of countries vary considerably and reveal several categories. The first category includes those countries that have moved or are moving to accrual accounting and budgeting and therefore observe the distinction between operational and investment budgets. Australia, Chile and New Zealand are in this group

and the United Kingdom will be having, what it calls Resource Accounting and Budgeting from FY 2000-2001. Some of these countries had previously a system of below the line accounting for loan transactions. The second category of countries includes those that show current and capital transactions in their accounts which are now based on an accrual system but the budget itself makes no such distinction although, for analytical purposes, extensive data are presented on capital formation. The United States belongs to this category. The third category includes some countries that have introduced accrual accounting but with a modification. They record expenditures on a commitment basis but do not show depreciation allowances as in their view, such a practice, is more appropriate for the corporate rather than for the government sector. This approach, for want of a better description, has acquired the label of a modified accrual system. The fourth category includes most industrial countries (including some of the former centrally planned economies, which have moved during recent years to the adaptation of an improved economic classification system) show that expenditures among others, in terms of those incurred on physical and financial assets and transfer payments that are of a capital nature. This classification is also used either as a part of the budget, or as a part of the international reporting system, by most developing countries. These approaches do not include depreciation allowances and capital receipts may not be shown or recorded separately. Also, most industrial countries rely more, for ascertaining the capital formation in Central and General Governments on National Income Accounts and associated forecasts. A similar trend is growing in developing countries. The fifth group of countries comprise those that had capital budgets but have moved to an investment budget. Denmark is one such case which now maintains an investment budget that can be spent beyond the fiscal year. The sixth group comprises those that have equivalents of capital budgets. Japan, Korea and Southeast Asian countries have special accounts (in Japan, the Fiscal Investment and Loan Program is the most important one which acquired even more importance during recent years as the primary instrument for the revival of the economy) that have selected features of capital budgets. In many developing countries, governments have 'developmental budgets' of a hybrid form. Some capital outlays are included in these budgets and the receipts include loans received for their financing but are not restricted to capital items only. In several governments, all projects and programs funded by donors and international financial

institutions are included in this category. Developmental budgets have become a mixed bag of transactions with flexible applications. In the former centrally planned economies, the budget chapter on construction (the previous slogan was construction plus energy was equal to communism) was the nearest approximation of a capital budget. In these economies, a distinction was made between the transactions of routine government nature and those that were quasi-commercial. The latter were expected to have depreciation accounts. The last category includes those that have a capital budget but without the maintenance of depreciation allowances. India belongs to this category. China announced in the early nineties its intention to introduce a capital budget and to refine it over a period. Initially, following its previous tradition, the capital budget was limited to construction outlays.

### **Perspectives and Issues**

Given the previous traditions and the considerable diversity in experiences, the issue arises, as it has in the past, as to the purposes that are to be served by a capital budget. In considering this important issue and in seeking an answer to the most significant question whether capital budgets provide a better framework for the allocation of resources in general and more specifically, in the determination of long term investments, it is necessary to recognise that there are different perspectives in this regard depending on the professional discipline of the analyst. The different perspectives of accountants, financial managers, macro-economists, political participants and market participants are illustrated in Table 3. All these groups view capital budgets as instruments that offer a world of possibilities. If that hope is recognised, the issue arises as to why capital budgets have not become a regular part of the budgetary arsenal and even where they have recently re-entered the budget scene why they had to enter as a piggy back rider of accrual accounting. These aspects require a reconsideration of the arguments for and against capital budgets which are recapitulated in Table 4.

It needs to be recognised that traditional approaches are very difficult to overcome and this has been the case with capital budgets too. For too long capital

budgets were considered as essential for the commercial sector and not for the government sector. Nearly fifty years ago, a committee that went into the form of government accounts in the United Kingdom felt that depreciation allowances had no place in government. At the beginning of the new century, this stance has changed and now the government holds the view that “the introduction of resource accounting and budgeting (RAB) is a key part of our commitment to modernising Government for the 21<sup>st</sup> Century” and that “it will put the UK government accounting in line **with commercial practice** (emphasis added) and developments in government accounting and budgeting being adopted in a number of countries around the world”.<sup>3</sup> Now governments are more receptive to the idea and to the exploitation of the realism of possibilities and opportunities.

For too long however the issue was not the appropriateness of the capital budget but whether it was inescapable. Implicit in this approach is the argument that the informational outputs coming from capital budgets can be obtained from other sources too. But much the same can be said about the budget too and the argument has been

**Table 3**  
**Different Perspectives on Capital Budes**

Accountant	<ul style="list-style-type: none"> <li>• Capital budgets promote a balanced approach to asset creation and asset maintenance.</li> <li>• Promotes the allocation of costs over the useful period of the asset of life.</li> <li>• Permits a clearer identification of assets and thus distinguishes between investment and operational budget.</li> <li>• Promotes greater conformity with GAAP.</li> </ul> <p>Paves the way for a full introduction of accrual accounting.</p>
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<sup>3</sup> See, U.K., 1999 page 1.

Financial Manager	<ul style="list-style-type: none"> <li>• Capital budgets promote a balanced approach to asset creation and asset maintenance.</li> <li>• Promotes the allocation of costs over the useful period of the asset of life.</li> <li>• Permits clearer identification of assets and thus distinguishes between investment and operational budget.</li> <li>• Promotes greater conformity with GAAP.</li> <li>• Paves the way for a full introduction of accrual accounting.</li> </ul>
Macroeconomist	<ul style="list-style-type: none"> <li>• Permits a greater recognition of the economic significance of some government activities.</li> <li>• Could contribute to a better distinction of the cost of government services among beneficiaries and taxpayers.</li> <li>• Debt financing could promote greater intergenerational equity and could lead to more smooth tax policies (by switching lumpy investments to debt financing from pay as you go methods).</li> <li>• Could be useful as a tool of compensatory policy but needs to be tempered by the recognition that most categories of capital expenditures may have the same effect as current expenditures.</li> <li>• Promotes workable limits on borrowing and more co-ordinated borrowing.</li> <li>• Techniques of deficit estimation need to be sound and should emphasise from the viewpoint of sustainability, the overall deficit.</li> </ul>
Political Participant	<ul style="list-style-type: none"> <li>• Provides alternatives to tax financed activities.</li> </ul>

	<ul style="list-style-type: none"> <li>• Provides more visibility on government activities.</li> <li>• Provides the much-needed infrastructure that facilitates government services.</li> <li>• Has the potential to promote greater accountability.</li> <li>• Provides a basis for exploring partnerships with the corporate sector.</li> </ul>
Market Participants	<ul style="list-style-type: none"> <li>• Permits a specific linkage between bond issues and the projects financed.</li> <li>• Facilitates an assessment of the risk factors and networth of government.</li> <li>• Offer a better perspective than financial statements which are too aggregative in nature.</li> </ul>

made in some quarters that there may be no need to have a budget in the government since the private sector does its business without the fanfare and the ritual associated with the budget. This, however, ignores the fundamental features of a public budget, viz., an expression of a policy intent, and a signal to the national economy as to what the government intends to do in the next year. If however, the capital budget is to subserve the purposes associated with it, then more effort is indicated to address some of the controversial issues and to bring greater convergence among the different perspectives.

It is contended, for example, that the scope of expenditure items included in a capital budget is somewhat narrow and that outlays on social capital education, health, research and training and poverty alleviation measures should be included in the capital budget. In this regard, it has to be recognised that the scope of capital budget conforms to the scope of capital formation included in national accounts. What is 'capital' is itself a concept that has undergone change in public discussion and to

**Table 4**  
**Arguments for and against Capital Budgets**

<b>Arguments for</b>	<b>Arguments against</b>
<ul style="list-style-type: none"> <li>• Capital budgets are the primary instruments of compensatory fiscal action</li>   <li>• Capital budget planning is an important part of capital budget and to that extent envisages the institutionalisation of the application of project appraisal techniques.</li>   <li>• Capital budgets provide a window on the network of governments.</li>   <li>• Direction of the macro-economic management of the country may be specified in fiscal responsibility legislation and capital budgets provide additional support in support of the desire to pursue prudent fiscal policy.</li>   <li>• Provides a clear identification of borrowing, its costs, utilization and impact.</li>   <li>• Permits identification of capital formation in the government sector.</li> </ul>	<ul style="list-style-type: none"> <li>(i) The impact of most categories of expenditures is identical and there is no particular need for capital budgets.</li>   <li>(ii) Financing through long term debt could contain short-term budgetary flexibility</li>   <li>• Application of capital budget planning does not necessarily require the existence of a capital budget.</li>   <li>• Greater importance should be attached to the proper macro-economic management of the economy than to the maintenance of net work of government.</li>   <li>• Fiscal responsibility stands by itself and the evidence of its pursuit is to be found in the overall budgetary stance.</li>   <li>• Could serve as a handmaiden to political approaches that may place emphasis on borrowing which may in the long run place major hurdles to economic development.</li>   <li>(i) Data on capital formation can be glanced from National Income Accounts. While the existence of a properly organised capital budgets may facilitate the transition of government accounts into national income accounts, it is not necessary to have separate budgets.</li> </ul>

<ul style="list-style-type: none"> <li>• Facilitates the work of bond rating agencies.</li> <li>• As a technique, facilitates linkages between budgets, medium term rolling plans, public investments planning and the estimation of recurrent costs of maintenance.</li> <li>• Provides a link with other financial statements relating to assets, balance sheets, sources and uses of funds, etc. shows the depreciation allowances and thus the use of assets through their life cycle.</li> <li>• Provides a sounder basis for macro-economic management by differentiating types of outlays and their financing.</li> <li>• Facilitates the participation of the corporate sector in projects identified and pursued as part of public policy.</li> <li>• Capital budgets imply more manageable autonomy to project manager, and the application of different techniques of implementation including project scheduling and monitoring (where projects are carried out through contractual arrangements) where projects are funded through borrowing, they facilitate the growth of a sense of financial responsibility.</li> </ul>	<ul style="list-style-type: none"> <li>(ii) May contribute to a shift in emphasis toward brick and mortar projects.</li> <li>(iii) May, in the absence of proper arrangements for transparency and accountability, contribute to budgetary gimmicks and to manipulation of deficit levels by arbitrary shifting of items between current and capital outlays.</li> <li>• Bond rating agencies look into a wide ranger of data before making an assessment and capital budgets are not insisted upon by them.</li> <li>• These techniques including rolling public investment planning do not require capital budgets.</li> <li>• Although now the application of accrual accounting is more widely accepted than before, it is suggested that there are limits to the application of commercial accounting techniques to the government sector. A form of modified accrual may be adequate.</li> <li>• In principle this is accepted but this does not necessarily require a capital budget.</li> <li>• These projects are best conceived and implemented outside the budget.</li> <li>• There is an inherent danger of the development of a `dual culture' and enclave mentalities.</li> </ul>
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illustrate the subtle differences between physical financial and social capital, distinctions are made between capital formation and investment in a broader sense that brings returns for the society as a whole. The existing scope of capital items facilitates a tie-in with national accounts.

It is suggested that in most central governments bulk of the capital budgets as noted at the outset, would be in the form of transfers to autonomous agencies and other levels of government and therefore asset formation takes place at the receiving end. As such, it may be more useful to have capital budgets at local rather than central levels of government. A capital budget at the central government, however, would facilitate the establishment of a more organised buyer-seller relationship and to that extent would contribute to a smoother financial management system. The good old argument that capital budgets would contribute to greater emphasis on brick and mortar projects raises the more philosophical issue analogous to the chicken-first-or the egg-first variety. In a context of formulation of medium term plans, and detailed scrutiny by the legislature and the public alike, it could be difficult to introduce projects except after proper scrutiny and capital budget planning described earlier. If this emphasis persists and is able to get its way, then it illustrates the triumph of politics and the logrolling pork-barrelling approaches over the organised process of budget formulation. If anything, a capital budget raises the threshold for the consideration and inclusion of projects for funding, rather than reducing it. Depreciation is another item, on which controversy abounds. Should governments follow the corporate practice and depreciate all assets (including defence) as some countries have done (e.g., New Zealand) or should there be separate practices that are more appropriate for the public sector. Increasingly, now, the view is moving towards the latter, and more efforts are being made, through autonomous accounting Boards, to specify the relevant accounting standards for the purpose.

The main problem with the capital budget has been the fact that it was never implemented in conformity with the conceptual framework except in the first phase of its introduction. The extensive prevalence of equivalents and distorted variations has changed the debate during recent years. In essence, therefore, capital budgets with all the possibilities and the discipline that they bring to the process are in need of a fresh impetus.

## Bibliography

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