



How CBO Determines Whether to Classify an Activity as Governmental When Estimating Its Budgetary Effects

When the Congress considers legislation that would establish a new program or mandate a new activity, the Congressional Budget Office must decide whether to treat the associated cash flows as federal transactions in its estimates of the bill's budgetary effects. For most legislation, that determination is straightforward because federal agencies would perform any functions required by the bills. In such cases, the cash flows would be classified as federal. In some instances, however, that determination is more complicated because the legislative proposals would authorize nonfederal entities to carry out certain activities that might or might not be considered governmental, and the cash flows related to those activities might or might not involve the U.S. Treasury.¹

In preparing its estimates, CBO generally treats the transactions of nonfederal entities as federal if those entities would use the sovereign power of the federal government, would work to achieve a governmental purpose, or would be subject to a significant degree of federal control.² To make such determinations, CBO follows guidelines from the 1967 *Report of the President's Commission on Budget Concepts*, which includes the following recommendation: "The federal budget should, as a general rule, be comprehensive of the full range of federal activities. Borderline entities and transactions should be included in the budget

unless there are exceptionally persuasive reasons for exclusion."³

Although the federal budget is primarily a tool for tracking the government's cash flows, it also serves as a measure of the scope of federal activities and their effects on the economy. Treating the activities of some nonfederal entities as part of the federal budget, even if those transactions would not flow through the Treasury, helps to accomplish that objective. This report reviews numerous examples of circumstances in which CBO has addressed the question of whether to classify an activity and its associated cash flows as federal when preparing its cost estimates.

Criteria for Identifying Governmental Activities

Certain activities, such as defending U.S. territory, representing the nation's interests in foreign affairs, collecting federal tax revenues, or regulating interstate commerce, involve powers of the federal government that are enumerated in the Constitution. Such inherently governmental functions are executed by or under the direct control of federal agencies. However, the federal government also carries out other activities—safety inspections of the commercial supply of meat, poultry, and egg products, for instance—that conceivably could be privatized or performed by a nonfederal entity but which are classified as governmental simply because the federal government conducts them.⁴ In its estimates, CBO shows

1. A nonfederal entity is one that is not a component or subordinate element of one of the three branches of the federal government or that is created by legislation specifying that the entity should not be considered part of the federal government.

2. The Office of Management and Budget in the executive branch is responsible for recording cash flows related to enacted legislation in the federal budget. Its budgetary treatment of activities may differ from the treatment CBO uses in its cost estimates.

3. See *Report of the President's Commission on Budget Concepts* (October 1967), p. 25.

4. For example, the federal government owned and operated the Naval Petroleum Reserve No. 1 in Elk Hills, California, and recorded the operating costs and proceeds from the sale of oil as federal outlays and receipts. The government sold the asset in 1997, and the cash flows associated with the oil field no longer appear in the federal budget.

the costs of both types of activities carried out by the federal government as federal budgetary transactions.

In addition, nonfederal entities carry out some functions that involve the federal government in a variety of ways. The costs to those nonfederal entities of carrying out some of those functions might be included in CBO's budget estimates for the following reasons:

- The activity would require the exercise of the sovereign power of the federal government by or on behalf of a nonfederal entity; or
- The activity would serve a specific governmental purpose; the entity would be directed, controlled, or owned by the government; or both of those conditions would be met.

Analyzing and applying those criteria involve some judgment. Consequently, CBO carefully evaluates those factors, on a case-by-case basis, when determining whether the cash flows of a nonfederal entity should be included in the federal budget.

When legislation would enable a nonfederal entity to use one or more of the federal government's sovereign powers, CBO has typically included the cash flows related to that entity's activities in its budget estimates. The entity's use of the government's sovereign power makes such a determination relatively straightforward.

By contrast, it is more difficult for CBO to make judgments about whether to include activities in its budget estimates when the agency must assess the extent to which a nonfederal entity's activities would meet a governmental purpose or must identify the amount of control the federal government would exert. In making such determinations, CBO considers a combination of those factors. CBO considers transactions to be federal if the nonfederal entity's sole purpose would be unambiguously governmental or if the entity would be subject to a significant degree of governmental control. A nonfederal entity that would have multiple purposes, one of which was governmental, and that would be subject to some governmental control might also fall into that category.

Occasionally, an entity's activities would meet both of the criteria for inclusion in CBO's budget estimates. In

those cases, the determination to classify the related cash flows as federal is relatively clear-cut.

The Exercise of Sovereign Power

The federal government has a variety of sovereign powers that are derived from the Constitution and other statutory authorities. It can compel individuals, organizations, and businesses to participate in certain activities, to surrender private property, and to pay taxes or make other payments to the federal government. It also can preempt state or local laws, regulate commerce between the states, and conduct other regulatory functions. In general, a new federal law is required to permit nonfederal entities to employ sovereign powers otherwise reserved to the government. If legislation would authorize a nonfederal entity to use the sovereign powers of the federal government, CBO considers the cash flows of activities related to that exercise to be federal.

Governmental Purposes and Governmental Control

Legislation might allow or require a nonfederal entity to work to achieve a governmental purpose, such as meeting a regulatory aim or providing a good or service that the government deems necessary. The government can control a nonfederal entity or activity in many ways and to varying degrees. The extent to which an activity would meet either or both of those criteria will affect CBO's decision about whether its cash flows should be considered federal.

If a nonfederal entity would serve a governmental purpose or act on behalf of the government to satisfy a federal policy objective or achieve a regulatory outcome, CBO might consider the costs of those activities to be federal costs. That would be especially true if the entity would act to meet the requests or requirements of the federal government rather than demand from the private sector. If nonfederal entities initially finance physical assets that are designed and constructed specifically for use by the government, CBO generally considers the activities of those entities to be federal budgetary transactions because the entities are acting on the government's behalf. The government typically repays that investment with periodic outlays (for example, annual payments for leases). In such cases, CBO sometimes concludes that the nonfederal entity's up-front investments and expenditures would represent commitments of the government; therefore, the agency shows them as budgetary flows (rather than showing the government's payments over time to the entity).

The government exerts some degree of control over many functions and activities outside of the federal realm, not all of which CBO treats as federal. However, if the federal government would exercise substantial control over the operations of a nonfederal entity, CBO might consider the transactions of that entity to be federal. The government can control a nonfederal entity or activity in a number of ways: It can approve the entity's budgets, plans, or strategies; direct the entity to achieve certain policy goals or to pursue specific priorities; appoint the entity's members and staff; be the primary impetus or genesis of the activity being undertaken; or take an ownership interest in the entity. The greater the extent of control, the more likely it is that CBO would consider the cash flows related to the activities to be federal budgetary transactions.

Examples of Activities by Nonfederal Entities and Their Budgetary Treatment

In preparing cost estimates, CBO has often faced the question of whether to treat the transactions of a nonfederal entity as federal. Some of the examples below illustrate how the use of sovereign power affected the answer. Others demonstrate how CBO's determination was influenced by the fact that an entity would have served a governmental purpose or been subject to some degree of governmental control.

Use of Sovereign Powers by or for Nonfederal Entities

In certain instances, legislation has delegated a sovereign power of the federal government to nonfederal entities. Examples of such entities and their associated activities include the following:

Marketing and Promotion Boards. Legislation may require a federal agency to conduct a referendum among participants in a particular industry about whether to form a marketing and promotion board or other organization. The purpose of the board or organization would be to promote or expand markets for industry products, to conduct industry-related research, or to develop programs to educate the public about the industry and its products. Such organizations are typically formed upon the vote of a majority of industry participants to do so. Once the board is formed, however, payments from or assessments on all participating businesses are mandatory, regardless of whether the participant voted in favor of forming the board or even voted on the matter at all. In cost estimates, CBO classifies the payments

to such boards as federal revenues and expenditures of those amounts as federal outlays because the authority to compel payments arises from an act of Congress.⁵ That treatment would apply to legislation creating a new board or reauthorizing a board after existing authorities expire. Many long-standing marketing boards were not treated as federal entities when they were first established, and the Office of Management and Budget (OMB) has not reclassified them as such in the federal budget. In its budget projections, CBO follows OMB's treatment of those boards while they continue to operate under current law.

Universal Service Fund. The Universal Service Fund (USF) uses the federal government's sovereign power to levy taxes to meet a legislated governmental purpose. The Telecommunications Act of 1996 requires that telecommunications carriers contribute a percentage of the revenues they derive from long-distance telephone and other interstate and international services to the USF. The fund disburses payments to eligible carriers that deliver services that federal policy seeks to make widely available (such as providing residential phone service to low-income people). Overall responsibility for the process lies with the Federal Communications Commission (FCC), which, in conjunction with state utility regulators, determines the amount of spending necessary to meet the requirements of the law and ensures that telecommunications companies make adequate contributions. The Universal Service Administrative Company (USAC), a not-for-profit corporation regulated by the FCC, administers the specific programs that promote universal service. The USAC collects the funds to pay for the programs and dispenses payments to eligible telecommunications providers. Because the cash flows from the USF are used to achieve a governmental purpose and because payments into and disbursements from the USF are required by law, they are counted as revenues and outlays in the federal budget, even though the USAC is not a federal entity and its cash flows do not involve the Treasury.

Air Traffic Control Corporation. H.R. 4441, the Aviation Innovation, Reform, and Reauthorization Act of 2016, would create a nonfederal Air Traffic Control (ATC) Corporation to take over some duties of the

5. For an example, see Congressional Budget Office, cost estimate for H.R. 985, the Concrete Masonry Products Research, Education, and Promotion Act of 2015 (December 7, 2016), www.cbo.gov/publication/52323.

Federal Aviation Administration. The ATC Corporation would be the only entity authorized to provide air traffic services within U.S. airspace and would be authorized to charge user fees to cover the costs of those services. It also would be authorized to enforce that requirement in U.S. courts, if necessary. Although the legislation would designate the proposed corporation as an independent and autonomous entity, CBO would treat it as governmental for budgetary purposes because it would effectively act as an agent of the federal government by carrying out a regulatory function. Further, the ATC Corporation would collect fees that CBO would classify as federal revenues because they would be compulsory.⁶

Power Transmission. The Department of Energy (DOE) is authorized by law to participate with nonfederal entities in the development of electric power transmission projects, subject to certain conditions. Under section 1222 of the Energy Policy Act of 2005, that participation may involve owning, building, or operating transmission facilities that are located in any of the 19 states where customers are served by either the Southwestern or Western Area Power Administrations (SWPA or WAPA). DOE recently entered into an agreement under section 1222 to participate in a \$2.5 billion interstate transmission project in SWPA's service area. That agreement suggests that successful implementation will depend on DOE's use of eminent domain to acquire some property that is necessary for siting the transmission lines. The department will also use its exemption from state, local, or tribal regulations to ensure that parts of the project are not blocked by those entities. Given the anticipated use of sovereign power (as well as the extent of federal control), CBO considers such projects to be governmental and includes the associated cash flows in its budget projections and in estimates for related legislation.⁷

6. See Congressional Budget Office, cost estimate for H.R. 4441, the Aviation Innovation, Reform, and Reauthorization Act of 2016 (March 9, 2016), www.cbo.gov/publication/51362.

7. See Congressional Budget Office, cost estimate for H.R. 3062, the APPROVAL Act (November 18, 2016), www.cbo.gov/publication/52207. That bill would limit the use of certain sovereign powers in conjunction with the project, reducing the likelihood that the government would continue to participate. Thus, CBO estimated that enacting the bill would reduce the amount of federal budgetary transactions.

Nonfederal Entities That Serve a Governmental Purpose or Are Under Federal Control

CBO has included in its cost estimates the cash flows of certain nonfederal entities whose activities would serve a specific governmental purpose. Similarly, in some instances, CBO has concluded that the extent of governmental control would justify including the cash flows of those nonfederal entities in federal budget totals. In still other instances, the agency took into account the cash flows of nonfederal entities whose activities both serve a federal purpose and are subject to governmental control. (When the government would exercise little control and no governmental purpose would be served, CBO usually has not included the activities of those entities in its estimates of federal budgetary effects.) The official budget figures recorded by OMB also reflect such distinctions in some cases (but not necessarily those that CBO makes in its cost estimates).

Examples of instances in which CBO considered whether such entities and their activities served a governmental purpose or were subject to governmental control include the following:

Privatized Military Housing. Beginning in the late 1990s, the Department of Defense (DoD) began the nominal privatization of government-owned housing for military personnel. Before the privatization program, DoD acquired housing for some military personnel by contracting with housing developers or construction companies to build housing on military installations—paying the builders as they performed and completed construction. DoD owned and operated that housing after it was constructed. Under the Military Housing Privatization Initiative, the department entered into an array of long-term agreements with residential housing developers who established limited liability companies (LLCs), partnerships, or other special-purpose entities specifically for the purpose of renovating, constructing, operating, and maintaining the military family housing at each military base or other location. Ownership of existing housing units was conveyed from DoD to the LLCs, which owned and operated the new or renovated facilities. However, the housing was built at the request of, and to the specifications of, the federal government to achieve DoD's goal of providing such housing. The projects are managed in accordance with government criteria, and rental rates are set to match the housing allowance that the department pays to service members. In its cost estimates for legislation dealing with such projects, CBO showed the LLCs' costs of constructing that housing up front in its budget estimates because the housing was

provided to meet the government's purpose and was subject to significant governmental control.⁸ However, OMB and DoD do not include those costs in their budget figures. Instead, they record the annual housing allowances that the department pays to service members who occupy such housing after appropriations for those allowances are enacted each year.

Enhanced-Use Leases. Various federal agencies are allowed to lease underutilized property to a nonfederal entity in exchange for cash or in-kind compensation. In some instances, agencies have exercised that authority to enter into enhanced-use leases to obtain third-party financing for the acquisition, construction, rehabilitation, operation, and maintenance of real property used by the agencies. Those agencies use a variety of agreements and contracts to assure the nonfederal partner that, over time, it will be able to recover its capital costs for the facilities through payments from the federal government. Those arrangements are made for governmental purposes and generally involve a significant amount of governmental control.

For example, Public Law 114-226 (H.R. 5936) authorized the Department of Veterans Affairs (VA) to lease property at the department's medical campus in Los Angeles to developers who would design, construct, and operate supportive housing and rehabilitation facilities for homeless veterans. VA personnel would provide a variety of services on an ongoing basis to resident veterans and the project would receive several operating subsidies from the federal government. CBO classified the cost of designing and operating those facilities as federal in its cost estimate for that bill for the following reasons:

- The facilities would be built on VA property;
- The department would approve construction plans and operating budgets for the facilities;
- The housing would be reserved primarily for veterans;
- Ownership of the facilities would revert to the government at the end of the lease term;

8. See Congressional Budget Office, cost estimate for H.R. 4879, the Military Housing Improvement Act of 2004 (July 30, 2004), www.cbo.gov/publication/15869.

- VA personnel would work in the facilities to provide rehabilitation services to resident veterans; and
- The housing would receive ongoing operating subsidies from federal housing programs.

Thus, CBO's estimate showed the construction costs financed with private funds as if they were financed directly by the government.⁹

Health Care. Major health care legislation considered by the Congress has raised significant budgetary issues. For example, the Clinton Administration proposed legislation that would have created a federal entitlement to health benefits and a system of mandatory payments to finance those benefits. Many aspects of the proposal were clearly governmental activities that would fall within the scope of the federal budget. For example, the proposal would have provided federal subsidies for individuals and employers to purchase health insurance. It would have made changes affecting outlays for Medicare and Medicaid, and it would have expanded certain discretionary health care programs.¹⁰ It also would have increased taxes on tobacco products.

However, that legislation also raised broader budgetary issues. The proposal would have essentially supplanted the existing market for health insurance with one that was managed and controlled by the federal government and its agents. It would have established a system of health care alliances to manage insurance programs, collect premium payments from individuals and employers, and make payments to health care providers.¹¹

For several reasons, CBO concluded that the alliances would have acted as federal agents and that their cash flows should have been recorded as federal revenues and spending, even though such amounts would not have passed through the Treasury. The proposal defined the universal entitlement to health care in considerable

9. For additional information on a similar bill, see Congressional Budget Office, cost estimate for H.R. 3484, the Los Angeles Homeless Veterans Leasing Act of 2016 (May 17, 2016), www.cbo.gov/publication/51583.

10. Funding for discretionary programs is provided and controlled by annual appropriation acts.

11. See Congressional Budget Office, *The Budgetary Treatment of an Individual Mandate to Buy Health Insurance* (August 1994), Chapter 3, www.cbo.gov/publication/15010, and *An Analysis of the Administration's Health Proposal* (February 1994), www.cbo.gov/publication/15076.

detail, dictated the means by which the outcomes would have to be achieved, prescribed the financing mechanism that would have to be used, and included authority to enforce the prescribed transactions. The activities would have been monitored and regulated by federal agencies. Further, the alliances would have been able to borrow money and receive start-up grants from the federal government. Finally, the alliances would have been granted powers that are derived from sovereign federal authority. For example, each alliance would have been able to collect premium payments from businesses that employed residents of the states covered by that alliance, even when those businesses engaged in no activity in those states.

Several optional components of the Clinton health plan would have provided alternatives to states, employers, and individuals. However, CBO concluded that those components were not sufficient to classify the program as a nonfederal activity.

More recently, the Affordable Care Act (ACA) modified the nation's health care system in several significant ways.¹² The law imposes a mandate on individuals to maintain health insurance that provides a minimum level of benefits. It requires employers to either offer health insurance to their employees or make payments to the federal government. The law subsidizes insurance for people with incomes below certain levels. It expanded existing health care programs such as Medicaid. The act also includes a method by which income is transferred between insurers to adjust for the varying costs of insuring people with poorer health or costly medical needs. Further, it established health care marketplaces (similar to the alliances in the Clinton proposal). Marketplaces do not provide insurance. They are entities run by the federal government or state governments that provide shopping and enrollment services that individuals and some small employers can use to purchase insurance.

The federal budget includes the components of the ACA that involve cash flows to and from the Treasury. Federal subsidies to individuals are shown as increases in federal outlays and reductions in federal revenues. Additional payments through Medicaid are shown as increases in federal outlays. Penalty payments from individuals and businesses that do not maintain qualifying insurance

are treated as federal revenues. And mandated transfers between insurers under the risk-adjustment program are recorded as federal revenues and spending.

However, for several reasons, in its cost estimates for the legislation, CBO did not consider the payments from individuals and businesses to insurers that participate in the federal and state-run health care marketplaces to be federal transactions. (OMB has made the same judgment in its budget presentation.) Payments are made directly to the insurer, not to the marketplaces themselves. Although the ACA significantly increased the federal government's role in the market for health care, CBO concluded that there would be ways to purchase health insurance other than through the government marketplaces. Individuals also could purchase plans that did not comply with the minimum coverage mandates of the ACA. Additionally, the law provides some flexibility in the percentage of premium payments that insurers spend on health care, enabling insurers to provide more than one or two coverage plans.

Thus, the system provides flexibility in terms of the types, prices, and number of private-sector sellers of insurance available to people. As a result, CBO concluded that the insurance market as a whole would continue to be part of the private sector (as was the case before enactment of the ACA). Therefore, except for certain transactions that explicitly involve the government, CBO has treated the cash flows associated with the health insurance system (for example, premium and benefit payments) as nongovernmental in its estimates and budget projections.¹³

Puerto Rico Control Board. The Puerto Rico Oversight, Management, and Economic Stability Act (P.L. 114-187) established a control board for the Commonwealth of Puerto Rico to oversee solutions to the territory's financial crisis. Although the legislation specified that the control board and its receipts and spending should not be considered part of the federal budget, CBO decided to include those cash flows in its cost estimate because of the degree to which the federal government would exercise power over the board. Specifically, the board members were to be nominated by the Congress and appointed by the President; the board would have broad powers to effectively overrule decisions

12. The ACA comprises the Patient Protection and Affordable Care Act (P.L. 111-148) and the Health Care and Education Reconciliation Act of 2010 (P.L. 111-152).

13. For additional information, see Congressional Budget Office, *The Budgetary Treatment of Proposals to Change the Nation's Health Insurance System* (May 2009), www.cbo.gov/publication/41185.

by Puerto Rico's legislature, governor, and other public authorities; and the territory would be required to provide funding for the board's operations.¹⁴

CBO did not treat the rest of the territory's budget as part of the federal government. Although the board itself was to have some control over the territory's budget, CBO concluded that the legislation did not empower the board to supplant the territorial government. Thus, CBO did not find that the degree of federal control was sufficient to justify considering the territory's cash flows to be federal.

Fannie Mae and Freddie Mac. In CBO's judgment, the federal government's current financial and operational relationship with Fannie Mae and Freddie Mac warrants their treatment as governmental enterprises; consequently, the agency considers their transactions to be federal. Before the housing bust that began in 2007, Fannie Mae and Freddie Mac were considered to be private firms, despite their having a unique legal status and a long history linking them closely with the federal government. Further, the President's Commission on Budget Concepts recommended that government-sponsored enterprises such as Fannie Mae and Freddie Mac be excluded from the budget if the federal government does not have an equity stake in those entities. However, in September 2008, the director of the Federal Housing Finance Agency placed those entities into conservatorship, giving control of the entities to the federal government. In exchange for providing capital to ensure that those entities could continue to support the mortgage market, the Treasury received shares of preferred stock and warrants to purchase common stock in Fannie Mae and Freddie Mac. As the majority owner, the government sometimes prioritized its policy objectives ahead of corporate financial goals. For example, the entities have been required to transfer profits to the Treasury in amounts that exceed the government's financial aid. Because the government exercises a significant degree of control and uses the entities to achieve a governmental purpose, CBO revised its budgetary treatment of the entities and currently treats the mortgages owned or guaranteed by Fannie Mae and Freddie Mac as loans and loan guarantees of the federal government. (The executive branch has not adopted that budgetary treatment.)

14. See Congressional Budget Office, cost estimate for H.R. 5278, the Puerto Rico Oversight, Management, and Economic Stability Act (June 3, 2016), www.cbo.gov/publication/51650.

The Federal Home Loan Bank System. In contrast with Fannie Mae and Freddie Mac, the Federal Home Loan Bank (FHLB) System is a government-sponsored enterprise that is not classified as a federal entity in CBO's cost estimates. (Similarly, the system as a whole is not included in the federal budget by OMB.) The system was established by the federal government during the Great Depression to increase access to financing for housing. The FHLB system is a cooperative made up of 11 regional banks that offer financing to more than 7,500 members (banks, thrift institutions, insurance companies, and credit unions). FHLBs make loans and provide other credit services that members use to fund mortgages and other loans. FHLBs are exempt from all corporate federal, state, and local taxation, except for local real estate tax. Although the banks are regulated by the Federal Housing Finance Agency, they are owned and operated by the member institutions. Further, they do not receive federal funding for their operations, and the federal government does not have an equity stake in the FHLB system (as it does with Fannie Mae and Freddie Mac).

Federal law requires the system to direct 10 percent of its annual earnings toward affordable housing programs. Although those funds do not flow through the Treasury and are not spent by a federal agency, the amounts set aside are treated as federal revenues because they are compulsory, and the spending is treated as federal outlays. However, the FHLB system's day-to-day operations are not controlled by the federal government, and thus most of the system's transactions are not included in federal budget totals.

General Motors. The federal government provided nearly \$50 billion to assist General Motors after the company declared bankruptcy in 2009 and, in return, received a 61 percent equity stake in the company. Although that financial aid was clearly federal, in CBO's judgment, the government's ownership did not warrant classifying all of the company's transactions as federal because the degree of governmental control was insufficient. The government announced at the outset that it would not exercise any control over the day-to-day operations of the reorganized company and that it intended to divest of its ownership interest as quickly as possible while preserving the taxpayers' investment. Subsequently, the federal government did not use the company to achieve a governmental purpose and liquidated its shares over the next four years. Thus, neither CBO nor OMB treated that corporation as a governmental entity.

This report provides background information about how the Congressional Budget Office determines whether to classify an activity as governmental when estimating its budgetary effects. In keeping with CBO's mandate to provide objective, impartial analysis, the report makes no recommendations.

David Newman prepared this report with contributions from Megan Carroll and guidance from Kim Cawley, Theresa Gullo, and Sarah Jennings. Perry Beider, Joseph Kile, Nathan Musick, and Chad Shirley provided comments on the report, as did Jim Hearn of the Public Company Accounting Oversight Board. (The assistance of an external reviewer implies no responsibility for the final product, which rests solely with CBO.)

Mark Hadley, Jeffrey Kling, and Robert Sunshine reviewed the report, Loretta Lettner edited it, and Jorge Salazar prepared it for publication. An electronic version of the report is available on CBO's website (www.cbo.gov/publication/52803).



Keith Hall
Director
June 2017

