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Public Buildings: Own or Lease?

Statement of
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Operations Issues
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Committee on Public Works and Transportation
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PUBLIC BUILDINGS: OWN OR LEASE?

SUMMARY OF STATEMENT BY
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OPERATIONS ISSUES

At the request of the Senate Appropriations and Environment and Public Works Committees, GAO is nearing completion on a series of reports addressing GSA's efforts to reduce the proportion of costly leased space in its inventory. In one forthcoming report, GAO reviewed 43 projects identified by GSA and found that $12 billion could be saved over 30 years by constructing space that GSA would otherwise lease -- a "present value" savings of nearly $1.3 billion in 1989 dollars. GAO also found that one-quarter of the leases proposed by GSA in 1988 would be more economical as construction projects.

GAO identifies two principal obstacles to increasing the amount of federal ownership of office space it will need for the long term. One is funding constraints -- the inadequacy of the Federal Buildings Fund to cover long-term construction needs. This factor is also recognized in the recent GSA/OMB study of federal real estate, in which OMB expresses a commitment not to reimpose rent restrictions. GAO's report will recommend that Congress also refrain from imposing restrictions on rent charged to tenant agencies.

A second factor, not addressed in the GSA/OMB study, is the inherent bias against capital investment built into the current federal budget process. Because the entire costs of constructing a new building are outlayed in the years of construction, leasing invariably seems to be the cheaper alternative for any one year since only one year's lease cost needs to be recorded each year. The current budget structure fails to recognize that an owned building produces a stream of benefits over its life, while lease payments lead to no future benefits.

GAO advocates a restructuring of the federal budget along lines already used by the private sector and state governments, to distinguish between operating expenses and capital investments. GSA, in its comments on GAO's report, has agreed to take the first step toward implementing a capital budget by recommending to OMB that the Federal Buildings Fund separately present capital and operating activities in the 1991 budget.

GSA's capital investment program has been seriously hampered by the agency's lack of a long-range facility plan. The GSA/OMB study recognizes the need for a plan of action to identify and meet future requirements, provides some general criteria for determining whether office space needs in a given community are short-term or long-term, and includes a list of 21 projects for construction in the near term. GAO believes this is a step forward, but notes the absence of an overall perspective on how far these projects go toward meeting overall ownership needs.

Mr. Chairman and Members of the Committee:

We welcome this opportunity to appear before you today as you consider the September 7, 1989, study of federal real property prepared by a joint task force of the Office of Management and Budget and the General Services Administration. The basis for my remarks today is a body of work we are just now completing on the effectiveness of GSA's efforts to improve the ratio of government-owned to leased space. This work was undertaken at the request of the Senate Committee on Environment and Public Works and the Senate Committee on Appropriations. Senators Moynihan, Domenici, DeConcini, and Chafee have given us permission to use the results of this work in our testimony today, even though two of the key reports will not be issued until October.

In one report that was published in April 1989, Public Buildings Service: GSA's Projection of Lease Costs in the 1990s (GAO/GGD-89-55), we analyzed GSA's projection that the cost of leasing space would increase from $900 million in 1986 to $2 billion by 1995. We found that some of the data used to make the projection was unreliable, although the current model for making the projections is basically sound. GSA now estimates that its leasing bill will reach $2 billion by the late 1990's -- indisputably a major increase in costs over the coming decade.

In a second report, which is scheduled to be issued next month, we examined GSA's building purchase program. Its major message is that although purchases need to be better managed, the program has proven to be an economical means for acquiring office space. GSA has reviewed this report and accepted its recommendations.

Finally, and most directly related to the subject of this hearing, we have completed drafting a report addressing (1) whether GSA is meeting identified federal office space needs in the most economical manner, and (2) whether economic or noneconomic factors have hampered GSA's ability to own more space. We sought comments on this draft report from OMB and GSA on August 4. GSA provided us written comments on September 15, and OMB provided its written comments on September 25. Both generally agreed with our analysis and pointed out that our conclusions were similar in many ways to the joint GSA/OMB task force recommendations communicated to you on September 7.

GAO'S ANALYSIS

We did two analyses to compare the costs of increased ownership to the alternative of continuing to lease equivalent space. First, we obtained a list of 43 potential construction projects that GSA thought it could undertake for fiscal years 1991 through 1995 if funds were available. We applied the results of economic analyses that GSA or we did in accordance with OMB Circular A-104 to determine whether government ownership of the 43 buildings would be more cost-beneficial than leasing equivalent space in the same locations.

OMB Circular A-104 provides the commonly accepted methodology for comparing the long-term costs and benefits of leasing to ownership. Second, we reviewed the economic analyses for the 72 specific leases, each of which cost more than $500,000, that GSA proposed to this Committee for approval during calendar year 1988.

Increased Ownership Would Result in Significant Cost Savings

Our audit work indicated that GSA can realize significant savings by increasing the proportion of federally-owned space. We found that constructing the 43 projects we reviewed would save $12 billion over 30 years when compared to leasing the same amount of space -- a "present value" savings of nearly $1.3 billion in 1989 dollars.

We also found that federal ownership of about one-quarter of the space GSA proposed leasing in 1988 would save about $116 million over 30 years in 1988 dollars. However, ownership is not always preferable to leasing. For three-quarters of the space, leasing was either less expensive than construction or preferable for practical reasons, such as to meet temporary space needs during building repairs.

The question arises why ownership was not selected and proposed to Congress in the instances where GSA data showed ownership was the more cost-effective alternative. The question becomes even more pertinent considering that owned space has decreased by 15 million square feet since 1975. Here our conclusions at least partially coincide with those of the GSA/OMB task force study that you are considering today.

FUNDING AND BUDGETING CONSTRAINTS HAVE LIMITED GSA'S ABILITY TO INCREASE OWNERSHIP

Basically there are two explanations for GSA's inability to increase the amount of federal ownership--funding constraints and an inherent bias against capital investment in the budgetary system. The GSA/OMB task force study directly addresses the first constraint, but sidesteps the second.

Funding Constraints

Historically, the Federal Buildings Fund has generated little revenue for capital investment. Between 1975 and 1988, the Fund generated an average of only $97 million per year for construction and acquisition. The inadequacy of this funding level is apparent when it is compared to the estimated $3 billion in funding required to construct the 43 buildings GSA identified as cost-effective candidates for construction in the 1991-95 period. One reason for the low funding level is that OMB and Congress have restricted the rent GSA charges tenant agencies. For the period 1983 to 1987 alone, these rent restrictions have reduced Federal Building Fund income by $1.3 billion in 1988 dollars.

OMB has indicated that it will not reimpose rent restrictions, and our report will recommend that Congress also refrain from this practice. Nevertheless, GSA's fiscal year 1990 budget estimates, as well as the GSA/OMB real property study, both indicate the Fund will continue to fall short in financing identified cost-effective capital investment projects. The budget estimates show that even without rent restrictions the Fund will generate an annual average of only $111 million between 1990 and 1994 for construction and acquisition. Although this is a slight improvement, it is far short of the $3 billion that would be needed for cost-effective construction identified in our study.

Budgetary Bias

Another factor hampering GSA's ability to increase government ownership of space is the inherent bias against capital investment built into the federal budget process, a factor not addressed in the GSA/OMB study. This bias occurs because the federal cash budget makes no distinction between an outlay for a capital asset that will produce a future stream of benefits and an outlay for current operations. For example, the budget does not distinguish between an outlay for constructing a building and an outlay for leasing equivalent space, even though the two types of costs are fundamentally different. The difference is that a one-time investment in an owned building will provide a stream of future benefits by housing federal employees, while rental payments will have to be made year after year.

The budget system is inherently biased against capital investment because of the disadvantage capital investments face due to the need to record total costs in a relatively short period for capital investments. In contrast other costs, such as leasing costs, can be spread out over a much longer period. In other words, the entire costs of construction are outlayed during the few years of construction but only one year's rent has to be outlayed for a leasing project.

As a result, the budget process places capital investment projects at a disadvantage during budget deliberations. These projects must compete with other means for acquiring space, such as leasing, which have much lower initial costs but, in many of the cases covered in our analysis, significantly higher long-term costs. And so GSA and Congress have typically selected the option that is actually more costly over the long-term.

GSA HAS TURNED TO COSTLY ALTERNATIVE FINANCING TECHNIQUES

To counteract the Fund's limited resources and the budgetary bias against capital investment, Congress has directed GSA to use alternative financing methods to finance federal ownership in recent years. Alternative financing methods, a form of borrowing from the private sector, allow GSA to supplement limited funds. By providing a waiver of the Anti-Deficiency Act, Congress has also counteracted unequal budget treatment. However, there is a cost to using alternative financing methods. GSA pays a higher interest rate than could be attained by borrowing from the U.S. Treasury.

We looked at the costs associated with two alternative financing techniques. The first alternative financing technique, purchase-contract, was authorized for 3 years preceeding the operation of the Fund. Under this program, GSA financed construction of 68 buildings by selling mortgages in the private sector and financing through the Federal Financing Bank. Financing these projects through the private sector rather than the Treasury has increased costs by a present value of $288 million in 1988 dollars.

The most recent technique used is lease-purchase agreements, which are lease-type arrangements with developers in which the federal government owns the building at the end of the lease period. Congress authorized the use of lease-purchase on a project specific basis beginning in 1986, and GSA has negotiated agreements for two projects (one in Chicago and one in Oakland). Interest costs over the life of these two projects have a present value of $23 million more in 1988 dollars than if GSA had borrowed the funds through the Treasury.

In their study, GSA and OMB advocate financing 21 projects through lease-purchase agreements, terming this "least cost financing mechanisms." Although lease-purchase may be less expensive than leasing for long-term needs, GSA could save even more by financing these projects through the Treasury.

CAPITAL BUDGETING CAN HELP IMPROVE DECISION-MAKING

We believe that a restructuring of the current federal budget would in the long run provide a preferable alternative to the GSA/OMB approach. The Comptroller General has for some time been urging such a restructuring to include a capital component in the budget. Capital budgeting is a budget approach that is used extensively by state governments and in the private sector.

A capital budget differs from the federal cash budget in that it separates costs into two components -- operating expenses and capital expenses. Because a capital budget distinguishes between operating expenses and capital investments, it can help decision-makers make informed choices when allocating resources between short-term operating needs and long-term investment needs. For example, Congress could establish different deficit reduction targets for operating costs and capital costs.

A capital budget would help correct the budget bias but would still disclose the entire cost of acquiring assets. The basic idea would be to annualize the costs of capital acquisitions by spreading the costs in the budget over the useful lives of the assets. The annual amount would be shown in the operating part of the budget as an operating expense. This would put capital acquisition costs on a comparable basis with annual lease costs. A fuller description of our concept is contained in a report issued to the Congress in August (Budget Issues: Restructuring the Federal Budget -- The Capital Component, GAO/AFMD-89-52).

However, capital budgeting should be considered as a long-term objective. There are many conceptual and practical questions to be resolved before such a system could be implemented. In our report, we will be recommending that GSA take a leadership role in both testing and demonstrating the benefits of capital budgeting, beginning with a separation of the activities in the Federal Buildings Fund budget into the categories of operating expenses and capital investment. In its comments on our report, GSA said it would give this recommendation serious attention and has taken the first stp toward implementing it by recommending to OMB that the Federal Buildings Fund's capital and operating activities be separated for presentation purposes in the fiscal year 1991 budget.

NEED FOR LONG-RANGE FACILITY PLAN

We are pleased to note that the GSA/OMB study recognizes the need for long-range planning to meet federal office space needs. This new emphasis on comprehensive planning is valuable since GSA's capital investment program has been seriously hampered by the agency's lack of a long-range facility plan identifying overall space needs and the most economical way of meeting them.

In the past, GSA has simply presented a list of projects requiring funding in the current year as part of the budget cycle without identifing the total amount of space the federal government should own. As a result, Congress could not monitor its progress in meeting long-term capital investment needs. Nor could GSA or Congress anticipate how much funding would be needed for capital investment in the future, or identify how much would be saved by owning buildings rather than continuing to rely on leasing. During our audit work, GSA officials expressed doubt about the usefulness of a long-range plan because the agency lacked sufficient funds to implement it.

The GSA/OMB study recognizes the need to determine short-term and long-term requirements and provides some general criteria for determining whether office space requirements in a given community are short-term or long-term. The study also recognizes the need to develop a plan of action to satisfy future requirements, and includes a list of 21 projects for construction beginning in fiscal years 1992 through 1994. Although this is a valuable first step, we believe two things are still missing: a perspective on how far these projects go toward meeting overall ownership needs and an estimate of how much will be saved by constructing these projects.

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That concludes my prepared statement, Mr. Chairman. My colleagues and I would be pleased to respond to any questions you may have.