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CONGRESSIONAL TESTIMONY

The Broken Budget Process: Legislative Proposals

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My name is Alison Acosta Fraser. I am the Director of the Thomas A. Roe Institute for Economic Policy Studies at The Heritage Foundation. The views I express in this testimony are my own, and should not be construed as representing any official position of The Heritage Foundation.

Congressional and executive oversight of the federal budget are in turmoil. The political aversion to tackling federal overspending is enhanced and enabled by the inadequate processes that govern the budget. The last time a concurrent budget resolution was passed on time was April 11, 2003. The Senate's record for failing to pass a budget resolution is even more discouraging. The budget process is especially inadequate for addressing and managing the long-term affordability and sustainability of fiscal policy. Indeed, much about the process serves to incentivize the avoidance of our long-term problems if not to exacerbate them. The biggest drivers of long-term spending—entitlements—are not subject to annual or even regular budget review and they continue sharp growth under budgetary "auto-pilot." And there are other problems with the budget process: from the way the budget window can be gamed to the exploitation of emergency spending.

Two things are needed to prevent a European-style fiscal and debt crisis: process changes which require—some would say force—solutions and ensure fiscal results are achieved, and the robust policy solutions themselves. Today's hearing on process reform is particularly welcome.

Need for Action

Today, federal spending is at about 23 percent of GDP and debt held by the public is approximately 70 percent. When compared to the historical, post–World War II average of approximately 20 percent of GDP for federal spending and 44 percent for debt held by the public, this growth alone would be cause for concern. But the sad fact is that U.S. federal debt soon will explode to economically damaging levels and spending will be the primary driver of that explosion.

Economic growth is materially slowed when debt approaches the size of the economy. But in a world like today's, where the global economy is increasingly interconnected and global capital markets in particular, it is possible that even this can miss the true potential magnitude of a debt and spending driven crisis. There is no better evidence than to watch the European budget and debt crises continue to unfold.

By the end of the decade, debt held by the public will reach 100 percent of GDP. After a generation it will reach nearly 200 percent[1] and continue to skyrocket thereafter. The driver of this debt is federal spending; in 10 years federal spending will be at 22.1 percent of GDP, while revenues will reach 18.3 percent of GDP, essentially at their

[1] Congressional Budget Office, 2011 Long-Term Budget Outlook, Alternative Fiscal Scenario, June 2011 at http://www.cbo.gov/sites/default/files/cbofiles/attachments/06-21-Long-Term_Budget_Outlook.pdf.

historical average of 18.1 percent.[2] Then the situation deteriorates dramatically. By 2035, spending will reach 34 percent of GDP, driven primarily by the three major entitlement programs: Social Security, Medicare, and Medicaid. In 2012, they comprise approximately 45 percent of total federal spending, or 10 percent of GDP, and by 2035 they will reach approximately 16.5 percent of GDP. Left alone, they will devour all tax revenues by 2045, assuming the historical level of taxation.

Taking Back Our Fiscal Future

Many budget experts on the right and left have been rightly concerned about our grave situation and the lack of substantive legislative progress. One such project, *Taking Back our Fiscal Future*, stemmed from a joint project of the Brookings Institution and the Heritage Foundation. Experts from those and five other organizations across the ideological spectrum worked together for over a year to "define the dimensions and consequences of the looming federal budget problem, examine alternative solutions, and reach agreement on what should be done. Despite our diverse philosophies and political leanings, we have found solid common ground."[3]

Even with these diverse ideological perspectives, the recommendations in this report included taking entitlement spending off budgetary auto-pilot and budgeting for the long term. This paper was published over four years ago. One striking passage in the report notes the "huge problem the candidates are not talking about" namely, "how to narrow significantly the enormous gap between projected federal spending and revenues." Fast forward four years to the 2012 election and an even worse fiscal picture. The same flaws in the budget process still exist today, but the urgency for solving the fiscal picture is even more imperative. Fixing the process is equally important.

Fixing the Process

Process reform legislation should include tools to address the major gaps that exist today, controlling the growth in spending—including entitlement spending—over the both short term and the long term.

My testimony will focus on the first two of the three bills under discussion today:

- **Spending Control Act, H.R. 3576**, which would put enforceable limits on federal spending over the 10-year budget window, which would be enforced through sequestration;
- **Balancing our Obligations for the Long Term (BOLT) Act, H.R. 3580**, which would focus on the long-term budget picture by putting budget

[2] http://www.heritage.org/federalbudget/runaway-spending-tax-revenue There are different ways to calculate average historic levels of revenue, spending, and debt. Such averages vary due to the time periods covered. In the Heritage Foundation's *Federal Budget in Pictures* publication, these averages span 50 years (1959–2008), encompassing post–World War II and pre–Great Recession years. *www.heritage.org/federalbudget*

[3] Joseph Antos, Robert Bixby, Stuart Butler, et al., "Taking Back our Fiscal Future," Brookings Institution and Heritage Foundation, April 2008, http://www.brookings.edu/~/media/research/files/papers/2008/4/fiscal%20future/04_fiscal_future.pdf (accessed May 30, 2012).

controls on total federal spending over a 30-year period, increase disclosure of the true long-term budget picture to Members of Congress and the public; and

- **Review Every Dollar (RED) Act, H.R. 3579**, which would make it more feasible to control spending by creating reserve accounts for deficit reduction and placing new limits on administrative actions which can drive up spending on mandatory programs.

The **Spending Control Act** starts by tightening the discretionary caps in the Budget Control Act (BCA), and importantly gives more discretion to Congress to set budget priorities between security and non-security spending. Both of these are important; the BCA's total of $2.1 trillion was only a first step toward slowing the growth in spending, and more should be done. Indeed, the size of cuts taken in isolation sounds impressive, yet over the 10-year period covered by the BCA, these cuts represent merely 4.7 percent of total spending and just over half of the new debt projected over the same period. As noted earlier, reforms to the budget process must be accompanied by policy changes. The new spending caps in the Act are taken from the House-passed budget resolution, which included policy recommendations to committees, which effectively links process to the policy goals and strengthens the budget resolution. Congress should, however, have the discretion to set priorities across the entire budget, so removing the firewall between security and non-security spending is sound policy.

One major gap in the budget process today is that direct (or mandatory) spending is not budgeted. Thus, the big three entitlement programs—which enjoy essentially open-ended appropriations—are allowed to grow on auto-pilot. Put another way, the biggest drivers of the federal budget are able to enjoy an automatic "first call" on tax revenues, squeezing other priorities—be they strong defense or education. This is remarkable in the sense that affording such a budget priority to any program—much less such a major one—effectively limits congressional debate on setting national priorities. This is especially problematic for solving our spending and debt crises as it places more budget emphasis on the smallest portion of the budget and diverts attention away from the biggest drivers. To address this imbalance, this legislation would cap spending on the major entitlements in two ways.

First, it places caps on three categories of direct spending: Medicare, Medicaid and other health-related spending, and all other direct spending (exempting Social Security and net interest). Here too, the caps are set to the levels in the House-passed budget resolution—further linking program modernization with the enforcement and process side of budgeting. It is unfortunate that Social Security is exempt from caps, as it is unsustainable over the decade and beyond.[4] The program is already in permanent deficits, which means it is placing a strain on the rest of the federal budget by crowding out other spending or—more likely—higher borrowing. Exempting Social Security from spending restraint will mean more years of drawing on general revenues to cover its

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[4] U.S. Social Security Administration, "The 2012 Annual Report of the Board of Trustees of the Federal Old-Age and Survivors Insurance and Federal Disability Insurance Trust Funds," April 23, 2012, http://www.socialsecurity.gov/OACT/TR/2012/index.html (accessed April 23, 2012).

deficits and will not require the program reforms that are sorely needed to make it solvent and sustainable. Indeed, this seems at odds with the intent of the legislation.

Second, this legislation would also cap total spending, including both discretionary and direct spending, and also requires enforcement should the caps be exceeded. Putting the brakes on total spending is essential, as noted earlier, and any limits must be enforceable. Federal spending must be evaluated by the sum of its breadth; comparisons of one part of the budget or another are simply inadequate unless the budget in its entirety is measured and limited. The devil is always in the details of just how to enforce such caps. Across-the-board cuts, which are the Act's mechanism for enforcement, are the most simple to implement, especially quickly. Moreover, there is the semblance of shared sacrifice across all programs. However, they are quite a crude tool for de facto policy-setting. This is especially true for complex programs like Medicare where such a mechanism can have all manner of unintended consequences, or in the Department of Defense where it can jeopardize efficient and cost-effective management of long-term contracts. Paraphrasing Churchill, other cuts have been tried and across-the-board cuts are the worst form …except for all the others.

<u>Areas for Improvement:</u> As noted above, Social Security is exempt from the individual direct spending caps. To set policies which both meet the needs of our citizens and are affordable and sustainable, all programs across the entire federal budget should be on a level playing field, open for debate and trade-offs. This should include even the most popular or seemingly sacrosanct ones like Social Security. It too should be subject to some form of spending restraint—whether part of an individual spending cap or subject to some limit so that all federal programs are brought under some form of budget discipline and assessment. Leaving one out—no matter how integral it is in our society—paves the way for additional exemptions. As for Social Security itself, eliminating it from a cap simply delays the day of reckoning when the trust fund is finally exhausted and solutions will happen one way or another.

The policy results of budget enforcement should be as important as the fiscal ones. So, one improvement for sequestration could be to link the particular policy proposals included in the budget resolution into sequestration rather than relying on sequestration. For example, the phase-in period for moving Medicare to a premium support model could be expedited, or income adjusting for affluent seniors could be enhanced. In such a way, the policy changes to modernize these programs would be an integral part of enforcement. Similar enforcement could be done for Social Security such as phasing in a retirement age, or further income adjusting for affluent retirees.

Another concern in the legislation is the sheer number of caps it contains: discretionary spending, three individual program caps for entitlements, and a cap on total spending. In addition to this, there is a cap on deficits. This adds potentially unnecessary complexity and makes it much harder for budget and program managers to anticipate and prepare for sequestration, and conceivably could lead to more than one set of sequestration cuts in a given year. These should be addressed in future versions of the bill. Additionally, since deficits are the result of spending *and* revenue levels, the deficit cap would be an impractical one that—as the bill is written—would be difficult and problematic to enforce. Since deficits are specified on budget resolutions, this seems an unnecessary addition to this bill.

The **Balancing Our Obligations for the Long Term (BOLT) Act** has many of the same strengths of the Spending Control Act, and some of the same concerns. Its strengths lie in the steps it takes to ensure that the entire budget—and federal spending in particular—is affordable over the longer term beyond the rather arbitrary 10-year budget window. There are several reasons this is of crucial importance.

First, lawmakers and the public must know whether existing policies are affordable over both the near term and long term. In past years, the 10-year budget window would show relatively modest increases in spending and stable debt levels. However, over the longer term, spending—especially on entitlements—explodes and the debt along with it. This was the case, for example, in the last years of the George W. Bush Administration where spending growth tapered off and revenues grew with a stronger economy which lowered deficits and the debt ratio. But it was well known that this was a false sense of security as shown by the annual reports of the Medicare and Social Security Trustees and long-term budget projections by the CBO and GAO. Lawmakers still did nothing to tackle this huge problem. The lack of long-term budget measures in the budget process allowed Congress and the Administration to ignore the problem. Exclusive reliance in the budget process on shorter-term projections even seemed to incentivize huge increases in federal spending, as in the examples of the Medicare Drug Benefit or universal health care subsidies in the Affordable Care Act, the Farm Bill, or the budget busting SAFETEA-LU Transportation reauthorization.

Second, it is possible for individual programs to appear affordable, but when examined in concert with all other spending a different, troublesome picture can emerge. When the appalling condition of Social Security and Medicare is added to the growing expanse of the federal government, the true picture of federal finances is markedly worse. Alternatively, especially important today, the longer-term horizon shows the efficacy of spending reductions. Those that do not tackle entitlement programs will do very little to bring the budget in line to where it can be either affordable or sustainable. So the objective of this legislation is sound and these kinds of changes are sorely needed.

Lastly, it is possible to game legislation such that it appears to be affordable within the 10-year budget window. The two biggest examples of new programs—the Medicare drug benefit and the Affordable Care Act—both employed this gimmick. They were affordable according to the criteria established for the legislation within the 10-year window. But since each of them back-loaded their new spending, they failed the test of sustainable and affordable policy changes over longer-term measures. For example, excess costs for the Medicare Drug Benefit were estimated to approach $8 trillion over the 75-year time horizon, net present value, more than twice the debt held by the public at the time the bill was passed.

The BOLT Act addresses these flaw by first requiring reporting over a long-term budget window—an additional 30 years after the end of the 10-year budget window. Both the legislative branch, through CBO and GAO, and the executive branch through OMB and the President's own budget submission must present an analysis of the long-term budget picture and the sustainability of policy. To be sure, these kinds of projections will not be accurate and are based on numerous assumptions such as the growth in discretionary spending, needs of defense, interest rates, the size and growth of the economy, etc. However, such projections are made regularly by the departments named above which present a reasonable picture of future spending and finances for lawmakers and the public to gauge whether the budget and major policies are sustainable. This first step, disclosure of long-term sustainability in the budget process itself is important so it can be used to guide policy in the budget resolution.

The legislation imposes spending caps over a 30-year period, beginning after the 10-year budget window closes. Here, caps include the same direct spending categories as the Spending Control Act, in addition to a total spending cap. As noted earlier, budgeting only for discretionary spending covers less than half of the budget and leaves the biggest drivers of the budget out of annual budget debates. As entitlement spending will automatically grow ever larger, these programs must be brought under a formal review process, and thus extending spending caps to them will be an important part of constraining spending to affordable levels. These caps are set using the same levels of spending as the House-passed FY-2013 budget resolution, again linking policy objectives to fiscal targets.

Spending is kept under control by long-term reconciliation, a regular review of sustainability every five years. Tens of millions of Americans rely on entitlements for retirement security, so new changes to these programs should be periodic, allowing seniors to plan and react to changes. If reconciliation and regular review fail to keep spending in check, there will be sequestration. These steps are welcome improvements over today's glaring lack of long-term budgeting. The downgrading of the nation’s credit ratings last summer serves as further warning that the debt is reaching unsustainable levels and must be addressed. As the long-term budget gap is exclusively driven by spending, this legislation is properly focused on spending.

As noted above, it is important to measure the costs of new legislation over the short term, but this alone is an incomplete measure as it allows gaming of the rules towards greater spending. Measuring major legislation over the long term is an important step in ensuring sustainable policy. Such formal measures would have markedly changed the debate for the Medicare Drug Benefit and the Affordable Care Act.

Improvements: While there are fewer caps than the Spending Control Act, setting targets for Medicare, Medicaid and other health, and all other excluding Social Security may set an unnecessary level of detail for budget caps—especially over the long term. It is difficult enough to forecast spending over the long run, and requiring enforcement mechanisms at such detailed levels may prove troublesome. It is valuable to assess sustainability of individual programs. So one enhancement might be to provide additional flexibility to Congress to move resources from one category to another.

The old saw that economists spend their careers explaining why their predictions are wrong has some relevance here. Long-term estimates are bound to be wrong. So giving some breathing room for the caps and sequestration in particular through a small, acceptable margin of error would still incentivize reforms and budget control if done carefully. Ensuring that entitlement programs are not whipsawed by frequent policy changes in response to the annual sustainability report are also important. There should be a balance between the tension needed for urgent steps to rein in spending and predictability for those who rely heavily on such programs.

The Spending Control Act's shortcoming of excluding Social Security also is present in the BOLT Act.

General Observations

If it was only rules and procedures that were needed, our severe budget challenges would likely be resolved today. Indeed, existing laws have been ignored, whether intentionally as with the Senate, from gridlock, or just plain lack of will to address these serious problems. Since the last timely concurrent budget resolution was passed (excluding FY 2013), there has only been a concurrent budget resolution in four of out eight years. Reconciliation, the process originally designed to help Congress change current law to conform revenue, spending, and debt limit levels to the policies laid out in the budget resolution, has only been used to minor effect for deficit reduction in recent years.[5]

The nature of the political process today has tremendous inertia to ignore our severe spending and debt problems until forced to by outside events. But this approach to governing is the worst way to set policy, as crisis-driven decisions are often desperate choices which will fail. The flawed concept of the Supercommittee and the equally flawed BCA sequester are good examples. Moreover, crisis-driven decisions rarely allow for public discourse, weighing the pros and cons of such changes and building support so they are accepted. Congress and the President must act with purpose and intent to solve the spending and debt challenges, yet the system is sorely inadequate to ensure that all spending over the short term and long term is both affordable and sustainable. The objectives of these bills are sound and sorely needed: to provide more transparency, strong spending controls across the entire federal budget over the short term and the long term, and to require steps for reining in spending to meet those limits. They are important steps to fixing the budget process. In the end, Congress itself will decide if it will act. Better if it does so in an intentional, prudent way rather as these bills would provide, rather than in a crisis.

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[5] See Alison Acosta Fraser and Brian M Riedl, "The Deficit Reduction Act: One Small Step for the House," Heritage Foundation *WebMemo* No. 911, November 9, 2005, http://www.heritage.org/research/reports/2005/11/the-deficit-reduction-act-one-small-step-for-the-house.

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