BUDGET REFORM FOR THE 111TH CONGRESS

Statement before the

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Any opinions expressed herein are those of the author's and are not meant to represent those of the foundation or its trustees. The foundation is dedicated to increasing public awareness of the nature and urgency of several key challenges threatening America's future, to accelerating action on them, and to working to bring Americans together to find sensible, long-term solutions that transcend age, party lines and ideological divides.

Mr. Chairman and Members of the Committee:

It is a privilege, as always, to join with you—this time to try to address one of the nation's most daunting and increasingly pressing challenges, which I will define simply as restoring sensible balance to the long-run budget of the government of the United States. Absent such reform, we have a budget that increasingly looks like that of a declining nation. As I will demonstrate, while short-term imbalances have occurred before, these long-term imbalances are a relatively new phenomenon in the history of this country. I am also honored to testify today with two of the most distinguished experts attempting also to deal with this issue.

The urgency of our fiscal situation has recently been intensified by the immediate revenue and spending demands imposed by the collapse of several major financial institutions. This collapse imposes large costs on our citizens as homeowners, workers, and, now, taxpayers. There are disturbing parallels between the factors that have contributed to this mortgage- and debt-related crisis and the deteriorating fiscal outlook of the U.S. government. Most importantly, there is a dangerous disconnect between the parties who benefit from various practices and those who pay the price, while both public and private sectors failed to mitigate related risks in the face of clear and compelling warning signals.

Consider how we intend to pay for the reform being implemented to stem financial collapse. Just where do we think the money is coming from? Absent efforts to get the long-term budget in order, and to reduce our current account deficit that partly results from our importing more than we export, we are likely to borrow yet more from abroad, often from countries whose interests may not be the same as ours. The current world-wide economic slowdown and the crisis in our financial markets adds to the risk that foreign lenders at some point will reduce their demand for our debt and lend to us only at increasingly higher cost. Alternatively, we might directly or indirectly attempt to pay by printing money and trying to inflate our way out of the problem. Either way, the financial crisis has added to risks that arise from our failure to deal with our long-term budget and vice-versa.

In my testimony, I will argue strongly that we do know how to significantly mitigate the risks imposed by our long-term fiscal outlook. The complications are political, not economic. Budget reform can and should focus on all of the following three approaches:

- Changing the budget process—so the long-term budget is tackled first, or, in the situations where emergencies arise, at nearly the same time as the shorter-term budget;

- Directly reforming programs and setting up processes likely to achieve that result;

- Reporting on the budget in a way that holds elected officials accountable for changes both newly enacted and already built into the laws.

In every case, there are a variety of mechanisms that might be employed—some better than others, but many much better than current practice. I will touch on several. Just as in confronting the financial crisis, however, the important point is that restoring confidence requires that something be done NOW.

Defining the Problem in Order to Fix It

Before getting into details, we must address briefly the nature of the problem. Put simply, we are dealing with a budget problem without precedent in the United States. We are in the midst of what I have labeled the nation's "third fiscal turning"—a time when we must change the fundamental paradigms through which we both think about and set the nation's fiscal policies. The previous two fiscal turnings—at the nation's founding and during the progressive era's response to powers unleashed by the industrial revolution—differed in the adjustments required, but not in the fundamental problem. In all three cases, the nation had to fundamentally reform its fiscal policy so that it could better find and allocate limited resources efficiently to meet the nation's needs. And in each case we had to remove powerful institutional barriers to achieve that goal.

Never before in the nation's history has so much been promised to so many people for so many years into the future. Little or no slack remains to address new needs, accommodate new wants, take advantage of new knowledge, or meet new emergencies. Indeed, our current laws essentially specify how most, all, and then more than all of the revenues of the government will be spent for an eternity. While some recognize that the growth rate at which these promises compound cannot be sustained arithmetically, fewer recognize the increased cost and strain put on society today—not some day in the future when some trust fund balance or other measure hits some magic asterisk.

Simple arithmetic tells us that when increasing shares of our national income goes for items that are not priorities, then decreasing shares inevitably go for priorities.

Consider. Every day our federal budget churns to provide:

- A very low share for children, who already on a per capita basis receive only about one-fifth what is provided to the elderly;

- Decreasing shares of the budget for items that might be labeled as investment, almost no matter how defined;

- Decreasing shares of the budget for those programs that might enhance opportunity;

- Increasing shares of an "old age" budget for those who are middle age;

- A strong encouragement for people to retire for one-third or more of their adult lives at time when we are experiencing low or negative labor force growth;

- And within health care,
    - Greater rewards for acute health care than for prevention;
    - Decreasing shares of government health care support for families in their working years;
    - Higher subsidies for the richer workers than for the middle class;
    - Greater rewards for development of chronic treatments than cures; and
    - Discouragement of primary care in favor of specialization

To achieve these negative results, we are borrowing more, saving less, investing in our future less, and increasing our reliance on foreign lenders.

This is a budget for a declining nation.

Meanwhile, Congress and Presidential candidates find themselves in a straightjacket—less and less in control of their own budgets. Indeed, my projections show that the next President is liable to have no flexibility whatsoever in absence of dramatic reform of the budget.

To make this more concrete, it appears that under current law, sometime between 2015 and 2020, revenues will be sufficient only to cover the cost of Social Security, Medicare, Medicaid, a smaller defense establishment, and interest on the debt. Nothing will be left over for children's programs, infrastructure, justice, or turning on the lights in the Capitol.

While much of government is getting crimped, every year the budget increases the lifetime promises to people in this room for when they retire by about $20,000. Thus, couples making a combined income of about $100,000 and retiring today will receive about $900,000 in lifetime Social Security and Medicare benefits; for similar earning couples between the ages 41 and 45 today, that package increases in value to about $1.4 million. These are among the large promises that keep growing over time to the increasing exclusion of almost everything else that government could do.

As another example, last year a Democratic Congress and a Republican President essentially allowed spending on the three major entitlements to increase by over 5 percent, or significantly more than the rate of growth of the economy, while letting programs for children grow by less than 1 percent, thus getting a smaller share of the national pie. Many of these children's programs declined in real terms as well.

How did we reach this point? Since the focus of today's hearing is on budget reform, I cannot go into the depth I would like. However, the history is vitally important because it tells us of the factors that we must now avoid.

Bad budget or fiscal policy is not new. Many times in the past our budget was unnecessarily imbalanced. What is unique now is that those temporary imbalances were just that—temporary. No one locked in the future.

Increasingly over the past few decades, however, elected officials have discovered more and more how to give away money not just for today, but for the future—leaving future generations the requirement to pay for it.

Meanwhile, the competition between major political parties has put us in a classic "prisoners' dilemma," where if one side behaves in a fiscally responsible manner, it only enhances the power of the other to try to give away the future for what it wants. This "two Santa Clauses at the same time" policy (tax cuts without paying for them; spending increases without paying for them) may appear foolish from above—it certainly doesn't enhance our belief in Santa Claus. But the mantra in each party is that it has to play Santa Claus as much as the other party or else it loses political power. Another mantra floating around political circles is that President George H.W. Bush lost the Presidency by attempting some budget reform, including modest tax increases, and President Bill Clinton lost the Congress for the same reason—even though the amount of budget and tax changes enacted in each case were relatively modest and small relative to what is required today.

Whatever past short-term profligacy in the budget, over most of the first two centuries of the United States Congress did not put the long-term budget into imbalance for one simple reason. Most programs were discretionary in nature. In theory that meant there were few permanent commitments on the give-away side of the budget. Revenues would grow with the economy and eventually overtake any previous level of spending, no matter how high. With the significant growth of permanent "mandatory" programs (sometimes called entitlements), and with growth in the permanent give-aways in the tax code (sometimes called tax entitlements), we have moved further and further away from a discretionary budget over which the Congress, President—and, most importantly, the voter—have much say.

But even permanent programs do not necessarily cause the long-run budget to be out of balance, whatever their inefficiency in foreordaining spending for a future that is still unknown. It is the built-in, automatic, growth features of some of these programs that wreak havoc on future budgets. Particularly in health and retirement programs, those features give the programs higher growth rates than the economy, ***essentially no matter how fast the economy grows***.

Thus, for example, Social Security, Medicare, and Medicaid are expected to absorb between 6 and 9 percent *more* of the gross domestic product (GDP) within a few decades than they do today. And much growth is also built into several tax subsidies.

This makes it absolutely clear that true budget reform must deal foremost with those automatic growth features.

Changing the Budget Process to Address the Long-Term Budget

Our budget process is almost entirely geared toward the short-run. This short-run focus has given an extraordinary incentive for Congresses and Presidents simply to move costs of government actions, both spending increases and tax cuts, outside that short-run budget window.

Due to the extraordinary growth in the promises they have made, the long-term budget remains out of order no matter how much reform is achieved over the short run. Every business and household knows that it should not sign contracts today for most of what it hopes to spend decades from now. All long-term budgets must have slack and be adaptable, not totally set in advance of an unknown future.

Of course, crises—and we have many of them over time—often require quick action for the short run. Keynes' warning that we are all dead in the long run was a call to action when necessary, not a call to make unsustainable promises for the future. Short-run crises cannot become excuses for neglecting the long-term budget. And, as I have noted, our ability to deal with short-run crises—especially financial ones like the current crisis where there is a need to restore confidence—actually calls for better control over the long-term budget.

We need to fundamentally change the current dynamic. One way is to change the budget process so that the President first submits a long-term budget, and then Congress tackles those issues. Congress could also set aside periods—it can still be within an annual cycle—when the long-term issues are given priority. Still another possibility is for the Congress to request that the President submit a budget where mandatory spending in no future year is projected to exceed 50 percent (or some other fraction) of available revenues. The Congressional Budget Office could be tasked with measuring whether his budget met this goal, and the leaders of Congress could pledge themselves in advance to send the budget back to the President when it fails to meet the requirements or vote to make an exception, thereby going on the record in support of the President's proposed "seizure" of future resources. I realize that capturing control of these symbols and processes does not insure that solutions will be adopted, but they provide examples of ways to give the long-term budget the greater attention it deserves on an ongoing basis.

Directly Reforming Programs

Nothing, of course, is superior to directly reforming programs and setting up processes likely to achieve that result. One type of process has been promoted recently by a number of top level officials and budget experts, including the President of the Peter G. Peterson Foundation, David Walker: to try to set up a commission that has teeth to it to address a number of fundamental long-term challenges.

Many commissions, of course, do not succeed. To succeed, they must be set up with a strong commitment by both President and the Congress to follow through on the recommendations, although not necessarily on every detail. A good example of successful reform along these lines can be seen in the recent British reform of both their Social Security and private pension system—a reform that started with a White Paper and proceeded to cover items

ranging from later retirement ages to greater levels of private retirement plan coverage for low and moderate income workers.

Another model of reform was given by the efforts leading to the Tax Reform Act of 1986. As economic coordinator and original organizer of the 1984 Treasury study that led to that reform, I am somewhat biased here. But a common element to both the British effort and that 1986 tax reform effort is that the original suggestions were largely crafted by nonpartisan staff and experts, allowing a vetting of the broad policy concerns before the lobbying performed its necessary role. Contrast that process, if you will, with much current U.S. legislation, where politics and lobbying begin playing their role too soon.

In the ideal, direct reform would address program specifics. In Social Security, for instance, it would address not only the imbalances in the system, but it would take on the failure of the system to reduce poverty much for the additional amounts spent each year, would tackle the fundamental discrimination against single heads of household, and would discourage working less.

Adjusting Downward Automatic Growth Rates

Obviously, there will be periods where it is difficult to reach agreement on what an ideal reformed system would be. In those cases, a modest set of reforms can be enacted in lieu of or as a backstop to fundamental reform. These more modest reforms would simply adjust the automatic growth rates downward in programs with such high growth rates.

In Social Security, for instance, one can index lifetime benefits to grow at a slower rate through increases in retirement ages or to index annual benefits to grow at less than the rate of wage growth. The former, I believe, is more progressive than the latter and more progressive than across the board increases in Social Security tax rates, but that is an issue for analysis. In health care, the problem is more complicated, because of open-ended budgets in Medicare and the tax subsidy for buying employer-provided insurance. Still, tightening methods can be developed—for instance, through fixed budgets for any government program, as in other countries, or through conversion toward voucher-like programs (with safeguards for insuring health insurance access for the less healthy). In both cases, increases in spending—either in a total budget or in size of credit—is and would be voted on by Congress each year.

Triggers

An even more modest set of reforms is to implement triggers. Rudolph Penner and I have suggested that policymakers can develop "triggers" that can be pulled at certain "trigger points" to automatically lower growth rates in programs expanding at unacceptably high rates. Triggers were also a reform supported by the signers of a recent statement, "Taking Back Our Fiscal Future." These signers included two of the three witnesses here at the table (both Maya MacGuineas and myself), as well as the first three directors of the Congressional Budget Office.

Triggers are not superior to systemic reform. Far from it. Much preferable are discretionary efforts that reform programs over time. A trigger actually has two major

components: (1) a “triggering event”—that is, an event that forces the pulling of the trigger; and (2) a “triggering adjustment”—that is, a “hard” adjustment applied immediately to the existing law or a “soft” adjustment in policymaking procedures. Because pulling the trigger occurs automatically when the event occurs, a hard trigger adjustment creates two growth paths, which differ depending upon whether the triggering event occurs.

For instance, Social Security benefits might grow at one rate when actuaries project long-term balance and another when they project imbalance. An imbalance would trigger a reduction in the rate of growth of benefits. Obviously, there are many options for measuring imbalances and determining alternative growth rates. The design of the triggering event and adjustment, therefore, will be a matter of legislative debate.

Depending upon both the triggering mechanism and the triggering consequence, triggers may be inferior to adjusting automatic growth rates directly, which I just discussed. For both economic and political reasons, however, sometimes triggers may be the only practical way of overriding automatic, eternal growth in programs.

In the current political climate, triggers have an appeal over paring the growth of programs directly. One major argument used against broad reform is that no one can predict the future and that the economy may grow enough to pay for these programs. In fact, the argument is technically weak since retirement and health programs actually grow faster when the economy grows faster. On the other hand, triggers would allow policymakers to skip that debate by simply responding that if future growth makes these programs more affordable in the future, the trigger won’t be pulled.

A related advantage of triggers is that they can be based on objective and transparent criteria. Further, triggers can control spending and prevent the budget problem from getting worse while politicians are engaged in a protracted debate about more fundamental reforms. Of course, it is entirely possible that a future Congress might step in and override the triggered adjustment. Fine. At least there will have to be a debate about options. At present, the budget dynamic allows lawmakers to dodge responsibility.

For instance, suppose Medicare were to grow at 7 percent absent the pulling of the trigger, but only 4 percent if the trigger were pulled. Then, for Congress to restore the 7 percent growth path, it would have to choose that additional growth over other spending, say, for community development. Any departure from using the trigger for Medicare would also have to be paid for with tax increases or other entitlement cuts under pay-as-you-go rules.

Reporting On the Budget in a Way that Holds Elected Officials Accountable

One of the most important reforms that this committee should consider is how it reports on the budget. The budget rules today obscure reality and reduce accountability.

The comedian Flip Wilson used to complain, "The devil made me do it." Our elected officials do him one better almost by saying "The budget made me do it." Like Flip, however, Congress and the president have more control than they say.

Here is a simple table from President Bush's 2008 budget documents showing the spending changes he suggests should occur by 2013. I use the word "suggested" because these numbers sometimes show little resemblance to proposals.

President's Proposed Budget for 2013 (in billions of 2007$)		
Additional resources available in 2013 compared to 2007	**TOTAL**	+478
How these resources will be spent in 2013	Social Security	+167
	Medicare	+73
	Medicaid & SCHIP	+67
	Net Interest	+31
	Other Mandatory	+49
	Discretionary Non-Defense	-60
	Defense	-38
	Deficit Reduction	+189
	TOTAL	+478

The message is clear: of the $478 billion extra in real revenues that the President proposed collecting in 2013 over and above revenues in 2007—largely due to economic growth—Social Security would get about 35 percent, Medicare and Medicaid about 29 percent. Defense not only would get no additional spending out of these additional revenues, it would drop dramatically in real terms.

Wait, you say. Didn't President Bush propose big increases for defense and big cuts for Medicare and Medicaid? Well, he did and he didn't. That's why the budget in its standard form is so confusing.

What the President did was propose a lot more for defense for one year (2009) and then suggested in his budget accounting that those increases would immediately tail off so he could get his future deficits to look better. All those newly hired troops and defense industry workers presumably would be fired in the next couple of years. As for the costs of the war in Iraq, they are on top of this one-year buildup, but the president showed only one part of one year's expense in the budget.

On Medicare and Medicaid, the President did propose cuts, but from a fairly high growth path. Meanwhile, the Social Security budget would keep swelling as baby boomers retired and because new individual accounts for workers would be funded under his proposals.

On the tax front, he suggested that the alternative minimum tax not be allowed to wrap its arms around more taxpayers, but then he counted on the additional revenues it would bring in.

The budget needs to be presented in a way that allows Americans to hold the President's *and* Congress' feet to the fire. Our leaders must be held accountable for both for the laws they

make *and for changes born of their often-calculated inaction*. They must accept responsibility for growth of spending outside the annual appropriations process that is hidden by today's scorecard.

A better scorecard would present *first* all the changes that the President proposes through both direct and passive action. Current spending *levels*, no matter what the legislative source, would be compared first to past spending *levels*. We essentially get this type of readout now only for "discretionary" spending—that dwindling share of the pie that isn't already committed to ongoing programs.

My proposed reformed scorecard represents nothing more than a return to the basic budget accounting that occurred naturally in the past.

One great advantage to focusing first on the total change in spending levels is that cuts look like cuts and increases like increases. Suppose an education program without automatic growth built in would need to grow by $5 billion just to keep up with inflation, while the president proposes a legislative boost of only $1 billion. Then the budget's initial scorecard on total proposed change should show a $4 billion cut in real (inflation-adjusted) terms as what he would like to achieve *in aggregate*. Similarly, if a health program would grow automatically at $70 billion, but $20 billion of that increase is just inflation, and the president proposes a $10 billion legislated cut from the current law growth path, our revised table would show that on net he suggested a $40 billion real expansion.

Other budget accounting is still required. For a variety of legislative purposes, it is necessary to know how much of total change is due to accepting past laws' built-in growth and how much to new legislation.

In addition, it should be clear by now that failure to acknowledge the potential costs associated with budget activities does not serve us well over the long run. The pretense that Fannie Mae and Freddie Mac were somehow not federal responsibilities and leaving them out of the budget misrepresented the significant financial risk they posed to taxpayers. Similarly, relying on emergency designations to provide funding for everything from ongoing military activities to disaster relief undermines budget discipline and sound accounting practices. Policy makers and the public should be able to rely on the budget as providing a comprehensive presentation of the federal government's exposures—which it currently does not. It would be extremely useful to have a better idea of what else is already "out there" in the form of explicit or implicit liabilities before undertaking costly new tax or spending initiatives. One step would be to establish rigorous rules and concepts that would help to control further attempts to get "something for nothing" by minimizing unmeasured claims against future budgetary resources.

Conclusion

Government must restore confidence in both our financial system and in its budget. Every day that we maintain an imbalanced long-term budget, we impose additional risks on the American public. Once that is done, it will be easier to have a discussion about priorities. Right now our priorities orient resources away from investment, from children, from the oldest and

most needy of the elderly, and from preventative and primary health care, while encouraging less saving and work.

There are a variety of budget processes that can be set in place quickly to restore confidence in government. These processes range from those that would give greater priority to the long-term budget; direct reform processes in which Congress and the President pledge that action will follow upon recommendations made in a nonpartisan way; triggers and similar procedures that can be set up as back-stops while reforms are being considered; and improved reporting on the budget that would hold elected officials accountable for both what they legislate and the changes they allow to transpire under a current law they could have amended.

No budget process is perfect. A process is only a means to an end. But reforming the process will enable us to set priorities more clearly and with more accountability, help restore confidence to the markets, and put us on a path toward better government for all.