CBO TESTIMONY

Statement of
Douglas Holtz-Eakin
Director

The Economic Costs of Long-Term Federal Obligations

before the
Committee on the Budget
U.S. House of Representatives

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CONGRESSIONAL BUDGET OFFICE
SECOND AND D STREETS, S.W.
WASHINGTON, D.C. 20515

Mr. Chairman and Members of the Committee, I appreciate the opportunity to discuss the adequacy of budget measures in portraying the federal government's long-term fiscal outlook. The Congress adopts federal programs to provide benefits to U.S. citizens and uses the budget to indicate the costs of those policies. In preparing for this hearing, I have been especially mindful of the mission of the Congressional Budget Office (CBO)—to provide the Congress with objective information and analyses for budgetary and economic decisions. At the heart of that mission is CBO's responsibility to quantify the costs of federal programs and policies.

With that objective in mind, and with the strong caveat that I will be speaking only about costs while ignoring benefits, I want to make the following points in my statement today:

- Over the long term, the U.S. government faces enormous demands for federal spending, which are not adequately reflected in the budget.

- Every dollar of federal spending has a cost. It makes no difference if the payment is charged to the general fund, a trust fund, or an enterprise fund; nor does it matter if the payment purchases goods and services, provides income support, subsidizes an activity, or liquidates a guarantee or an insurance claim.

- Government spending is usually a good measure of the cost of government to the economy—its economic cost—because that spending preempts the use of resources by others for other purposes. The dollars spent measure the value of forgone alternatives for the private sector and within the budget.

- The budgetary costs of federal commitments should reflect their economic costs. Even though the government commits to future spending in a variety of ways, including social and other insurance, federal pensions, credit programs, and the support of international organizations, all uses of funds can be compared in terms of their economic costs.

- Reliable, comparable, and comprehensive cost information for all federal activities would inform Congressional decisions and align federal spending with the value of alternative uses of those funds.

- It is timely to reassess the principles of federal budgeting to better measure economic costs. CBO has begun to provide supplementary estimates of mandatory and discretionary spending, the effects of expiring legislation, the effects of risks on spending, and costs of federal activities not currently shown in the budget.

Let me discuss each point in turn.

The Long-Term Outlook for Government Spending

It will not be news to Members of this Committee that the United States faces severe fiscal demands in the decades ahead. CBO projects that, on the basis of current rules for benefits, federal spending, excluding interest payments, will rise as a share of national income from the level of roughly 18 percent in 2002 to about 28 percent by 2075 (*see Table 1*). Little disagreement exists about the cause of that situation. It stems primarily from federal policies aimed at improving the well-being of retirees, the disabled, and the chronically ill.

Other commitments, such as defense spending, may also claim a substantial share of society's resources. Additional potential demands include the war on terrorism, homeland security, environmental cleanup (including that resulting from defense activities), and settlements of asbestos claims.

In short, the federal budget faces known, growing demands that will absorb an increasing share of the U.S. economy.

In addition to those relatively predictable demands, the government faces significant fiscal exposures that are not fully counted in the budget, including those arising from its insurance and guarantee programs—as exemplified by the Pension Benefit Guaranty Corporation (PBGC), through which the government insures over $2 trillion in projected benefits in 33,000 defined-benefit plans. For years, the PBGC generated more money in premiums than it paid out in benefits, and the budget reflected that positive cash flow instead of the underlying liability. Currently, insured pension plans are underfunded by an estimated $300 billion, so the ultimate cost of pension insurance to the government could be significantly larger than current figures would suggest.

For many programs, the federal budget fails to extrapolate costs over an appropriate horizon. While five- or 10-year projection horizons may be adequate for some budget decisions, they are especially deficient when evaluating the implications of changes in entitlement programs. For example, the proposed Medicare prescription drug benefit is estimated to cost roughly $400 billion from 2004 through 2013, but, under reasonable assumptions about future drug spending and demographics, costs would exceed $1 trillion and could approach $2 trillion during the following decade.

Thus, the United States faces huge fiscal demands in the coming years, yet the federal budget does not adequately capture future commitments.

Table 1.

Federal Outlays by Category, 1950 to 2075

(As a percentage of GDP)

Fiscal Year	Social Security	Medicare	Medicaid	Social Security, Medicare, and Medicaid Combined	Other Spending, Excluding Interest Expense	Total, Excluding Interest Expense
1950	0.3	n.a.	n.a.	0.3	13.5	13.8
1960	2.2	n.a.	n.a.	2.2	14.2	16.4
1970	2.9	0.7	0.3	3.9	12.8	16.7
1980	4.3	1.2	0.5	6.0	13.7	19.7
1990	4.3	1.9	0.7	6.9	11.7	18.6
2000	4.2	2.2	1.2	7.6	8.5	16.1
2010	4.4	2.7	1.8	8.8	7.6	16.4
2020	5.4	3.6	2.3	11.3	7.1	18.4
2030	6.2	4.9	2.8	13.9	7.1	21.0
2040	6.2	6.0	3.4	15.5	7.1	22.6
2050	6.0	6.7	3.9	16.7	7.1	23.8
2060	6.1	7.7	4.3	18.1	7.1	25.2
2070	6.2	8.9	4.9	20.0	7.1	27.1
2075	6.2	9.6	5.3	21.1	7.1	28.2

Source: Congressional Budget Office.

Note: n.a. = not applicable.

The Economic Costs of Federal Spending

As a general rule, the best measure of the economic burden of a government program is its spending. Consider, for example, a discretionary program financed by annual appropriations. Spending by such a program diverts productive resources from private consumption or investment to government use. If the activity replaces private consumption with government consumption, the costs are felt in the present. If, however, the effect of government spending is to displace private investment, the cost is forgone growth in the capacity of the economy to produce—a loss that persists into the future. Federal financing of expenditures, either through taxes or borrowing, reduces the resources available in the private sector, and the people deprived of those resources bear the burden of government spending.

Resources are limited. The use of resources for one purpose necessarily denies them to others—a fact of life that is sometimes easy to forget. For example, much of the discussion about future spending for Social Security and Medicare has focused on

whether revenues earmarked for those programs will be sufficient and whether their trust funds will become insolvent. Although those issues may be important, they should not distract from the more fundamental economic consideration: the resources expended on those programs must be financed either by taxes or by borrowing, which implies future taxes. Thus, that spending will be just as costly as any other federal spending.

In economists' jargon, every dollar spent on a government program has an opportunity cost: that dollar is not available to be spent on something else. The cost, then, is whatever is forgone. When, as an individual consumer, I am deciding whether to buy an automobile, I am (at least implicitly) determining whether I would get more value using the money for that purpose than for any other. When, as elected representatives, Members are deciding whether to spend $100 million for a federal program, they are making a similar determination: is that the best use for taxpayers' money, given the possibility of other uses? Even though most such legislative decisions are not directly tied to decisions about taxes, the result is the same: unless other expenditures are reduced, current or future taxpayers will be required to give up the benefits from their use of those funds.

A distinction is sometimes drawn between the economic costs of government activities in which the government directly purchases goods and services, such as military procurement, and other government activities in which the government transfers purchasing power to recipients, such as the Social Security program. In the first case, the government is causing taxpayers to have fewer resources at their disposal so that it can use those resources to purchase specific goods and services. In the second case, the government is reducing the resources available to taxpayers in general and is increasing the resources available to the program's beneficiaries but is not directly purchasing specific goods and services. Recipients can use the resources to buy whatever they want or save them for themselves or their heirs. In both cases, however, taxpayers are giving up control of resources. Whether their tax payments are then used by the government to purchase aircraft or by the recipients to purchase consumer goods or anything else does not affect the cost to the taxpayers.

Although I am stressing spending as a measure of economic burden, it is worthwhile to note an additional cost of public programs financed through tax revenues. The existence of taxes may change the behavior of the taxpayers in ways that reduce their well-being, a cost referred to as the excess burden of taxation. For example, a tax on wages may cause some people to work fewer hours or to retire earlier than they otherwise would have. A tax levied on a good or service will induce taxpayers to reduce consumption of the taxed item to avoid the tax. (Of course, in some cases, the tax is designed to reduce consumption, as with the taxes on alcohol and tobacco, because consumers may not fully cover the adverse costs of their

behavior.) Taxes that distort economic decisions thus have two costs: the amount collected and the loss to individuals from induced changes in behavior. The latter cost, however, would be quite difficult to estimate, which suggests that focusing in the budget on the direct burden of government spending is the most valuable immediate objective.

No Free Lunch: No Costless Spending

It is human to hope for magical solutions to thorny problems. Accordingly, policymakers sometimes encounter proposals for "costless" spending based on the existence of unused capacity, gains from public investment, or regulation. None of those lives up to the promise of magic, however.

When the economy is operating below full employment, the opportunity cost of government spending can be smaller than at full employment. For example, when there is large-scale unemployment, putting people to work on federal jobs may divert few resources from other productive activities. The timing of such projects, however, is tricky. By the time they are launched, the labor market is already likely to have tightened. That is, over the long term, the economy tends to return to full employment of its human, technological, and financial resources. For example, by CBO's projections, today's relatively high unemployment rate of 6.4 percent (as of June 2003) will gradually decline to 5.2 percent by 2007 and remain at that level. Therefore, to assume that the resources used for a government program otherwise would have been idle is not judicious.

In principle, one might also argue that federal spending for investments would result in more resources for other uses, not fewer. That would be the case if the rate of return on the federal investments exceeded the returns that could have been earned by taxpayers themselves. But that characteristic is rare for a federal program. Many federal investments substitute for state and local spending or private investments that would otherwise occur. In any event, only a small fraction of federal spending is for investments. (The Office of Management and Budget estimates that outlays for major federal investments, such as the acquisition of military equipment, research and development, and grants to state and local governments for transportation infrastructure and education, accounted for about one-sixth of total federal spending in 2002.) The argument does not apply to the bulk of government spending, which goes to consumption, or to income transfers to support consumption, including those for Social Security, Medicare, and Medicaid.

Similarly, one might cite the social benefits effected by certain laws or regulations with low or no federal costs. Through law and regulation, the federal government frequently requires other levels of government and private entities to expend resources to achieve federal policy goals. For example, the federal government has

enacted laws mandating that new cars meet certain safety and fuel-efficiency standards. Consequently, automakers' production costs and the prices that they pass along are higher, causing some consumers to seek alternatives to new cars, including keeping old cars in service longer or purchasing used cars (which, presumably, are less safe and less fuel-efficient). The benefits provided by regulation are no more "free" than those that derive from spending.

That economic fact has not been lost on the Congress. The Unfunded Mandates Reform Act of 1995 (UMRA) was enacted to focus attention on regulatory costs. One provision of UMRA requires CBO to estimate the costs of federal legislation that would impose mandates on public- or private-sector entities. Such information aids the Congress by enabling Members to consider the costs of proposals beyond those currently reflected in the federal budget.

Some proposals for "costless spending" that come before the Congress lack even the veil of legitimacy assumed from promising to use unemployed resources, invest in particularly high-return projects, or improve welfare through regulation. Those efforts to hide budget costs, sometimes referred to as innovative financing, and at other times as budget gimmickry, come in many guises, including public/private partnerships, government-sponsored enterprises, off-budget special-purpose entities, and directed scorekeeping.

A common method of hiding the cost of government is through "tax expenditures," by which the government selectively reduces tax liability to substitute for spending. They are employed to finance education, housing, and health expenditures; to provide assistance to particular industries; and to aid state and local governments, to name but a few uses. By appearing as reductions in receipts in the budget, they mask costs. But they have many of the same attributes as more spending, diverting resources from other uses in the economy and causing higher tax rates to make up for the reduced tax base.

The Relevance of Economic Costs to Public Policy

Policymakers constantly weigh the costs and benefits of proposed and existing legislation. Just as markets work best in allocating resources to their highest valued uses when prices reflect the true costs of goods and services, the Congress is best served when Members have the most comprehensive and accurate information about the costs of legislation. Moreover, because federal budgeting affects the allocation of resources between private and public uses as well as among public uses, the relevant cost is the highest valued alternative to all other uses, private as well as public. All alternatives can be better compared when budgetary costs reflect economic costs.

Spending is a good measure of cost because it will have to be financed, at least eventually, by taxes. Thus, a guiding budgetary principle should be to recognize in the budget the amount of taxes that will be needed to finance a commitment. Further, at the point when the commitment has been made, its cost should be recognized in the budget, even if the spending will not occur immediately. Nevertheless, I acknowledge that it is sometimes difficult to distinguish exactly when a commitment to spend has been made and how durable that commitment may be.

While a one-time appropriation may reflect a commitment with clear timing, relatively few spending decisions are that straightforward. In fact, many programs that are nominally controlled by annual appropriations are ongoing functions—such as defense, transportation, and education—that the federal government could reasonably be expected to continue, and baseline budget projections reflect that expectation.

The difficulty of determining the timing of commitments is illustrated by a federal policy to provide financial assistance to low-income students enrolled in higher education. That policy might be regarded as a commitment to spend for students who are now eligible and for students who become eligible in the future. However, because the commitment is not contractual, the Congress retains the right to change the law defining eligibility or to substitute a different form of assistance. Clearly, the current program cannot be regarded as irrevocable; therefore, the present value of the assistance should not be recorded in the budget.

Indeed, for social insurance programs, it seems fair to say that although the commitments are clear in current law and are so reflected in baseline budget projections, the government has not firmly committed to paying the current level of benefits to all future generations. In other cases, such as loan guarantees and insurance, the government's commitment to spend may be contractual and firm, but the value of the dollar payments may be uncertain and difficult to estimate.

I suggest that the principle of recognizing the cost of commitments in the budget when they are incurred implies that the mere expectation of future spending is not sufficient to warrant recognition in the budget. The government's obligation in the future must be firm to justify including the costs for it in the budget today. However, I also suggest that the principle of being timely in recognizing costs in the budget never excuses an estimated cost of zero just because the amount is not yet certain.

Economic Costs in the Budget: Accomplishments and Challenges

The objective of recognizing economic costs in the budget reminds me of an exchange that occurred years ago between the Chairman of a House committee and a representative from the administration, who was advocating the creation of a program. In answer to the Chairman's question, "How much will this cost?" the witness replied, "Do you want that in budget authority, outlays, or discounted present values?" To which the Chairman thundered, "I want it in dollars!"

I sympathize with that Chairman's desire for transparency and simplicity in the budget. When the amount of dollars spent adequately captures the economic cost of a federal activity, as it does in most cases, we should look no further for an appropriate cost measure.

In spite of the efforts of many to improve the budget process over the years, much more remains to be done. Some activities currently classified as nonbudgetary, such as those of Amtrak, may be more appropriately considered within the budget. Similarly, other types of contract-specific activities, such as the construction and leasing of buildings for military housing and federal offices, may warrant budgetary treatment that is different from the way they are currently handled. Federal exposure under insurance programs is another area in which the current budgetary presentation could be enhanced. Also, information about the long-range commitments for social insurance programs could be more prominent in budget documents.

Budgeting for Risk

A particularly difficult and increasingly important issue is the treatment of risky activities like providing loans and guarantees, and insurance. Indeed, federal direct loans and guarantees constitute an area of budgeting where the Congress addressed accounting shortcomings through passage of the Credit Reform Act of 1990. Prior to that law, both direct loans and guarantees were treated on a cash basis in the budget. For direct loans, cash flows in any single year consist of outlays for new loans and repayments for some outstanding ones. The net cash flow in any single year is a meaningless amalgam of the amounts of cash in and out. The cost of new loan programs is especially overstated on that basis because nearly all the cash flows are out in the early years. For guarantees, single-year cash flows are a mix of fee collections, payments for defaults, and inflows from recoveries. Before credit reform, the misstatement of costs for new guarantee programs was especially perverse because cash flows in the early years often were dominated by the inflow of guarantee fees, with few outlays for defaults.

Under the Credit Reform Act, the cost of a direct loan or loan guarantee is the net present value of all cash flows over the life of the loan, recognized when the loan is disbursed. Net present value is calculated by discounting cash flows with interest

rates on Treasury securities of the same maturity. Credit reform was a much needed step toward getting the economic cost of credit programs in the budget, and it follows the principle of recognizing budgetary impacts at the time loans and guarantees are extended. In my judgment, the budget information now available to the Congress on the cost of credit programs is far superior to what existed before.

With the experience of the past 10 years or so, however, it may be time to revisit the credit-reform model and its application. One shortcoming of the current approach is that it appears to understate the economic cost of federal credit programs because the discounting of expected cash flows at the government's risk-free borrowing rate ignores certain costs of risk. Private investors, by contrast, require compensation to induce them to bear risks that cannot be eliminated by diversification—for example, market risk. The compensation to investors for market risk comes in the form of an expected return that is higher than the rate on government debt that is used to value loans and guarantees under the credit-reform model.

Turning to other areas involving the federal treatment of risk, I would point out that the current budgetary accounting for federal insurance programs, such as deposit and pension insurance, still falls far short of the objective of assigning full economic costs to those activities. Currently, the costs of those activities are reported on a cash basis, which does not reflect the multiyear nature of the commitment. One result is that the programs report negative spending in most years, suggesting that they provide net income to the government, when in fact they represent a potentially enormous contingent liability. Consequently, alternative approaches may be needed to recognize the economic costs of insurance programs in the budget, perhaps building on the principles underpinning credit reform.

Future Directions

The line between concrete, and therefore budgeted, commitments and less firm spending plans is not always clear. For a commitment that is contractual, the estimated cost is its present value when the commitment is made. But for a commitment made under policies that are subject to periodic revision, like the major entitlement programs now fueling increases in spending, the economic costs for the entire future of the program should be recognized in the budget only to the extent that the commitment is not subject to revocation. For such programs, however, it is useful for the budget to include additional supplementary disclosures. Where the government's commitment to spend is very strong but not irrevocable or unalterable, determining the appropriate budgetary treatment for those programs will be difficult.

CBO's annual report on the budget and economic outlook already includes alternative projections for discretionary spending, as well as estimates for extending tax provisions that are scheduled to expire. Similarly, for the few mandatory spending

programs (such as those providing aviation terrorism insurance or the federal backstop for property and casualty terrorism risk insurance) that are allowed to expire under the procedures for CBO's baseline, the agency could report estimated costs under the assumption that the programs will not terminate as legislated.

CBO is developing the capacity to provide long-term projections for Social Security and Medicare to more accurately estimate future commitments under those programs. It will also use a long-term model as a basis for cost estimates for changes in those programs. In addition, I will soon become a voting member of the Financial Accounting Standards Advisory Board, which considers government standards for financial reporting with a view toward comprehensive disclosure of the costs of federal activities. Further, CBO is expanding its use of techniques of modern financial analysis, which will enable the agency to better assess the risk exposure of the federal government through its guarantee and insurance programs and public/private partnerships.

Such issues and developments, along with the huge impending demands on federal spending, make it timely to reassess the principles underlying federal budget accounting. Specifically, participants in the process need to renew their commitment to the objective of getting the most relevant measures of cost into the budget in support of Congressional decisions.