

REINVENTING GOVERNMENT

The Federal Budget

Part I

**Why It's Unsustainable
&
What We Can Do About It**



Congressman Mike Quigley

November 2010

Executive Summary

Our country is on an unsustainable fiscal path. This trend has accelerated over the last 10 years, and the huge deficits that were once a more distant concern of our children's generation are impacting the lives of ordinary Americans today. For a country with the proud history and vast resources of the United States, this is unacceptable.

We wrote this report not because we see fiscal sustainability as an end in itself, but rather because we believe that a fiscally sustainable government can provide better, more reliable, and more efficient services to its citizens. Government's mission matters, and succeeding in that mission means getting serious about reinventing government and changing our fiscal path.

This report, the first in a series, is a guide to reinventing the federal budget. In it, we make 15 recommendations that will establish greater budgetary transparency and accountability. Our key finding is that the American public deserves more honest and transparent information about how their tax dollars are being spent. To that end, one of our recommended reforms is a requirement that the federal government send each taxpaying American an itemized tax receipt. This receipt would show not only how their tax dollars are being spent, but also how much the federal government has borrowed in their name. This way Americans can better decide for themselves which government programs and services they value.

Taken together, our 15 recommendations will ensure that the federal budget is more transparent and accountable to its citizens. Only with increased transparency can we know where we have been and where we are going—and where we have gone wrong, so it doesn't happen again.

The magnitude of our fiscal challenge makes the need for greater budgetary transparency and accountability even more urgent. The Congressional Budget Office projects that by 2030, the federal government will be spending 30 percent of GDP but collecting only 20 percent in tax revenue. By 2050, the government will be collecting that same 20 percent, but spending 45 percent. Our deficits will only get worse from there.

Rising health care costs are driving these deficits. Between 1970 and today, health care spending quintupled as a percent of our budget. As a percent of GDP, health care spending is now projected to double in the next 25 years. Its growth closely correlates with the projected growth in deficit spending.

Deficit spending will also generate its own costs. Eventually, the accumulated costs of past deficits will be the drivers of new ones. The Congressional Budget Office projects that just 10 years from now, in 2020, the interest we will pay on previous borrowing will cost taxpayers \$778 billion—accounting for all of 2020's projected \$685 billion deficit and then some.

The practical effect of these structural deficits is that interest payments will crowd out more important spending programs. Strong national defense and accessible health care are priorities that will have to fall by the wayside if our fiscal path is not adjusted. But before we can move forward on the policy changes necessary to achieve meaningful deficit reduction, we need an honest and transparent assessment of our fiscal outlook.

Step one in righting our course is agreeing on what defines fiscal sustainability. Some would have us believe that any deficit whatsoever is a threat to government's solvency. Others would prefer to ignore deficits altogether and continue spending vast sums of borrowed money.

We disagree with both of these extreme positions. While deficits can help smooth dips in the economy and put unemployed Americans back to work, left unchecked they can also exacerbate future deficits and slow economic growth. Either way, this should be a choice that future leaders can make if so needed and not be one forced upon them by the profligacy of previous generations. As it stands now, we are leaving them no choice at all.

Step two must be fixing our broken budget process. Trillions of dollars in hidden spending persist with close to zero accountability while huge organizations like the Department of Defense cannot keep track of their cash flows or environmental liabilities. It is difficult to find budgetary savings when our budget itself is so opaque. Effectively, we are flying blind.

All this must change. Greater transparency and accountability can help us fix our budget and then help us keep it on a sustainable path.

Why We Wrote This Report

Our country is on an unsustainable fiscal path. The most realistic Congressional Budget Office (CBO) budget projection shows that our outstanding debt will equal 100 percent of our GDP in 2023. By 2035 it will begin to approach 200 percent, a debt burden never before seen in our country's history.

Servicing this debt will increase future deficits. The Department of Treasury projects that our tax revenues will remain relatively constant as a share of GDP at approximately 20 percent. Our spending outlays, however, are projected to jump from 25 percent of GDP in 2010 to 45 percent of GDP by 2050 and will surpass 70 percent of GDP by 2080. The main drivers of these deficits will be health care costs and net interest payments.

Even as we spend far beyond our means, our budget process is confusing and unaccountable to taxpayers. The budget itself conceals trillions of dollars in hidden spending while huge organizations like the Department of Defense cannot keep track of their cash flows.

This lack of transparency permits our deficits and debt to continue growing, even though we know this fiscal path is unsustainable and growing worse by the year.

What We Are Recommending

We recommend 15 specific reforms in six categories that will make our budget more transparent and accountable to taxpayers. To begin with, we recommend that taxpayers receive a tax receipt from the federal government, showing not only how their tax dollars are being spent, but also how much the federal government is borrowing in their name.

Second, we recommend that more information be made public about long-term spending, including analysis of the second decade for costly legislative proposals as well as net present value estimates for proposals for which costs escalate outside the budget window. The OMB should also issue an annual report examining our unbudgeted fiscal exposures to entities like Fannie Mae and Freddie Mac.

Third, our budget process needs to focus more on fiscal sustainability. Both the President's Budget and the Budget Resolution should include specific debt and deficit sustainability targets. The OMB should issue a Quadrennial Fiscal Sustainability Review. The President should also be invited to deliver a Fiscal Sustainability State of the Union Address to a joint session of Congress each year.

Fourth, we need more oversight of tax expenditures, which add up to \$1.2 trillion in hidden spending. Tax expenditures should be required to sunset after 10 years so they cannot circumvent PAYGO rules. The Department of Treasury should publish regular tax expenditure performance reviews. The IRS should also provide more data to policymakers to aid in these performance reviews.

Fifth, we need reform of our security budget. DOD must be audit-ready so we can conduct effective oversight of this \$720 billion annual investment in our national defense. We should also establish a unified security budget so we can conduct oversight of all security expenditures jointly.

Sixth, we need more transparency and accountability for our quarter trillion dollars in environmental liabilities.

Reinventing Government: The Federal Budget (Part I)

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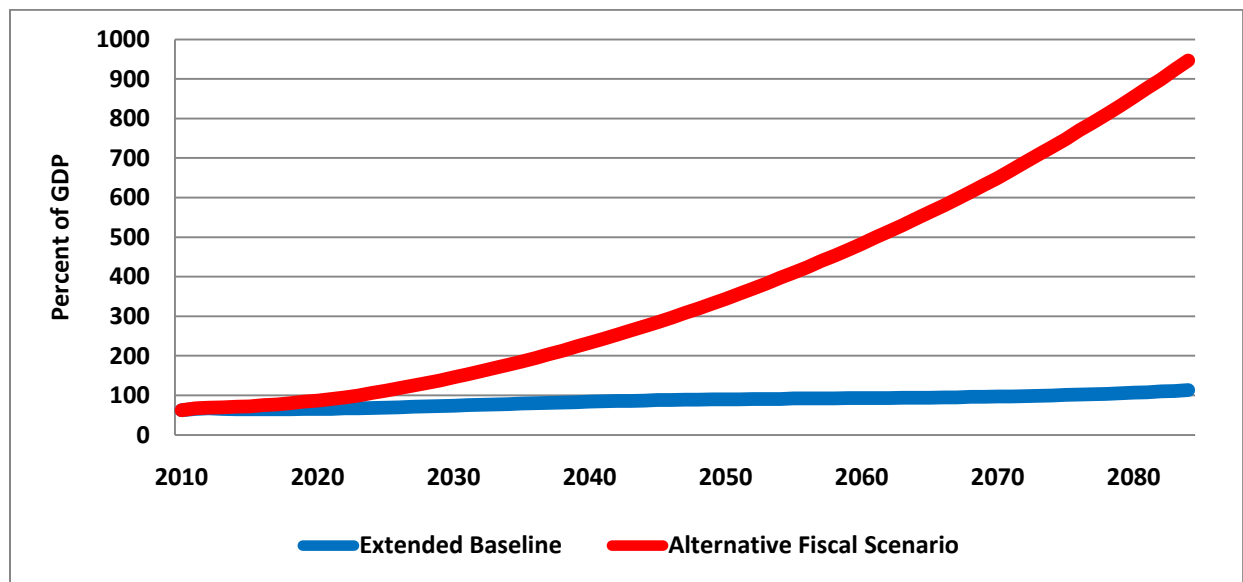
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Introduction

Our fiscal path is unsustainable. This trend has accelerated over the last 10 years and the huge deficits that were once a more distant concern of our children's generation are impacting the lives of ordinary Americans today. In 1999, for example, even the most pessimistic Congressional Budget Office (CBO) projection had the 2030 deficit pegged at eight percent.¹ Now, however, the CBO projects a 2030 deficit of 13 percent.² For a country as rich and powerful as our own, this is irresponsible and unacceptable.

Fiscal sustainability—the ability of the federal government to meet its fiscal obligations, now and in the future—is not out of reach, but getting there will require shared sacrifice. We need to act soon: the longer we wait, the harder it will be to adjust our course.

Figure 1: Public Debt as a Percent of GDP³



A simple way to quantify the scale of this challenge is to look at the public debt to gross domestic product (GDP) ratio (see Figure 1 above). The relevance of this measurement is not only predicated on the basic idea that bigger economies can sustain higher levels of debt than smaller economies, but also on the idea that there's a maximum sustainable amount for any

¹ Congressional Budget Office, "The Long-Term Budget Outlook: An Update", in *Congressional Budget Office* <<http://www.cbo.gov/ftpdocs/18xx/doc1806/lrbudg99.pdf>> [accessed 22 November 2010]

² Congressional Budget Office, "The Long-Term Budget Outlook", in *Congressional Budget Office* <<http://www.cbo.gov/ftpdocs/115xx/doc11579/06-30-LTBO.pdf>> [accessed 22 November 2010]

³ Congressional Budget Office, "The Long-Term Budget Outlook", in *Congressional Budget Office* <<http://www.cbo.gov/ftpdocs/115xx/doc11579/06-30-LTBO.pdf>> [accessed 22 November 2010]

economy, no matter its size. The Congressional Budget Office (CBO) baseline⁴ budget projection shows that under current law, outstanding debt will equal 66 percent of our GDP in 2020.⁵

This is already a high debt to GDP ratio—in fact, it’s the highest in fifty years in the U.S.—but when we take into account widely expected policy changes (including the likely renewal of the 2001 and 2003 tax cuts), the debt level rises to over 100 percent of GDP by 2023 and continues going straight up in the years thereafter. By 2035 it begins to approach 200 percent, a debt burden never before seen in our country’s history. This path is unsustainable and the outcome is unacceptable.

What We Learned in Chicago and Cook County

To meet this fiscal challenge, we have to reinvent the way government does business. We can’t dismiss this challenge, no matter how abstract it may seem. We can’t doctor the books to show comforting falsehoods and we can’t let sacred cows stand in our way.

Government should be simpler and more accountable to its citizens.

The concept of reinventing, or starting over and assessing how best to meet today’s needs with today’s resources, is not an unfamiliar one. While serving as a Commissioner on the Cook County Board in Cook County, Illinois⁶, Mike Quigley authored a series of eight, in-depth reports outlining a number of innovative

ways to reduce duplication and waste, streamline services where appropriate, identify non-taxpayer revenue sources, and make County government simpler and more accountable to its citizens.

These reports were motivated by a basic problem which faces many governments, including the federal government: they spend more money than they take in. Most policy-makers see two solutions to this deficit hurdle: either increase revenue or cut services. But what we found at Cook County was a third option, a middle ground, which we dubbed “reinventing government”.

When Mike Quigley entered office in 1998, Cook County government was mired in red ink, even in the midst of a strong economy. Despite this troubling situation, spending was still projected

⁴ The CBO baseline is a 10 year projection of spending that only takes into account current law.

⁵ Congressional Budget Office, "The Budget Outlook: Fiscal Years 2010 to 2020", in *Congressional Budget Office* <<http://www.cbo.gov/ftpdocs/108xx/doc10871/01-26-Outlook.pdf>> [accessed 22 November 2010]

⁶ Cook County includes all of the City of Chicago as well as many neighboring suburbs.

to steadily increase and onerous new taxes were the only solution proposed to get the government into the black. By assessing the County's budget woes through the lens of reinventing government, however, we issued eight reports detailing dozens of reforms that cumulatively would save Cook County tens of millions of dollars each year. These reforms ranged from consolidating county offices like Assessor and Treasurer, to eliminating duplicative services, to identifying private and corporate sponsorships opportunities. They also included recommendations to transfer responsibility of some government duties to adjacent municipalities, to privatize janitorial services and golf courses, to modernize the County's hiring processes, and to audit existing positions to determine the necessity of each.

Some of the proposed reforms have been implemented, many are in the process of being implemented, and many more remain to be acted upon. Still, what began as a set of ideas to help make government work better for its citizens is now part of the common discourse at the local government level. Today, in a far more challenging fiscal environment, a viable menu of options exists for accomplishing more with less. Both at the local level and at the federal level there is a need for policymakers to pursue a middle ground and look beyond simply raising revenue or cutting services. We need to examine how we can reinvent the way government works so it provides better and more efficient services to its citizens. This is what we strove to do during our 10 years in Chicago, and it is also what this report hopes to accomplish at the federal level.

What We Have Offered in Washington

In Washington, we have been developing a legislative plan to reinvent the federal government beginning with the budget. On July 15, 2010, we introduced H.R.5752, the Transparent and Sustainable Budget Act of 2010. This bill was designed to achieve three goals: (1) To make fiscal sustainability a fundamental objective of the budget process, (2) To end the deceptive accounting that hides spending off-budget, and (3) To establish the first effective oversight of tax expenditures, \$1.2 trillion of hidden spending each year.

This report is intended to build on and improve the legislative proposals we introduced in H.R.5752. Going into the 112th Congress, we plan to introduce a new bill that will incorporate the new ideas in this report as well as any other thoughtful ideas that are brought to our attention.

Additionally, in the 112th Congress, we plan to issue a second report that will go beyond transparency and procedural reforms to discuss specific cost savings that can be found in the federal budget. We need a fiscally sustainable budget, and we plan to play a key role in that debate.

The Goal of this Report

To understand our fiscal challenge, imagine that you're flying a plane across the Pacific Ocean from Tokyo to Chicago. Once you take off, you orient yourself in the direction of Chicago, but your navigation system is broken and it has slightly miscalculated your flight path. While this miscalculation seems insignificant in the early going, you realize hours later that you're way off course and halfway to Alaska. What do you do?

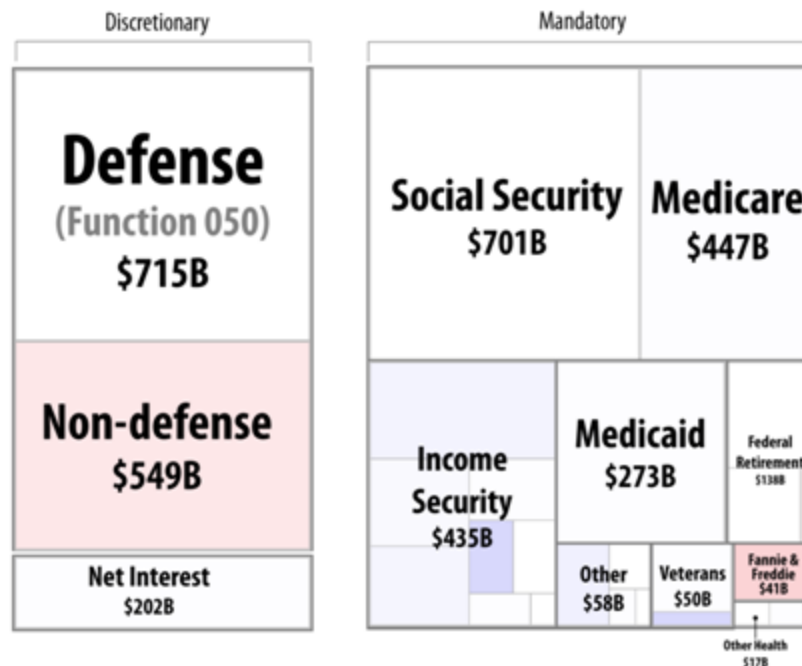
This is where we find ourselves today, at least as it pertains to our budget. We're way off course, in the sense that we've spent far beyond our means. And we're flying blind, with a broken budget process that gives us too little information about how we're spending our money or where it's going. But the situation is not hopeless. We *can* get back on track.

This report is a guide to getting back on track. Section One discusses how far off course we are. Large persistent deficits present us with this historic challenge. Section Two considers how to fix our budget process—specifically, how to address the transparency issues that are standing between us and reform. A forthcoming report will discuss specifics of how to reach our destination. It will examine the areas of the budget that could generate the most savings in the years ahead and help return us to fiscal sustainability.

Section I: The Costs of Deficits

Deficit spending is a tool of public economic policy and is not inherently undesirable. Governments run deficits to stimulate economic activity during times of recession. These temporary deficits can also have negative consequences, but they are limited and manageable. Even persistent small-scale deficits are relatively unproblematic.

Figure 2: Fiscal Year 2010 Budget Authority⁷



If large deficits persist in the long-term, however, the negative consequences tend to outweigh the benefits. This is because large persistent deficits compound in effect, mostly through the accumulation of debt, and turn deficits of choice into permanent structural deficits.

This section examines the negative consequences of large persistent deficits and how they relate to our economy and budget. Our conclusion—which

motivates the rest of this report—is that our long-term fiscal path is unsustainable. We need to make fundamental changes to our budget today to reduce our projected deficits and to prevent our budget and economy from developing structural weaknesses. It is not too late, but we need to act soon.

Where Are We?

In Fiscal Year 2010, Congress authorized \$3.6 trillion in spending.⁸ The bulk of this spending falls into seven categories: Defense, Social Security, non-defense discretionary, Medicare, income security, Medicaid, and net interest (see Figure 2 above).

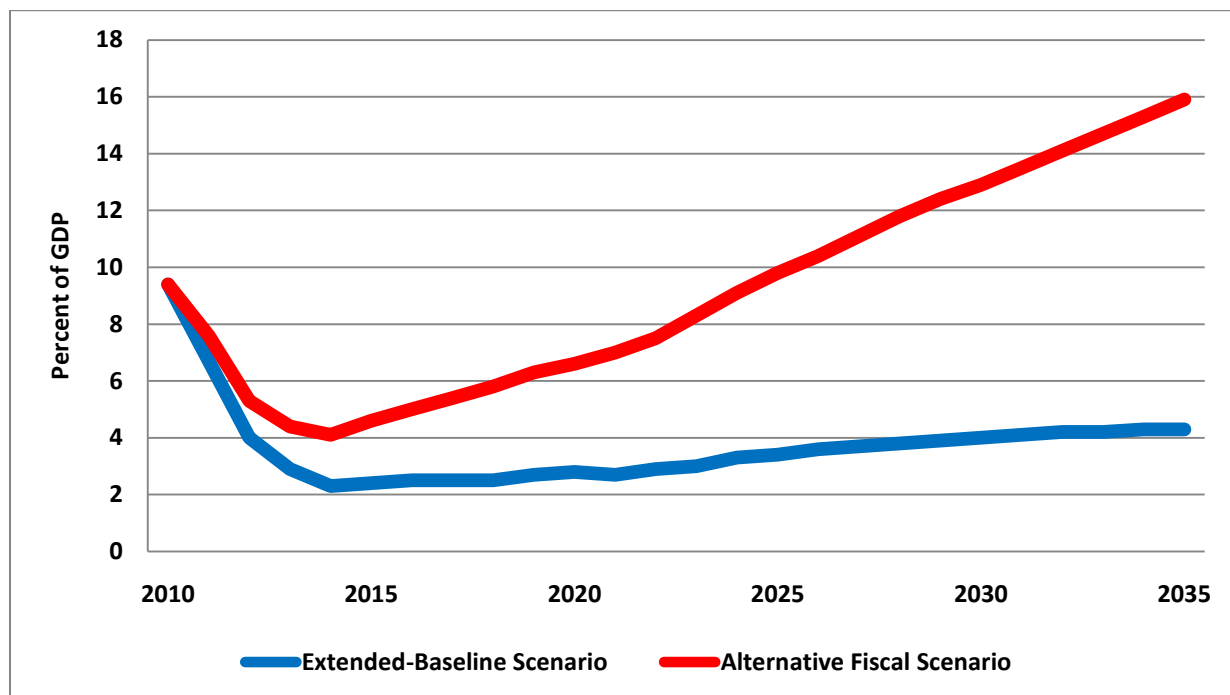
⁷Figure provided by the Congressional Research Service

⁸To be precise, on an annual basis, Congress only authorizes discretionary spending. Mandatory spending, which is larger than discretionary spending, is outlayed regardless of annual Congressional authorization.

Given that the federal government will only collect a projected \$2.1 trillion in 2010 tax revenues, the CBO projects that 2010's deficit will exceed \$1.3 trillion, or approximately 9.1 percent of GDP. The CBO also projects that deficits will drop to between 2.5 and 3.0 percent of GDP by 2014, but begin to creep up thereafter.⁹

However, this CBO projection is based on current law only, which does not take into account widely expected policy changes. The CBO also publishes an alternative fiscal scenario that takes into account these widely expected policy changes (including, for example, an extension of the 2001 and 2003 tax cuts).¹⁰ Under this alternative fiscal scenario, deficits are projected to drop to as low as 4.1 percent of GDP in 2014, but begin increasing again in 2015 (see Figure 3 below).

Figure 3: Deficits as Percent of GDP 2010-2035¹¹



This data only takes us through 2020. Projecting deficits beyond 2020, however, quickly becomes more difficult because the results depend so much on relatively fluid and imprecise assumptions. Nevertheless, looking beyond the short- and medium-term fiscal outlook is important insofar as it can help us understand the long-term implications of our policy decisions in this Congress and the next.

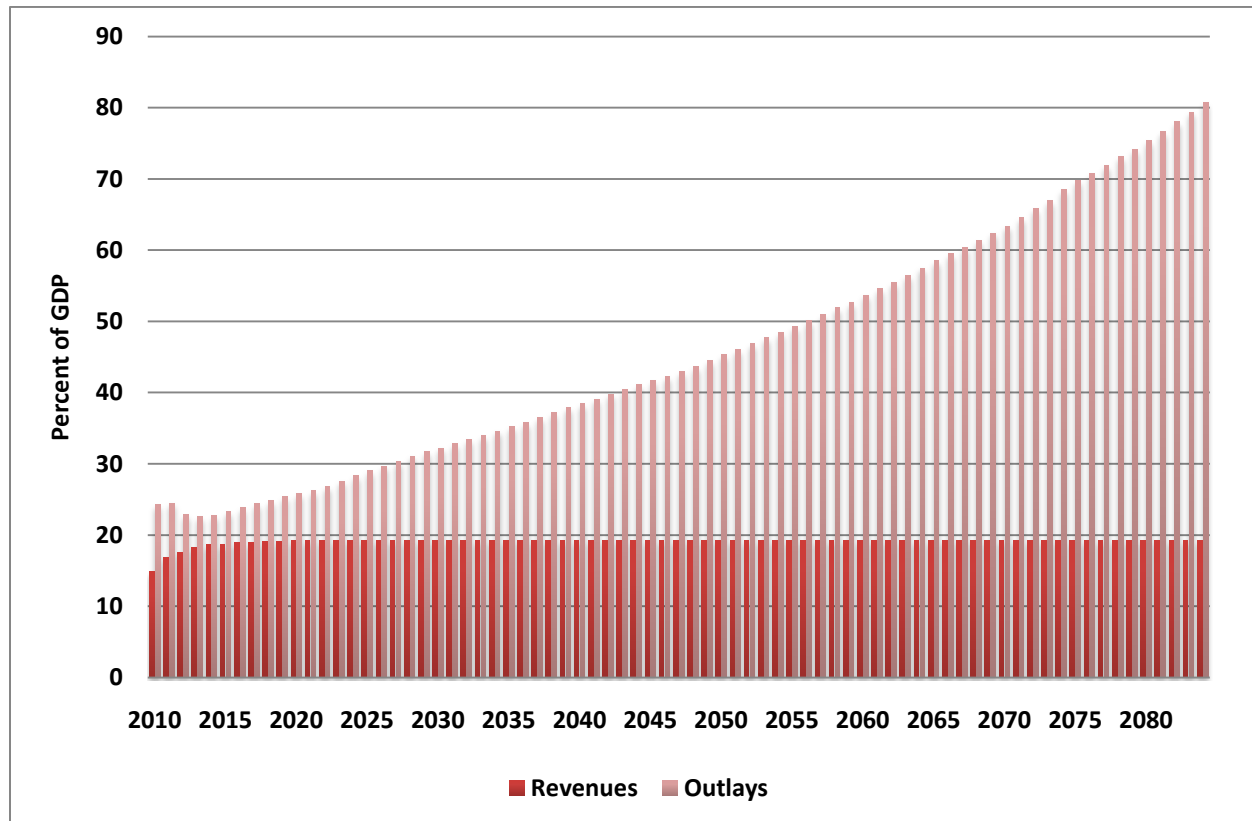
⁹ Congressional Budget Office, "The Budget and Economic Outlook: An Update", in *Congressional Budget Office* <<http://www.cbo.gov/ftpdocs/117xx/doc11705/08-18-Update.pdf>> [accessed 22 November 2010]

¹⁰ Unless otherwise noted, all the data in this report, including all figures and graphs, were derived from the CBO's alternative fiscal scenario which takes into account widely expected policy changes. See the CBO website, www.cbo.gov, for additional information on its methodology.

¹¹ Congressional Budget Office, "The Long-Term Budget Outlook", in *Congressional Budget Office* <<http://www.cbo.gov/ftpdocs/115xx/doc11579/06-30-LTBO.pdf>> [accessed 22 November 2010]

Looking at the following several decades, the CBO's alternative fiscal scenario¹² projects that our tax revenues will remain relatively constant as a share of GDP at approximately 20 percent. Our spending outlays, however, are projected to jump from about 25 percent of GDP in 2010 to 45 percent of GDP in 2050 and will approach 80 percent of GDP by 2080 (see Figure 4 below).¹³

Figure 4: Projected Future Outlays in Excess of Future Revenues¹⁴



In other words, our projected deficit in 2080 is nearly half of that year's GDP. And without changes to our fiscal baseline, deficits of this scale are unavoidable: mandatory spending will make up the bulk of 2080's deficit.

What's Driving Deficits?

The main cause of our deficits is the rising cost of health care. Other areas of the budget are also rising in cost, but none are rising so quickly relative to the growth rate of GDP as health

¹² The alternative fiscal scenario is different from the normal extended baseline in that it assumes certain changes to current law that are very likely to occur.

¹³ Congressional Budget Office, "The Long-Term Budget Outlook", in *Congressional Budget Office* <<http://www.cbo.gov/ftpdocs/115xx/doc11579/06-30-LTBO.pdf>> [accessed 22 November 2010]

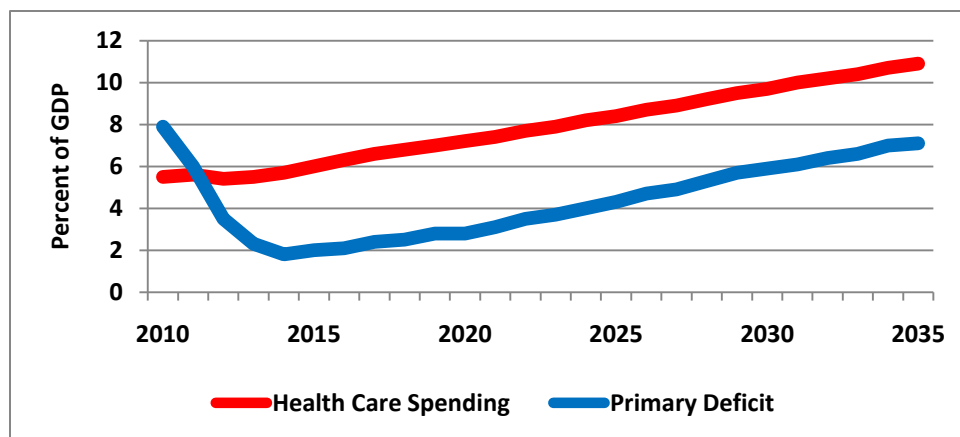
¹⁴ Congressional Budget Office, "The Long-Term Budget Outlook", in *Congressional Budget Office* <<http://www.cbo.gov/ftpdocs/115xx/doc11579/06-30-LTBO.pdf>> [accessed 22 November 2010]

care. Health care driven deficits will persist for as long as federal health care programs continue unreformed and will create additional budgetary liabilities by increasing federal borrowing and the subsequent annual interest payments.

According to CBO projections, “All of the projected growth in primary outlays as a share of GDP in coming years stems from increases in mandatory spending, particularly in spending for government’s major health care programs”.¹⁵ While experts may disagree about how to reduce federal deficits, there is a striking consensus among budget experts at the CBO, the Brookings Institution, the GAO, the Pew-Peterson Commission, and others that the “continued rapid growth of per-person health care costs is the single biggest reason for the projected long-term increases in deficits and debt.”¹⁶

The rate of increase of health care costs is highly correlated with the rate of increase of our primary deficits (see Figure 5 below).¹⁷ Without over-interpreting the data, the obvious conclusion is that the projected growth in our primary deficits as a share of GDP over the next 25 years is almost entirely owed to the growth in health care costs.

Figure 5: Health Care Spending vs. Primary Deficits as a Percent of GDP¹⁸



This is to say that if we can get our health care spending under control, we can fix our deficit problem and prevent our net interest payments from spiraling out of

control. As Marc Labonte, a macroeconomic specialist for the Congressional Research Service, puts it, “any policy changes to place the budget on a sustainable path must include reductions in the growth rate of government health spending.”¹⁹

¹⁵ Congressional Budget Office, "The Long-Term Budget Outlook", in *Congressional Budget Office* <<http://www.cbo.gov/ftpdocs/115xx/doc11579/06-30-LTBO.pdf>> [accessed 22 November 2010]

¹⁶ Robert Greenstein, "Testimony of Robert Greenstein, Executive Director, Center on Budget and Policy Priorities, before the House Budget Committee", in *Center for Budget and Policy Priorities* <<http://www.cbpp.org/files/1-21-10bud-test.pdf>> [accessed 22 November 2010]

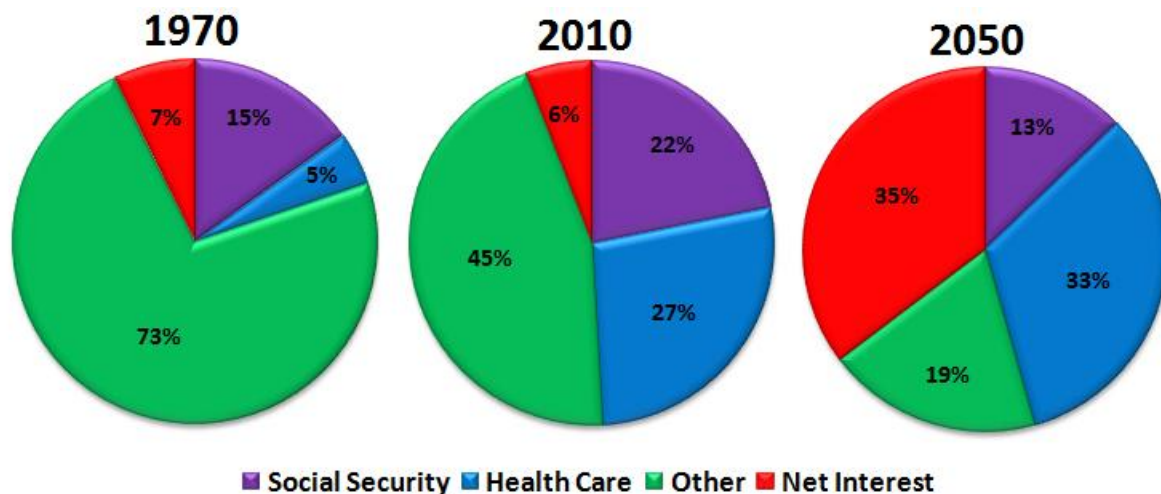
¹⁷ Primary deficits are the difference between revenues and outlays minus net interest payments.

¹⁸ Congressional Budget Office, "An Analysis of the President's Budgetary Proposals for Fiscal Year 2011", in *Congressional Budget Office* <<http://www.cbo.gov/ftpdocs/112xx/doc11280/03-24-apb.pdf>> [accessed 22 November 2010]

The other noteworthy impact of this rise in health care spending as a percent of GDP is that it has begun to crowd out other areas of the budget. Over the past 40 years, federal tax revenues have shifted from paying for discretionary programs appropriated on an annual basis to paying for mandatory health care programs like Medicare and Medicaid.

This trend is likely to continue unless health care spending programs are reformed. Figure 6 below shows the shift in budgetary resources towards health care spending.

Figure 6: Spending as a Percent of the Budget 1970-2050²⁰



If we are to limit skyrocketing deficits and free up public resources for other desirable programs, the trajectory of federal health care spending has got to be brought under control. Certainly other areas of the budget can also be targeted for savings, but no fiscal sustainability plan can be complete without significant reform of federal health care spending.

While this report examines the scope of our deficit problem as well as the transparency and accountability issues that are standing in the way of meaningful budget reform, Part Two will propose budgetary reforms that could generate specific cost savings. It will include a discussion of health care spending reform and its potential cost savings.

¹⁹ Marc Labonte, "Economic Effects of a Budget Deficit Exceeding \$1 Trillion", in *Congressional Research Service* <<http://www.crs.gov/Products/r/pdf/R40770.pdf>> [accessed 22 November 2010]

²⁰ Office of Management and Budget, "Historical Tables, Budget of the U.S. Government Fiscal Year 2011", in *The White House* <<http://www.whitehouse.gov/sites/default/files/omb/budget/fy2011/assets/hist.pdf>> [accessed 22 November 2010] & Congressional Budget Office, "An Analysis of the President's Budgetary Proposals for Fiscal Year 2011", in *Congressional Budget Office* <<http://www.cbo.gov/ftpdocs/112xx/doc11280/03-24-apb.pdf>> [accessed 22 November 2010] & The Defense Business Board, "Reducing Overhead and Improving Business Operations", in *The Defense Business Board* <<http://dbb.defense.gov/MeetingFiles/presented.pdf>> [accessed 22 November 2010]

Are All Deficits Problematic?

“Deficits are bad” is the mantra of fiscal watchdogs. We agree for the most part—large persistent deficits drive up long-term costs, consume budgetary resources, crowd out private investment, and send American dollars overseas. Certainly the huge deficits discussed in the previous section are unthinkable bad. Even the shrewdest financial managers at Treasury would have a hard time finding buyers for the quantity of debt we would have to sell to cover 2080’s projected budget shortfall.

However, there are those who believe that temporary or small deficits are not the end of the world. According to CRS, short-term deficit spending “can stimulate economic activity” and “counteract recessions.” Broadly, “a countercyclical fiscal policy, in which taxes are cut or

Future leaders should get to make their own spending decisions and not be burdened by the profligacy of previous generations.

spending is increased, can dampen economic fluctuations and limit the depth of economic downturns.”²¹

This was the reasoning behind the American Recovery and Reinvestment Act (ARRA) of 2009.

The non-partisan Congressional Budget Office (CBO) credits ARRA for increasing real GDP by between 1.7 and 4.5 percent, lowering the

unemployment rate by between 0.7 and 1.8 percent, and for increasing the number of people employed by between 1.4 million and 3.3 million during the second quarter of 2010.²² These are notable results.

Despite ARRA’s price tag, the CBO still does not believe that similar deficit spending is entirely inconsistent with fiscal sustainability: “...there is no intrinsic contradiction between providing additional fiscal stimulus today, while the unemployment rate is high and many factories and

²¹ D. Andrew Austin, “Running Deficits: Positives and Pitfalls”, in *Congressional Research Service* <<http://www.crs.gov/Products/rl/pdf/RL33657.pdf>> [accessed 22 November 2010]

²² Lori Montgomery, “CBO Says Stimulus May Have Added 3.3 Million Jobs”, in *The Washington Post* <http://voices.washingtonpost.com/political-economy/2010/08/cbo_says_stimulus_may_have_add.html> [accessed 22 November 2010] & Congressional Budget Office, “Estimated Impact of the American Recovery and Reinvestment Act on Economic Employment and Economic Output From April 2010 Through June 2010”, in *Congressional Budget Office* <<http://www.cbo.gov/ftpdocs/117xx/doc11706/08-24-ARRA.pdf>> [accessed 22 November 2010]

offices are underused, and imposing fiscal restraint several years from now, when output and employment will probably be close to their potential.”²³

Additionally, small deficits, even if they persist for many years, are unlikely to cause too many problems. As long as deficits as a percent of GDP are smaller than the rate of economic growth, public debt will not increase as a share of GDP. This would stop the growth of interest payments and completely change the trajectory of the graph shown in Figure 4 on page 7. The goal here is sustainability, of both deficits and debt, and not a fiscal austerity program that goes far beyond what is necessary.

This is all to say that deficit spending is not inherently bad. There will always be a trade-off between today and tomorrow that policymakers will have to make, but the risk level inherent in this choice should not be catastrophic. In some cases this trade-off will be worth it; in some cases it will not. Even if temporary deficits can help smooth ups and downs in the economy and put unemployed Americans back to work, this should be a choice that future leaders get to make and not be a situation forced upon them by the profligacy of previous generations. As it stands now, we are leaving them no choice at all.

Why Are Large Persistent Deficits Problematic?

While deficits, especially temporary deficits, may increase demand and stimulate economic growth, large persistent deficits have negative consequences. In many cases, these negative consequences can overwhelm the positive effects of increasing aggregate demand. Four negative consequences of large persistent deficits are listed below. While not a comprehensive list, these should be helpful in conceptualizing the broader negative impact of large persistent deficits on our budget and on our economy.

1. Large persistent deficits can increase interest payments for debt service.
2. Large persistent deficits can redirect American wealth overseas.
3. Large persistent deficits can crowd out private sector investment.
4. Large persistent deficits can cause a debt crisis.

The following four subsections discuss these negative consequences in greater detail, particularly focusing on how they might apply to our budget and economy.

²³ Douglas W. Elmendorf, "The Economic Outlook and Fiscal Policy Choices, Statement of Douglas W. Elmendorf, Director, before the Committee on the Budget, U.S. Senate", in *Congressional Budget Office* <http://www.cbo.gov/ftpdocs/118xx/doc11874/09-28-EconomicOutlook_Testimony.pdf> [accessed 22 November 2010]

1. Large Persistent Deficits Increase Interest Payments

Deficit spending is financed with borrowed money. The cost of borrowing—interest payments—depends on two factors: (1) the principal amount borrowed, and (2) the interest rate. Government budgets cannot sustain persistent deficits larger than the growth rate of the economy because financing these deficits with lots of borrowing (debt) means paying lots of interest for years to come.²⁴

These interest payments can eventually add up to an unsustainable level, consuming more and more of our budgetary resources each year. As the Congressional Research Service (CRS) explains, “the federal debt cannot indefinitely grow faster than output. If it did, a greater and greater share of national income would be devoted to servicing the debt, until eventually the government would be forced to monetize the debt (finance it through money creation) or default on it.”²⁵

Unfortunately that is exactly the path we are on. According to current CBO projections, the rates on 10 year Treasury notes will increase from below 3.0 percent today to 5.9 percent by the latter half of this decade.²⁶ Recognizing also that large deficits are likely to persist, the CBO forecasts that annual net interest outlays will more than double between 2011 and 2020, increasing from 1.5 percent of GDP (\$225 billion) in 2011 to 3.4 percent of GDP (a whopping \$778 billion) in 2020.²⁷ This is effectively the same cost to taxpayers as enacting a new 2009-style stimulus each year. But instead of using that money to invest in infrastructure or other public goods, we will have to pay it back to our lenders, many of them overseas.²⁸ By 2014, net interest outlays will account for nearly our entire deficit and will eventually surpass it in size by 2017 (see Figure 7 on the next page).

²⁴ “Large deficits” are those deficits that as a percent of GDP are greater than the nominal growth rate of GDP.

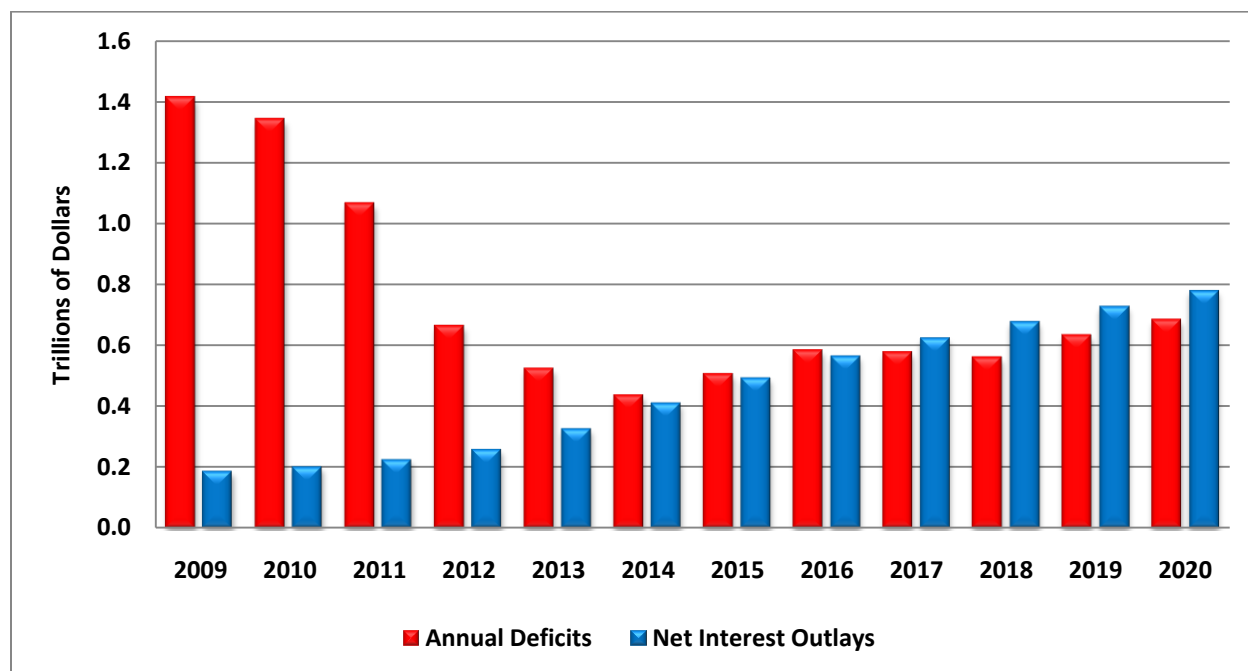
²⁵ Marc Labonte, “Economic Effects of a Budget Deficit Exceeding \$1 Trillion”, in *Congressional Research Service* <<http://www.crs.gov/Products/tr/pdf/R40770.pdf>> [accessed 22 November 2010]

²⁶ This is not necessarily related to any increasing currency risk.

²⁷ Congressional Budget Office, “The Budget and Economic Outlook: An Update”, in *Congressional Budget Office* <<http://www.cbo.gov/ftpdocs/117xx/doc11705/08-18-Update.pdf>> [accessed 22 November 2010]

²⁸ Lenders, investors, and creditors are terms that can be used interchangeably in this context.

Figure 7: Annual Deficits vs. Net Interest Outlays²⁹

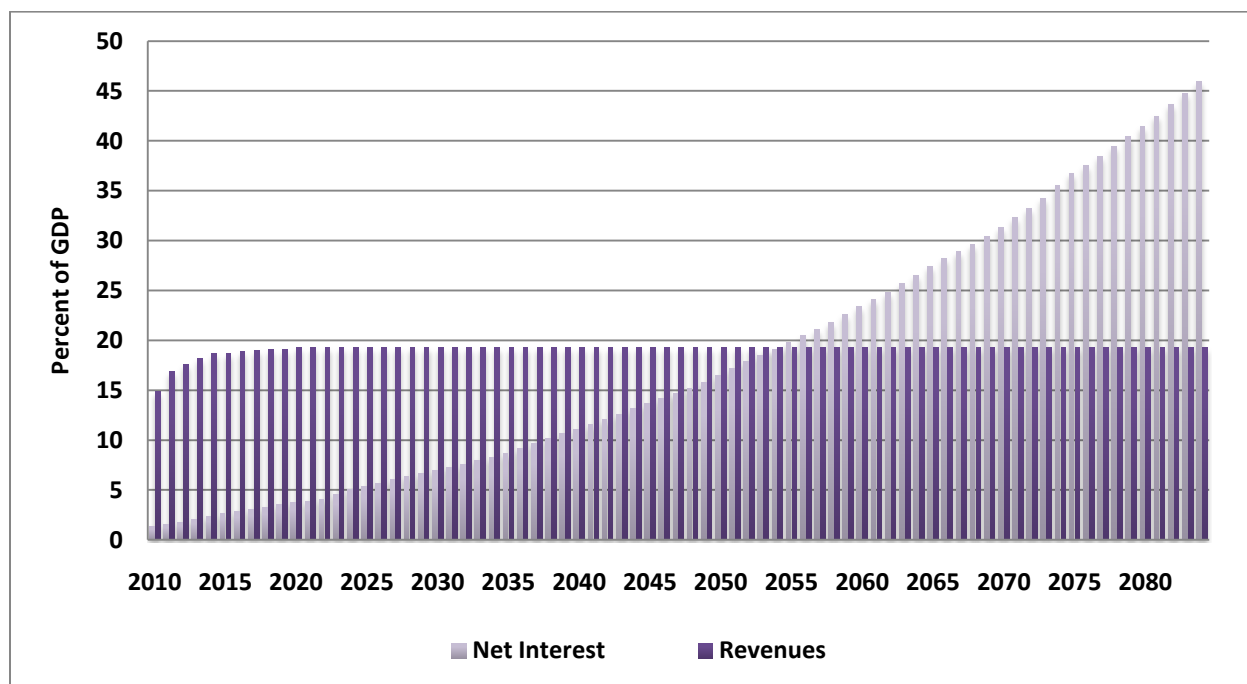


The practical effect of this growth in mandatory net interest payments is that it will consume the space in our budget that would otherwise be reserved for the things government is supposed to do. This is an unfair burden on future generations who will receive few of the benefits of deficit spending but will bear all of the costs. In effect, each deficit is a transfer of wealth between generations, from our children's or our younger colleagues' to our own. Others may prefer to describe deficits as a tax on future generations. Either way, if we care about strong national defense and accessible health care, we need to get our fiscal house in order.

This trend towards higher interest payments is projected to accelerate in the long-term. CBO projections (Figure 8 on the next page) show that interest payments alone will dwarf revenues by the latter half of this century.

²⁹ Congressional Budget Office, "The Budget and Economic Outlook: An Update", in *Congressional Budget Office* <<http://www.cbo.gov/ftpdocs/117xx/doc11705/08-18-Update.pdf>> [accessed 22 November 2010]

Figure 8: Projected Net Interest Payments vs. Projected Revenues³⁰



Essentially, the debt issued to finance 2011's deficit would then add to the burden of 2012's deficit by piling on additional interest payments. By 2080 all this extra debt service will have added up: interest on debt in 2080 is projected to cost 50 percent of GDP. However, it's unlikely we will ever see this day: no budget or economy could sustain deficits of this magnitude for so many consecutive years.

2. Large Persistent Deficits Can Redirect American Wealth Overseas

Large persistent deficits will exacerbate another already worrying trend: the outflow of American budgetary resources to foreign countries. How so?

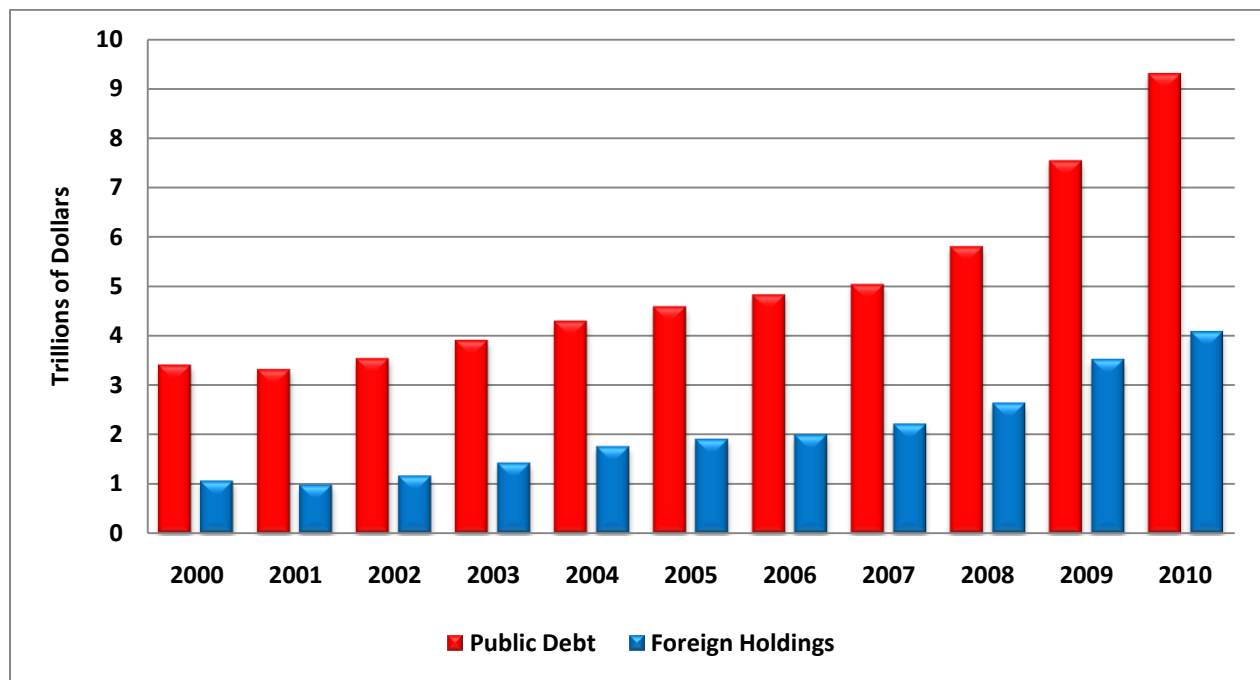
Foreign governments and other international entities hold approximately 30 percent of our total debt. Since 2000, as deficits have increased, these foreign holdings of U.S. debt have nearly quadrupled, from just over \$1 trillion in 2000 to just over \$4 trillion in 2010.³¹ This increase in foreign holdings of U.S. debt has coincided with a period of large and growing annual deficits, and also with an increase in the size of our total debt. In fact, nearly 40 percent

³⁰ Congressional Budget Office, "The Long-Term Budget Outlook", in *Congressional Budget Office* <<http://www.cbo.gov/ftpdocs/115xx/doc11579/06-30-LTBO.pdf>> [accessed 22 November 2010]

³¹ Department of Treasury, "Major Foreign Holders of Treasury Securities" <<http://www.ustreas.gov/tic/mfh.txt>> [accessed 22 November 2010] & Department of Treasury, "Major Foreign Holders of Treasury Securities" <<http://www.ustreas.gov/tic/mfhhis01.txt>> [accessed 22 November 2010] & TreasuryDirect, "Historical Debt Outstanding - Annual 2000-2010" <http://www.treasurydirect.gov/govt/reports/pd/histdebt/histdebt_histo5.htm> [accessed 22 November 2010]

of the growth in our total debt over the last 10 years has been sold to foreign entities. In other words, foreign investors financed 40 percent of the sum of our annual deficits between 2000 and 2010, lending us a huge portion of the funds we did not raise through taxes. Figure 9 (shown below) compares total public debt against that portion of the total public debt held by foreign entities over the last decade.

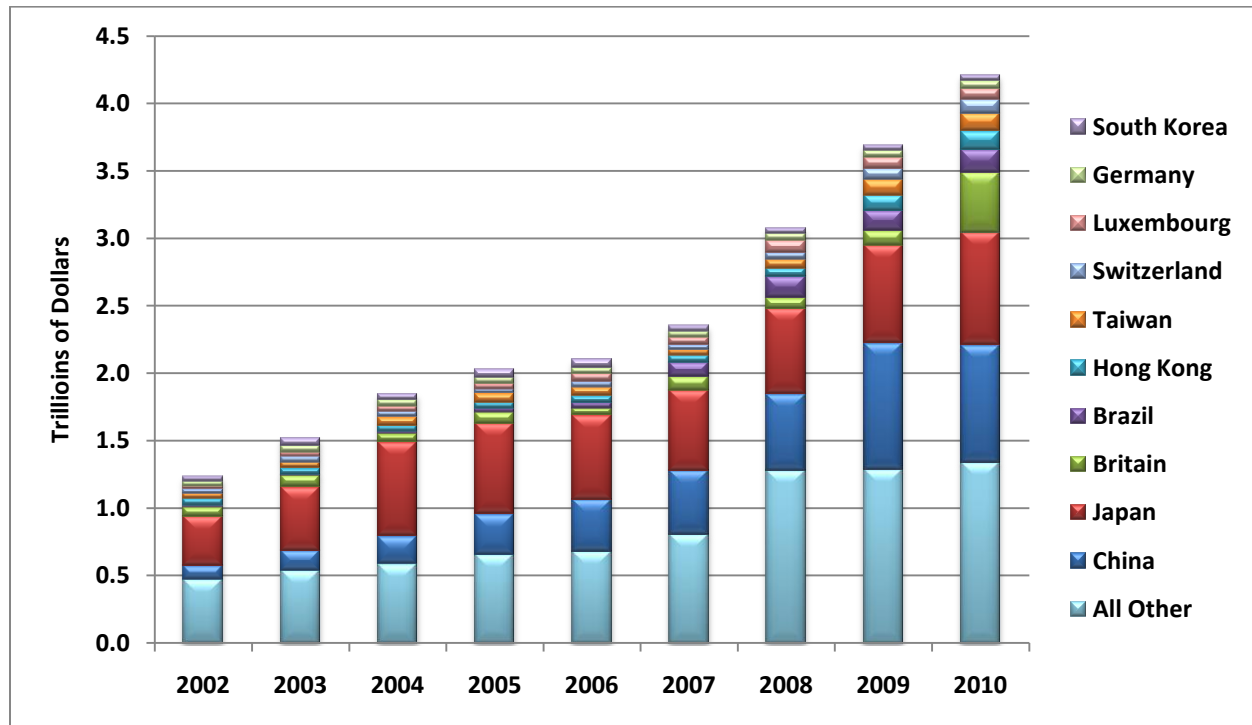
Figure 9: Public Debt vs. Foreign Holdings of U.S. Debt³²



The result of this trend towards borrowing abroad is that foreign countries, particularly China, Japan, and Britain, have been some of the key beneficiaries of the increase in interest payments in recent years (see Figure 10 on the next page for each country's share of foreign holdings of U.S. debt). In effect, foreign governments and individuals get a return on their investment to the detriment of taxpaying Americans, who derive fewer and fewer benefits from the same drain on their financial resources.

³² Department of Treasury, "Major Foreign Holders of Treasury Securities" <<http://www.ustreas.gov/tic/mfh.txt>> [accessed 22 November 2010] & Department of Treasury, "Major Foreign Holders of Treasury Securities" <<http://www.ustreas.gov/tic/mfhhis01.txt>> [accessed 22 November 2010] & TreasuryDirect, "Historical Debt Outstanding - Annual 2000-2010" <http://www.treasurydirect.gov/govt/reports/pd/histdebt/histdebt_histo5.htm> [accessed 22 November 2010] & Congressional Budget Office, "The Long-Term Budget Outlook", in *Congressional Budget Office* <<http://www.cbo.gov/ftpdocs/115xx/doc11579/06-30-LTBO.pdf>> [accessed 22 November 2010]

Figure 10: Foreign Holdings of U.S. Debt³³



Wariness of selling so much debt to countries like China is not without good reason—certainly China’s vast holdings of U.S. debt give it a greater voice in international economic affairs, and perhaps one that does not benefit the U.S. But China is also dependent on a strong dollar that maintains its value lest its heavily dollar invested portfolio suffers. The size and liquidity of the Treasury security market also makes it unlikely that China could exercise much influence through its U.S. debt holdings. Former Secretary of Treasury Hank Paulson explains that “[because of] the size of our debt outstanding and the way it trades and the diversity and so on”, a Chinese sell-off of Treasury securities was not at the top of his list of concerns.³⁴

Regardless of the potential for foreign influence, there is still a huge cost associated with selling our debt to foreign entities. The transfer of budgetary resources to China, Japan, and other countries heavily invested in American debt is a measurable, direct, and undesirable cost of running large persistent deficits.

³³ Department of Treasury, "Major Foreign Holders of Treasury Securities" <<http://www.ustreas.gov/tic/mfh.txt>> [accessed 22 November 2010] & Department of Treasury, "Major Foreign Holders of Treasury Securities" <<http://www.ustreas.gov/tic/mfhhis01.txt>> [accessed 22 November 2010]

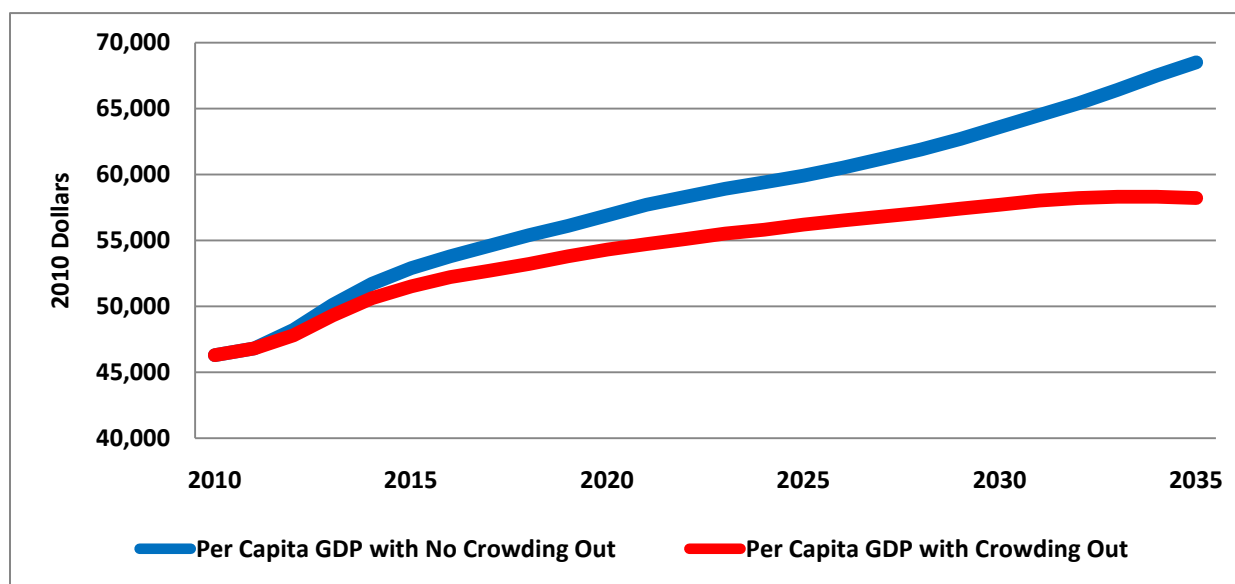
³⁴ Wayne M. Morrison and Marc Labonte, "China’s Holdings of U.S. Securities: Implications for the U.S. Economy", in *Congressional Research Service* <<http://fpc.state.gov/documents/organization/99496.pdf>> [accessed 22 November 2010]

3. Large Persistent Deficits Can Crowd Out Private Sector Investment

A third negative consequence of large persistent deficits is that they can “crowd out” private sector growth. This happens when productive capital is invested in high interest government debt rather than in the job creating private sector. This is not so relevant now, when Treasury rates are extraordinarily low, but the projected increase in Treasury rates over the next few years will change this equation.³⁵

“Crowding out” is not an immeasurable phenomenon. In fact, basing its analysis on historical trends, the CBO has estimated that real GDP per capita, under the alternative fiscal baseline, “would be about 6 percent lower in 2025 and 15 percent lower in 2035 than it would be under the stable economic conditions (*with no crowding out*) assumed for the long-term budget projections.” This is to say that crowding out has a noticeable and substantial impact on our economy at the projected levels of spending. Figure 11, shown below, estimates the long-term impact of crowding out on economic growth.

Figure 11: Effect of "Crowding Out" on Economic Growth³⁶



By 2030, without a change to our projected deficits, this slower economic growth³⁷ could amount to a drop of thousands of dollars in potential per capita income. This will hurt the

³⁵ Debt-financed government spending on public goods (like infrastructure) can actually spark additional private sector investment. Economists sometimes call this effect “crowding in”—in effect, public investment in roads, bridges, and ports can incentivize private investment in businesses that take advantage of this infrastructure. This doesn’t mean that “crowding out” doesn’t occur, but that its negative impact can potentially be outweighed by the positives of “crowding in”.

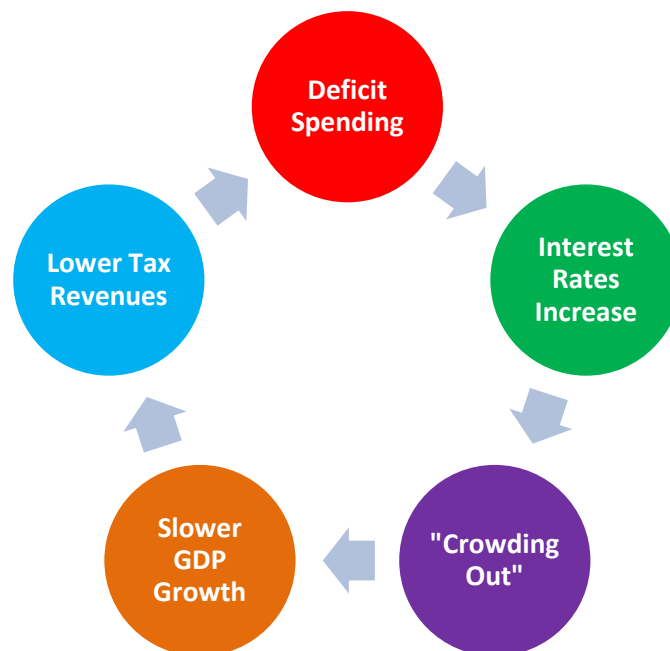
³⁶ Congressional Budget Office, “The Long-Term Budget Outlook”, in *Congressional Budget Office* <<http://www.cbo.gov/ftpdocs/115xx/doc11579/06-30-LTBO.pdf>> [accessed 22 November 2010]

³⁷ This is to say that crowding out could be less harmful to GDP if our deficits are smaller than projected.

bottom line for ordinary Americans, limiting their ability to buy cars or pay off mortgages or to do any number of things that we take for granted.

Federal Reserve Chairman Ben Bernanke, testifying before the National Commission on Fiscal Responsibility and Reform earlier this year, made a similar point: “Achieving long-term fiscal sustainability will be difficult, but the costs of failing to do so could be very high. Increasing levels of government debt relative to the size of our economy can lead to higher interest rates, which inhibit capital formation and productivity growth—and might even put the current economic recovery at risk.”³⁸ Given today’s exceptionally low interest rates, Chairman Bernanke’s argument may seem easy to dismiss, but that is a risk we should be wary of taking.

Figure 12: The "Crowding Out" Deficit Cycle

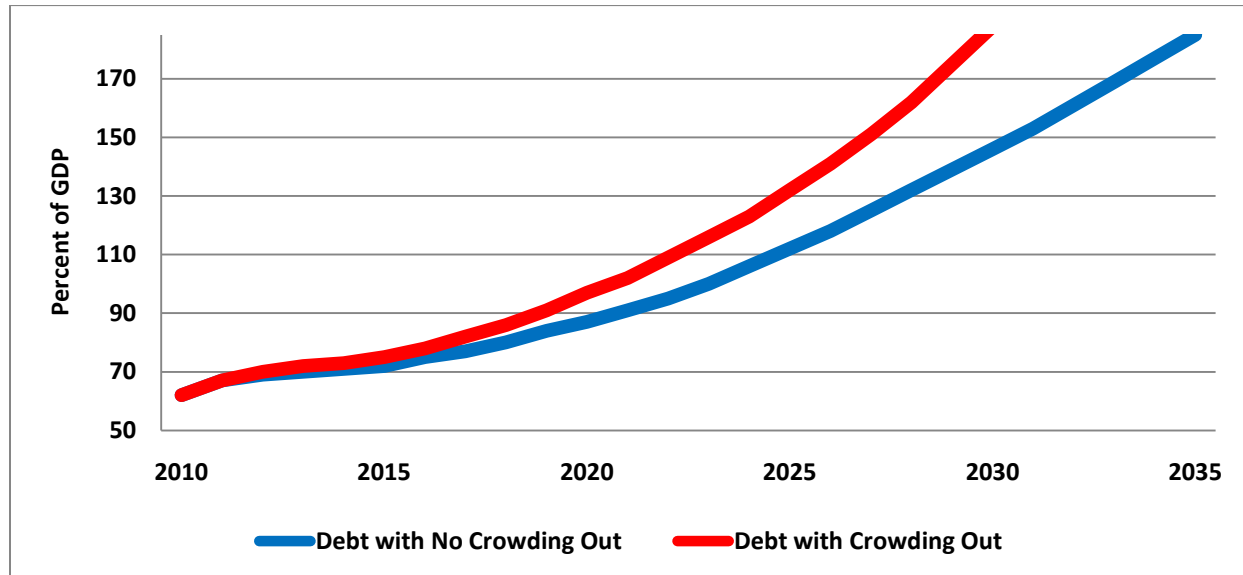


Any drop in income from crowding out will also lower government tax revenues from what they could potentially have been, further exacerbating future deficits (see Figure 12 above). Even slightly slower economic growth can have a huge impact on our budget. The CBO estimates that if the growth rate of real GDP were just 0.1 percent below current baseline projections from 2011 through 2020, the debt would increase by a cumulative \$288 billion, including a deficit increase of \$62 billion in the year 2020 alone. 86 percent of this increase in the debt would come from lower tax revenues with nearly all of the remaining cost owed to increased

³⁸ Joshua Zumbrun, "Bernanke Says Budget Gap Might Raise Interest Rates", in *Bloomberg Businessweek* <<http://www.businessweek.com/news/2010-04-27/bernanke-says-budget-gap-might-raise-rates-endanger-recovery.html>> [accessed 22 November 2010]

net interest payments to service outstanding debt. Figure 13 (below) shows the effect of crowding out on our debt/GDP ratio, a commonly cited measure of our government's solvency.

Figure 13: Effect of "Crowding Out" on Public Debt³⁹



Crowding out slows economic growth and increases government debt. When deficit spending is temporary, this effect is less noticeable. But if large deficits persist, this effect compounds. In the long-term, it can have a dramatic impact on our budget.

4. Large Persistent Deficits Can Cause a Debt Crisis

Large persistent deficits can also cause investors to lose confidence in the ability of government to manage its fiscal policy, including servicing and repaying its outstanding debt. This is what happened in debtor countries like Mexico and Greece: as investors began to realize that Mexico and Greece were unable to service their outstanding debt, interest rates shot up, making it more expensive for these governments to borrow, costing them billions more in additional interest payments. In the end, Mexico and Greece could not pay and had to be bailed out by third parties (Mexico by the U.S. in 1994; Greece by a French and German led European coalition in 2010).

To illustrate what happened, take a look at the interest rate spread between German debt, the European standard for creditworthiness, and debt from Greece, Ireland, and Portugal (see Figure 14 on the next page). Entering the Eurozone in early 2001, Greece consistently paid an interest rate slightly higher than Germany. But that spread began widening in mid-2007 to reflect the growing perception that Greece might default. A larger than expected Greek deficit

³⁹ Congressional Budget Office, "The Long-Term Budget Outlook", in *Congressional Budget Office* <<http://www.cbo.gov/ftpdocs/115xx/doc11579/06-30-LTBO.pdf>> [accessed 22 November 2010]

projection in October 2009 sent Greek rates skyrocketing. This made borrowing even more expensive and pushed Greece to the brink of default (before it was bailed out).

Figure 14: Basis Points over Germany September 2008 – September 2010⁴⁰



Source: Citi Investment Research and Analysis

While possible in the United States, a debt crisis or default remains extremely unlikely. Control of our monetary policy and the dollar's position as an international reserve currency somewhat protects us against such an event. Foreign treasuries and individuals continue to purchase Treasury debt at very low rates and the Federal Reserve maintains the ability to print dollars and "inflate" our way out of a fiscal crisis (unlike Greece, whose central bank couldn't print Euros to pay for deficits).

⁴⁰ Edward Hugh, "The European Sovereign Debt Crisis Is Over? Not Quite", in *Seeking Alpha* <<http://seekingalpha.com/article/227111-the-european-sovereign-debt-crisis-is-over-not-quite>> [accessed 22 November 2010]

Accrued Liabilities over the Very Long-Term

In the very long-term, these same deficit and debt-related challenges will persist, but they will be compounded by the huge commitments we have accrued to pay benefits through Social Security, Medicare, Medicaid, and other similar programs.

In February of this year, the Department of Treasury released the *2009 Financial Report of the United States Government*, an annual report similar to those required of publicly traded companies. It is the only document issued by the federal government to use accrual accounting⁴¹, the standard for private businesses as well as state and local governments. This report, by taking into account the promises made yesterday to spend tomorrow, reveals a staggering \$62 trillion in total unfunded obligations, not counting Medicaid. We would need to have that money in the bank today, earning interest, to cover the eventual shortfall.

Figure 15: Projected Revenues vs. Projected Outlays by Budget Area⁴²

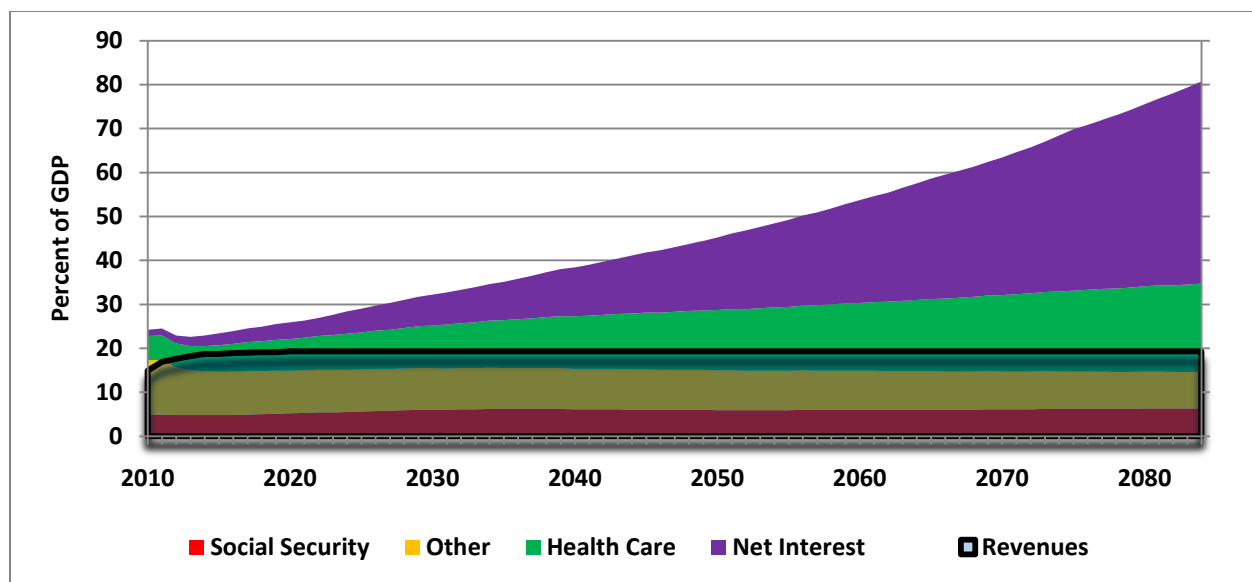


Figure 15 (above) shows the growth in future costs in excess of future revenues for the entire budget, including net interest, as a percent of GDP. Revenues, discretionary spending, and Social Security remain roughly constant as shares of GDP, but health care costs far outpace economic growth. All this projected spending in excess of revenues will create massive amounts of new debt, a fact clearly reflected in the projected rapid growth of net interest payments relative to economic output.

⁴¹ Accrual accounting is used in federal accounting for credit programs and was also used for calculating the costs of the Troubled Asset Relief Program (TARP).

⁴² Congressional Budget Office, "The Long-Term Budget Outlook", in *Congressional Budget Office* <<http://www.cbo.gov/ftpdocs/115xx/doc11579/06-30-LTBO.pdf>> [accessed 22 November 2010]

While Figure 15 only shows projected deficits through 2084, the infinite time horizon reveals \$62 trillion in accrued obligations *in excess of projected revenues*.⁴³ Again, this is money we would need to have in the bank today, earning interest, to cover the shortfall. While this figure is alarming and disheartening, it is not as bad as it seems. Through sound financial management and limited adjustments to the long-term benefit structure of certain programs, we can reduce this shortfall. Think of the slight change in the course of the flight from Tokyo to Chicago—a small difference over a long period. Because these accrued costs have yet to be paid out and will not be due for many years, minor tinkering with the benefits structure today can produce big savings tomorrow.

Going Forward

This is our point: our fiscal position unsustainable, but it is fixable. We have large deficits today that will persist well into the future. These include huge accrued costs in the form of promises to pay future benefits that are simply out of reach.

Fixing this problem won't be easy, economically or politically, but it can be done. We need to be clear about how bad things are and we need to make tough decisions about how to move forward. We need to carefully review the facts and neither exaggerate them nor trivialize them. Most importantly, we need to act soon. Delaying action by more than a couple years could set in motion a vicious and unsustainable cycle of borrowing today to pay for current large deficits, and then borrowing tomorrow to pay for yesterday's excessive borrowing.

This is step one. Having recognized the seriousness and urgency of our challenge, step two means reinventing the way our federal government does business. Our government must be more transparent and more accountable. By bringing reform to our flawed accounting, to our opaque budget, and to our confusing tax system, we can get a clearer picture of which spending programs are working and which aren't working. As it stands now, we are flying blind.

Step three means finding savings in the budget. Although we may not have all the information we need to fairly and effectively evaluate the different elements of our budget, we need to act now using the best information available. That said, even if we are successful on this count, we cannot rest easy. Today's progress could easily be rolled back by future leaders less attentive to fiscal responsibility. This is why transparency and accountability reforms must be enacted alongside budgetary savings.

⁴³ Department of Treasury, "Financial Report of the United States Government", in *Department of Treasury* <<http://www.fms.treas.gov/fr/09frusg/09frusg.pdf>> [accessed 22 November 2010]

Section II: The Way Forward

Our Budget Process is Broken

Budgets are guides to prioritizing limited resources. If the tax code collects two trillion dollars, elected legislators should decide how to spend those two trillion dollars. If circumstances call for extra spending or new tax cuts, then the government can borrow money to cover the newly created deficit. Legislators should be held accountable for these decisions by their well-

We are effectively flying blind.

informed colleagues and by the American public. That's the way the budget process is supposed to work, anyway.

But it's not reality—in reality, our budget process is broken. It's broken because trillions of dollars in hidden

spending, like tax expenditures, persist with close to zero accountability. It's broken because liabilities outside a ten-year budget window are simply ignored and unbudgeted. It's broken because huge organizations like the Department of Defense can't keep track of their cash flows or their growing environmental liabilities. Simply, we lack the information necessary to evaluate where our tax dollars are going and whether they're being spent wisely. We are effectively flying blind.

This lack of budgetary transparency has played a major role in making our long-term fiscal outlook unsustainable. Without proper information about where our money's going and how much of it we're spending, fiscal planning in Congress has been haphazard and rudderless. Partial successes like Pay-As-You-Go (PAYGO) legislation have been matched or even exceeded by failures, often of omission rather than of deliberate action. The consequences of flying blind aren't pretty.

It Can Be Fixed

To get back on course, we need to fix our navigation equipment. We need a crystal clear picture of our budget that informs Congress and the American people alike. We must bring hidden spending out of the dark, to fix our accounting so it captures long-term spending, and to hold agencies accountable for waste, abuse, and financial mismanagement. We must reinvent government so it's more efficient, transparent, and accountable to the taxpayers who are

fronting the bill. Only with increased transparency can we know where we've been and where we're going—and where we've gone wrong.

This section discusses several reforms that would help on this count. Below is a list of the broad reforms that we are recommending:

- ▶ Require a receipt for taxpayers from the federal government.
- ▶ Require better information about long-term spending.
- ▶ Focus more on fiscal sustainability in the budget process.
- ▶ Provide for greater oversight of tax expenditures.
- ▶ Provide for greater oversight of national security spending.
- ▶ Provide more information about environmental liability costs.

It should be up to the American people to decide the size of government they want.

These are important reforms that will make our government more transparent and accountable. It all begins with providing better information to the public. It should be up to the American people to decide the size of government they want. We in our role as legislators can spend all day debating the pros and cons of the military's budget, but only taxpayers truly feel the trade-off between extra F-22s and money in their pockets.

That is why we are calling for an itemized breakdown of each American's taxes—essentially a receipt for taxes paid—to be provided to them immediately following tax day on April 15 of each year. This way Americans will have the information they need to judge for themselves whether government programs are worth what they pay in tax dollars.

Taxpayers Should Get a Receipt from the Federal Government

OUR RECOMMENDATIONS

- ▶ **RECOMMENDATION 1: All taxpaying Americans should receive an itemized receipt from the federal government that shows how their tax dollars are being spent.**
- ▶ **RECOMMENDATION 2: This receipt should include information on both the revenue side (how much you paid in taxes, how much the government borrowed in your name, etc.) and the spending side (how their tax dollars are being spent).**

One of the best and most important ideas for reinventing federal government would be to provide each taxpaying American with an itemized receipt for their federal income and payroll taxes. Think about it: do you really know where your tax dollars are going? Probably not, given that the federal budget is confusing and complex. Try digging through a few government websites and you'll see the difficulty. This is unacceptable: the federal government has a responsibility to provide accessible information to its citizens about where their tax dollars are going.

The results of this lack of accessible information are unfortunately predictable: about half of Americans think that we spend more on foreign aid than on either Social Security or Medicare.⁴⁴ In reality, foreign aid amounts to about one tenth of one percent of our budget. Both Social Security (19 percent) and Medicare (12 percent) are immensely larger.

This is a serious problem, especially when it comes to fixing our budget. If Americans do not have the information they need to evaluate the return on their tax dollar investment, then they won't be able to hold their members of Congress accountable for failing to pare down the areas of the budget most in need of reform. Legislators shouldn't be able to claim the mantle of fiscal responsibility when they attack tiny items in the budget, like funding for the arts or foreign aid, while much more substantial areas of the budget remain untouched.

⁴⁴ Public Agenda, "About Half of Americans Mistakenly Believe We Spend More on Foreign Aid than on Medicare and Social Security" <<http://www.publicagenda.org/charts/about-half-americans-mistakenly-believe-we-spend-more-foreign-aid-medicare-and-social-security>> [accessed 22 November 2010]

► **RECOMMENDATION 1: All taxpaying Americans should receive an itemized receipt from the federal government that shows how their tax dollars are being spent.**

An itemized receipt for federal income and payroll taxes would go a long way towards solving this problem. The American public would get the information it needs to evaluate our budget. This sort of information is already commonly provided for property taxes.

Figure 16: Example of a Tax Receipt for the Median American Taxpayer⁴⁵

| What You Paid For | |
|--|------------|
| 2009 tax receipt for a taxpayer earning \$34,140 and paying \$5,400 in federal income tax and FICA (selected items) ⁴ | |
| Social Security | \$1,040.70 |
| Medicare | \$625.51 |
| Medicaid | \$385.28 |
| Interest on the National Debt | \$287.03 |
| Combat Operations in Iraq and Afghanistan | \$229.17 |
| Military Personnel | \$192.79 |
| Veteran's Benefits | \$74.65 |
| Federal Highways | \$63.89 |
| Health care research (NIH) | \$46.54 |
| Foreign Aid | \$46.08 |
| Education Funding for Low Income K-12 Students | \$38.17 |
| Military Retirement Benefits | \$32.60 |
| Pell Grants for Low Income College Students | \$29.75 |
| NASA Space Program | \$28.09 |
| Internal Revenue Service | \$17.69 |
| Environmental Clean Up (EPA) | \$11.67 |
| The FBI | \$11.21 |
| Head Start | \$10.91 |
| Public Housing | \$10.50 |
| National Parks | \$ 4.27 |
| Drug Enforcement Agency | \$3.14 |
| Amtrak | \$2.23 |
| Smithsonian Museum | \$1.12 |
| Funding for the Arts | \$0.24 |
| Salaries and benefits for members of Congress | \$0.19 |

Third Way, a centrist think tank based in Washington, has put forward one of the leading proposals of this type.⁴⁶ It suggests “providing each taxpayer with a receipt that shows them exactly how their money is spent to the penny. Taxpayers could either receive a receipt online (if they file electronically) or through the mail that breaks down their tax bill and provides them the exact contribution they made towards twenty or thirty budget items of interest.” Figure 16 (at left) is an example of what a tax receipt might look like for a taxpayer with the 2009 median income of \$34,140, paying \$5,400 in federal income tax and FICA.

This type of receipt would help clear up the confusion among taxpayers that has led some to believe that we are spending more on foreign aid than on Social Security or Medicare, by far the two largest expenditures for any taxpaying American. Broadly, it would help overcome some of the disconnect between Americans and the seemingly abstract government services they pay for with their tax dollars, allowing them to easily see the priorities of their government and judge on the merits of those priorities.

⁴⁵ David Kendall and Jim Kessler, "A Taxpayer Receipt", in *Third Way* <http://content.thirdway.org/publications/335/Third_Way_Idea_Brief_-_A_Taxpayer_Receipt.pdf> [accessed 22 November 2010]

⁴⁶ David Kendall and Jim Kessler, "A Taxpayer Receipt", in *Third Way* <http://content.thirdway.org/publications/335/Third_Way_Idea_Brief_-_A_Taxpayer_Receipt.pdf> [accessed 22 November 2010]

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- ▶ **RECOMMENDATION 2: This receipt should include information on both the revenue side and the spending side.**
-

However, the Third Way proposal does not go far enough. Each taxpayer should actually receive two receipts, one for taxes paid (the revenue side) and one for how those tax dollars paid to the government were actually spent (the spending side, as in the Third Way example). On the revenue side, the receipt should show how much you paid in taxes, how much the government borrowed in your name in domestic and international markets, and how much your tax liability was reduced by the individual tax benefits you claimed. This would provide Americans with a complete and relatively simple picture of their financial interactions with the federal government.

The idea of a receipt from the federal government is one of the best ideas for reinventing the way our government does business. By empowering taxpayers with the information they need to hold elected officials accountable, it will be that much easier to explain and justify the reforms necessary to fix our budget and ensure its long-term fiscal sustainability.

We Need Better Information about Long-Term Spending

OUR RECOMMENDATIONS

- ▶ **RECOMMENDATION 3: The CBO and JCT should analyze the second decade budget impact for any bill that they score for Congress.**
- ▶ **RECOMMENDATION 4: The CBO and JCT should provide a net present value (NPV) estimate for any major pieces of legislation for which costs escalate outside the 10-year budget window.**
- ▶ **RECOMMENDATION 5: The OMB should issue an annual report examining our unbudgeted fiscal exposures.**

A principal reason our budget process does not work is that it does not provide enough information about long-term spending and revenues. This lack of information on long-term spending and revenues has significantly contributed to our unsustainable fiscal outlook. Now, in 2010, we're paying the price for the shortsighted excesses of the past. Getting our budget back on track means providing better information about long-term spending and revenues to Congress and to the American public.

The key concept here is the budget window. When Congress considers the fiscal impact of policy changes, it looks at the 10-year budget window. Only spending and revenues inside this 10-year budget window count when Congress debates the merits of legislation. This window has historically been limited because of the difficulties of estimating costs more than five or 10 years out from the budget year.

While this 10-year budget window concept has existed for many years, both informally and in statute, it was permanently enshrined in law by the Statutory Pay-As-You-Go (PAYGO) Act of 2010. PAYGO, created “to enforce a rule of budget neutrality on new revenue and direct

The 10-year budget window allows and even incentivizes the proliferation of hidden spending after year 10.

spending legislation”, effectively prevents Congress from enacting legislation that is not, at a minimum, budget neutral over the 10-year window (as estimated by the CBO and as printed in the Congressional Record by the House and Senate Budget Committees).

The 10-year budget window, however, does not tell us enough about the long-term budget trajectory of bills under consideration. Any spending or revenues outside of those 10 years are ignored. Our accounting does not figure

in the present value of money. And many of our fiscal exposures, that might create huge deficits in 10 or 20 years time, are simply deemed “off-budget.” We recommend three reforms that would provide better information to Congress and to the public about the long-term spending consequences of policy decisions.

- ***RECOMMENDATION 3: The CBO and JCT should analyze the second decade budget impact for any bill that they score for Congress.***

PAYGO was an important step in budget process reform. While in effect during the 1990s, it had a solid record of restraining deficits. Going forward, it will likely remain effective. But by reinforcing the primacy of the 10-year budget window, it doesn’t do enough to restrain long-term mismatches between spending and revenues. To address this problem, we recommend requiring the Congressional Budget Office (CBO) and Joint Committee on Taxation (JCT) to provide qualitative analysis of the second decade budget impact for any bill that they score.

Why doesn’t the 10-year budget window work? It allows and even incentivizes the proliferation of “hidden” spending after year 10. Imagine a bill that spends, on average, \$5 billion per year over 10 years, and pays for that new spending with a corresponding tax increase that raises \$5 billion per year over those same 10 years. In year 11 the tax increase could be dropped altogether but the spending could be boosted to \$50 billion or even \$500 billion without factoring into Congress’s deficit calculations.

One option could be adjusting PAYGO to include the second decade in its budget neutrality rule. However, there are substantial difficulties in calculating spending and revenues for years that far out. While Congress could ask the CBO and the JCT to make the necessary assumptions, the results wouldn't be particularly accurate or meaningful. It's already hard enough to produce meaningful projections for the first 10 years.

The better alternative is to require additional analysis from the CBO and JCT that takes a more qualitative look at the budget impact in this second decade. While this analysis would not be precise, it would give members of Congress some sense of the magnitude of deficits that would be expected outside of the 10-year budget window. At the very least it would be more transparent about the potential for future deficits. Armed with this information about spending and revenue trends in the long-term, members of Congress would have the opportunity, if not the imperative, to minimize long-term deficits.

This second decade analysis has already been provided by the CBO in past circumstances. During the health care reform debate, for example, second decade analysis had a substantial impact on the legislative outcome, especially insofar as the CBO projected that health care reform would cut the deficit in years 11 through 20 "in a broad range between one-quarter percent and one-half percent of gross domestic product (GDP)".⁴⁷ While not as precise as calculations for the first decade, this broad projection for the second decade helped establish the claim that the health care legislation was fiscally responsible. Going forward, we should ensure that every bill with a substantial budgetary impact under serious consideration by Congress is analyzed in both its first and second decades.

- ▶ ***RECOMMENDATION 4: The CBO and JCT should provide a net present value (NPV) estimate for any major pieces of legislation for which costs escalate outside the 10-year budget window.***
-

In addition to second decade analysis, the CBO and JCT should also provide Congress with a net present value estimate for any proposed legislation for which costs escalate outside the 10-year budget window. We recommend this because proposed legislation can entail substantial spending commitments that do not show up on-budget in either the first or second decades, but that eventually cause massive deficits if they are not paid for through higher taxes or spending cuts. The idea is not to create rigid rules that prevent Congress from legislating, but rather to provide members of Congress and the American public with the information they need to have an informed opinion and, hopefully, to avoid unaffordable spending. Transparency and accountability will produce better outcomes over time.

⁴⁷ Douglas Elmendorf, "Letter to Speaker Pelosi", in *Congressional Budget Office* <<http://www.cbo.gov/ftpdocs/113xx/doc11379/AmendReconProp.pdf>> [accessed 22 November 2010]

Consider the Tax Increase Prevention and Reconciliation Act of 2005, which is a prime example of the failure of short-term budgeting. This bill, among other things, eliminated the income limits on Roth IRA conversions. Without getting into the specifics of how Roth IRA conversions work, the key point is that this reform generated immediate savings but postponed the costs until many years later, well outside the first two decades. This makes intuitive sense since Roth

Transparency and accountability will produce better outcomes over time.

IRAs are retirement savings accounts, but it also makes the reform very difficult to budget.

The Joint Committee on Taxation (JCT) estimated that the Roth IRA reform portion of the bill would raise about \$6.4 billion in the 10-year budget window through 2015. The Urban Institute-Brookings Institution Tax Policy

Center concurred with this estimate through 2015, but then *also* projected “that the provision would lose \$100 billion through 2049”.⁴⁸ For the sake of budgeting, Congress got to claim \$6.4 billion in savings that could be used to pay for other spending programs or tax cuts. But in reality, they were \$14 to \$15 billion in the red for that fiscal year: “the projected loss through 2049 equals between \$14 and \$15 billion in ‘net present value;’ this represents the amount that, if set aside today and allowed to collect interest for the next 45 years, would offset the cost of this tax cut”.⁴⁹

A net present value estimate, provided in some official capacity to Congress, would have provided ammunition to critics who might have convinced Congressional leadership to avoid this budgetary blunder. Congress got to take credit for a spending cut when it actually had increased spending by more than double the amount it was claiming to save!

This Roth IRA reform and other examples are exactly why the GAO has officially endorsed requiring “NPV estimates for major proposals—whether on the tax side or the spending side—whose costs escalate outside the 10-year window”. Publicly available NPV analysis for major legislation would mitigate some of problems inherent in using the 10-year budget window while helping legislators and the public oppose fiscally irresponsible legislation.

⁴⁸ Aviva Aron-Dine and Robert Greenstein, “Provision in Tax Cut Bill Effectively Eliminates Income Limits on Roth IRAs Establishes Major New Tax Shelter For High-Income Households”, in *Center for Budget and Policy Priorities* <<http://www.cbpp.org/files/5-11-06tax.pdf>> [accessed 22 November 2010]

⁴⁹ Aviva Aron-Dine and Robert Greenstein, “Provision in Tax Cut Bill Effectively Eliminates Income Limits on Roth IRAs Establishes Major New Tax Shelter For High-Income Households”, in *Center for Budget and Policy Priorities* <<http://www.cbpp.org/files/5-11-06tax.pdf>> [accessed 22 November 2010]

► **RECOMMENDATION 5: The OMB should issue an annual report examining our unbudgeted fiscal exposures.**

Finally, the OMB, in conjunction with the Department of Treasury, should issue an annual report that examines our unbudgeted fiscal exposures. These include the contingent liabilities that result from Fannie Mae's and Freddie Mac's mortgage portfolio. The reason for doing this is to responsibly disclose to the public the approximate losses that taxpayers have been exposed to as a result of government's unbudgeted spending programs, unbudgeted loan guarantees, and other liabilities of a similar nature.

This report would help bring to light some of the most costly fiscal exposures of recent years. Chief among them is our continuing exposure to losses on mortgages guaranteed by the Federal Home Loan Mortgage Corporation (Freddie Mac) and the Federal National Mortgage Association (Fannie Mae). Since the collapse of the housing market in 2007, the federal government has provided over \$150 billion in federal funds to these two entities to help keep them and the mortgage market afloat.⁵⁰ Going forward, the Department of Treasury has estimated that Freddie and Fannie may need as much as \$363 billion in additional support from the federal government. This number seems more and more plausible given the recent travails in the housing market, which seems headed for further difficulty. In fact, the scale of losses to which taxpayers are exposed could theoretically be almost infinite: with the removal of the \$200 billion bail-out cap in December 2009, the federal government effectively guaranteed the entire universe of Freddie and Fannie mortgage loans.

These fiscal exposures are not included in the budget. This is why a report that examined these exposures and put them in context with other spending programs is so important. It would go a long way towards helping legislators and the public reach informed and sensible policy decisions.

⁵⁰ Nick Timiraos, "Fannie Mae Posts \$1.3 Billion Loss", in *The Wall Street Journal* <<http://online.wsj.com/article/SB10001424052748704353504575596811729767540.html>> [accessed 22 November 2010]

Our Budget Process Needs to Focus on Fiscal Sustainability

OUR RECOMMENDATIONS

- ▶ **RECOMMENDATION 6: The President’s Budget and the Congressional Budget Resolution should include specific long-term deficit and debt sustainability targets.**
- ▶ **RECOMMENDATION 7: The OMB should issue a Quadrennial Fiscal Sustainability Report.**
- ▶ **RECOMMENDATION 8: Upon submission of the President’s Budget, the President should be invited to deliver a “Fiscal Sustainability State of the Union” address to a joint session of Congress.**

Another reason our budget process does not work very well is that it is insufficiently focused on fiscal sustainability. For too long, budgeting has only been an exercise in distributing resources between various program accounts without considering the sustainability of those resources themselves. As Jim Bates, the former Project Director for the Peterson-Pew Commission on Budget Reform at the Committee for a Responsible Federal Budget, points out, our budget process “foster[s] compromise at the level of individual appropriations bills, where the question is simply how to spend money within a narrowly defined area of appropriations” rather than on all the “different pieces of legislation that combine to form the big fiscal picture.”⁵¹

For budgeting to be effective, we need to look at the fiscal big picture. Only recently, as deficits and debt began to pile up, did Congress begin to include deficit and debt targets as a part of its budget process. But this effort has been too small to shift the discussion away from the annual bickering over whose pet projects will get funded in that year. We need a dramatic rethink of how we approach budgeting. This should emphasize fiscal sustainability as a fundamental objective of the budget process. Below we recommend three reforms that could help move the budget process in that direction.

- ▶ **RECOMMENDATION 6: The President’s Budget and the Congressional Budget Resolution should include specific long-term deficit and debt sustainability targets.**
-

We recommend that the President’s Budget and the Congressional Budget Resolution be required to include specific deficit and debt sustainability targets and also to be required demonstrate how these targets will be achieved.

Deficit and debt targets of one form or another have occasionally been included in both budget documents. The draft 2010 Congressional Budget Resolution, for example, would have declared that “by 2015 the Federal budget should be in primary balance—meaning that outlays

⁵¹ Jim Bates, "Fiscal Disorder - The Broken Budget Process and the Dire Need for Reform", in *Committee for a Responsible Federal Budget* <<http://crfb.org/document/op-ed-fiscal-disorder-broken-budget-process-and-dire-need-reform>> [accessed 22 November 2010]

in the Federal budget shall equal receipts during a fiscal year, not counting outlays for debt service payments".⁵² The 2010 President's Budget also included deficit reduction targets which would reduce the deficit from 10.3 percent of GDP in 2010 to 4.3 percent of GDP in 2015.⁵³ When included, these targets have been helpful for policymakers, but they could be improved.

We believe that both budget documents should not only target sustainable deficit and debt levels, but should also specify how we might get there. The preliminary recommendations released by the co-chairs of the National Commission on Fiscal Responsibility and Reform make a similar suggestion.⁵⁴ We believe that these targets would be an important tool in holding Congressional leaders and the President accountable for making progress towards fiscal sustainability.

► ***RECOMMENDATION 7: The OMB should issue a Quadrennial Fiscal Sustainability Review.***

Another way to overcome the limited perspective of the yearly budget process would be to conduct a wide-ranging review of our fiscal outlook, with an emphasis on sustainability, every four years. The goal of this review would be to assess what we're doing right and wrong as well as to develop a strategy for achieving fiscal sustainability. A secondary goal would be to foster public discussion around the review. This report should include its own deficit and debt sustainability targets.

The Department of Defense (DOD) does something similar in its congressionally mandated *Quadrennial Defense Review* (QDR). The QDR includes "a comprehensive examination of the national defense strategy, force structure, force modernization plans, infrastructure, budget plan, and other elements of the defense program and policies of the United States with a view towards determining and expressing the defense strategy of the United States and establishing a defense program for the next 20 years."⁵⁵ This document has been widely successful in helping DOD make forward thinking strategic plans, a necessary task at a time when armed threats and the nature of armed conflicts are rapidly changing. Michèle Flournoy, the Undersecretary of Defense for Policy, has noted that "QDRs are helpful with the most difficult

⁵² The Honorable John Spratt, "Resolution Providing for Budget Enforcement for Fiscal Year 2011", in *House Committee on the Budget* <http://budget.house.gov/doc-library/fy2011/06.30.2010_budgetenforcementres.pdf> [accessed 22 November 2010]

⁵³ Congressional Budget Office, "An Analysis of the President's Budgetary Proposals for Fiscal Year 2011", in *Congressional Budget Office* <<http://www.cbo.gov/ftpdocs/112xx/doc11280/03-24-apb.pdf>> [accessed 22 November 2010]

⁵⁴ Alan Simpson and Erskine Bowles, "Co-Chairs' Proposal", in *National Commission on Fiscal Responsibility and Reform* <http://www.fiscalcommission.gov/sites/fiscalcommission.gov/files/documents/CoChair_Draft.pdf> [accessed 22 November 2010]

⁵⁵ Jeffrey D. Brake, "Quadrennial Defense Review: Background, Process, and Issues", in *Congressional Research Service* <<http://www.crs.gov/Products//rs/pdf/RS20771.pdf>> [accessed 22 November 2010]

part of strategic planning; that is, bringing into alignment what you want to accomplish—your ends—with the concepts and capabilities you have to do so—your ways and means.”⁵⁶

This is precisely the same challenge that’s facing our budget: reconciling our ends (sustainability) with our ways and means (spending and revenue reform). A *Quadrennial Fiscal Sustainability Review* (QFSR) produced by the OMB that focuses on strategic budget planning would help us make the necessary decisions to achieve fiscal sustainability.

- ▶ ***RECOMMENDATION 8: Upon submission of the President’s Budget, the President should be invited to deliver a “Fiscal Sustainability State of the Union” address to a joint session of Congress.***
-

A third recommendation for focusing the budget process more closely on fiscal sustainability would be for the Congress to convene a joint session near the end of each fiscal year for the purpose of receiving a “State of the Union” address from the President. This address would exclusively focus on our country’s fiscal sustainability.

The State of the Union address is one of the oldest traditions in our country’s history. The Constitution requires that the President “shall from time to time give to Congress information on the State of the Union and recommend to their Consideration such measures as he shall judge necessary and expedient.” Originally delivered in person by President George Washington, this practice was discontinued and written statements were simply reported to Congress until President Woodrow Wilson revived the practice of a live address in 1913. Nevertheless, written statements were occasionally offered in lieu of a live address as late as 1981 under President Jimmy Carter.⁵⁷ But today it would be almost unthinkable for a president to decline to deliver the State of the Union address in person. It has evolved into a critical moment for national self reflection and priority setting. Millions of otherwise unengaged Americans tune in to the State of the Union address to fulfill their civic duty.

For this reason we believe that a “Fiscal Sustainability State of the Union” address would be successful. While Congress controls the national purse-strings, the President tends to set the national agenda. This would be an important opportunity for our leaders, specifically the President, to engage the public’s attention in a serious discussion of national priorities in the context of achieving a sustainable budget. The President could even discuss his own tax receipt (recommended earlier in this report) and offer an opinion on whether the various government expenditures merit the cost to him and other Americans in tax dollars.

⁵⁶ Council on Foreign Relations, "Transcript: Rebalancing and Reforming Defense: Quadrennial Defense Review 2010" <http://www.cfr.org/publication/21363/rebalancing_and_reforming_defense.html> [accessed 22 November 2010]

⁵⁷ Gerhard Peters, "State of The Union Messages" <<http://www.presidency.ucsb.edu/sou.php>> [accessed 22 November 2010]

We Need More Oversight of Tax Expenditures

OUR RECOMMENDATIONS

- ▶ **RECOMMENDATION 9: No tax expenditure should be enacted that does not “sunset” (terminate) inside the 10-year budget window.**
- ▶ **RECOMMENDATION 10: The Department of Treasury, in conjunction with the Office of Management and Budget and the policy-relevant federal agency, should issue regular performance reviews of all tax expenditures.**
- ▶ **RECOMMENDATION 11: There should be more publicly available data for evaluating tax expenditures.**

What do you think is our government’s most expensive housing program? In Fiscal Year 2010, Congress enacted \$26.4 billion in appropriations for the Department of Housing and Urban Development’s (HUD’s) Public and Indian Housing program (this includes programs like Section 8). It enacted \$8.6 billion in appropriations for HUD’s Community Planning and Development program. It enacted \$10.0 billion for other HUD housing programs. HUD’s mandatory programs consumed a further \$5.8 billion in Congressionally enacted budget authority. But none of these housing programs comes even close to being the federal government’s most expensive housing program. In fact, even if you add up the entire HUD budget and count it as one spending program, its combined \$49.3 billion in budget authority still does not rank as the federal government’s most expensive housing program.⁵⁸

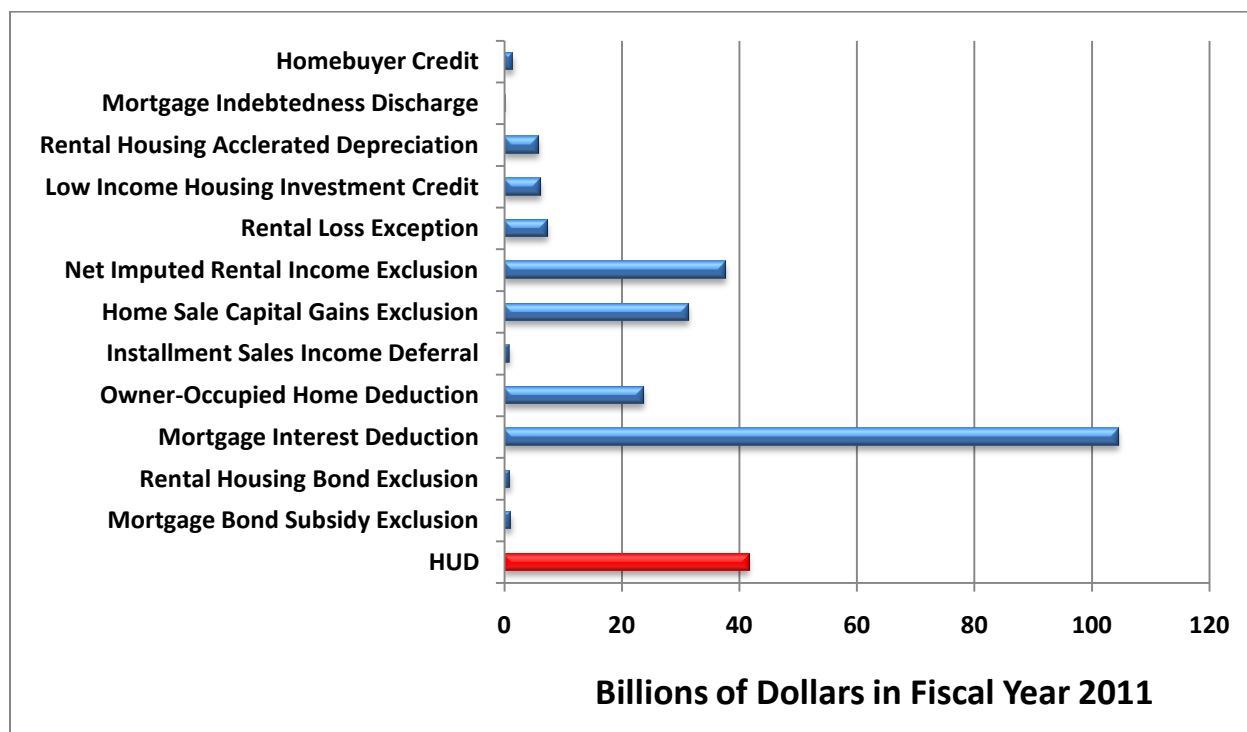
No, the title of the federal government’s most expensive housing program is held by the mortgage interest deduction, a single tax expenditure⁵⁹ that will cost government \$104.5 billion in Fiscal Year 2011.⁶⁰ In other words, the mortgage interest deduction costs more than twice as much as the entire Department of Housing and Urban Development. Nor is the mortgage interest deduction the only housing tax expenditure. All told, housing tax expenditures will cost \$221.3 billion in Fiscal Year 2011 (see Figure 17 on the next page for a comparison of spending on all housing tax expenditures and spending in the HUD budget).

⁵⁸ Department of Housing and Urban Development, "Budget Authority by Program, Comparative Summary, Fiscal Year 2009-2011", in *Department of Housing and Urban Development* <<http://hud.gov/budgetsummary2011/budget-authority-by-prog.pdf>> [accessed 22 November 2010]

⁵⁹ Tax expenditures are spending through the tax code. They are tax credits, deductions, exemptions, deferrals, and other breaks that expand the scope of government by distorting market incentives and redirecting public resources—just like any other federal spending program.

⁶⁰ Office of Management and Budget, "Estimates of Total Income Tax Expenditures for Fiscal Years 2009-2015", in *Office of Management and Budget* <http://www.whitehouse.gov/sites/default/files/omb/assets/budget/teb2011_final.xls> [accessed 22 November 2010]

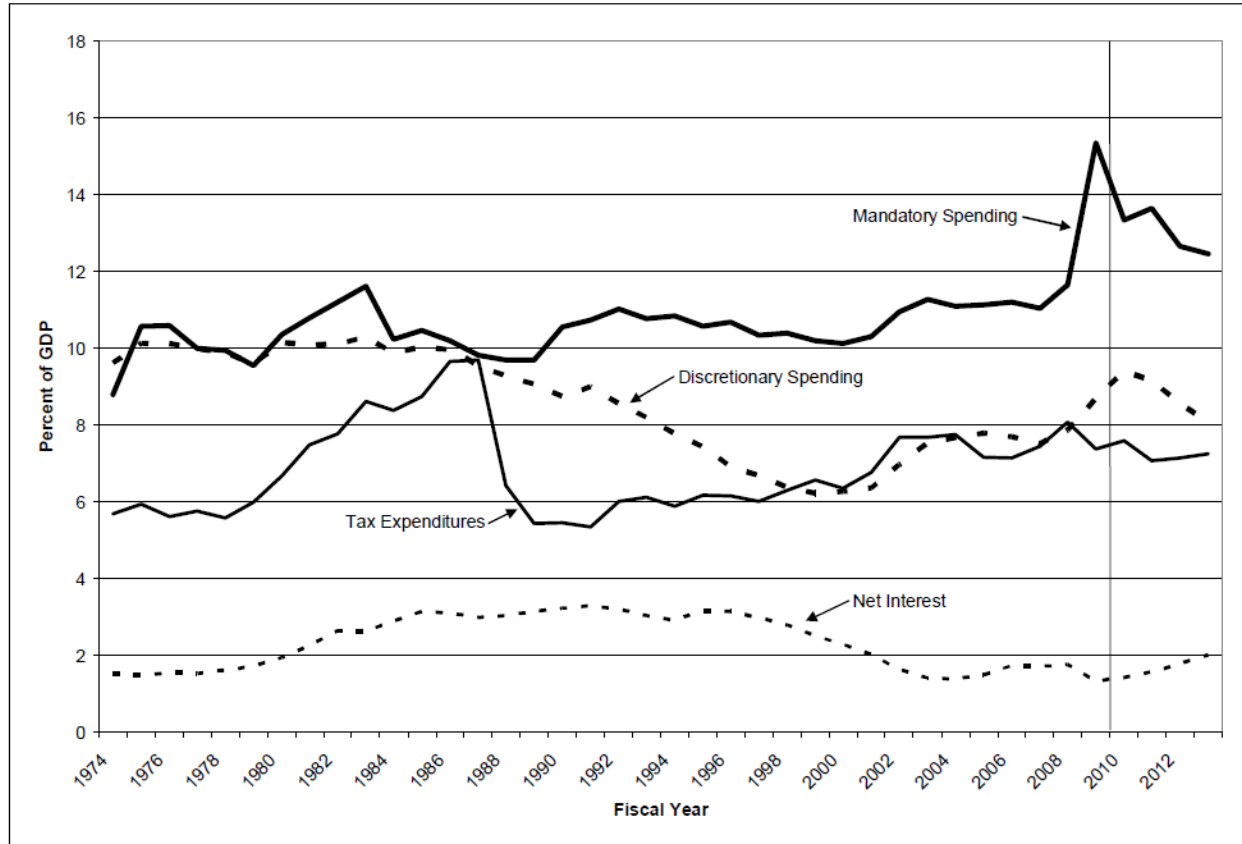
Figure 17: Spending by Housing Tax Expenditures vs. Spending by HUD⁶¹



The magnitude of spending through tax expenditures does not end with housing. Tax expenditures, which will add up to \$1.2 trillion in spending in Fiscal Year 2011, are almost entirely unaccountable to and immune from the budget control processes that exist today. This is true even though the amount of spending through tax expenditures is virtually the same as the amount of spending through all discretionary outlays combined (see Figure 18, a graph from the Congressional Research Service, on the next page). Even more dramatically, tax expenditures in Fiscal Year 2011 will cost more than the entirety of the wars in Afghanistan and Iraq over the past 10 years. It is unacceptable that \$1.2 trillion in tax expenditures receive so little oversight.

⁶¹ Office of Management and Budget, "Estimates of Total Income Tax Expenditures for Fiscal Years 2009-2015", in *Office of Management and Budget* <http://www.whitehouse.gov/sites/default/files/omb/assets/budget/teb2011_final.xls> [accessed 22 November 2010] & Department of Housing and Urban Development, "Budget Authority by Program, Comparative Summary, Fiscal Year 2009-2011", in *Department of Housing and Urban Development* <<http://hud.gov/budgetsummary2011/budget-authority-by-prog.pdf>> [accessed 22 November 2010]

Figure 18: Tax Expenditures vs. Other Areas of the Budget 1974-2014⁶²



Source: OMB, JCT, and CBO.

What are tax expenditures? How do they work? Tax expenditures are spending through the tax code. They are tax credits, deductions, exemptions, deferrals, and other breaks that expand the scope of government by distorting market incentives and redirecting public resources—just like any other federal spending program.

Suppose, for example, that a member of Congress wants to subsidize oil companies in the oil extraction process. This member could propose a federal program that pays those companies a certain amount of money each year. If passed and signed into law, Congress could then appropriate funds into that program's account and oil companies would then be subsidized at taxpayer expense. But this whole situation is extremely unlikely given public opposition to increasing spending, and especially given how politically unpalatable it would be to increase spending to subsidize oil companies.

⁶² Thomas L. Hungerford, "Tax Expenditures and the Federal Budget", in *Congressional Research Service* <<http://www.crs.gov/Products/rl/pdf/RL34622.pdf>> [accessed 22 November 2010]

Acknowledging this reality, our hypothetical member of Congress might accept the impossibility of subsidizing oil companies at taxpayer expense. On the other hand, this member could achieve the same desired results, at effectively the same cost to taxpayers, and even claim to have cut taxes in the process. How? Through a tax expenditure, by providing oil companies with tax credits valued at approximately the same amount as the original spending program.

Tax expenditures are problematic because everyone's taxes must go up and stay up to subsidize special interests and favored constituencies.

It's no different from spending, but it counts as a tax cut: hence the appeal of tax expenditures as a means of delivering benefits to various special interests and constituencies.

The proliferation of tax expenditures is a problem, not because tax expenditures are inherently bad, but because they allow legislators to spend money without any of the accountability of normal outlay programs while at the same time being framed as tax cuts.

Tax expenditures also tend to persist in the tax code out of inertia rather than because of any active effort to keep them. In that sense, it is not only easier to create new tax expenditures, but it is also much hard to eliminate existing ones.

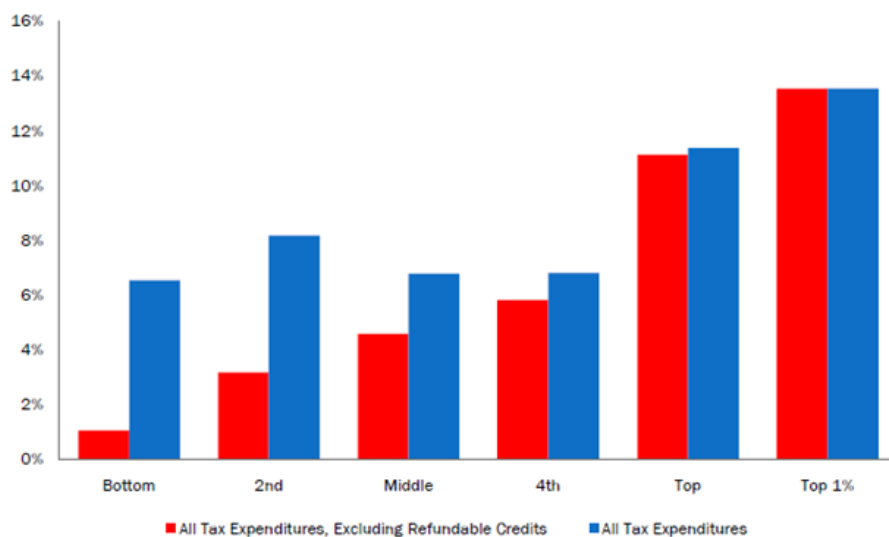
Tax expenditures are also problematic because everyone else's taxes must go up to and stay up to subsidize special interests and favored constituencies. As Jason Furman, currently Deputy Director of President Obama's National Economic Council and formerly a Senior Policy Fellow at the Center on Budget and Policy Priorities, explained in 2006 testimony before the Senate Homeland Security and Governmental Affairs Committee, "If the government approves a new \$1 billion spending project it will have two choices: raise taxes to pay for the project or cut other spending...The financing choices for a new \$1 billion tax expenditure are identical: the government will have to raise taxes on everyone who is not specially favored by the tax expenditure or cut other spending."⁶³ In fact, as Len Burman points out in the Washington

⁶³ Jason Furman, "Increasing Transparency and Accountability for Tax Expenditures", in *Senate Committee on Homeland Security and Governmental Affairs* <http://hsgac.senate.gov/public/index.cfm?FuseAction=Files.View&FileStore_id=0c7c9cf3-a45c-4e69-ba2c-1ce27e218598> [accessed 22 November 2010]

Post, eliminating just individual income tax expenditures “would permit a 44 percent across-the-board cut in [income] tax rates without reducing revenue. The top rate could drop from 35 percent to 20 percent.”⁶⁴

Tax expenditures also create other problems including “creating the perception or reality of unfairness”, “adding complexity”, “disguising the true size of government”, and “reducing fiscal flexibility”, according to Jason Furman.⁶⁵ Sometimes the benefits can outweigh these costs, but generally that is not the case. On the whole, some tax expenditures can be useful, but the accumulation of so many of them in the tax code has become a real problem.

Figure 19: Effect of Tax Expenditures on After-Tax Income by Income Quintile and the Top One Percent⁶⁶



The unfairness issue is particularly profound: upper income taxpayers receive the biggest portion of tax expenditure benefits (see Figure 19 at left, a graph from the Co-Chairs of the National Commission on Fiscal Responsibility and Reform). “For example,” asks Len

Burman, “would it make sense to design a health insurance voucher worth 35 cents per dollar for high-income families, but only 10 cents per dollar for those with low income?”⁶⁷ The answer is obviously no, but that’s the system we’ve got in place. Tax expenditures are ultimately a regressive way of distributing public resources.

⁶⁴ Lee Burman, “Let’s Freeze More Than Chump Change”, in *The Washington Post* <<http://www.washingtonpost.com/wp-dyn/content/article/2010/02/01/AR2010020103072.html>> [accessed 22 November 2010]

⁶⁵ Jason Furman, “Increasing Transparency and Accountability for Tax Expenditures”, in *Senate Committee on Homeland Security and Governmental Affairs* <http://hsgac.senate.gov/public/index.cfm?FuseAction=Files.View&FileStore_id=0c7c9cf3-a45c-4e69-ba2c-1ce27e218598> [accessed 22 November 2010]

⁶⁶ Alan Simpson and Erskine Bowles, “Co-Chairs’ Proposal”, in *National Commission on Fiscal Responsibility and Reform* <http://www.fiscalcommission.gov/sites/fiscalcommission.gov/files/documents/CoChair_Draft.pdf> [accessed 22 November 2010]

⁶⁷ Lee Burman, “Let’s Freeze More Than Chump Change”, in *The Washington Post* <<http://www.washingtonpost.com/wp-dyn/content/article/2010/02/01/AR2010020103072.html>> [accessed 22 November 2010]

Part of the solution, then, is eliminating bad tax expenditures. These cuts will be considered in our forthcoming part two report. But to facilitate this process and to ensure that frivolous or massively unfair tax expenditures do not return, we need to bring much more transparency and accountability to tax expenditures as a whole. In this section we make three recommendations for enhancing the transparency and accountability of tax expenditures.

► ***RECOMMENDATION 9: No tax expenditure should be enacted that does not “sunset” (terminate) inside the 10-year budget window.***

One of the biggest problems with tax expenditures is that they can be enacted on a permanent basis, but only must be paid for through the first 10 years (according to PAYGO rules). We propose a requirement that tax expenditures must sunset within the 10-year budget window. This is not to prevent them from being reenacted, but only to ensure that they are paid for when reenacted.

This all goes back to the 10-year budget window. Although an imperfect way to budget, the 10-year window is part of the statutory PAYGO rules that Congress passed in 2009. Under PAYGO, any increase in spending or decrease in revenue during the 10 years of the budget window

Once enacted, many tax expenditures exist without any further review, oversight, or appropriation from Congress.

must be matched with a corresponding decrease in spending or increase in revenue during those same 10 years. This includes tax expenditures, which decrease government revenues by reducing the tax liability of particular firms or individuals.

A tax expenditure, however, can be enacted permanently. That is to say that once enacted, many tax expenditures exist without any

further review, oversight, or appropriation from Congress. Through the first 10 years these tax expenditures must be paid for (so they cause no deficit in the budget window), but beginning in year 11 this PAYGO requirement disappears. This is especially problematic given that more and more spending programs that would normally be implemented through outlays have instead been proposed and enacted as tax expenditures. This allows members of Congress to spend the same amount of public dollars while entirely disregarding the imperative of fiscal responsibility after year ten.

Our proposal is not to extend the budget window (for reasons explained earlier in this report), but rather to require that tax expenditures sunset after no more than 10 years, at which time they could be considered for renewal and paid for at their true cost or simply allowed to expire. Members of Congress would have to consider whether a \$20 billion per year subsidy to oil companies is worth it. If it is not, then they would have the option of not renewing it. If they decide it is in fact worth it, then they would have to pay for it by increasing revenue or decreasing spending in some other area of the tax code or budget.

This proposal, however, is not meant to affect certain tax expenditures that actually do belong in the tax code on a permanent basis, such as the tax credit for research and development. We would like to point out that these tax expenditures are already written into the tax code and would not be affected by a requirement that any tax expenditures *enacted* must sunset after 10 years. This point is important because it would allow us to design an ideal tax code that incentivizes productive behavior. Going forward, then, deviations from that ideal baseline tax code in the form of new tax expenditures would have to be paid for at least every 10 years.

► ***RECOMMENDATION 10: The Department of Treasury, in conjunction with the Office of Management and Budget and the policy-relevant federal agency, should issue regular performance reviews of all tax expenditures.***

Tax expenditures should receive regular performance reviews. This is not only because we need better information about their efficiency, effectiveness, and equity, but also because tax expenditures are unique among spending programs in that they are hidden in the tax code.

To make more informed decisions about these hidden spending programs, we need to make an extra effort to highlight the good and the bad among them. While performance reviews are strongly advisable for normal spending programs, they are an imperative for hidden tax expenditure spending programs. Performance reviews conducted by the Department of Treasury, in conjunction with the OMB and the policy-relevant federal agency, would go a long way towards helping Congress make better policy decisions.

This perspective is shared by a number of groups. In a 2005 report “Tax Expenditures Represent a Substantial Federal Commitment and Need to be Reexamined”, the non-partisan Government Accountability Office (GAO) noted that “although tax expenditures represent a substantial federal commitment of resources, little progress has been made in the Executive Branch to increase the transparency of and accountability for tax expenditures.” GAO goes on to recommend that tax expenditures “should be subject to periodic reviews and reexamination

to ensure that they are achieving their intended purposes and designed in the most efficient and effective manner.”⁶⁸

Citizens for Tax Justice (CTJ) has been an outspoken advocate of tax expenditure performance reviews. In a November 2009 report, CTJ concluded that “federal tax expenditure performance review has the potential to direct much needed attention to a large and often poorly understood area of public policy.”⁶⁹

The Center for American Progress (CAP) also endorses the idea of tax expenditure performance reviews. In an April 2010 report “Auditing the Tax Code”, CAP observes that “We could potentially achieve billions in savings if we gave tax expenditures the scrutiny they deserve.” For example, explains CAP, some tax expenditures spending programs may be more effectively delivered by other means, including by direct spending. Further, some tax expenditures may not be achieving their original purpose. Others may reward special interests or may be purely wasteful.⁷⁰ All this information would be exposed and publicly available through a tax expenditure review process.

Would this work? Washington State has actually adopted a system of tax expenditure performance reviews: “A joint legislative committee reviews and evaluates certain tax expenditures each year. The committee then provides recommendations to fiscal committees for consideration in the budgeting process.” The Washington State system has conducted 95 tax expenditure reviews of which 19 were recommended for further review, nine for automatic expiration, and five for termination.⁷¹

Other states have taken more limited steps towards reviewing tax expenditures. California and Delaware conduct limited performance reviews. Rhode Island releases some information about the recipients of corporate tax expenditures. Nevada prohibits enactment of new tax exemptions absent a positive cost/benefit analysis. But, as the CTJ reports points out, none of these efforts has been as effective as Washington State’s, which to date is the only exhaustive tax expenditure review process in the country. Although its benefits have been limited since its 2006 enactment, CTJ contends that “as more tax expenditures are reviewed each year...the opportunities for successful policy change will continue to grow.”

⁶⁸ <http://www.gao.gov/new.items/d05690.pdf>

⁶⁹ Citizens for Tax Justice, “Judging Tax Expenditures”, in *Citizens for Tax Justice* <<http://www.ctj.org/pdf/judgingtep1109.pdf>> [accessed 22 November 2010]

⁷⁰ Sima J. Gandhi, “Auditing the Tax Code: Doing What Works for Tax Expenditures”, in *Center for American Progress* <http://www.americanprogress.org/issues/2010/04/pdf/dww_tax_framing.pdf> [accessed 22 November 2010]

⁷¹ Citizen Commission for Performance Measurement of Tax Preferences, “Citizen Commission for Performance Measurement of Tax Preferences” <<http://www.citizen taxpref.wa.gov/>> [accessed 22 November 2010] & Citizens for Tax Justice, “Judging Tax Expenditures”, in *Citizens for Tax Justice* <<http://www.ctj.org/pdf/judgingtep1109.pdf>> [accessed 22 November 2010]

We strongly agree with these assessments from GAO, CTJ, and CAP and believe that implementing a system of tax expenditure performance reviews is an essential step in more comprehensive budget reform and deficit reduction. Our recommendation is to house this review process in the Department of Treasury, which possesses the requisite data and resources for successful reviews, and to require consultation with the OMB for a more budget-oriented perspective and with the policy-relevant federal agency to ensure that the policy merits of energy-, housing-, or agriculture- related tax expenditures are not absent from the discussion.

These reviews should be conducted on a regular basis. We recommend reviewing every significant⁷² tax expenditure at least once every four years. Additionally, if feasible, we recommend reviewing related tax expenditures at the same time. If there are 10 energy-related tax expenditures, for example, then Treasury should develop a tax expenditure review schedule that places their reviews within the same calendar year. Upon completion of these reviews, they should be made available to the public through publication on the Department of Treasury website. Finally, the House Ways and Means Committee, the Senate Finance Committee, the House Budget Committee, and the Senate Budget Committee should hold regular hearings to receive testimony on the results of the performance reviews.

► ***RECOMMENDATION 11: There should be more publicly available data for evaluating tax expenditures.***

For tax expenditure performance reviews to be successful, we need better publicly available data on their efficiency, effectiveness, and equity. One important step, already recommended in this report, would be to include tax expenditures in the income and payroll tax receipts that taxpayers would receive each year. This way taxpaying Americans would have more information about the cost of tax expenditures and would be better able to decide whether specific tax expenditures are worth keeping or not.

We additionally recommend that the IRS provide more data to policymakers and the public on the performance of specific tax expenditures. In its 2005 report on tax expenditures, the GAO reported that “inadequate or missing data and difficulties in quantifying the benefits of some tax expenditures can impede studies of their efficiency, effectiveness, and equity.”⁷³ This was born out in GAO’s 2008 review of one tax expenditure, the Indian Reservation Depreciation (IRD) tax expenditure: “We found no way to determine reliably from the available data which

⁷² “Significant” could be defined as having an annual budgetary impact of more than \$500 million, for example. This threshold could increase or decrease as appropriate.

⁷³ Government Accountability Office, “Government Performance and Accountability: Tax Expenditures Represent a Substantial Federal Commitment and Need to Be Reexamined”, in *Government Accountability Office* <<http://www.gao.gov/new.items/d05690.pdf>> [accessed 22 November 2010]

taxpayers use IRD, how much IRD investment is made, or whether the provision is having a positive effects on Indians".⁷⁴ This is completely unacceptable for a spending program that as a whole⁷⁵ costs us \$1.2 billion per year, and is exactly why we are proposing that the IRS expand and enhance its data collection on all tax expenditures so it can provide this essential information to policymakers.

Currently, according to IRS officials, the "IRS seeks to collect information necessary to determine whether taxpayers have accurately reported their income and calculated the correct amount of tax liability."⁷⁶ This limited data collection may have made sense earlier in our history, or might still make sense in a world where all spending is done through outlay programs, but it makes very little sense in one where the tax code spends \$1.2 trillion annually. GAO, recognizing the desirability of this additional data collection, acknowledges that "if policymakers conclude that additional data would facilitate reexamining a particular tax expenditure, decisions would be required on what data are needed, who should provide the data, who should collect the data, how to collect the data, what it would cost to collect the data, and whether the benefits of collecting additional data warrant the cost of doing so."⁷⁷

Given the \$1.2 trillion price tag of the tax expenditure budget, the benefits of collecting the additional data surely warrant the costs. The bigger questions, in our view, are "what data?", "who collects it?", and "how is it collected?" This is because of privacy concerns. As Jason Furman correctly observes, "Disclosing any individual tax expenditures, like medical deductions or mortgage interest deductions, would be a gross violation of privacy that would be contrary to the public interest."⁷⁸ His solution—limiting disclosure to business tax expenditures—respects these privacy concerns, but might be too limited for our purposes. Certainly the disclosing the names of corporate tax beneficiaries makes sense because we already release names for other "non-tax" corporate subsidies. But without any data whatsoever on the recipients of individual income tax expenditures, we would have a hard time evaluating the biggest portion of tax expenditure spending.

⁷⁴ Government Accountability Office, "Tax Expenditures: Available Data Are Insufficient to Determine the Use and Impact of Indian Reservation Depreciation", in *Government Accountability Office* <<http://www.gao.gov/new.items/d08731.pdf>> [accessed 22 November 2010]

⁷⁵ This includes the entire Enterprise Community and Empowerment Zone tax expenditure, which is not limited only to Indian reservation depreciation.

⁷⁶ Government Accountability Office, "Government Performance and Accountability: Tax Expenditures Represent a Substantial Federal Commitment and Need to Be Reexamined", in *Government Accountability Office* <<http://www.gao.gov/new.items/d05690.pdf>> [accessed 22 November 2010]

⁷⁷ Government Accountability Office, "Government Performance and Accountability: Tax Expenditures Represent a Substantial Federal Commitment and Need to Be Reexamined", in *Government Accountability Office* <<http://www.gao.gov/new.items/d05690.pdf>> [accessed 22 November 2010]

⁷⁸ Jason Furman, "Increasing Transparency and Accountability for Tax Expenditures", in *Senate Committee on Homeland Security and Governmental Affairs* <http://hsgac.senate.gov/public/index.cfm?FuseAction=Files.View&FileStore_id=0c7c9cf3-a45c-4e69-ba2c-1ce27e218598> [accessed 22 November 2010]

The logical answer is to use aggregated and anonymous data sets for individual income tax returns. The IRS already provides a lot of aggregated data on its Statistics of Income website, but so far it is not very useful for evaluating tax expenditures. If we were to require the IRS to collect the relevant information, we would be in much better shape.

Some data of this type was collected by the Department of Treasury “after the close of the 2008 tax year.” However, after “describing its importance in the fiscal 2003 through 2007 budgets, reference to the sample was removed from the fiscal 2008, 2009, and 2010 budget without explanation”, reports Citizens for Tax Justice.⁷⁹ We share CTJ’s belief that this data sample could be used to begin tax expenditure performance reviews in the next couple years. Either way, this example suggests that collecting relevant tax expenditure data is possible and feasible.

⁷⁹ Citizens for Tax Justice, "Judging Tax Expenditures", in *Citizens for Tax Justice* <<http://www.ctj.org/pdf/judgingtep1109.pdf>> [accessed 22 November 2010]

We Need More Oversight of National Security Spending

OUR RECOMMENDATIONS

- ▶ **RECOMMENDATION 12:** *The Department of Defense should be audit ready by 2014 and required to pass a comprehensive audit by 2015 so that policymakers can conduct effective oversight of Department expenditures.*
 - ▶ **RECOMMENDATION 13:** *All federal spending on security—including military, homeland security, and foreign engagement—should be considered under one unified security budget.*
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Even as we face an unprecedented deficit, defense spending has doubled since 2001 and this year reached its highest level since World War II.⁸⁰ Defense spending has been the largest contributor to growth in discretionary spending, accounting for 65 percent of all discretionary spending growth since 2001.⁸¹ Much of this increase can be attributed to the direct cost of the wars in Iraq and Afghanistan, which have now surpassed \$1 trillion, but nearly 37 percent of the defense spending growth falls under the “base” or “peacetime” military budget.⁸² With these levels of defense spending, oversight of our security budgets has never been more important. Unfortunately, the Department of Defense (DOD) has a serious financial mismanagement issue which requires immediate action.

The \$720 billion Department of Defense is effectively the largest business in the world, but unlike any other large business, DOD cannot pass an independent audit. This means that it cannot account for its assets or where it spends its budgetary resources. Without a clear picture of where our tax dollars are going, we are essentially flying blind with defense spending. This is unacceptable.

Imagine a family whose growth in annual costs is outpacing growth in the family’s income. In this situation, the family would need to sit down and make a list of all their costs to determine where they are spending the most and where they can cut back without lowering their quality of life. Unfortunately, unlike this hypothetical family, DOD does not know fully where its funds are going and is therefore unable to review its budget for wasteful or unnecessary spending that might be cut. Audit-readiness is the foundation on which all other reforms are built. As long as it fails to prepare for an audit by not properly accounting for all its resources, DOD has

⁸⁰ Dr. Gordon Adams, "Interagency National Security Reform: The Road Ahead", in *House Committee on Armed Services* <http://armedservices.house.gov/pdfs/OI060910/Adams_Testimony060910.pdf> [accessed 22 November 2010]

⁸¹ The Sustainable Defense Task Force, "Debt, Deficits, and Defense", in *The Commonwealth Institute* <<http://www.comw.org/pda/fulltext/1006SDTFreport.pdf>> [accessed 22 November 2010]

⁸² The Sustainable Defense Task Force, "Debt, Deficits, and Defense", in *The Commonwealth Institute* <<http://www.comw.org/pda/fulltext/1006SDTFreport.pdf>> [accessed 22 November 2010]

no hope of reforming its budget and the Congress cannot conduct the oversight it needs to hold DOD accountable.

The majority of our national security expenditures go through DOD. This means that budget transparency and financial responsibility at DOD are critically important. Still, a number of other federal departments and agencies, including the Department of State, the U.S. Agency for International Development, the Department of Homeland Security, and the multiple intelligence agencies all play key roles in our national security strategy and should be included in resource allocation decisions. But despite mission similarities, budgets for these security departments and agencies are all considered separately. This makes it difficult to do “integrated thinking about the security challenges we face and the best applications of our resources to address them,” as the Task Force for a Unified Security Budget, an independent think tank, points out.⁸³

An increasing number of security experts, including Secretary of Defense Robert Gates, Chairman of the Joint Chiefs Admiral Mike Mullen, and Secretary of State Hillary Clinton have recently called for a unified security budget to incorporate all security-related agencies and allow a whole-of-government approach to numerous security challenges.⁸⁴

As spending on our national security continues to grow, we must be able to account for where our funds are going and whether we are getting the most bang for our buck. At this time, we do not have a clear financial picture of the Department of Defense. Nor do we have a clear financial picture of our security budget as a whole given that the budgets of our security-related agencies are “siloed” in the context of our broader national security objectives. Outlined below are two recommendations intended to improve transparency, oversight, and accountability of our security expenditures.

► ***RECOMMENDATION 12: The Department of Defense should be audit ready by 2014 and required to pass a comprehensive audit by 2015 so that policymakers can conduct effective oversight of Department expenditures.***

We currently lack a complete financial picture of the Department of Defense. DOD is one of the only federal agencies that cannot pass an independent audit, which means it cannot properly account for all of its expenditures and assets. DOD’s inability to pass an audit and account for

⁸³ Task Force on a Unified Security Budget for the United States, "A Unified Security Budget for the United States, FY 2011", in *Institute for Policy Studies* <http://www.ips-dc.org/reports/USB_fy_2011> [accessed 22 November 2010]

⁸⁴ Task Force on a Unified Security Budget for the United States, "A Unified Security Budget for the United States, FY 2011", in *Institute for Policy Studies* <http://www.ips-dc.org/reports/USB_fy_2011> [accessed 22 November 2010]

its expenditures harms its ability to safeguard its assets, properly use its funds, and prevent and identify waste, fraud and abuse, according to the DOD Inspector General.⁸⁵

The Government Accountability Office (GAO) has issued numerous reports highlighting DOD's poor financial management. In a July 2010 report, GAO found that DOD is not able to properly "identify, aggregate, and account for the full cost of military equipment it acquires."⁸⁶ In other words, DOD does not know the cost of what it buys or how much it costs to support what it buys. In another July 2010 report, GAO found that DOD lacks "important information" needed to analyze the rate of cost growth for major weapons, identify cost drivers, and develop plans for controlling these costs.⁸⁷ Without a full financial picture, neither we nor DOD can identify trends such as cost growth in major weapons systems. This prevents oversight of spending areas ripe for cuts and reform.

DOD's inadequate financial management also means that it cannot determine the cost of many of its missions. The U.S. Commission on National Security points out that DOD has "program element codes associated with tactical systems, but [they] cannot evaluate the price of tactical operations or missions".⁸⁸ We cannot make vital policy decisions on how to spend our limited resources if we do not know how those resources are currently being spent.

Proper financial management can save significant sums of money. According to the President's Fiscal Commission, "If the Department of Defense can significantly improve its financial management, and achieve audit readiness, it can generate substantial savings over time."⁸⁹ The Commission's report cites savings achieved by financial improvements made in the Marine Corps, which realized approximately \$3 for every \$1 it invested in "improvements to its

⁸⁵ Inspector General of the Department of Defense, "Agency Financial Report for Fiscal Year 2009: Addendum B", in *United States Department of Defense Office of the Inspector General* <http://www.dodig.mil/PUBS/strategic_plan/2009_DoDIG_Summary_of_Management_Challenges.pdf> [accessed 22 November 2010]

⁸⁶ Government Accountability Office, "Additional Actions Needed to Improve Financial Management of Military Equipment", in *Government Accountability Office* <<http://www.gao.gov/new.items/d10695.pdf>> [accessed 22 November 2010]

⁸⁷ Government Accountability Office, "DOD Needs Better Information and Guidance to More Effectively Manage and Reduce Operating and Support Costs of Major Weapons Systems", in *Government Accountability Office* <<http://www.gao.gov/new.items/d10717.pdf>> [accessed 22 November 2010]

⁸⁸ U.S. Commission on National Security/21st Century, "Creating Defense Excellence: Defense Addendum to Road Map for National Security", in *Air University* <http://www.au.af.mil/au/awc/awcgate/nssg/addendum/Creating_Defense_Excellence.pdf> [accessed 22 November 2010]

⁸⁹ Alan Simpson and Erskine Bowles, "Co-Chairs' Proposal: \$200 Billion in Illustrative Savings", in *National Commission on Fiscal Responsibility and Reform* <http://www.fiscalcommission.gov/sites/fiscalcommission.gov/files/documents/Illustrative_List_11.10.2010.pdf> [accessed 22 November 2010]

rudimentary financial operations,” as proof that department-wide financial improvements would result in significant cost savings.⁹⁰

For 20 years DOD has been asked to get its finances in order, but so far it has been unable to do so. The Chief Financial Officers (CFO) Act of 1990 was designed to improve DOD accountability

DOD has had over 20 years to prepare for an audit. It's time that DOD was held accountable.

and required the Pentagon and other federal agencies to pass annual audits to account for their expenditures. Initially, DOD promised to be audit ready by 1997, but that deadline was pushed back to 2006, then to 2007, then to 2016, and most recently to 2017. According to the current DOD Chief Financial Officer, the Pentagon will need another extension, pushing the deadline for audit readiness back to more than 27 years since the passage of the CFO Act.⁹¹

This pattern of continually deferring an audit is simply unacceptable. Particularly given current budgetary pressures, the September 2017 deadline for DOD audit readiness is too late and should be moved up to 2014 with a requirement to pass an audit by 2015.

DOD has had over 20 years to prepare for an audit, but has never succeeded because it has never been held accountable. Four more years should be sufficient to allow DOD to stand for an audit and five more years should provide ample time to actually pass this audit. These steps will allow DOD to reap the benefits of reformed financial management sooner than expected.

Some proponents of an earlier audit deadline have even argued that those divisions of DOD that do not meet the audit readiness deadline and pass a comprehensive audit should have their accounts frozen or curbed until they can stand for and pass an audit. This may seem too extreme for some, but a case can be made that (1) so far nothing has motivated DOD to get its books in order, so more extreme action is necessary, and (2) no tax dollar should be spent unless it can be accounted for, so until DOD can pass an audit and account for all its funds, those funds should be withheld. Withholding funds until DOD can stand for and pass an audit is an option (and is supported by some Congressional leaders like Senator Tom Coburn), but

⁹⁰ Alan Simpson and Erskine Bowles, "Co-Chairs' Proposal: \$200 Billion in Illustrative Savings", in *National Commission on Fiscal Responsibility and Reform* <http://www.fiscalcommission.gov/sites/fiscalcommission.gov/files/documents/Illustrative_List_11.10.2010.pdf> [accessed 22 November 2010]

⁹¹ Center for Defense Information, "New Letter to Deficit Commission on DOD Budget", in *Center for Defense Information, Straus Military Reform Project* <<http://www.cdi.org/friendlyversion/printversion.cfm?documentID=4628>> [accessed 29 November 2010]

either way the deadlines for audit readiness and passing an audit should be 2014 and 2015, respectively. DOD should be held accountable by Congress to meet that goal.

- **RECOMMENDATION 13: All federal spending on security—including military, homeland security, and foreign engagement—should be considered under one unified security budget.**
-

Currently, federal security spending flows through several different departments including the Departments of Defense, State, and Homeland Security. Each has a separate budget. This discourages coordination between the departments on joint security issues like terrorism, and forces departments with similar goals to compete for resources rather than encouraging them to work together. For example, most experts agree the most likely delivery vehicle for a nuclear attack on U.S. soil would be a container on a ship rather than a missile. A unified security budget would allow Homeland Security and DOD to coordinate and determine whether our resources would be better spent on a Coast Guard program to inspect container ships or on a traditional missile defense system.

The concept of unifying security spending under one budget has recently been endorsed by Secretary of State Hillary Clinton, Secretary of Defense Robert Gates, and the Chairman of the Joint Chiefs of Staff Admiral Mike Mullen.⁹² In a recent speech at the Brookings Institution, Secretary Clinton noted that both Secretary Gates and Admiral Mullen recently sent letters to House and Senate leadership making the case that we should move toward a unified national security budget.⁹³ In his letter, Admiral Mullen articulated the importance of an integrated security budget:

*We are living in times that require an integrated security program with budgets that fund the full spectrum of national security efforts...The diplomatic and developmental capabilities of the United States have a direct bearing on our ability to shape threats and reduce the need for military action. It is my firm belief that diplomatic programs as part of a coordinated strategy will save money by reducing the likelihood of active military conflict involving U.S. forces.*⁹⁴

⁹² Task Force on a Unified Security Budget for the United States, "A Unified Security Budget for the United States, FY 2011", in *Institute for Policy Studies* <http://www.ips-dc.org/reports/USB_fy_2011> [accessed 22 November 2010]

⁹³ Task Force on a Unified Security Budget for the United States, "A Unified Security Budget for the United States, FY 2011", in *Institute for Policy Studies* <http://www.ips-dc.org/reports/USB_fy_2011> [accessed 22 November 2010]

⁹⁴ Chairman of the Joint Chiefs of Staff Admiral Mike Mullen, "Letter to Speaker of the House Nancy Pelosi", in *Foreign Policy* <http://www.foreignpolicy.com/files/fp_uploaded_documents/100524_Speaker%20Pelosi%20State%20Letter.pdf> [accessed 22 November 2010]

This statement makes clear that diplomatic and development capabilities cannot and should not be separated from military capabilities, and further that better coordination and utilization of our diplomatic programs could help us avoid the use of military force, in so doing saving money. It should be noted that this emphasis on diplomatic and developmental capacities is being championed not only by diplomatic leaders, but by one of our most senior defense experts.

Secretary Clinton also makes a strong case for a coordinated security budget. In a speech at the Brookings Institution, she said the following:

You cannot look at a Defense budget, a State Department budget, and a USAID budget without Defense overwhelming the combined efforts of the other two and without us falling back into the old stovepipes that I think are no longer relevant for the challenges of today. So we want to begin to talk about a national security budget, and then you can see the tradeoffs and the savings.⁹⁵

Her statement highlights the importance of seeing the whole picture to make appropriate budget tradeoffs with limited resources.

The Task Force for a Unified Security Budget (USB), an independent think tank, has long called for a unified security budget that combines resources for offense (military), defense (homeland security), and prevention (non-military foreign engagement) to solve the problem of “stovepiped” decision-making that prevents the overall balance from being adequately considered.”⁹⁶ James R. Locher III, President and CEO of the Project on National Security Reform, also explained his support for a unified security budget in his testimony before a House Armed Services Subcommittee explaining that “because resource decisions are made on an agency-by-agency basis, the Executive Branch is unable to allocate resources from a whole-of-government, mission-oriented perspective and to make tradeoffs that maximize progress toward desired outcomes.”⁹⁷ All proponents of a unified security budget agree that without the ability to look at each of our security expenditures together under one budget, we will never be able to accurately determine whether our tax dollars are being spent wisely or not. This is a huge transparency and accountability problem, but the solution is clear.

⁹⁵ Secretary of State Hillary Clinton, "Remarks on the Obama Administration's National Security Strategy", in *Department of State* <<http://www.state.gov/secretary/rm/2010/05/142312.htm>> [accessed 22 November 2010]

⁹⁶ Task Force on a Unified Security Budget for the United States, "Unified Security Budget for the United States, FY2010", in *Institute for Policy Studies* <http://www.ips-dc.org/reports/unified_security_budget_fy_2010> [accessed 22 November 2010]

⁹⁷ James Locher, "Pragmatic, Near-Term Steps for Creating a More Effective and Functional ", in *House Committee on Armed Services* <http://armedservices.house.gov/pdfs/OI060910/Locher_Testimony060910.pdf> [accessed 22 November 2010]

We strongly agree with the recommendations of Secretary Clinton, Secretary Gates, Admiral Mullen, USB, and the Project on National Security that we need a unified security budget. This would help policymakers more thoroughly scrutinize security expenditures and make better and more informed budget decisions on how to spend our limited resources. Creating a unified security budget is a key step in reinventing our federal government and establishing higher standards of transparency, accountability, and sustainability.

We Need More Information about Environmental Liability Costs

OUR RECOMMENDATIONS

- ▶ **RECOMMENDATION 14:** *The Department of Defense should resolve internal control weaknesses and other uncertainties in long-term cost estimates for environmental liabilities.*
- ▶ **RECOMMENDATION 15:** *More up-front information should be required about the costs of environmental liabilities that would be incurred with the purchase of new assets.*

The federal government faces significant environmental liabilities resulting from the production of hazardous waste at the Department of Defense and the Department of Energy. Specifically, military installations and nuclear weapons production facilities have produced hazardous waste requiring clean-up that totaled nearly \$249 billion in Fiscal Year 2004. In 2006, these environmental liabilities made up the federal government's third largest liability behind accrued interest on federal debt and benefits payable to federal employees and veterans⁹⁸.

Major accounting weaknesses at both the Department of Defense and the Department of Energy make it difficult to properly estimate the magnitude of their respective environmental liabilities. GAO reports that not only have DOD's controls "hindered it from producing auditable environmental liability estimates," but also that "Even if Defense resolved its internal control weaknesses, uncertainties exist for both Energy and Defense...that could increase the government's environmental liabilities beyond the currently recorded amounts." This is a serious issue that contributes to an overall lack of accountability and transparency in the government's finances.⁹⁹

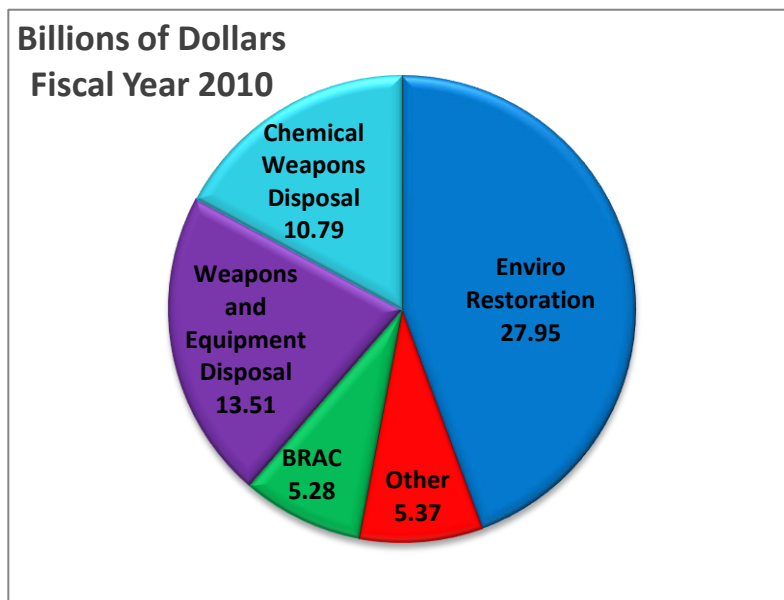
⁹⁸ Government Accountability Office, "Environmental Liabilities: Long-Term Fiscal Planning Hampered by Control Weaknesses and Uncertainties in the Federal Government's Estimates", in *Government Accountability Office* <<http://www.gao.gov/new.items/d06427.pdf>> [accessed 22 November 2010]

⁹⁹ Government Accountability Office, "Environmental Liabilities: Long-Term Fiscal Planning Hampered by Control Weaknesses and Uncertainties in the Federal Government's Estimates", in *Government Accountability Office* <<http://www.gao.gov/new.items/d06427.pdf>> [accessed 22 November 2010]

- **RECOMMENDATION 14: The Department of Defense should resolve internal control weaknesses and other uncertainties in long-term cost estimates for environmental liabilities.**

Ninety-nine percent of the federal government’s environmental liabilities are incurred by the Department of Defense and the Department of Energy. In its March 2006 report on environmental liabilities, GAO made eight recommendations to the Department of Defense to improve internal controls, and one similar recommendation to the Department of Energy. Five of these recommendations have been implemented, including the one to the Department of Energy. This is a major step forward for transparency and accountability in the budgeting of environmental liabilities.

Figure 20: DOD Environmental Liabilities in Fiscal Year 2010¹⁰⁰



Still, four of these GAO recommendations have not been implemented. This failure constitutes a major impediment to effective oversight of environmental liabilities at the Department of Defense (see Figure 20 at left for a breakdown of DOD environmental liabilities in Fiscal Year 2010, by type of liability). As soon as possible, the Department of Defense should:

1. “Develop, document, and implement a program for financial management review, approval, assessment, and monitoring of the estimation and reporting processes for environmental liabilities”
2. “Improve compliance with federal accounting standards and FMR guidance...by reporting financial liabilities for (1) the Navy’s nuclear ships and submarines, (2) the Air

¹⁰⁰ Department of Defense, "Department of Defense Fiscal Year 2010 Agency Financial Report", in *Office of the Undersecretary of Defense, Comptroller* <http://comptroller.defense.gov/afr/fy2010/Fiscal_Year_2010_DoD_Agencywide_Agency%20Financial%20Report.pdf> [accessed 22 November 2010]

Force’s cleanup and restoration costs, and (3) all costs intended to be paid for with prior-year budgetary authority by the Army, Navy, and Air Force”

3. “Determine that all sites with cleanup or corrective action costs and all hazardous waste operations with cleanup or closure costs are included in financial reports of environmental liabilities and all are reported by the appropriate Defense component”
4. “[Produce and maintain] adequate supporting documentation for Army, Navy, and Air Force environmental liabilities at all levels in accordance with internal control standards in the federal government”

The Department of Defense should implement these recommendations as soon as possible and provide documentation to Congress that they have been implemented. DOD must properly account for billions of dollars in environmental liabilities. Clean-up costs for environmental liabilities should be fully transparent to the public to ensure that the relevant agencies, particularly DOD, are held accountable.

► ***RECOMMENDATION 15: More up-front information should be required about the costs of environmental liabilities that would be incurred with the purchase of new assets.***

Lack of information about long-term environmental liabilities is a glaring problem in our budget. Though the government may undertake a project or program that will have huge clean-up costs at a later date, today’s budget process does not require any relevant information about that project’s or program’s long-term costs due to environmental clean-up.

Because the federal government has the responsibility to conduct these clean-up activities, they should be reported in the budget. In January 2003, the GAO published a report on the budgetary implications of long-term environmental liabilities and presented two options that would require a full cost estimate before the government could acquire any new asset with an environmental liability:

The government could increase awareness of full costs by reporting the long-term environmental liability costs associated with new assets as supplemental information alongside budget authority and outlay figures in the budget...it will help ensure that information is generated and made more transparent. Alternatively, budget process mechanisms could be established to require explicit disclosure and prompt consideration of the full costs of environmental liabilities associated with a proposed asset acquisition.¹⁰¹

¹⁰¹ Government Accountability Office, "Long-Term Commitments: Improving the Budgetary Focus on Long-Term Liabilities", in *Government Accountability Office* <<http://www.gao.gov/new.items/d03219.pdf>> [accessed 22 November 2010]

Either one of these options would provide much better information about the long-term cost trajectory of environmental liabilities associated with new assets acquired by the federal government. In the interest of greater budgetary transparency and accountability, we recommend that one of these options be enacted as a statutory requirement of the budget process.

Conclusion

Our budget is on an unsustainable fiscal path. Skyrocketing health care costs are driving huge deficits while many other costly areas of the budget are in bad need of reform. Because of the proliferation of tax expenditures, our tax code loses \$1.2 trillion each year that could be used to close our annual deficits. At the same time, the debt we're accumulating to finance deficit spending is costing us additional billions of dollars per year in net interest payments and thereby exacerbating future deficits. Unless we act soon, our deficits will spiral out of control.

Just as our hypothetical flight from Tokyo to Chicago made a series of small navigational errors and eventually found itself way off course, the federal government has made plenty of its own bad decisions that taken together have led our budget far astray. At the root of this problem is the lack of transparency and accountability for our budget.

Taxpayers do not know where their tax dollars are going. The budget process is not sufficiently focused on fiscal sustainability. Long-term cost estimates are few and far between. \$1.2 trillion in annual tax expenditures persist with effectively zero oversight. The Department of Defense cannot pass an audit and environmental liabilities that will cost us billions are not properly reported. We do not have the necessary tools to evaluate the sustainability of our budget and to hold policymakers accountable for their decisions.

Getting back on track, then, is not just about pointing ourselves in the right direction, but is fundamentally about fixing the problems that led us in the wrong direction in the first place. To fix these problems, this report has made 15 recommendations that will increase the transparency and accountability of our federal budget. In the upcoming 112th Congress, we will be introducing new legislation to this effect and working hard to see these legislative proposals enacted into law.

Part two of this report series is forthcoming. It will go beyond transparency and accountability reforms to discuss potential cost savings in the federal budget. This must be a priority of the 112th Congress. Fiscal sustainability may sound like an abstract ideal, but the effects of an unsustainable budget will be all too real.

Solving these problems is not an impossible goal, but our recommendations will require honesty and boldness to implement and a shared sacrifice to see through.

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