

Fixing The Broken Budget Process: Legislative Proposals

Testimony to the U.S. House of Representatives
Committee on the Budget

Douglas Holtz-Eakin, President
American Action Forum*

May 31, 2012

* The opinions expressed herein are mine alone and do not represent the position of the American Action Forum. I thank Gordon Gray for his assistance.

Introduction

Chairman Ryan, Ranking Member Van Hollen and members of the Committee, I am pleased to have the opportunity to appear today. In this testimony, I wish to make a few basic points:

- The U.S. faces a dramatic threat from the current and projected levels of federal debt, driven by ever-increasing mandatory spending;
- The outlay reductions in the president's budget proposal or the Budget Control Act are dwarfed by the scale and imminence of the problem;
- The current Congressional budget process is broken, and does not facilitate addressing the threats to the Nation;
- The legislation contemplated in this hearing have relative strengths and weaknesses, but are clearly designed to introduce greater discipline in the budgeting process;
- In particular, to the extent they involve the adoption of a "fiscal rule" these proposals would be a valuable step toward budgetary practice that would address the debt threat and preclude its recurrence; and
- Budget process reforms are commendable, and to the extent they can precipitate action, they should be pursued, but are no substitute for necessary underlying policy changes.

Let me discuss each in turn.

The Threat from Federal Debt

The federal government faces enormous budgetary difficulties, largely due to long-term pension, health, and other spending promises coupled with recent programmatic expansions. The core, long-term issue has been outlined in successive versions of the Congressional Budget Office's (CBO's) *Long-Term Budget Outlook*¹. In broad terms, the inexorable dynamics of current law will raise federal outlays from an historic norm of about 20 percent of Gross Domestic Product (GDP) to anywhere from 30 to 40 percent of GDP. Any attempt to keep taxes at their post-war norm of 18 percent of GDP will generate an unmanageable federal debt spiral.

¹ Congressional Budget Office. 2011. *The Long-Term Budget Outlook*. Pub. No. 4277.
http://www.cbo.gov/ftpdocs/122xx/doc12212/06-21-Long-Term_Budget_Outlook.pdf

This depiction of the federal budgetary future and its diagnosis and prescription has all remained unchanged for at least a decade. Despite this, lasting action (in the right direction) has yet to achieve the force of law.

In the past several years, the outlook has worsened significantly.

Over the next ten years, according to the Congressional Budget Office's (CBO's) analysis of the President's Budgetary Proposals for Fiscal Year 2013², the deficit will average over \$630 billion over the next ten years. Ten years from now, in 2022, the deficit will be 3.0 percent of GDP, roughly \$700 billion. As a result of the spending binge, in 2022 debt held by the public will nearly have doubled from its 2008 level to roughly 80 percent of GDP and will continue its upward trajectory.

The "Bad News" Future under Massive Debt Accumulation. A United States fiscal crisis is now a threatening reality. It wasn't always so, even though – as noted above – the Congressional Budget Office has long published a pessimistic *Long-Term Budget Outlook*. Despite these gloomy forecasts, nobody seemed to care. Bond markets were quiescent. Voters were indifferent. And politicians were positively in denial that the "spend now, worry later" era would ever end.

Those days have passed. Now Greece, Italy, Portugal, Spain, Ireland, and even Britain are under the scrutiny of skeptical financial markets. And there are signs that the U.S. is next – as witnessed by the decision of S&P to downgrade the federal credit rating. The federal government ran a fiscal 2011 deficit of \$1.3 trillion – nearly 9 percent of GDP, as spending remained above 24 percent of GDP and receipts remained below 16 percent of GDP.

How did this happen? First, the U.S. frittered away its time for easier action. It was widely recognized that the crunch would only arrive when the baby boomers began to retire. Guess what? The very first official baby boomer already chose to retire early at age 62, and the number of retirees will rise as the years progress. Crunch time has arrived and nothing was done in the interim to solve the basic spending problem – indeed the passage of the Medicare prescription drug bill in 2003 made it worse.

Second, the events of the financial crisis and recession used up the federal government's cushion. In 2008, debt outstanding was only 40 percent of GDP. Already it is approaching 70 percent and rising rapidly.

Third, active steps continue to make the problem worse. The Affordable Care Act "reform" added two new entitlement programs for insurance subsidies and long-term care insurance without fixing the existing problems in Social Security, Medicare, and Medicaid.

² Congressional Budget Office. 2012. *An Analysis of the President's 2013 Budget*. <http://www.cbo.gov/sites/default/files/cbofiles/attachments/03-16-APB1.pdf>

Financial markets no longer can comfort themselves with the fact that the United States has time and flexibility to get its fiscal act together. Time passed, wiggle room vanished, and the only actions taken thus far have made matters worse.

As noted above, in 2022 public debt will have nearly doubled from its 2008 level to nearly 80 percent of GDP and will continue its upward trajectory. Already, gross federal debt exceeds 100 percent of GDP. Using this measure, research shows that a debt-to-GDP ratio of 90 percent or more is associated with the risk of a sovereign debt crisis.

Perhaps even more troubling, much of this borrowing comes from international lending sources, including sovereign lenders like China that do not share our core values. Rather than reducing this threat, according to news reports the United States is facilitating increased indebtedness to China by providing the People's Bank direct access to Treasury markets.³

For Main Street America, the "bad news" version of the fiscal crisis occurs when international lenders revolt over the outlook for debt and cut off U.S. access to international credit. In an eerie reprise of the recent financial crisis, the credit freeze would drag down business activity and household spending. The resulting deep recession would be exacerbated by the inability of the federal government's automatic stabilizers – unemployment insurance, lower taxes, etc. – to operate freely.

Worse, the crisis would arrive without the U.S. having fixed the fundamental problems. Getting spending under control in a crisis will be much more painful than a thoughtful, pro-active approach. In a crisis, there will be a greater pressure to resort to damaging tax increases. The upshot will be a threat to the ability of the United States to bequeath to future generations a standard of living greater than experienced at the present.

Future generations will find their freedoms diminished as well. The ability of the United States to project its values around the globe is fundamentally dependent upon its large, robust economy. Its diminished state will have security repercussions, as will the need to negotiate with less-than-friendly international lenders.

The "Good News" Future under Massive Debt Accumulation. Some will argue that it is unrealistic to anticipate a cataclysmic financial market upheaval for the United States. Perhaps so. But an alternative future that simply skirts the major crisis would likely entail piecemeal revenue increases and spending cuts – just enough to keep an explosion from occurring. Under this "good news" version, the debt would continue to edge northward – perhaps at times slowed by modest and ineffectual

³ Flitter, Emily. Reuters. <http://www.reuters.com/article/2012/05/21/us-usa-treasuries-china-idUSBRE84K11720120521>

“reforms” – and borrowing costs in the United States would remain elevated and escalating.

Profitable innovation and investment will flow elsewhere in the global economy. As U.S. productivity growth suffers, wage growth stagnates, and standards of living stall. The combination of sluggish income growth and a very large tax burden from the debt, assures that the next generation will inherit a standard of living inferior to that bequeathed to this one.

The Need for Action

The federal budget problem demands fundamental reforms to major mandatory spending programs – Medicare, Medicaid, Social Security, the Affordable Care Act – and would benefit from the improved growth derived from fundamental tax reform. Despite this, successive budget proposals by the president are devoid of reform proposals and characterized at best by the type of piecemeal spending cuts and tax increases that invite stagnation.

Recently, the passage of the Budget Control Act of 2011, its caps on discretionary spending, and the formation of the Joint Select Committee on Deficit Reduction represented a commitment to move the nation’s finances in a better direction.

However, the failure of the Committee to report recommendations to address our fiscal challenges has left the United States in a perilous position. It faces the expiration of tax polices most recently extended in 2010 and a sequester that is widely judged to be bad policy. The combined effect of these policies, in an unprecedented statement from CBO, threatens recession.⁴

However, the structural budget challenges the nation faces are so pressing and significant that they outweigh in terms of their implications for economic output even a near-term recession. Clearly something must be done to avoid a downturn, but any such undertaking must be paired with reforms to address our fiscal imbalance.

The Broken Budget Process

The Congressional budget process is broken and does not engender regular evaluation of the fiscal health of the federal government. Indeed, the *prima facie* evidence of its failure is that fact that the president has regularly submitted budgets that clearly display a path to a sovereign debt crisis, the U.S. Senate has not adopted

⁴ Congressional Budget Office. 2012. *Economic Effects of Reducing the Fiscal Restraint That Is Scheduled to Occur in 2013*. http://www.cbo.gov/sites/default/files/cbofiles/attachments/FiscalRestraint_0.pdf

a budget resolution in three years, and the Congress as a whole regularly operates without a binding budget resolution – all with no consequence.

The budget process is intended to facilitate a regular and disciplined evaluation of the inflow of taxpayer resources and outflow of federal spending. It should enhance the role of the Congress as a good steward of the federal credit rating. It does neither because the current process is insufficiently binding. As a result, it easily degenerates to the mere adoption of current-year discretionary spending levels, with no review of the real problem: the long-term commitments in mandatory spending.

Legislative Proposals for Process Reform

To the extent that process reforms introduce added discipline to governance, and contribute to good budgetary outcomes, they should be commended. I believe there are elements of each of the three bills considered today that meet that test.

Balancing our Obligations for the Long Term Act of 2011

As noted above, the U.S. long-term budget challenge is daunting – now more so because what was once a truly long-term challenge now confronts in the medium term. Indeed, if credit markets observe a continued failure to put in place a credible plan to address this challenge, there would likely be near-term implications.

The BOLT Act should be viewed favorably for its focus beyond the standard budget window. Any meaningful reform to major entitlements may have only modest impact within the 10 year budget window, but are the only sort of reforms that will address our looming, spending-driven debt crisis. Some efforts on this issue have been made in the past, such as the long-term budget point of order, the codification of which is a particularly laudable aspect of this legislation. Strengthening of the “Medicare trigger” enacted in 2003, but repeatedly ignored by the current administration is also a worthy pursuit.

I must also note with caution the reliance inherent in this legislation on long-term budget projections. Any budget process that is contingent upon a long-term estimate of federal finances and a subsequent long-term estimate on how legislation (the compulsory “fast-track” legislation) might alter those finances is fraught with uncertainty. It is simply beyond the scientific capabilities of the budget community to project these impacts with great certainty. The need for Congress to consider the long-term outlook is undeniable. Assuring that federal finances are sustainable and that the debt trajectory is downward are far more important than hitting precise projected numerical targets.

Spending Control Act of 2011

Any serious approach to budget discipline must include mandatory spending, which comprises over half of federal spending. The Budget Control Act, and other efforts, principally stemming from this body have put the brakes on discretionary spending growth. I would commend any policymaker for rooting out additional savings in discretionary programs, in domestic and defense appropriations, but much of the low-hanging fruit has been culled, and undue effort to squeeze less consequential savings from discretionary programs at the expense of a much needed debate on entitlement reforms would likely be unproductive. While praise-worthy for staunching the recent discretionary spending binge, the Budget Control Act, in its post Super Committee-failure guise, suffers from this flaw.

The Spending Control Act addresses this flaw by introducing measures to restrain direct spending, overall spending, and deficits. I believe the inclusion of mandatory spending into any budget process reform regime is critical. While ultimately, we must reform the underlying elements of mandatory programs, the desire to establish a global budget for mandatory spending, which is essentially what such a cap would do, is well intentioned, and would advance the goal of imposing needed reforms to these programs.

Review Every Dollar Act of 2011

Much like the previous two proposals, this legislation addresses the critical driver of our budget woes – direct spending. A periodic reassessment, as called for in the Review Every Dollar Act, of all federal programs should serve as a catalyst for the necessary debate on how to address our mandatory programs. That is the crucial first step to reining in the largest and fastest growing federal programs.

The RED Act also seeks to address other specific flaws in current budget practice that are worthwhile efforts. Making explicit the tens of billions in federal transfers to the Highway Trust Fund is critical to effectively prioritizing federal spending initiatives. In a time of tight budgets, prioritization must determine funding allocations, and if we are to do so with any fidelity, then the masking of the state of the Trust Fund's finances is a practice that must come to an end. Additional measures in the RED are also commendable for their approaches to other such anomalies that impede proper budgetary practice.

The Value of Fiscal Rules

One way to think of the reforms under consideration today is in the context of a federal “fiscal rule.” At present, the federal government does not have a fiscal “policy.” Instead, it has fiscal “outcomes”. The House and Senate do not reliably agree on a budget resolution. Annual appropriations reflect the contemporaneous politics of conference committee compromise, and White House negotiation. Often,

the annual appropriations process is in whole or part replaced with a continuing resolution. Annual discretionary spending is not coordinated in any way with the outlays from mandatory spending programs operating on autopilot. And nothing annually constrains overall spending to have *any* relationship to the fees and tax receipts flowing into the U.S. Treasury. The fiscal outcome is whatever it turns out to be – usually bad – and certainly not a policy choice.

I believe that it would be tremendously valuable for the federal government to adopt a fiscal rule. Such a rule could take the form of an overall cap on federal spending (perhaps as a share of gross domestic product (GDP)), a limit on the ratio of federal debt in the hands of the public relative to GDP, a balanced budget requirement, or many others. Committing to a fiscal rule would force the current, disjointed appropriations, mandatory spending, and tax decisions to fit coherently within the adopted fiscal rule. Accordingly, it would force lawmakers to make tough tradeoffs, especially across categories of spending.

Most importantly, it would give Congress a way to say “no.” Spending proposals would not simply have to be good ideas. They would have to be *good enough* to merit cutting other spending programs or using taxes to dragoon resources from the private sector. Congress would more easily be able to say, “not good enough, sorry.”

As documented by the Pew-Peterson Commission on Budget Reform⁵ other countries have benefitted from adopting fiscal rules. The Dutch government established separate caps on expenditures for health care, social security and the labor market. There are also sub-caps within the core sectors.

Sweden reacted to a recession and fiscal crisis by adopting an expenditure ceiling and a target for the overall government surplus (averaged over the business cycle). Later (in 2000) a balanced budget requirement was introduced for local governments. Finally, in 2003 the public supported a constitutional amendment to limit annual federal government spending to avoid perennial deficits.

A lesson is that, no matter which rule is adopted, it will rise or fall based on political will to institute it and the public’s support for its consequences.

Necessary Political Will

All three of the measures being discussed today share the necessary goal of controlling the largest drivers of our spending problem. To the extent that the three bills before the Committee impel reforms to our entitlement programs, then I support their passage. However, process reform, no matter how well intentioned or considered is no substitute for the actual reforms needed to address the looming debt crisis fueled by federal spending. No statutory spending cap or scheduled

⁵ <http://budgetreform.org/>

sequester can replace the needed debate on what a realistic or fair retirement age should be, or what the proper federal role in seniors' health care delivery is. So while I commend the authors of the legislation we are discussing, I would also caution this Committee's membership, as many know, the clock is ticking on the need for that broader discussion.

Thank you. I look forward to your questions.