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BUDGET PROCESS

Better Transparency, Controls, Triggers, and Default Mechanisms Would Help to Address Our Large and Growing Long-term Fiscal Challenge

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BUDGET PROCESS

Better Transparency, Controls, Triggers, and Default Mechanisms Would Help to Address Our Large and Growing Long-term Fiscal Challenge

Highlights

Highlights of GAO-06-761T, a testimony before the Subcommittee on Federal Financial Management, Government Information, and International Security, Committee on Homeland Security and Governmental Affairs, U.S. Senate

Why GAO Did This Study

The nation's long-term fiscal outlook is daunting. While the budget process has not caused the problems we face, the absence of meaningful budget controls and other mechanisms has served to compound our fiscal challenge. Conversely, a process that illuminates the looming fiscal pressures and provides appropriate incentives can at least help decision makers focus on the right questions. Meaningful budget controls and other mechanisms can also help to assure that difficult but necessary choices are made.

The budget process needs to provide incentives and signals to address commitments the government has already made and better transparency for and controls on the long-term fiscal exposures being considered. Improvements would include the restoration of realistic discretionary caps; application of pay-as-you-go (PAYGO) discipline to both mandatory spending and revenue legislation; the use of "triggers" for some mandatory programs; and better reporting of fiscal exposures.

www.gao.gov/cgi-bin/getrpt?GAO-06-761T.

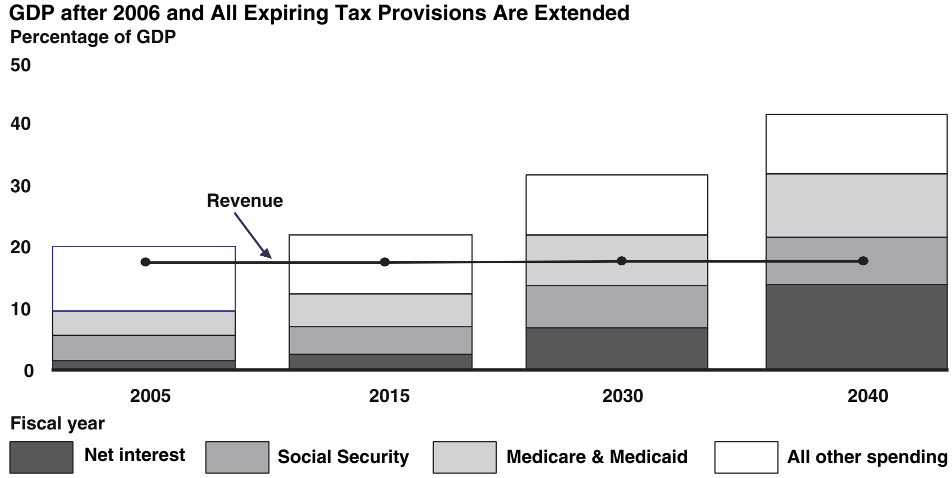
To view the full product, including the scope and methodology, click on the link above. For more information, contact Susan J. Irving at (202) 512-9142 or irvings@gao.gov.

What GAO Found

Over the long term we face a large and growing structural deficit due primarily to known demographic trends and rising health care costs. Continuing on this imprudent and unsustainable fiscal path will gradually erode, if not suddenly damage, our economy, our standard of living, and ultimately our national security. Our current path will also increasingly constrain our ability to address emerging and unexpected budgetary needs and increase the burdens that will be faced by our children, grandchildren, and future generations.

The budget process itself cannot solve this problem, but it can help policymakers make tough but necessary choices. If citizens and government officials come to better understand various fiscal exposures and their implications for the future, they are more likely to insist on prudent policy choices today and sensible levels of fiscal risk in the future.

Composition of Spending as a Share of GDP Assuming Discretionary Spending Grows with GDP after 2006 and All Expiring Tax Provisions Are Extended



Source: GAO's May 2006 analysis.

Note: This includes certain tax provisions that expired at the end of 2005, such as the increased alternative minimum tax exemption amount.

We cannot grow our way out of our long-term fiscal challenge. We must make tough choices and the sooner the better. A multi-pronged approach is needed: (1) revise existing budget processes and financial reporting requirements, (2) restructure existing entitlement programs, (3) reexamine the base of discretionary and other spending, and (4) review and revise tax policy and enforcement programs—including tax expenditures. Everything must be on the table and a credible and effective Entitlement and Tax Reform Commission may be necessary. Fundamentally we need a top-to-bottom review of government activities to ensure their relevance and fit for the 21st century and their relative priority.

Mr. Chairman, Senator Carper, and Members of the Subcommittee:

I appreciate the opportunity to speak with you today about a budget process that can help Congress deal with the large and growing fiscal challenges facing our nation. As you know, I have been vocal about our long-term fiscal imbalance and the need to make difficult but necessary choices soon so that we do not burden our children and grandchildren with a crushing debt. While the budget process has not caused the problems we face, the absence of meaningful budget controls and other mechanisms has served to compound our fiscal challenge. Conversely, a process that illuminates the looming fiscal pressures and provides appropriate incentives, transparency and control mechanisms can help decision makers to slow the bleeding and put us on a more prudent and sustainable long-range fiscal path.

When updating the budget process, you face a two-pronged challenge:

- the need to reinstitute and strengthen controls to deal with both near-term and longer-term deficits and
- the need to design a process that helps Congress tackle our large and growing long-term fiscal challenges facing this nation by, among other things, improving the transparency of the long-term costs of current decisions.

Today I want to focus on the long-term budget challenge and what role the budget process can play in helping to deal with it. Since at its heart the budget debate is about the allocation of limited resources, the budget process can and should play a key role in helping to address our broader challenge of modernizing government for the 21st century.

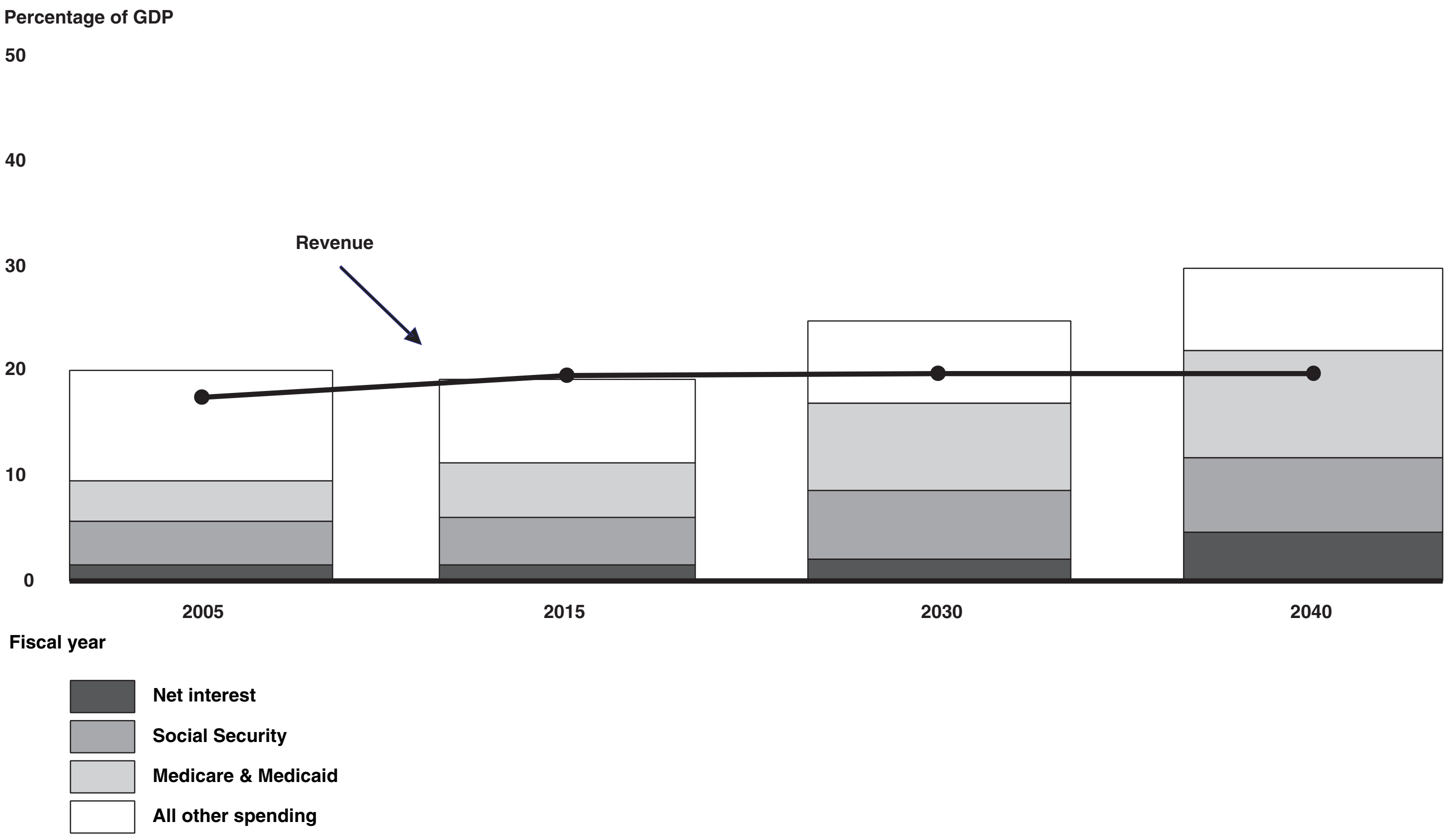
The Long-term Fiscal Challenge

The nation's long-term fiscal outlook is daunting under any realistic policy scenarios and assumptions. For over 14 years, GAO has periodically prepared various long-term budget simulations that seek to illustrate the likely fiscal consequences of our coming demographic challenges and rising health care costs. Indeed, the health care area is especially important because the long-term fiscal challenge is largely a health care challenge. While Social Security is important because of its size, health care spending is both large and projected to grow much more rapidly.

Our most recent simulation results illustrate the importance of health care in the long-term fiscal outlook as well as the imperative to take action soon. These simulations show that over the long term we face large and growing structural deficits due primarily to known demographic trends and rising health care costs. These trends are compounded by the presence of near-term deficits arising from new discretionary and mandatory spending as well as lower federal revenues as a percentage of the economy. Continuing on this imprudent and unsustainable fiscal path will gradually erode, if not suddenly damage, our economy, our standard of living, and ultimately our national security. Our current path will also increasingly constrain our ability to address emerging and unexpected budgetary needs and increase the burdens that will be faced by our children, grandchildren, and future generations of Americans.

Figures 1 and 2 present our long-term simulations under two different sets of assumptions. For both simulations, Social Security and Medicare spending is based on the 2006 Trustees' intermediate projections, and we assume that benefits continue to be paid in full after the trust funds are exhausted, although current law does not provide for such. Medicaid spending is based on the Congressional Budget Office's (CBO) December 2005 long-term projections under its midrange assumptions. In figure 1, we start with CBO's 10-year baseline, constructed according to the statutory requirements for that baseline. Consistent with these specific yet unrealistic requirements, discretionary spending is assumed to grow with inflation for the first 10 years and tax cuts scheduled to expire are assumed to expire. After 2016, discretionary spending and revenue are held constant as a share of gross domestic product (GDP) at the 2016 level. Under this fiscally restrained scenario, spending for Social Security and health care programs would grow to consume over three-quarters of federal revenues by 2040.

Figure 1: Composition of Spending as a Share of GDP under Baseline Extended

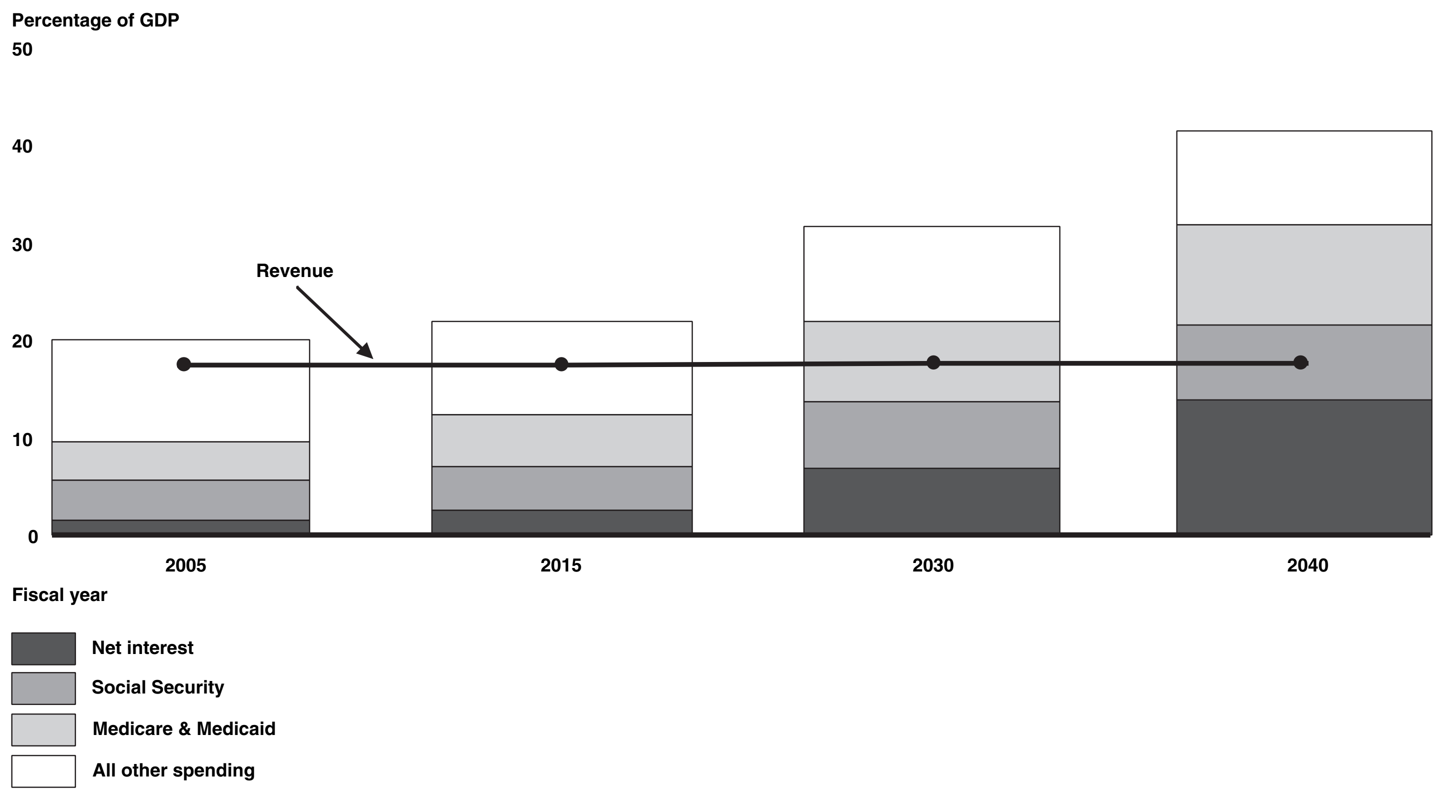


Source: GAO's May 2006 analysis.

Note: Importantly, this simulation does not include the "Tax Increase Prevention and Reconciliation Act of 2005" (P.L. 109-222) enacted on May 17, 2006. Under this scenario, in addition to the expiration of tax cuts, revenue as a share of GDP increases through 2016 due to (1) real bracket creep, (2) more taxpayers becoming subject to the alternative minimum tax (AMT), and (3) increased revenue from tax-deferred retirement accounts. After 2016, revenue as a share of GDP is held constant.

In figure 2, two assumptions are changed: (1) discretionary spending is assumed to grow with the economy after 2006 rather than merely with inflation, and (2) all expiring tax provisions are extended. In this less restrained but possibly more realistic scenario, federal revenues will cover little more than interest on the large and growing federal debt by 2040.

Figure 2: Composition of Spending as a Share of GDP Assuming Discretionary Spending Grows with GDP after 2006 and All Expiring Tax Provisions Are Extended



Source: GAO's May 2006 analysis.

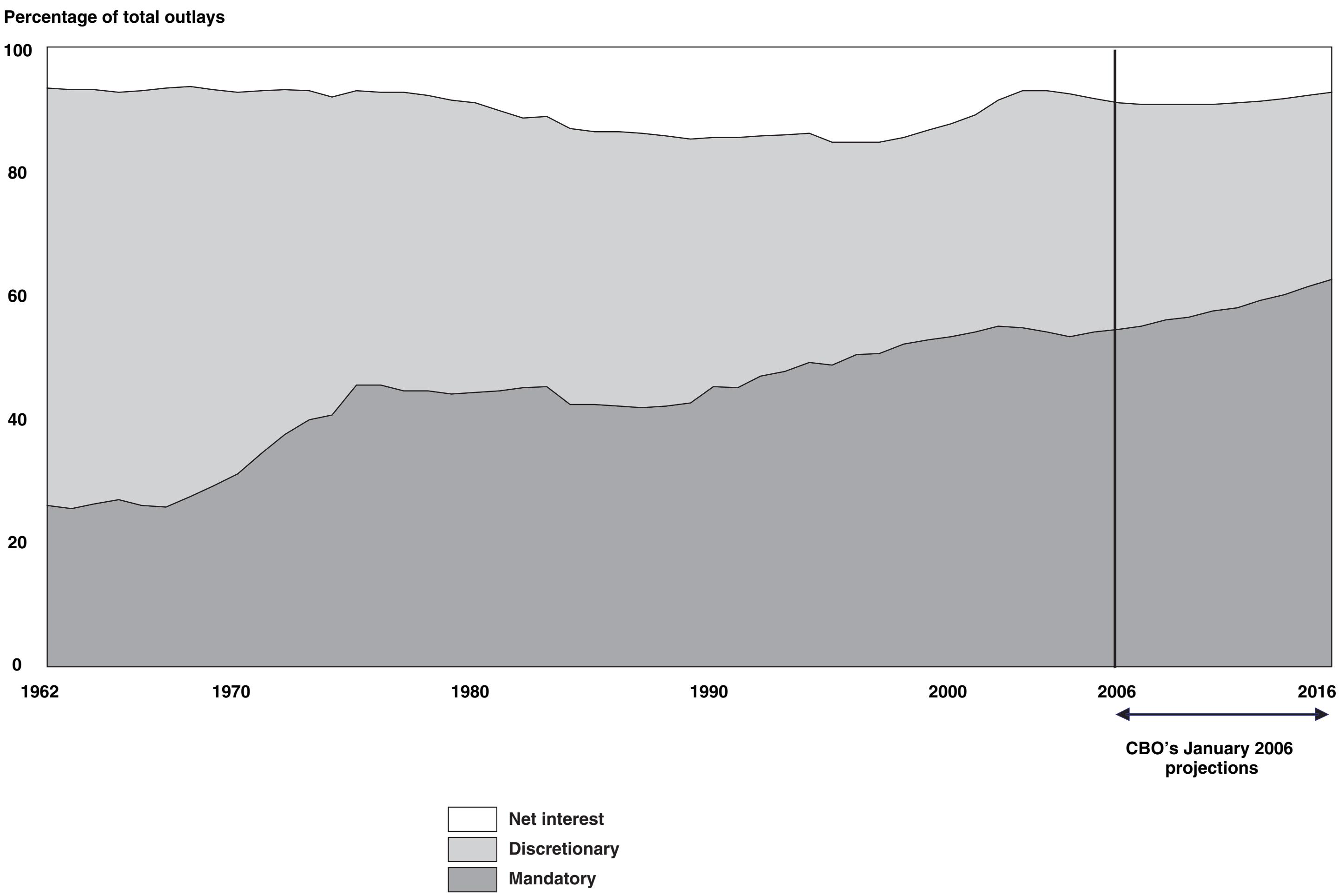
Note: This includes certain tax provisions that expired at the end of 2005, such as the increased AMT exemption amount.

While many alternative scenarios could be developed incorporating different combinations of possible policy choices and economic assumptions, these two scenarios can be viewed as possible "bookends" to a range of possible outcomes.

Budget flexibility—the ability to respond to unforeseen events—is key to being able to successfully deal with the nation's and the world's uncertainties. By their very nature, mandatory spending programs—entitlement programs like Medicare and Social Security—limit budget flexibility.[1] They are governed by eligibility rules and benefit formulas, which means that funds are spent as required to provide benefits to those who are eligible and wish to participate. As figure 3 shows, mandatory spending has grown as a share of the total federal budget. For example, mandatory spending on programs (i.e., mandatory spending excluding interest) has grown from 27 percent in 1965—the year Medicare was created—to 42 percent in 1985 to 53 percent last year. (Total spending not subject to annual appropriations—mandatory spending and net interest—has grown from 34 percent in 1965 to 61 percent last year.) Under both the CBO baseline estimates and the President's Budget, this spending would grow even further.

[1]Similarly, tax expenditures—subsidies provided through the tax system—may limit flexibility on the revenue side; there is a trade-off between tax rates and revenue lost through tax expenditures. In order to raise a given amount of federal revenue, tax rates must be raised higher than they otherwise need to be due to revenue losses from tax expenditures.

Figure 3: Federal Spending for Mandatory and Discretionary Programs

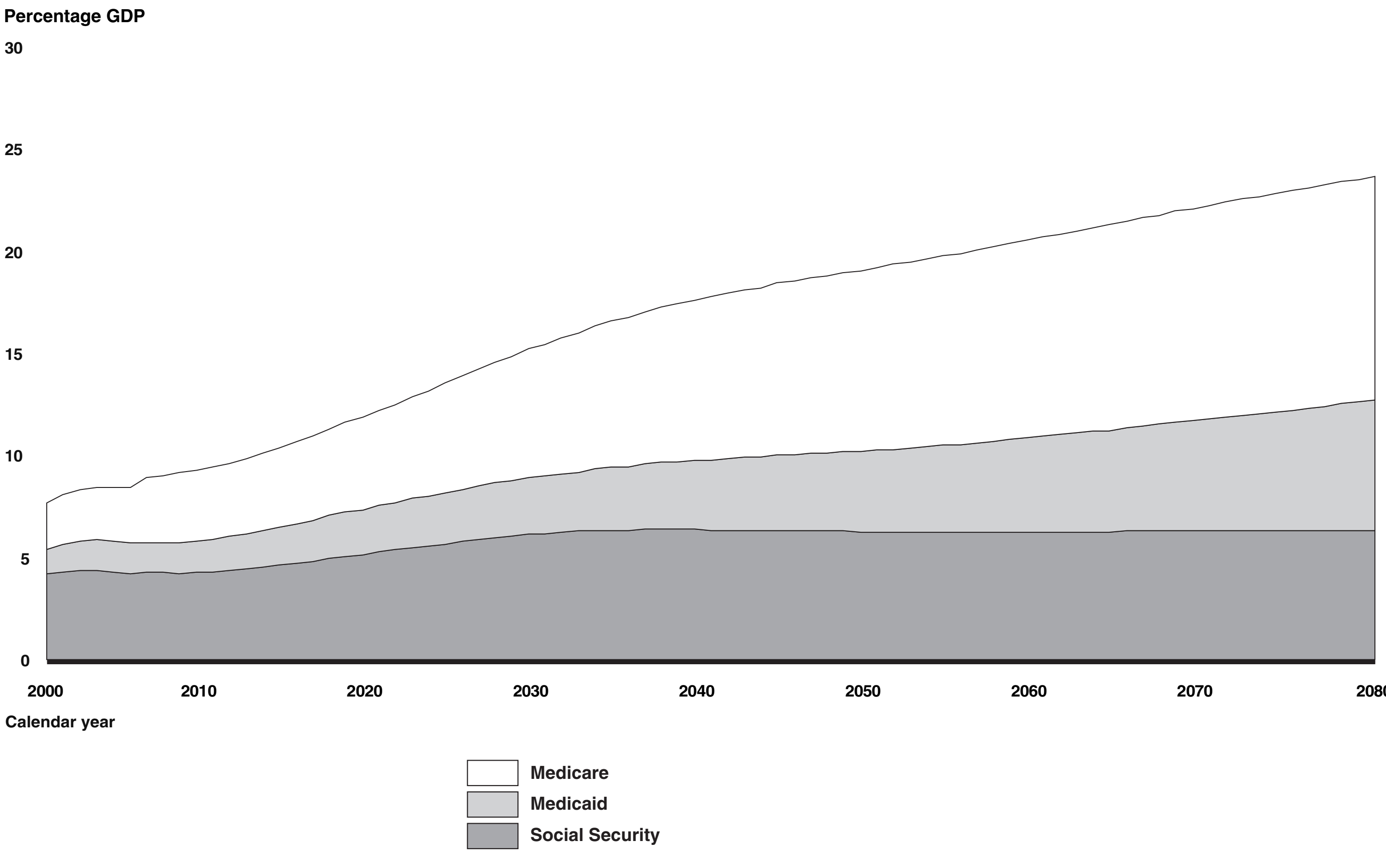


Sources: The Office of Management and Budget and CBO.

Figure 3 illustrates that while it is important to control discretionary spending, the real challenge is mandatory spending. Accordingly, substantive reform of the major health programs and Social Security is critical to recapturing our future fiscal flexibility.

The aging population and rising health care costs will have significant implications not only for the budget but also our economy and competitive posture. Figure 4 shows the total future draw on the economy represented by Social Security, Medicare, and Medicaid. Under the 2006 Trustees' intermediate estimates and CBO's 2005 midrange and long-term Medicaid estimates, spending for these entitlement programs combined will grow to over 15 percent of GDP in 2030 from today's 8.9 percent. It is clear that taken together, Social Security, Medicare, and Medicaid represent an unsustainable burden on the federal budget and future generations. Ultimately, the nation will have to decide what level of federal benefits and spending it wants and how it will pay for these benefits.

Figure 4: Social Security, Medicare, and Medicaid Spending as a Percentage of GDP



Sources: GAO analysis based on data from the Office of the Chief Actuary, Social Security Administration; Office of the Actuary, Centers for Medicare and Medicaid Services; and the Congressional Budget Office.

Note: Social Security and Medicare projections are based on the intermediate assumptions of the 2006 Trustees' reports. Medicaid projections are based on CBO's January 2006 short-term Medicaid estimates and CBO's December 2005 long-term Medicaid projections under midrange assumptions.

While Social Security, Medicare, and Medicaid are the major drivers of the long-term spending outlook in the aggregate, they are not the only promises the federal government has made for the future.[2] The federal government undertakes a wide range of responsibilities, programs, and activities that may either obligate the government to future spending or create an expectation for such spending. Specific fiscal exposures vary widely as to source, likelihood of occurrence, magnitude, and strength of the government's legal obligations. If we think of fiscal exposures as extending from explicit liabilities (like military and civilian pensions) to specific contingencies (like pension, flood, and other federal insurance programs) to the commitments implicit in current policy and/or public expectations (like the gap between the present value of future promised and funded Social Security and Medicare benefits), the federal government's fiscal exposures totaled more than $46 trillion at the end of 2005, up from about $20 trillion in 2000. This translates into a burden of about $156,000 per American, or approximately $375,000 per full-time worker—more than double what it was in 2000. These amounts are growing every second of every minute of every day due to continuing deficits, known demographic trends and compounding interest costs.

What Can Be Done?

Many are beginning to realize that difficult choices must be made, and soon. A crucial first step in acting to improve our long-term fiscal outlook will be to face facts and identify the many significant commitments already facing the federal government. If citizens and government officials come to better understand our nation's various fiscal exposures and their implications for the future, they are more likely to insist on prudent policy choices today and sensible levels of fiscal risk in the future.

How do we get started? Today you are focusing on budget process improvements. That's a good start. While the process itself cannot solve the problem, it is important. It can help policymakers make tough but necessary choices today rather than defer them until tomorrow. Restoration of meaningful budget controls—budgetary caps and a pay-as-you-go (PAYGO) rule on both the tax and spending side of the ledger—is a start toward requiring that necessary trade-offs be made rather than delayed. Although the restoration of caps and a PAYGO rule are important, they are not enough. Among the characteristics a budget process needs for that to happen are

[2] While interest is a large and growing share of the budget, it does not directly drive the fiscal outlook in that interest is the result of other decisions affecting spending and tax policy.

- increased transparency and better incentives, signals, triggers and default mechanisms to address the fiscal exposures/commitments the federal government has already made and
- better transparency for and controls over the long-term fiscal exposures/commitments that the federal government is considering.

Let me elaborate.

Better Incentives and Signals

There is broad consensus among observers and analysts who focus on the budget that the controls contained in the expired Budget Enforcement Act constrained spending for much of the 1990s. In fact, annual discretionary budget authority actually declined in real terms during the mid-1990s. I endorse the restoration of realistic discretionary caps and PAYGO discipline applied to both mandatory spending and revenue legislation. But the caps can only work if they are realistic; while caps may be seen as tighter than some would like, they are not likely to bind if they are seen as totally unreasonable given current conditions. While PAYGO discipline constrained the creation or legislative expansion of mandatory spending and tax cuts, it accepted the existing provisions of law as given. Looking ahead, the budget process will need to go beyond limiting expansions. Cost increases in existing mandatory programs cannot be ignored and the base of existing spending and tax programs must be reviewed and re-engineered to address our long-range fiscal gap.

Specifically, as I have said before, I would like to see a process that forces examination of “the base” of the federal government—for major entitlements, for other mandatory spending, and for so-called “discretionary” spending (those activities funded through the appropriations process).

Reexamining “the base” is something that should be done periodically regardless of fiscal condition—all of us have a stewardship obligation over taxpayer funds. As I have said before, we have programs still in existence today that were designed 20 or more years ago—and the world has changed. I would suggest that as constraints on discretionary spending continue to tighten, the need to reexamine existing programs and activities becomes greater. One of the questions this Congress is grappling with—earmarks—can be seen in this context. Whatever the agreed-upon level for discretionary spending, the allocation within that total will be important. How should that allocation be determined? What sort of rules will you want to impose on both the allocation across major areas (defense, education, etc.) and within those areas? By definition, earmarks specify how some funds will be used. How will the process manage them? After all, not all earmarks are bad but many are highly questionable. It is not surprising that in times of tight resources, the tension between earmarks and flexibility will likely rise.

Although mandatory spending is not amenable to caps, such spending need not—and should not—be permitted to be on autopilot and grow to an unlimited extent. Since the spending for any given entitlement or other mandatory program is a function of the interaction between eligibility rules and the benefit formula—either or both of which may incorporate exogenous factors such as economic downturns—the way to change the path of spending for any of these programs is to change their rules or formulas. We recently issued a report on "triggers"—some measure that when reached or exceeded, would prompt a response connected to that program.[3] By identifying significant increases in the spending path of a mandatory program relatively early and acting to constrain it, Congress may avert much larger and potentially disruptive financial challenges and program changes in the future.

A trigger is a measure and a signal mechanism—like an alarm clock. It could trigger a "soft" response—one that calls attention to the growth rate of the level of spending and prompts special consideration when the threshold or target is breached. The Medicare program already contains a "soft" response trigger: the President is required to submit a proposal for action to Congress if the Medicare Trustees determine in 2 consecutive years that the general revenue share of Medicare spending is projected to exceed 45 percent during a 7-fiscal-year period.[4] The most recent Trustees' report to Congress for the first time found that the general revenue share of financing is projected to exceed that threshold in 2012.[5] Thus, if next

[3]GAO, *Mandatory Spending: Using Budget Triggers to Constrain Growth*, GAO-06-276 (Washington, D.C.: Jan. 31, 2006).

[4]For the purpose of the Medicare trigger, general revenue Medicare funding is defined as the difference between Medicare program outlays and dedicated Medicare financing sources. Dedicated Medicare financing sources are defined as Hospital Insurance (HI) payroll taxes; the HI share of income taxes on Social Security benefits; state transfers for Part D prescription drug benefits; premiums paid under Parts A, B, and D; and any gifts received by the trust funds.

[5]The Boards of Trustees, Federal Hospital Insurance and Federal Supplementary Insurance Trust Funds, *The 2006 Annual Report of the Boards of Trustees of the Federal Hospital Insurance and Federal Supplementary Medical Insurance Trust Funds* (Washington, D.C.: May 2006), 27.

year's report again concludes that it will exceed the threshold during the 7-fiscal-year period, the trigger will have been tripped and the President will be required to submit his proposal for action.

Soft responses can help in alerting decision makers of potential problems, but they do not ensure that action to decrease spending or increase revenue is taken. In contrast, a trigger could lead to "hard" responses under which a predetermined, program-specific action would take place, such as changes in eligibility criteria and benefit formulas, automatic revenue increases, or automatic spending cuts. With hard responses, spending is automatically constrained, revenue is automatically increased, or both, unless Congress takes action to override—the default is the constraining action. For example, this year the President's Budget proposes to change the Medicare trigger from solely "soft" to providing a "hard" (automatic) response if Congress fails to enact the President's proposal.[6]

Any discussion to create triggered responses and their design must recognize that unlike controls on discretionary spending, there is some tension between the idea of triggers and the nature of entitlement and other mandatory spending programs. These programs—as with tax provisions such as tax expenditures—were designed to provide benefits based on eligibility formulas or actions as opposed to an annual decision regarding spending. This tension makes it more challenging to constrain costs and to design both triggers and appropriate responses. At the same time, with less than 40 percent of the budget under the control of the annual appropriations process, considering ways to increase transparency, oversight, and control of mandatory programs must be part of addressing the nation's long-term fiscal challenges.

[6]The response would include a sequester if Congress did not act on the President's proposal. The proposed sequester would result in a four-tenths of a percent reduction in all payments to providers beginning in the year the threshold is exceeded. Each year the shortfall continues to occur the reduction would grow by an additional four-tenths of a percent. We have not yet analyzed how this would work.

Increased Transparency and Disclosure of Long-term Costs

Besides triggers, transparency of existing commitments would be improved by requiring the Office of Management and Budget (OMB) to report annually on fiscal exposures—the more than $46 trillion figure[7] I mentioned earlier—including a concise list, description, and cost estimates, where possible. OMB should also ensure that agencies focus on improving cost estimates for fiscal exposures. This should complement and support continued and improved reporting of long-range projections and analysis of the budget as a whole to assess fiscal sustainability and flexibility.

Others have embraced this idea for better reporting of fiscal exposures. Senator Voinovich has proposed that the President report each January on the fiscal exposures of the federal government and their implications for the long-term financial health and Senator Lieberman introduced legislation to require better information on liabilities and commitments. This year Representatives Cooper, Chocola, and Kirk have sponsored legislation also aimed at improving the attention paid to our growing federal commitments. And, in his last few budgets the President has proposed that reports be required for any proposals that would worsen the unfunded obligations of major entitlement programs. These proposals provide a good starting point for discussion. Reporting is a critical first step—but, as I noted above, it must cover not only new proposals but also existing commitments, and it should be accompanied by some incentives and controls. We need both better information on existing commitments and promises and information on the long-term costs of any new significant proposed spending increases or tax cut. Ten-year budget projections have been available to decision makers for many years. We must build on that regime but also incorporate longer-term estimates of net present value (NPV) costs for major spending and tax commitments comprising longer-term exposures for the federal budget beyond the 10-year window. Current budget reporting does not always fully capture or require explicit consideration of some fiscal exposures. For example, when Medicare Part D was being debated, much of the debate focused on the 10-year cost estimate—not on the long-term commitment that was obviously much greater. While the budget was not designed to and does not provide complete information on long-term cost implications stemming from some of the government's commitments when they are made, progress can and should be made on this front. For example, we should require NPV estimates for major proposals—whether on the tax

[7] This figure is as of the end of 2005—it will be higher at the end of this year.

side or the spending side—whose costs escalate outside the 10-year window. And these estimates should be disclosed and debated before the proposal is voted on.

Regarding tax provisions, it is important to recognize that tax policies and programs financing the federal budget can be reviewed not only with an eye toward the overall level of revenue provided to fund federal operations and commitments, but also the mix of taxes and the extent to which the tax code is used to promote overall economic growth and broad-based societal objectives. In practice, some tax expenditures are very similar to mandatory spending programs even though they are not subject to the appropriations process or selected budget control mechanisms. Tax expenditures represent a significant commitment and are not typically subject to review or reexamination. This should not be allowed to continue nor should they continue to be largely in the dark and on autopilot.

Finally, the growing use of emergency supplemental appropriations raises concerns that an increasing portion of federal spending is exempt from the discipline and trade-offs of the regular budget process.[8] Some have expressed concern that these "emergency" supplementals are not always used just to meet the needs of unforeseen emergencies but also include funding for activities that could be covered in regular appropriation acts. According to a recent Congressional Research Service report, after the expiration of discretionary limits and PAYGO requirements at the end of fiscal year 2002, supplemental appropriations net of rescissions increased the budget deficit by almost 25 percent per year.[9] On average, the use of supplemental appropriations for all purposes has grown almost 60 percent each year, increasing from about $17 billion in fiscal year 2000 to about $160 billion in fiscal year 2005. Constraining emergency appropriations to those which are necessary (not merely useful or beneficial), sudden, urgent, unforeseen, and not permanent has been proposed in the past. The issue of what constitutes an emergency needs to be resolved and discipline exerted so that all appropriations for activities that are not true emergencies are considered during regular budget deliberations.

[8] While most budget enforcement mechanisms expired in fiscal year 2002, Congress generally includes overall limits on discretionary spending and PAYGO points of order in its budget resolution to manage its internal budget process.

[9] Congressional Research Service, *Supplemental Appropriations: Trends and Budgetary Impacts Since 1981* (Washington, D.C.: Nov. 2, 2005).

Concluding Observations

We cannot grow our way out of our long-term fiscal challenge. We have to make tough choices and the sooner the better. A multi-pronged approach is necessary: (1) revise existing budget processes and financial reporting requirements, (2) restructure existing entitlement programs, (3) reexamine the base of discretionary and other spending, and (4) review and revise tax policy and enforcement programs. Everything must be on the table. Fundamentally, we need to undertake a top-to-bottom review of government activities to ensure their relevance and fit for the 21st century and their relative priority. Our report entitled *21st Century Challenges: Reexamining the Base of the Federal Government*[10] presents illustrative questions for policymakers to consider as they carry out their responsibilities. These questions look across major areas of the budget and federal operations, including discretionary and mandatory spending and tax policies and programs. We hope that this report, among other things, will be used by various congressional committees as they consider which areas of government need particular attention and reconsideration.

The understanding and support of the American people will be critical in providing a foundation for action. The fiscal risks I have discussed, however, are a long-term problem whose full impact will not likely be felt for some time. At the same time, they are very real and time is currently working against us. The difficult but necessary choices we face will be facilitated if the public has the facts and comes to support serious and sustained action to address the nation's fiscal challenges. That is why if an Entitlement and Tax Reform Commission is created to develop proposals to tackle our long-term fiscal imbalance, its charter may have to include educating the public as to the nature of the problem and the realistic solutions. While public education may be part of a Commission's charge, we cannot wait for it to begin. As you may know, the Concord Coalition is leading a public education effort on this issue and I have been a regular participant. Although along with Concord the core group is the Heritage Foundation, the Brookings Institution, and the Committee for Economic Development, others are also actively supporting and participating in the effort—the state treasurers, auditors and comptrollers, the American Institute of Certified Public Accountants, AARP, and the National Academy of Public Administration. I am pleased to take part in this national education and outreach effort to help the public understand the nature and magnitude of the long-term financial challenge facing this

[10]GAO, *21st Century Challenges: Reexamining the Base of the Federal Government*, GAO-05-325SP (Washington, D.C.: February 2005).

nation. This is important because while process reform can structure choices and help, broad understanding of the problem is also essential. After all, from a practical standpoint, the public needs to understand the nature and extent of our fiscal challenge before their elected representatives are likely to act.

Thank you, Mr. Chairman. This concludes my prepared remarks. I would be happy to answer any questions you may have.

Contacts and Acknowledgments

Contact points for our Offices of Congressional Relations and Public Affairs may be found on the last page of this testimony. For further information on this testimony, please contact Susan J. Irving at (202) 512-9142 or irvings@gao.gov. Individuals making key contributions to this testimony include Christine Bonham, Assistant Director; Carlos Diz, Assistant General Counsel; and Melissa Wolf, Senior Analyst.

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