THE PRESIDENT'S FY2003 BUDGET

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Mr. Chairman, Senator Domenici, and members of the Committee, thank you for inviting me to appear today to discuss the President's FY2003 budget. I am here representing The Concord Coalition, a bipartisan organization dedicated to strengthening the nation's long-term economic prospects through prudent fiscal policy. Concord's co-chairs are former Senators, Warren Rudman (R-NH) and Bob Kerrey (D-NE).

My testimony today will review the President's budget in light of the many new security and economic challenges presented over the past year and the familiar long-term fiscal challenges that loom just beyond the current 10-year budget window as the huge baby boom generation enters its retirement years. I will also discuss five policy guidelines recommended by The Concord Coalition to help ensure that the long-term fiscal health of our nation is not sacrificed to short-term concerns.

The President's Budget Message identifies five overall priorities: protecting the homeland, winning the war on terrorism abroad, returning to economic vitality, governing with accountability and funding other initiatives while moderating the growth in spending. These are worthy objectives. But to this list, The Concord Coalition would add a sixth critical objective: addressing the unsustainable long-term fiscal challenge of our aging population. With the first of the boomers qualifying for both Social Security and Medicare within the coming decade, The Concord Coalition strongly believes that the long-term challenge is, by itself, a short-term concern.

I. The Short-term Context: A Dramatic Change

President Bush's FY2003 budget is presented in a short-term context that is far different from presidential budgets in recent years:

- We have embarked upon a worthy, but costly, effort to defeat the worldwide terrorist network that launched a deadly attack on our nation last September.

- We have come to recognize the need to substantially increase spending on homeland security.

- We are in an economic recession for the first time in 10 years.

- We have enacted a series of escalating tax reductions over the next decade that will reduce revenues and increase debt service costs by an estimated $1.7 trillion.

- As a result of the above factors, the huge surpluses, which were projected just a year ago, have been diminished by about 70 percent

- The non-Social Security surplus has vanished, and for the first time in many years there is no clear, agreed upon fiscal policy goal to constrain spending increases and tax cuts.

- The budgetary enforcement mechanisms, caps on discretionary spending and the pay-as-you-go requirement for tax cuts and entitlement spending, no longer apply.

The President's budget, like the January 2002 report of the Congressional Budget Office (CBO), clearly demonstrates the rapid decline in the government's fiscal position over the past year. Deficit spending will return this year for the first time since 1997, and continue through 2004 assuming enactment of the President's policies.

The numbers demonstrate a startling turnaround:

- Last year the President's budget projected that even with enactment of his recommended tax cut and other policy priorities there would be a 10-year budget surplus of $3.4 trillion — enough to eliminate the debt held by the public. This year's budget, assuming enactment of the President's policies, projects a surplus of just $665 billion over the same 10-year timeframe.

- Last year the President's budget showed a 10-year non-Social Security surplus of $841 billion. This year's 10-year projection is for a non-Social Security deficit of about $1.6 trillion over the same period (FY2002-2011).

- In last year's budget, non-Social Security surpluses were projected for every year. In the current budget, the opposite is true. There is no year in which a non-Social Security surplus is projected.

The policy initiatives in the President's budget respond to the challenges of the new environment. As the President notes, the government "will have new bills to pay." These new costs, plus the proposed new tax cuts in the President's budget, are expected to produce deficits for the next couple of years. If so, they would be the first federal budget deficits since 1997.

The Concord Coalition is as strong an advocate of balanced budgets as there is. We recognize, however, that there are times when a deficit is an appropriate response to pressing national needs. This may well be true in fiscal year 2002 and perhaps 2003. But the temporary need to deficit spend should not be taken as an excuse to abandon fiscal discipline, which is still needed to prepare for the long-term challenges. We should not dig such a large hole now that it will be impossible to climb back out of it before the baby boomers begin to leave the workforce and qualify for Social Security and Medicare. That is not a "new bill," but one we are already on the hook for.

With that observation, let me turn to some of the policy prescriptions in the President's budget. These will be general observations given the short time that has passed since the budget documents were published.

Defense increase

The President's proposed increase in defense spending represents a substantial increase over the budgets of recent years. This is not surprising given that we are now engaged in an ambitious and worthy effort to defeat worldwide terrorism. Simply put, the peace dividend, which helped to control total discretionary spending in the 1990s, is over.

Large as the defense increase may appear it is relevant to note that according to OMB tables, defense spending as a percentage of GDP would essentially remain constant at about 3.4 percent over the next five years. As a point of comparison, defense spending was at 5.4 percent of GDP in 1991 when we were preparing for and fighting the Persian Gulf War. If the current war effort expands, the level of spending projected in the President's budget may well prove to be a down payment on even larger increases. In a time of such uncertainty, this possibility cannot be lightly ignored.

Non-defense discretionary spending

This category includes homeland security, which deservedly gets a big boost in the President's budget. However, non-defense discretionary spending is assumed to grow at an average annual rate that is unrealistically low. After an initial increase of 6 percent in 2003 non-defense discretionary spending is assumed to grow at 3.2 percent in 2004 and by just 1.5 percent on average from 2004 to 2007. While the need to spend more on homeland security and defense should, as the President says, prompt a careful review of all other budgetary priorities, it is not prudent fiscal planning to assume large savings in the out years based on an assumption that future lawmakers will be able to achieve a level of fiscal restrain not achieved in the recent past. Baseline assumptions are highly dependent on the presumed growth of discretionary spending. Using an assumption that is too low will produce presumed budgetary resources that will never materialize. For example, if total discretionary spending grows at roughly the rate of GDP growth instead of the rate assumed in the President's budget it makes a difference of about $1 trillion over 10 years.

Economic stimulus

The President's budget leaves room for an economic stimulus package of $77 billion in FY2002, $57 billion in FY2003, and $141 billion over the new five-year budget window (FY2003 through FY2007.)

What leaps out from the OMB documents is that without the economic stimulus proposal the budget would be very close to balance in FY2003 and would be in overall surplus again by FY2004. This raises a very real question as to whether you should postpone the idea of a major stimulus bill and thus avoid larger deficits, or go ahead with a stimulus bill on the assumption that the economy needs it to recover. In recent months the economy has shown promising signs of recovery. While there is reason to remain vigilant at this point there appears to be diminishing need for an economic stimulus bill designed to "fix" an economy that seems to be fixing itself.

If you do choose to go ahead with an economic stimulus bill, great care should be taken to front-load its cost and minimize the long-term budgetary drain. It is important to recognize that a great deal of fiscal stimulus is already in the pipeline. The tax cut enacted in June and the new spending approved since September 11 will provide stimulus along with the "automatic stabilizers" in the budget. Moreover, this fiscal stimulus comes on top of the substantial monetary stimulus provided by the Federal Reserve Board since last January.

New tax cuts

The President's budget requests another $600 billion in new tax cuts over the next decade, including the stimulus package. The biggest initiative in this regard is his suggestion that the "sunset" provision of last year's tax bill be removed. This would make permanent all of the provisions scheduled to expire at the end of 2010.

Obviously, the sunset provision should not be taken literally. The very absurdity of the presumption written into last year's bill that all rates and other provisions of the tax code would revert to their 2001 status on midnight December 31, 2010, guarantees that it will never happen. The real significance of the provision is that it allowed lawmakers to temporarily avoid making hard choices about which tax cuts would have to be eliminated from the bill to fit within the carefully negotiated budget resolution limit of $1.35 trillion over 11 years.

But it also serves a useful purpose — it is the ultimate "trigger." At some point the cliff effect of last year's tax cut will have to be addressed. As events unfold over the next year or two, and we see whether deficits are as short and modest as the President hopes, it may make sense to adjust the tax cuts accordingly — perhaps extending some of them permanently while limiting or delaying the effect of others. For that reason, The Concord Coalition does not, at this time, believe it would be a good idea to remove the sunset from the tax cuts. However, if Congress chooses to maintain the sunset provisions it should ensure that new policies be assessed against a baseline that accounts for the tax cut as if the sunset provisions didn't exist. The fiction that the sunsets will take place as planned should not be indulged to justify new initiatives.

Regarding tax cuts, it should also be noted that the President's budget assumes that certain provisions of the tax code, referred to as "extenders," will not be renewed for the full 10-year window. This tends to overstate likely revenues. According to CBO extending all of the extenders for 10 years would cost $166 billion.

Moreover, there are some mini-sunsets in last year's tax bill that also artificially depress its cost estimate. For example, the Alternative Minimum Tax (AMT) provision, which costs $14 billion from 2001-2005, terminates at the end of 2004. A new above-the-line deduction for higher education expenses is assumed to sunset after 2005. It is no more likely that these mini-sunsets will take effect than it is that the overall sunset will occur in 2010. And yet it does not appear that the President's budget includes the cost of extending theses items, which according to the CBO would cost $194 billion over 10 years.

For purposes of comparison, the cost of extending all expiring tax provisions is estimated by CBO to be $735 billion, not including interest, over the next 10 years. The cost of extending expiring tax provisions in the President's budget is about $400 billion.

With deficits back, and a large tax cut having been enacted last year based on surplus projections that were overly optimistic, The Concord Coalition strongly believes that this is not the year to engage in another round of major tax cuts. It's time to get back to the pay-as-you-go principle that was so useful in constraining the growth of deficits before escalating surplus projections eroded that discipline.

The Social Security fiscal firewall has come down

Perhaps the most dramatic consequence of the deteriorating budget outlook is that we're back to spending the Social Security surplus. What was said to be a fiscal and political 'firewall' has come down due to a combination of factors. While temporarily using the Social Security surplus in response to both a recession and a military conflict is not by itself a major problem, it will quickly become a major problem if politicians once again get comfortable with the idea. If the past is any guide it will be all too easy for that to happen.

For the first time in several years there is no clear, agreed upon, fiscal policy goal to prevent things from getting out of hand. The budget caps and pay-as-you-go rule for tax cuts and entitlement spending, last renewed in the 1997 Balanced Budget Act, have expired. The need to pry open the so-called Social Security lockbox in response to the terrible events of September 11 has opened up a Pandora's box of interest group demands that had been held in check by the fear of causing a "raid" on the trust funds.

As a result, open-ended budgeting may be back. Rather than setting priorities and making hard choices, it will be very tempting to fall back on an old habit — cut taxes, increase spending, eat up the Social Security surplus, and run up the debt.

It's a dangerous path to follow when looming just beyond the artificial 10-year budget window are the huge unfunded retirement and health care costs of the coming senior boom. It will take over $8 trillion in today's dollars just to cover the cash shortfalls in Social Security and Medicare Part A between 2016 and 2040. Things only get worse from there. Sufficient resources have not been set aside to finance these costs, and the re-emergence of budget deficits will make it more difficult to do so.

On September 10, 2001 a strong bipartisan consensus existed that the goal of fiscal policy should be to run a budget surplus equal to at least the size of the Social Security surplus. The reason for doing so was equally clear — to use the Social Security surplus as a means of increasing national savings in anticipation of the program's long-term unfunded obligations.

It is not surprising, therefore, that the most contentious fiscal policy issue in Washington before September 11 was whether the budget would dip into the Social Security "lockbox" in 2002. The prospect of spending the entire Social Security surplus — in other words, running a unified budget deficit — was not even contemplated. By the end of the day on September 11 all that had changed. The horrific acts of terrorism, and their impact on an already weakened economy, made it clear that short-term fiscal policy would have to be loosened.

The President's budget appropriately recognizes this new reality. But it also demonstrates that we can't have it all. We can't have major new spending on security and defense, a prescription drug benefit, a big farm bill, and new tax cuts to go along with the ones already enacted, and still expect to do all of this without touching the Social Security surplus — not just for one or two years, but permanently.

Even with non-defense discretionary spending constrained to the level recommended by the President, his budget does not produce a non-Social Security surplus in any year over the coming decade. Unless the goal of not using the Social Security surplus to fund other operations of government is to be totally abandoned, spending will have to be lower than the President's request or revenues will have to be higher.

All of this argues for great caution in making new commitments. Hard choices must be made. We cannot have a big government agenda at a limited government price. We cannot have guns and butter and tax cuts. We are a rich enough nation to be able to pay for the level of government we want without asking our children to pay the bills later or to spend the money we pretend to save by crediting it to a government trust fund. And while running a short-term deficit in response to an emergency is entirely appropriate, the decision to run sustained deficits is simply a decision to have future generations pick up the bills we leave behind. It is neither fiscally responsible nor generationally responsible.

II. Beyond the 10-year budget window

Today's major budgetary decisions must not be viewed through a short-term lens. Fiscal discipline is the key to providing for the unmet needs of the future. Somehow, sufficient resources must be set aside to meet the huge retirement and health care costs associated with the coming "senior boom." The time to address the long-term challenge is now, while the demographics are favorable and changes can be phased in.

The current trend in entitlement spending remains unsustainable.

- All told, CBO projects that these three programs will nearly double as a percent of GDP by 2030, from about 7 percent to almost 15 percent.

- The three biggest benefit programs for seniors—Social Security, Medicare, and Medicaid—along with net interest consume all federal revenues by 2030 under the August 2001 GAO "eliminate unified surpluses simulation." This may look at little worse when GAO updates the numbers at the end of this month.

- According to the 2001 Trustees' report, Social Security outlays will exceed earmarked tax revenues by a widening margin starting in 2016. By 2025, Social Security will face an *annual* cash shortfall of over $400 billion. By 2038, the last year the trust funds are technically solvent, the *annual* shortfall will be over $1 trillion.

- To cover these deficits, the trust funds will have to redeem their IOUs from the Treasury. And to come up with the cash, Congress will have to hike taxes, cut other spending, consume surpluses if they exist, or borrow from the public—exactly as if the trust funds never existed.

- This year, all Social Security benefits could be paid for with a tax rate of 10.5 percent of payroll. By 2040, the Trustees project that they will cost 17.7 percent of payroll. Add in Medicare Part A and the projected burden rises to 24 percent of each worker's taxable paycheck.

- The recent prosperity has not lowered Medicare's long-term cost rate. Nor has it altered the demographic, social, and technological forces driving up the future cost of health care. Far from it: Following the recommendation of an official technical panel, the Trustees this year increased their projection of Medicare's long-term cost rate by a staggering 60 percent.

This year's dynamic of increased spending and cutting taxes creates the threat of squandering the Social Security and Medicare surpluses that should be used to increase savings. Savings from deficit and debt reduction have helped provide the capital to increase the productivity of American workers — a major factor in the record growth of the last 10 years. Further gains in productivity will become especially urgent when the retirement of the huge baby boom generation virtually halts the growth in the size of the U.S. work force.

The challenges of an aging society include fiscal pressures that cannot be remedied simply by assuming that renewed economic growth, following a brief period of deficits, will bail us out. The inevitable growth in spending on age-related entitlement programs will put pressure on discretionary spending, revenues, and public debt. Tough choices will need to be made to avoid burgeoning public debt in the future. Spending the Social Security surplus allows today's economy to benefit from the increased consumption, but it leaves tomorrow's economy burdened with the huge stack of unfunded IOUs building up in the Social Security trust fund. By contrast, saving the Social Security surplus will make it easier for future generations to afford the costs of the coming "senior boom."

But here is a political caveat. There is a danger that the goal of saving the Social Security surplus will be confused with Social Security reform. The two things are very different. While it is often couched in terms of "saving" Social Security, the goal is more a matter of wise fiscal and economic policy, which will help prepare for the retirement expenses of the baby boom generation. But it will not reduce Social Security's looming cash shortfall. Regardless of what is done with the Social Security surplus, the program's trust funds will be credited with the same amount of IOUs, and taxpayers will have to begin redeeming those IOUs in about 2016. For purposes of Social Security reform, the key issue is how future taxpayers will afford the program's huge unfunded obligations including, but not limited to, the IOUs now building up in the trust fund. Even if the entire projected trust fund surplus of $3.8 trillion in 1999 dollars is saved, it will not come close to offsetting Social Security's projected deficits of $22.2 trillion over the next 75 years.

III. The Concord Coalition's recommended guidelines

The new security and economic environment after September 11 requires a careful examination of fiscal policy goals. If saving the Social Security surplus (i.e., the "lockbox") is not a feasible goal in the short-term, should it be abandoned altogether as a goal? If there is a budget deficit in 2002, will it be a short-term development caused by the events of September 11 and a slow economy? Or, will it signal the beginning of a new era of deficits for as far as the eye can see?

The answers to these questions will be determined, in large measure, by whether Congress and the President resist the temptation to abandon long-term discipline as they respond to legitimate short-term needs. In this time of crisis, attention has been understandably diverted from the need for long-term fiscal discipline, which imposed a sense of restraint prior to September 11.

But long-term discipline is still needed to prepare for the looming fiscal challenges posed by our aging population. The unfunded obligations of Social Security and Medicare are still unfunded. If anything, the events of September 11 reinforce the need for long-term discipline because it's clear that the government is going to have to spend more in the short-term on homeland security, disaster relief and the war on terrorism.

Moreover, even as Congress and the President debate fiscal stimulus measures to enhance short-term consumption, they must not lose sight of the need to enhance long-term savings. Responsible fiscal policy always involves trade-offs.

With the FY2003 budget process about to get underway, The Concord Coalition recommends five fiscal policy guidelines to help ensure that the long-term fiscal health of our nation is not sacrificed to short-term concerns:

1. Reaffirm the fiscally responsible goal of balancing the budget without using the Social Security surplus. It may take a few years to achieve, but unless the goal is set there is a clear danger of drifting back into an era of sustained deficits. We cannot afford taking such a risk in advance of the huge fiscal challenges that loom just beyond the 10-year budget window.

2. Recognize that the post-September 11 environment requires a careful examination of budgetary priorities. Policymakers can no longer delude themselves that large perpetual budget surpluses will allow them to avoid making hard choices — not just for the long-term, but now. Everything should be on the table.

3. If it is decided that an economic stimulus bill is needed, it should be carefully designed to have its maximum effect in the very near future, minimize costs in later years, and provide the most bang for the buck. Back loaded options, whether tax cuts or spending increases, are not the right method of providing short-term economic stimulus.

4. Establish a new budgetary enforcement framework to replace the expiring provisions of the 1997 Balanced Budget Act. The prospect of renewed budget deficits makes this all the more important. A realistic set of spending caps and renewal of some type of pay-as-you-go rule for mandatory spending and tax provisions would help achieve the goal of returning to non-Social Security surpluses.

5. Don't put Social Security reform on the back burner. There is no good reason why this issue should be kept off the 2002 legislative agenda. The demographic and fiscal challenges facing Social Security in the years ahead are well known. Failure to change current law amounts to an endorsement of a deep benefit cut for today's 25 year olds, or a steep payroll tax increase. It is understandable that political leaders will disagree on the details of any reform plan. But what's needed now is rejection of the Do Nothing Plan.