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BUDGET PROCESS

Enforcing Fiscal Choices

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Chairman Baucus, Senator Hatch, and Members of the Committee,

It is a pleasure to be here today as you consider the role and design of appropriate budget enforcement mechanisms in changing the government's fiscal path. My testimony today outlines some elements that could facilitate debate and contribute to efforts to place the government on a more sustainable long-term fiscal path.

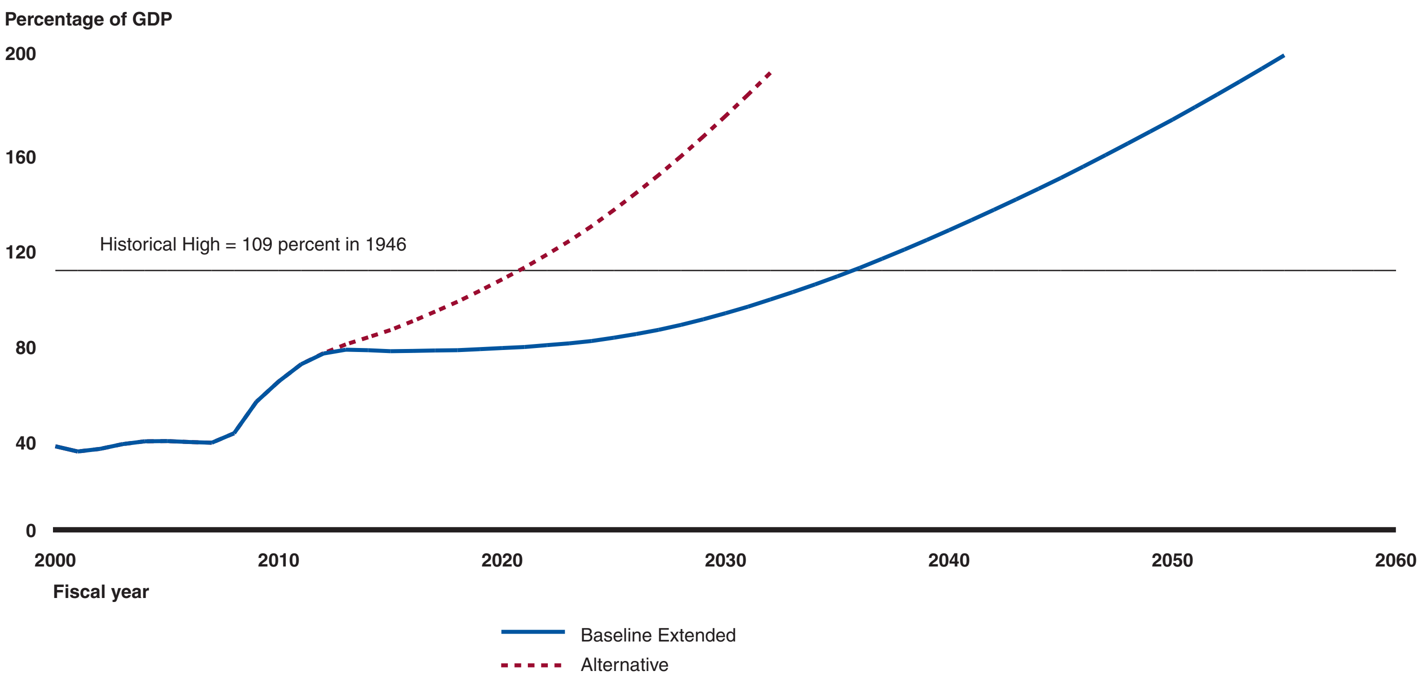
Budgeting is the process by which we as a nation resolve the large number of often conflicting objectives that citizens seek to achieve through government action. The budget determines the fiscal policy stance of the government—that is, the relationship between spending and revenues. And it is through the budget process that Congress and the President reach agreement about the areas in which the federal government will be involved and in what way.

Because these decisions are so important, we expect a great deal from our budget and budget process. We want the budget to be clear and understandable. We want the process to be simple—or at least not too complex. But at the same time we want a process that presents Congress and the American people with a framework to understand the significant choices and the information necessary to make the best-informed decisions about federal tax and spending policy. This is not easy.

We have all heard the statement "The process is not the problem; the problem is the problem," which in this case is the federal government's unsustainable fiscal path.[1] As the Committee knows, we have been raising concerns about the long-term trajectory of the budget for nearly two decades. Our first long-term simulation of the federal budget path was issued in 1992 for members of the Finance and Budget Committees. As in 1992, our latest simulations continue to show that the federal budget is structurally unbalanced and on an unsustainable path. (See fig. 1.)

[1]See GAO, *The Federal Government's Long-Term Fiscal Outlook: January 2011 Update*, GAO-11-451SP (Washington, D.C.: Mar. 18, 2011) and http://www.gao.gov/special.pubs/longterm/fed/.

Figure 1: Debt Held by the Public under Two Fiscal Policy Simulations



Source: GAO.

Note: Data are from GAO's January 2011 simulations based on the Social Security Trustees' assumptions for Social Security and the Medicare Trustees' and the Centers for Medicare & Medicaid Services Office of the Actuary's assumptions for Medicare.

Since our first simulations in 1992, we have continued to report on the nature and drivers of the long-term imbalance and on mechanisms to help address the challenge. Focusing on the long term does not mean ignoring the near term. While concerns about the strength of the economy may argue for phasing in policy changes over time, the longer action to change the government's long-term fiscal path is delayed, the greater the risk that the eventual changes will be more disruptive and more destabilizing. Starting on the path to sustainability now offers many advantages. Our increased awareness of the dangers presented by the long-term fiscal outlook leads to a focus on enforcement provisions within the budget process that can facilitate the debate and contribute to efforts to put the government on a more sustainable long-term fiscal path.

Principles for a More Transparent and Effective Budget Process

Before turning to enforcement in particular, I will discuss some broad principles of budget process since it is the framework within which enforcement mechanisms exist. No process can force choices Congress and the President are unwilling to make. Having an agreed-upon goal justifies and frames the choices that must be made. A budget process can facilitate or hamper substantive decisions, but it cannot replace them. While no process can substitute for making the difficult choices, it can help structure the debate. The budget structure can make clear information necessary for important decisions or the structure can make some information harder to find. The process can highlight trade-offs and set rules for action.

In our past work, we have identified four broad principles or criteria for a budget process that can help Congress consider the design and structure of future budget enforcement mechanisms. A process should

1. provide information about the long-term effect of decisions, both macro—linking fiscal policy to the long-term economic outlook—and micro—providing recognition of the long-term spending implications of government commitments
2. provide information and be structured to focus on important trade-offs such as the trade-off between investment and consumption spending.
3. provide information necessary to make informed trade-offs between the different policy tools of government (such as tax provisions, grants, and credit programs), and
4. be enforceable, provide for control and accountability, and be transparent, using clear, consistent definitions.

Since my comments about enforcement will be related in part to these four principles, let me touch briefly on each of them.

First, selecting the appropriate time horizon in which the budgetary impact of policy decisions should be measured is not just an abstract question for analysts. If the time horizon is too short, Congress may have insufficient information about the potential cost of a program. In addition, too short a time horizon may create incentives to artificially shift costs into the future rather than find a sustainable solution. The move from a focus on a single year to 5 and then 10-year horizons represented a major step forward. At the same time, we need to also understand the longer-term effects of policy decisions. As the first agency to do long-term simulations for the federal budget as a whole, we are well aware of the fact that the further out estimates go, the less certain are the numbers. But policymakers should be given information on the direction and order of magnitude of looming challenges. This is especially important where the short-term snapshot may be misleading. This concern has led us to propose improved recognition of the government's long-term "fiscal exposures"—which may not be explicit liabilities.[2]

Second, the structure and rules can determine the nature of the trade-offs surfaced during the budget process. Consumption may be favored over investment because the initial cost of an infrastructure project looks high in comparison to support for consumption. Distinguishing between support for current consumption and investing in economic growth in the budget would help eliminate a perceived bias against investments requiring large up-front spending. We have previously proposed establishing an investment component within the unified budget to permit a focus on federal spending on infrastructure, research and development, and human capital—spending intended to promote the nation's long-term economic growth. This proposal focuses on the allocation of spending within an agreed-upon amount. For example, we identified several options such as establishing investment targets within a framework similar to that contained in the Budget Enforcement Act of 1990. Under such an approach, and the Administration would agree on the appropriate level of investment spending within an overall target and create targets or "fire walls" to limit infringement from other activities.

The third principle focuses on the method through which the federal government provides support for any federal goal or objective. The renewed interest in overlap and duplication has highlighted the different ways in which such support is provided: direct federal provision, grants, loans or loan guarantees and tax preferences or tax incentives. These vary in design and in how effective they might be for a given mission. In addition, they vary in the timing of cash flows. The budget and budget process should provide the information necessary to permit looking across federal agencies and policy tools—which means across committee jurisdictions—to make an informed choice. Such comparisons also require that their budgetary costs be measured on a comparable basis. The Federal Credit Reform Act of 1990 addressed this issue for loans and loan guarantees; the budget now reflects the estimated size of the government's commitment, regardless of the timing of the cash flows. For federal insurance programs, however, the budget offers a misleading picture

[2] GAO, *Fiscal Exposures: Improving the Budgetary Focus on Long-Term Costs and Uncertainties*, GAO-03-213 (Washington, D.C.: Jan. 24, 2003).

about the nature and size of the government's exposure. The cash-based treatment of these programs distorts choice on several dimensions. First, at the time the insurance program is created or insurance is offered, there is no discussion of the subsidy being provided to those obtaining insurance, and second, there need not be an estimate of the likely budgetary impact over the insurance period. This means decisions about insurance programs are not made based on their likely cost to the federal government—nor is the amount of the subsidy ever recognized in the budget. Given our concerns that long-term costs of programs be understood and that programs or policies be considered on a comparable-cost basis, we recommended that the budget record the "missing premium" for insurance programs.[3]

Lastly, and perhaps of most interest given the focus of this hearing, the budget process should be enforceable, provide for control and accountability, and be transparent. These three elements are closely related and achieving one has implications for the others. Further, the way these are interpreted has implications for the design of any enforcement mechanism. By enforcement I mean not a mechanism to force a decision but rather a mechanism to enforce decisions once they are made. Accountability has at least two dimensions: accountability for the full costs of commitments that are to be made, and targeting enforcement to actions taken. It can also encompass the broader issue of taking responsibility for responding to unexpected events. For example, Congress and the President may want to consider periodically looking back and assessing the progress toward reducing the deficit. Such a process would be valuable because economic and technical factors driving direct spending program costs above anticipated levels have remained outside policymakers' control. Finally, the process should be transparent, that is, understandable to those outside the process.

I will turn now to the issue of enforcement. In considering any new enforcement mechanisms going forward, it is helpful to draw on the lessons learned from the past. Therefore, I will start with a brief history of budget enforcement mechanisms and a summary of the key lessons learned before turning to the design and implementation of budget enforcement mechanisms for today's challenges.

[3] GAO, *Budget Issues: Budgeting for Federal Insurance Programs*, GAO/T-AIMD-98-147 (Washington, D.C.: Apr. 23, 1998).

History of Budget Enforcement Mechanisms

The process created in the Congressional Budget and Impoundment Act of 1974 Act was not created to produce a specific result in terms of the deficit. Rather, it sought to assert the Congress's role in setting overall federal fiscal policy and establishing spending priorities and to impose a structure and a timetable on the budget debate. Underlying the1974 Act was the belief that Congress could become an equal player only if it—like the executive branch—could offer a single "budget statement" with an overall fiscal policy and an allocation across priorities. This was an important step.

It was not until the Balanced Budget and Emergency Deficit Control Act of 1985—commonly known as Gramm-Rudman-Hollings or GRH—that the focus of the process changed from increasing congressional control over the budget to reducing the deficit. Both the original GRH and the 1987 amendments to it sought to achieve a balanced budget by establishing annual deficit targets to be enforced by automatic across-the-board "sequesters" if legislation failed to achieve the targets. GRH sought to hold Congress responsible for the deficit regardless of what drove the deficit. If the deficit grew because of the economy or demographics—factors not directly controllable by Congress—the sequester response dictated by GRH was the same as if the deficit grew because of congressional action or inaction. If a sequester was necessary, GRH did not differentiate between those programs where Congress had made cuts and those where there had been no cuts or even some increases. Finally, the timing of the annual "snapshot" determining the deficit and the size of the sequester and the fact that progress was measured 1 year at a time created a great incentive for achieving annual targets through short-term actions such as shifting the timing of outlays.

GRH demonstrated that no process change can force agreement where one does not exist. However, the experiences gained led to the Budget Enforcement Act (BEA) of 1990.[4] This act was designed to enforce substantive agreement on the discretionary caps and pay-as-you-go (PAYGO) neutrality reached by the President and Congress. BEA sought to influence the result by limiting congressional action. Unlike GRH, BEA held Congress accountable for what it could directly control through its actions, and not for the impact of the economy or demographics, which are beyond its direct control. BEA did this by dividing spending into two parts: PAYGO and discretionary. It imposed caps on the discretionary part

[4]The major provisions of BEA expired in 2002.

that succeeded in holding down discretionary spending and through PAYGO it constrained congressional actions to create new entitlements (whether through direct spending or tax preferences) or tax cuts.

What then do I believe we have learned from GRH and BEA?

- Enforcing an agreement is more successful than forcing an agreement.
- Covering the full range of federal programs and activities—rather than exempting large portions of the budget—can strengthen the effectiveness of the controls and enforcement.
- Targeting sequestration to those areas that exceed their agreed-upon level creates better incentives than punishing all areas of the budget if only one fails to achieve its deficit reduction goal.
- Focusing on a longer time horizon can help Congress find a sustainable fiscal path rather than artificially shifting costs into the future.
- Incorporating a provision under which Congress would periodically look back at progress toward reducing the deficit can prompt action to bring the deficit path closer to the original goal.

Budget process helped once to achieve a goal that had consensus; it could work again.

Enforcement Mechanisms Moving Forward

While BEA's focus on actions offered advantages for enforcement, it did not go far enough to meet today's needs. BEA specified that Congress must appropriate only so much money each year for discretionary programs and that any legislated changes in entitlements and/or taxes during a session of Congress were to be deficit-neutral. The effect of this control on discretionary programs and on entitlements was quite different.

Spending for discretionary programs is controlled by the appropriations process. Congress provides budget authority and specifies a period of availability. Controlling legislative action is the same as controlling spending. The amount appropriated can be specified and measured against a cap.

For mandatory programs and revenues, controlling legislative actions is not the same as controlling spending or revenues. For an entitlement program, spending in any given year is the result of the interaction between the formula that governs that program and demographics or services provided. Similarly, for a tax provision, the revenue impact is not directly determined by Congress. Under BEA legislated changes in entitlements and taxes were to be deficit-neutral over multiyear periods. However, BEA did not seek to control changes in direct spending or in revenues (including tax expenditures) that resulted from other sources—whether from changes in the economy, changes in population, or changes in costs. Moving forward this is a major gap: it is the underlying structure of the budget that is driving the long-term fiscal imbalance.

BEA succeeded as far as its reach. It controlled discretionary spending and prevented legislative expansion of entitlement programs and new tax cuts unless they were offset. However, it did nothing to deal with expansions built into the design of mandatory programs and the allocation of resources within the discretionary budget. Congress enacted a return to a statutory PAYGO process in 2010.[5] As with the previous iteration, this can help prevent further deterioration of the fiscal position, but it does not deal with the existing imbalance. The problem confronting us today requires going beyond the "do no harm" or "stop digging" framework of BEA. Going forward, the budget process will need to encourage savings in all areas of the budget and contain mechanisms for automatic actions (whether spending cuts, reductions in tax expenditures, or surcharges) if agreed-upon targets are not met.

Discretionary Spending

Caps on discretionary spending—and Congress's compliance with the caps—are relatively easy to measure because discretionary spending totals flow directly from legislative actions (i.e., appropriations laws). However, there are other issues in the design of any new caps. For example, what categories should be established within or in lieu of an overall cap?[6] Categories define the range of what is permissible. By design they limit trade-offs and so constrain both Congress and the President. As I previously discussed, a category could be established for investment spending. Such a category could help Congress focus on spending that promotes economic growth within a framework that still constrains overall spending. Should these caps be ceilings, or should they—as was the case for highways and violent crime reduction—provide for "guaranteed" levels of funding?

[5]Statutory Pay-As-You-Go Act of 2010, Pub. L. No. 111-139 (Feb. 12, 2010).

[6]While the original BEA envisioned three categories (Defense, International Affairs, and Domestic), over time categories were combined and new categories were created. At one time or another caps for Nondefense, Violent Crime Reduction, Highways, Mass Transit and Conservation spending existed—many with different expiration dates.

Because caps are defined in specific dollar amounts, it is important to address the question of when and for what reasons the caps should be adjusted. Without some provision for emergencies, no cap regime can be successful. The design of any provision for emergencies can be important. How easy will it be to label something an “emergency?” If the emergency is something like a natural disaster, at what point should the related spending be incorporated into the regular budget process rather than remain an emergency exception? The regular budget and appropriations process provides for greater legislative deliberation, procedural hurdles, and funding trade-offs which may be bypassed through the use of emergency supplementals. If appropriations committee oversight and procedural controls over the enactment of supplementals—whether all spending is designated emergency or not—are less than that applied to the regular process, there may be an incentive to expand the use of supplementals. In the past we have recommended a number of steps to improve budgeting for emergencies—both in terms of how much is provided in the budget for yet unknown emergencies and in terms of procedures and mechanisms to ensure that emergency supplementals do not become the vehicle for other items.[7]

It is worth noting that discretionary spending caps leave the decision about how to comply with the caps to the committees of jurisdiction. Budget control legislation has set the level of the caps, but it has not specified how much should be spent on each department or activity under the cap.

Entitlements, Revenues, and Tax Expenditures: PAYGO Plus

Unlike discretionary spending, mandatory spending programs and tax expenditures are not amenable to simple “caps.” Further, even if a cap on mandatory programs were to be designed and imposed, it would not deal with the underlying structure of these programs and hence would not address the longer-term growth trends.[8]

[7]GAO, *Supplemental Appropriations: Opportunities Exist to Increase Transparency and Provide Additional Controls*, GAO-08-314 (Washington, D.C.: Jan. 31, 2008).

[8]GAO, *Budget Policy: Issues in Capping Mandatory Spending*, AIMD-94-155 (Washington, D.C.: July 18, 1994).

An alternative that would be more consistent with the design of these programs would be to set savings targets or specify a downward trend.[9] Under the current budget process, if Congress wishes reductions in mandatory programs or increases in revenues, it may use reconciliation instructions to assign targets to the committees of jurisdiction; it does not generally direct those committees as to the specific nature of the change to meet such targets.

While changing our long-term fiscal path requires looking down the road, we should start now. If Congress were to agree on a fiscal goal and set targets along a multiyear path, then enforcement would be tied to those targets and that path. The lessons of GRH and BEA could be applied: tie enforcement to actions. A look-back provision would create a mechanism to reconcile results with intent.

The growth of some mandatory programs might be slowed by creating program-specific triggers which, when tripped, prompt a response. A trigger could result in a "hard" or automatic response, unless Congress and the President acted to override or alter it. By identifying significant increases in the spending path of a mandatory program relatively early and acting to constrain it, Congress and the President could avert larger financial challenges in the future. A similar approach might be applied to tax expenditures, which operate like mandatory programs but do not compete in the annual appropriations process.[10]

Since the growing deficit and debt is a function of the structural and growing imbalance between spending and revenues, we have said that both sides of the equation should be covered by whatever enforcement mechanism is selected. At the same time, the design of the mechanism must recognize the differences in design and hence in control of discretionary spending, mandatory spending, spending through the tax code in the form of tax expenditures, and revenues.

As a general rule, incentives or penalties—which are what enforcement mechanisms often serve as—are most successful if they are plausible and

[9]GAO, *Tax Policy: Tax Expenditures Deserve More Scrutiny*, GGD/AIMD-94-122 (Washington, D.C.: June 3, 1994).

[10]GAO, *Mandatory Spending: Using Budget Triggers to Constrain Growth*, GAO-06-276 (Washington, D.C.: Jan. 31, 2006) and *Tax Policy: Tax Expenditures Deserve More Scrutiny*, GGD/AIMD-94-122 (Washington, D.C.: June 3, 1994).

tied to a failure to act rather than imposed too broadly. As I noted, we have said that enforcement is an important part of any budget process; in designing enforcement mechanisms it is important to pay attention not only to their interaction with the design of different parts of the budget but also to any perverse incentives or unintended consequences that are likely to result.

Debt Limit

Finally, I would like to comment about one measure that does not serve as an enforcement mechanism but is often misunderstood as one: the debt limit. The debt limit does not control or limit the ability of the federal government to run deficits or incur obligations. Debt reflects previously enacted tax and spending decisions. The debt limit, therefore, is a limit on the ability to pay obligations already legally incurred. If the level of debt—or debt as a share of GDP—is to serve as a fiscal policy goal or limit, then it must constrain the decisions that lead to debt increases when those decisions are made.

Our recent work highlights some options for better linking spending and revenue decisions to the decisions about the debt limit at the time that those decisions are made.[11] For example, many have suggested that since the Congress's annual budget resolution reflects aggregate fiscal policy decisions including levels of federal debt, this would be the appropriate point in the budget process to make the necessary adjustments to the debt limit. If that were done, then Congress might also adopt a process whereby any legislation that would increase federal debt beyond that envisioned in the resolution would also contain a separate title raising the debt limit by the appropriate amount. Congress took this approach with three pieces of legislation enacted in 2008 and 2009: the Housing and Economic Recovery Act of 2008, the Emergency Economic Stabilization Act of 2008, and the American Recovery and Reinvestment Act of 2009 each included a separate provision increasing the debt limit.

Conclusion

The budget process is the source of a great deal of frustration. The public finds it hard to understand. Members of Congress complain that it is time-consuming and duplicative, requiring frequent votes on the same thing.

[11]See GAO, *Debt Limit: Delays Create Debt Management Challenges and Increase Uncertainty in the Treasury Market*, GAO-11-203 (Washington, D.C.: Feb. 22, 2011) and http://www.gao.gov/special.pubs/longterm/debt/.

And, too often, the results are not what was expected or desired. It is inevitable that, given the nature of today's budget challenge, there will be frustration. It is important, however, to try to separate frustration with process from frustration over policy. To change the fiscal path requires hard decisions about what government will and will not do and how it will be funded. A process may facilitate the debate, but it cannot make the decision. Enforcement mechanisms are not terribly successful in forcing actions when there is little agreement on those actions. Carefully designed mechanisms, however, can enforce agreements that have already been made and ensure compliance.

Chairman Baucus, Senator Hatch, Members of the Committee, this concludes my statement. I am happy to answer any questions and provide any assistance as you move forward in this important endeavor.

We conducted our work from April to May 2011 in accordance with all sections of GAO's Quality Assurance Framework that are relevant to our objectives. The framework requires that we plan and perform the engagement to obtain sufficient and appropriate evidence to meet our stated objectives and to discuss any limitations in our work. We believe that the information and data obtained, and the analysis conducted, provide a reasonable basis for any findings and conclusions in this statement.

Contacts and Acknowledgments

For further information regarding this testimony, please contact Susan J. Irving, Director for Federal Budget Issues, Strategic Issues, on (202) 512-6806 or irvings@gao.gov. Contact points for our Offices of Congressional Relations and Public Affairs may be found on the last page of this statement. Individuals making key contributions to this testimony include Carol Henn, James McTigue, and Thomas McCabe.

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