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THE COMMITTEE FOR A RESPONSIBLE FEDERAL BUDGET

PETERSON-PEW COMMISSION ON BUDGET REFORM

PETERSON-PEW FISCAL TARGETS: TEN ISSUES IN DESIGNING A NEW DEBT FAILSAFE APRIL 28, 2011

As part of his new budget framework, President Obama called for a *debt failsafe* "to hold Washington—and to hold me—accountable and make sure that the debt burden continues to decline." The debt failsafe, or trigger, would kick in with across the board spending and tax expenditure cuts if, by 2014, debt as a share of GDP were not projected to be declining by the end of the decade. Some programs – including Social Security, low-income programs, and Medicare benefits – would be exempted. The debt failsafe also would be designed to ensure that deficits averaged no more than 2.8 percent of GDP in the second half of the decade.

Budget targets and triggers potentially serve a number of purposes. These include pushing policy makers toward agreement on difficult policy changes and enforcing agreements once they are reached.[i]

Over the past two years, the Peterson-Pew Commission on Budget Reform has studied various budget reforms, with a particular focus on targets and triggers. We developed a budget reform framework similar to the President's proposal, as well as other target and trigger frameworks, including one to help keep an enacted budget deal on track.

The primary purpose of the President's trigger, it appears, is to force policy action on the deficit. According to a fact sheet on the President's framework, "the President is confident that with a robust economic recovery and bipartisan agreement on deficit reduction, we will put our debt as a share of the economy on a declining path by the second half of the decade. However we must provide a strong incentive for Congress to act on a deficit reduction framework and renew confidence that we will hit this goal."

Those designing a budget trigger need to address a set of specific design questions. Some of those questions, possible answers, and the arguments for and against different answers are presented below.

Box 1
Peterson-Pew Targets and Triggers

- Establish statutory medium-term and annual debt targets. Medium-term target should stabilize the publicly held debt at a reasonable level. (Peterson-Pew recommended 60 percent GDP by 2018.)
- Set annual targets to provide a glide path for achieving medium-term target.
- Calculate projected annual savings necessary to achieve debt targets.
- Include a trigger mechanism that would impose automatic spending cuts and revenue increases if budget legislation did not achieve the savings required to meet the year's target.

1. What is the right target?

In the past, the most common goal has been a balanced budget. Now, given the size of our deficits and the fiscal path we are on, in the near term, balancing the budget is probably not realistic.

The Peterson-Pew Commission recommended a medium-term target of stabilizing the debt by the end of the decade at 60 percent of GDP, and bringing it closer to historical levels of below 40 percent of GDP thereafter. Others have since recommended similar targets.[ii]

While we recommended initially picking a medium-term debt target and corresponding annual debt targets, we also recommended turning these debt targets into savings targets, to hold policy makers accountable for the policies they implement—what they can control—rather than economic performance, over which they have less control. Savings targets can be updated along the way. This approach is consistent with core elements of the annual congressional budget process, including dollar allocations through the budget resolution, use of reconciliation to help ensure that these are followed when the budget is enacted, and use of a baseline to estimate the budgetary effects of legislation.[iii]

After the Peterson-Pew Commission released its proposal on targets and triggers, the President's bipartisan National Commission on Fiscal Responsibility and Reform (the Bowles-Simpson Fiscal Commission) released its policy plan. Because the Peterson-Pew framework was developed to be adaptable, it would be reasonable to change the proposed targets to reflect the Bowles-Simpson proposal – or any other plan to reduce the debt.

Recommendation: Debt and savings targets should be set to achieve at least the level of proposed savings in the Fiscal Commission's plan.

Box 2
The President's Debt Failsafe

The President's proposed debt failsafe would:

- Ensure that if, by 2014, budget projections do not show the debt-to-GDP ratio as stabilized and declining in the second half of the decade, the failsafe would trigger an across the board spending reduction, including spending through the tax code.
- Ensure that deficits as a share of the economy average no more than 2.8 percent of GDP in the second half of the decade.
- Exclude Social Security, low-income programs, and benefits for Medicare enrollees.
- Also include a mechanism to ensure that it does not exacerbate an economic downturn or interfere with our nation's ability to respond to a national security emergency.

2. Is the trigger a "forcing" or "enforcing" trigger?

A trigger can be enacted either in advance of a comprehensive budget deal or as part of one.

In the first case, a forcing trigger is used to push policy makers to develop and adopt specific policies to meet their set target. If, within a specified time frame, policies have not been adopted that would meet the fiscal target, the trigger is pulled.

Alternatively, an enforcing trigger can be established as part of a comprehensive budget deal to help enforce the intended outcome of the deal, once enacted. This kind of trigger ensures that savings materialize as promised and protects against the use of rosy policy or economic assumptions.

A third option is a trigger that is established as part of a budget deal where specific policies are enacted to get part way to the target, but the trigger is included to help policy makers get the rest of the way there.

The President's proposed trigger could be either a forcing or enforcing trigger, depending on whether a budget deal had been adopted before it went into effect in 2014.

Recommendation: A forcing target and trigger mechanism should be adopted as quickly as possible – perhaps as part of the debt ceiling increase – and enforcing triggers should be part of the subsequent budget deal to keep the plan on track.

3. When should a trigger be applied, and how long should it remain in place?

A target/trigger framework needs to specify when the trigger would kick in. The President's trigger would not apply until 2014 at the earliest, and may only apply then or perhaps may be applied annually thereafter or again at the end of the decade.

The Peterson-Pew Commission recommended that a trigger be applied immediately, at the time medium-term and annual debt targets are established. A trigger that is not applied for three or more years would not apply as much immediate pressure on negotiators as one that is made effective sooner. Later application also may encourage policy makers to "back load" budget savings rather than act more quickly to slow debt growth, because they face no immediate punitive automatic adjustments for delay.

It is also useful to apply triggers annually. This keeps pressure on policy makers to meet each year's target and thus stay on track to the medium-term goal of stabilizing the debt. It also would apply triggered adjustments if the annual target were missed, again helping keep things on track.

Recommendation: Triggers should apply annually until the ultimate debt target is achieved.

4. How should the triggering event or threshold be defined and measured?

The trigger point should be both straightforward and readily measurable. The President's proposal ties the trigger to a fiscal goal for the second half of this decade, to first slow and then reverse the growth of federal debt so it is falling as a share of GDP by the decade's end; this might be labeled a medium-term debt target or possibly a series of annual targets. Without more details, it is unclear how soon the trigger point would be reached.

If the trigger is intended to apply early pressure to reach agreement on and enact policy changes sufficient to stabilize the debt, an annually applied trigger may be best. The Peterson-Pew Commission's approach would be to apply the trigger when savings from enacted budget legislation are less than required to meet an annual savings target based on that year's debt target. Or, consistent with the President's goal, the trigger point might be based on a projection for the end of the decade. In that case, the trigger would be applied in a year when the savings from enacted policies are *not* estimated to be sufficient to put the debt on a declining path by then.

Recommendation: Apply the trigger annually if savings consistent with a prescribed debt path are not achieved.

5. Should the triggers be applied based on *actual* budget outcomes or *estimates* of future outcomes?

The test to decide if the trigger will apply could be whether the enacted budget actually meets the target, when that is known after the budget is executed, or whether the results are projected to meet the target as of the time budget legislation is scored. A "look back" procedure, where the trigger test was based on actual budget outcomes for the prior year was used in the 1990 Budget Enforcement Act (BEA). However, the time lag between policy decisions and possible application of the trigger weakens the incentives for policy makers to preempt the trigger and may even penalize a new Congress or President who was not involved in the decisions that led to the trigger being pulled.

While basing a trigger on estimates is not as precise, we believe it is more likely to be an effective spur to agreement if the trigger is prospective, using the scoring of budget legislation when or soon after it is enacted.

Recommendation: Base the trigger on estimates of whether budget legislation will achieve the prescribed annual savings.

6. When the trigger is used, what should be adjusted?

The President's proposed failsafe would apply across the board spending and tax expenditure cuts, though it would exempt Social Security, Medicare benefits, and programs for the poor. This has been done in the past in the case of both the Gramm-Rudman-Hollings (G-R-H) Act and BEA sequester requirements. These both exempted from automatic reductions Social Security, veterans' benefits, many programs serving low-income people, and a long list of other programs.

The Peterson-Pew Commission recommended that a trigger include both revenues and spending and be applied to the broadest base possible. This would spread the pain widely, affecting nearly all voters and interests, and do the most to spur action.

Peterson-Pew originally recommended a 50-50 divide between spending cuts and revenue increases, but has adapted its recommendations to reflect the balance of the Fiscal Commission, a 2-to-1 spending cuts to revenue increases ratio.

The application of automatic adjustments is relatively straightforward for discretionary spending. An across-the-board percentage reduction can be applied to all appropriated accounts. For appropriated programs, the adjustment is made by reducing budget authority (BA), but the timing of the outlay savings from reducing BA depends on details of program execution and may vary, as it is an estimate.[iv] Moreover, because it takes time for appropriated funds to be obligated and outlayed, outlay savings in the first budget year for many programs will be only a fraction of the BA reduction, with the balance occurring later.

Similarly for taxes, a percentage surcharge can be applied to the taxes otherwise owed by each taxpayer. An alternative that some will argue is preferable is to adjust income or payroll tax *rates*. Adjusting rates may be problematic given both the complexity of the tax laws and variations in taxpayers' circumstances. These make it less certain that all will be affected by a rate adjustment and make the resulting distribution of increases less transparent than with a simple surcharge. On the other hand, an adjustment to tax *rates* if applied to all filers would ensure that even many taxpayers in the lowest income tax bracket and those with negative tax liability (taxpayers receiving refundable credits) would feel the effects of a triggered adjustment.

Another option is a trigger that when applied adjusts tax expenditures. In 2010, revenue losses resulting from tax expenditures were estimated to total over $1 trillion.

Conventionally, these amounts are not reflected in budget totals either as revenues or spending. For purposes of adjusting spending using a trigger, however, they are best treated as a distinct category. One could apply a haircut to the value of all tax expenditures. This could be implemented by allowing each taxpayer to compute the full value of her tax expenditures and then reducing their value by the percentage estimated to be equivalent to their share of the total triggered spending adjustment.[v]

Mandatory programs present a challenge to designers of an automatic adjustment mechanism. The issues are different for programs such as pensions that provide specified dollar benefit amounts than for programs such as health care that pay for services. In the former case, it would be possible to reduce payments to recipients by a percentage sufficient to generate budget savings proportional to those achieved in other categories of spending. In the latter case, payments to service providers could be reduced relative to those otherwise owed under the law's statutory formula or reimbursements to service consumers could be similarly reduced.

Recommendation: Have the required automatic adjustments apply as broadly as possible to all categories of spending and revenues, including tax expenditures.

Box 3
Past Triggers in the U.S.

Balanced Budget and Emergency Deficit Control Act of 1985 (G-R-H). The Gramm-Rudman-Hollings Act, as it was known, included a trigger – sequestration – to enforce specified deficit targets. If the year's deficit target was not met, sequestration procedures triggered spending cuts. In the five years of G-R-H, two sequesters were required, one of which was reduced by legislation and the other overridden by a subsequent budget agreement.

Budget Enforcement Act (BEA) of 1990. The BEA replaced deficit targets with statutory limits on discretionary spending and a pay-as-you-go (PAYGO) requirement for mandatory spending programs and revenues. Sequestration procedures were again included to enforce the discretionary caps and the PAYGO requirement. The Act was extended in 1993 and 1995. Under the BEA, sequestration was triggered three times: twice for discretionary spending (one of which was overturned by enacted legislation) and once for violation of the PAYGO process, which was also overturned by enacted legislation.

Entitlement Caps. During congressional debates on the Omnibus Reconciliation Act of 1993, the House considered setting triggers that would be activated if entitlement spending exceeded the targets established in the budget. However, the final bill did not include the language. In response, President Clinton issued Executive Order No. 12857 that set targets for direct spending for 1994 through 1997. If the entitlement spending in any year threatened to exceed the caps, the order required the President to include in his annual budget a proposal to reduce spending or to suggest additional revenue. The Clinton Administration had the good fortune of avoiding this circumstance because the affected program outlays came in under estimates.

Medicare Solvency. In the 2003 Medicare Modernization Act (the prescription drug bill), Congress imposed a Medicare solvency trigger designed to address Medicare's long-term solvency. The law required that the Medicare trustees issue a warning if two consecutive trustees reports projected that general revenue would be needed to fund more than 45 percent of Medicare outlays. After such a warning, the law requires the President to submit a legislative proposal to reduce the general fund's contribution to 45 percent or less. In 2007, the trustees, for the second year in a row, reported that the general fund's contribution would exceed this percentage. President Bush proposed, in his FY 2009 budget, an automatic trigger if Congress and the President failed to agree on Medicare reforms. However, not only did Congress not take action on the President's proposal, it also eliminated the rule requiring it to consider proposals to achieve Medicare solvency on an expedited basis. In its FY 2010 budget, the Obama Administration quietly disputed congressional authority to mandate presidential submission of a legislative proposal.

Pay-As-You-Go Act of 2010. This act contained a trigger mechanism similar to the PAYGO trigger in the 1990 BEA. However, because the programs to which the enforcement mechanism applies exclude all programs administered by the Department of Veterans Affairs, income tax credits, low-rent public housing loans and expenses, and more than 100 other programs, the act's effectiveness in promoting fiscal restraint is limited.

7. How large should a triggered automatic adjustment be?

Triggered adjustments will be more likely to be sustained if they are harsh but not too harsh. It is a matter of finding the right balance. Whatever its size, a triggered adjustment applied at the wrong moment is likely to be overturned. If not formally overturned, too harsh a trigger is vulnerable to being subverted under pressure by various means, including misuse of emergency spending exceptions, scorekeeping gimmicks, or overly optimistic economic or technical assumptions.

The automatic adjustments to spending and revenues can either be sufficient to close the entire estimated gap between the goal or target and the results of enacted budget legislation, or just part of that gap. If the purpose is to enforce or incentivize greater fiscal discipline, the triggered adjustment must be large enough to be painful, but not necessarily enough to close the entire gap. If the adjustment is too small, policy makers may not have a sufficient incentive to avoid it by enacting budget savings. If the adjustment is too large, the trigger is likely to be overridden; it may lose its effectiveness as an incentive and be abandoned.

For its recommended version of an action-forcing trigger, the Peterson-Pew Commission proposed capping the size of the automatic adjustment in any one year at no more than one percent of GDP, both to reduce the risk to economic growth of too sharp a fiscal adjustment and to strike a balance between the pain inflicted if the trigger were used and the risk that too large an adjustment would prove politically unacceptable. Triggered adjustments from the trigger's use would be cruder and less politically attractive to most budget makers than a negotiated agreement that met annual debt targets as proposed by the Peterson-Pew Commission.[vi] Thus, it is likely they would try to avoid them. If they were only partly successful, then the savings from reduced spending and/or higher revenues achieved through budget legislation could be applied as an offset to the calculated automatic adjustments otherwise provided for under the trigger mechanism, thus giving policy makers credit for the actions they were prepared to take that year.

One design option is to stage the automatic adjustments so that they bite more deeply later – that is, so that larger portions of the gap are closed if the trigger is used in later years, thereby gradually ratcheting up pressure for an agreement. Introducing adjustments in stages is consistent with the goal of using a trigger as an incentive for adhering to a fiscal rule. With a "staged" trigger, even if policy makers are initially unable to conform to the rule, thus triggering automatic adjustments, they may still feel under pressure to avoid even larger adjustments by continuing to work toward adherence. In the present context, policymakers might be able to avoid the trigger by achieving relatively modest budget savings in the first year or two but might be required to achieve larger annual savings in the years that follow.

Recommendation: The trigger should be large enough to incentivize all parties to budget negotiations to find agreement on and enact legislation to meet annual and multi-year debt targets, but not so large as to invite policy makers to override or overturn the trigger.

8. What opportunities should be provided to revisit budget legislation after initial scoring and before automatic reductions are applied?

Before the trigger is applied, policy makers should have an additional opportunity to enact policy changes to meet their specified fiscal targets and avoid the trigger's automatic adjustments. This approach recognizes the complicated political challenges facing negotiators and makes full use of the established budget process and calendar. Fast track processes can also be made available to meet the targets to help facilitate policy agreements.

Recommendation: Give policy makers a second chance to agree on and enact budget legislation each year before automatic adjustments are triggered.

9. How should a trigger apply in the wake of an emergency or serious economic downturn?

An annual trigger used in conjunction with annual savings targets can be re-benchmarked at the start of each year's budget process for new economic and technical assumptions. This would allow for changes in the required savings associated with changes in economic conditions – for better or worse – within the usual range. However, in some years economic conditions may worsen the outlook substantially. If the trigger were applied in those circumstances, the adjustments could have adverse effects on the economy.

The Peterson-Pew Commission sought to reduce this risk by capping the size of the triggered adjustments at one percentage point of GDP. But even a fiscal adjustment of this size in the face of a downturn could have adverse economic consequences. Thus, any trigger that could have a large economic effect should include an "escape hatch" that allows it to be suspended in the face of an emergency, such as an unplanned military conflict or a weak or unstable economy.

One option is simply to waive the trigger requirement in the face of an emergency or severe downturn. Or the trigger could be waived if and when certain economic conditions were met.

Recommendation: Our advice is that a trigger be waived if the GDP has declined during two quarters of the preceding year or in the face of a national emergency.

10. How effective are targets and triggers?

The Peterson-Pew Commission recommended its detailed proposed regime of targets and triggers to help nudge the political discussion towards adopting a comprehensive, multi-year fiscal plan. We also recommended additional triggers to make sure the intended savings materialize as promised and spending on the most problematic areas of the budget is controlled.

In light of the current need to increase the debt ceiling and make changes to our fiscal trajectory, we believe the Peterson-Pew Commission framework could be a useful piece of a combined debt ceiling increase and budget reform package. Targets and triggers vary in their effectiveness. However, one thing is certain: a budget deal which seeks significant debt and deficit reduction will be *ineffective* if not paired with some form of targets and triggers to help realize the savings and debt levels. In the end, only policy changes will improve our fiscal situation, and only political will can make them stick.

Recommendation: Use targets and triggers to help come to a deal, and keep it on track, but focus on the important work of enacting policy changes to bring down deficits and the debt.

NOTES

[i] Rudy Penner and Eugene Steuerle, two members of the Peterson-Pew Commission, have done pioneering work on budget triggers; cf., *Stabilizing Future Fiscal Policy: It's Time to Pull the Trigger.* The Urban Institute, August 2007.

[ii] See, for example, the Bipartisan Policy Center's Debt Reduction Task Force (Domenici-Rivlin) report, *Restoring America's Future,* and *Choosing the Nation's Fiscal Future*, a joint research study produced by the National Research Council and National Academy of Public Administration.

[iii] Another option for defining the target or trigger point is as a specified reduction in spending, or spending plus tax expenditures. This is not inconsistent with a test based on a broader measure of budget outcomes. Policy makers may want to add a second layer of control by prescribing limits on the growth of spending and tax expenditures, similar to the caps on discretionary spending enacted in the 1990 BEA. The main drawback of using this as a primary control or trigger point is that it addresses only part of the budget equation driving deficits and debt, and is therefore insufficient to ensure that debt is stabilized. Some also may consider focusing on some elements of the budget equation while ignoring others gives them too much attention and violates the principle that "everything should be on the table." A secondary test, however defined, also adds complexity, which may reduce public understanding of the standard against which budget negotiations are to be held.

[iv] An alternative approach would be to adjust total budgetary resources available that year for each program, including new BA, to achieve the required outlay savings. Budgetary resources include, for some programs, collections such as premiums or fees for service that help finance program outlays.

[v] For a specific proposal to cap the value of tax expenditures to individuals, see Feldstein, Feenberg, and MacGuineas, "Capping Individual Tax Expenditure Benefits," *Tax Notes,* May 2, 2011.

[vi] See Peterson-Pew, *Getting Back in the Black*, November 2010, page 12.