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PETERSON-PEW COMMISSION ON BUDGET REFORM

Budgeting for the Long Term

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With the retirement of the baby boom generation drawing closer, concerns about the sustainability of current policies has made the long-term impacts of those policies a far more important part of the budget process. The seriousness of this problem should prompt us to reexamine the information, concepts, incentives, and goals underpinning the federal budget process and find ways to focus budget decision-makers on the long-term implications of our current policy paths and on possible alternatives.

Finding politically sustainable process reforms has never been more important due to the unsustainable long-term budget outlook. Like many advanced nations, the United States stands on the precipice of a major fiscal shift – a structural imbalance that has been recognized for nearly 15 years. On top of record deficits stemming from the financial crisis, the nation faces an even more difficult second wave of deficits flowing from explosive health- care cost growth and an aging society. Unlike the current deficits, these longer-term deficits cannot be tempered by economic growth and the normal reassertion of the business cycle. All federal policy analysts – the Office of Management and Budget, Congressional Budget Office and Government Accountability Office – agree that the nation is on an unsustainable fiscal course. As the baby boomers retire, the federal budget deficit will escalate to unsustainable levels, approaching 20 percent of GDP over the next 20 years if nothing is done. As spending pressures accumulate to finance an aging nation, a smaller cohort of workers will be left to finance these costs.

Herbert Stein long ago suggested that if something is unsustainable, it will stop. But there is a corollary – how it stops matters. Will these trends be reversed through a gradual process brought about by policy interventions or through a rude shock caused by economic forces over which we will have little control? Creating sustainable long-term fiscal policy requires early action. Early action can pay dividends by intercepting the growth of the problem before it requires precipitous and hasty actions in the face of an economic, social, or ecological crisis. Moreover, if started early enough, changes in social, economic, and fiscal policy commitments can be phased in gradually, permitting the American public time to make adjustments in their own retirement and savings plans and expectations about the role of government in their lives.

The Political Challenges

Resolving fiscal challenges requires perennial real-world exercises in hard choices. In any democracy, it is always difficult to allocate fiscal sacrifice. The narrow groups benefitting from specific tax and spending programs are more mobilized than the broader public that would benefit from a more responsible budget.

The long-term fiscal challenges raise the specter of even more daunting political challenges than other current challenges. Taking on the drivers of long-term deficits and entitlement programs raises vexing intertemporal challenges for the current generation of decision-makers and voters alike – whether to make sacrifices in current consumption and benefits today to avoid some projected crisis in future decades and potentially improve the lives of future generations in the process, or to continue down an unsustainable path hoping that the problem will be fixed in the future. Rather than being the proverbial wolf at the door, early action on these problems is more akin to dealing with the "termites in the basement" – problems that are not immediately apparent but that can bring down the entire edifice if not dealt with proactively. For instance, Social Security, a program that will eventually outgrow its revenues and trust fund assets, is still generating a cash surplus within the federal budget and will for another 10 years. If policymakers wait until the Social Security trust fund actually has insufficient funds to pay current benefits, they will face that prospect in the 2040s, a decade when the overall deficit will have already slowed economic growth and encumbered the budget with ever-mounting interest payments.

The role of budget process reform

Conventional wisdom suggests that the budget process can only work if "political will" supports the changes and reforms. While this is generally the case, budget rules and concepts can shape political behavior and attain independent influence, particularly when political will is unsettled – i.e., when the nation is conflicted between allegiance to fiscal responsibility norms and other values, such as the protection of existing benefits. To be sure, budget rules and structures can protect members from near-term political pressures by providing a binding set of fiscal targets and restraints and shouldering the responsibility for unpopular and difficult fiscal choices. However, those rules and structures can also function proactively by helping political leaders reframe the choices so that the advantages of fiscal restraint are highlighted over other competing dimensions of policy debates. Historically, fiscal norms of balance and responsibility have commanded a strong latent constituency, and process reforms can enable political leaders to mobilize these interests and values.

Some go further and suggest that the only thing that will prompt leaders to address the long-term challenges will be an economic crisis. Let's hope not, for such an event would cause unprecedented economic and political costs for the nation. Moreover, our recent history does suggest that reforms to policies such as Social Security and the creation of responsible fiscal policies are not politically impossible or suicidal events. While deficit reduction is never easy, leaders who mount a proactive strategy can take the political high ground and head off even more ruinous political and economic fallout from fiscal gridlock.

A Budget Process Regime for the Long Term

The current budget process is focused on the short term. It uses a five- or 10-year framework as the primary period for the baseline and the cost of most proposals is calculated only for this time frame. It does not include incentives to address existing programs that are driving the long-term fiscal outlook. There are no explicit fiscal goals. Budgetary costs are largely presented on a cash basis, which can be misleading for programs with exponential long-term growth paths. As with most OECD nations, existing long-term sustainability analyses are not integrated into the budget process in the near term.[i]

This section suggests a budget process regime that would establish a long-term horizon for federal budgeting. Such a process is absolutely critical to head off the looming fiscal and economic crisis. How should this process be constructed? What kinds of metrics or goals could promote greater attention to the long-term fiscal challenges? And what type of process is necessary to increase the probability that policymakers will take early action to prevent a long-term crisis and to create a sustainable fiscal outlook?

There are six specific areas where reform is necessary to highlight the long-term implications of current programs, encourage decision-makers to act now, and to place the budget on a sustainable long-term path. They include:

- Establishing near-term fiscal goals linked to long-term fiscal outcomes;
- Establishing accountability for fiscal goals ;
- Providing incentives to implement these goals in annual budget resolutions;
- Creating points of order against new commitments that would worsen the long-term outlook;
- Establishing better estimates of long-term costs and fiscal exposures; and
- Introducing accrual concepts for selected fiscal exposures to show their true long-term costs.

Fiscal goals: Integrating long-term goals with short-term budget processes

Fiscal goals are a critical first step in institutionalizing the consideration now of the long-term outlook. Using long-term models, the current unsustainable fiscal policy path is the starting point for crafting a set of alternative fiscal policies anchored by a set of long-term targets for deficits, debt levels, or fiscal gaps. These targets can then be used to establish alternative fiscal policy paths that are more sustainable long term.

How would such targets work? No one would suggest that the federal government should budget for the next 50 or 75 years. Rather, since the federal budget is prepared annually, the budget process needs a strategy that would guide short-term trade-offs and choices by institutionalizing the consideration of their long-term implications.

To ensure that long-term goals are a part of the contemporary budget debate, these objectives would be the basis for a set of 10-year fiscal targets. These near-term targets need not, and probably should not, be ambitious enough to eliminate the long-term fiscal gap. It is most likely that the long-term fiscal imbalances will be addressed iteratively in manageable chunks rather than comprehensively. This is particularly the case with health care, where it is not clear how to achieve sustainable fiscal restraint that is both economically and socially acceptable.

Nonetheless, targets could make a significant dent in the long-term fiscal problem by providing a politically compelling metric and accountability processes to enforce adherence to the goals. Such processes will include fiscal rules to discourage new commitments that threaten long-term fiscal sustainability, as well as triggers that can prompt review and limits on existing tax and spending programs to change their long-term growth trajectory

There is considerable controversy over whether fiscal goals and targets would constitute a substantive constraint on policymakers. Both in the United States and internationally, experience with fiscal rules – which use a summary indicator of fiscal condition to bind political decisions by the executive and/or legislature – has often been discouraging. Soured by experience with the overly rigid Gramm-Rudman statute in the 1980s, the United States backed away from highlighting or enforcing overall fiscal targets as a guide to policymaking.

Some believe the evidence suggests that countries that practice fiscal discipline without explicit fiscal rules (e.g., Australia and New Zealand) do not need them, whereas countries that have fiscal rules often fail to achieve their own goals for the same reasons that prompted them to reach for goals in the first place. In recent years, however, some nations have adopted fiscal targets and frameworks that have helped create fiscal responsibility. In nations like Sweden and New Zealand, the adoption of overall fiscal targets, in concert with market pressures, reframed policy debates by including fiscal sacrifice. In contrast to the Gramm-Rudman model, other nations' use of fiscal targets had an impact not through formulaic cuts but by providing a compelling way to frame budget debates based on the long-run implications of their current budget choices.

Accountability: Implementing Fiscal Targets

Provisions to implement the fiscal target are necessary to establish real accountability for the long-term fiscal future. They should include a periodic process to compare actual fiscal results with targets and goals. If the results fail to meet a target or goal, the process should include either:

- A hard trigger with predetermined spending cuts and/or tax increases. Congress and the president could waive the trigger during economic or national security crises. Hard triggers must be carefully designed, since the Gramm-Rudman experiment of enforcing balanced-budget goals with harsh triggers illustrated that such triggers will be rejected if the result is politically or economically unsupportable cuts to programs.

- A soft trigger. This trigger is based on the power of shame. It would require that Congress and the president either take subsequent action to meet the target or to announce publically that they could not meet the target. While a soft trigger does not impose the complexity of fallback cuts, it is also a weaker constraint that is more easily ignored.

Given the importance of health care, Social Security and tax policy for the long-term outlook, existing programs in these areas would have to be periodically modified to meet the fiscal targets. Currently, such programs are open-ended. Only those few programs funded by trust funds have limitations, and these limits would become a real constraint years after those programs have become net burdens on the budget.

The best way to develop a path to sustainability is by addressing the drivers of long-term deficits. The process could establish limits for entitlements and tax policies based on their implications for satisfying the fiscal targets and goals.

Should spending or revenue losses exceed these targets, the budget process could institute either soft or hard triggers. Soft triggers would require Congress or the president to act to ignore the limit or take some action to address it.[ii]

Alternatively, a hard trigger could be established. In this case, specific policy reforms are automatically instituted through spending cuts or revenue increases.[iii] While the current system places the political burden on those wishing to slow growth in costs or benefits, a hard trigger forces program advocates to act to override the triggered changes. Other nations have used various triggers or "automatic balancing mechanisms" tied to long-run projections for some or all parts of their budgets. [iv]

A broad-based coalition of think tanks and interest groups, including analysts from the Heritage Foundation, the Brookings Institution and the Urban Institute, embraced hard triggers for Social Security and Medicare. The coalition's proposal sets limits on growth for these programs, enforced by automatic cuts in benefits and premiums when those limits are exceeded.[v] An opposing coalition of analysts from liberal think tanks argued that the proposal would shift risk from the government to weaker clients and would fail to address tax expenditures whose growth is also jeopardizing the fiscal outlook.[vi]

Hard triggers can still be ignored or undermined since no Congress can bind a succeeding Congress or even its own subsequent actions. The hard ceiling on Medicare doctors' fees has been ignored every year by legislation that overrides those limits. Some argue that triggers should be adjusted to account for economic changes affecting benefits during difficult times, while others object to the obfuscation of accountability by elected officials for their actions.

Complex choices must be faced in designing such caps and triggers, including how triggers are activated, the resulting actions, how triggers can be adjusted for economic downturns, and the frequency of reviewing the trigger mechanism to reflect changes in the program and the overall budget.[vii] However, given the lack of any real constraints on open-ended programs, such a concept will be necessary to achieve a sustainable long-term fiscal outcome.

Budget Resolutions and the Long Term

A fiscal goal or target could be established in the annual congressional budget resolution or in separate legislation that would be used to assess the president's budget and the annual congressional budget resolution.

However, with either option, significant changes would be needed in the information and incentives supporting the budget process. First, the annual budget documents prepared by both OMB and CBO must have additional long-term information. For example, while the president's budget includes a long-term model in its *Analytical Perspectives* volume, the long-term estimates are not presented in the summary budget tables or presentations of the president's near-term five- or 10-year outlook. Similarly, CBO prepares a separate report on the long-term outlook rather than as a part of its annual economic and budget outlook in January and its midyear assessment of the budget. Closer integration of long-term analyses and short-term budget presentations is necessary to ensure that long-term fiscal issues are taken seriously in today's budgets.

In addition, CBO should estimate the impact of the proposed budget resolution on the long-term outlook. If Congress adopts a fiscal target, CBO should compare the budget resolution against the overall fiscal goals. While budget resolutions may not provide sufficient detail to generate detailed estimates over the long term, a report that attempts to assess the budget resolution's impact on the long-term target is useful. It could, at a minimum, assess whether the budget resolution would make the long-term outlook better or worse. The process could also include a new point of order prohibiting consideration of a budget resolution that worsened the long-term budget outlook or did not meet the fiscal target.

Long-Term Points of Order

Designing points of order to inhibit the enactment of new long-term commitments is already in the current structure. In fact, the Senate has already incorporated such a point of order in its rules, requiring policies to be deficit neutral in each decade over the next 40 years. The House has a point of order against changes to Social Security that would further erode its solvency over a 75-year period.

While this is sufficient for most pieces of legislation, the emphasis on the short-term costs disguises the consequences of new tax and spending policies on the long-term outlook. The 2003 debate on prescription drugs, for instance, focused on which 10-year estimate was more accurate – the administration's estimate or the CBO's estimate. However, both cost estimates were about $500 billion, and almost none of the debate focused on the long-term impact: a net cost of more than $8 trillion in claims on the federal budget over 75 years. If the long-term cost had been a larger part of the discussion, it might have changed the debate and, possibly, the design of the new program.

Here, too, points of order could raise the importance of the long-term outlook and enforce the fiscal targets. For example, a point of order could be created that would prohibit consideration of legislation with costs that grow exponentially after the 10-year period. CBO could present the cost of legislation in both cash and net present value terms over several decades, giving Congress a realistic estimate of the effects of its actions on the long-term. Another point of order might be against any new proposal that increased the deficit over the long term or that did not include a hard trigger, requiring automatic cuts or tax increases if the proposal caused the breach of a fiscal target.

Information on Long-Term Outlook and Costs

As the foregoing illustrates, taking the long term seriously requires significant augmentation to the information base of budgeting. The long-term fiscal models already produced by CBO, GAO and OMB illustrate how credible information alone can gradually reframe the terms of the debates. While rarely sufficient on its own, new information disclosing long-term fiscal implications of existing choices can be used by skillful political leaders to highlight the visibility of these issues.

The process needs more ways to improve the visibility of and accountability for long-term consequences of budget choices. For example, GAO introduced the concept of "fiscal exposures" for programs and commitments that are estimated to grow exponentially over the years. While not a macro picture of the entire long-term outlook of fiscal policy, this measure reflects the net present value of the major spending commitments of government over a long term horizon. GAO's concept encompasses long-term financial commitments recorded on the government's financial statements, such as debt held by the public, as well as those programs with long-term spending expectations that are not currently considered liabilities, including Social Security and Medicare. [viii]

GAO also recommended several options to improve the routine production of information on fiscal exposures. For example, it called for OMB to produce an annual report estimating the long-term costs of these programs and for the report to be reviewed and evaluated by GAO.

Second, GAO recommended that fiscal exposures be routinely reported at the program activity levels for those items with exponential costs that are not currently and adequately reflected in near-term budget numbers. These exposures could include employee pensions, long-term costs of decommissioning nuclear weapons or nuclear-powered ships, operations and maintenance costs for existing assets, and other longer term expenses associated with current program commitments. This reporting could be in net present value terms to capture the costs of long-term line items in current dollar terms. Both recommendations will improve the information available to policymakers to support a long-term budget framework.

Budget Concepts and Accounting

The way that costs are accounted for in the budget sends definitive signals to policymakers about the timing of fiscal commitments. For the most part, the federal budget uses a cash-based approach in measuring program costs. And cash is indeed the most appropriate measure to capture the current-year impact of federal fiscal policy on the economy.

However, for selected programs, the cash approach is inadequate for giving federal policymakers information about the long-term financial costs of long-term commitments. These costs represent contracts between the federal government, beneficiaries, and providers that extend over many years. A cash-based approach understates these commitments, while an accrual approach, which records the net present value of these commitments in the year they are made, regardless of the actual flow of cash payments, can give a better picture. [ix] The federal government adopted the accrual method for loan and loan guarantee programs in 1990 – as a result, the budget for loan guarantees that formerly appeared to have zero cost in the first year of a program now reflects the estimated longer-term costs of defaults and interest-rate subsidies provided by the government. For credit programs, a cash approach understated the magnitude and risks associated with federal subsidies and protections, while the current approach fully captures the underlying risk to the federal Treasury over the longer term.

The budget process should use similar approaches for other commitments such as federal employee retired health-care costs and insurance program costs. Accrual treatment is particularly relevant for those commitments defined as liabilities in the federal government's financial accounting statements, such as federal employee pension and retiree health contributions. Insurance programs, such as federal deposit and pension benefit guarantee protections, often appear to have surpluses in the current-year budget, without showing the underlying risks and longer-term deficits in the programs.

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[i] Barry Anderson, "Fiscal Futures, Institutional Budget Reforms and Their Effects: What Can Be Learned?" (Paris: OECD, April 2009).

[ii] Currently, the Medicare program has a trigger that is activated when the general revenues supporting the program exceed 45 percent of the total program. Since the trigger was activated for FY2009, the president included proposals in his budget to bring Medicare below the threshold, but Congress took no action in response. Senate Budget Committee, *Budget Bulletin*, April 3, 2008.

[iii] Rudolph G. Penner and C. Eugene Steuerle, "Stabilizing Future Fiscal Policy: It's Time to Pull the Trigger." The Urban Institute, August 2007. Penner and Steuerle argue that such formulaic changes reverse the presumption in our system for spending growth.

[iv] Ibid.

[v] Brookings-Heritage Fiscal Seminar, *Taking Back Our Fiscal Future,* April 2008.

[vi] Henry Aaron and Robert Greenstein, *A Balanced Approach to Restoring Fiscal Responsibility*, July 2008.

[vii] Should the trigger concept be extended to tax expenditures, particular challenges will arise including the several years' lag before data on revenue losses become available and the larger number of exogenous factors affecting tax expenditure revenue losses including changes in tax rates and other tax expenditures.

[viii] U.S. Government Accountability Office, *Fiscal Exposures: Improving the Budgetary Focus on Long-Term Costs and Uncertainties*, GAO-03-213, January 24, 2003. The Peterson Foundation has added these exposures to arrive at a total figure of $56 trillion on a net present value basis, which is argued to constitute a future claim on budgetary resources.

[ix] U.S. Government Accountability Office, *Budget Issues: Accrual Budgeting Useful in Certain Areas but Does Not Provide Sufficient Information for Reporting Our Nation's Long Term Fiscal Challenges*, GAO-08-206, 2008