**MEMO #1:** BUDGETING FOR THE LONG TERM, AVOIDING THE REAL FISCAL CLIFF

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***Abstract:*** *To address a large long-term gap between federal revenues and spending commitments, the budget process and institutions should be reformed to be more far-sighted. Reforms will raise the salience of the long-term fiscal challenge and make it more difficult for policy makers to ignore the long-term implications of their decisions or their failure to act. The President and Congress should agree on fiscal goals as a starting point for work on the annual budget and the budget resolution should be a multi-year plan to meet specific fiscal targets. The President should show how his fiscal policies will play out over the far horizon and how much his policies will do to close the long-term fiscal gap. Other procedural and institutional changes can be made to provide the incentives and discipline needed to put the budget on a sustainable path.*

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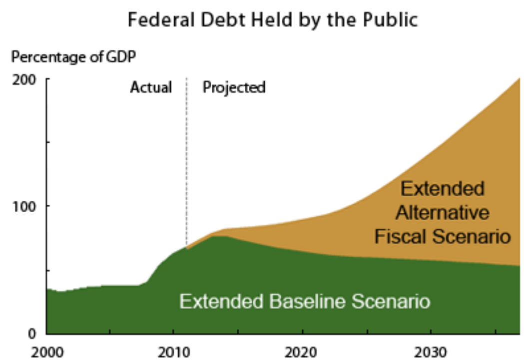
The United States, along with most advanced nations, faces nearly unprecedented fiscal risks, over the longer term. Even as the United States recovers from the current recession, an aging population and rising health care costs will, in the absence of policy changes, send the budget into a tailspin, with deficits and debt rising to unsustainable levels that would eventually cause an economic shock. As these spending pressures accumulate, a smaller cohort of workers will be left behind to finance these costs. Unless a longer view of the budget is adopted to address the problem of its long-term sustainability, Americans' standard of living will assuredly decline and the precipitous policy changes necessary to rescue the nation from economic meltdown will cause lasting damage to the political fabric of the nation.

The chart below from the Congressional Budget Office's (CBO) latest long-term outlook illustrates the nature of the long-term challenge. Under a likely extension of current policies, represented by the "extended alternative fiscal scenario," debt is projected to explode. In other words, the current course leads to deficits that would eventually be economically unsustainable, as rising government debt crowded out nearly all private investment and growth.




Economist Herbert Stein long ago suggested that if something is unsustainable, it will stop. But there is a corollary—how it stops matters. Will we see a gradual adjustment, or a rude shock caused by economic forces over which we will have little control? Achieving a more sustainable fiscal policy without such a shock requires early action. If started early enough, needed changes in spending and taxes can be phased in gradually, giving people and businesses time to adjust their plans and expectations.

The alternative is an unavoidable crisis, which will cause harm to current and future generations. Such a crisis would force policy makers to make far more painful and precipitous policy changes than are required to meet the challenge now. Such a so-called "hard landing" has in fact occurred in other nations where financial markets lost confidence in fiscal and economic management.

The central question facing the U.S. system and those of other advanced nations dealing with similar fiscal outlooks is whether a democratic nation like ours can take proactive leadership before a crisis forces our hand. Unlike many nations in Europe, the U.S. does not face immediate pressures to undertake massive deficit reduction. We have the opportunity to phase in changes to entitlements and taxes that will take effect when the economy recovers sufficiently. Studies across the Organization for Economic Cooperation and Development (OECD) nations have shown that national leaders spearheading fiscal reforms increase their chances of getting reelected.

**A Long-Term Approach to the Federal Budget**

The budget process and institutions can be reformed to raise the salience of the long-term fiscal challenge and make it more difficult for policy makers to ignore the long-term implications of their decisions or their failure to act. Four sets of reforms can make a difference:

1. **Information -** The President should be expected to show how his fiscal policies will play out over the far horizon, and should be expected to say how much his policies will do to close the long-term fiscal gap. CBO should regularly assess and report on the impact of

both the President's budget and proposed Congressional budget resolutions on the long-term fiscal outlook.

More systematic information should be provided to the public on what the Government Accountability Office (GAO) calls "fiscal exposures" – a concept including traditional accounting liabilities such as federal debt as well as commitments such as Medicare and Social Security.[1]

For selected programs that are considered firm commitments, long-term measures of the net present value of costs could be considered for inclusion in the budget itself, as is currently done for loan and loan guarantee programs. Such items as the accruing long-term costs for federal retiree pension and health care could be considered to be booked in the budget on an accrual basis; the long-term accruing costs of federal insurance subsidies for such areas as private pensions and deposit insurance are also amenable to this kind of noncash treatment. In these programs, the costs of what amounts to contracts are understated by a cash approach to budgeting. Accrual approaches to these items would record these longer term costs in the budget year when the commitments are actually made.

2. **Fiscal Goals** - The President and Congress should agree on fiscal goals as a starting point for work on the annual budget. This could be done by establishing targets for medium- and long-term deficits, levels of debt, fiscal gaps or other measures that could be widely understood and gain broad support. Other nations, such as New Zealand and Sweden, have managed to sustain budgetary surpluses for many years, thanks partly to their adoption of overall fiscal targets that serve to reframe debates by justifying fiscal sacrifice. Fiscal sustainability, like price stability and full employment, should be an explicit goal of national fiscal policy and economic management.

   The use of a multi-year framework for budgeting is now an international standard and has proven useful in establishing a longer-term view and greater discipline. While other countries have adopted a hard "fiscal rule," such as a requirement that budgets be balanced over economic cycles, we do not believe such a mechanical rule is the best approach for the U.S. However, the Peterson-Pew Commission on Budget Reform has recommended setting a glide path to achieve a 60 percent debt to GDP ratio within a decade, a level far below the projected result of current policy. Adoption of this or a similar goal for the medium term would be both practical and helpful. Because the U.S.,

[1] U.S. Government Accountability Office, *Fiscal Exposures: Improving the Budgetary Focus on Long Term Costs and Uncertainties*, GAO-03-213, January, 2003.

unlike many other nations, has failed to adopt an overarching fiscal goal or target, it has deprived leaders and voters of a key compass point as it conducts budget debates.

Medium- and long-term fiscal targets, and estimated budget savings to achieve them, should serve as a starting point for developing annual budgets in both the executive and Congressional phases of the process. In the latter phase, the budget resolution could be reformulated to enact a multi-year deficit reduction agreement to meet a pre-established debt target. The resolution would specify policy changes and spending caps consistent with the target and shape the work of other Congressional committees. As time goes by, the target can be adjusted as needed for changes in the economy, national security challenges, or other emergencies. The budget resolution would annually reaffirm Congressional commitment to reaching the target. Any budget resolution that did not comply with the law would be subject to points of order and backed up by sequestration if the points of order did not have their desired effect.

3. **Incentives -** Incentives such as points of order and triggers can help promote action on some of the major drivers of the long-term fiscal gap on both the spending and revenue sides of the budget. Designing points of order to inhibit the enactment of *new* long-term commitments is something that is well within our current policy traditions – 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 forty years. However, we will need to go beyond restraints on new policies to prompt policy reforms in existing spending and revenue programs driving the long term outlook.

   Enforcement mechanisms can include *"soft triggers."* These would be linked to a benchmark policy goal, can prompt accountability by requiring Presidents and/or Congress to make an affirmative decision to either ignore the trigger or take some action to address it. Such triggers have been described as "speed bumps" because they permit determined majorities to ignore their blandishments, but provide leverage for leaders looking for a reason to act. Some also advocate *"hard triggers"* which, when a benchmark policy goal is exceeded, automatically institute specific policy reforms, either through spending cuts or revenue increases. Hard triggers for Social Security and Medicare were supported by a broad based coalition of budget experts from think tanks ranging from the Heritage Foundation to the Brookings Institution and Urban Institute. This proposal would seek, in effect, to cap these mandatory programs by setting limits on growth, enforced by automatic cuts in benefits and premiums, among other things, when exceeded.[2] An opposing coalition of liberal think tanks and experts argued that

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

the proposal would shift risk from the government to weaker clients and would fail to also address tax expenditures whose growth is also jeopardizing the fiscal outlook.

Spending ceilings accompanied by triggers and caps on the growth of automatic tax and spending programs would transform the nature of government's commitment from open-ended to resource-limited. Given the long-term challenge, it is time to change the presumption that the major share of spending and revenues should remain on automatic pilot.

Significant questions remain about how triggers can be designed to ensure accountability while also providing reasonable certainty and equity for families and businesses, particularly during downturns. Revenue triggers, which could take the form of surtaxes or delays in indexing and other scheduled revenue-reducing provisions, would present novel design challenges, as none have yet been developed, enacted, or applied. Congress has failed to observe its own triggers in the past when it was unable to resolve sensitive equity issues across programs – the failure of Gramm Rudman Hollings deficit triggers and Medicare doctor payments limits are two prominent examples. It is difficult to imagine that hard triggers will be politically sustainable absent major reforms to health care and other programs driving long-term growth of debt. Soft triggers are less controversial and a good place to start enforcing targets and limits.

**Institutional Reforms**

A long-term approach to the budget requires strengthening the central fiscal policymaking institutions for both the President and Congress. As other memos from this group have highlighted, the budget processes followed by Congress and the Executive Branch have split and divided decision-making. This has frustrated the thoughtful consideration of the nation's budget expenditures and revenues – the parts have often been stronger than the whole.

Addressing the long-term budget agenda will require central institutions for budget formulation able to steer change and shape resource decisions across a wide range of programs, committees and agencies. In Memo #2, we discuss strengthening the budget committees as a way to provide a longer-term and more strategic approach.

**Recommended Actions**

1. The President should be required to include in annual budgets a detailed analysis of the impact of his fiscal policies over two decades at least. The President also should provide specific budget proposals to close any projected long-term fiscal gap.

2. The Office of Management and Budget (OMB), GAO and CBO should prepare annual reports on “fiscal exposures”, including the long-term costs of major social insurance and pension commitments.
3. Accruing costs for long-term commitments such as federal pensions and health care and federal insurance programs should be addressed as they arise and included in annual estimates of spending and deficits.
4. The President should propose and Congress enact medium- and long-term targets for the debt, as a starting point for estimating annual and multi-year budget savings required to achieve them.
5. The President and Congress should collaborate to develop soft triggers for both major entitlement and tax programs.
6. Annual budget resolutions should be used to implement a multi-year target such as debt as percent of Gross Domestic Product and should include specified policy changes and caps on appropriated spending consistent with that multi-year framework.

   CBO should be required to assess whether the President’s budget and the budget resolution meet overall savings targets previously adopted by deficit-reduction legislation.