



A Radical Proposal for Escaping the Budget Vise

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Only by changing the budget's auto-pilot programming can we gain the flexibility needed to continually improve government policies and services.

It's clearer by the day that fundamental, radical reform is needed to restore fiscal responsibility to the federal budget. Under current policy, spending grows automatically, by default, faster than tax revenues as the population ages and health costs soar. These defaults are threatening the economy with large, unsustainable deficits. More important, they deny to each generation the opportunity to orient government toward meeting current needs and its own preferences for services. Only by changing the budget's auto-pilot programming can we gain the flexibility needed to continually improve government policies and services.

Background

For over a quarter-century, budget policy has focused on the next year or the next few years while leaving the long run out of sight and out of balance. Even when short-run budgetary success resulted in surpluses at the turn of the century, the limited gains were quickly dissipated by a splurge of spending and tax cutting. Now the unaddressed long-run problems loom ever larger with each year. This specter will grow as long as policymakers continue the feckless quest for a permanent, universal policy to meet every generation's shifting needs or pass misguided laws that attempt to fix almost all of tomorrow's policies today.

Defaults—which govern what happens automatically in the absence of policy reform—permeate government programs, but those of most concern cause programs to grow faster than the economy and rev-

enues. The chief culprits affect health care and retirement.

A few decades ago, such defaults were rare. In the first full fiscal year of John F. Kennedy's presidency, for instance, almost three-quarters of total federal spending was appropriated annually. Of that amount, defense spending constituted over 70 percent (or 53 percent of total 1962 outlays). Over the next 43 years, defense spending grew far more slowly than the economy and the rest of the budget. But mandatory spending—which doesn't have to be appropriated annually—soared over the same period. The three largest entitlement programs—Social Security, Medicare, and Medicaid—accounted for 42 percent of the budget in 2004, compared with 13 percent in 1962.¹ Essentially, these three programs absorbed more than the so-called peace dividend—the resources freed up when defense spending declined. Had all these programs maintained their 1962 share of GDP, in 2005 alone Social Security, Medicare, and Medicaid would be smaller (and defense larger) by about two-thirds of a trillion dollars.²

Congress has little discretion over funds that don't have to be appropriated annually or expenditure levels that don't have to be recalibrated periodically. Even with the reduced flexibility of permanent mandatory programs, however, the budget would still at least come into balance over time if the programs at issue here weren't also designed to *grow* automatically and indefinitely. Thus, as the economy expands by, say, 40 percent over the next decade, revenues will grow by a similar percentage.³ If permanent programs merely

used up constant amounts, those additional revenues would be available for new programs or tax cuts, as the public and its representatives saw fit.

But all this revenue growth—and then some—is already committed to a few mandatory programs. In particular, the cost of the big three is propelled upward by design: pension levels rise automatically as wages rise, more years of retirement payments and Medicare support are provided as people live longer, and Medicare payments expand as new medical drugs, technologies, and services are made available almost regardless of cost. Meanwhile, declines in the birth rate will reduce the future growth of employment and revenues, and the number of beneficiaries of retirement and health care programs will surge after 2007. If Congress makes no changes in these programs, the big three will require an additional 6 to 9 percentage points of GDP by 2030, and more after that.

With so much spending veering on automatic pilot toward levels that cannot be sustained without huge tax increases or draconian cuts elsewhere in government, the fiscal policy discussions of the 1960s now look almost quaint. Macroeconomists then understood that tax revenues would naturally grow faster than spending and talk turned to the high-class problem of “fiscal drag.” Revenue sharing with the states was then considered a nifty way to get rid of “excess” federal revenues.

If budget policy once tended toward greater responsibility, as recent history suggests, the opposite is now the case. To be sure, the budget process has changed some in response to intensifying pressures. The Budget and Impoundment Control Act of 1974, for instance, provides a mechanism for setting a target for total spending, including entitlements, and allows the Senate to pass entitlement and tax changes with a simple majority. The Budget Enforcement Act of 1990 (BEA) capped discretionary spending and created pay-as-you-go procedures that prevented changes in tax or entitlement policies from adding to the deficit in the medium term. But after the surpluses of the late 1990s destroyed fiscal discipline, the Act was allowed to expire at the end of fiscal 2002. With it went

any political consensus on how to handle the large deficits that were then emerging.

In general, process changes have not been nearly as dramatic as changes in budget conditions. Lengthy debate over whether to resuscitate the BEA has gone nowhere. Nor did the debate address the more fundamental issue: that the budget as a whole—both old programs and new ones—needs a new default system, one that makes it harder to deprive the next generation of its decisions and the funds needed to execute them.

Mustering a consensus behind the idea of tightening the reins on automatic spending growth will be hard, but what’s the alternative? Conventional wisdom and procedures cannot solve long-run budget problems. Meanwhile, every additional day that reform is delayed makes a financial meltdown more probable and further squeezes almost every function of government that does not grow automatically.

Budget Constraints

State policymakers are constrained by both constitutional and legislated rules aimed at keeping budgets under control. Forty-nine of 50 states require a balanced operating or total budget. Numerous states have limits on particular taxes, such as the property tax, or on total tax revenues or spending relative to state personal income.

Some budget-watchers have advocated a constitutional amendment that would require a balanced federal budget, but such initiatives have never received enough votes to pass in Congress. The Gramm-Rudman-Hollings Act of 1985 (GRH) specified gradually declining admissible deficit levels—supposedly the path to a balanced budget—and automatic spending cuts if deficit targets were breached. But though GRH ultimately failed—other legislation constantly overrode its requirements—it did prompt passage of the deficit-reduction package of 1990 and the BEA, which ultimately helped balance the budget.

GRH’s failure teaches some important lessons. First, near-term deficit levels are too volatile to use to trigger automatic spending cuts and tax increases or indicate long-term budget problems. Various economic condi-

tions interact—sometimes in complex ways—to affect tax revenues and spending on such entitlements as unemployment insurance. And regardless of the economy’s temperature, other technical factors—such as capital gains realized when the stock market is booming—also influence revenues or spending on particular programs. Indeed, in a typical year, many factors outside congressional control have more impact on the deficit than legislated policy changes do. In the case of GRH, the deficit targets had been formulated using overly optimistic economic and technical assumptions, so the automatic spending cuts needed to achieve those targets were far more painful than could be tolerated politically.⁴

Budget Triggers

If spending or tax policy is to be changed automatically in response to violating some target, the GRH experience strongly suggests looking to something less mercurial than the deficit as a trigger. Options include the ratio of total spending or total entitlement spending to GDP, though neither the numerator nor the denominator of such ratios is immune to economic whims. In any case, it’s more productive to focus first on the long run, where economic cycles are much less in play, and only then on particular program variables—*not* on the budget as a whole.

As noted, among existing programs, Social Security and Medicare are causing the biggest problems. (Medicaid and some tax entitlements need attention too, but first things first.) Automatic changes in Social Security will be necessary, of course, only if the president’s recent proposals don’t prompt reforms or if those reforms are merely partial in concept or execution and don’t solve the system’s financial problems. Even a substantial reform can be incomplete. Some proposals, for instance, bring the system into long-term balance under a set of economic and demographic assumptions, but then move back out of balance if mortality or birth rates fall.

Social Security

Looking first at Social Security in the absence of complete reform, the program

might be changed automatically whenever the trustees report for three consecutive years that it is likely to be in long-run deficit. Once that trigger is pulled, two of many options at that point seem particularly simple and easy to implement. First, the early and normal retirement ages could be automatically increased two months faster per year than under current law for everyone younger than, say, 57 in the year the trigger is pulled. Alternatively, in those years, the benefit formula could be indexed to the lower of price or wage growth, thus allowing average real benefits to increase but more slowly than wages.⁵ This approach could be supplemented by a new special minimum benefit indexed to wage growth. Other options that are somewhat harder on high earners than on low earners could also be contemplated.⁶

There is, of course, no reason to believe that the automatic changes being advocated will alone lead to a socially optimum Social Security system. That is a separate issue deserving of a national dialogue. The point of changing the defaults is, rather, to migrate from a system in which Congress has little choice but to enact painful benefit cuts to one in which it has the opportunity to provide more generous benefits from time to time—that is, to play Santa Claus rather than Scrooge sometimes, as politics requires.

Making the budget automatically more responsive and responsible to future taxpayers and beneficiaries also opens the door to spending more on programs for people who aren’t elderly—especially children—and on public investments. Or Congress might use the freed up resources to make Social Security benefits more generous to those with low average lifetime earnings or to provide more cash to the lower-income elderly to help pay for medical payments. And, of course, Congress can always choose to raise taxes to provide a higher benefit growth rate in each year, though remaining responsible means making each year’s decision to increase benefit levels independent of the next year’s.

Should the payroll tax be raised automatically when the Social Security system faces financial difficulties? Might automatic increases in the base or rate make sense in tandem with benefit decreases? Perhaps,

but in our view, a major fault line in the current system is that it is squeezing out government activities that should have a higher priority than financing longer and longer retirements for a late middle-age and elderly population that includes many fairly affluent people. Automatic payroll tax rate increases would exacerbate this problem by eroding public tolerance for paying, much less raising, the taxes devoted to more worthy causes. On the other hand, consistent with our notion that automatic features should move toward responsibility, the Social Security tax base could be stabilized so it does not erode over time.

Also, taxes as a whole are scheduled to rise as a percentage of GDP thanks to so-called bracket creep (the fact that higher real income over time tends to raise income tax rates). In other words, though short-term tax levels are not sufficient to cover expenditures, the automatic features of the tax system as a whole already move toward greater responsibility and balance over the long run. Don't forget, also, that discretionary increases in tax rates could be introduced as part of a broader reform.

Medicare

Designing reasonable automatic constraints for Social Security is relatively easy compared to taming Medicare growth. For Medicare, the type of trigger featured in the prescription drug bill makes some sense. In a nutshell, the president must recommend remedial policies if a "funding warning" is issued in response to the president's budget. This warning is sounded when the Medicare actuaries predict that general revenue financing will be required to cover more than 45 percent of total program costs in two of the next seven years. So warned, the president has 15 days to submit Medicare funding legislation in response. Although Medicare outlays are difficult to forecast, this trigger is very unlikely to be reset once it has been pulled.

Once this trigger is pulled, however, there is no guarantee that any meaningful legislation will be enacted. Medicare policy, by default, would remain out of balance. Congress could rewrite the default to increase the eligibility age automatically using a formula similar to the one sug-

gested for controlling Social Security spending. Although the system's solvency couldn't be restored this way—the youngest of the elderly cost Medicare far less than the average beneficiary—the change would still generate important additional revenues (not just to Medicare but to the budget as a whole). An alternative approach to staying within budget would cease covering treatments that have low benefit-cost ratios. Oregon attempted such an approach for Medicaid some years ago, but with limited political success. The sticking point here is that, regardless of merit, such an elaborate structure would be difficult to design and implement in the short run.

We suggest that the rule enacted in the prescription drug bill be allowed to operate for two years supplemented by an additional rule. If the first rule fails to slow Medicare cost growth to something approximating the growth of potential GDP, the program's cost growth would be capped either highly restrictively (e.g., equal to potential GDP growth in the past five years) or less restrictively (e.g., 1 percent above potential GDP growth). Since it is impossible for programs to grow forever faster than GDP, an initially high cap could be pushed down over time. If the cap is exceeded, the growth in all payments to health care providers would be slowed by whatever percentage is required to stay within budget. Such an approach would legitimately provoke howls of anguish from health care providers, but the intent is to spur action and to recognize more explicitly that health care costs do not have a greater budgetary claim than education or other programs.

Spending on New Programs

Any budgetary rule is inevitably arbitrary. But current rules governing automatic growth are themselves more than arbitrary. They ossify programs and priorities over time while attacking government functions that don't enjoy the automatic spending growth. In contrast, responsible budget rules free up resources to respond to growing or emerging needs. Moreover, well-wrought rules could provoke Congress to undertake more efficient and equitable cost-saving measures than can be pre-

scribed in a simple one-size-fits-all-generations rule. Further, nothing prevents Congress in any year from short-circuiting that year's automatic rule and deciding to spend more *that year* on Social Security and Medicare.

A somewhat different approach is needed to restrain the creation of new programs that would automatically impose a growing economic burden. The 2006 Senate budget resolution contains a good start. One provision allows points of order against the creation of any program whose costs are expected to grow in successive 10-year periods. More specifically, this limitation on long-term spending proposals requires the Congressional Budget Office (CBO) to prepare an estimate over four decade periods, from 2015 to 2055, for any bill or resolution that increases net direct spending in excess of \$5 billion in any of these four periods. The Senate will not consider any bills or resolutions that exceed this limit unless three-fifths of its members vote to waive the limit. Provisions could be added that automatically curb these programs if actual costs exceed forecast costs.

Triggers that would automatically increase income tax burdens if total spending grows faster than some limit wouldn't be hard to design technically. But tax rates already rise automatically for a different reason than spending on Medicare and Social Security does. To expand on a point made earlier, income tax burdens automatically increase under a do-nothing policy as people are pushed into higher tax brackets by real economic growth, as more middle-class taxpayers become subject to the alternative minimum tax, and as the Bush tax cuts of 2001–03 phase out after 2010 if new legislation is not enacted. Again, whether taxes or expenditures should be higher or lower is another issue; our concern here is whether the automatic features of all major spending and tax systems move the nation toward greater budget responsibility or irresponsibility.

Conclusion

Current budget policy is unsustainable. That is not the inevitable result of an aging population and soaring health costs. Rather, past Congresses have chosen pro-

gram designs that *automatically* accommodate such social goods as longer lives and better health care by scheduling some spending programs to grow forever faster than national income and tax revenues. Yet, determining future policy design by these defaults has serious consequences that can't be ignored. Better ways to mind the nation's budget don't saddle coming generations with inappropriate or unaffordable commitments but they do make it easier to allocate budget growth where it's needed most.

Notes

1. The modern forms of Medicare and Medicaid were not created until 1965, though a tiny amount of health spending in 1962–64 is classified as Medicaid spending.
2. Defense spending declined by about 5.5 percent of GDP from 1962; Social Security, Medicare, and Medicaid increased by a similar percentage of GDP. The decline in defense spending is well over \$1 trillion if counted from 1954.
3. In fact, revenues tend to grow somewhat faster than the economy as the growth in real incomes pushes personal income taxpayers into higher tax brackets.
4. This occurred in 1990 even though the GRH targets had been eased once in 1987.
5. Technically, the so-called bend points in the benefit formula could be indexed to the lower of wage or price growth. This approach to price indexing differs from some recent proposals that ratchet down future benefits by the difference between the rate of growth of wages and prices.
6. The term "progressive price indexing" has sometimes been applied to this effort, but there are many ways it can be implemented. Relative to various forms of price indexing, increasing the retirement ages allows for higher lifetime benefits because it raises more revenues and does not affect the benefits of those who adjust their working years to accommodate the changes.

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