Mr. Chairman and Members of the Committee:

This nation has now lived through a long and arduous cycle of deficit reduction and budget cutting that stretches back almost a generation. The deficit reduction agreements in 1982, 1984, 1987, 1990, 1993, and 1997 were only the principal among many budgetary actions taken to get the nation's fiscal house in order. For the tenure of most members of today's Congress and for the voting lives of the generation of voters in their 20s and early 30s, it must appear as if deficit reduction is the primary legislative function of the federal government.

Think about it, however. The government doesn't exist to reduce its own deficit! The deficit is merely the residual from all of the other spending and tax actions that are taken. Despite higher levels of confidence in public officials, as is often associated with an economic expansion, the public simultaneously expresses both distrust and alienation from government. This alienation, I believe, reflects in part a reaction to the continual legislative preoccupation with cutting back—through net tax increases and net expenditure cuts—on excessive promises that could not be met in the first place.

From this last remark, it may appear that increasing spending or reducing taxes would be our next order of business. Appetites recently have been whetted toward spending budget surpluses anticipated for the next few years. Unfortunately, however, the nation's fiscal house is not yet in order. Although I applaud many of the efforts made in budget agreements to date, they all had one fatal flaw. They focused on short run deficits, not long-run policy. Short run deficits were continually reined in, sometimes more, sometimes less. But most long-run issues were left to another day. Strong budget policy, however, would center its focus first on the long-run. Get the long-run budget in order and the short-run will come around. As long as we continue to look ahead only a short distance, long-run problems almost inevitably are going to continue to plague us.

Three fundamental problems confront us as a nation because of this unwillingness to deal with the long-run:

- First, we are sitting in the eye of a fiscal storm. Hit by large deficits of the past, we are soon to be buffeted by gale force winds. Engaging in a bit of free spending today would be equivalent to dumping what little sand we have in our sandbags onto the beach just before the back part of the storm is about to hit us. And the gale force of an aging population is not scheduled to dissipate.
- Second, EVEN if projected deficits were zero forever, we would not have gained control of our budget. Even if current policy were sustainable in the sense of avoiding mounting public debt, there would still be no fiscal slack. Never before in the history of our nation have so many commitments and so much growth been scheduled in our laws literally for an eternity. Our laws now assert to all future generations that we know better today how to spend all the revenues they will have 10, 50, 100, or 200 years from today. By way of comparison, imagine if at the time the Constitution was first ratified in 1776, our ancestors had put into law provisions and promises for how to spend all the revenues that the government collected today.
- Third, our budget priorities are now upside down relative to our true societal problems. We are scheduled to spend ever rising amounts as a response not to problems but to advances in well-being due to gains in life spans and improvements in health care. Our laws grant us a 16th, a 17th, an 18th year in retirement and require ever rising shares of national income and of government revenues to be spent on health services. Under these laws, most people have already become primarily dependent upon the government for combined retirement and health support for the last third (and rising) of their adult lives. Where we have problems as a society—children unattended by adults, failures of our educational system, areas with too high crime rates—we are scheduled to spend ever smaller shares of our revenues, offset only with occasional attempts to engage in what are primarily symbolic efforts when we are not decrying that we have more will than wallet.

I will speak briefly to each of these issues—sitting in the eye of a fiscal storm, inheriting eternal commitments that leave no room for the needs of tomorrow, and choosing among spending priorities on an uneven playing field.
The Eye of the Storm

It is not hard to understand why we are sitting in the eye of the storm. Under almost any reasonable projection for discretionary expenditures, federal deficits will rise dramatically in the near future. For budget analysts, the last decade of the 20th century and the first decade of the 21st have always been viewed as a time of very modest respite and preparation for the future.

Budget cash flows now largely follow a demographic cycle. The baby bust population of the 1920s, the Depression and World War II is now retiring. Soon, however, they will be followed by the baby boomers, who will swell the numbers of adults dependent upon government while simultaneously leaving the ranks of working taxpayers. Meanwhile, they are succeeding in the working population by another, more permanent, baby bust population. Within a generation - a revolutionarily short period of time by demographic standards—the proportion of the population that is elderly will rise dramatically and the worker-to-retiree ratio will plummet. Within a few decades, according to different projections, the pension and health demands of retiring baby boomers, combined with the rising costs of other health care and interest on debt, will eat up close to 100 percent of projected revenues at current tax rates.

When the impacts of the net interest implied by these projections are factored in and realistic assumptions are made with respect to discretionary spending, the overall federal deficit is projected to rise by as much as 10 percent of GDP within about five decades even before taking into account possible economic feedback effects. Social Security, Medicare, and Medicaid (including nursing home care) will cause expenditures to rise by as much as 7 percent of GDP within about three decades, while interest on the debt potentially adds several percentage points more. These are the strictly programmatic effects with which Congress must deal. Declining national saving due to rising deficits would magnify these problems significantly, as discussed in analysis by the General Accounting Office.

Let me be clear. Partly because of the drastic impact upon national saving and growth, policy makers will not allow these levels of deficits to happen. The projections, however, do warn us of the extraordinarily level of commitment now in the laws. They also reflect that some of the increase in demand to support rising numbers of truly old people will be unavoidable. Finally, they reveal the importance of compounding. Saving surpluses now, as well as avoiding future deficits, can yield very large additional gains in terms of lower interest costs on the nation's debt. Put another way, an additional dollar per year saved in an entitlement program now, at an interest rate of 6 percent, starts reducing the projected annual deficit by two dollars and more annually within a little more than a decade. The magic of compounding can help work wonders on government debt.

Eternal Commitments of Program Growth for an Unknown Future

Never before in our history has the law pre-ordained so much of our future spending patterns. Never before have dead and retired policy-makers so dominated officials elected today. And never before has so much of policy bypassed the traditional set of breaks applied through normal democratic decision-making. When the nation has dramatically increased its financial obligations in the past—through wars, such enormous land acquisitions as the Louisiana Purchase, assistance to workers and the unemployed in depressions—the accompanying budgetary commitments were temporary no matter how large their initial impact. It is the permanence of our newer obligations that is so different and so inappropriate. It makes no more sense to commit today almost all of the future economic resources that will be available to government than it would be to decide today where to station all of our troops until the next millennium.

How did we reach this state of affairs? The answer involves several factors. Societal expectations were built around a higher rate of growth in the 3rd quarter of the 20th century than in the last couple of decades. Rapid growth in domestic spending as a percent of gross domestic product was also made possible through peace dividends and reductions in defense spending. Indeed, most of the domestic spending growth in this nation's history took place under Presidents such as Nixon, Eisenhower, Bush, and Truman, who presided over the spending of Vietnam, Korea, Cold War, and World War II peace dividends.

But the drying up of peace dividends and slower rates of growth still do not explain our fiscal straitjacket. Even if the slower economic growth environment of the post-1973 period continues into the future, future government revenues per capita, after adjusting for inflation, will still double within another half century, perhaps less if we are lucky and engage in good economic policy. Under normal circumstances, this increase of more than one trillion dollars in annual revenues (in today's dollars) would yield significant fiscal slack and projections of surpluses under current law.

The truth is that past policy makers essentially spent more than all the growth in government revenues by building more and more automatic growth into public programs. It would be one thing if they merely bought too many goods and services in a current year. Instead, they bought larger and larger levels of goods and services for decades and decades to come.

Two areas have dominated the built-in growth picture in the United States and other industrial nations: health care and retirement security. The demand for health care is virtually unlimited if we do not recognize any costs when we go to the doctor or the hospital, or when we buy insurance. Not that the costs aren't borne, they are simply shifted to other insurance buyers and taxpayers. Although most policy makers and individuals define a thousand or two thousand dollars of health expenses as catastrophic, average household expenses on all health care goods and services is now around $12,000. Again, that's the average. Most government insurance—and, until recently, most private insurance—hid these costs. This insurance has yet to impose adequate incentives, or, alternatively, constraints on prices and use to slow down the extraordinary growth in health costs—including growth in payments to doctors and other health care providers.
Social Security and other retirement payments by government, in turn, have grown faster than the economy largely because of improvements in health and longevity. A larger share of the population is living to retirement and individuals are spending more of their lives in retirement—almost a decade more than early Social Security retirees. For a typical couple retiring today, Social Security benefits for the longer living of the two will last about 25 years. Thus, the cost of the program has risen significantly because there are so many more years of payment. More years of retirement also reduce the number of taxpayers for both Social Security and other purposes, thus raising tax rates on those still working.

These longevity cost increases are added to programs already scheduled to grow significantly, because annual benefits to new retirees are indexed to grow as fast as average wages in the economy. This indexing system not only protects retirees against inflation—a worthy goal, in my view—but promises each successive generation a higher standard of living. If benefits were held to a much more modest rate of growth, it could much more easily finance the retirement of the baby boomers.

One consequence of so much built-in growth is that it takes ownership of government away from current voters and their elected representatives. This debate is sometimes framed in the language of mandatory or entitlement spending. In the early 1960s, over 2/3rds of spending was discretionary; today it is less than 1/3rd and the fraction has been declining under both Republican and Democratic budget proposals alike. Depending upon this type of decline in discretionary spending to continue—even independently from its corrosive effect on the democratic process—simply has no theoretical or empirical justification. One can assume it only through a mechanical calculation that has no relationship to foreign threats, educational opportunities, transportation demands, the needs of the impaired and disabled, or other future domestic concerns. In the fiscal 1999 budget, for instance, the Administration showed how continual declines in discretionary spending could pay for some of this growth in mandatory spending, but the assumption required to pay for huge mandatory spending growth was that discretionary spending would continue to fall toward zero relative to the size of the economy. (Figure 2 shows both historic and hypothetical changes in mandatory and discretionary expenditures under this impossible scenario. Figure 3 shows how different program areas fare under the Clinton budget between fiscal 1999 and 2003.)

An Uneven Playing Field for the Setting of Priorities

There are those who would argue that automatic growth in programs doesn't matter. From one camp come concerns over protecting growth in social programs, from another it is the growth in tax breaks for businesses and savers that is sacrosanct. The plea made is that, well, we established them, we can get rid of them as well. What's wrong with making excessive promises or committing the wealth of future generations as long as we can renge along the way?

Backing up crystal ball predetermination of future needs with the force of the state is not costless. These extra costs arise inevitably because of the uneven playing field among programs, between entitlement (including entitlement to permanent tax breaks) and discretionary spending, and among entitlements with different built-in growth rates. The impact of the vast differences in the way these two types of spending are currently treated can hardly be overestimated. To restrain the automatic growth of entitlement spending requires what is really a super majority—the combination of a simple majority in the House, a simple majority in the Senate, plus the President's support (i.e., no presidential veto), or, alternatively, the combination of two-thirds majorities in both Houses. A super majority is now required to expand discretionary spending. Thus, new needs, which must be funded out of new legislation, are put at a dramatic disadvantage relative to old needs, already prefunded out of old legislation. This has been and continues to be a practical recipe for stultifying the responsiveness of government to change.

Summary

In summary, we have only begun our journey toward a sound budget policy. The deficit has never been more than a symptom of the disease from which we suffer, and even attention to that symptom has so far focused primarily on current, not future, relief.

Current law still has built into it extraordinary growth rates of as much of 7 percentage points of GDP in a few retirement and health programs within a little over three decades. It is this type of automatic growth that must be brought under control—not simply to avoid future deficits, but to build a government that is more responsive to the needs and demands of the nation.

One should not approach this issue with pessimism. It is said that a pessimist is one who smells flowers and then looks for a casket. The budgetary fix we are in is mainly due to success at living longer, better health care, and stable population growth. We need merely to recognize these as successes, and then accommodate our budget to these conditions, not to the standards of a bygone era.
DEFICITS -- PAST, PRESENT AND FUTURE

Mandatory and Discretionary Spending as a Percent of GDP 1960-2060
Clinton Budget Proposal without Long-Run Reform

Source: C. Eugene Steuerle and Andrea Barnett, THE URBAN INSTITUTE. Based on Data from the Budget of the United States Government, Fiscal Year 1999. Note: Domestic Discretionary Spending = Discretionary Spending minus spending for defense and international affairs.

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