COMMITTEE FOR A RESPONSIBLE FEDERAL BUDGET

BUDGET UPDATE
JULY 12, 2005

Being a budget watchdog generally involves a healthy degree of pessimism and the last few weeks have provided plenty of reminders why. It was encouraging to see the appropriations process moving forward within the tight spending limits set by the budget resolution. That is, until a political firestorm over veterans benefits erupted, leading to pressure for increased spending. While efforts to achieve the modest savings in mandatory spending programs are moving forward slowly, momentum is growing for further tax cuts beyond those contemplated in the budget resolution, which already increases the deficit above current law. Discussion about restoring Social Security solvency has been replaced by a debate about whether to save Social Security surpluses in government trust funds or individual accounts, which, for whatever their merits, would not improve solvency.

Appropriations Update

The appropriations process was moving forward smoothly until a controversy regarding funding for veterans healthcare flared up. It was extremely encouraging that the House was able to pass all eleven appropriations bills before the Fourth of July recess and complied with the tight spending limits contained in the budget resolution with very few gimmicks (except for the now-routine gimmick of shifting funds from defense to non-defense accounts in anticipation of replacing the defense funds in a supplemental appropriations bill next year). Numerous amendments attempting to increase funding were offered, but while a couple of amendments to restore funding for popular programs such as Amtrak and the Corporation for Public Broadcasting by reducing funding for other programs were adopted, for the most part the House passed the bills reported by the Appropriations Committee. Although it remains to be seen whether this trend can continue as the appropriations bills move through the Senate and conferences, the House deserves credit for starting the appropriations process in a relatively orderly and responsible manner.

The New America Foundation
1630 Connecticut Ave. N.W. 7th Floor, Washington, DC 20009
(202) 986-6599 / CRFB@Newamerica.net

Then the Veterans Administration announced budget shortfalls for veterans healthcare of $1 billion in the current fiscal year and $1.5 billion for fiscal year 2006. There is disagreement about whether this shortfall was the result of outdated budget projections or a failure to anticipate the increased healthcare demands as a result of military operation in Afghanistan and Iraq. The VA is currently covering the shortfall in healthcare programs by deferring $600 million in non-critical capital expenses and tapping into $375 million in unused accounts elsewhere that the VA had planned to carry over to fiscal year 2006.

The Senate passed an amendment providing $1.5 billion in supplemental appropriations for fiscal year 2005. The funds were designated as emergency spending and are not subject to the spending limits established by the budget resolution. The Senate amendment assumes that some of those funds would remain available to be spent in fiscal year 2006, but the Senate may also plus up funding in the regular fiscal year 2006 appropriations bill. Meanwhile, the House passed a freestanding supplemental appropriations bill approving the Administration's request for $975 million in supplemental funding for fiscal year 2005 to replenish the VA accounts being used to cover the shortfall. This funding level fits within the budget resolution spending allocations for fiscal year 2005 because there is roughly $1 billion remaining under the discretionary spending allocations as a result of appropriations that were rescinded as part of the Iraq supplemental. The House leadership has indicated that it will try to provide additional funds requested by the Administration to fill a shortfall in VA funding for next year within the budget resolution allocations for fiscal year 2006.

Press attention has focused on the issue of how much additional funding will be provided. There is, however, a related issue important to budgeters of whether this additional funding will be designated as emergency spending and exempted from spending limits. It remains unclear how much additional funding will be provided for fiscal year 2006 through the regular appropriations process and whether these additional funds for fiscal year 2006 have to fit within the budget resolution allocations or will be designated as emergency spending above the budget resolution limits.

This flare-up raises a cautionary note as Congress continues work on the appropriations bills. Even if Congress and the President can enact appropriations bills that fit within the budget resolution spending limits, there is no guarantee that spending will actually stay within those limits. Congress and the President may understate the funding needs of certain programs – knowingly or unknowingly – resulting in a political crisis that requires additional funding next year. Alternatively, policymakers may agree to increase funding for high-profile programs by cutting funding for less glamorous "nuts and bolts" programs, which may go unnoticed now but could create a shortfall that will require additional funding to continue important government operations.

Highway Bill

The news regarding the highway bill was somewhat more encouraging. House and Senate negotiators reached agreement on an overall funding level of $286.5 billion over the next five years, $8.5 billion less than the bill passed by the Senate by a veto-proof 89-6 margin. President Bush had said he would veto legislation over $284 billion, but the Administration has reportedly indicated that it would accept this level. The agreed to level would be a substantial increase above the $218 billion in spending over the last six years and considerably higher than the $256 billion spending level limit the White House set last year, but is well below the spending levels that were being discussed by Congressional leaders. Many important issues remain to be resolved regarding the allocation of funding, the amount of special projects that will be earmarked by the bill, and whether the conference report will contain the "re-opener" clause from the House bill that would require Congress to revisit the bill if states do not receive a minimum guaranteed level of funding under the bill. The President has indicated he would veto a bill with a re-opener clause.

Reconciliation Update

The budget resolution instructed several committees to report legislation by September 16th. The largest source of savings, and therefore the area of most controversy, is the Medicaid program. The reconciliation instructions assumed savings of $10 billion from the Medicaid program, although there has been speculation that the committees may substitute changes in Medicare for some of the required savings. Governors have put forward a plan to achieve Medicaid savings by giving states greater flexibility to control costs by reduction of payments for Medicaid covered drugs, further restricting the ability of people to shelter assets to qualify for Medicaid covered nursing home care, and expanding cost-sharing requirements. The Governors' recommendations met with a mixed response by the members of the Finance and Energy and Commerce Committees.

The Department of Health and Human Services has announced the creation of the commission to make recommendations for changes in Medicaid to achieve savings. The commission has been directed come up with suggestions for ways to achieve $10 billion in savings from Medicaid over five years by September 1st, as well as recommendations for long-term changes to the program. The outlook for the commission has been put in doubt by the refusal of Congressional Democrats and the National Governors Association to participate in the commission. Former Tennessee Gov. Don Sundquist, a Republican, was named as commission chairman and former Maine Gov. Angus King, an independent, was name vice chairman. The two positions set aside for governors as well as the eight non-voting slots for Members of Congress have not been filled.

Improved Budget Outlook?

Federal revenues have continued to increase much faster than anticipated. As a result, this year's budget deficit is likely to be much lower than previously projected, even with additional spending for military operations and faster than expected growth in Medicare and other programs. Last week, the Congressional Budget Office indicated that it expected the deficit for the fiscal year to be significantly lower than $350 billion, perhaps even lower than $325 billion. This would be well below the $400 billion it had previously projected (after adjusting for supplemental appropriations for Iraq that were not included in the earlier forecast). Revenues have continued to increase at a rapid pace, leading some analysts to speculate that the deficit may be as low as $300 billion.

Some advocates of tax cuts have begun to argue that this increase is a validation of the Laffer Curve and supply side economics. Under supply side theory, revenues should be higher than projected when the tax cuts were enacted. However, even with the recent surge, total revenues this year will be much lower than the projections made in 2001 adjusted to reflect the costs of the 2001 and 2003 tax cuts under so-called “static” scoring.

The recent increase in revenues is unlikely to change the long-term budget outlook in any significant way. As CBO Director Doug Holtz-Eakin pointed out, the increase is the result of unique circumstances and factors including temporary corporate tax breaks that may not continue in the future. We assume that CBO will not incorporate much of the increased revenue growth in its long-term budget projections.

Certainly, policymakers should not repeat the mistakes of 2001 by allowing improvements in the short-term budget outlook serve as an excuse to further relax, already overly lax, fiscal discipline.

Social Security Reform

Republicans in Congress introduced legislation to divert existing Social Security surpluses into individual accounts, creating “personal lockboxes”. The Republican leadership in the House has indicated that they intend to move this proposal forward in lieu of changes to restore long-term solvency. However, Ways and Means Chairman Bill Thomas and Senate Finance Committee Chairman Chuck Grassley are continuing to push for more comprehensive legislation that also addresses solvency.

The Committee has long maintained that comprehensive reforms to fully restore solvency are needed, and, moreover, that a comprehensive and coordinated approach to tackle both the retirement and the healthcare challenges of the aging population would be in the best interest of the fiscal health of the country. While it is possible that the basic idea of using individual accounts rather than government trust funds to prefund Social Security would be a more effective way of increasing national saving, we are concerned that many legislators view this plan as a way to put the issue of Social Security reform behind them without addressing the tough choices that will be needed in order to restore solvency.

The plan would place $1.7 trillion of payroll tax surpluses into individual accounts between 2006 and 2016 ($1.1 trillion in constant 2005 dollars). Because these funds would not be available to finance deficits in the rest of the budget, the government would have to replace these funds with additional borrowing from the public at a time when the federal government is already placing substantial demands on private capital markets to finance structural deficits.

The plan would make transfers from general revenues of $422 billion (present value) so that the trust funds would not be exhausted sooner than under current law. The long-term savings from the benefit offsets counter most, but not all, of the transfers. When the savings from the benefit offset that are realized after 2040 are counted, the net long-term impact of the legislation would be to increase the cash shortfalls of the system by $91 billion in net present value as a result of the costs for administering the accounts, as well as some leakage from the system.

However, the political economy effects *could* have a positive impact on the government's fiscal outlook. The existence of the current trust fund surpluses masks the full size of the budget deficit and, many observers believe, allows Congress and the Administration to tolerate larger on-budget deficits than they otherwise would. Thus, ending the practice of using the Social Security surplus to mask the full deficit could result in a positive change in budgetary behavior. The day after the President signed the bill, the unified deficit for fiscal year 2010 would increase from $260 billion to approximately $390 billion. In theory, the higher unified deficit numbers could increase pressure for deficit reduction and make policymakers more reluctant to enact new tax cuts or increase spending. The budget skeptic in us, however, makes us question whether policymakers who apparently are comfortable tolerating unified deficits in excess of $200 billion a year into the future would respond differently to continued deficits in excess of $300 billion a year.

Different versions of this proposal were introduced in the House and Senate. Although both bills are based on the same concept, there is a fundamental difference in the way the bills are structured that has significant consequences. Under the Senate version, excess payroll taxes would be deposited in an individual account *instead* of the trust fund. By contrast, under the House version, payroll taxes would first be credited to the Social Security trust fund and lent to the general fund in exchange for Treasury bills, and then transferred to an individual account. Instead of using accounts as a different mechanism to save current payroll tax surpluses, the House bill effectively double-counts the funds and establishes a new debt-financed entitlement program on top of the existing trust fund, creating the appearance of improving trust fund solvency on paper without actually improving the ability of the government to finance benefit obligations in any real way.

Neither bill would address the long-term financial shortfalls facing Social Security. The sponsors of the bill in the Senate have acknowledged the need for further reforms to restore solvency. That is an improvement over some of the "free lunch" rhetoric which presents individual accounts as an alternative to the tough choices of increasing revenues and restraining costs. Advocates of the bill argue that it would make it easier to enact comprehensive reform once there was a mechanism to truly save the Social Security surpluses. This would give legislators (and their constituents) greater confidence that any savings from tax increases and/or benefit changes in Social Security reform would be saved for Social Security and not used to further mask the size of the deficit and effectively finance other rounds of tax cuts or spending increases. On the other hand, it is also possible that by playing into the public misperception that the problems facing Social Security are purely a result of "Congress stealing the surplus" the bill could create the false belief that placing the surplus in accounts would solve the problem, making structural reforms unnecessary.

Whether this plan would have a positive or negative impact on the budget and/or prospects for comprehensive Social Security reform depends on how the changes would influence future legislative actions. Would removing the Social Security surpluses entirely from budget calculations have a salutary impact on the budget decisions? Would passage of the plan create the misimpression that the real work of reform had been completed, thus making subsequent necessary actions less likely? We would be much less skeptical about this plan if we had more confidence in the answers to these questions.

Re-Instating the Pay-As-You-Go Principle

The Committee recently joined other budget watchdog groups to issue a statement calling for reinstatement of pay-as-you-go rules for all legislation that would increase the deficit. http://crfb.org/documents/FiscalDisciplineJointStatement.pdf

Reinstating paygo rules would not by itself balance the budget, but it would represent an important first step in bringing discipline to the budget process by prohibiting policy changes that would further enlarge the deficit.

Several tax cut proposals with bipartisan support are being seriously considered in Congress. Legislation to repeal the Alternative Minimum Tax has been introduced in the Senate with significant bipartisan support, including the Chairman and Ranking Member of the Finance Committee. Although some of the sponsors of the AMT repeal bill have expressed a desire to pay for the costs of the bill, they have indicated that the AMT repeal is a high enough priority that an inability to identify offsets should not prevent action. The House of Representatives has passed legislation that permanently repeals the estate tax. Meanwhile, bipartisan negotiations are being conducted in the Senate on an estate tax compromise that could have a fiscal impact nearly as large as complete repeal. Members of both parties have talked about tax incentives for retirement savings or new entitlement programs as part of or a retirement security package. While there may be legitimate policy arguments for each of these proposals and each item may seem affordable individually (though given the current fiscal situation, none are), the cumulative impact of these proposals would be to make an already dire budget outlook even worse.

The threat to the pay-as-you-go principle may currently be coming primarily from tax cut proposals, but it could just as easily come from proposals to create or expand entitlement programs. Continuing to ignore the pay-as-you-go principle for tax cuts increases this likelihood. The pay-as-you-go rules of the 1990s were successful because they represented an agreement by both parties to place restrictions on the ability to advance their priorities in exchange for the other side doing the same.

In the absence of legislation formally reinstating pay-as-you-go rules, which is extremely unlikely to occur this year, Congress and the Administration should return to the pay-as-you-go ethic for all legislation.

When Congress and the Administration finally decide to reinstate basic rules for fiscal discipline, there are several issues that need to be addressed. For instance, many tax cut and spending proposals have relatively modest costs within the near-term budget window covered by paygo rules, but have much larger long-term costs that are not subject to limits. Similarly, the international tax bill enacted last year was the latest example of legislation with permanent costs offset by temporary savings that complied with the pay-as-you-go principle within the budget window but added to the long-term fiscal shortfall. On the flip side, some proposals with near-term costs are justified on the basis that they will produce long-term savings. Addressing these complex timing issues involves several difficult questions about how to measure long-term costs and savings of legislation, the increasing uncertainty of cost estimates as the time horizon expands, and how to balance the relative certainty of near-term costs with the less certain prospects for long-term savings.

A related issue is how budget rules should apply to extension of expiring tax cuts. The President's budget included a seemingly arcane proposal to include extension of expiring tax cuts in the budget. While most budgeters agree that including the costs of extending tax cuts is necessary to present an accurate picture of our fiscal future, including those costs in the baseline would mean that legislation permanently extending these tax cuts would be considered "free" for purposes of pay-as-you-go and other budget rules. Since many of the sunset provisions were added to tax cuts in order to fit within budget limits when they were enacted, allowing these tax cuts to be extended without being subject to budget limits would effectively undermine the agreement reached in 2001 and 2003 to limit the size of those tax cuts.

House Budget Committee Hearing

The House Budget Committee held a hearing on Budgeting in the Congress. Panelists included Bill Frenzel, Co-Chair of the Committee for a Responsible Federal Budget, Allen Schick, from the University of Maryland, and Richard Kogan from the Center on Budget and Policy Priorities. The three panelists agreed on a number of things including that it would be useful to include an annex to the budget to show the present value of accrued liabilities to the federal government. Furthermore, each of the panelists agreed that paygo rules covering tax cuts and entitlement spending should be reinstated. Finally, there was an interesting discussion of the use of baselines and sunsets. Committee Co-Chair, Bill Frenzel, suggested forming another Budget Concepts Commission to deal with these and other issues.

Bill Frenzel's testimony is avaialbe at:
http://www.house.gov/budget/hearings.htm

A webcast of the full hearing can be found at:
http://www.house.gov/budget/hearings.htm

The Exercise in Hard Choices

The new version of the Committee's *Exercise in Hard Choices* is available. The Exercise has been run in over 20 high schools around the country this year and has received rave reviews from students. It is available to be used at Town Hall meetings, for Members who want to run the *Exercise* in their home districts, and to high schools. Paper-based versions and remote hook-ups are available. For more information, contact the Committee at (202) 986-6599.