

Prospects for a Sustainable Budgetary Policy in the United States

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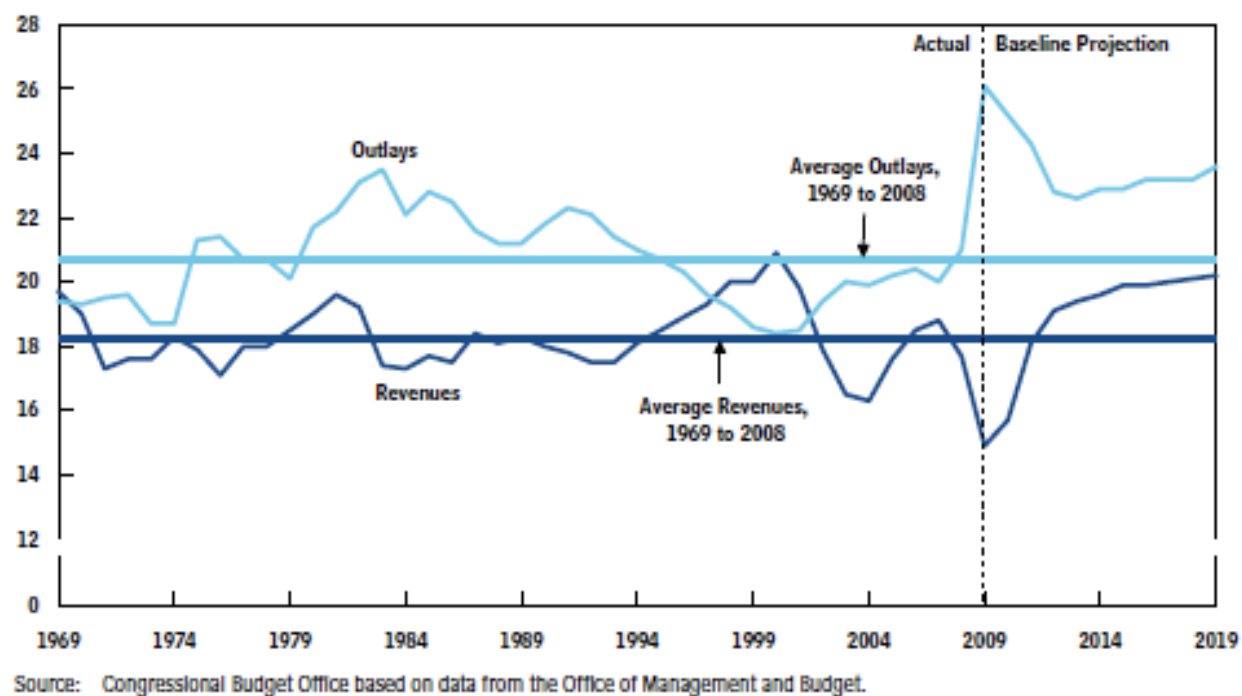
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The financial crisis of the the past one-and-a-half years has increased concerns about the sustainability of the United States budgetary position. While most budget experts in the United States had been warning of the difficulty of financing Social Security, Medicare, and Medicaid benefits for future generations, some are now also asking whether the United States can finance projected government borrowing over the medium-term at an acceptable cost. And, as you well know, creditors of the United States are concerned about the likely return to their investments and about the merits of the dollar retaining its status as the world's reserve currency.

Over the past decade, the U.S. government has substantially increased its structural deficits. Figure 1 shows the past forty years of budget totals, and official projections for the next ten years by the Congressional Budget Office (CBO, 2009b). This shows that deficits averaged about 2.4% of gross domestic product (GDP) over recent history, exceeding 5% of GDP only in the mid-1980s. The current deficit of about 10% of GDP is a cyclical aberration, jointly caused by the automatic stabilizers which have responded to the Great Recession, and a large and likely effective attempt to use countercyclical discretionary fiscal policy to reduce the depth and length of this recession. In addition, the Federal Reserve has creatively used its monetary powers, arguably in ways that at times substituted for powers usually reserved to the fiscal authority, in an impressive rescue of the economy from the brink (CRFB, 2009).

Figure 1: U.S. Budget Totals, Historic and Projected, as percentage of Gross Domestic Product

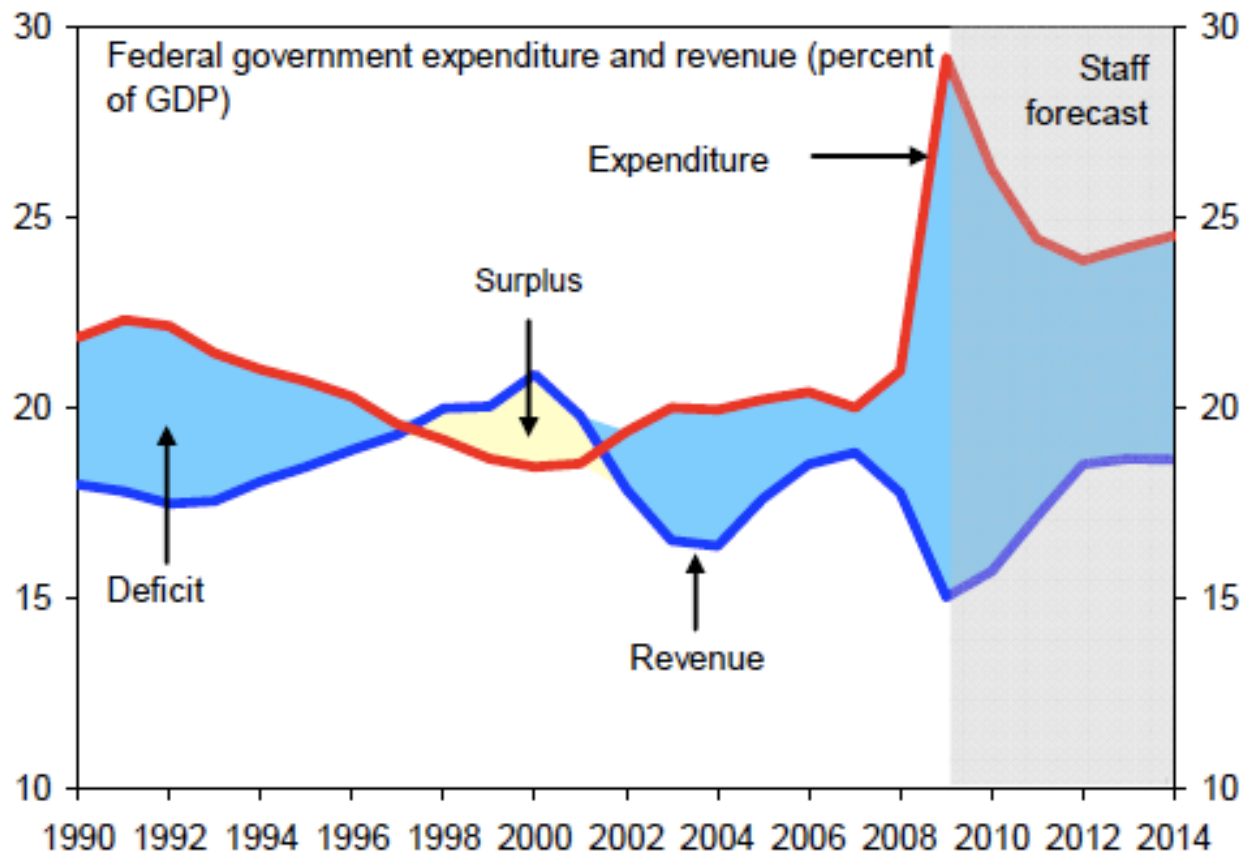


Looking forward, most experts are reasonably confident that the Fed will successfully unwind its balance sheet as the economy recovers. Official budget projections also show that deficits will return to a level not much larger than the recent historical average. However, a closer look at these budget projections reveals several problems.

The budget law of the U.S. requires the budget agencies to use several technical assumptions that have the effect of showing smaller deficits than are likely. The most important of these is the assumption that previous reductions in taxes which are scheduled in law to expire soon, thereby increasing revenues, will in fact expire. This assumption is responsible for much of the projected increase in revenues above its historical average. But there is no expectation among the public and elected officials that all of these effective tax increases will in fact occur. Official projections for the spending side of the budget also incorporate unrealistic assumptions, though this overoptimism is smaller than that on the revenue side.

Figure 2 shows more realistic projections, drawn from the International Monetary Fund staff report for the 2009 Article IV consultations with the United States (IMF, 2009).

Figure 2: U.S. Budget Projections by the International Monetary Fund, July 2009



Source: International Monetary Fund, <http://www.imf.org/external/pubs/ft/scr/2009/cr09228.pdf> p. 21.

Like the IMF projections, but in contrast to the CBO projections, President Obama's Office of Management and Budget (OMB) has ignored the budget law's technical requirements, by assuming that most of the scheduled tax increases will not go into place. This results in projections of larger deficits, which exceed 5% of GDP over the ten-year projection period.

The Obama administration has also proposed policy changes that would reduce these deficits. A revealing observation about these plans was made by OMB Director Orszag on his blog:

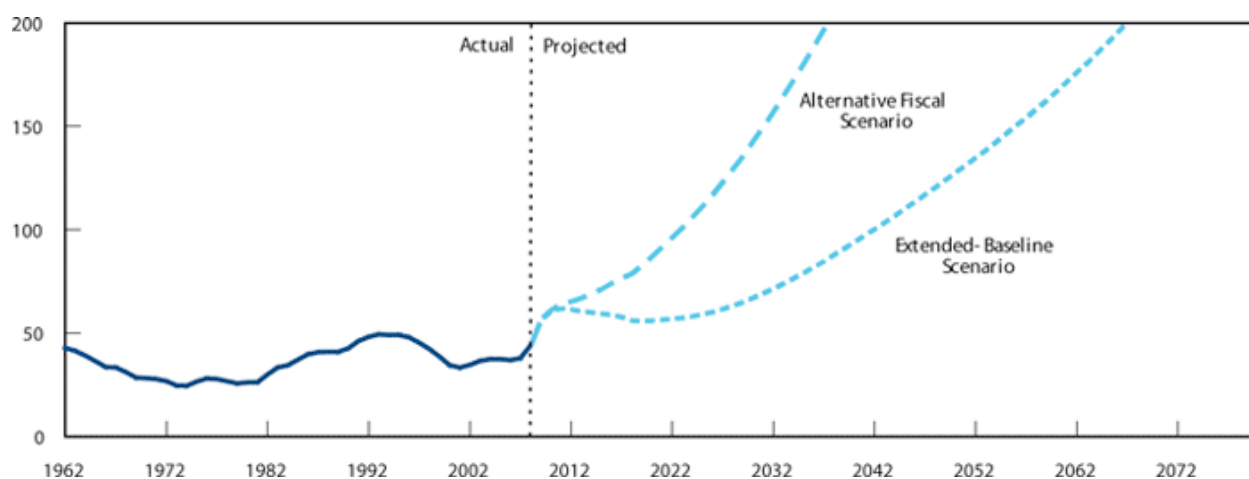
It is worth noting, however, that by 2019, the difference between non-interest spending and revenue, which is also known as the "primary deficit," is only 0.6 percent of GDP. (<http://www.whitehouse.gov/omb/blog/09/08/25/Mid-SessionReview/>)

In other words, the Obama administration has proposed relatively small reductions in deficits over the next ten years. This very slow glide path towards “balance” has been common in recent budget history--e.g., President George W. Bush promised to cut the deficit in half over five years. Note also that these policy-based projections assume, among other things, revenues from the auction of CO₂-equivalent emissions allowances (which Congress is rejecting), and deficit-neutral expansion of health insurance to almost all citizens (which is very difficult to pull off).

Continued primary deficits guarantee that public debt will increase dramatically, unless economic growth accelerates to levels that are almost unimaginable for the United States. The country can entertain this option because it still has a ratio of public debt-to-national income that is relatively low compared to some other rich countries. Yet, the U.S. policy is also “rich” in irony to smaller and poorer countries that have been required to run primary surpluses for many years in order to drive their ratios of public debt-to-national income to acceptable levels.

Even worse is the scenario presented by longer-run projections. These projections must be treated as highly uncertain. I am much more skeptical than are most U.S. budget experts about the wisdom of making projections that extend seventy-five years into the future. But these projections clearly show unsustainable conditions over the near-long term, far before the 75-year period ends.

Figure 3: Federal Debt Held by the Public Under CBO’s Long-Term Budget Scenarios



Source: Congressional Budget Office

In Figure 3, the projection to the right (“extended baseline”) relies on the assumptions I earlier described as politically unrealistic in the short-term, and the projection to the left (“alternative fiscal”) assumes that the tax rates and other policies now being applied continue through the projection period (CBO, 2009a). But before the ratio of public debt-to-national

income reaches 200%, these policies will change. In the words of Herbert Stein, President Nixon's economic advisor, "if something can't continue forever, it will stop."

Budget experts in the U.S. frequently cite this so-called "Stein's law" with a sardonically humorous tone. It is true, but it doesn't answer the questions that must be posed next: When will we stop it? And how will we stop it? These are the questions that I will address in the rest of this talk.

I believe that the answers to these questions necessarily involve the budget process of the U.S., and more generally, some of the topics that you are addressing at this conference, such as fiscal transparency. Though the U.S. and China both have massive economies and take leading roles in world governance, the two countries also differ greatly in their histories, cultures, and political and economic institutions. But I also believe that my review of the budget process of the United States will in some ways be quite relevant to the situation in China.

The constitutional structure of the United States is exceptional in the tremendous authority it grants the Congress over public finances. From 1789 to 1920, the legislature was usually the dominant budgetary power. But in 1921, the Congress ceded some of its authority to the executive, as the final product of a decades-long movement to reduce massive corruption first in local and state governments, and eventually in the federal government.

This centralization of the budget process has largely worked as intended, and in many significant respects American budgeting and financial management is of very high quality. Some summary details are:

- Throughout the federal government, and especially in the Treasury and the central budget bureau (OMB), there is a highly-professional and honest civil service,
- The supreme national auditor, the Governmental Accountability Office, is independent and influential,
- The challenging task of revenue forecasting is done with professionalism, and in most recent years, has been largely unbiased,
- Despite occasional complaints about an overbearing revenue administration, revenue collection is fair and often efficient, with tax evasion at a comparatively low level,
- Appropriations are provided typically in lump-sum form, but are based on detailed agency justifications, and are supported by a sensible classification system,
- Enacted budgets are largely spent as intended, and supplemental appropriations for unanticipated expenditures are usually not large (supplemental funding for the current wars is large but anticipated),

- Extrabudgetary funds (in U.S. parlance, “off-budget” funds) are relatively rare, given the well-accepted principle that the budget should be “unified,”
- Funds raised by agencies through fees for services are authorized and appropriated by the Congress and the President,
- Capital spending is included in the budget along with recurrent spending,
- Staffing and compensation decisions are fully integrated with the budget, and
- Cash and debt management are very efficient.

Though these attributes are now commonly viewed in the U.S. as indispensable elements of a technically sophisticated budget process, they were put into place through lengthy political and often controversial processes. And of course, there are additional opportunities for improving the current system. Some examples are:

- Imperfect control over contracts with private vendors, particularly for national security, enables excessive reimbursements,
- While the federal budget is generally comprehensive, it has improperly excluded some entities which presented significant financial risks to the central government, as illustrated recently by the effective nationalization of Fannie Mae and Freddie Mac,
- The cash basis of accounting for most of the federal budget underestimates likely expenses for insurance programs and for selected entitlement programs, and
- The budget process gives insufficient scrutiny to most tax preferences, which has produced a tax code that is grossly unfair, and so complicated that compliance is a significant burden to ordinary taxpayers.

Reforms that address these problems could make a significant contribution to moving the U.S. towards a more sustainable budgetary policy. The Obama administration is especially interested in saving money by reforming defense contracting. However, using this to promote budget sustainability would require a reduction in the defense spending total rather than the transfer of the savings from contracting reform to other defense missions. While public opposition to operations in Iraq and Afghanistan has been relatively strong, that has not yet progressed to a decision to reduce the military’s ability to project power, or to put it more controversially, to lessen the ambition towards empire.

Regarding the budget’s scope and its recognition of the future, health reform is the major issue for now, and for the future. I think it quite likely that a significant health reform bill will

pass, and that this bill will expand access and set in motion a reduction in the projected rapid growth rate in health care costs. However, the latter savings can be realized only over an extended period of years.

This issue also illustrates a challenge that you will recognize--the extent to which subnational governments should be expected to mobilize resources and provide services, particularly those that redistribute income to the needy. Medical services for the poor in the U.S. are paid for by Medicaid and related programs, the financing of which are shared by the federal, state, and local governments. Health reform could place an additional financing burden on subnational governments, which in the U.S. are expected to balance their operating budgets. This is a particular problem during economic downturns, for budget balancing by subnational governments "automatically destabilizes" the economy, partially counteracting stimulative efforts by the national government. The states also compete with the federal government in drawing on certain tax bases, particularly individual income and certain excises (tobacco and gasoline). The long-term possibility of a national VAT would increase this competition, as state and local governments now rely heavily on sales taxes.

Many advocates of budget sustainability in the U.S. have advocated cuts to health spending and to the other large entitlement program, Social Security. While on limited occasions they have been successful, such as by reducing payments to medical providers and by delaying the age for eligibility to full retirement benefits, in general they have failed. There are several reasons why this should be unsurprising; one is that the generosity of the U.S. safety net is quite low when compared to other rich countries, which shows up in the relatively high inequality of U.S. society.

Undaunted, some of these "budget hawks" have proposed an alternative procedure, in which a government commission of "independent" experts would propose cuts, which would then be ratified by Congress and signed by the President (Walker, 2009). The theory is that by ceding some authority, elected officials could avoid blame from the public for advocating cuts in benefits, and let experts work out the details of budget savings without having to deal with excessive interest group pressure. Though the advocates of this approach include the Chairman of the Senate Budget Committee, they have not convinced President Obama and other influentials to adopt this approach. Yet they appear poised to attempt again by proposing this procedure as an amendment to an upcoming statutory increase in the limit on the government's debt. I think their aspirations are unrealistic. It is highly unlikely that legislators will believe that they could avoid blame for spending cuts adopted under this procedure, so they are unlikely to approve the procedure in the first place.

This is not to suggest that there are no deficit reduction possibilities with spending. Over the past two decades, government agencies have made impressive progress with measuring program performance, and have often incorporated this information into the budget preparation process. In theory, this should allow the elimination of outdated programs which may have made sense when initiated but no longer do so, aside from the political one that beneficiaries are

politically active. But those political forces are often more influential than budget hawks, particularly in the legislative branch. An obvious example is subsidies to agriculture.

To date, the Obama administration has avoided tax policy, but the scheduled expiration of the Bush tax cuts will provide it with the opportunity to push for a comprehensive reform of the tax code. This approach is consistent with the views of his major budget and finance advisors, who would target tax increases on the rich and reduce tax preferences. Another option to consider for the long-term is a national VAT, with the proceeds to be dedicated to health spending. However, among rich democracies, the U.S. has the most anti-tax political culture, one which has long provided the foundation for the Republican Party. It will be exceedingly risky for the Democratic Party to advocate tax increases of the magnitude needed for sustainability.

This discussion has recognized that budget sustainability is attained only through policy changes that increase revenues and reduce spending. But it also should be recognized that such policies are more likely to be adopted with a particular kind of budget process. That kind of process is not simply one in which governments have skill in the more technical aspects of budgeting. The required process also needs features that are inevitably political. Specifically,

- both elites and public must develop an understanding of the sustainability problem,
- both elites and public need to feel obligated to support prudent policies, in part by accepting norms and in part by responding to well-designed incentives, and
- elites should design institutional structures, processes, and rules to enable them to adopt and maintain prudent policies.

To address these points, I return to the issue of what is the appropriate level of centralization for effective budgeting. The recent budget history of the United States can only be understood by recognizing that in 1974 the country returned to a root idea of its constitution, which is that overcentralization is dangerous.

The prime actor in this drama was the leader responsible on the U.S. side for the revitalization of U.S.-China relations, President Richard Nixon. His use of budgetary powers was viewed by the Congress as “imperial,” and the Congress responded by enacting the Congressional Budget Act. This law asserted a Congressional right and responsibility to draft its own budget plan--a daunting task for a bicameral legislature in a political system of competitive parties, numerous influential interest groups, frequent elections, and strong expectations that its budget actions will be transparent to the media and the public.

The three-plus decades of experience under this law includes some great successes and some great failures, so making a summary judgment is not easy. However, it is my view, and the

view of a number of other budget experts, that the process is substantially flawed, and in some cases, broken.

I believe that the problem is not that people are unaware of the sustainability challenge. Elites know it exists, and many citizens do as well, though they may not understand its real magnitude. Instead, one problem is that in the current process of partisan competition, a party that proposes policy that would increase budget sustainability can expect to be attacked by the other party. Worse, these attacks often work, as the public responds by blaming the would-be prudent party. This strategy takes advantage of the well-known human problem of “time inconsistency.” A current example is Republican support for control of health care costs in the abstract, but opposition to all specific methods of control, such as reducing prices charged by well-compensated providers or funding research that identifies cost-ineffective medical procedures. In doing so, they are repeating some of the strategy used by Democrats in 1995-6, which came to be called “Mediscare.”

Once in full control of government, parties also face the temptation that they could push through their favored policies, even though doing so would worsen the sustainability problem. The Republicans did this during the Reagan and George W. Bush presidencies. The fear of many is that Democrats are doing so now.

Over recent decades, though, control of government’s branches has often been divided between the two major parties. The designers of our system wanted powers to be shared between branches with separate bases of authority. There are many examples of how this system has worked well. The current budget process is not one. This is the inevitable result of the Congress requiring the President to submit a budget plan, and then writing its own budget plan, without having an effective process of resolving differences between the two. This is especially ironic because the details of budgets must be agreed upon by the branches in subsequent legislation. The result has been frequent disagreements between the branches that feature blame generation, the regular adoption of agency budgets far after the beginning of the fiscal year, and in the worst case of 1995-1996, a near complete shutdown of the federal government.

The final major problem I wish to identify is the inability of the current budget process to set priorities in a reasonable way. Like China, the United States would like to make progress towards a “well-off society.” Knowing how to do this depends in part on having good information about actual conditions, and then incorporating this information into budgeting. But many in the United States also worry that this approach would lead towards an overly centralized system of national planning. So though the United States generates much useful information about conditions, it does not organize it into a system of national indicators that could guide debates about budget priorities.

Nor is the priority-setting process organized in a sensible way. At the executive level, budgets are prepared by program and agency, but with only limited strategic reviews for sectors of the society (e.g., health). In the Congress, the budget plan claims to allocate resources by

“budget functions,” but in reality the real allocations are by the jurisdictions of Congressional committees, which differ substantially from the categorization of budget functions. These jurisdictions are traditional and obsolete--for example, rather than unifying major health programs in one jurisdiction, these programs are reviewed by different committees in an often-uncoordinated way. This makes it harder to make tradeoffs between potentially competing ways of addressing priority goals--an indispensable part of a sensible approach to budget sustainability.

I, among several others, have suggested specific reforms that could reduce these problems (Meyers, 2009). For example, the United States could emulate the practice in the Netherlands of estimating the sustainability of party platforms before the election. It could change the process of writing the Congressional budget resolution to require negotiations on budget totals between the President and the Congress. And it could reorganize committee jurisdictions to encourage strategic reviews and more efficient designs of spending and tax programs.

However, there are few in Washington who are now willing to seriously consider these options. While part of the explanation could be that we haven't convincingly demonstrated the potential benefits of proposed reforms, I believe the main reason is that most legislators, and particularly committee leaders, are simply unwilling to consider major changes to the status quo budget process.

This procedural conservatism might be abandoned should a currency/borrowing crisis occur. But in general, I am skeptical that the United States will make marked progress towards budget sustainability.

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