The Budgetary Outlook, PAYGO and Fiscal Discipline

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Chairman Spratt, Ranking Member Ryan, and Members of the Committee, thank you for the opportunity to discuss the outlook for the U.S. federal budget and, in particular, the Administration's PAYGO proposals. I wish to make three primary points:

- The budgetary outlook for the federal government is bleak, the policy risks are that it will worsen, and a failure to address the deficits and rising debt are a danger to the Nation's economic outlook.

- The Administration's PAYGO proposals are a modest step, at best, toward this objective. Stronger budgetary controls would be more comprehensive in scope and focused on controlling federal spending.

- PAYGO procedures are not a substitute for the political will to undertake fiscally-responsible policy proposals. The health care reform debate will be a test of whether Congress and the Administration are serious about addressing the budgetary outlook.

I discuss these in more detail below.

The Budget Outlook

The federal budget outlook is bleak. As estimated by the Congressional Budget Office, under the President's Budget proposals, the federal deficits exceeds $600 billion every year from 2010 to 2019, falls only as low as 3.9 percent of Gross Domestic Product (GDP) in 2013, and is rising both in absolute value and as a fraction of GDP toward the end of the budget window. As a result, debt in the hands of the public is estimated to be 82 percent of GDP in 2019 – up from 41 percent in 2008 – and rising. In 2019, net interest costs are essentially $800 billion, over two-thirds of the overall deficit.

The bottom line is clear: these policies place the U.S. on a path of dangerously large deficits, spiraling debt burdens, and borrowing dominated by the need to pay interest costs on previous borrowing.

On balance, I think this is an optimistic assessment of the outlook as the budget has large political and economic risks. To begin, the expected climate auction revenues are unlikely to materialize. There has never been a climate bill that auctioned a significant fraction of the permits. There has never been a climate bill that passed the Senate. There has never been a climate bill that has been voted on the floor in the House. In short, there has to be an incredible shift in the history for this to happen in a timely enough fashion to get the anticipated revenues that exceed $600 billion. Evidence from the House debate further solidifies the assessment that the odds are that it won't happen and the deficit will be higher.

In the same way, many of the Administration's tax hikes on individuals and businesses are politically difficult and economically undesirable. The business community has correctly pointed out the anti-competitive impacts of moving away from the ability to defer taxes on foreign-source income. Higher marginal tax rates will impact productive Americans and small businesses. If the economy is not strong in 2011, will it be a good idea to hit it with a massive tax hike? In short, these revenue increases are risky.

In contrast, the tax credits and spending that these revenues are planned to pay for are already on the books courtesy of the "stimulus" bill. A reasonable reading of the outlook is that all the revenue will not show up, all the spending and transfers will not go away, and deficits will be even higher than CBO estimates.

In addition, interest rates could easily exceed the projected levels, adding an economic risk to the policy risks. As debt continues to pile up, U.S. international creditors will impose unpleasant terms and a potentially-struggling economy will be further burdened.

The Administration's PAYGO Proposal

In light of the budgetary outlook, it is encouraging that the Administration has put forward proposed statutory changes to impose PAYGO rules on the budget process. At the same time, the proposals are far from a comprehensive framework for budgetary enforcement, contain too many "loopholes", are needlessly complex, and ultimately are not likely to contribute significantly to improving the fiscal outlook.

The first observation is that the PAYGO proposals fall short of a comprehensive framework for budget enforcement. In particular, they are not accompanied by complementary proposals for discretionary spending such as multi-year spending caps. In their absence, there will be an unavoidable temptation to migrate proposals to the appropriations process. The Administration's proposals do recognize this incentive and attempt to mitigate it. However, my reading of the language suggests it remains possible to start initiatives as discretionary programs, convert them to mandatory spending after several years, and avoid PAYGO constraints.

A more comprehensive approach would be desirable. And any such budget enforcement initiative would be well-served to focus on the outlay side. As successive publications of the CBO's *Long Term Budget Outlook* have made clear, the long-run fiscal policy problem <u>is</u> a spending problem; it is not reasonable to expect to "grow our way" out of the problem or economically feasible to "tax our way" out of it. Setting in place comprehensive budgetary controls to limit spending growth should be the top enforcement priority.

A second issue with the Administration's proposals is the exemptions for particular policies such as fixes to the Alternative Minimum Tax, updates to physicians' payments in Medicare baseline policies, extension of the tax policies enacted in 2001 and 2003, and (apparently) the resources to fund Fannie Mae and Freddie Mac. Spending is spending, tax cuts are tax cuts, and deficits are deficits. Any PAYGO should provide a level playing field among such initiatives and these proposals do not.

In effect, the Administrations proposals tilt the playing field toward their preferred policies. In this regard, it is worth noting that the operation of the PAYGO procedures potentially raise the power of the Administration relative to Congress, as the Office of Management and Budget would have the only say over the scorekeeping related to operation of the proposals.

In addition to the favored treatment of particular policy initiatives, the proposals exempt large amounts of spending from the potential for sequester. This has a two-fold effect on the operation of the enforcement. First, it becomes unlikely that a substantial sequester will be tolerated on such a narrow budgetary base, thereby undermining the very discipline that PAYGO is intended to introduce. Second, because the procedures will be most effective in negative "small" violations, it begs the question as to whether these proposals represent a significant enough advance over the existing rules in both the House and Senate budget procedures.

Finally, the procedures appear to be needlessly complex. In previous implementations of PAYGO, it was necessary to offset any deficit increases as they occurred in each budget year, or else face a sequester in that year. These proposals require the average deficit increase over the next 10 years to entered into the budget year and, thus, trigger a potential sequester. This appears to permit nothing to be offset up front. Why is this a better system, given that it is both more complicated and less stringent?

Fiscal Discipline

Fiscal discipline will not take the form of new rules for the budget process. Instead, it must be a collective political effort. There is a lot of talk about the need for bipartisanship in Washington, and I think fiscal responsibility would be a good place to start. And there is no greater opportunity than in proposals to reform the health care system.

Health care reform is one of the most important issues facing the United States is its underperforming health care sector. There are three major problems. First, it costs too much. For the past three decades health care spending per person has grown roughly 2 percentage points faster *every year* than income per capita. That is, in the horse race between costs and resources, costs have been winning. The result is that health care spending right now exceeds 17 cents of every national dollar – and will rise to 20 percent by the end of next decade. Within the federal budget, the rising cost of Medicare and Medicaid threatens a tsunami of red ink in the decades to come.

Second, because health care is getting more expensive, the cost of health *insurance* is skyrocketing. Over the last decade, insurance costs have increased by 120 percent – three times the growth of inflation and four times the growth of wages. With higher costs has come reduce insurance coverage – more than 45 million are uninsured. It is important to solve the first problem – rising costs – before committing to large-scale coverage expansions. Doing them in the wrong order will be prohibitively expensive, and likely cause the reform effort to unwind.

Finally, both the health insurance and health care systems under-perform. A job loss typically also means loss of health insurance. High spending has not yielded comparably high outcomes for infant mortality, longevity, or treatment of chronic disease.

Health care reform can address these issues. However, it will not automatically be consistent with budgetary objectives. It seems likely that mandatory health care legislation addressing reform will be considered before any PAYGO legislation is put in place. One will not be able to count on its provisions to constrain the budgetary impact of health care reform. Instead, the Congress must make a commitment to impose this on the legislation.

This suggests that the first principle should be to focus on the value provided by care. Any reform that does not address low-value care and cost growth will fail. Suppose, for example, that the "reform" consisted of a mandate to purchase insurance, thereby achieving "universal" health insurance. In the absence of changes to the growth in health-care spending, this insurance would become increasingly expensive and ultimately force families to evade the mandate as a matter of economic necessity. At the same time, those dollars that were devoted to health care would purchase care that was of no greater overall effectiveness than at present. In short, the reform would fail to address the policy problems.

Fiscal responsibility also suggests that it would be unwise to move immediately to universal coverage or other massive expansion. Reforms to the delivery system could generate system-wide savings that could be funneled to expanding coverage, and opportunities within government programs could generate savings as well. But it is implausible that these savings would be sufficient for an immediate, large-scale coverage expansion costing over $1 trillion. Instead, the fiscally-responsible reform should be a process that leads to increasing insurance.

I believe that a fiscally responsible and durable reform is more likely if it is genuinely bipartisan enterprise. Any other path will likely lead to even larger budget pressures; perhaps so large that it undercuts the momentum of health reform itself and opens the economy to the risk of higher interest rates and pressures from international capital markets.