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BUDGET PROCESS

Long-term Focus Is Critical

Statement of David M. Walker
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Highlights

Highlights of GAO-04-585T, a testimony before the Subcommittee on Legislative and Budget Process, Committee on Rules, House of Representatives

Why GAO Did This Study

The structure of the budget process can help ensure that budget decision makers are presented with the information and choices for timely and informed decision-making. GAO's long-term budget simulations show that, absent substantive entitlement reform and/or dramatic changes in tax and spending policies, we will face large, escalating, and persistent deficits. A budget process incorporating new metrics and mechanisms that better signal the long-term commitments and promises made by the government will help concentrate decision makers' efforts on long-term sustainability.

What GAO Recommends

The reinstitution of realistic spending caps and PAYGO is necessary to deal with the near- and medium-term deficit. Beyond that, a fundamental reexamination of existing programs and activities must be undertaken. To enable budget decision makers to consider the full range of the government's commitments, OMB should report annually on fiscal exposures, including a concise list and cost estimates, where possible. To address the nation's fiscal imbalance, we need to employ a three-pronged approach to (1) restructure existing entitlement programs, (2) reexamine the base of discretionary and other spending, and (3) review and revise the federal government's tax policy and enforcement programs.

www.gao.gov/cgi-bin/getrpt?GAO-04-585T.

To view the full product, including the scope and methodology, click on the link above. For more information, contact Susan J. Irving at (202) 512-9142 or irvings@gao.gov.

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What GAO Found

The long-term fiscal pressures created by the impending retirement of the baby boom generation sharpen the need to look at competing claims on existing federal budgetary resources and emerging new priorities. Truth and transparency in government reporting are essential if the United States is to effectively address these long-term fiscal challenges. Current metrics and mechanisms do not fully inform policy makers about the sustainability of existing federal programs or commitments they are considering making. While Social Security and health programs are the major drivers of the long-term spending outlook, they are not the only promises the federal government has made to the future. The government undertakes a wide range of responsibilities, programs, and activities that may either obligate the government to future spending or create an expectation for such spending. It is useful to think of such fiscal exposures as a spectrum extending from explicit liabilities to the implicit promises embedded in current policy and/or public expectations.

Selected Fiscal Exposures (End of FY 2003)

Type	Example (dollars in billions)
Explicit liabilities	Publicly held debt ($3,913) Military and civilian pension and post-retirement health ($2,857) Veterans benefits payable ($955) Environmental and disposal liabilities ($250) Loan guarantees ($35)
Explicit financial commitments	Undelivered orders ($596) Long-term leases ($47)
Explicit financial contingencies	Unadjudicated claims ($9) Pension Benefit Guaranty Corporation ($86) Other national insurance programs ($7) Government corporations e.g., Ginnie Mae
Implicit exposures implied by current policies or the public's expectations about the role of government	Debt held by government accounts ($2,859)[a] Future Social Security benefit payments ($3,550)[b] Future Medicare Part A benefit payments ($5,931)[b] Future Medicare Part B benefit payments ($9,619)[b] Life cycle cost including deferred and future maintenance and operating costs (amount unknown) Government Sponsored Enterprises e.g., Fannie Mae and Freddie Mac

Source: GAO analysis.

Note: Updated February 27, 2004.

[a]This amount includes $774 billion in securities held by military and civilian pension funds that would offset the explicit liabilities reported by those funds.

[b]Figures for Social Security and Medicare are as of January 1, 2003, and are estimated over a 75-year period. These amounts represent net present value and are net of debt held by the trust funds ($1,378 billion for Social Security, $235 billion for Medicare Part A, and $34 billion for Medicare Part B). The estimate for Social Security over an infinite horizon would be $10.5 trillion according to the Social Security Trustees' 2003 annual report. There is no infinite horizon estimate for Medicare included in the Medicare Trustees' 2003 annual report. Medicare Part D was enacted after the end of FY 2003.

Madam Chairman and Members of the Subcommittee:

I am pleased to be here today to discuss budget process reform ideas that can help the Congress deal with the long-range fiscal challenges facing our nation. I want to thank the Subcommittee for its role in beginning the discussion and debate on what the nation needs to do to address our large and growing fiscal challenges. As part of that discussion, today we are focused on how best to structure a budget process to help ensure that decision makers are presented with the information and choices for timely and informed decision-making. While former Congressional Budget Office (CBO) Director Rudy Penner was correct when he said, "The problem is not the process, the problem is the problem," process is important. A lack of process and discipline can certainly work against attempts to make the difficult decisions that will be required to address our large and growing fiscal imbalance. And, a process that illuminates the looming fiscal pressures and provides appropriate incentives can at least help decision makers focus on the right questions.

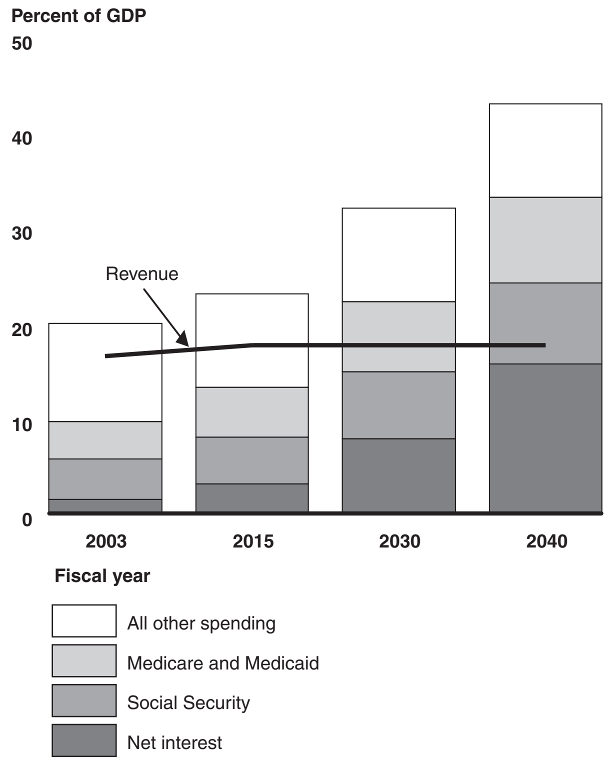
As you look at the challenge of updating the budget process, you face a two-pronged challenge: first, the need to reinstitute controls to deal with the near- and medium-term deficit; and second, the need to design a process that helps the Congress tackle the formidable long-term fiscal challenges facing this nation. With regard to deficit reduction in the near- and medium term, changes on both sides of the ledger affect the bottom line. I endorse what many budget experts have suggested here and elsewhere—namely, the restoration of realistic caps and of pay-as-you-go (PAYGO) discipline. Today, however, I want to focus more on the role the budget process can play in dealing with the longer-term budget and fiscal challenges facing this nation. Indeed, since at its heart the budget debate is about the allocation of limited resources, it is understandable and appropriate for the budget process to play a key role in helping to address our broader challenge of modernizing government for the 21st century.

The Long-term Budget Challenge

The long-term fiscal pressures created by the impending retirement of the baby boom generation, rising health care costs and increased homeland security and defense commitments sharpen the need to look at competing claims on existing federal budgetary resources and emerging new priorities. As we look ahead, our nation faces an unprecedented demographic challenge. Between now and 2035, the number of people who are 65 years old or over is expected to double, driving federal spending on the elderly to a larger and ultimately unsustainable share of the federal budget. Absent substantive entitlement reform and/or dramatic changes in tax and spending policies, we will face large, escalating, and persistent deficits.

For over ten years, the GAO has periodically prepared various long-term budget simulations that seek to illustrate the likely fiscal consequences of our coming demographic challenges and rising health care costs. Our latest long-term budget simulations reinforce the need for change in the major long-range cost drivers—Social Security and health care programs. As shown in figure 1, by 2040, assuming no changes to currently projected benefits or revenues, projected federal revenues may be adequate to pay little beyond interest on the debt.

Figure 1:Composition of Spending as a Share of GDP Assuming Discretionary Spending Grows with GDP after 2004 and All Expiring Tax Provisions Are Extended



Source: GAO's January 2004 analysis.

Notes: Although expiring tax provisions are extended, revenue as a share of GDP increases through 2014 due to (1) real bracket creep, (2) more taxpayers becoming subject to the AMT, and (3) increased revenue from tax-deferred retirement accounts. After 2014, revenue as a share of GDP is held constant.

Reducing the relative future burdens of Social Security and federal health programs is critical to promoting a sustainable budget policy over the longer term. Absent reform, the impact of federal health and retirement programs on budget choices will be increasingly felt as the baby boom generation retires. While much of the public debate concerning the Social Security and Medicare programs focuses on trust fund balances—that is, on the programs' solvency—the larger challenge facing these programs is how to assure their longer-term security and sustainability.

The Social Security and Medicare Health Insurance (HI) programs are currently running surpluses that are invested in U.S. Treasury securities, resulting in an accumulated balance of Treasury assets that can be drawn upon to pay future benefits. According to the 2003 Trustees' projections, these trust funds would be considered insolvent in 2042[1] for Social Security and in 2026 for Medicare HI.

The information on insolvency provides one signal to policy makers that claims will exceed trust fund balances, but this measure alone can provide a false sense of security regarding these important federal programs. If we rely solely on trust fund insolvency to trigger actions to reform these programs, we will have delayed action far past the point when these two programs have become a significant and unsustainable fiscal burden on the federal government as a whole. Based on the 2003 Trustees Reports, the cash flows for Social Security will shift to a deficit in 2018 and for Medicare HI in 2013—at these points, both programs will then have to draw on their accumulated IOUs from the Treasury to pay a portion of benefits. The only way that Treasury can pay off these IOUs is by increased taxes, spending cuts, or increased borrowing from the public, or some combination of the three. Moreover, the trust funds' balances do not reflect the full future cost of existing government commitments. In addition, the HI trust fund reflects only a portion of the Medicare program, which is financed primarily through payroll taxes. Other parts of the Medicare program include the Part B Supplementary Medical Insurance component and the new Part D drug benefit, both of which are financed through general revenues and beneficiary premiums. Taken as a whole, the Medicare program is fiscally unsustainable in its present form as program expenditures are expected to exceed program revenues dramatically in the future. From a macro perspective the critical question is not how much a trust fund has in assets, but whether the government as a whole has the economic capacity to finance the benefits promised by these programs both now and in the future and, if so, at what cost, and with what implications.

As a result, we need to incorporate new metrics and mechanisms into the budget process that better signal the long-term commitments and implicit promises made by the government—its fiscal exposures—so that decision

[1] The year 2042 is when the combined Social Security trust fund—the Old Age and Survivors Insurance and Disability Insurance trust funds—is projected to become insolvent.

makers' attention and efforts can be more concentrated on their long-term sustainability. The difficulty of developing meaningful measures of sustainability is exacerbated by the length of time covered by our long-term commitments. The longer the span of time between the collection and the expenditure of funds, the greater the uncertainty involved in forecasting future needs. Since trust fund balances do not fully inform policymakers and the public about the long-term sustainability of the programs financed by earmarked funds, consideration is warranted of other ways to make the long-term implications of spending and tax proposals and policies more apparent when making budget decisions. The future sustainability of programs is the key issue policymakers should address—that is, the capacity of the economy and budget to afford the proposed actions.

Fiscal Exposures Are Wide-ranging and Varied

While Social Security, Medicare, and Medicaid are the major drivers of the long-term spending outlook in the aggregate, they are not the only promises the federal government has made to the future.[2] The federal government undertakes a wide range of responsibilities, programs, and activities that may either obligate the government to future spending or create an expectation for such spending. Specific fiscal exposures vary widely as to source, likelihood of occurrence, magnitude, and strength of the government's legal obligations. They may be explicit or implicit; they may currently exist or be contingent on future events. Their ultimate costs may or may not be reasonably measurable. Given this breadth, it is useful to think of fiscal exposures as a spectrum extending from explicit liabilities to the implicit promises embedded in current policy and/or public expectations. Figure 2 shows some selected fiscal exposures. These liabilities, commitments, and implicit exposures have created a fiscal imbalance that will put unprecedented strains on the nation's spending and tax policies. In addition, certain tax expenditures[3] may have uncertain or accelerating future growth paths that have significant implications for the long term. Although economic growth can help, our projected fiscal

[2] While interest is a large and growing share of the budget, it does not directly drive the fiscal outlook in that interest is the result of other decisions affecting spending and tax policy.

[3] Tax expenditures are revenue losses attributable to a provision of the federal tax laws that allows a special exclusion, exemption, or deduction from gross income or that provides a special credit, preferential tax rate, or deferral of tax liability.

gap is now so large that we will not be able to simply grow our way out of the problem. Tough choices are inevitable.

Figure 2: Selected Fiscal Exposures (End of FY 2003)

Type	Example (dollars in billions)
Explicit liabilities	Publicly held debt ($3,913) Military and civilian pension and post-retirement health ($2,857) Veterans benefits payable ($955) Environmental and disposal liabilities ($250) Loan guarantees ($35)
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Particularly troubling are the many existing "big-ticket" items that taxpayers will eventually have to deal with. The federal government has pledged its support to a long list of programs and activities, including pension and health care benefits for senior citizens, veterans' medical care, and, implicitly, various government-sponsored entities, whose potential claims on future spending total tens of trillions of dollars. Despite their serious implications for future budgets, tax burdens, and spending flexibilities, these fiscal exposures often get short shrift in reporting on the government's current financial condition and in budgetary deliberations. Even though some fiscal exposures stem from liabilities and are reported in the financial statements, their recognition in the current cash- and obligation-based budget process is wholly inadequate. And beyond explicit liabilities and contingencies, there are implicit exposures—implied commitments embedded in the government's current policies or in the public's expectations about the role of government—that may encumber future budgets or reduce fiscal flexibility. One example is the life cycle cost of fixed assets, including deferred and future maintenance and operating costs.

An exposure recognized in the financial statements is the federal government's gross debt which, as of September 2003, was about $7 trillion, or about $24,000 for every man, woman, and child in this country today. But that number excludes items such as the gap between promised and funded Social Security and Medicare commitments. If these items are factored in, the burden for every American rises to well over $100,000. In addition, the new Medicare prescription drug benefit will add thousands more to that tab.

The new drug benefit is one of the largest unfunded commitments ever undertaken by the federal government. The Trustees of the Social Security and Medicare trust funds will include an official estimate of the discounted present value cost of this new benefit over the next 75 years in their annual report, which is scheduled for issuance today. Preliminary estimates of its long-term cost range up to $7-8 trillion in discounted present value terms over a 75-year period. To put that number in perspective, it is as much or more than the total amount of the federal government's gross debt outstanding as of September 30, 2003. Even before the drug benefit was enacted, our long-term simulations showed that by 2040, the federal government may have to cut federal spending in half or double taxes to pay for the mounting cost of the government's unfunded commitments. Either would have devastating consequences on the nation's future economy and the quality of life for Americans in the future.

Where Do We Go from Here?

Truth and transparency in government reporting are essential if the United States is to effectively address its long-term fiscal challenges. The fiscal exposures just mentioned can be managed only if they are properly accounted for and publicly disclosed. A crucial first step will be to face facts and identify the many significant commitments already facing the federal government. If citizens and government officials come to understand various fiscal exposures and their potential claims on future budgets, they are more likely to insist on prudent policy choices today and sensible levels of fiscal risk in the future.

So how do we start this hard process? Today you are focusing on budget process improvements, so I will start there. We need a process that does two things better than the processes we have used in the past. The budget process needs (1) better transparency and controls about the fiscal exposures/commitments that the federal government is considering making and (2) better signals and incentives to address the fiscal exposures/commitments the federal government has already made. GAO has encouraged reforms that would help move forward on both fronts.

Transparency of existing commitments would be improved by requiring that the Office of Management and Budget (OMB) report annually on fiscal exposures, including a concise list, description, and cost estimates, where possible. OMB should also ensure that agencies focus on improving cost estimates for fiscal exposures. This should complement and support continued and improved reporting of long-range projections and analysis of the budget as a whole to assess fiscal sustainability and flexibility.

Others have also embraced this idea for better reporting of fiscal exposures. Last year Senator Voinovich proposed that the President report each January on the fiscal exposures of the federal government and their implications for long-term financial health. The President's fiscal year 2005 budget proposes that future Presidents' budgets report on any enacted legislation in the past year that worsens the unfunded obligations of programs with long-term actuarial projections, with CBO being required to make a similar report. Senator Voinovich's bill would require GAO to review the President's report on fiscal exposures for completeness, quality and the long-range fiscal outlook. Senator Lieberman has also introduced legislation to require better information on liabilities and commitments over both a 75-year and indefinite time horizon. Such reporting would be a good starting point. Senator Lieberman's bill provides for a point of order against bills that adversely affect the net present value of overall liabilities and commitments by more that a specified amount.

Better information on existing commitments and promises must be coupled with estimates of the long-term discounted net present value cost of any new proposed commitments. Ten-year budget projections have been available to decision makers for many years. We must build on that regime but also incorporate longer-term estimates of net present value costs for spending and tax commitments comprising longer-term exposures for the federal budget beyond the 10-year window. Better reporting is just a starting point, however.

While Social Security and Medicare drive the long-term spending outlook, decisions are made about a whole host of other programs with long-term implications too small to drive the long-term outlook. A budget is all about how to allocate available resources. Budget decisions reflect a number of factors including beliefs about the appropriate role of government in various areas, judgment about the likely success of a program in achieving certain goals, and the cost of a program. It is important that Members of the Congress and the President—and citizens—be able to compare the full costs of programs on a consistent basis. In the past, GAO has suggested that the budget numbers should themselves reflect long-term cost commitments for programs such as credit, federal pension and retiree health benefits, and insurance programs. The Federal Credit Reform Act of 1990 put credit programs on a comparable basis with grants and other assistance programs. This reform enabled decision makers to budget for credit based on the net present value of the federal subsidies over the life of the loan or guarantee. We have suggested that a similar treatment be applied to insurance programs in which the cost of the program in the budget would, in effect, be the missing premium—the subsidy provided by the government to the insured. This approach was included in legislation sponsored by Congressmen Nussle and Cardin several years ago. They recognized, as did GAO, that the budget's current cash treatment of insurance programs could misstate the cost of the commitments that have been made. Some improvements have been made in budgeting for federal pension and retiree health benefits, but they have not been applied to all employees.

Along with better reporting, budget process mechanisms could establish opportunities for the explicit consideration of important fiscal exposures—both new and existing. When considering the creation of new exposures, Congress could modify budget rules to provide for a point of order against any proposed legislation that creates new spending or tax exposures over some specified level or trigger. This would encourage the explicit consideration of potential future costs. To make sure the cost estimates are made available, rules could also provide for a point of order against any proposed legislation that does not include estimates of the potential costs of fiscal exposures it would create.

A different budget process approach would be to establish triggers that address the growth in existing exposures. Triggers would signal when the future costs of exposures rise above a certain level. Reaching the trigger would require some action to address costs or reaffirm acceptance of the increase in potential fiscal exposure. There are many different ways to construct a trigger. Possible triggers include future costs of a specific exposure exceeding a specified dollar amount, or expected program growth beyond a specified share of the federal budget or the gross domestic product. Congress already adopted an approach similar to this for the Medicare program last year. Under this process, the program as a whole would trigger a requirement for presidential and congressional consideration when the general revenue share of Medicare funding is projected in two consecutive years to exceed 45 percent during a 7-year period. The design of triggers is important and has implications for the mix of financing to be provided for covered programs. My staff would be happy to work with you if you choose this approach.

Looking More Broadly

We must look through a wide-angle lens when deciding what to do about the nation's fiscal imbalance. Based on realistic assumptions, our future fiscal gap is simply too great to grow our way out of the problem. As a result, we need to employ a three-pronged approach to (1) restructure existing entitlement programs, (2) reexamine the base of discretionary and other spending, and (3) review and revise the federal government's tax policy and enforcement programs. Fundamentally, we need to undertake a top-to-bottom review of government activities to ensure their relevance and fit for the 21st century and their relative priority. The understanding and support of the American people will be critical in providing a foundation for action. The fiscal risks I have discussed, however, are a long-term problem whose full impact will not be felt for some time. At the same time they are very real and time is currently working against us.

While I agree with others that realistic spending caps and the restoration of PAYGO are necessary, additional actions are needed to prompt a reexamination of existing programs and activities. In the 1990s, the Congress and the Administration put in place a set of laws designed to improve information about cost and performance. More performance information has become available thanks to 10 years of experience under the Government Performance and Results Act (GPRA) and better financial and cost information has been produced as a result of legislative actions, including the Chief Financial Officers (CFO) Act of 1990. This information can clearly help inform the debate about what the federal government should do and how it should do business.

Congress now has the challenge to use new information and data to engage in a process to systematically reexamine the base of federal programs across the entire budget. In previous testimonies and reports, we have suggested that Congress might equip itself to engage in this debate by (1) establishing a vehicle for communicating performance goals and measures for key congressional priorities; (2) developing a more structured oversight agenda to permit a more coordinated congressional perspective on crosscutting programs and policies; and (3) using such an agenda to inform its authorization, oversight and appropriations processes. Some have suggested a commission to jump-start this process while others have suggested periodic sunsetting of major programs. We at GAO stand ready to provide assistance to whatever process Congress chooses for this important work.

Such a process can be supported by a national education campaign and outreach effort to help the public understand the nature and magnitude of the long-term financial challenge facing this nation. After all, an informed electorate is essential for a sound democracy. Members of Generation X and Y especially need to become active in this discussion because they and their children will bear the heaviest burden if policy makers fail to act in a timely and responsible manner. The difficult but necessary choices we face will be facilitated if the public has the facts and comes to support serious and sustained action to address the nation's fiscal challenges.

In closing, Madam Chairman, I want to reiterate the value of sustained congressional interest in these issues, as demonstrated by this Subcommittee's hearing.

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