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before the

Senate Budget Committee
Senate Governmental Affairs Committee
January 27, 1999

I. INTRODUCTION

Thank you for inviting me to discuss the Federal budget process. I begin by briefly describing some relevant budget history, particularly concerning the rise and fall of the recent large deficits. Because the budget process at the least exacerbated these problems, I then turn to flaws in the process, beginning with the balkanization of spending authority. Finally, I discuss other flaws in the current process, including those with the Budget Enforcement Act.

II. SOME BUDGET HISTORY

It might seem that in this new era of projected surpluses, the budget process is no longer an important concern. The reason for the rise and fall of large deficits, and the role of the budget process in those changes, should give us pause, however. Before the mid-1970s, large peacetime deficits were a temporary phenomenon. Thus, the large (by the standards of the time) deficits in 1959, 1968, and 1971-72, when the deficit exceeded two percent of GDP, quickly disappeared.[(1)] The budget was either in a small surplus (1960 and 1969) or a small deficit (1974).

Change occurred in the mid 1970s however. In the seven budgets from 1975 to 1981, the deficit was at least 2.6 percent of GDP in every year except 1979 (when it was 1.6 percent). Something had changed to prevent rapid elimination of large deficits. In the summer of 1981, however, better times appeared to be on the horizon. This, in July of 1981, CBO's Budget Baseline Projections for Fiscal Years 1982 - 1986 were released, and are reprinted in Table 1.

TABLE 1

BASELINE BUDGET PROJECTIONS

Deficit (-) or Surplus

(by years)

Projections

	1982	**1983**	**1984**	**1985**	**1986**
In Billions of Dollars	-30	18	76	138	209
As a Percent of GNP	-0.9	.5	1.9	3.1	4.3

Source: CBO - July, 1981

According to CBO, the budget would not only be balanced by 1983, it would thereafter run massive surpluses. These CBO estimates assumed both a strong economy and that the laws in place would not change. CBO was not alone in the former assumption, as the Administration and most economists in mid-1981 pronounced the economy as strong. As Table 2 summarizes, the consensus forecast, represented by the Blue Chip estimates, was optimistic.

TABLE 2

<u>Blue Chip Headlines:</u>

March - July 1981

March "1981 Economic Consensus Inches Upward"
April "1981 Full Year Consensus Forecast Continues to Pick-up Steam"
May "1981 Consensus Forecast Tilts Up Again"
June "The Recovery Continues"
July "Economic Exuberance Envisioned For 1982"

We now know the folly of these projections. In July, 1981, the economy was about to enter the worst recession since the Great Depression of the 1930s. But this fact would not be known for months.[(2)] It was this unforeseen event that was the major cause of the large deficits that followed. Taxes were cut and defense spending increased. Both policies enjoyed wide support in 1981, however, although the particulars were hotly debated. Moreover, both contributed to important policy goals -- economic growth and victory in the Cold War. Because the deficits of the preceding seven years had persisted, this unforeseen recession increased already substantial deficits. By the end of the Reagan years, the situation had returned to where it started, with the 1989 deficit (2.8 percent of GDP) virtually identical to the 1980 and 1981 deficits (2.7 and 2.6 percent of GDP, respectively).

Because the events of the 1990s are more recent and thus more familiar, I will not recount them in as much detail. A mild recession, the S & L bailout, and unforeseen technical changes in projected tax receipts and in Medicare and Medicaid spending increased deficits once again, to 4.7 percent of GDP by 1992. The resumption of the strong economy, a drop in S & L outlays, the end of the cold war, and the 1990 and 1993 tax increases reduced the deficit again. When the Republican control of the Congress began four years ago, however, CBO was projecting $200 billion deficits well into the future.[(3)] Even President Clinton's proposed budget for 1996, released in early 1995, projected deficits of this magnitude.

Then, the unforeseen intervened again. Deficits ended, defying the prognosticators, as revenue growth exploded well beyond expectations. Although higher than predicted economic growth contributed to the deficit fall as did a slowdown in the growth of mandatory spending, the bulk resulted from unanticipated other factors, such as the strong stock market. Without major legislative action, we moved from an era of deficits to one of projected surpluses.

What are we to make of this brief history? At least two lessons for current budgeting can be discerned. First, humility is in order. The most important events in the recent rise and fall of large deficits were all major surprises -- the length and depth of the early 1980s recession, the end of the cold war,[(4)] and the revenue surge of the late 1990s. Second, the budget process has lost its flexibility to respond quickly to unforeseen events, at least to unpleasant ones. Because we cannot control the unforeseeable, let me turn to problems that we can influence, in this case the current budget process.

III. THE BALKANIZATION OF LEGISLATIVE CONTROL[(5)]

During the period of large deficits, two views were most often advanced for failure to end them. The first was that the problem was one of political gridlock: the Republican (or Democrat) majority in Congress and the Democrat (or Republican) President could not agree on the mix of spending and tax policies necessary to solve the problem. The second view was that logrolling among legislators and rent seeking by special interests combined to produce spending higher than would exist in a world with lower information costs. For example, transportation projects benefit concentrated interests who care intensely about the project's benefits (reduced congestion and local jobs), while the costs are widely dispersed among taxpayers. Participating in the political process is not free, and opposing inefficient programs is simply not worth the time and effort for most individuals. For many, concerned about maintaining their jobs and supporting their families, collecting enough information to participate effectively in the political process is simply too difficult.

Although there is significant truth to these two views, they do not tell the whole story. Changes in the institutional structure within the Congress and in the budgetary framework in which Congress operates have combined to create the incentives and the means for the deficit to grow and become difficult to control. Regarding institutions, the balkanization of legislative control over spending has led to increases in spending. Moreover, the consolidation within committees over both revenue and spending authority for entitlement programs has fueled the growth of specific programs. Two key institutional changes made during the 1930s were critical in producing a bias in the process toward deficits. The first and most important was to transform jurisdiction over expenditures from a highly centralized committee structure to one in which various committees had spending authority.

A. <u>The Dispersal of Spending Authority</u>

For most of our nation's first century, a single committee in each house controlled almost all spending authority. This institutional arrangement persisted until 1877; in rule changes over the next nine years, the House stripped the Appropriations Committee of its authority over eight of the fourteen appropriation bills. In each instance, appropriations authority was transferred to the legislative committee that had authorizing jurisdiction over the programs contained in the appropriations bill. By 1885, the House had transferred almost one-half of all non-mandatory appropriations to various legislative committees. In 1899, the Senate followed suit, dividing appropriations jurisdiction.

An upward surge in spending followed the dispersal of appropriations jurisdiction. During the seven years following the House decision, spending grew at a r ate unprecedented in U.S. history. By 1893, program spending was 50 percent larger than it had been in 1886. Expenditures continued upward following the Senate's decision to divide appropriations jurisdiction, rising 45 percent between 1900 and 1916.

As a result of this rapid growth in spending, calls for budget process reform increased throughout the years preceding World War I. In October 1919, a select committee on the budget was established and recommended that the House consolidate the authority to report all appropriations in one committee. This recommendation was approved in 1920. In 1922, the Senate amended its rules to provide that all appropriations also be considered by one committee. Consequently, the U.S. budget was in surplus for the eleven year period 1920-1930, the longest streak of consecutive budget surpluses since spending authority was dispersed in the House.

Unfortunately, the process of spreading spending jurisdiction among committees began anew in 1932 when the Reconstruction Finance Corporation was created and financed outside normal appropriations channels. Decentralization accelerated during the next four decades, particularly between 1965 and 1975. By the mid 1970s, most substantive congressional committees had authority to report legislation to the floor committing funds from the U.S. Treasury. In 1932, the Appropriations Committees controlled 89 percent of outlays through the annual federal budget process. By 1992, fewer than 40 percent of federal outlays resulted from decisions under the Appropriators' control.

This balkanization of spending authority creates a "common pool" problem. When no one owns a common resource, such as the fish in a lake, there is an incentive for too much fishing, depleting the population. With the budget, the common resource is general-fund revenue. As the Appropriations Committee controls less and less spending, and, correspondingly, other congressional committees control more and more, no one committee has the incentive to restrain spending because the total level of spending is no longer the responsibility of any one committee. To the contrary, the resulting competition among committees to spend results in more spending than would otherwise occur, increasing deficit spending.

B. The Movement Towards Tax Financed Trust Funds

The creation of tax financed trust funds, most predominately Social Security and, later, Medicare Hospital Insurance, and the placement of jurisdiction over them in the tax-writing committees was the second institutional change contributing to the increase in general fund, and hence total, deficits.

Unlike general fund taxes, trust fund revenues are dedicated to specific programs. Moreover, general fund taxes are generally raised under the jurisdiction of a committee that does not control how the money is spent, unlike trust funds which are raised by the committee responsible for the specific fund. Since World War II, general fund revenues have decreased as a percentage of gross domestic product (GDP) with a corresponding increase in trust fund receipts. In the early 1950s, trust fund receipts amounted to little more than 1 percent of GDP, and general fund receipts equaled 16 percent of GDP. By the mid 1990s, trust fund receipts had increased to nearly 7 percent of GDP, while those of the general fund decreased to about 12 percent.[(6)] The rise in trust fund revenues seems to be crowding out general revenues.

Significantly, trust fund programs have not run deficits. Although spending for such programs has increased dramatically, trust fund taxes have increased to pay for that spending. Increased federal deficits have thus occurred in areas in which the committee in charge of raising the taxes does not control the spending.

Important implications arise from the merging of the tax and spending authority. In particular, if one committee controls all taxes and benefits, we might expect that both will increase at a relatively higher rate. This conclusion follows because raising taxes, a politically painful step, is made less painful when those who raise the taxes directly obtain the benefit of the increase, through political support from the beneficiaries of the spending. All members of the legislature ultimately vote on taxes and spending, and thus share in the credit and blame. But because committee members exert more influence over the legislation than do noncommittee members, they can more easily tailor spending to increase the credit they receive.

C. Econometric Testing

Dr. Mark Crain of George Mason University and I studied the fifty state legislatures to test the thesis that the dispersal of spending authority among various committees results in significantly greater spending than when one committee controlls spending. We also attempted to assess the significance of rules that combine or separate the committees overseeing revenue and spending decisions.

States that have only one committee with appropriations authority should have more control over spending than states with appropriations authority dispersed among committees. Consolidating control within one committee is an institutional means to overcome the common pool problem; it establishes a mechanism to contain spending pressures. By contrast, states that have balkanized spending authority should experience relatively higher spending, resulting from over-use of the common resource, the state's total revenue. Spending pressures are less controllable, absent an institutional mechanism to internalize spending accountability.

The results reveal that states with centralized appropriations authority have more control over spending than states with appropriations authority dispersed among several committees. As predicted, states that centralize spend less, on average, than states that decentralize spending authority. The difference is about 6 percent, holding other factors equal.[7]

The second aspect of our analysis tested the effect on state revenues of combining spending and taxing committees. When these functions are combined into one committee, the legislators who initiate revenue decisions have the most control over how those funds are spent, the taxers are the spenders. When the legislators controlling revenues are not the appropriators, the revenue committee members cannot capture as fully the political benefits of their labors, because spending programs are more likely to be designed to benefit the constituents of the appropriators. Thus, the tax committee is less likely to take the politically costly step of raising taxes if there is no offsetting benefit. We would expect that where taxing and spending authority are merged, taxes would be higher.

As predicted, states that merge spending and taxing authority into a single committee have higher revenues than those that separate these responsibilities among multiple committees. On average, states with merged committees have higher revenues, per capita, by 28 percent (again all other things equal).

IV. OTHER FLAWS IN THE BUDGET PROCESS

Recognizing that it was losing control over the budget, Congress created a new budget process in 1974. Rather than directly address the central problem of the balkanization of spending authority, Congress instead created a new process with only a weak capability to control budget totals or various budget programs. (Of course, returning more power to one committee was, and is, a politically difficult step.)

The new process does have some advantages over the period prior to 1974. In particular, the current process facilitates the development of large deficit reduction plans, such as the one Congress passed in 1995. Nevertheless, despite numerous such efforts, the deficit problem persisted for two decades. Besides the failure to rest real control in one committee, the new process has several flaws that exacerbate the deficit problem. The first involves the use, or more appropriately misuse, of baseline budgeting. Moreover, the much praised, most recent effort to "strengthen" the budget process, the Budget Enforcement Act (BEA) of 1990, is itself flawed.

A. Baseline Budgeting[8]

The budgetary framework in which Congress operates further biases policy in the direction of increased spending. Over the last twenty years, politicians and budget professionals -- Democrats and Republicans, liberals and conservatives--have transformed budget terminology into Orwellian doublespeak. Increases in spending are labeled "cuts," taxes paid the government "reduce" spending, and laws that continue a policy about to expire are said to "cut" spending. Politicians can announce "cuts" that satisfy the public's general desire for reduced government spending and deficit control, while increasing spending for most programs, thus assuring themselves the support of special interest groups. Moreover, all these claims seem legitimate to many policy analysts and are too often accepted uncritically in the press.

1. Origins of the Baseline

Throughout most of U.S. history, the base used to compare alternative budget proposals was either the levels in the previous year's budget or those proposed by the President. Beginning with the Congressional Budget Act of 1974, more elaborate bases, called baselines, came into play. The Act required a baseline that continued current programs at "the same level as the current year without a change in policy." Such a baseline, it was felt, would be better for assessment of the fiscal impact of new proposals than the cruder measures previously used.

How to define the baseline was unclear, however, and the legislative history gave no precise guidance. Alternative definitions developed. One is to measure a constant level of goverment services to determine if a proposed change would increase or decrease government. This view uses as a baseline "current services." This baseline was intended to provide a policy-neutral method to project accurately what it would cost in the future to continue government as it exists today. Such a baseline, it was felt, would allow better assessment of the fiscal impact of new proposals than the cruder measures previously used.

Another definition focus on the words "without a change in policy." Under this approach, the baseline puts the government on "automatic pilot," determining how much it would cost to fund it in the future if no new legislation were passed. This view is called "current policy." A third alternative is called "current law." It differs from "current policy" in not including adjustments for inflation of discretionary spending. The current policy baseline has been the most frequently used measure for evaluating and reporting on budget proposals.

2. The Baseline Used Does Not, and Could Not, Measure Current Services

Any baseline that projects the cost of the current level of all government activities into the future is an illusion. There are two major problems. First, events outside the congressional spending process can change the funding level needed to hold government services constant. In other words, because of events outside its control, tomorrow's government can require more or less money than today's to provide the same services.

An example of an event exogenous to congressional spending decisions is the accomplishment of a program's objectives. To hold government activity constant, sensitivity to the purposes of programs is required. If the original purpose of a program is achieved, yet spending continues for a new purpose, then government involvement in the economy has increased, not remained constant. For example, early in the Carter administration, Congress increased job-training funding to help alleviate the impact of a recession. Once the recession ended, continuing the program meant a change in its purpose, not a mere continuation of past efforts.

The second problem is that, even ignoring for such exogenous events, determining what amount will be necessary to fund government at a constant level is a complex matter. Simple formulas such as adjusting all discretionary programs for inflation can fail to measure accurately a constant level of government. Many variables can influence the calculus, and even when current services for a particular program are carefully calculated, experts may reasonably disagree over the correct estimate, thus undermining the supposed policy neutrality and objectivity of the current services baseline. For example, defense experts disagree over the level of funds needed to support any given force structure.

In any event, it is clear that the baseline used does not measure current services. Consider Medicare. CBO anually divides projected growth into three parts--increased caseload, price inflation, and greater use of services. The first two should be part of any effort to define true current services, i.e. how much it will cost tomorrow to fund today's program. But the final category--greater use of services--obviously represents more, not current, services. It is this last category that accounts for the bulk of the projected increase in Medicare spending--over 60 percent. Despite the fact that most of Medicare growth has been in excess of true current services, in the last decade public debate of the program has been dominated by discussion of "cuts."

3. Impact of the Baseline

Proponents of the baseline approach both argue its necessity and maintain that "objections [to the baseline system] have more to do with form than substance. . . . In the end, the budget totals are the same whichever approach is used."[(9)] Yet, any system that fundamentally alters how the public understands political action influences outcomes. Indeed, this pattern continued in the budget negotiations of 1990, 1993, 1995, and 1997. The rhetoric that dominated the process was of extreme pain, yet in 1990 Congress expanded Medicare and Medicaid significantly and continued the large increases in domestic discretionary spending that began in the last year of the Reagan administration. The reality of substantial new spending hardly matched the harsh rhetoric of severe restraint.

The rhetoric of the budget is biased toward increased spending. This claim can be reduced to a simple proposition: In dealing with the press and public, would an advocate for a program prefer that built-in increases above the previous year's level be characterized as "current," so that a restraint in growth leaving expenditures well above last year's would be presented as a "cut"? Or, would he or she prefer to have the debate be over the, for example, 10 percent increase assumed in the baseline, or a mere 8 percent increase over last year's spending levels? Particularly given the short time one often has to make a point--in many cases a 10 second "sound byte"--it would be a rare program advocate indeed who did not prefer the current policy language of "cut" to the alternative of defending an annual increase.

The defenders of the current Medicare and Medicaid programs provide many excellent examples. In 1995, for example, the Congress made a serious attempt to slow the growth of Mediare. Nevertheless, the annual growth rate was still projected to be in the six to seven percent range, depending upon which plan and whose estimates were used. Yet, because of the rhetoric of the baseline, most Americans thought that the Congress was actually attempting to reduce spending below the 1995 level.

Even when the proposed reform is more modest, critics of the reform use the baseline to devasating effect. On January 5, 1987, for instance, then President Reagan's budget for 1988 was released, and proposed to restrain the growth in Medicare from 63 percent (10 percent annually) in the administration's five year, current policy baseline to 46 percent (8 percent annually). The next day, the American Association of Retired Persons, the American Hospital Association, the American Medical Association, the American Nurses Association, and the Federation of American Health Systems ran the following full-page advertisement in the Washington Post.

The ad featured a large picture of an elderly woman and a young soldier embracing. The following appeared above the picture:

> During the past five years,
> more than $30 billion has been
> cut from Medicare and Medicaid.

Now the administration
wants to cut $50 billion more.

Below the picture, the ad asked:

Isn't it time we started
defending the home front?

The body of the ad appears to compare yearly increases in defense spending with "cuts" in medical programs. Against the current policy baseline, Medicare and Medicaid had been cut. Yet, in absolute numbers, national defense outlays grew by 110 percent from 1980 to 1987 ($134 billion to $282 billion), while Medicare and Medicaid increased by 123 percent, from $48 billion to $107 billion. Thus, the medical programs actually grew by a greater percentage than defense. By claiming that defense was increasing while Medicare and Medicaid were being cut, however, the ad effectively used the current policy baseline to protect large growth in the medical programs.

The misleading use of "cut" is not the baseline system's only fault. The system has been manipulated, often producing "savings" dubious even under the baseline's peculiar logic. The manipulation of the baseline exacerbates this bias in favor of spending. When, as in the 1990 budget summit, $17 billion can be claimed as "cuts" simply by extending current law (and even allow for paying hospitals a higher percentage for capital than previously), when $9 billion can be claimed as savings over three years by limiting pay increases to 4 percent, when paying hospitals a higher update than they previously received is the largest "cut" in the 1987 budget summit category of entitlement "savings," and when money can simply be shifted to the next fiscal year to claim savings, a large package of "reductions" can be enacted with little or no impact on actual spending or the deficit. Even in the 1995 Reconcilliation Act, which clearly is more ambitious than past efforts, almost one-third of the "savings" needed for Medicare can be obtained simply by extending expiring provisions and continuing current policies.

One of the biggest games is what I call "The Perpetual Motion Machine of Expiring Spending Cuts." A program is categorized as being "cut" if a policy designed to reduce costs relative to the previous policy is scheduled to expire and then extended. Because the previous, higher-cost, policy is "in" the baseline for the years after the lower cost policy expires, extending the "saver" once again "reduces" costs. Repeated extension of the Medicare Part B premium at twenty-five (25) percent of program costs is a notorious example.

A closely related practice occurs when programs are annually increased. By having the baseline assume an annual increase higher than the one usually paid, large savings can be claimed. Medicare again provides an example, with the long-standing practice of assuming a high payment increase to hospitals in the baseline and then increasing payments annually by less than the assumption. Beginning in 1984, Congress began requiring hospitals to be paid under the prospective payment system (PPS) based on the diagnosis of the patients' illness, not on the services they actually receive. Each year, the PPS payment scale is increased or "updated." This update, once set by the Secretary of Health and Human Services, is supposed to be based on several variables, including input inflation (called the "market basket"), hospital practice patterns, and hospital productivity.

Initially, both practice patters and productivity were used to keep the update below the market basket. But after a few years Congress mandated that the baseline assume an update at the full market basket. Congress then legislated the update below the market basket, claiming budget savings each time, although in fact the outcome was identical to the intent of the system.

These "games" have become an established part of our budget system. The budget process has focused too much on producing a respectable number of "cuts"; if the cuts merely manipulate the baseline, the political pain, which is greater when programs are actually cut than when they are increased, is lessened. More important, some of these cuts are then used to offset real spending increases or to protect other programs from real spending restraint. Congress frequently pays for new initiatives, which can dramatically increase outlays, by "cuts" from the baseline. In this way, "soft" savings offset "hard" increases.

Created to give policy makers a better handle on budgetary decisions, in practice the current policy baseline has given rise to a charade divorced from fiscal realities. It should be scrapped.

B. The Budget Enforcement Act

1. The Discretionary Caps[10]

Proponents of the BEA have claimed that the limits on discretionary spending have been a resounding success in achieving their goal of restraining budgetary growth. The BEA placed ceilings, or "caps," on the levels of annually appropriated spending, providing separate limits for domestic, defense, and international spending through fiscal 1993 and then one limit for major discretionary spending categories through 1997. Defense has a separate cap for 1998 and 1999, and there are separate caps for certain smaller areas, such as violent crime and transportation programs. When the BEA was enacted, these ceilings were proclaimed as restraining domestic discretionary spending to the level of inflation, and were said to be particularly tight after the agreement's first year. So successful are they perceived to be that Congress has continued them.

Reality, however, is far different. Properly measured, domestic discretionary, spending growth has exploded since 1988, two years prior to the enactment of the BEA, and 1998. Of course, defense spending has fallen since the end of the cold war, an event that can hardly be attributed to the BEA. Indeed, the effect of the 1990 budget deal was to increase short term defense spending above the level Congress was otherwise planning to appropriate.

a. The Sources of Confusion

There are two major reasons why reality and perceptions are so at odds. The first is that officially-reported budget authority and outlay figures do not measure the monetary size of programs accurately. The availability of means of financing programs other than direct appropriations, such as receipts from offsetting collections, obligation limitations, transfers from entitlement programs, and recoveries of prior year spending authority can all increase program size without being fully reflected in annual budget authority and outlay figures.

A truer picture emerges if "budgetary resources" are used to gauge the monetary size of programs. Budgetary resources for a program are the total amount of funds made available for obligation by that program in a given year. This measure includes all the available means of financinglisted above. Once this measure is developed, a true picture of changes in domestic discretionary spending can be seen.

The second reason for the mismatch between reality and perception involves the caps themselves. Although the caps are a constraint, their impact on spending growth depends upon the level of the caps. In fact, for many reasons, particularly the level at which the caps were first set and adjustments that the 1990 law requires to be made to them, the caps have not restrained the growth of domestic discretionary spending.

The failure to measure spending accurately and to understand the nature of the caps helps explain the rhetoric and commentary that has occurred each year about the level of domestic discretionary spending. Throughout the year, from release of the President's Budget through enactment of the appropriation bills, the dominant theme is how tight the caps are. Some commentators, pointing to measures of spending such as budget authority and outlays which, although incomplete, can capture the direction of spending changes, note that while the caps may have been generous in the past, they are now tight. Yet, when that past was the present, i.e., when the Congress was working on the appropriations now recognized as allowing generous growth, the dominant theme--severe restraint--prevailed. Because the caps are both adjustable and are incomplete measures of spending, the seemingly tight caps are revealed, long after the fact, to be not so tight after all. By this time, however, Congress is working on new appropriations, again bemoaning how severely it is restricted.

b. <u>Accurately Measuring Program Size</u>

In measuring the size of discretionary programs, reported outlays are frequently equated with total spending. This is incorrect. Outlays are recorded net of certain payments made to the government from the public. Moreover, outlays are recorded only when a check is issued, not when the government assumes an obligation. Outlays for many programs, therefore, occur years after the programs have been funded.

Using appropriated budget authority to measure program size avoids the timing issue, but for some programs, this measure is irrelevant or only one method of financing. Particularly in the last 20 years, other methods have been used with increasing frequency to enable Congress to produce the appearance of budget cutting while the total amount available for spending has been maintained or increased.

One such method is requiring the public to pay a fee for a particular service. Such fees, called offsetting collections, are excluded from reported outlay and budget authority figures, but the agency providing the service is frequently allowed to use the fees to cover some or all of its costs. By increasing the fee and reducing the amount of appropriated budget authority, Congress can increase the amount of money the agency has to spend while reducing the agency's budget on the government's books. The use of such fees has become increasingly common, and are funding more and more of the regulatory state.[11]

Another type of budgetary resource that has not been included in calculations of budget authority are obligation limitations. Obligation limitations are used to control programs with trust or revolving funds. Highway programs, for example, are financed through a trust fund that receives money each year, mostly from taxes earmarked for that purpose. A limit on the amount in the fund that can be obligated for new spending, called an obligation limitation, controls program size. Obligation limitations thus serve the same purpose as appropriations do in other accounts, and are functionally equivalent to budget authority. Obligation limitations should be equated with budget authority to compute program size.

There are other methods Congress can use to conceal the true level of spending on discretionary programs. For example, Congress has transferred money from entitlement programs to discretionary programs. Congress can also "recover" expiring funds to spend on new programs. This is money, usually budget authority, that was previously appropriated and obligated. Unless it is "recovered," it will not be spent because it is no longer needed.

c. Adjustments to the Caps

As mentioned above, several adjustments to the caps have made them more generous than they originally appeared.

i. **Emergencies**

Under the budget rules, both as negotiated in the BEA and as reaffirmed in August 1993 and 1997, emergencies do not count against the caps. This loop-hole has added billions of dollars to discretionary spending.

Until Appropriations for 1998, there was much self-congratulatory praise in past Congresses and the Executive branch about how this provision has been limited to "true" emergencies, such as hurricanes and earthquakes. This praise was misplaced. The emergency exception is designed for unforeseen events, on the theory that no rational budget process could account for them. It is true that the particular emergencies that occur are unforeseen. In a nation as large as ours, however, the fact that there will be emergencies (almost) annually is foreseeable. Whether it is hurricanes, earthquake, riots, major floods, drought, or military emergencies, it is predictable that somewhere, in some fashion, nature or other forces will produce the need for "emergency" spending.[12] Rather than treat emergencies as acts of God for which the budget process should be held unaccountable, these events are, in the aggregate, predictable. An amount, based on past experience, should be set aside within the caps as a contingency to fund them. Moreoever, these funds should be released only for true emergencies.[(13)] Senator Domenici's bill will provide a useful check on abuse in this area.

ii. **The Outlay Cushion**

The drafters of the BEA recognized that a budget authority cap does not control all forms of spending. Although retaining the traditional treatment of offsetting collections, and thus allowed increases in such fees to fund programs without counting against the ceilings, the BEA attempts to control obligation limitations through an outlay cap. The cap was apparently calculated to provide outlays sufficient to fund the programs at the modest levels of growth implied by the budget authority cap. The original Budget Enforcement Act allowed for an additional $6.5 billion in outlays, however, ostensibly as a cushion to provide for differences in estimating outlays between OMB and CBO.[(14)] Although some estimating differences still exist for discretionary programs, they have largely been eliminated as, beginning with the Gramm-Rudman-Hollings sequester report in 1986, the career staffs of both agencies have sought to narrow their differences.

The outlay cushion also serves another purpose, namely providing for additional growth in budgetary resources. The cushion provides some additional ability to increase obligation limitations and hence increase the total of budgetary resources. To the extent that the cushion is not needed for estimating differences or other reasons, every additional dollar of outlays available allows for the creation of greater than a dollar in budgetary resources if the programs funded produces outlays beyond the first year. In fact, the largest program funded via an obligation limitation, highways, produces less than 20 cents in first-year outlays for every dollar of new budgetary resource.

iii. **The Budget Authority Cushion**

Like outlays, the original BEA provided for a BA cushion. Two cap adjustments were allowed. The first adjusted the domestic cap for 1992 and 1993 by ".1 percent of the sum of the adjusted discretionary spending limits on new budget authority for all categories for fiscal years 1991, 1992, 1993 (cumulatively) . . . ."[(15)] The second adjustment is "the amount of new budget authority . . . [that] exceeds the discretionary spending limit . . . due to technical estimates made by the director of the Office of Management & Budget."[(16)] Several billion dollars were added to the caps through these allowance adjustments. (Outlays from the BA cushion count against the outlay cushion as they accrue.) Like the outlay cushion, these adjustments allowed for some increase in budgetary resources above the level implied in the original caps.

iv. **Inflation Updates**

The BEA originally provided for very modest growth in the domestic discretionary caps beyond 1991. The caps themselves were to be adjusted for a variety of factors, including inflation. If actual inflation was higher than the BEA anticipated, then the caps would increase; if inflation was lower, then the caps would decrease. In fact, actual inflation was below the BEA's projections, causing the caps to be lowered.

For two reasons, however, these adjustments did not fully remove the impact of the mistaken projections; thus, to the extent the caps were set to grow with inflation, the adjustments allowed the caps to exceed this goal. First, neither the caps for the year in which the mistake occurred nor those for the year following were adjusted. For example, actual inflation for 1991 was not known until after fiscal 1991 ended and most appropriations for fiscal 1992 had already occurred. Thus, only the caps for 1993 and beyond were lowered. Second, OMB read the BEA to force adjustments only for the nonpersonal accounts of discretionary spending. CBO and GAO argued that the adjustment should have applied to all accounts.[17] OMB's position thus caused smaller decreases than a full adjustment would have.

2. PAYGO

As part of the 1990 BEA, pay-as-you-go (PAYGO) rules were adopted to insure that congressional action on revenue and entitlement spending did not increase the deficit. PAYGO requires that, at least as long as the on-budget category is in deficict, new legislation increasing outlays or reducing revenues be deficit neutral. Thus, such legislation must include offsetting revenue increases or expenditure decreases. If Congress does not act, a sequestration of certain entitlement programs will occur.

Although much praised, PAYGO has had a limited impact. PAYGO only applies to policy changes to existing laws. It does not reach mistakes because of inaccurate economic or technical estimates. Simply, PAYGO does not require cost "overruns" to be paid for if the excesses resulted from optimistic or mistaken projections.

Consider the problems government and private forecasters had in estimating the effects of President Reagan's first budget, discussed above. The estimates of the administration, CBO, and private forecasters all greatly understated the deficits that would arise from the first Reagan budget. Similarly, the economic forecast accompanying the 1990 budget deal was highly inaccurate.

Regarding technical re-estimates that increase the deficit, one of the best and most recent examples of this recurring problem can be found in the 1990 Budget Agreement. Congress and then President Bush claimed that they were "cutting" health programs by $35 billion over five years and "saving" $7.5 billion by extending the current policy regarding patient payment of premiums for Part B of Medicare. Since the 1990 agreement, the Congressional Budget Office (CBO) reestimated the cost of these programs through 1995 (the last year covered by the 1990 deal) numerous times. Although the number or size of the mistakes should be random, with as many overestimates as underestimates, the CBO has reported positive technical adjustments for Medicare and Medicaid that are many times the size of the claimed "cuts." In other words, the "progress" made in restraining growth was eliminated by an actuary's pen -- yet no one required additional restraint because of mistakes in the previous estimates.

The fastest growing area of Medicare -- post-acute care -- provides specific examples of the problem. Consider home health care. In 1988, the estimate for total home health outlays in 1993 was $3.8 billion; the actual amount was $9.3 billion--two-and-a-half times the original estimate. Outlays for home health continue to explode after 1993. What happened? The primary reason behind the growth was an out-of-court settlement HCFA negotiated with provider and consumer groups after losing a court decision concerning limits on the amount of home health services Medicare allows. The settlement effectively eliminated the limits. HCFA's new policy was enacted independent of Congressional oversight and OMB review. Again, no penalty resulted.

Similar rapid growth has occurred in the skilled nursing facility benefit, expenditures for which grew even faster than for home health. A key event that helped trigger the unexpected increase was the passage of the Catastrophic Coverage Act in 1988. That law repealed the previous requirement for a three-day hospital stay before Medicare would pay for skilled nursing care in a nursing facility. In the short period before the Act was repealed, the program's costs nearly tripled. Despite the repeal, expenditures did not return to previous levels and have continued to rise rapidly.

The reasons for underestimation of the cost of certain government programs is not obvious. One major reason appears to be a consistent inability to foresee all of the myriad ways in which providers will use changes in the law to their advantage. Such lack of foresight is hardly surprising, given that there are thousands of highly intelligent people who specialize in obtaining additional money from the government, and that government estimators are largely unwilling to increase their estimate of specific program costs in the absence of hard evidence.

V. POSSIBLE SOLUTIONS

A. Eliminate, or at Least Reduce, Balkanization

As in the 1920s, we should centralize spending control within one committee. The historical record and our research indicate that reestablishing a single committee control over spending authority would have significant effects on decreasing both the level of spending and the prospect of deficits. This proposal may be difficult for the Congress to implement because it greatly concentrates power over "pocketbook" issues. However, recent voter disenchantment and the electoral upheaval in the 1990s should have put Congress on notice that control of key committees and the ability to direct favors to interest groups is no longer enough to protect incumbents from the voter's increasing desire to see progress on national problems.

If full consolidation is impossible, several steps in that direction should be easier to adopt. Entitlement status should be ended for all programs except earned entitlements, such as Social Security. A new appropriations subcommittee could be created, with jurisdiction over the former entitlements and membership consisting of the committees with previous jurisdiction. At a minimum, all programs should be reviewed periodically, with future spending ended without reauthorization.

Control could also be strengthened through a default rule that penalizes Congress and the Executive when they fail to achieve their goals. Although much maligned, Gramm-Rudman-Hollings (GRH) was better than what has replaced it. GRH was imperfect, in particular because the House in 1985 successfully removed numerous programs from its reach. But it did exert pressure to reduce the deficit, producing significant restraint, particularly in domestic discretionary programs in fiscal 1986 and 1988. GRH died because of the unique S&L crises, which exploded deficit projections, and because it was mistakenly ended as part of the 1990 budget deal. It should be renewed, with its coverage expanded to remedy the problems discussed above.[18] Moreover, we should require the use of multiple year targets, not just annual ones.

B. Scrap the Baseline System

By assuming a continually growing level of spending, baseline budgeting makes it harder to consider ending programs. Further, it fundamentally alters how the public understands the budget process. Allowing continuous and large increases in programs to be classified as "cuts," it creates the impression of action when nothing significant has occurred. The greatest check on state power can occur only when the public respects and can fathom what the government is doing. Baseline budgeting does not allow either. A device created to promote good government has become instead an exercise in gamesmanship to justify politically expedient results.[19]

Of course, the problems that led to the baseline system cannot be ignored. As now calculated, the current policy baseline does provide useful information for many programs, i.e., a knowledge of what spending would be in the absence of congressional action. But for many other programs, notably discretionary ones, and those parts of mandatory programs that require frequent adjustments, there is no automatic pilot to measure. Rather than pretend to solve an insoluble problem, we should acknowledge that no good baseline is possible.

Although all programs should be measured against the base of the previous year's spending, for those programs that automatically increase the underlying reasons should be understood and evaluated. Breaking down the increases in programs into their components would improve Congressional and public understanding of the dynamics of government spending. For Medicare, for example, the past year's spending could be presented along with the projected increase in beneficiaries, changes caused by the aging of the population, general inflation, medical inflation, increased volume and intensity of use, and the costs of phasing in expansions and expiring provisions. The technical display should be as neutral as possible.

To be sure, such a procedure would be more complex than using the current policy baseline alone, but it would be a more accurate picture of reality. Medicare and many other government programs are not simple. Understanding and making intelligent decisions about those programs requires knowing why and how the program is growing. If the presentation of these programs oversimplifies a complex reality, it conceals important information and indirectly influences outcomes.

No system of evaluating budget decisions will be entirely immune from distortion and gamesmanship, but abandoning the present system will make it easier to understand the impact of spending and tax decisions on the deficit. We should decrease the likelihood of claiming victories in the battle against deficits when they occur while steadily losing the war.

C. Modify The BEA

The BEA should be changed, especially if the more significant changes discussed above are not adopted.

1. Discretionary Programs

First, the concept of budgetary resources should be substituted for the BA and outlay caps currently used. At the least, offsetting receipts should no longer be "free" under the caps. Second, the loopholes that allow the caps to be increased should be curtailed, especially that for emergencies.

2. Mandatory Programs

PAYGO rules should be adjusted to require the inclusion of adjustments for technical and economic errors. Although correct forecasting is a difficult mix of science and art, not correcting for mistakes means that they are simply being ignored. Given the degree to which mistaken assumptions are common and increase deficits, the country cannot afford to pretend they do not exist. Future deficits will be controllable only when responsibility for them is accepted. Requiring that mistakes be addressed does only this.

1. Unless otherwise indicated, all years are fiscal.

2. Thus, the record does not support the view that the Reagan Administration used a "rosy scenario" to hide the effects of its first budget. A comparison of the forecasts and assumptions used by the Administration finds that, in the aggregate, they did not differ dramatically from those of CBO or the private sector. What does stand out is the degree to which the administration, CBO, and private economists understated the chance and degree of a major recession. See Muris, The Rise of Large Deficits: What Really Happened in 1981 (working paper available from the author).

3. Because the economy would grow, deficits as a percent of GDP were projected to decline slowly.

4. The contribution of lower defense outlays to defecit reduction has been dramatic, falling from 6.3 percent GDP in 1986 to 3.4 percent in 1997.

5. " " "

6. The recent surge in revenues has increased general fund revenues to over 13 percent. Despite this surge, the non trust fund budget was still in defecit through 1998.

7. [7] We used regression analysis, a statistical technique designed to sort out the relative impact that several independent variables (such as centralized or decentralized committee structure) have on the dependent variable (here state expenditures per capita). Our results are significant at the .01 percent level.

8. [8] I discuss these issues at greater length in Timothy J. Muris, "The Uses and Abuses of Budget Baselines," in <u>The Budget Puzzle; Understanding Federal Spending</u>, eds. Cogan, J. F., Muris, T. J. & Allen Schick (Palo Alto: Stanford University Press, 1994).

9. [9] U.S. Congress, Congressional Budget Office, <u>A Profile of the Congressional Budget Office</u>, at p. 32-33 (Sept. 1990).

10. [10] For more details on how to measure domestic discretionary spending, see John F. Cogan and Timothy J. Muris, "Changes in Discretionary Spending During the Reagan Years," in <u>The Budget Puzzle; Understanding Federal Spending</u>, eds. Cogan, J. F., Muris, T. J. & Allen Schick (Palo Alto: Stanford University Press, 1994).

11. [11] Indeed, as documented by CBO, offsetting collections grew rapidly even as deficits grew. Between 1980 and 1991, user charges classified as offsetting collections increased two and one-half times. User charges to fund regulatory agencies have increased even faster, by more than five times. See CBO, <u>The Growth of Federal User Charges</u> (August 1993).

12. [12] All years in this sentence are calendar years.

13. ' -- " " -- " " -

14. [14] For budgets since 1995, the special outlay allowance has been 0.5 percent of the total discretinary spending limit on outlays. Although not a stated reason, the cushion also allow for some change toward a mix of programs that produce outlays faster than the mix allowed in the original BEA numbers. Budgetary resources produce outlays at different rates. If Congress changes the mix of appropriated budgetary resources toward programs that produce outlays quickly, then more outlays will be produced in the first year from the same amount of budgetary resources.

15. [15] The quote is from §251(b)(2)(E)(i) of Gramm-Rudman-Hollings, as amended by the BEA. This section was not included in the 1997 agreement.

16. [16] §251(b)(2)(E)(iv). The quoted language covered 1994 and beyond, when there was only to be one discretionary cap. Para. 251(b)(2)(E)(iii) contains an identical provision for 1992 and 1993, except that it provides for a separate adjustment for each of the three individual caps. Both

sections limited the total BA cap adjustment allowed. For example, for 1994 and beyond, the statute defined the limit as ".1 percent of the adjusted discretionary limit on new budget authority for that fiscal year." §251(b)(2)(E)(iv). These sections were not included in the 1997 agreement.

17. [17] See, e.g., GAO, Budget Issues: Compliance With the Budget Enforcement Act of 1990 (Nov. 1992). This latest BEA does not contain an inflation adjustment.

18. [18] Another useful step would be to follow the BEA and first sequester the individual areas that cause the deficit targets to be breached.

19. [19] As an adjunct to eliminating the current policy baseline, we should modify the reconciliation process. As discussed above, numerous program expansions were funded in past reconciliations. Indeed, one of the few benefits of the 1990 budget deal was that it eliminated the need for reconciliation, at least for a few years. The expansions stopped for a while. They should be barred from future reconciliation bills.