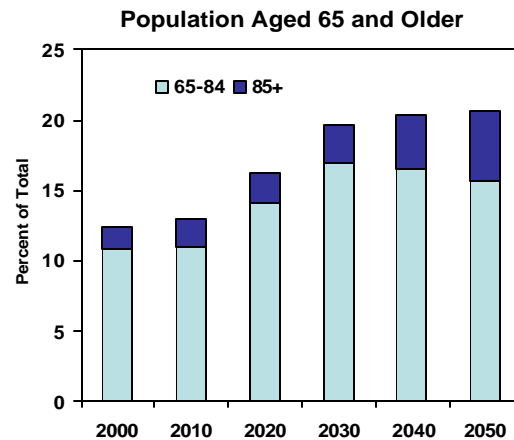


The Fiscal Future: Overview

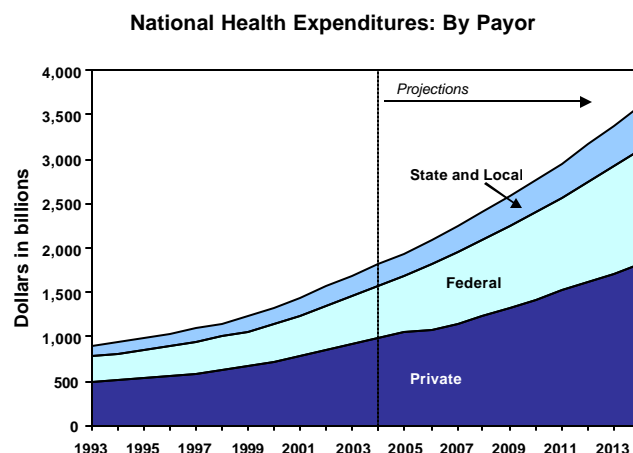
Public budgets are more than volumes of numbers. The figures represent the programs, benefits, services, and activities that we as citizens have decided that our governments should undertake. And they show who we have decided should pay the resulting bills. Those decisions go beyond setting today's public spending and taxes. They also create expectations of and impose obligations on future citizens. Present budget policies are out of balance. The federal budget continues to run large deficits despite a growing economy. State and local finances are precarious. There is little reason to believe that underlying pressures will abate, and so today's priorities come at the cost of fiscal opportunities for the future. That situation is simply not sustainable. And there is worse to come.

As the population of the United States ages, the costs of supporting people 65 and older will increase. That will have profound impacts on public budgets—and thus on the ability of the federal, state and local governments to address the needs of their citizens. If we begin to plan now, the coming fiscal challenges will be more manageable, while further denial and delay will make them only more difficult to address.



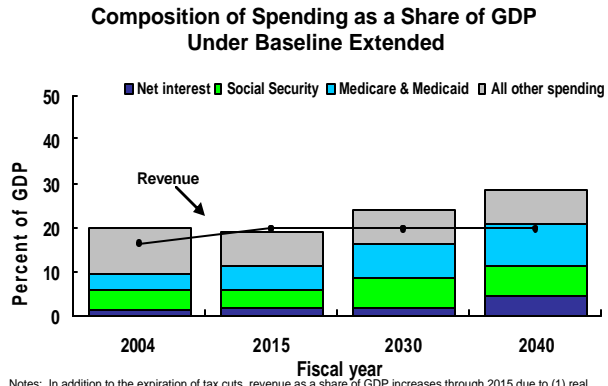
Source: U.S. Census Bureau, <http://www.census.gov/ipc/www/usinterimproj/>, March 2004.

The future will raise many issues—some known, some suspected, and some unknown. Among the most urgent will be one that is known: the rapid increase in health care costs. That growth affects everyone, but public budgets are particularly at risk. Taxpayers pay for those with the greatest needs—the elderly, the disabled and those with lower incomes. People ages 65 and older comprise 13 percent of the population but use almost 40 percent of all health care dollars. As their numbers grow, so too will health care spending and the pressure it exerts on public budgets.



Source: Centers of Medicare and Medicaid Services and Office of the Actuary.

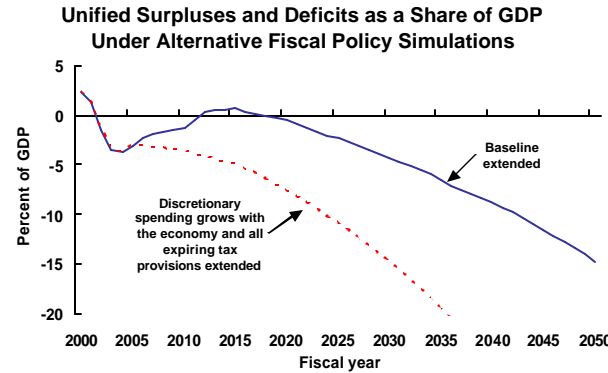
Federal spending for programs serving older people—Social Security, Medicare and Medicaid—will, unless policies change, use half of total revenues within 10 years and all revenues in 2040. That threatens not only to crowd out spending for other federal programs including defense and homeland security, education, transportation and other infrastructure, but also to increase significantly the pressure on state and local budgets.



Notes: In addition to the expiration of tax cuts, revenue as a share of GDP increases through 2015 due to (1) real bracket creep, (2) more taxpayers becoming subject to the AMT, and (3) increased revenue from tax-deferred retirement accounts. After 2015, revenue as a share of GDP is held constant.

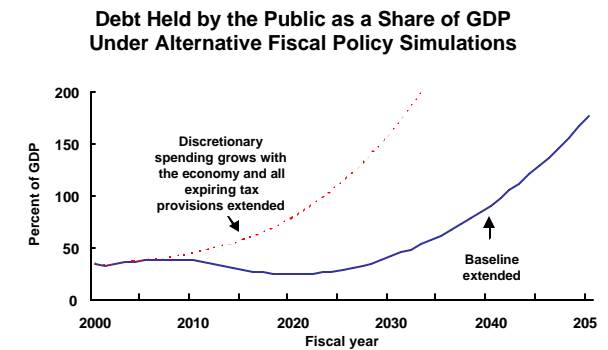
Source: GAO's March 2005 analysis.

If left unchanged, current policies will lead to exploding federal deficits and increased debt that will overwhelm the budget. That would put the economic well-being of future generations at risk. In addition, it would drastically limit their ability to determine for themselves government's role and how to pay for it.



Note: Assume currently scheduled Social Security benefits are paid in full throughout the simulation period.
Source: GAO's March 2005 analysis.

There is no magic bullet. Economic growth alone will not suffice. What is required is for policy makers and the public to recognize that today's decisions can change the fiscal future—making it better or worse. Setting priorities and making the difficult choices will pay off in the years to come and strengthen the ability of government at all levels to serve the public interest.



Note: Assume currently scheduled Social Security benefits are paid in full throughout the simulation period.
Source: GAO's March 2005 analysis.

Public budgeting is not an easy process. It tries to match voters' desire for public services with their willingness to pay for them. Individual voters could make separate calculations, but in a country as diverse as the United States, people are bound to disagree widely among themselves. That makes a combination of the political process and the budget process the only means at our disposal for reaching resolution of these conflicting aims.

Unless current policies change, public budgeting will become even more difficult. The oldest members of the baby boom generation will soon become eligible for publicly financed health care and retirement benefits. The growing number of older beneficiaries and rising health care costs will exert mounting pressure across federal, state and local budgets. That could lead to much higher tax burdens, unsustainable levels of public borrowing, or deep reductions in other important activities including national defense, education, infrastructure, and homeland security.

Those long-term challenges are becoming increasingly important to annual budget debates. At the federal level, the cost of retirement and health care benefits is rising faster than revenues available to pay for them, resulting in an ever-widening fiscal gap and a growing federal debt that places at risk standards of living for generations to come. State and local budgets are also strained by rising health care and retirement costs—especially nursing home and prescription drug benefits—as well as continuous demands for better education, improved public safety and other necessary services. Moreover, because of intergovernmental linkages, no level of government is completely insulated from the problems and prospects of others. Policy decisions taken at one level can easily flow through to other levels as well.

Alan Greenspan, Chairman of the Board of Governors of the Federal Reserve, recently noted:

Under current law, those longer-run pressures on the federal budget threaten to place the economy on an unsustainable path. Large deficits could result in rising interest rates and ever-growing interest payments on the accumulating stock of debt, which in turn would further augment deficits in future years. That process could result in deficits as a percentage of gross domestic product rising without limit. Unless such a development were headed off, these deficits could cause the economy to stagnate or worse at some point over the next couple of decades.¹

If policy makers kept that long-term outlook in mind during current policy debates, they could weigh future consequences against short-term gains. Instead, while focused on the next year or two,, they are tempted by actions that look relatively affordable now, but whose costs could balloon over time and cause serious damage to an already uncertain fiscal future.

Today's policies commit growing shares of future budgets to retirement and health care programs and, if deficits are not eliminated, interest payments on a growing federal debt—expenses that future policy makers and voters would have great difficulty changing. That would leave them with dwindling resources to meet other public needs unless they go deeper into debt or raise taxes significantly. In sum, by refusing to address the long-term structural imbalance,

¹ Testimony before the Committee on Financial Services, U.S. House of Representatives, *Federal Reserve Board's Semiannual Monetary Report to the Congress*, July 20, 2005.

baby boomers and other older generations are preserving improvements in their own standards of living and passing the bills on to their children and grandchildren.

A Better Budget for a Better Fiscal Future

The National Academy of Public Administration (the Academy) is keenly concerned about the state of fiscal policy-making across the country. There are two inter-related steps that will be required to strengthen the budget process:

- First, it is vital to rebuild the consensus that existed prior to 2001 about the importance of fiscal restraint over the nearer-term (five to 10 years) budget period.
- Second, it is essential to develop a strong commitment to fiscal balance over the long term.

Acting on these concerns, the Board of the Academy created the Committee on Fiscal Futures (the Committee) and assigned it the task of developing approaches for federal, state, and local governments to deal with their financial issues and the potentially increasing structural deficit. In addition, the Committee was charged with recommending ways to improve public understanding of the scope and consequences of the problem, as well as its impacts on our ability to meet national goals and on the influence of the United States in the world.

This report contains the Committee's observations and recommendations based upon its activities over the past year. (The observations and recommendations contained within this report reflect views of the Committee, not of the Board or the Academy as a whole.) The Committee commissioned three papers, which are summarized in this report, and can be accessed on the Academy's website:²

- *The Federal Budget: The Long-Term Fiscal Challenge* outlines the causes and consequences of the long-term fiscal imbalance in the federal budget.
- *State and Local Finances in an Age of Structural Deficit* examines the condition of state and local public finances.
- *The Fiscal Challenge: Federal Budget Concepts and Practices* assesses the suitability of current budget concepts and processes at the federal level for addressing fiscal stress.

In addition the Committee hosted a forum on budget process and concepts on June 16, 2005 in Washington, DC, for Academy fellows, budget experts from the executive and legislative

² http://napawash.org/about_academy/fiscalfutures.htm

branches of government and representatives of public policy research organizations.³ (A summary of the forum proceedings is also available on the Academy's web site.)

The Committee notes that there is no shortage of information about the long-term prospects of the federal budget. The Committee further notes that in addition to pressures caused by their own retirement and health care programs, linkages to federal policies exposes state and local budgets to significant uncertainty and serious risk.

This report emphasizes the clear need for policy makers and the public to focus on the connections between short-term decisions and long-term fiscal prospects. Although the Committee hopes that greater public education and communication will suffice, we further acknowledge that it is unlikely that policy makers will change their priorities until action-forcing events focus their attention on the undesirability of current fiscal trends. It is unmistakably a question of "when" not "if" such a "crisis" will occur. In the meantime, the Committee views this project as a prudent step that will help prepare for a time when fiscal discipline once again becomes a top priority.

An Agenda for Change

The fiscal challenges that lie ahead for the federal government, states and localities are serious. Yet elected officials have been unable to agree upon plans for addressing them. That may be because the problems appear to lie far enough in the future that elected officials perceive little advantage in considering unpopular tradeoffs or making compromises now to remedy those woes. Indeed, current surpluses in the Social Security program and the recent pickup in revenues serve to mask the longer-term problems on the horizon. The reluctance to make difficult choices is not new, but time is running short. With each passing year, legislative activity revolves more around proposals to maintain or increase benefits and other spending or to cut taxes that would further destabilize the long-term fiscal outlook.

Structural imbalances in fiscal policy must be resolved through the budget process. That process provides the only legislative opportunity to take a comprehensive look at all programs and all resources. It has the potential to promote long-range planning. Thus, at the federal level, a stronger process could provide a suitable framework for improving long-run fiscal outcomes. States and localities could also reform their budget processes to accommodate longer-term influences and lessen exposure to factors (including changes in federal policies) that now appear to be outside of their control.

The budget is a key element of governance. The budget process should create a level playing field so that the debates about public policy and priorities are fair and open. It is therefore essential that the budget be honest, comprehensive and transparent, and that the projected costs of potential activities be presented on a comparable, "apples-to-apples" basis. Without those

³ Budget processes at the state and local level vary considerably. Although the Committee restricted its work to the federal budget process and concepts, many of the issues are generic to public budgeting. The Committee's observations and recommendations for the federal budget would also apply generally to other levels of government.

qualities, the decision-making process is distorted, and voters find it more difficult to hold their elected representatives accountable for their decisions about fiscal policy.

Policy makers, however, must find a way within the budget process to bridge the gap between short- and long-term objectives. Until they do, long-term challenges may not be addressed. At the federal level, as well as for most states and localities, budgeting is an annual process. The year-to-year cycle is important to governments' efforts to control the allocation and use of public funds. Annual decision-making, however, places great weight on current- and budget-year results and discounts longer-term developments. That is contrary to the type of focus that will be needed to resolve the structural imbalances affecting public budgets.

Work is needed in three broad areas to incorporate the long-term outlook into the budget process:

- **Public education, awareness and engagement:** The public needs to: (1) understand better how current policies and proposed alternatives will affect younger generations; and (2) become more engaged in the establishment of principles, setting goals, ranking priorities and weighing alternatives. A continuation of current policies will consume future public resources and result in levels of deficits and debt that will harm future standards of living. Without greater popular support for adequate levels of taxation and benefit changes, elected officials will be reluctant to set fiscal goals and make the tough decisions required to achieve them.
- **More effective communication, measurement, and disclosure.** New ways to present information about complex issues, options and consequences and make them accessible to general audiences are required. More effective presentation of fiscal trends and economic consequences could help motivate policy makers by making risks and rewards much clearer to the public. Better ways of measuring potential impacts of proposed policies over the long term and incorporating those assessments into annual budget deliberations could help disclose adverse long-term outcomes. Budget accounting concepts may also need to be revised or updated to improve the budget's transparency and comprehensiveness and to discourage gimmickry.
- **Budget enforcement and enhanced fiscal discipline.** Additional efforts should focus on the development of workable and effective approaches that would put the budget on path to structural balance and fiscal sustainability instead of on the do-nothing path of bigger deficits and deeper debt. The statutory pay-as-you-go provisions (which expired in 2002) were designed to keep deficits from worsening by requiring offsets for deficit-increasing measures. Now even that objective, while better than nothing, is inadequate. New measures should reflect agreed-upon benchmarks and set a higher standard that works towards closing gaps that exist under current law.

Next Steps

The Academy stands ready to assist federal, state and local officials in their efforts to address long-term fiscal challenges. The stakes are almost immeasurably high. This project therefore has the potential to make an important contribution to the public good, for years and even generations to come. This report is a first step. The following chapters of this report provide specific observations and recommendations related to federal fiscal policy, state and local budgeting, and federal budget process and concepts.

The Fiscal Futures Committee of the National Academy of Public Administration is dedicated to furthering public understanding and debate over these issues. The Academy's national membership and experience in the mechanics of government equip the organization to play a constructive role in the formulation of ideas that will help improve the budget process. The organization is well positioned to contribute to the essential task of helping policy makers develop workable approaches. In particular, the Academy has important collective expertise on policy-making processes within government, and on the process and fiscal policy aspects of relations between levels of government. In addition, the Academy's membership facilitates dialogue among levels of government. Isolated responses are not likely to provide enduring relief. A greater collective understanding, however, of the issues and options, could promote more sustainable solutions.

The good news is that today's budget predicament can be fixed. Bipartisan leadership from the White House and the Congress can move the process towards agreement about fiscal objectives and priorities. The fairest, and most effective, plan will have to put taxes and spending on the table, include all programs including national defense and Social Security, affect rural and urban constituents, and touch voters in every state of the Union. Small fixes today can translate into significant gains in the future, but change has to start soon.

The cost of inaction is greater exposure to uncertainty and risk and less control over our fiscal destiny. To some deficits may not now appear to be a big problem because long-term interest rates are at historically low levels and the surplus in the Social Security trust funds partially offsets the federal government's deficit in other accounts. Those perceptions could change rapidly for reasons that would quickly escape the control of elected policy officials. The greater the national debt the more the United States puts itself at the mercy of global market pressures and decisions taken in foreign capitals. That outcome presents undesirable risks. The only alternative is to reassert control over fiscal policies and make the hard choices that will be necessary to put public budgets on a better course.

The Federal Budget: The Long-Term Fiscal Challenge

The Fiscal Futures Committee of the National Academy of Public Administration concludes that the fiscal policy of the United States is on an unsustainable path. Fiscal policy at the federal level is increasingly characterized by the promises—both explicit and implicit—that successive Congresses and Administrations have built into current programs.⁴ The revenue streams provided under today's tax laws are insufficient to pay for all of those promises. As a result the budget is structurally out of balance—a condition that will worsen over the long term.

Observations

The Committee makes the following key observations:

1. The federal budget's structural imbalance cannot be solved by small changes at the margin and, almost certainly, cannot be eliminated by economic growth alone.
2. Failure to address this challenge would have significant consequences for the economy as a whole, for government at the federal, state and local levels, and for intergovernmental relationships.
3. There are no easy solutions to the mismatch between what the American people expect from government and how much they are willing to pay. Policy makers and the public must begin now to confront the difficult trade-offs that are required to restore sustainable fiscal policy.

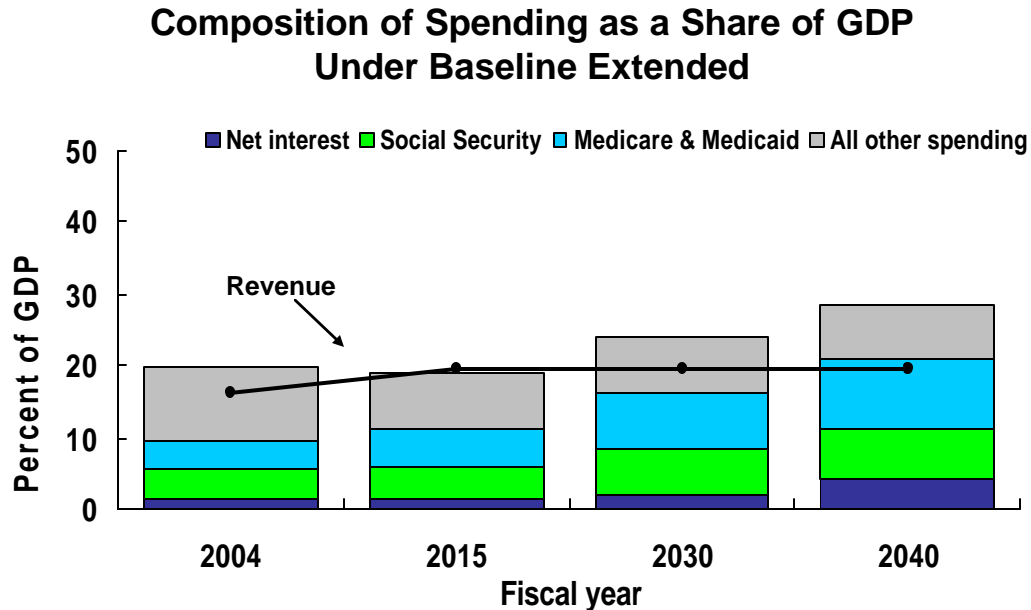
Observation 1: *The federal budget's structural imbalance cannot be solved by small changes at the margin and, almost certainly, cannot be eliminated by economic growth alone.*

The seriousness of the structural imbalance in federal fiscal policy has been well documented both by government agencies such as the Congressional Budget Office (CBO), the Government Accountability Office (GAO), and the Office of Management and Budget (OMB), and by analyses by independent organizations such as the Brookings Institution, Urban Institute, and others. Simulations by those agencies and organizations show that as the population ages, the growth in federal spending for Social Security, Medicare and Medicaid will increase dramatically as a share of the budget and the economy (see figure 1). Under current policies the

⁴ This summary is based upon, *The Federal Budget: The Long-Term Fiscal Challenge*, written by Susan Irving and Joseph J. Minarik. The paper is available through the Academy website at: http://napawash.org/about_academy/fiscalfutures.htm

increase in the beneficiary population coupled with expected high rates of growth in health care costs will lead to escalating deficits and debt that will undermine future standards of living.

Figure 1.



Notes: In addition to the expiration of tax cuts, revenue as a share of GDP increases through 2015 due to (1) real bracket creep, (2) more taxpayers becoming subject to the AMT, and (3) increased revenue from tax-deferred retirement accounts. After 2015, revenue as a share of GDP is held constant.

Source: GAO's March 2005 analysis.

In fiscal year 2004, the federal government spent \$2.3 trillion, or approximately 19.8 percent of gross domestic product (GDP). It raised revenues of \$1.8 trillion, or 16.3 percent of GDP. The resulting deficit of \$412 billion represented 3.6 percent of GDP. CBO estimates that the gap will narrow temporarily, but only if policy makers do not extend the expiring tax cuts enacted between 2001 and 2004 or implement other changes that would contribute to deficits. If they extend the tax cuts, for example, annual revenues in 2012 and beyond would be 1.7 percent smaller as a percentage of GDP. That would make the longer-term imbalance more difficult to address. If current policies do not change, the budget gap will increasingly widen as revenues fail to keep pace with the projected growth in entitlements and the cost of servicing an ever-larger debt.

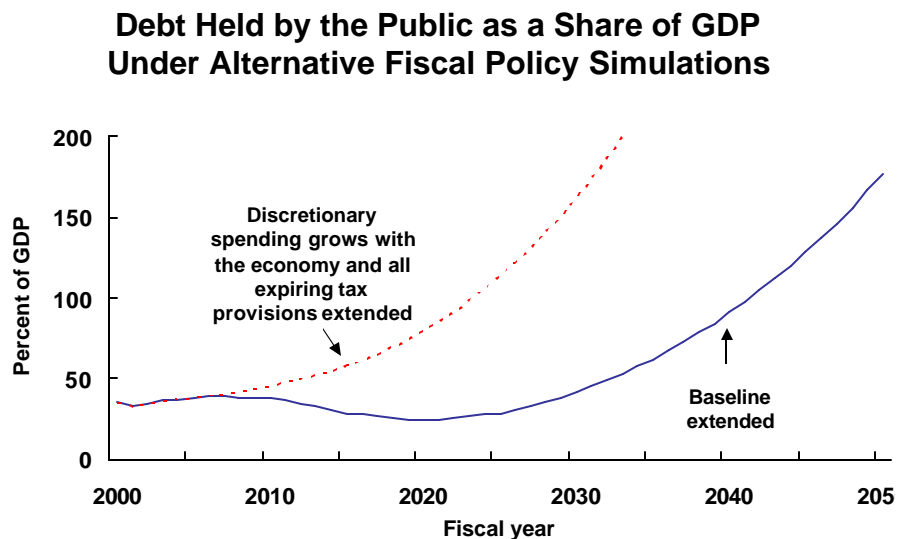
Within the budget, spending is shifting toward entitlement programs, which are not controlled by the annual appropriation process. The largest entitlements—Social Security, Medicare and Medicaid—provide benefits primarily to older individuals. As life expectancies lengthen and the baby-boom generation retires, the number of older beneficiaries will grow. The growth in the older population, coupled with continued and rapid increases in the cost of health care, are expected to drive up spending for those three programs. CBO and GAO project that Medicare and Medicaid in particular will grow rapidly. CBO estimates that in 2005, spending for Social

Security, Medicare and Medicaid will total 8 percent of GDP. If current policies and trends do not change, CBO estimates that spending for those programs will grow to almost 28 percent of GDP in 2050—that is, 40 percent more than the entire budget’s current share of GDP.

Modest federal deficits, if short-lived, can be accommodated within the \$12 trillion U.S. economy. However, the deficits the country is projected to face in the coming decades are neither modest nor temporary. Once deficits accumulate into debt, the interest cost of servicing that debt will compound, creating a vicious cycle of deficits and escalating debt. Furthermore, federal deficits use resources that otherwise could be used for the productive investment that the economy needs to grow. Thus while steady economic growth would reduce the burdens associated with a larger and older population, the projected deficits will make that growth more difficult to sustain over the long term.

In the next 10 years alone, the federal government’s debt held by the public is projected to rise by nearly \$1.4 trillion—or more than \$4,600 for every man, woman and child living in the United States. Over the longer term, debt held by the public will rise to unsustainable levels as a share of GDP (see figure 2).

Figure 2.



Note: Assumes currently scheduled Social Security benefits are paid in full throughout the simulation period.

Source: GAO’s March 2005 analysis.

Observation 2: *Failure to address the fiscal challenge would have significant consequences for the economy as a whole, for government at the federal, state and local levels, and for intergovernmental relationships.*

Over the long term, unless policies and trends change, federal deficits and debt are expected to grow exponentially and without limit. Continuing on that path not only risks harming the country's future economy: it also has significant implications for governance at the federal, state and local levels, and could substantially alter intergovernmental relationships.

Fiscal stress at the federal level puts pressure on lawmakers to reduce spending for programs and services that citizens take for granted. Constraints at the federal level affect other levels of government as well. States and localities complement their own resources with funds provided through federal grants. As a result, federal budgetary stress translates into increased pressure on state and local budgets. For example, states are already struggling with the rapid rate of growth in Medicaid costs because they contribute about 43 percent of that program's total financing—a contribution that accounts for over 20 percent of their budgets. If efforts at the federal level to reduce Medicaid spending transfer costs to the states those policies would have an immediate and direct impact on the fiscal condition of the states. It could also affect the availability of health care services particularly to lower income populations.

At the federal level, the shift within the budget toward Social Security, Medicare and Medicaid spending will increasingly limit the government's ability to address other needs. At today's taxation levels, little revenue would be left to fund essential programs and services—homeland security, housing assistance, the FBI, national parks, transportation, education, and even national defense—that are taken for granted. With limited means, the federal government's ability to respond to humanitarian needs and emergencies will be increasingly constrained. That loss of flexibility ultimately will reduce the ability of the federal government to respond to national needs and international requirements.

Furthermore, the lack of room to maneuver could lead lawmakers to follow a path of least resistance. Given the growing pressure on the annual appropriation process and discretionary programs, policy makers could find it easier to resort to across-the-board cuts than to engage in rigorous program oversight, elimination of outdated or ineffective programs and a search for innovative policy approaches. Across-the-board cuts are presented as "fair," but can also be viewed as a defensive measure that protects existing programs at the expense of new requirements. In brief, policy makers risk creating a "hollow" government in which core government functions are de-funded and left unable to meet their objectives.

Observation 3: *There are no easy solutions to the fiscal challenge facing the nation. But policy makers and the public must begin now to confront the difficult trade-offs that are required to restore sustainable fiscal policy.*

Plainly put, the United States will not simply grow its way out of the fiscal challenges it faces. Economic growth will help, but will not be sufficient to close the structural imbalances between revenue and spending policies. Therefore public policies must change. The amount of adjustment needed is large enough that it is not likely to be accomplished solely through tax increases or spending cuts. Instead, any plausible solution will likely require a combination of the two.

Economic growth is a fundamental prerequisite to maintaining and improving the national well-being. However, simulations by CBO and GAO indicate that in the absence of policy change the economy would have to grow at rates far in excess of what it has been able to sustain for any extended period, including the postwar booms, in order to keep the debt from exploding. Looking forward, the combination of a growing public debt and a slowdown in the growth of the workforce will hamper the economy's ability to grow. Consequently, without significant sustained improvements in workforce productivity well above historical levels, it will be impossible to maintain the current rate of growth, let alone increase that rate sufficiently to outgrow impending budget problems.

The size of the federal government's fiscal gap is too large to be solved by nibbling around the edges. Assuming current policies and trends continue unchanged, GAO simulations show that in 2040 the deficit will be so large that balancing the budget in that year could require cuts in total federal spending of as much as 60 percent or raising taxes to almost two times today's levels. Neither action is politically feasible. Some combination of spending reductions and tax increases is far more likely to be sustained by policy makers and the voting public.

Recommendations

The Fiscal Futures Committee of the National Academy of Public Administration believes that efforts to help the body politic to recognize the problem and to find a way to make the best possible decisions are critically important. That includes assisting with the development of processes that bring forth the important decisions and present a clearer view of the cost of those decisions. To those ends, the Committee makes the following recommendations:

Recommendation 1: Policy makers and the public should begin now to confront openly the difficult trade-offs that are required to restore a sustainable fiscal policy. From this point forward, lawmakers should factor in the long-term consequences of short-term budget decisions.

The “long-term” challenges that must be addressed are now near-term. The oldest of the baby boom generation—those born in 1946—turn 62 and become eligible for early (reduced) retirement benefits from Social Security in 2008—three years from now. They become eligible for Medicare three years later, in 2011. Those milestones fall easily within the 10-year budget window. That provides scant time to realign major entitlement and revenue policies with fiscal realities. In the meantime, policy makers should guard against making fiscal problems any worse.

Recommendation 2: The nation should begin a realistic discussion about the basic elements of the federal fiscal challenges and potential solutions. That discussion should focus on core issues such as:

- What do we collectively want from government, and what are we willing to pay for it?
- What share of the economy and the budget should be devoted to the elderly and to their health care, and what share to other choices including national and homeland security and children and their education?
- What government programs are outdated or ineffective? What programs respond to problems that have already been solved or address circumstances that have since changed? What programs address problems that have now fallen to lower priorities among national issues?
- What changes and adjustments should be made to the tax system? With tax cuts becoming increasingly popular, is the tax code becoming an easier means to provide benefits than direct spending? If so, what mechanisms will help assure that such provisions are held to the same standards of performance and accountability as direct spending programs?
- Given the size of the commitments of the federal government, how much taxation of the American economy is appropriate? Other developed countries utilize much higher rates of taxation. Are those models instructive for the United States? If the generally lower rates of U.S. taxation are deemed important to maintain in the future relative to other priorities, are the potential benefits thereby derived negated by the effects of structural deficits that deepen over time?
- How should we change our budget processes to promote continuing fiscal responsibility?

Recommendation 3: Political leaders, policy research organizations and public interest groups must develop better approaches to communicating the issues and engaging a broad range of people in a national conversation and debate about fiscal choices. Needed elements include:

- Improved understanding of the nature of the problem and of the composition of the budget. That would include a better understanding of why deficits and debt matter, the

efficacy of apparently painless solutions (including forecasts of high economic growth), and the relationship between taxes and government services.

- Correction of common, but mistaken, preconceptions (e.g., that the deficit can be eliminated by cutting “waste, fraud and abuse”) and clarification of misunderstood concepts and terms (e.g., the Social Security “trust fund”). Better education would inject more realistic perspectives into the debate and may reinforce the need to act sooner rather than later.
- Development of better and more comprehensible measures of the size of the problem and the impact of particular choices over a longer time horizon.
- Commitment by political leaders to engage in a constructive discussion of issues and options and to refrain from further political polarization, which makes it harder to define common ground and develop collaborative solutions.

Conclusion

The fiscal challenges facing the federal government are daunting. Political realities favor satisfying the immediate wants of constituents over developing sustainable long-term solutions. However, with each passing year, problems that have been characterized as long term become more immediate. Policy choices are already severely constrained because of decisions made in the past that were short-sighted, but politically appealing. Further delay only increase the pressures within the budget and makes available adjustments more difficult.

The Fiscal Challenge: State and Local Level

State and local governments are emerging from the fiscal stress resulting from the 2001 recession and subsequent years of slow growth in employment and wages. Conditions and circumstances vary widely across and within states. The Fiscal Futures Committee of the National Academy of Public Administration concludes, however, that underlying trends and other factors generally make state and local governments vulnerable to continuing and increasingly volatile financial risk.⁵

Observations

The Committee observes that the deep and persistent budget problems generally experienced by state and local governments following the 2001 recession indicate that their financial issues may be becoming increasingly difficult to address. State and local governments face greater financial instability and uncertainty resulting from:

- The shifting composition of state and local revenues and expenditures.
- The linkages between federal and state policies that make states vulnerable to changes in the budgetary outlook at the national level.
- Dependency (by localities) on direct transfers of state funds and smaller transfers (mostly indirect) of federal funds, and requirements for meeting federal and state regulatory constraints.

The deep and persistent budget problems generally experienced by state governments following the 2001 recession indicate that financial issues at that level may be becoming increasingly difficult to address.

While economic and political circumstances vary considerably among them, state governments generally endured a sustained period of fiscal turbulence following the 2001 recession that belied the national economic downturn's relatively shallow nature. Although short-lived, the recession represented a dramatic shift from the years of robust growth that produced revenue windfalls and appeared to accommodate permanent policy changes that reduced revenues and increased spending. Furthermore, although the recession officially occurred in March to October 2001, the seriousness and duration of the shortfalls in state revenues were not well understood until well

⁵ This summary is based upon a paper written by John Peterson, *State and Local Finances in an Age of Structural Deficits*, which is available through the Academy website at: http://napawash.org/about_academy/fiscalfutures.htm

into the states' 2002 fiscal years. That meant that the states' budgets did not begin their first substantial attempts to address fiscal imbalances until 2003.

Aggregate spending by the states continued to grow in nominal terms through 2003, albeit at a slower pace than during the 1990s, while revenue growth fell to zero in 2001 and turned negative in 2002 and 2003. Beginning in 2000, real (inflation-adjusted) revenues declined an average of about 1 percent for three consecutive years while per capita expenditures increased about 2 percent a year. Resulting budget gaps depleted state balances⁶ from a peak of 10.4 percent of expenditures in 2000 to 3.2 percent of expenditures in 2003.

The unwelcome turnaround in state finances in the first half of this decade represented an abrupt change from the immediately preceding years. In the 1990s state coffers filled up fast enough to permit lawmakers to cut taxes while increasing expenditures. After the 2001 recession, initial state responses mostly were heavy on short-term fixes and light on long-term solutions. State policy makers maintained spending for programs whose growth rates—even in the absence of economic slowdowns—exceed that of their revenue systems. And they did not take back tax reductions enacted in 1993-2000, attempting instead to ride out the recession.

For many states, the use of temporary, non-recurring resources to maintain spending levels during the first two years of the slowdown added to the severity of the subsequent budget problems. State lawmakers first turned to accumulated “rainy day” funds and instituted short-term fixes such as the use of one-time receipts (e.g., asset sales and the capitalization of tobacco settlement payments) and other “one-shot” measures. In addition, in 2002-2003, state lawmakers requested and received a one-time infusion of \$20 billion from the federal government. States exercised modest expenditure restraint—often in the form of across-the-board cuts—to reduce the growth rate of spending. But revenues did not recover to anticipated levels. Once lawmakers exhausted rainy day funds and other reserves accumulated during the 1990s and used up other available “one-shots,” budget gaps were even larger than ever. As a result, they eventually turned to revenue increases and spending reductions.

By 2003, over half of the states were cutting capital budgets to help protect operating budgets. Many states initially exempted fast-growing programs—such as education—from the cuts and increased spending for income support and unemployment activities. In 2003, half the states cut real per capita spending for activities other than Medicaid, and more than half reduced real per capita spending for elementary and secondary education. That exercise in fiscal restraint was largely offset, however, by Medicaid spending, which grew by more than 7 percent in real per capita terms between 2002 and 2003.

The mix of policy measures to close state budget gaps following the latest recession differed from that used to address the fiscal effects of previous downturns. During previous recessions, state policy makers responded to budget gaps through a combination of spending reductions and revenue increases. During the latest recession, however, distaste for revamping the flagging revenue systems reflected a change in political attitudes that has been growing nationally since

⁶The National Association of State Budget Officers defines state balances as ending general fund balances plus budget stabilization or “rainy day” funds that states may use to address unforeseen circumstances after budget obligations have been met.

the mid-1970s. Unlike the responses to previous recessions, state lawmakers relied on spending cuts for the largest share of the gap-closing measures. Consistent with recent trends, revenue measures consisted largely of increases in fees and other charges and smaller taxes (for example, cigarette taxes and state tuition and fees charges). They largely avoided more lucrative sources of revenues such as sales and income taxes.

As at the federal level, those advocating smaller government pressured state lawmakers to tighten restrictions on spending and revenues. During the 1990s, powerful economic growth masked the effects of such limitations on state and local finances. Cutting taxes proved an easy step when state and local coffers were overflowing, as did expanding programs and benefits. Once economic growth subsided, state and local officials found themselves without the resources needed to meet their spending obligations. The slowing economy played a significant role in the deterioration of state finances, accounting for about one-third of the budget deterioration. But, two-thirds of the change was structural—that is, the result of policy decisions that created a fundamental mismatch between revenue and spending levels.

Current budget trends at the state and local level indicate that revenue and spending policies remain out of balance and are likely to get worse, not better. The aging of the population will exert increased pressure for more spending—particularly in the area of health care—while political, economic, and structural constraints on revenue show no signs of abating. State budget practices do not promote longer-term planning. Only 36 percent of states extend their budget projections for more than 3 years beyond the immediate budget year or biennium (in the case of states that adopt 2-year budgets). Over one-third of states produce only operating budgets for the budget year or budget biennium. As a result, policy makers in most states have a limited perspective on how their fiscal policies will fare over time as program enrollment and other factors change. That short budget horizon exposes them to “surprises” that could be anticipated and acknowledged if officials had access to longer-term projections (e.g., five to 10 years).

State and local governments face greater financial instability and uncertainty resulting from the shifting composition of state and local revenues and expenditures.

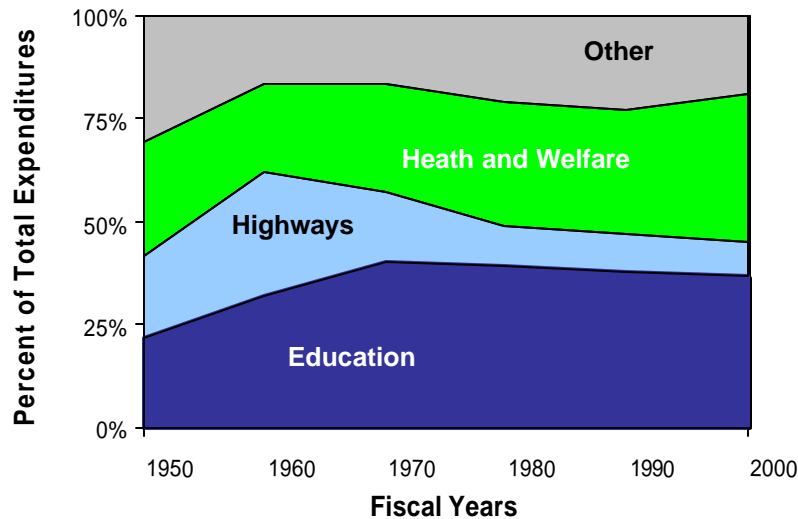
Over time, the contours of state government finances have changed. Changes in the composition of spending and revenues have complicated efforts to stabilize state finances. Strong and steady growth in health care costs (largely Medicaid) have had the same impact on state and local budgets as on other health care payers. Aside from health care costs, states spend increasing shares of their budgets for education, and, more recently, public safety and corrections—areas that are politically appealing. On the other side of the ledger, state revenues also face growing constraints.

In the 1960s, state expenditures were about 5 percent of gross domestic product (GDP). The amounts states allocated to education and highways were about even (32 and 30 percent, respectively, of total expenditures), and they spent about 21 percent of their budgets on health and welfare programs (see figure 1). In 2000, total state spending had doubled as a percentage of

GDP, and its allocation had changed. Education expenditures were 37 percent of the total, health and welfare programs had grown to 36 percent, and highways had declined to only 8 percent.

Figure 1.

Composition of State Spending by Major Category



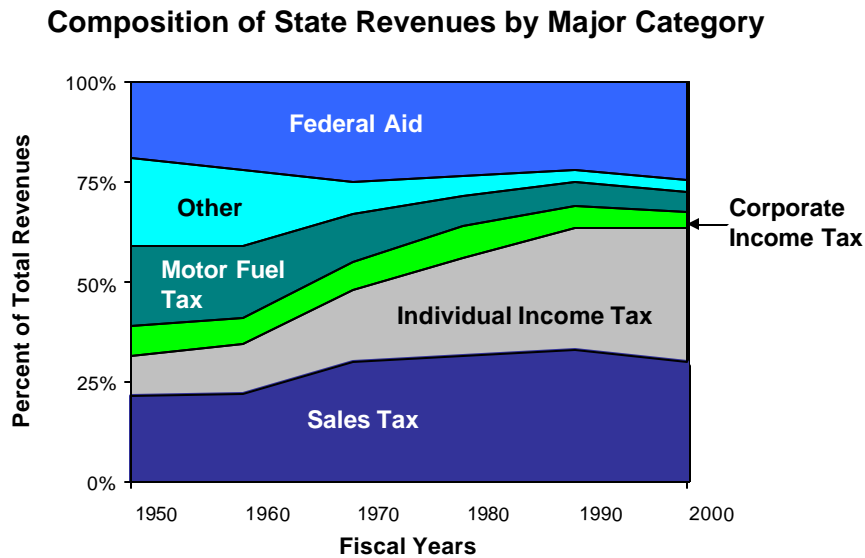
Although by tradition states are responsible for their public educational systems, the financing of elementary and secondary education has been primarily a local responsibility. However, local sources of funding for education vary widely, resulting in large disparities in per pupil funding within individual states. In addition, recent increases in enrollment, a growing need for special education and added needs resulting from federal requirements for grant funds distributed under the No Child Left Behind Act have contributed to rising education costs. Under judicial and political pressure to even out funding across school districts, many states have engaged in various tax reforms that shifted greater responsibility for education financing to the state level. Those changes have often provided local property tax relief but also have increased budgetary pressure at the state level.

In addition, the rising cost of health care is crowding out state spending for other purposes. States provide health insurance coverage to low-income families and children, the elderly and disabled through Medicaid. States contribute about 43 of total Medicaid costs—spending that now ranks as second in size only to education in most state budgets. Although Medicaid is an individual entitlement established under federal statute, states share control over its spending. States have recently imposed cost-containment measures, but Medicaid has been growing eight or 10 percent a year. Without comprehensive reform to the Medicaid program, any savings that states manage

to achieve are likely to be short-lived. Medicaid is the largest third-party payer for long-term care. The aging of the population will fuel increased enrollment of one of the most costly segments of the Medicaid population. Continuing advances in medical technology will also drive future Medicaid costs even higher. With the federal and state budgets under stress, there is ongoing tension concerning Medicaid cost-sharing, which raises fundamental questions about the appropriate allocation of responsibilities between the federal government and the states.

The composition of state revenues has also changed—partly due to stagnation in revenue systems (see figure 2). In 1960, state revenues comprised, in order of importance, sales taxes, federal aid, other revenues (tobacco and alcohol taxes, mortgage taxes, etc.), motor fuel taxes, individual income taxes, and corporate income taxes. Since then, individual income taxes have surpassed the sales tax as the largest component of state revenues, while sales taxes have grown more slowly, and federal aid has stabilized. Together, sales taxes and individual income taxes now provide about 64 percent of states’ resources, an increase from the 32 percent combined share in 1960. Greater reliance on individual income taxes has injected more volatility into state revenues. Such receipts declined precipitously following the recession and did not begin to rebound until mid-way through 2003.

Figure 2.



Sales tax revenues, which are also dependent on economic conditions, have suffered from additional constraints. Those include an expanding share of economic activity that escapes state taxation including an economy-wide shift toward services (which many states exempt from sales

taxes), greater sales tax avoidance from Internet and catalogue sales, and the greater volume of exempt activities (including those of nonprofits, most manufacturing activities, and legislated exemptions of items like food and medical supplies). Other state revenues have been less responsive to the improving economy. Overall, at 7.4 percent, the growth in state and local tax collections in 2003-2004 slightly outpaced national economic growth of 6.7 percent. Some regions of the country, however, face still-faltering economies and slow growth in revenues.

In sum, state lawmakers face increasingly difficult challenges characterized by weaknesses in state revenue systems and increasing pressures for greater expenditures. Age-related spending will grow while states face continuing challenges to their revenue systems. Factors underlying current shortfalls—e.g., erosion of the state sales tax base, as sales grow from mobile sources such as the Internet and the elusiveness of taxable corporate income—will likely continue.

Statutory provisions that limit fiscal flexibility both reinforce and complicate lawmakers' ability to manage their budget challenges. Such provisions are generally designed to promote budget balance, but can in fact make that goal more elusive. Most states have statutory or constitutional balanced budget requirements. In 45 states the governor must submit a balanced budget. In 41 states, the budget adopted by the legislature must be balanced. However, absent enforcement measures that assure that the budget will indeed balance, lawmakers are free to resort to largely cosmetic and temporary fixes that only appear to close budget gaps; and truly effective enforcement measures can be difficult, if not impossible, to design and implement. Other measures are also used to control state budgets, including restraints on state borrowing and debt issuances, limits on the size of rainy day and reserve funds, and, in 30 states, limitations on how rapidly state revenues or expenditures may be increased. Those provisions may encourage lawmakers to reexamine budget priorities, but where consensus is absent could also make it more difficult to resolve major differences. Moreover, limitations and restraints affect budgets differently at different time of the economic cycle. For example, revenue limitations that encourage fiscal restraint when state treasuries are flush could greatly complicate lawmakers' efforts to close fiscal gaps when the economy slows.

In the end, resolving state and local fiscal imbalance relies on a combination of political pressure and economic factors—just as it does at the federal level. Research indicates that tax and expenditure limitations have been effective in forcing budget-balancing behavior. The response has been skewed more in the direction of cutting spending than increasing taxes, so that services have been reduced as a result.⁷ Rigid requirements have also encouraged the use of creative accounting measures, including off-budget public entities and asset sales, and the incorporation of optimistic revenue projections to help balance budgets. Those tendencies are somewhat limited by the bond markets. If state and local fiscal policies appear weak or suspect, their bond ratings will suffer. That will raise their borrowing costs and further aggravate their budget problems.

⁷ There is growing evidence that tax and spending limitations are losing their popularity as they clamp down on state budgets. See T. R. Reid, "GOP Governors Fight Tax limits" *Washington Post* (March 27, 2003) A4

The linkages between federal and state policies further constrain state budgets and make them vulnerable to changes in the budgetary outlook at the national level.

The federal government has been and continues to be an important player in state government finances. Efforts to address federal deficits could amplify state budget woes and substantially alter the existing allocation of responsibilities between levels of government.

Federal aid accounts for about 25 percent of state revenues. However, that aid is program-specific and comes with “strings” that heavily influence state budgets. Because federal aid consists primarily of transfer payments to individuals rather than funds that supplement direct state activities, states exercise limited control over how the money gets spent. That complicates their ability to coordinate activities supported by federal funds with those funded with their own resources. Incompatible program requirements may result in more fragmented and less efficient service delivery.

To receive many types of federal funds, states must satisfy a wide variety of federal requirements. State compliance with many federal requirements is voluntary, but states may feel that they cannot afford to turn the federal funds down. Some requirements impose “federal mandates” on states that are designed to encourage states to meet specific performance standards or satisfy federal policy objectives. Other federal grants impose match requirements—states must contribute their own resources in order to be eligible for federal funds. Those requirements generate additional demands for state funds and thus affect the allocation of resources within state and local budgets. Moreover, many federal grant programs carry “maintenance of effort” requirements designed to ensure that states and localities do not use federal funds to reduce or supplant their own contributions.

States are also linked to federal policies through their revenue systems. For example, state individual and corporate income taxes are tied closely to the federal tax code to reduce the burden of compliance. In some states, state tax liability is based upon federal adjusted gross income. Other states calculate state taxes as a percentage of federal tax liability. Federal tax reductions enacted in 2001 through 2004 triggered state tax revenue reductions without any action on the part of state lawmakers. State officials could have acted to decouple their taxes from the federal system, but they would have appeared to be countermanding the federal tax cut. Now that the effects of the recession have largely passed, some states are decoupling from the federal estate tax and certain corporate income tax provisions. Nevertheless, the revenue impact of federal tax changes remains significant. If states do not act the estate tax change will cost them an estimated \$4 billion a year if it is fully phased-out as scheduled in 2010.⁸

Federal law limits the states from tapping other potential sources of revenue. For example, it prohibits states from taxing Internet access—an estimated loss of at least \$325 million a year in revenues according to Congressional Budget Office (CBO) estimates. According to CBO, states lose another \$10 billion to \$12 billion a year from Internet and mail order sales: it would require federal legislation to capture those lost revenues.

⁸ National Association of State Budget Officials, *Budgeting Amid Uncertainty*, February 2004.

Comprehensive tax reform at the federal level, if ever undertaken, would have profound effects on state revenue systems. Whether such change would be largely positive or negative from the states' perspective would depend on the nature of the reform. It could help states and localities if it allowed them to “piggyback” onto a stronger federal system. It would hurt them if it eliminated the preferential treatment accorded to state and local taxes and borrowing costs (state and local interest payments are exempt from federal taxation) under the current federal code and gave nothing back in return. That would put state and local budgets under greater stress and could create greater taxpayer resistance at those levels of government.

The dependency of local governments on direct transfers of state funds and smaller transfers (mostly indirect) of federal funds and requirements for meeting federal and state regulatory constraints subject localities to greater financial instability and uncertainty.

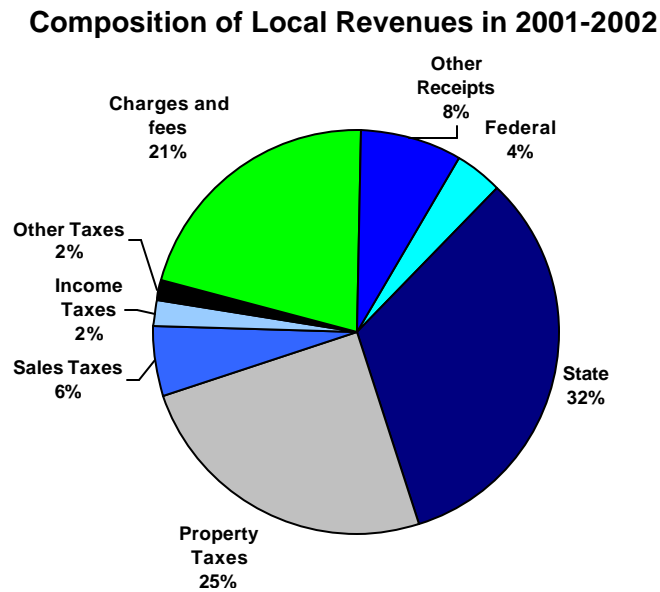
Local governments are responsible for the delivery of basic public services—education, health care, public safety, sanitation, roads, and public transportation. Local governments include some 86,000 cities, counties, school districts, townships, and the fastest growing entity—special districts. The scope of their activities, the sources of their revenues and the fiscal issues confronting them differ widely, making it difficult to generalize about the financial condition of local governments. Despite their differences, the general prognosis is that they are likely to face increasingly difficult structural deficits for the foreseeable future.

The two principal sources of local government resources are state assistance (particularly for elementary and secondary education) and property taxes. However, the degree of dependency on each of those sources varies significantly depending on the type of governmental entity. In 2001-2002, intergovernmental transfers made up 36 percent of local revenues—almost 90 percent of those funds came from or through the states and about 10 percent came directly from the federal government (see figure 3). Averages vary by type of government: for school districts it was 54 percent of local revenues, while the average for cities was 18 percent. Similarly, property taxes raised almost 25 percent of overall local resources, but represented only 8 percent of the revenues of special districts and 53 percent of township revenues. Special districts rely principally on fees or other charges (63 percent of their revenues), making their fiscal concerns very different from those of townships.

States have a preferred position when it comes to getting federal aid. The federal government provided the states with a one-time infusion of \$20 billion in relief over the 2002 -2003 period, largely to offset sharp rises in Medicaid costs but also to provide general fiscal relief from the effects of the recession. Local governments had to fend for themselves. Fortunately, in many areas, the low interest rate environment fueled a booming real estate market and rising property values. That enabled receipts from property taxes to grow throughout the recession and subsequent years. Spiraling property values have even permitted local officials to reduce property tax rates in the strongest markets. However, real estate markets are not uniform and many areas of the nation lag behind the general growth in property values. Although property taxes are not as sensitive to general economic conditions as sales and income taxes, an over-dependence on

real estate values can create problems for local budgets. Should real estate values reverse themselves, as they did in the late 1980s and early 1990s, those revenues could plummet sharply. Furthermore, rising property tax bills can burden low- and moderate-income property owners whose cash incomes do not keep pace with rising real estate values and, thus property tax bills if local governments fail to adjust rates accordingly.

Figure 3.



Local budgets are subject to additional constraints. If local policy makers fail to maintain stable finances, they could lose control of their financial affairs to state overseers. Local borrowing and taxation may be subject to state controls and approvals. In many states they are subject to tax and expenditure limits. Further, local expenditures are heavily concentrated in personnel-related areas. Wages and salaries, health insurance coverage, and pension costs account for 60 percent of local tax-supported spending. State and local employees constitute a major block of politically-savvy voters. They are often unionized or well organized to advance their interests, making it difficult to balance budgets by reducing jobs or cutting pay. Instead local governments may find it easier to defer maintenance and stretch out construction projects to remedy budget gaps. At best, such measures provide only temporary relief and may worsen future financial prospects.

To summarize, local governments are at the end of a chain of intergovernmental financial relationships, but first in line in terms of impact on the lives of their citizens. Federal and state attempts to manage their respective fiscal problems may create a cascade of financing difficulties

that local governments are ill-equipped to absorb. The resulting impact on public goods and services would likely be highly visible to citizens and could erode voter confidence in government. That could help create a vicious cycle of growing resistance to tax increases followed by further erosion in public services.

Recommendations

The Fiscal Futures Committee makes the following recommendations:

Recommendation 1: State and local lawmakers should examine their budgets for opportunities to reduce revenue volatility and to increase spending flexibility. That would enhance their ability to respond to budgetary pressures when external conditions turn negative. The financial difficulties experienced in the wake of the most recent recession show that budgets are at significant risk from factors largely beyond the immediate control of state and local lawmakers. Some approaches that officials might consider that could help insulate their finances from those factors include:

- Maintaining linkages of state tax systems to the federal tax code to provide efficiency while making any necessary changes to reflect tax policy differences or to avoid the loss of revenue which comes from changes in federal tax policy.
- Revisiting impediments to the accumulation of reserves and “rainy day” funds, which may need to be increased given the greater elasticity of revenue systems;
- Broadening their tax bases to reduce exposure to risks associated with dependence on narrow categories of economic activity.
- Extending their budget projection period to four years beyond the immediate budget year.

Recommendation 2: State and local policymakers should seek to improve the transparency of their budgets and budget processes by facilitating the public’s access to budget-related information. Such measures might include:

- Creating independent budget offices, if such organizations do not already exist, whose analyses would be explicitly non-partisan and would be available to policy makers and the public;
- Developing a “primer” that explains basic budget facts, the budget process and timetable.
- Posting materials on their web sites that explains budget alternatives.

Closing budget gaps requires elected officials to make unpopular decisions such as eliminating services, *de facto* rationing of services and making greater use of market-based solutions (user fees). The political support that is necessary to sustaining such decisions depends on voters understanding budget choices and tradeoffs. Increasing the availability and credibility of budget information could help build that support.

While executive budget materials are generally available, those documents represent only one side of the debate. Legislative alternatives are more difficult to find. That makes it difficult for the public to understand choices and tradeoffs. Legislative budget agencies can provide greater balance to the policy discussion and produce neutral analyses of the issues. In addition, the presence of such organizations can help improve the quality and availability of statistical information and performance data. Such data can be used to improve accountability and enhance effectiveness of public programs and policies.

Recommendation 3: State and local officials should seek greater understanding and awareness of the long-term outlooks of their fiscal policies. They should undertake analyses of the potential impact that the aging of the population will have on public revenue systems and programs and services. That would provide decision makers with better information about the size and scope of structural imbalances in their budgets and help them to improve the alignment of revenue streams and spending demands.

Such analyses should acknowledge that federal resources are likely to be increasingly constrained and that fiscal cures adopted at that level will have major implications for state and local finances. The long-term fiscal challenge confronting all levels of government is serious. It cannot be ignored whenever the policy discussion touches upon the intergovernmental allocation of responsibilities between the federal, state and local governments. States and localities should be better prepared analytically so that they can better inform federal policy makers of the likely consequence of pending decisions.

Conclusion

The prognosis for solving state structural deficits is not good. Continued downward pressure on spending has helped states to close near-term budget gaps. But there remains a fundamental mismatch between spending programs now on the books and the ability of revenue systems to support them. Future deficit avoidance at the state level that focuses on spending cuts could inflict financial instability on local governments, either in the form of unfunded state mandates to provide services at the local level or reduced state aid.

The Fiscal Future: The Role of Federal Budget Concepts and Process

Near-term improvements in the federal deficit threaten to mask the serious challenges of the fiscal future. If nothing is done, spending for three programs alone—Social Security, Medicare, and Medicaid—will add enormously to the deficit as program expenditures grow faster than the revenues to support them. By themselves they will result in dangerously high and growing deficits and debt.

A strong budget process, backed by clear and consistent concepts, is needed to confront these circumstances. Such a process would provide policy makers with a framework with which to deal with the long-term fiscal imbalance. It does not exist today. The Fiscal Futures Committee of the National Academy of Public Administration (NAPA) concludes that the federal budget process is in a state of growing disarray and that the annual budget process is increasingly ill-suited to the challenges posed by current fiscal policies.⁹

Observations

The Committee makes the following key observations:

1. The federal budget process is broken. Its capacity to promote responsible fiscal outcomes in the short term, but especially in the long term, needs to be strengthened.
2. Budget documents and analyses could highlight more prominently and more clearly the likely long-term consequences of proposed budget policies on federal deficits and debt.
3. Additional quantitative and qualitative measurements and benchmarks are needed to describe the impact of major revenue and benefit policies on the long-term structural gap between overall federal revenues and spending.
4. New policy initiatives often blur the line between public and private responsibilities and within the public sector, between federal, state and local government and raise questions about how they should be treated in the budget. Because there is no limit to budget creativity, budget concepts and scorekeeping rules must also evolve to assure that they are up to the task of keeping the budget transparent and comprehensive.

⁹ This chapter is based, in part, on proceedings of *The Forum on Fiscal Futures: The Role of Budget Process and Concepts*, which the Academy convened on June 16, 2005, and Academy Fellow David Mathiasen's paper, *The Fiscal Challenge: Federal Budget Concepts and Practices*. A summary of the forum proceedings and Mr. Mathiasen's paper are posted at http://napawash.org/about_academy/fiscalfuture.htm

Observation 1: *The capacity of the federal budget process to promote responsible fiscal outcomes in the short term, but especially over the long term, needs to be strengthened.*

There are no requirements that policy makers establish enforceable short- or long-term goals for fiscal policy. That means that elected officials cannot be expected to aim for, let alone hit or be held accountable for, any definite budget targets. The budget process currently lacks enforcement procedures that are strong enough to support efforts to improve the short- and long-term outlook for the federal budget.¹⁰ The annual caps on discretionary spending and the self-financing, pay-as-you-go (“paygo”) requirements that were first adopted in the 1990 Budget Enforcement Act expired in 2002. Those statutory enforcement measures provided the structure for obtaining agreement between the House, Senate and the White House on the overall direction of fiscal policy. The remaining measures that are still available to the House and the Senate to enforce budget levels are procedural rules that are too easily evaded.

The weakening of the budget process could not come at a worse time. The fiscal pressures that will accompany the retirement of the baby boomers are still far enough in the future to be of lesser importance to elected officials than the immediate political rewards and penalties of annual budget decisions. That short-sightedness has gradually built a budget in which more than two-thirds of spending is used for six purposes—national defense, homeland security, Social Security, Medicare, Medicaid, and net interest payments. Within two years, the continued strong growth in health care costs, followed soon afterwards by the boomers’ retirement, will accelerate the growth in entitlement spending so that within 10 years those six items will comprise three-quarters of projected spending.

Over the last eighty-odd years, since the submission of a budget was first required by law, the budget process and budget concepts have evolved. The size and scope of government have changed. Elected officials have demanded new tools to manage the process and inform their decisions. Looking forward, new challenges require new budgeting techniques. Reform is never easy. Changes should not be undertaken lightly. Without firm agreement that they are valid and necessary, changes will prove unsustainable. And ultimately, budget process changes cannot substitute for substantive policy change.

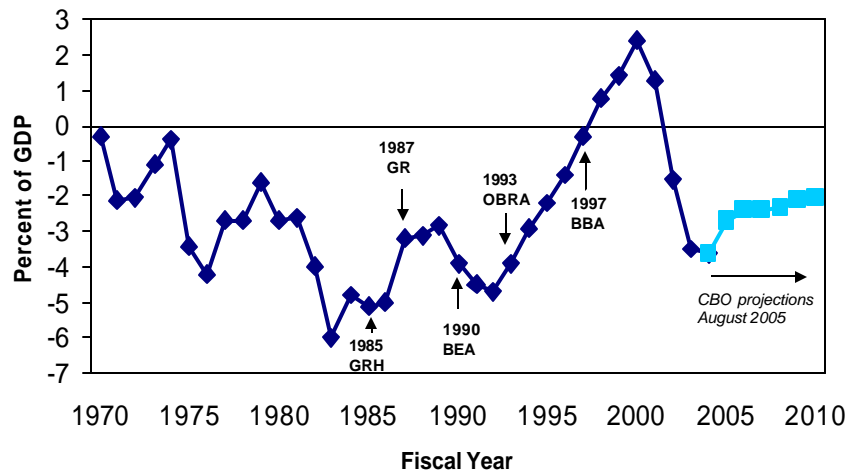
Throughout the 1980s and 1990s, the Congress and the president recognized the need to balance the budget. They adopted successive changes to the budget process that would help them achieve that goal.¹¹ While the constraints were not easy to meet, they provided essential discipline. The budget balanced in 1998 and ran surpluses through 2001. Subsequently the budget outlook deteriorated in part because of changes in the economy, but mostly because of explicit decisions to cut taxes and increase spending and to abandon fiscal discipline. Although recent baseline projections show improvement in the deficit over the next 10 years, they do not

¹⁰ For information about the federal budget and budget process, see the House Budget Committee’s budget tutorial web page <http://www.house.gov/budget/budgettutorial.htm>. The Congressional Research Service (CRS) report, *The Congressional Budget Process: A Brief Overview* is accessible through that web page.

¹¹ 1985 Balanced Budget and Emergency Deficit Control Act (also known as “Gramm-Rudman-Hollings”), 1987 Balanced Budget and Emergency Deficit Control Reaffirmation Act (“Gramm-Rudman”), 1990 Balanced Enforcement Act (BEA), 1993 Omnibus Budget Reconciliation Act (OBRA), and 1997 Balanced Budget Act (BBA).

reflect likely requirements for additional spending for defense and homeland security, adverse economic developments (e.g., rising interest rates or slower growth), unanticipated requirements from emergencies and contingent liabilities, or the enactment of new measures that reduce revenues or increase spending.

Federal Deficits and Surpluses



Statutory limits on discretionary spending and the paygo requirements expired in 2002. Since then the Congress has relied on self-imposed rules to enforce budget levels contained in annual budget resolutions. At present, the budget process consists of three separate efforts to draw the broad outlines of fiscal policy—the president’s budget proposal, the House budget resolution and the Senate budget resolution. With no requirement that policymakers formulate and articulate jointly a coherent plan the result is often chaotic. The House and Senate work independently on individual budget-related bills, while the White House lobbies for its priorities.

The lack of consensus on overall budget targets and goals does not halt the legislative process. With the House, Senate and White House each working to satisfy its own criteria, however, the passage of appropriation bills, tax law changes, and other legislation becomes much more unwieldy. The absence of overall guidelines and parameters makes it impossible for elected leaders to manage, control and coordinate all the various pieces of the legislation that collectively constitute the Nation’s fiscal policy.

While current political leaders voice support for cutting deficits, short-term budget restraint is no longer an adequate objective. Although the next stage in the evolution of the budget process

must begin where the last stage ended—with the need to set and enforce short-term budget targets—the budget process should be modified to include new approaches to measuring the long-term implications of current revenue and spending decisions.

Policy makers must look beyond the next five to ten years and agree to work toward improvements in the long-term outlook for the budget. Unless they do, they risk being seduced by improvements in the immediate budget outlook and persuaded to ignore or even worsen long-term budget woes. That would squander precious time needed to make the major adjustments needed to bridge the long-term gap between revenues and spending.

***Observation 2:** Budget documents and analyses could highlight more prominently and more clearly the likely long-term consequences of proposed budget policies on federal deficits and debt.*

The CBO baseline provides congressional policy makers with a 10-year projection of budget levels that they use as a benchmark for evaluating the budgetary impact of their policy choices. Budgeting, however, is an annual exercise, and policy makers today focus most closely on the near-term impact of budget decisions—what matters most are spending and revenue levels in the current and upcoming (budget) year. Those annual decisions can affect budget trends for years, even decades, to come. Without explicit fiscal goals for which they can be held accountable, policy makers may see little advantage to adopting a longer-term perspective.

A more prominent display of the long-term consequences of those policy choices could help influence them to adopt that longer perspective. The president’s budget request and the congressional budget resolution identify deficit and debt impacts only five to 10 years into the future.¹² That short time horizon allows them to ignore analyses by CBO, GAO, OMB, policy research organizations, budget “watchdog” groups, and academic scholars detailing the consequences of policy trends beyond the five- to 10-year budget window. Routine, “upfront” inclusion of long-term costs (and benefits) of policy options in budget-related materials might be harder to ignore and encourage better fiscal stewardship.

More information, however, could be a two-edged sword. The debate about long-term policy is beginning, releasing a flood of technical terms that confuse and distract general audiences. Traditional, well-defined terms like on-budget, off-budget, actuarial balance, solvency and trust fund are often misunderstood or misused. New terms—such as carve-out, add-on, present-value accounting, closed- and open-group, infinite time horizons—are now appearing in the mainstream public discussion and are even more baffling. Even the definition of “private” is up for interpretation and subject to qualification. Thus it is increasingly important that analyses clearly identify and explain benchmarks, projected changes and consequences both within the budget and between the budget and the private sector.

¹² The Senate adopted a new point of order that restricts consideration of legislation that would increase direct spending by more than \$5 billion per decade between 2016 and 2056. That will require CBO to produce longer term estimates. The rule exempts provisions included in the budget resolution and ignores revenue reductions.

Observation 3: *Additional quantitative and qualitative measurements are needed to describe the impact of major revenue and benefit proposals on the long-term structural gap between overall federal revenues and spending.*

Budget reporting largely uses annual cash flows to quantify projections and outcomes. Budget authority (the legal authorization to obligate federal funds), outlays (the expenditure of funds) and revenues are the most common measures of the federal government's financial activity in any given year. Those metrics are limited in their ability to measure the government's financial exposure because: (a) they are provided for limited time periods;¹³ and (b) they do not adequately account for risks that could cause spending to exceed projections.

Given the increasing impact that the aging population will have on the federal budget within the next decade, annual cash flows over the next five or 10 years fail to describe adequately the fiscal health of the federal government. For example, the programs such as Medicare provide individuals with a virtually open-ended entitlement to specific benefits whose costs largely fall beyond CBO's 10-year projection period. Similarly, tax policies define revenue levels that continue beyond baseline projections. CBO's cost estimates, which are available to legislators as proposed changes to entitlement or revenues laws make their way through the legislative process, do not fully capture their long-term costs (or savings). In addition, cost estimates often do not capture potential costs associated with unforeseen or uncontrollable events (e.g., health care costs escalate more rapidly than projected).

Some budget and policy experts have suggested that new measurements of the long-term implications of policy choices could be added to major budget documents such as the president's budget request, the congressional budget resolution and cost estimates for entitlement and revenue legislation. The analyses could identify more clearly the potential effects of proposals that may not be fully visible until anticipated demographic and health care cost trends unfold over coming decades.

However, new metrics, such as net present values, are not widely understood and would be controversial. Projecting revenues and outlays a year or two in advance is not exact. Projections of the multi-decade cash flows upon which many of the new metrics would rely would be an even "iffier" proposition. Such metrics would also mask serious timing issues (e.g., near-term expenditures can be offset by much larger, but more distant, revenues).

So far, potential new approaches have generated lively debate among experts about underlying models and assumptions. A major program change can have substantial implications for other parts of the budget, including related programs as well as tax measures. Potential impacts of major reforms are likely to be of such magnitude that there are economic impacts. These considerations need to be reconciled with overall budget and macroeconomic constraints. Five and 10-year deficit or surplus projections are clearly inadequate. But, longer timeframes necessitate greater allowances for uncertainty and risk than are reflected in current budget

¹³ CBO generally provides 10-year projections. OMB currently provides projections for only five years, but OMB varies its projection period depending on circumstances.

measurements. Static economic and behavioral assumptions may not be realistic, but dynamic analyses are highly imprecise.¹⁴

The development of analytically sophisticated models to generate long-term financial flows is already underway. Although further efforts will be needed to distill the information into a digestible form for consumption by general audiences, such efforts may provide new ways of assessing the longer-term impacts of policies and thus better informing the decision-making process.

***Observations 4:** New policy initiatives often blur the line between public and private responsibilities and within the public sector, between federal, state and local government and raise questions about how they should be treated in the budget. Because there is no apparent limit to budget creativity, budget concepts and scorekeeping rules must also evolve to assure that they are up to the task of keeping the budget transparent and comprehensive.*

The last formal effort to review budget concepts and recommend changes was the President's Commission on Budget Concepts, which published its report in October 1967.¹⁵ Since then policy makers have adopted additional methods of providing federal assistance besides direct payments. Although many of the approaches can be justified as being more efficient or economical (that is, supplementing rather than competing with private capabilities), they are often advocated because they also result in lower outlays in the short run, look less costly than direct spending, and therefore are more appealing.

The task of determining how a financial transaction would affect the budget falls to the budget analysts, lawyers and economists. That process—called “scorekeeping”—is highly technical and relies on established budget concepts, scorekeeping rules and precedents. The scorekeepers' goal is accurately and completely to display the potential impact of transactions on federal finances. Direct payments may raise fewer conceptual issues, but cost estimates may involve very complicated analytic assumptions about how a law is translated into an operating program.

Other methods of accomplishing public objectives include tax subsidies, credit assistance, insurance, and mandates. Budget analysts must scrutinize very carefully those approaches, which mix public with private activity and federal with state and local government operations, to identify the extent of the federal government's role and its financial exposure. Some methods

¹⁴ Budget analysts are charged with estimating the impact of proposed legislation on the budget. When making their estimates, analysts generally limit their estimates to the direct effects of the proposed change. For example, an estimate for a proposal to increase in tobacco taxes would reflect projected reductions in consumption of tobacco products. The estimate would not reflect indirect effects such as lower corporate income taxes as a result of lower sales by retailers, a decline in farm income, etc. A dynamic analysis would attempt to capture broader changes in behavior and indirect impacts of proposed changes. Thus, a dynamic analysis of a significant tax cut might assume that a resulting increase in economic activity would produce new federal revenues, which would offset some of the direct revenue losses.

¹⁵ Budget staff from the congressional budget committees, CBO and OMB meet periodically to review technical scorekeeping issues. The purpose of such meetings is to identify and discuss problems, but even if they agree staff cannot change major budget accounting rules and concepts which often originate in statute.

are determined to be private and do not affect the budget. Others may be governmental, but not budgetary (e.g., regulations). Still others, despite appearances, entail sufficient federal involvement and interest that scorekeepers determine that they should be included in the budget. Excluding such transactions would downplay costs and could mislead the public about the government's financial condition.

As policy makers begin to address long-term, "big ticket" issues—such as Social Security, health care, physical infrastructure and defense requirements—they continuously search for innovative ways to accomplish their objectives at the lowest cost to the budget. Mandating private financing, spreading costs over several years, deferring major costs beyond the budget projection period, dedicating revenues to offset costs, and assigning temporary status to what are intended to be permanent provisions are some of the ways that costs can be made to look smaller. However, the eventual cost of some approaches can be greater than more straightforward methods that acknowledge cost up front.

Budget concepts, like the budget process itself, should promote a level playing field so that the policy proposals can compete fairly on an "apples-to-apples" basis. That is not a simple objective, but one that is of critical importance to budgeting and overall governance.

Recommendations

The Committee recommends that the Academy support efforts to: (a) frame the issues and options to reform the federal budget process; and (b) review, update and refine budget accounting concepts. The Committee recognizes that legislative action on budget process reform is not likely to occur without a wider consensus about the need for long-term fiscal discipline and the participation of leaders of the executive and legislative branches. Although we hope that greater public education and communication will suffice, that consensus is not likely to develop without a crisis or other action-forcing event. In any event, should a crisis take place, there will be no time to study process innovations. Therefore, the committee is committed to promoting and facilitating the development of improved budget processes and concepts so that they will be ready when they are needed. To those ends, the Committee makes the following recommendations:

Recommendation 1: The Committee urges policymakers to develop and adopt budget enforcement measures that promote budget restraint over the short and longer terms. Based upon past experience, the most effective budget enforcement procedures are:

- Policy neutral—bias in enforcement measures invites gimmickry and prevents broad support, eventually undermining their overall effectiveness and sustainability.

- Gradual—if enforcement measures require deep cuts in spending or large increases in revenues, they will be overturned. On the other hand, if penalties are minor, the measures will not achieve the desired outcome within a reasonable period of time.
- Universal in their application (no exempt activities)—exceptions invite more exceptions. Measures that affect all programs and all constituencies are viewed as more “fair” than ones that exempt specific groups from contributing to painful solutions. If those with sufficient clout manage to exempt themselves, the weakest constituencies will end up bearing a disproportionate share of the penalty burden.

Although it is not the Academy’s role to endorse specific policies, we note the success of statutory caps on discretionary spending and the pay-as-you-go (paygo) requirements for changes to entitlements and revenues.

We further note that the long-term fiscal gap under current law is unsustainable. Consequently, the paygo mechanism, which is designed to keep the gap between revenues and spending from getting worse, is inadequate. Therefore, we encourage continued development of budget process reforms that would set the budget on a path towards long-term balance and reverse the current trends toward increasing deficits and debt. Past enactments and renewals of budget process reforms have included policy savings, which would be welcome. A renewal of the paygo restraint might begin with a negative balance on the initial scorecard (instead of zero) to require even greater subsequent action. A reenactment of the discretionary spending caps presumably would set them at a level yielding budget savings. Self-corrective measures, such as the approach proposed by Rudolph G. Penner and C. Eugene Steuerle, hold promise.¹⁶ The Committee recommends additional work in this area to expand the number of viable and effective options that will be available to policy makers.

The appendix of this report contains illustrative proposals from various sources over the past several years and should be considered for possible inclusion in a comprehensive budget process reform effort.

Recommendation 2: Budget process reform should place greater emphasis on long-term fiscal challenges and highlight consequences of proposed policy actions beyond the end of the formal budget projection period. That change would help to identify more clearly budget proposals that have the potential to worsen long-term deficits. Such indicators would supplement, not replace, the annual projections reported in congressional and executive branch budget documents.

Among approaches that could be considered are: a requirement to include measures of the long-term fiscal gap under the CBO’s January and August baseline projections, the president’s proposed budget policies, and the congressional budget resolution; and CBO’s cost estimates of reconciliation bills and other major entitlement or revenue legislation (over a set threshold—e.g., measure that would have a budget impact of more than \$50 billion in any year over the 10-year

¹⁶ Rudolph G. Penner and C. Eugene Steuerle, *A Radical Proposal for Escaping the Budget Vise*, June 1 2005, <http://www.urban.org/url.cfm?ID=311192>.

projection period). A more basic improvement would be to establish a standard 10-year period for published estimates for the president's budget request and the congressional budget resolution.

Recommendation 3: Additional methods of projecting and measuring budgetary impacts should be incorporated into the budget process. New approaches could include the construction of alternative baselines, the development of new long-term indicators or metrics; better means of accounting for uncertainty and risk; and assessments of the impact of proposed policies on national savings over the long term.

No single metric is foolproof. The largely cash-based budget is designed to control the annual commitment and expenditure of federal funds. However, it can be gamed by various measures (e.g., moving pay dates and incurring non-cash liabilities) and provides little perspective on longer-term issues. New metrics can be circumvented, too. The availability of alternative presentations, when presented alongside traditional measurements (revenues, outlays, deficits and debt), could deepen understanding of potential effects and help broaden awareness of the long-term fiscal situation.

Recommendation 4: Budget accounting concepts and scorekeeping rules should be reviewed to identify those that may need to be strengthened, modified or changed to ensure that the budget provides an accurate description of the federal government's financial activity and exposure.

Of particular concern are efforts to blur the line between budgetary and non-budgetary activities. There are many incentives to remove activities from the budget—to take them “off-budget” or to “privatize” them. Such efforts should be rigorously reviewed to assure that any residual role of the federal government is properly captured and presented in the budget. Oftentimes, efforts to remove activities from the budget (and thus escape a measure of regulation, oversight and public scrutiny) also attempt to retain the federal government as a financial backstop. Although it is impossible to draw a bright line between the budget and the rest of the economy, it would be helpful to develop criteria that would help increase understanding of what impact proposed actions would have on future public resources.

Other budget concepts may create unintended biases within the budget that can distort policy choices. Those instances should be identified and reviewed to help ensure that budget accounting is policy neutral.

Conclusion

Although a political consensus to reform the budget process does not yet exist, efforts to design workable and effective approaches to budgeting, identify conceptual weaknesses, and develop new techniques and ways of presenting complicated information must continue. The budget process is difficult precisely because the issues and the options touch upon the basic question of

the roles and responsibilities of citizens and our government. A strong budget process and sound budget concepts can provide vital support of an important civic debate.

Appendix: Illustrative Proposals to Reform the Budget Process

The following list is intended to illustrate the type of changes that should be considered for inclusion in legislation to reform the budget process. It does not represent the Academy's recommendations nor does it present an exhaustive and complete exposition of both the advantages and the disadvantages of each proposal.

- Replace the concurrent congressional budget resolution with a joint resolution. Currently, there is no budget for the United States government. The congressional budget resolution carries no presidential signature and is not law. A joint budget resolution would go beyond statutory caps and paygo requirements and advocates contend that it would force the Congress and the executive branch to establish the parameters of annual budget legislation. Skeptics believe that it could delay or possibly derail the process, and that the President's proper role is fulfilled by his submission of a recommended budget, and dealing with the individual pieces as they are delivered to him by the Congress in the form of legislation.
- Extend the timeframe covered by budget agreement. A five- or 10-year window excludes perspective on the impact of proposed budget policies on the already existing long-term gap between revenues and spending. Although multi-decade budget targets are impractical, a formal requirement for assessments of the long-term implications of spending and revenue decisions would help inform near-term policy choices.
- Consistently impose a comprehensive framework for decisions that affect the budget. The Congress and the president are considering policy options—such as proposals to reform Social Security—that are highly complex and technical in nature. There is a tendency to view such proposed changes, which can affect direct spending or revenues or both, separately from the remainder of the budget and fiscal policy. However, because those reforms are likely to affect the rest of the budget, whether directly or indirectly, the overall budget perspective must be maintained. Otherwise, policymakers may fail to acquire a complete understanding of the potential impacts of such proposals, including the impact that the sequence in which reforms are undertaken will further complicate the successful accomplishment of other major objectives.
- Apply more-uniform controls over the level of federal obligations. Obligational limitations are designed to control the federal government's exposure to spending requirements. Budget authority constitutes the most common limit on obligations. However, various practices minimize the upfront use of budget authority in order to circumvent limits (e.g., structuring capital leases to look like operating leases, cash instead of accrual-based accounting for insurance programs, annual funding for multi-year

projects, etc.). Better restrictions on such approaches would help to reduce back-door spending pressures that often escape full disclosure in the current budget process. More uniform practices would also create a more level playing field between competing priorities.

- Budget for tax expenditures. The growing emphasis on spending control creates greater incentives to use tax provisions to provide benefits or to encourage certain behaviors. A tax expenditure budget would permit greater control over the use of tax benefits and put such measures on a more equal footing with direct spending.
- Limit the use of reconciliation procedures to deficit reduction. The Congress created the reconciliation process to help reduce budget deficit levels to targets contained in annual budget resolutions. Until the FY 1996, reconciliation was used to reduce spending or increase taxes. The FY 1996 reconciliation bill, which was vetoed, contained a major tax cut. The special rules¹⁷ governing the consideration of reconciliation bills were designed to facilitate passage of unpopular deficit reduction measures and to improve fiscal discipline, not to speed passage of measures that would increase deficits. This proposal would restrict the use of reconciliation to deficit reduction.
- Budget on a biennial basis. The federal budget and appropriation process is an annual process that consumes a major portion of the legislative calendar. Biennial budgeting would reduce the frequency of occurrence of this contentious process, potentially freeing up more time for congressional planning, oversight and program review, according to advocates. Two-year budgets would also provide program managers with a more stable funding environment in which to operate their programs. Skeptics fear that supplemental appropriations would become routine in off-years, yielding little change in the legislative workload; and that the annual review of appropriations bills, possibly the most effective form of legislative oversight, would be lost.
- Integrate program performance information into Congressional deliberations. Since 1993, agencies have been required to develop annual performance plans and multi-year strategic plans. The executive branch has used this information and taken it into account in developing its executive budget proposals. Similar use of such information by Congress would improve the quality of oversight and evaluation, thereby helping policymakers to allocate resources to programs found to be the most effective and best managed.
- Create automatic sunsets for all federal programs (and tax expenditures). With no requirement that they be reauthorized, many existing programs enjoy favorable treatment akin to inertia—given no requirement to stop, they go on and on. An automatic sunset provision would require policy makers periodically to review programs to determine if they should be renewed and provide an opportunity to eliminate programs that have outlived their usefulness. The same sunset provision could also be applied to tax expenditures. Automatic sunsets have a distinct downside—they would provide an

¹⁷ Reconciliation bills are considered under special rules in the Senate that protect them from extraneous amendments, limit debate, and reduce the likelihood of filibusters.

artificially benign perspective on the budget's future. Depending on details of the implementation of such a rule, the baseline might exclude spending and revenue policies that are highly likely to be reauthorized.

- Improve the definition of emergencies. Caps on discretionary spending, if reinstated, would likely provide for adjustments for emergencies. There should be a clear definition of when that emergency provision could be used to limit potential abuse of the provision. The definition would include terms such as “unforeseen,” “sudden,” “not likely to recur,” and “temporary in duration.”

About the Fiscal Futures Committee

The National Academy of Public Administration, as part of its Big Ideas initiative, created the Fiscal Futures Committee in 2004. The Committee is composed of the following Academy fellows:

G. Edward DeSeve, Vice Chairman of The National Academy of Public Administration and Chairman of the Fiscal Futures Committee; Professor and Director of the Management Finance and Leadership Program, School of Public Policy, University of Maryland

Susan Irving, Director for Federal Budget Issues, U.S. Government Accountability Office (GAO)

David Mathaisen, former Counselor to the Chief, Public Management Service, Organization for Economic Cooperation and Development (OECD); former Assistant to the Comptroller General, U.S. Government Accountability Office (GAO); former Assistant Director for Budget Review, Office of Management and Budget (CBO).

Joseph J. Minarik, Senior Vice President and Director of Research, Committee for Economic Development (CED).

John Peterson, Professor of Public Policy and Finance at George Mason University, Fairfax, Virginia.

Beth Robinson, Assistant Director for Budget, Office of Management and Budget (OMB) and former Deputy Director for the Congressional Budget Office (CBO).

Richard Keevey, National Academy of Public Administration's Director of the Performance Consortium and of State and Local Operations coordinated the Fiscal Futures project.

Susan Tanaka served as independent consultant to the Committee.