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CONGRESS' ROLE IN FEDERAL FINANCIAL MANAGEMENT: IS IT EFFICIENT, ACCOUNTABLE, AND TRANSPARENT IN THE WAY IT APPROPRIATES FUNDS?

HEARING

BEFORE THE

FEDERAL FINANCIAL MANAGEMENT, GOVERNMENT INFORMATION, AND INTERNATIONAL SECURITY SUBCOMMITTEE

OF THE

COMMITTEE ON HOMELAND SECURITY AND GOVERNMENTAL AFFAIRS UNITED STATES SENATE

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CONTENTS

CONGRESS' ROLE IN FEDERAL FINANCIAL MANAGEMENT: IS IT EFFICIENT, ACCOUNTABLE, AND TRANSPARENT IN THE WAY IT APPROPRIATES FUNDS?

THURSDAY, MAY 25, 2006

U.S. SENATE,
SUBCOMMITTEE ON FEDERAL FINANCIAL MANAGEMENT,
GOVERNMENT INFORMATION, AND INTERNATIONAL SECURITY
OF THE COMMITTEE ON HOMELAND SECURITY
AND GOVERNMENTAL AFFAIRS,
Washington, DC.

The Subcommittee met, pursuant to notice, at 2:30 p.m., in room SD–342, Dirksen Senate Office Building, Hon. Tom Coburn, Chairman of the Subcommittee, presiding.

Present: Senators Coburn, Carper, and Levin.

OPENING STATEMENT OF SENATOR COBURN

Senator COBURN. The Subcommittee on Federal Financial Management, Government Information, and International Security of the Homeland Security and Governmental Affairs Committee will come to order. I will give you all notice that we have six stacked votes at some time after 3 p.m., so I am going to put my statement into the record, just make a short summary, and I am going to ask General Walker to start out.

I have read each of your testimonies. Senator Carper will be here sometime before we adjourn. Six stacked votes means about an hour and a half, and I am not about to ask anybody to hang around for that. What we will try to do is probably pick up our third panel at some point in the future. This is not the only hearing. This is a big issue; it is the biggest issue that we face.

We are going to spend $2.7 trillion this year, of which we are going to add to the debt between last year and this year $1 trillion. When you do real accounting and you say what do we have left over and what do we owe at the end of the year, last year we added $538 billion to the debt. The debt this year is probably more likely $450 billion.

We are on a truly unsustainable course. The question is, what do we do now? What do we do in the near and midterm so that the consequences of the solution fix the ultimate problem? I have two posters that I want to put up to just show one of the big problems is supplementals.[1] Because they are outside of the budget guidelines, the rules that we have do not apply to them, so consequently you can see what is happening in terms of total dollar amount and as well as percentages for as to what is happening in terms of supplemental spending, net of rescissions, which go completely outside of the budget guidelines, completely outside of the authority we give ourselves.

The second poster, if you would, is the total amounts. As a percentage of the total budget deficit, supplementals in the last 3 years account for 23 or almost 24 percent of the total deficit. So just having the budget run on supplementals which is all sorts of mannerisms to play games, because now we put things we know are needed for legitimate things into supplemental and spend extra money inside the budget. So now we have a process going back and forth where the supplemental is now used as a tool to expand within the budget frameworks.

Because of the Federal financial management of our country, there are two things going on. One is process and one is people, and we have had a diversity of opinion in your statements. One says it is all process and it is not leadership related; others say it is leadership related, that you can accomplish it within the process. The whole purpose of ours is not to debate the leadership question today. The question is how do we set a structure to solve the problems and secure that future and meet the unending challenges of about $50 trillion of unfunded liability.

[The prepared statement of Senator Coburn follows:]

PREPARED STATEMENT OF SENATOR COBURN

Last year, the Federal Government spent $2.5 trillion (OMB). We're on track to spend at least $2.7 trillion this fiscal year. Last year our national debt increased a whopping $554 billion and it has already increased another $400 billion so far this year. This extra $1 trillion dollars that the Federal Government now owes, on top of the more than $7 trillion already owed, occurred because Uncle Sam continues to spend beyond his means year after year after year.

Right now, GAO—Congress' watchdog agency—estimates that our total debt is nearly 70 percent of the size of our entire economy. By the time our grandkids face the unenviable task of paying off this mountain of debt, GAO estimates that the debt will be almost four times larger than our entire economy. That means that if our grandchildren took every dollar of value created by the economy in one year to pay off the debt, they would still be left with debt three times larger than the economy.

Clearly, we are on an unsustainable course. Now the question is what to do about it, and that means identifying the source of our fiscal mess. There's been a lot of finger-pointing. Some claim the economy isn't booming enough to bring in sufficient tax revenues. But our unemployment rate of 4.7 percent is lower than the average rates from each of the past 4 decades. Over the past 32 months of consecutive job creation instead of loss, nearly 5.3 million new jobs have been created. Inflation remains low. Some blame big corporations for jacking up prices and making it harder to get as much out of the dollar. But the only thing keeping the equality higher and price of goods and services lower in America is less government meddling in private markets, not more like we see in Europe.

Some blame the tax cuts, but most Americans think that their government ought to be able to chug along just fine after confiscating 25–40 percent of their hard-earned income. Some blame the President for not vetoing enough spending bills. That's like driving drunk, and then blaming the bartender when you wreck your car. The Executive Branch is supposed to carry out the spending directions from Congress.

[1] The charts referred to by Senator Coburn appears in the Appendix on page 89 and 90 respectively.

The problem is us. Congress holds the power of the purse. The American people expect elected officials to run the government the same way to run a household or business—exercising the discipline to live within your means, saving some extra for emergencies and for long-term needs like retirement income and healthcare. If you fail to do that, and you spend beyond your means, the private market will step in and limit the amount you can go into debt by lowering your credit score and raising your rates.

Congress operates under no such limits. It's not because limits have never been set. Various budget reforms have passed for decades. But Congress has found ways around each and every one. And when the Senate's budget rules get in the way, the Senate just "waives" them by a vote of 60 Senators.

That's 60 of us saying "we don't have to live by the rules that American families and businesses live by." Nobody can take away our credit, because we set our own limit. And when we reach that limit, we just vote to raise it. The latest episode a few weeks ago raised the debt limit to $9 trillion.

It's clear that the answer is not tweaking the rules at the margins. We need radical budget process reforms. But more than that, we need to create an environment—a set of conditions—that helps us live with our rules. It's easy to break rules when there's no accountability. One of the key conditions to creating accountability is transparency. Most people—even politicians—aren't crooks by nature. But it never hurts to have transparency.

Transparency helps our better natures play by the rules and reduces temptation for our lesser natures to cheat. Americans know that if they don't pay their taxes, they might get audited and get caught. With the Enron and other corporate scandals, we saw that a lack of transparency to shareholders can result in bankruptcy and legal action. Our witnesses today will be talking about ways to bring transparency, efficiency and accountability to the budget process. I am pleased that our panel has several key players in the Federal budget process—both current and past—to help us discover weaknesses in the current system, and ways we can improve upon it.

Most Members are still not ready to swallow the idea of having to make politically difficult budget decisions on the floor of the U.S. Senate. The purpose of this hearing is to get experts past and present who know the process well—to be able to identify what is a true budget reform versus a sham sound bite intended only to make the 109th Congress look like budget hawks. This can begin an ongoing dialogue about what changes are really needed to restrain Congressional spending. The most effective way to discuss possible reforms to the current Congressional budget process is to ask the question: "Is the process efficient, accountable and transparent in the way it appropriates funds?"

Because we'd better figure this our. There's a rumble growing outside the Beltway. People are fed up with a Congress acting like teenagers who fritter away their allowance and then whine about how there isn't enough money to buy the important stuff. The American people want us to start playing by the rules they have to play by, especially when it's their money we're "playing" with. If we don't take our responsibility seriously, the rumble may just greet us at the ballot box.

Senator COBURN. And with that, I would like to introduce Hon. David Walker. He is Comptroller General of the United States since November 1998. He serves as the Nation's Chief Accountability Officer and head of the U.S. Government Accountability Office. He has extensive executive-level experience in both government and private industry. He is a certified public accountant, has a degree in accounting, and he also has a senior management in government certificate in public policy from the John F. Kennedy School of Government. Mr. Walker, thank you.

I also want to introduce—and then we will go in this order—the Hon. Jim Miller, extensive experience with the Federal budget process. He was Chairman of the Federal Trade Commission and Budget Director for President Reagan. He was the first Administrator of the Office of Information and Regulatory Affairs and the Executive Director of Vice President George Bush's task force on regulatory relief. He is a John M. Olin Distinguished Fellow at the Citizens for a Sound Economy Foundation and at the Center for Public Choice at George Mason University. He is also a Senior Fellow at the Hoover Institution at Stanford University. He is currently Chairman of the Capital Analysis Group and was elected by the U.S. Postal Service Board of Governors to be its Chairman in 2005.

Douglas Holtz-Eakin is the former Director of the Congressional Budget Office, Chief Economist of the White House Council of Economic Advisers. He is a leading expert in economics and economic policy, tax, entitlement, and health and budget policy, defense budgets, domestic and international finance. He was Chairman and Trustee Professor of Economics at Maxwell School, Syracuse University, a visiting professor at Princeton University, and a professor at Columbia University. His expertise in the realm of congressional budgeting will be invaluable to our discussion today.

Also, I am honored to have the Hon. Tim Penny, former Congressman, who co-directs the Humphrey Institute Policy Forum at the University of Minnesota. He represented southeastern Minnesota's 1st Congressional District from 1982 through 1994. While in the U.S. House, Mr. Penny served on the Agriculture and Veterans' Affairs Committee and the Select Committee on Hunger. While in Congress, he founded and co-chaired the Democratic Budget Group and drafted deficit-cutting initiatives. He is a board member of the Committee for a Responsible Federal Budget, the Concord Coalition, an advisory board member for a Clean Campaign Project, the Minnesota Compact. He is the co-author of two books, "Common Sense" and "Payment Due." It is a privilege to have an insider on the panel today who truly knows that spending in Washington is out of control.

Let me introduce first General Walker, if you would, and I will give our Ranking Member, my co-Chair, Senator Carter, an opportunity for an opening statement. I put mine in the record. There are six votes coming in.

OPENING STATEMENT OF SENATOR CARPER

Senator CARPER. Let me just say to our Governor, Governor Miller, to Congressman Tim Penny, who is one of my dearest friends and someone who—we were both elected to the class of 1982. If you ever look up in the dictionary the term "fiscal hawk" or "budget hawk," his picture is right there. He was a great leader on this front.

It is always great to be with General Walker, and to our former CBO Director, thank you for being here and for the good work you have done. I look forward to your testimonies. Thanks for joining us.

Senator COBURN. General Walker.

TESTIMONY OF HON. DAVID M. WALKER,[1] COMPTROLLER GENERAL, U.S. GOVERNMENT ACCOUNTABILITY OFFICE

Mr. WALKER. Mr. Chairman, Senator Carper, I would respectfully suggest that the entire statement be included in the record, and I am going to give you a quick executive summary so you can hear from the others and we can go to Q&A before your votes.

[1] The prepared statement of Mr. Walker appears in the Appendix on page 31.

Senator COBURN. All of your statements will be made a part of the record.

Mr. WALKER. Thank you. As you know, Mr. Chairman, I have been outspoken in saying that our Nation's financial condition is worse than advertised, and that we face large and growing structural deficits due to known demographic trends, rising health care costs, and lower Federal revenues as a percentage of the economy than historically has been the case. We are running very large structural operating deficits, most of which have nothing to do with Iraq, Afghanistan, and incremental Homeland Security costs. This must change.

The process is important, but it is not a panacea. Leadership is essential in any event. However, the process can help. In my view, we need to reinstitute and strengthen controls to deal with both near-term and longer-term deficits, and we need to focus on a process that will help the Congress to tackle the large and growing long-term fiscal challenges facing our Nation. Among other things, that means improving the transparency of long-term costs of current proposed tax and spending decisions, as well as in all likelihood the formation of a credible and a comprehensive tax and entitlement reform commission that can make recommendations to the President and the Congress.

Specifically, with regard to reimposed and enhanced budget controls; we need to reimpose discretionary spending caps; and reimpose pay-as-you-go rules on both the spending and the tax side of the ledger. When the bottom line is bleeding, we cannot afford to exempt one side of the ledger. Tax expenditures represent backdoor spending. If we don't have controls on both sides of the ledger, we are not going to control the bottom line.

We need mandatory spending triggers and appropriate sunset provisions for both direct spending programs and tax preferences, potentially with specific default mechanisms that would take place. And we need to modify the rules dealing with selected items such as earmarks and emergency designations.

Mr. Chairman, I could go on at some length, but let me just say again, the process is no panacea, but the process does matter. However, no matter what process is in place, leadership is essential. Our long-range imbalance has gone from $20 trillion in 2000 to $46 trillion at the end of fiscal year 2005. It will likely hit $50 trillion plus by the end of this fiscal year, and it is going up every second, of every minute of every day, due to continuing deficits, due to known demographics trends, and due to compounding interest costs. The time for action is now, Mr. Chairman. Thank you.

Senator COBURN. Governor Miller.

TESTIMONY OF HON. JAMES C. MILLER III,[1] FORMER DIRECTOR, OFFICE OF MANAGEMENT AND BUDGET

Mr. MILLER. Thank you, Mr. Chairman and Senator Carper. Thank you for inviting me here today. The budget process is clearly dysfunctional. Deadlines are missed; people don't know what are in the budgets. Telephone numbers are written in the side margins. I remember one time when the President received a budget that

[1] The prepared statement of Mr. Miller appears in the Appendix on page 48.

was so big and so long, it took all the OMB people working through the night to try to make sense of it. I told him the next morning, "I still don't know all that is hidden in there." But he had to sign it because the government would have to shut down otherwise.

I think people are important, leadership is important, but the main thing is the process needs to be changed. If you have a system, a set of processes that incorporate incentives to do bad things, you are going to get a lot of bad things. If you have a system that incorporates incentives for people to do the right things, you will tend to get the right things. It is sort of like the good man theory of regulation. Mr. Holtz-Eakin will probably remember this. Back in the 1960s and 1970s, there was a lot of debate over what caused the Federal economic regulatory agencies, such as the IC&C and the CAB, to do bad things, to get bad results. One idea was it was the "good man theory." If the President would just appoint good men and women to these agencies and the Senate would confirm them, then everything would be taken care of.

And another said, well, no, it is the institutions. It is the laws that have them do the regulating and make these bad decisions that are at fault. President Ford, President Carter, President Reagan, and the Congress during those periods of time made changes, and in fact we have had, rather universally applauded, more competition and greater efficiency in those markets.

Closer to home, many of us who are very concerned about excessive government and reining in the excesses of government spending and so forth. If you had a Republican House and a Republican Senate, all this would be taken care of. If you had a Republican President, it would be nirvana, right? But that is not what happened. You did have some changes in the class that came in in 1994, that was elected in 1994 and 1995, and so for a while you had retraction in the growth of spending. The deficit came down to zero. You had stimulated economic growth, but then there has been a lot of recidivism. And so an academic might legitimately ask the question, are there differences between Republicans and Democrats? Are there differences between conservatives, budget hawks, and big spenders? It would appear, with respect to the budget, that the budget process, the incentives that incorporated in being a Congressman and responding to constituent needs within the confines and the contours of the overall process, yield results irrespective of political leaning or ideological leaning. And so it is the budget process that really needs to be fixed.

Since leaving OMB, I have written about some of this. You have to applaud the 1974 Budget Act. Its intent was to rein in the excesses by having Congress vote on at least the limits, the total spending, the total revenues, etc. But the system is broken down because the deadlines are not met.

Gramm-Rudman-Hollings was a great thing and it worked the first year, and then Congress got cold feet and redrew the numbers. If you have targets and they do not like them, you change the targets.

I have recommendations. You ought to make the budget resolution a joint resolution, include the President, make it a law, not just a concurrent resolution. I would suggest a new Gramm-Rudman-Hollings law or something like that to limit spending. You need a line-item veto. Go ahead and approve the President's line-item veto. I wrote an op-ed published in yesterday's *Washington Times,* that talked about the President can actually "veto" most of the pork, the vast majority of the earmarks in the budget, because they appear in the report language, they don't appear in the legislation themselves. They don't meet the Presentment Clause of the Constitution, so the President can veto them himself.

I think you ought to sunset entitlements, not end them necessarily, but to force the process of evaluating them every few years. You ought to eliminate "budget speak." Only in Washington can you talk about a rate of spending this year that is less than what you might have liked to have seen and call it a cut, when this rate of spending for this year may be 10 percent more than it was last year. Also, I think you ought to institute a regulatory budget.

I see my time is up. Thank you, sir.

Senator COBURN. Congressman Penny.

TESTIMONY OF HON. TIMOTHY J. PENNY,[1] FORMER CONGRESSMAN, SENIOR FELLOW, UNIVERSITY OF MINNESOTA HUMPHREY INSTITUTE

Mr. PENNY. Thank you, Mr. Chairman and Mr. Carper. It is good to be with you today.

Budgets matter. I think it was former Rules Committee Chairman, Richard Bolling, who once said, "If I give you control over policy and you give me control over process, I will beat you every time."

Senator COBURN. John Dingell told me that.

Mr. PENNY. John Dingell was known to say that as well. These are the fundamental truths of Washington budgeting, that when we have had a budget process, we have done better. Gramm-Rudman-Hollings was violated after the first couple of years, but nonetheless it put the focus on deficit reduction. It forced us to make tougher decisions than we otherwise would have made. When we replaced that with the Budget Enforcement Act during the 1990s, those spending caps and that PAYGO system on entitlement and tax policy held the line on spending to a large extent and allowed the growth in the economy and the resulting growth in revenue to bring us back to a balanced budget for the first time in 30 years. So process matters.

Good process accomplishes several things. It sets the terms for the debate. It helps us to set overarching goals. It helps us to set priorities within those goals. It ought to give us some increased transparency so people understand what is happening and can hold folks accountable for what has happened—good, bad, or otherwise. A process also ought to help us measure results, because whatever we are spending, we ought to be getting value for our dollar. And finally, it ought to help us look over the longer term. It ought to help us look beyond the horizon into the implications that this might have in the next generation. That is what good process can do for us.

We have got a process in place for the past several years, and the numbers tell the story. In 2000, spending totaled $1.79 trillion

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[1] The prepared statement of Mr. Penny appears in the Appendix on page 52.

or 18.4 percent of GDP. In 2006, it is expected to reach $2.7 trillion or 20.2 percent of GDP. Going back to 2000, revenues totaled $2 trillion or 20.9 percent of GDP, and in 2005, revenues were expected to be $2.15 trillion or 17.5 percent of GDP. We have not had a budget process that has forced us to look at these two numbers and reconcile them in any way. And so without a budget process going forward, I think we can only expect more of the same.

I agree with some of the recommendations that have been made by the previous two speakers and will add a few more that will probably be repeated and reinforced by other speakers here today. Clearly, I think we need a national budget. We never have really had one. For many years the President set the terms of the budget debate and then the Congressional Budget Act in 1974 brought Congress into the act, but we have competed between OMB and CBO on budgets every year. Congress has it is own budget resolution that is a concurrent resolution. We really need a joint resolution so that the broad numbers are agreed upon at the front end of the process and it becomes a binding law that all parties have to abide by.

I think we need to move toward biennial budgeting. We reinvent the wheel every 12 months around here. We sometimes are dealing with the next year's budget at the same time that we are trying to implement the current year's budget. Too much overlap, too much duplication of effort. A biennial process would also give us more time for reflection. We have Inspectors General reports. We have GAO studies. We have CRS studies. We have more information than we know what to do with because we are always caught up in this frenzy of annual budgeting. If we had a year to take a breather to look at some of these reports and recommendations, we could clean up the budget process, find savings, find more efficient ways to deliver government services.

We need to restore the Budget Enforcement Act with its spending caps on the discretionary side of the budget, as well as its PAYGO principles on the tax and entitlement side of the budget. Frankly, we are getting so badly out of control between revenue and expenditures, much of it driven by automatic programs, the mandatory entitlement programs, that we may need to take the PAYGO process a step further, put it on steroids, and require that any tax increase be accompanied by comparable tax cuts. We are so far behind the eight ball right now that just holding the line perhaps is no longer enough.

Next, let me point to a couple of issues that a small in the scale of the overall deficit but huge symbolically, and significantly important because if we can't deal with these, who are we kidding to think that we can tackle these longer-term entitlement issues. It is pork barrel spending.

We need something akin to the Byrd rule that denies, unless there is a super-majority vote, extraneous matters from being included in the reconciliation bill. We need to apply that to all spending bills so that these extraneous pork barrel items are forced to a separate vote in some fashion before they clear the Congress.

We need to look at what has happened in the last decade or more on pork barrel spending. In 1991, there were like 546 pork barrel projects in all of the 13 appropriation bills. By 2005, that was

13,997. It went from costing us about $3 billion a year to now $27 billion a year. It is wildly out of control and needs to be brought back into some restraint. And we also need to look at the egregious approach to emergency spending in the last several years.

In the decade on the 1990s, we allowed a loophole of emergency spending to take us beyond our current year budget. But it was always very limited, and the bulk of that spending was tied to the immediate emergency at hand, averaging maybe $16 billion a year. We are now up to about $160 billion with some of our recent emergency spending bills, and they always get larded up with pork barrel items.

So that is the kind of reform that is sort of a prerequisite to courage. If you can't gin up the courage to do these things, who are we kidding to think we can do the longer-term things and entitlements? And I would also recommend that we authorize the CBO to do an intergenerational impact statement on every budget that comes through the Congress.

Senator COBURN. Thank you, Congressman. Dr. Holtz-Eakin.

TESTIMONY OF DOUGLAS HOLTZ-EAKIN,[1] FORMER DIRECTOR, CONGRESSIONAL BUDGET OFFICE, DIRECTOR, MAURICE R. GREENBERG CENTER FOR GEOECONOMIC STUDIES, PAUL A. VOLCKER CHAIR IN INTERNATIONAL ECONOMICS COUNCIL ON FOREIGN RELATIONS

Mr. HOLTZ-EAKIN. Mr. Chairman, Senator Carper, thank you for asking me to be here. As I mentioned in my written statement, there is a lost list of perceived failings with the current budget process. Let's just stipulate that it is failing and move past that.

It would be useful to develop a process that will identify the actual decisions Congress has to make and help to implement those decisions. In doing so, I think it is important to keep an eye on the ball and make sure that the process, whatever it may be, is comprehensive in scope; that there are no opportunities for claiming things are off budget or somehow irrelevant when they commit the taxpayer to coming up with resources to meet decisions made by the Congress.

It should identify all the decisions, including the ones that currently get passed by on a yearly basis, things which should be chopped out of the budget, things which should be renewed. It should include enforcement. To have a budget process that does not include the enforcement, allows for artificial trade-offs, pretend savings in future years for current appropriations stand out at the moment. It should be focused on the decisions Congress has to make, so it should be oriented around spending decisions, tax policy decisions, not outcomes. Gramm-Rudman-Hollings focused attention, but you can't control the outcomes. You can only control what the Congress does. And it should be tied to the financial management system. It should integrate smoothly with the actual operations of the agencies so that it is transparent, the link between what Congress decided and what came out. That will improve the accountability in result and help in the oversight process.

[1] The prepared statement of Mr. Holtz-Eakin appears in the Appendix on page 59.

I had a fairly long list of potential ways one could go forward, ranging from what I think of as small things like Band-aids to the rethinking it from scratch. It is important to recognize that there is no such thing as the budget process. There has to be a process which supports the Congress' policy decisions. As has been mentioned, it can't substitute for the Congress making policy decisions because a future Congress can always reverse it. So it cannot by itself get the right answer, but it can help Congress identify decisions, it can support the decisions that Congress has made. That is the obligation of a good budget process. In redoing a budget process for the future, as opposed to the one which we have had so far, I think it is important to do at least two things:

First, to clean up the concepts in the budget. Only in this day and age would it be possible to label something an offsetting receipt, call it negative spending, when it accounts to the same thing as a tax. On the other side of the budget, we have lots of tax credits which are just vouchers being handed out. They are spending programs done through the Tax Code. You can claim they are tax cuts; the economics is the same. It really needs to be cleaned up so that there is an actual matching between policy objectives and the instruments the Congress uses.

Second, it should be focused around mandatory spending. The big issue here is Social Security, Medicare, and Medicaid. That is it for the future. Once the decision is made to spend those monies, they are going to be paid for one way or another. So I think removing the distinction between discretionary and mandatory would be a good step. Money is money. The Congress is going to commit to spend taxpayers' money and the big money is in mandatory. So every year those programs should be looked at.

Thank you for the opportunity to be here, and I would be happy to answer your questions.

Senator COBURN. Well, let me thank each of you. Let me just go through. Do all of four of you agree that a biennial budgeting process could work better? Does anybody disagree with that?

Mr. WALKER. I think it deserves serious consideration, and I would like to think that Congress would spend the extra year doing more oversight and analysis, and if, in fact, they did, it would be a plus. I have my doubts as to whether or not they would.

Mr. HOLTZ-EAKIN. I am skeptical. At the moment we have Appropriations Committees that have to do appropriations every year, and authorizing committees which have years to do the oversight of the programs they have authorized. It doesn't happen. I don't see what more time will do besides give them more time to not do the oversight. It may work. I mean, no one knows, but it won't work worse.

Senator COBURN. One of the groups that does oversight is the appropriation process. They do oversight hearings besides authorizing committees like this Committee. If you had a 2-year budget cycle, would there not be more time available for the appropriators who tend to do more oversight than the authorizing—would there not be more time for the appropriators to do it? And could you not make it mandatory—if you had a budget process change where you mandated that, as a function of this Committee, at a minimum these programs will be looked at and oversighted every so many years. Whether you call that sunset or not, the fact is this Committee, myself and Senator Carper, have had more oversight hearings than any committee in Congress.

Mr. HOLTZ-EAKIN. I think you hit the nail on the head. It is not just biennial budgeting. That may, in fact, serve as part of a better process. It is what you do along with it to make sure that that time is used effectively. Just giving more time I don't think will do it.

Senator COBURN. Congressman Penny, you could probably address this more, having had the experience. Can you see a way where we could write that obligation into a budget bill that says this is a requirement of the committees, both the authorizing committee and the appropriating committee?

Mr. PENNY. The underlying Budget Act allows an opportunity for every committee of Congress to submit its recommendations to the Budget Committee before it develops the budget resolution. It seems to me that you could amend the budget law to require sort of a review and analysis of any and all reports from various agencies as part of the committee's responsibilities each year, and they could report that to the Budget Committee. The Budget Committee in turn could report essentially an off year-reconciliation bill to incorporate those changes. I think that there is a way that the budget process could anticipate and instruct that to happen.

Senator COBURN. Governor Miller.

Mr. MILLER. I think biennial budgeting is a good idea. One thing you would have to worry about or be concerned about is the abuse of the supplemental process, because on the off years there would be enormous pressure to do a supplemental appropriation which could easily get out of hand. You would have to zero sum with the existing budget or something of that nature.

Senator COBURN. Can you imagine a budget process reform that said if you have a supplemental bill, you have to have rescissions equal to the supplemental?

Mr. MILLER. Every supplemental I sent up or I prepared for President Reagan had that in there.

Senator COBURN. Let me rephrase that question. Do you think the American people could see that? Washington, I know doesn't see that. But if you were to look at everybody else, how they have to run their business or run their family, if they have to do a supplemental, they have to rescind somewhere.

Mr. MILLER. Exactly.

Senator COBURN. And they don't get the privilege of printing money to make the difference. So answer it in the context: One, is it good policy? Two, given your skepticism that I saw in all of your faces when I mentioned it, in light of what the American public might decide, should we try to do something like that?

Mr. HOLTZ-EAKIN. I think it is good policy. I think if you are going to go this way, the piece you need is a tight definition of emergencies, a genuinely tight definition of emergencies, and some allowance ex ante, right up front, for emergencies. So, budget for the emergencies and stick to it. And then anything above the budgeted, you have just got to deal with an offset. Otherwise, the temptation in circumstances which are genuinely bad to create an emergency and then expand the definition is going to overwhelm that process. So that is a key part of doing this.

Senator COBURN. Well, we have a good definition, a pretty good definition of "emergency" now and it is totally ignored. I spent a lot of time on the floor putting that definition out during the recent supplemental, and everybody ignored that part of the debate because it definitely didn't meet the qualifications. So if we don't follow the rules of what we say is an emergency, even though you tighten the definition, it gets back to the process.

Mr. PENNY. Well, supplementals are typically driven by emergency situations, natural disasters, and that can be anticipated because we have got decades of history telling us roughly how much we spend on that every year.

Senator COBURN. So we could budget.

Mr. PENNY. You could budget for it ahead of time, and then deal with the overages in a pay-as-you-go fashion.

Mr. MILLER. What you could also do is supplementals. You have the Budget Act requirement for supermajority for certain things. So, with 2-year budgeting and you have supplementals, maybe the way to police the supplemental would be to require supermajority for not zero budgeting or not rescinding as much as you proposed to increase spending. And that would also be a measure of emergency. If it is truly an emergency, you would easily get a supermajority.

Senator COBURN. General Walker.

Mr. WALKER. Mr. Chairman, I would say that if you are going to pursue biennial budgeting, it would be incredibly important to be able to link it as part of a package, to more comprehensive reforms, so you are not just going to a biennial budgeting process, but you are tightening up on emergencies, tightening up on supplementals, and doing something on earmarks as well as increasing the likelihood that the time that will be freed up from the normal process will be used productively.

Candidly, just this morning I was on the House side talking to the leadership on one side of the aisle, and bringing them a copy of our high-risk list, which you are very familiar with, and our 21st Century Challenges document, which you have read more than one time. That is a lay-up, an absolute lay-up for constructive oversight and yet this Subcommittee and the full Committee and your counterparts in the House are really the only ones that have used them to any great extent. I mean, this involves billions and billions of dollars every year.

Senator COBURN. Congressman Penny, you said that there may come a point in time when we look at the process of the national budget that tax increases would be accompanied by—you said tax cuts, but I think you meant——

Mr. PENNY. I meant spending cuts. The nice thing about testifying here is I get a chance to edit those remarks. I thought of that after I turned my light off. What I meant is this is so far out of whack with the spending lines and the revenue lines going in the wrong direction, that simply holding the line is not going to get us to a balanced budget anytime soon. And so we may need PAYGO on steroids, which is really tax increases matched with a comparable dollar's worth of spending cuts, so that we really begin to move the budget back toward balance. If we don't get this done before the baby boomers begin to retire and the cost of Medicare and Social Security begin to explode, we are in deep doo-doo.

Senator COBURN. Before I go to Senator Carper, because I want to give him some time, this Subcommittee has had testimony that the tax gap is $350 billion. This Subcommittee has already found in excess of $200 billion annually in wasted or defrauded payments by the Federal Government. That is $550 billion. Now, that solves our problem today, but it does not solve our entitlement problem.

How do we get past the point to where when we say we want to do a tax increase—which I have always said if we are efficient and we need more money, that is our option or we decrease benefits and that is the hardest thing to do. How do we justify a tax increase when we don't justify the ability to make the government run the way it should run?

Mr. PENNY. Well, and that is why I said this is like PAYGO on steroids. This way, if you match it with comparable spending cuts, measurable, scorable spending cuts, then you are guaranteeing that whatever tax revenue you achieve through cleaning up the Tax Code, getting rid of some wasteful loopholes and deductions, whatever it might be, you guarantee that all of those revenues go to the bottom line and help us reduce this deficit. But if you don't do that, I can understand resistance to do even tax reform for fear that the money will just be squandered on higher spending.

Senator COBURN. Senator Carper.

Senator CARPER. It is a great panel, isn't it?

Senator COBURN. It is. I was just thinking I am going to ask Senator Carper if he would help host a dinner where we could sit down and——

Senator CARPER. That is funny. I was thinking the same thing.

I think Dr. Eakin didn't put forth his list, but I suspect he had a laundry list there of things that we might do. But several of you have and they are actually quite good lists.

Where do you think you agree, where do you think there is consensus just on some of the truly significant steps that we ought to consider taking? Where is the consensus among the four of you?

Mr. WALKER. Reimpose budget controls. I don't know if we are in total agreement as to what that should be, but clearly I think all of us are saying that one of the reasons that Congress was able to bring back more fiscal discipline was because there were meaningful budget controls in place that forced the Congress to make tough choices. Right now they have all expired. If anything, you need tougher controls than you had before, because we are in worse shape over the long term today than we were then.

Senator, I would like to mention two examples of what is wrong with the current budget rules. They represent poster cases that need to be on the table. First, Medicare Part D, with a $8 trillion plus price tag. That number was never discussed or debated before the bill was enacted into law. It is absolutely critical that Congress consider the discounted present value dollar cost of major spending and tax proposals before it acts, because we need to understand the long-term affordability and sustainability of proposed legistation. Second, the recent tax cut extension, the way that was paid for is shocking. Short-term, one-time revenue gains through conversion of regular IRAs to Roth IRAs, coupled with long-term structural revenue losses. The only reason it worked is because the budget rules assume the country is going to end in 10 years. And it is not.

Senator CARPER. If we keep this up, it might.

Mr. WALKER. No, I think we have got longer than that.

Senator CARPER. I hope you are right. Again, I am looking for consensus. You have mentioned budget controls, budget rules, and we have talked about PAYGO on the spending side as well as on the tax side. Let me just ask you, is there a consensus on that, that PAYGO should be a two-way street?

Mr. MILLER. I am not all that big a fan of PAYGO because I think it did not have as much effect as some people believe it did. Tim and I both were saying a joint resolution, make the budget resolution a joint resolution.

Senator CARPER. Is there anybody that doesn't agree on that?

Mr. WALKER. Having a budget for the United States, would be a good thing.

Mr. MILLER. The transparency, I think we would all agree making the budget transparent, talking about it in plainer language and honestly, with integrity, would be something else that we would agree to. But whether it is PAYGO or whether it is Gramm-Rudman-Hollings or it is a constitutional amendment that limits spending or something like it, or a rule that spending cuts have to accompany every tax increase and things of this nature, those are very much needed. We could call those controls, but those kinds of institutional controls I think all four of us would agree are needed.

Senator CARPER. General Walker, go ahead, sir.

Mr. WALKER. I think that other thing that everyone would agree on is there has to be an improved conduct of oversight on both the tax and the spending side so that the American public has confidence in the use of their dollars so that when the future comes they don't feel "gamed," and so that they believe we are doing the best we can as a government.

And the second thing I think we would agree on is we will have to scale back the spending in Medicare, Medicaid, and Social Security. We may have to raise taxes as well given the scale of this.

They are going to have to feel the same way on the tax side.

So the oversight piece of this is both good government and a no-brainer. It is also essential to the compact between the public and the government.

Mr. WALKER. I think we all also agree that we need to tighten what is happening with regard to supplementals, with regard to emergencies, and with regard to earmarks. And the last thing I would say is, candidly, this country spends over $2.5 trillion a year and forgoes between $700 and $800 billion a year in revenues because of tax preferences. In a vast majority of the cases, we have no idea whether those programs and tax preferences are working or not and who is benefiting from them. And that is just outrageous. We need to figure out what we can do to make sure we are coming up with some outcome-based metrics that we can use to assess the effectiveness of these programs and policies and to reconsider them as part of a normal structured process over time, because last year we incurred expenses of $1.35 for every $1 in revenue, and it is going to get worse if we don't do something.

Senator CARPER. General Walker was up in Delaware with some folks from the Concord Coalition. Congressman Mike Castle and I hosted a forum. We thank you very much for coming, and you were well received and made a whole lot of sense. I mentioned to the folks that were gathered that day at the riverfront that when I was Governor of Delaware, if I had proposed budgets that were hopelessly out of balance and called in the legislature to do the tough work of balancing the budget, they would have run me out of town. In fact, they would have run me out of the State.

Congressman Penny and I once had an opportunity to vote on a balanced budget amendment to the Constitution that Charlie Stenholm, Larry Craig, and I had worked on for a long time. It was an amendment that did not mandate a balanced budget every year, but what it said is at a date certain, the President has to propose a balanced budget, and at a date certain, the Congress can unbalance the budget but you need a supermajority, three-fifths vote—to unbalance the budget, you need a supermajority; you need a three-fifths vote to raise the debt ceiling. I think we got 280 votes, we needed 290. We got pretty close in the House to passing it.

We also voted on something called statutory line-item veto powers for the President, something that Dick Armey joined me in offering. It was a little different than the one that actually passed and got signed into law, because our approach was sort of a 2-year test drive. There was a lot on unease about giving the President that kind of authority and would he or she use that to intimidate others to support his or her proposals in order to make sure that some things that we were interested in didn't get marginalized.

So we proposed a 2-year test drive on line-item veto powers. It said the problem with the President's rescission powers is Presidents can offer rescissions forever, but unless we vote on them, then it may as well not take the time to submit them, and we just basically were ignoring the rescissions that were submitted. So we said how about an approach where for 2 years we try this: When the President submits a rescission, there is an expedited process that brings it up for consideration before one body and then the other. Either body could literally defeat the rescission with a simple majority vote.

For programs that were authorized, fully authorized, the President could rescind as much as 25 percent of those; for unauthorized programs the President could propose rescission equal to 100 percent of the unauthorized programs. After 2 years, the authority to do this would sunset unless it were extended. And I think we had about a three-quarters vote in the House, the majority of both parties who voted for it. It got over here to the Senate, and my dear friend, who was then the Chairman of the Appropriations Committee, a senior Senator from West Virginia, whose name will go unmentioned from these lips, but I am told it got slowed down there and ultimately it didn't pass.

I am not sure that it would meet constitutional muster. We are going to ask CRS, among others, to give us their opinions on that. But that was one of the thoughts we had to—and I don't think the line-item veto is the end-all/be-all. I think it is a marginally helpful tool but it could be helpful.

General Walker.

Mr. WALKER. Based on the latest data I have seen, there have been no rescissions proposed in a number of years, nor have there been any vetoes in a number of years.

Senator COBURN. The last rescission package was 1996.

Mr. WALKER. It has been a while. Second, I was in California yesterday, and they have a large fiscal challenge on their own, and while in the short-term they are better off, in the long-term they have serious problems. One of the things they require is for the governor to submit a balanced budget proposal. They are not required to have a balanced budget but the Governor is required to submit a balanced budget proposal.

I think one of the things you ought to think about is whether or not the President should be required to submit a proposal to move toward balance, or if not to balance, then why not and attribute dollars to the gap. For example, today, how much money are we spending in Iraq and Afghanistan and how much are we going to have in one-time costs associated with Hurricane Katrina? One might argue that those are extraordinary expenses. On the other hand, we should not be running operating deficits in the hundreds of billions dollars a year. Companies can't do it. Not-for-profits can't do it. And countries can't do it over the long-term either.

Senator CARPER. It is actually funny you should say that because, Mr. Chairman, when I concluded after years of trying to get the balanced budget amendment up for a vote, I concluded that the most important provision was not the three-fifths vote to unbalance the budget or the three-fifths vote for raising the debt ceiling. I concluded the most important provision of our balanced budget amendment was a President, at a date certain, would have to propose a balanced budget. And any body that I have been a part of, whether governor, legislatures, mayors, city councils, county executives, county councils, was that the leadership on fiscal issues has to come from the chief executive and if it doesn't, it rarely comes from the legislative body. Go ahead, Dr. Holtz-Eakin.

Mr. HOLTZ-EAKIN. Just on the line-item veto, given that the courts have ruled that it is going to have to be something of a fast-track rescission authority instead of a pure line-item veto, I think one of the things to look at in that is making sure that you can just treat it as rescissions and not as a pretend line-item veto. What I mean by that is, don't rush the Administration to, say, in 5 days you have to send this up, in 10 days you have to send it up. The bills that are currently going up, that deserve a lot of scrutiny are a nightmare. We have seen them. Some of these supplementals——

Senator COBURN. They are rushed.

Mr. HOLTZ-EAKIN. And they are rushed. Give them time to go through those bills, find the sensible rescissions, then make the decisions, have a fast-track and expedited authority to vote up or down. But make sure that the bills get scrubbed. If you turn this into a 5-day operation, you haven't accomplished anything.

Mr. MILLER. The President has proposed—he calls it a "legislative line-item veto," which is enhanced rescission. And, Senator Carper, let me align myself with the recommendations that you just outlined. I thought those were all really quite good. On the question of the balanced budget, when I was Budget Director we did have budget deficits of a couple hundred billion dollars my first year and it came down to $150 and was plummeting further, until Congress changed its mind on the Gramm-Rudman-Hollings targets.

But at one point I said, "OK, I am going to put together a balanced budget," and people in the West Wing were very unhappy about that because it is an easy target. If you put together what would be required to balance the budget, the President would have a field day.

Senator CARPER. Going back to something the Chairman said earlier, if there were the requirement to submit a balanced budget, I bet we would do a hell of a lot better job, excuse my French, of collecting the revenues that are owed on some of these tax debts he was talking about.

Mr. MILLER. You are right.

Mr. PENNY. And that gets to my point about an intergenerational impact statement, because when you submit a budget but there is no requirement to submit a budget that is in the black, then whether it is $250 billion of red ink or $300 billion of red ink, it all sort of becomes meaningless. It is easy to throw a few extra billion or tens of billions of dollars into the mix because there is no bottom line. And yet there is a consequence. We have interest costs now, the fourth largest item in the Federal budget, and it is because of the accumulation of deficits year upon year upon year. And those interest costs don't go away.

An intergenerational impact statement would help us to identify those costs as what they really are, a tax on some future taxpayer. Without making that a more real and more visible cost item, in not only the current budget but perpetually in all future budgets, we allow both the White House and the Congress to get off the hook by using the deficit as sort of an open-ended ATM card. And it isn't open-ended because the price comes due someday; it is just that today's taxpayers are not the ones that are going to have to pay it.

Mr. WALKER. Two things on that: One, arguably, the biggest item of waste in the Federal budget today is interest on the Federal debt which is the fourth largest item and growing rapidly. Two, we have recommended previously that each budget each year that the President submits should have a statement of fiscal exposures and commitments, which is along the lines of what Mr. Penny is talking about. It should show these exposures, unfunded commitments and liabilities, how they are growing over time, and what the intergenerational implications are.

This morning I appeared before the Federal Accounting Standards Advisory Board, which promulgates accounting and reporting standards for the Federal Government, to make a pitch for a fiscal sustainability and intergenerational equity statement that we need as part of our basil financial statements, because we are running up the credit card at record rates and that means you are going to pay $1 plus plus plus down the road when you hit the day of reckoning. All of these, I think, are positive ideas and could help to get us to where we need to be.

Senator COBURN. Let me hit one other point. The rules for the CBO in terms of how things are scored often times don't reflect reality. The question that I would like to ask is, What do we need to do in terms of the direction? We can go to CBO right now under the rules and say that we want to show this, and with direction we can pretty well a lot of times get what we want. How do we change the rules for the CBO to accurately reflect future costs, not just in 10 years—it is like the debate on the immigration bill right now. The only thing they did is because it is after 10 years, they said it would cost more than $5 billion. Well, the fact is, if it were looked at, we would be astounded at what it is going to cost, but yet there is nothing in the rules that says they have to look at that.

So one of my questions is, How do we change the rules to accurately reflect the financial condition and environment that we are in? We use no dynamic scoring. Every business I know looks at inflation-adjusted or net present values to see what they are doing. The whole country bases it is finances, outside of the government, on what is the net internal rate of return, inflation adjusted, what are you really getting for it. So are there suggestions in the things we should change in terms of direction for the CBO so that what we really get is real numbers upon which to make real decisions? Because I think oftentimes, because of the direction that has been by law to CBO, we don't get what we need to make the real decisions. Could you address that?

Mr. HOLTZ-EAKIN. I think there is no harder problem, quite frankly. Obviously you can write any rules you want for the CBO and having lots of presentations which show long-term implications of current programs and current decisions, I am a big fan of. This hearing is about the budget process, which is how, in fact, you will make the decision to pull the trigger and spend the taxpayers' money. That is much harder because in the end, I think it is desirable to tie that process to the money you put in the checking account, and that is the annual flow of budget authority and some of it is now mandatory. I don't think that is a good idea. I think that is Congress' call and it should be taken and made discretionary across the board.

What I am nervous about is anything that would move toward actually trying to budget on a present value basis, because I believe that will be more damaging than helpful for the Congress. There are too many games that could be played. I would say right now at this table that under the current law, Medicare, Medicaid, Social Security are going to be such large burdens on the U.S. economy that ultimately growth will go negative. It is absolutely unsustainable in an economic sense.

So imagine cutting back and scoring a cutback of those programs to a sustainable basis. What would be, 50 years from now, the growth impact on the U.S. economy? I don't think the science is up to answering that question, and directing the CBO, or anyone for that matter, to come up with an answer to that so that the economy grows better, you get the tax revenues, suddenly you have got these games 50 years out solving your problem now; terrible place to go.

Know the problem. The problem is that the promises are up here, the money is down here. The gap is forever. But deal with what we have now, which is the authority to put money in the checking account so that agencies can write checks and focus the budget process on providing that authority. Know what you are getting into; lots of supplemental presentations. But I think the process should be focused on the financial management system because that is what these guys are actually going to do.

Senator COBURN. But when you do a budget, as I visited with Senator Judd Gregg, how the CBO scores it today determines what you can do. And so the games that are played today, under the rules that we have today, don't accurately reflect the financial condition of this country.

Mr. HOLTZ-EAKIN. There is no question about that. But when you pick the next process, because we agree that this particular one is not working very well, you will set up incentives to game it as well. If you put in place trade-offs and enforcement and people don't want to have to make trade-offs, they don't want to suffer enforcement, the incentives for the game will be there.

So focus the attention on the big ones, and the big one here really is long-term costs of entitlement programs. Senator Gregg put in place a point of order for any programs that raised spending outside the budget window in any 5- or 10-year periods. I thought it was a fabulous idea. Very quickly, every piece of legislature this Senate considered sunsetted at the end of the 10-year—and that was on the spending side. How you get that is the key question.

Senator COBURN. And the budget point of order has been waived every time on it.

Mr. HOLTZ-EAKIN. Right. So how do you——

Senator COBURN. So it has not done anything.

Mr. HOLTZ-EAKIN. I don't know how you beat that. That is the key question.

Mr. WALKER. Mr. Chairman, let me clarify something because I want to make sure you understand what we have recommended on this. We are not recommending accrual budgeting.

Senator COBURN. No, I know that.

Mr. WALKER. We are, however, recommending that as a supplement to reimposing meaningful, substantive budget controls that there be disclosures, transparency, that would be required on any major spending and tax proposal. Namely, to calculate the discounted present value dollar cost that must be considered as part of the legislative process, possible supermajority rules, whatever else. That is different. That is critically important.

The other thing one might reconsider is whether or not CBO ought to be required to assume that discretionary spending is going to grow by the rate of inflation over the next 10 years.

The other thing you might want to reconsider is whether or not CBO might have the option or be required that, when Administration policy is X, that somehow they have an ability to show what the impact would be if that was enacted by the Congress. What the Congress looks at and what the CBO is currently required to do for the 10 year projection is totally unrealistic and not credible.

Mr. HOLTZ-EAKIN. As an addendum to that, one of the great advantages to one of the recommendations that you have heard, a joint budget resolution, is that the current practice of the Administration's baseline reflecting one set of assumptions, the CBO's baseline reflecting a second set of assumptions, the incentives for scoring gimmicks on both sides being different and present, so that no one in their right mind can figure out whether some budgetary objective has been met. It would eliminate a lot of that.

Senator COBURN. So you are going to use the same assumptions? You would have to come to the same——

Mr. HOLTZ-EAKIN. You would be forced to come—under the Budget Enforcement Act, where there were rescissions and sequestration and the enforcement provisions, there was a head-to-head with the CBO and the OMB, there was a coming to grips with the scoring assumptions. It was an environment in which there was more transparency, because both sides had to talk about it. That was beneficial.

Mr. MILLER. In the budget deal of 1987, the Budget Accord, CBO and OMB had to agree on major assumptions and things of this nature. And it was kind of interesting because you do have a cadre of very devoted civil servants at OMB that think this is the right way to do it, and at CBO it is a different way. And you have to get them together and talk to each other and get them to agree to a system.

Could I just point out, just think of what Mr. Holtz-Eakin was just saying a while ago about the effects of these burgeoning spending demands in 50 years, or whatever, causing economic growth to come to a halt, and actually you would have contraction in total output. What you are establishing is the predicate for enormous intergenerational strife. You have young people 50 years from now who are going to be supporting old people and going to be really upset, not only with having to support old people, but the pie will be shrinking at the same time.

Senator COBURN. Well, the real manifestation of that is a lower standard of living for the next two generations. All you have to do is look at Germany today with 11-percent unemployment and 40 percent of their GDP as an expenditure of the take of their government, and growth that is one-fourth of what ours is. We see it, and the question is can we handle it. And the cost of making those decisions late versus the cost of making those decisions now is much less than that now.

Senator CARPER. Mr. Chairman, could I come back with another question? I think everybody has said the biggest budgetary challenge that we face is Medicare, Medicaid, and Social Security. The President suggested in his State of the Union Address that creating a sort of true bipartisan commission that examines, essentially, those three programs. It was one part of the State of the Union Address that I actually stood up and kind of saluted, and we haven't heard a whole lot about it since.

I remember when Congressman Penny and I were just elected to the House in 1982, with the brother of Carl Levin, Sandy Levin, and we got there and one of the first things that I learned was that a commission had been created in 1982 on Social Security reforms and was chaired by Alan Greenspan, Robert Dole was on it, Claude Pepper, a bunch of others, and Senator Moynihan was on it.

And they had worked in 1982 and presented to us in 1983 sort of a whole range of revenue increases, cost cuts and so forth, and this whole package, and they agreed, basically agreed unanimously on it, almost unanimously, and said this is what we think we ought to do. And they gave it to us, President Reagan signed off on it.

He had assigned part of the Commission—Tip O'Neill—I think Robert Byrd had to sign, appointed part of the Commission. They signed off on it, and the rest of us kind of drank the Kool-Aid together.

And when the President said in his budget address or in his State of the Union Address that we ought to have a blue-ribbon commission to look at Medicare and Social Security—I don't know that he mentioned Medicaid—I thought that sounds like a winner to me.

Your thoughts? We haven't really talked specifically on what to do to rein in the costs of those programs. My sense is that in order to take the politics out of it, you need that kind of approach.

Mr. WALKER. I think you need an entitlement and tax reform commission. There is a lot of interrelationship between what is going to have to be done with regard to entitlement programs and with regard to tax policy. I think from a practical standpoint, in order to get the kind of people on the commission and to make it meaningful, then you are probably going to have to have that scope in order to get it done. I will be happy to provide for you, and the other Members of the Subcommittee, an analysis that we just did at GAO, analyzing about a half a dozen policy-oriented commissions over the last 25 years and what were the key criteria that helped to determine success or failure. And you will find that there were only two that were really successful in the last 25 years. One was the 1982 Social Security Commission, but also keep in mind there was a very real action-forcing event back then. It was called the checks weren't going to go out on time within a matter of time.

The other one was the 9/11 Commission, where the American people were demanding action because of the cataclysmic events of September 11, 2001. I do think we need to consider something, but broader than what the President suggested.

[The information follows:]

Senator CARPER. OK. Thank you.

Senator COBURN. Welcome, Senator Levin.

OPENING STATEMENT OF SENATOR LEVIN

Senator LEVIN. Mr. Chairman, thank you for holding this hearing, again, a very useful hearing, as so many hearings are that this Subcommittee under your leadership has had. I think, Mr. Chairman, in your opening statement, you made reference to what is called a tax gap. I would like to ask our witnesses about that issue.

There is approximately a $350 billion tax gap between the amount of taxes which are collected and the amount of taxes which would be collected if everybody paid the taxes which were intended to be paid by them. So there is a gap in the collection of taxes that is huge. It obviously would make a big difference.

I am wondering whether or not—perhaps starting off with you Mr. Walker, but also the other witnesses might comment on the importance of trying to close that tax gap and any specific proposals that you might have. I know there is going to be a vote coming shortly, but if we could just get the answer perhaps to that question, my other questions I would reserve for the record, Mr. Chairman.

Mr. WALKER. Senator Levin, I have testified on this on a couple of occasions. It is about $350 billion. If you really want to make significant progress in closing that tax gap, you are going to have to authorize additional information returns and additional withholding. I would be happy to provide more information for your and the Subcommittee's consideration, but we do have some specific ideas for you.

Senator LEVIN. Have you given us your proposals on closing the loophole or the tax dodging and avoidance which is created through the use of offshore tax havens?

Mr. WALKER. I believe we have done a little work on that and we have some other work ongoing right now, but I will double check and provide an answer for the record.[1]

Senator LEVIN. On either of those questions do our other witnesses want to comment?

Mr. HOLTZ-EAKIN. I think there are two dimensions to the question. One is the numerical objective of collecting the revenue that has been identified in the tax gap. There, I would point you to the work of Joel Slemrod at the University of Michigan, who is the tax policy expert's tax policy expert, and he would argue that number is like the difference between reserves and proven reserves for oil companies, that you are not going to get all $350 billion, you are going to get something less than that and you ought to be sensible in your approaches to doing it.

But I think the bigger part of the question is making a sincere and honest effort to clarify the Tax Code and enforce it so that can't arise again because we have relied so much on voluntary compliance in the past, and what we have done is erode the confidence of Americans in our Tax Code, and we are undermining the voluntary compliance of it. I think it is essential to go after that tax gap, largely because we need this Tax Code to function better in the future, not worse. And that is really what is at stake.

Senator LEVIN. Any comments on tax havens?

Mr. HOLTZ-EAKIN. Tax havens are a big issue and are part and parcel of the way we have tried to run our international tax rules for large multinational corporations. The most important thing is to simplify this and clarify the objectives, and then I think the enforcement will be easier too. At the moment there are too many conflicting provisions to allow enforcement to proceed with any certainty at all.

Mr. WALKER. We currently need tax reform, Senator Levin, in order to streamline and simplify and in order to help voluntary compliance. We need to have credible enforcement as well. But one other area that I would give you for consideration: The U.S. Government does business with contractors, and also gives grants to entities that are significantly delinquent in their taxes. I think we need to consider establishing a date certain, and say that you either get current by the date certain, or we don't do business with you.

Senator LEVIN. There are a number of provisions which I believe are in our defense authorization bill, actually, on that issue, and I don't know whether the Chairman has got legislation along that

[1] The information supplied for the record appears in the Appendix on page 88.

line, but I know we do have a provision in the bill which is coming to the floor in the Armed Services Committee.

Mr. PENNY. I know that one of our Senators, Mr. Coleman from Minnesota, had some hearings on this a couple of months ago and I assume that it is part and parcel——

Senator LEVIN. That is correct.

Mr. PENNY [continuing]. Of the legislation that is now moving forward.

Senator LEVIN. Thank you for the reminder. It was Senator Coleman, the Chair of another Subcommittee.

Mr. PENNY. And it is certainly a good place to begin.

Senator LEVIN. He does have a bill on this which I have cosponsored, as a matter of fact, in addition to the defense authorization.

Mr. Miller, how are you doing?

Mr. MILLER. I am doing fine, sir. How are you? First let's stipulate that you and I have paid the taxes that we have due.

Senator LEVIN. I would be happy to stipulate that.

Mr. MILLER. I think it is very important that tax rates be low and that taxes be simple, understandable, and that everyone pay their fair share of taxes. And I think going after not only tax avoidance—excuse me, tax evasion. Tax avoidance is perfectly legal—tax evasion, but also people who owe the Federal Government money, people who have borrowed on some of these programs. When I was OMB Director, we tried to collect monies that were owed the Federal Government and actually Congress put an estoppel on our efforts to secure this money. I think, and Mr. Walker probably has in his own mind—you probably know how much is owed. I don't know what the current figure is.

Senator LEVIN. Well, we talk about tax avoidance and complicated rules. The Enron Corporation had 400 shell corporations in one Caribbean island, the Caymans. Now there are 1,500 other shell corporations apparently that they created in other tax havens. But do you have any comment, Mr. Miller, on the tax haven issue?

Mr. MILLER. This is just further evidence that the tax system is dysfunctional too, and it needs to be reformed dramatically and simplified.

Senator LEVIN. I have a lot of other questions. If our witnesses would be kind enough to answer them for the record, although they are not obligated to do so except probably for Mr. Walker. He is always willing to do it even if he weren't obligated. He does a tremendous job. Thank you all.

Mr. PENNY. Thank you, Senator. Mr. Chairman, if I could back up and respond to the question that Senator Carper asked, because my take on this is a bit different than General Walker's take on this. I think in a perfect world, General Walker's response that we need a broad-based entitlement and tax commission to deal with all of these issues, Social Security, Medicare and tax policy, because there is a lot of interrelationship, in a perfect world that is absolutely right because there are so many pieces, they all do fit together one way or the other and we have to look at the whole picture.

I think, realistically, if we are going to get a serious commission going, it is better to segment this. It needs to be bicameral. It needs to be bipartisan. Hopefully it would also include some outside experts, as did the Social Security Commission back in 1982–83 with Alan Greenspan and others. But I think the better construct for a commission today would be a retirement security commission. And the reason I say that is because we have a broken defined benefit system in America. Too many companies are now going bankrupt and turning those obligations over to the PBGC, and the PBGC is not financed adequately to take care of that.

Other companies are redefining their defined benefit plans in some way; in other words, shortchanging people. After decades of telling them they had a certain benefit level, they are now redefining those benefits. They haven't invested them properly. We have also got problems with (402)k and other defined contribution plans in the private sector.

The most easily addressed aspect of that is just enrollment. We have people who are not opting in. If we force them to opt out and automatically place them in, we would take from about 20 percent to 80 percent the number of participants in those programs. It is the kind of program that you really ought to be invested in from the very first job you take, from the very first paycheck you receive, and until we do that we are not going to prepare particularly lower- and middle-income Americans for their retirement because they are not benefiting from the magic of compound gains.

And then you tie that together with Social Security because in many ways the problems in Social Security mirror the problems in these private sector plans. And if you put it all together as a package deal, I think you can get both Democrats and Republicans to come to the table for that. Democrats clearly are reluctant to debate Social Security as a free standing issue. But if you make this retirement security and show how all these pieces fit together and what the end result can be, I think you can get some reform in that area. But I think if you load in Medicare and you load in tax reform as a part of that, it just gets too heavy to carry.

Senator COBURN. And you also might get encouragement in savings, which is one of the things that we lack.

Mr. WALKER. We had a negative savings rate for the first time since 1933, which wasn't a good year. The only concern that I have with that—and, of course, I have longstanding background in pensions, health care, Social Security and Medicare, and there is a need to look at this issue. But the problem is health care. That is the problem. I mean, of the $46 trillion in exposures, commitments and unfunded obligations, about $30 trillion is Medicare. And so we need to deal with all these issues, but when you are talking about retirement security, health care is as important as anything else.

Senator COBURN. Would health care be the problem if health care was 67 percent of the cost it is today?

Mr. WALKER. It wouldn't be as big a problem, but it would still be a problem over the longer term.

Senator COBURN. And the reason I want to put that out is we can document that $1 out of every $3 that goes into health care isn't going into health care under the systems that we have today. It doesn't go to help anybody get well. It doesn't go to help prevent the illness. It doesn't help in the treatment. It is consumed because of the way we have designed the health care system. And the $2.2 trillion that we are going to spend on it, only $1.6 to $1.7 trillion actually goes to help treat somebody or prevent illness or diagnose it.

Mr. PENNY. There are fundamental problems in the structure of our health care system, both the public programs and the private sector programs. But it is a much different issue with a lot of moving parts in a way that retirement security reform, Social Security and these other plans, are much more straightforward. I think it is easier to deal with them as separate issues. I don't dispute General Walker's comment that Medicare is a much more immediate and a much larger problem, and for that reason it ought to go first. But very much the way I have urged action on pork barrel spending as a way of ginning up some courage to deal with the bigger challenges, I think the same is true in the entitlement area. If you take on, arguably, the easier to fix piece, which is Social Security, you might gin up the courage it takes to take the next and larger step to deal with Medicare as well.

Mr. HOLTZ-EAKIN. I really want to echo that because there is a big difference between the medical issues and the Social Security issues. We can solve Social Security today. Analytically there is nothing to it. You can solve it 15 different ways. It is strictly a political issue. And the key with Social Security is it is pure demography, and every year that we wait, another generation, the cohort of baby boomers gets grandfathered. And if you grandfather the baby-boom generation, you have missed the money. And so my bumper sticker on Social Security has always been, "Get Doug Holtz-Eakin." I am the tailing end of the baby-boom generation. If you don't get me, you have missed the problem.

So that needs to be dealt with and dealt with quickly. And I think Mr. Penny is right in that the defined benefit pension system—our private sector experiment with that is over. We are going to clean up, but it is going to be defined contribution savings going future, that is good. Take care of that problem because it is the easy one analytically. Health care reform is just going to have to be part of a daily routine. There are so many things going on in health care in the United States that needs to be improved that I think a big fix is the wrong way to think about it. We need to make steady progress.

Senator COBURN. We don't really want to get into health care in here, even though it is a big segment in terms of Medicare and Medicaid.

Mr. HOLTZ-EAKIN. I think that is right. It is a health care problem. It is not a Medicare and Medicaid problem, where with Social Security, it is the structure of the program itself, and that is fixable.

Senator COBURN. All right. Any other comments?

[No response.]

Senator COBURN. Well, let me thank you and I am going to invite our other witnesses to come up. Senator Carper and I would very much like to have an off-the-record individual discussion with you all and if possible, we will be offering some dates that we might be able to find common with everybody so that we can sit down and talk about how do we do it. We both have a sincere interest in trying to address this issue, and it is my understanding the Majority Leader is going to have some time for budget process reform in

June on the floor. So we would like to maybe be able to do something together to put forward some of these ideas.

Thank you for your testimony. You will be receiving some written questions from us. If you would be so kind as to return those, I would appreciate it. Thank you very much.

Our next panel is Chris Edwards. He is Director of the Tax Policy Studies at the Cato Institute and a member of the Joint Economic Committee. He was a Consultant Manager with PricewaterhouseCoopers, examining fiscal issues being considered by Congress. He holds an M.A. in Economics from George Mason University in Virginia.

Our next witness is Maya MacGuineas. She is President of the Committee for a Responsible Federal Budget and Director of Policy Program of the New America Foundation. Her areas of expertise include the budget, entitlements, and tax policy. Before coming to New America, Ms. MacGuineas worked as a Social Security advisor to the McCain Presidential campaign where she helped craft the Senator's Social Security reform proposal and traveled with the campaign. Prior to that, she worked at The Brookings Institute, the Concord Coalition, and on Wall Street. She received her master's in public policy from the John F. Kennedy School of Government at Harvard University.

Thank you. I am sorry we are running behind.

Mr. Edwards, if you would, your complete testimony will be made part of the record. I have read it, and I want to thank you for it, and you are recognized for 5 minutes.

TESTIMONY OF CHRIS EDWARDS,[1] DIRECTOR OF TAX POLICY STUDIES, CATO INSTITUTE

Mr. EDWARDS. Thank you very much, Mr. Chairman. Thank you for having me testify on financial management today, and thank you, of course, for all your great leadership on fiscal issues the last couple of years. You have certainly shown that even a single Senator who is frugal-minded can have a really big impact on the policy debate, and if I had 20 Tom Coburns in the Senate, I think we would be moving a long way toward fiscal sanity around here.

Federal spending, as our previous panel discussed, continues to soar. Deficits are running year after year. The cost of entitlement programs are going to impose huge unfunded liabilities on young Americans. Clearly, current budget procedures don't work. We need to do something new. Let's experiment and try something new.

Without tight control of the problem, many members essentially just become advocates for narrow special interest causes, and broader concerns such as the size of the debt, the size of the burdens we put on the next generation are ignored. Without tight budget rules, there essentially becomes a budget anarchy in Congress.

As was discussed in the prior panel, the States have much tighter budget rules than the Federal Government. Virtually all the States have legal requirements to balance their budgets. One good idea that I think Senator Carper mentioned and I think Maya would agree with is that requiring a President to issue a balanced

[1] The prepared statement of Mr. Edwards appears in the Appendix on page 70.

budget every year, even as sort of a planning document, I think would be a very good and fairly simple step we could take.

Most State constitutions limit government debt pretty strictly. More than half the States have some sort of overall budget cap. And also importantly, the States are fiscally constrained by the need to make sure that their bond ratings don't fall, a constraint that the Federal Government essentially doesn't have. So if anything, we need tighter constraints at the Federal level than at the State and local level.

There, of course, have been numerous efforts in the past to put tighter budget controls in the Federal budget. Some of them were mentioned here: Gramm-Rudman-Hollings and the BEA of 1990. But I think a more direct and powerful way to control Federal spending is to put a cap on overall budget outlays tied to growth and some economic indicators such as GDP or personal income or inflation. The BEA of 1990 imposed caps on discretionary spending. This time around I think we need to put a cap on overall spending, both discretionary and entitlement spending.

I think we need to put cap ties to some indicator like growth in GDP. The principle is that the government should not consume an increasing amount of the economy's resources over time. With an overall cap in place, Congress would pass its annual budget resolution to insure that spending came in below the statutory cap. If needed, reconciliation instructions could be included to reduce entitlement spending. The OMB, as under GRH, would provide regular updates regarding whether Congress was above or below spending caps. If the session of Congress ended at the end on the year and OMB determined it was above the cap, there would be a sequester mechanism in place. Both discretionary and entitlement spending would, and I think should, be sequestered.

There have been numerous bipartisan proposals in the past, especially in the early 1990s, regarding the idea of putting a cap on overall entitlement spending. More recently the Republican study committees, the Family Budget Protection Act, would have included both a cap on discretionary and entitlement spending. They would protect their cap under their plan by both a sequester and a two-third supermajority voting requirement in both the House and the Senate.

The idea of capping the overall budget is inspired by budget caps in the States. Most noticeably, Colorado has a constitutional limit on overall growth in the State's revenues. Any revenue growth above the sum of population plus inflation growth is automatically rebated back to taxpayers. Federally, a cap on spending makes a lot more sense than a cap on revenues for variety of reasons. For one thing, Federal spending fluctuates a lot less than revenues and fluctuates a lot less than deficits. One of the problems with GRH was that it focused on deficits. Deficits fluctuate a lot and can surprise Congress with big changes. I think a cap on spending would allow Congress time to plan and make the reductions that would be needed to fit under the cap.

It is true that Congress could, of course, rewrite a spending cap if it was only statutory and not a constitutional cap anytime it wanted if it didn't want to comply with it. But I think if you had a simple cap on the overall budget, it would be a very high profile symbol of fiscal restraint that I think reformist Members of Congress and taxpayer and watchdog groups could rally behind and defend. I think if we put a cap in place now, before the entitlement cost explosion hits, we would have a number of years of experience with it. Taxpayers and citizens would start to understand that cap is there and Congress should live by it, so that when we get into further trouble down the road, I think the cap would be a really solid way to control spending.

So, to conclude, I think we need tougher budget rules to ward off a financial crisis in the future as entitlement costs soar. A spending cap is not a guarantee that Congress would take proactive steps to cut wasteful spending, to follow some of the ideas you have expressed earlier, but it would help prevent the type of huge spending orgy I think we have seen over the last few years. And I think it would be a very good solid step forward.

Thanks a lot for having the hearings and I would love to talk with you further about these ideas and work with your staff. Thank you.

Senator COBURN. Thank you. Ms. MacGuineas.

TESTIMONY OF MAYA C. MACGUINEAS,[1] PRESIDENT, COMMITTEE FOR A RESPONSIBLE FEDERAL BUDGET AND DIRECTOR, FISCAL POLICY PROGRAM, NEW AMERICA FOUNDATION

Ms. MACGUINEAS. Thank you. Good afternoon. Thank you for holding this hearing and thank you for inviting me to testify. Let me begin by saying that even the best budget process cannot serve as a replacement for responsible budget decisions and proper oversight. If politicians continue to cut taxes and increase spending, we will continue to run budget deficits no matter what the rules. If politicians continue to both build programs into the budget and Tax Code without sufficiently scrutinizing their effectiveness, we will continue to have a budget that is less efficient than it should be no matter what the rules.

And if politicians continue to make and expand promises for intergenerational programs such as Social Security and Medicare, we will continue to be faced with large unfunded liabilities and a highly inflexible budget that does not allow us to respond to important challenges and opportunities no matter what the rules. Ultimately, the most important component of responsible budgeting is the people who are involved and the decisions they make.

But while process cannot do the heavy lifting required to create responsible budgets, sensible and balanced rules certainly are important. I would say that I agree with almost everything we have heard this afternoon from Mr. Edwards and the previous panel. The fact that we are still not moving forward on some of those ideas, so that is it is even difficult to move forward on budget process rule reforms as important as they are.

The Committee for a Responsible Federal Budget, which I run—the board is made up of many of the past directors of GAO, CBO, the Federal Reserve Board, and the Budget Committees. We have a number of recommendations which I will just quickly go through.

[1] The prepared statement of Ms. MacGuineas appears in the Appendix on page 79.

The first is a joint budget resolution. We do believe that having the President and Congress agree on what budget they will be working with at the beginning of the process will be much more useful. It would also make transparent when Congress "busts the budget" during the year.

Second, expenditure limits, which Mr. Edwards just emphasized. In the past statutory limits have proven to be one of the most effective approaches to instilling discipline into the budget process. We believe that the budget resolution should include enforceable nominal dollar limits for both discretionary and direct spending. Let me just say on that topic, there is disagreement even amongst my board members about whether those caps should apply to direct spending. But I think it is certainly clear that as more of our budget is mandatory or entitlements, we have to look at how to cap that kind of area of the budget or have more oversight or take those areas off of automatic pilot.

Third, pay-as-you-go rules. We believe the pay-as-you-go principle is an important one that helped us in the past. It should be applied to the budget on both the spending and the tax side. If it is not, there is a huge loophole that is left to put spending programs through the Tax Code in the form of tax expenditures, which you see happening more and more often right now. PAYGO is a little bit lopsided; there is some disagreement about it because entitlement programs, when they are sunsetted, they come back in the budget without being subject to PAYGO. But they are also not in the baseline so you don't receive savings for that. We might want to find ways to even out the treatment of taxes and spending, but PAYGO should apply to both.

Fourth, tracking long-term spending promises. More information needs to be made clear and highlighted in budget documents about the long-term commitments that we have entered into on the costs of these intergenerational programs which are coming to dominate the budget.

Finally, triggers. We don't have an institutional position on this as a committee, but I believe that the use of triggers is something we should think about seriously bringing more into the budget process; where when we hit marks, whether it is a trigger that is triggered by spending, taxes, deficits, debt, unfunded liabilities, we have something that—a default that moves into place, either a soft default where Congress or the President has to make a recommendation about how to fix whatever problem has triggered the trigger, or a hard trigger, something as freezing all indexing on the tax side and the spending side until Congress comes up with a solution.

In addition to those recommendations, we support biennial budgeting with the reservations that were voiced before. There is some concern that supplementals would certainly be abused, and I don't know how Members of Congress are, but a lot of us who always wait until the last night to study for the exam might under biennial budgeting still not get that much more done even when you are given 2 years.

Senator COBURN. Could supplementals be any worse than what they are today?

Ms. MACGUINEAS. Sadly, probably. I mean, certainly that is one of the big problems we face right now. We need to find a way to fix supplementals, which are actually two of the next recommendations I would support: A very strict limit on what emergency spending is. You are more familiar than almost anybody on this topic and how hard it is to get people to stick to it. But we need to buy into the notion of an emergency requirement, an emergency definition that we stick to. And certainly rainy-day funds in the budget, we need to be budgeting for emergencies in advance. Something like Hurricane Katrina might have cost more than we budgeted for, but we still would have been in a better fiscal position to contend with that challenge.

Automatic continuing resolutions, and properly distinguishing between spending and tax cuts. As Mr. Holtz-Eakin pointed out, we have a tremendous problem of mislabeling things and putting them on the wrong side of the budget, to the point where we are not even sure how big our Federal budget actually is. And that is a real problem with transparency and trying to do national budgeting.

So, again, I will point out that process is no substitute for courageous choices. We can sit here and talk about the need to reform entitlements and the need for commissions, and all of those things are very true. But what we really have to do is make some tough choices on what taxes we will increase and what spending we will cut. And there is no way about getting around those choices no matter what. But as soon as we have Congress and the President willing to make those changes and those tough choices, budget rules will be instrumental in enforcing the kinds of agreements that we come up to as a country, helping keep us on track once we put ourselves on that track.

Thank you again for holding the hearing today. If we have time for questions, I look forward to that.

Senator COBURN. Thank you. I am going to include you all in our dinner because we have really got some good ideas here. This automatic CR is something that takes the pressure off and it also controls spending. Nobody has ever done a study to see how much money that is saved by not being able to come to an agreement on appropriations. I am sure it is billions of dollars because we did CRs.

We will submit some questions to you. I am probably going to miss this next vote because everybody else is gone to it. I want to thank you. I apologize for the delay, and I want to thank you for your prepared testimony as well as your words here today, and I look forward to an off-the-record get-together.

Ms. MACGUINEAS. I look forward to the dinner. Thank you.

Mr. EDWARDS. Thank you.

Senator COBURN. We are adjourned.

[Whereupon, at 4 p.m., the Subcommittee was adjourned.]

APPENDIX

United States Government Accountability Office

GAO

Testimony

Before the Subcommittee on Federal Financial Management, Government Information, and International Security, Committee on Homeland Security and Governmental Affairs, U.S. Senate

For Release on Delivery
Expected at 2:30 p.m. EDT
Thursday, May 25, 2006

BUDGET PROCESS

Better Transparency, Controls, Triggers, and Default Mechanisms Would Help to Address Our Large and Growing Long-term Fiscal Challenge

Statement of David M. Walker
Comptroller General of the United States

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Accountability * Integrity * Reliability

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Highlights

Highlights of GAO-06-761T, a testimony before the Subcommittee on Federal Financial Management, Government Information, and International Security, Committee on Homeland Security and Governmental Affairs, U.S. Senate

May 25, 2006

BUDGET PROCESS

Better Transparency, Controls, Triggers, and Default Mechanisms Would Help to Address Our Large and Growing Long-term Fiscal Challenge

Why GAO Did This Study

The nation's long-term fiscal outlook is daunting. While the budget process has not caused the problems we face, the absence of meaningful budget controls and other mechanisms has served to compound our fiscal challenge. Conversely, a process that illuminates the looming fiscal pressures and provides appropriate incentives can at least help decision makers focus on the right questions. Meaningful budget controls and other mechanisms can also help to assure that difficult but necessary choices are made.

The budget process needs to provide incentives and signals to address commitments the government has already made and better transparency for and controls on the long-term fiscal exposures being considered. Improvements would include the restoration of realistic discretionary caps; application of pay-as-you-go (PAYGO) discipline to both mandatory spending and revenue legislation; the use of "triggers" for some mandatory programs; and better reporting of fiscal exposures.

www.gao.gov/cgi-bin/getrpt?GAO-06-761T.

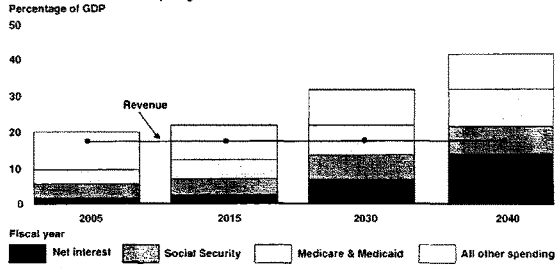
To view the full product, including the scope and methodology, click on the link above. For more information, contact Susan J. Irving at (202) 512-9142 or irvings@gao.gov.

What GAO Found

Over the long term we face a large and growing structural deficit due primarily to known demographic trends and rising health care costs. Continuing on this imprudent and unsustainable fiscal path will gradually erode, if not suddenly damage, our economy, our standard of living, and ultimately our national security. Our current path will also increasingly constrain our ability to address emerging and unexpected budgetary needs and increase the burdens that will be faced by our children, grandchildren, and future generations.

The budget process itself cannot solve this problem, but it can help policymakers make tough but necessary choices. If citizens and government officials come to better understand various fiscal exposures and their implications for the future, they are more likely to insist on prudent policy choices today and sensible levels of fiscal risk in the future.

Composition of Spending as a Share of GDP Assuming Discretionary Spending Grows with GDP after 2006 and All Expiring Tax Provisions Are Extended



Source: GAO's May 2006 analysis.

Note: This includes certain tax provisions that expired at the end of 2005, such as the increased alternative minimum tax exemption amount.

We cannot grow our way out of our long-term fiscal challenge. We must make tough choices and the sooner the better. A multi-pronged approach is needed: (1) revise existing budget processes and financial reporting requirements, (2) restructure existing entitlement programs, (3) reexamine the base of discretionary and other spending, and (4) review and revise tax policy and enforcement programs—including tax expenditures. Everything must be on the table and a credible and effective Entitlement and Tax Reform Commission may be necessary. Fundamentally we need a top-to-bottom review of government activities to ensure their relevance and fit for the 21st century and their relative priority.

Mr. Chairman, Senator Carper, and Members of the Subcommittee:

I appreciate the opportunity to speak with you today about a budget process that can help Congress deal with the large and growing fiscal challenges facing our nation. As you know, I have been vocal about our long-term fiscal imbalance and the need to make difficult but necessary choices soon so that we do not burden our children and grandchildren with a crushing debt. While the budget process has not caused the problems we face, the absence of meaningful budget controls and other mechanisms has served to compound our fiscal challenge. Conversely, a process that illuminates the looming fiscal pressures and provides appropriate incentives, transparency and control mechanisms can help decision makers to slow the bleeding and put us on a more prudent and sustainable long-range fiscal path.

When updating the budget process, you face a two-pronged challenge:

- the need to reinstitute and strengthen controls to deal with both near-term and longer-term deficits and
- the need to design a process that helps Congress tackle our large and growing long-term fiscal challenges facing this nation by, among other things, improving the transparency of the long-term costs of current decisions.

Today I want to focus on the long-term budget challenge and what role the budget process can play in helping to deal with it. Since at its heart the budget debate is about the allocation of limited resources, the budget process can and should play a key role in helping to address our broader challenge of modernizing government for the 21st century.

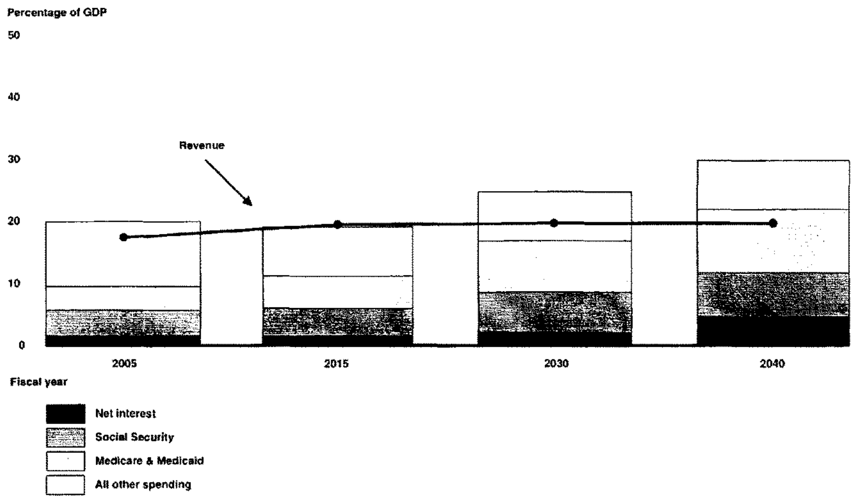
The Long-term Fiscal Challenge

The nation's long-term fiscal outlook is daunting under any realistic policy scenarios and assumptions. For over 14 years, GAO has periodically prepared various long-term budget simulations that seek to illustrate the likely fiscal consequences of our coming demographic challenges and rising health care costs. Indeed, the health care area is especially important because the long-term fiscal challenge is largely a health care challenge. While Social Security is important because of its size, health care spending is both large and projected to grow much more rapidly.

Our most recent simulation results illustrate the importance of health care in the long-term fiscal outlook as well as the imperative to take action soon. These simulations show that over the long term we face large and growing structural deficits due primarily to known demographic trends and rising health care costs. These trends are compounded by the presence of near-term deficits arising from new discretionary and mandatory spending as well as lower federal revenues as a percentage of the economy. Continuing on this imprudent and unsustainable fiscal path will gradually erode, if not suddenly damage, our economy, our standard of living, and ultimately our national security. Our current path will also increasingly constrain our ability to address emerging and unexpected budgetary needs and increase the burdens that will be faced by our children, grandchildren, and future generations of Americans.

Figures 1 and 2 present our long-term simulations under two different sets of assumptions. For both simulations, Social Security and Medicare spending is based on the 2006 Trustees' intermediate projections, and we assume that benefits continue to be paid in full after the trust funds are exhausted, although current law does not provide for such. Medicaid spending is based on the Congressional Budget Office's (CBO) December 2005 long-term projections under its midrange assumptions. In figure 1, we start with CBO's 10-year baseline, constructed according to the statutory requirements for that baseline. Consistent with these specific yet unrealistic requirements, discretionary spending is assumed to grow with inflation for the first 10 years and tax cuts scheduled to expire are assumed to expire. After 2016, discretionary spending and revenue are held constant as a share of gross domestic product (GDP) at the 2016 level. Under this fiscally restrained scenario, spending for Social Security and health care programs would grow to consume over three-quarters of federal revenues by 2040.

Figure 1: Composition of Spending as a Share of GDP under Baseline Extended

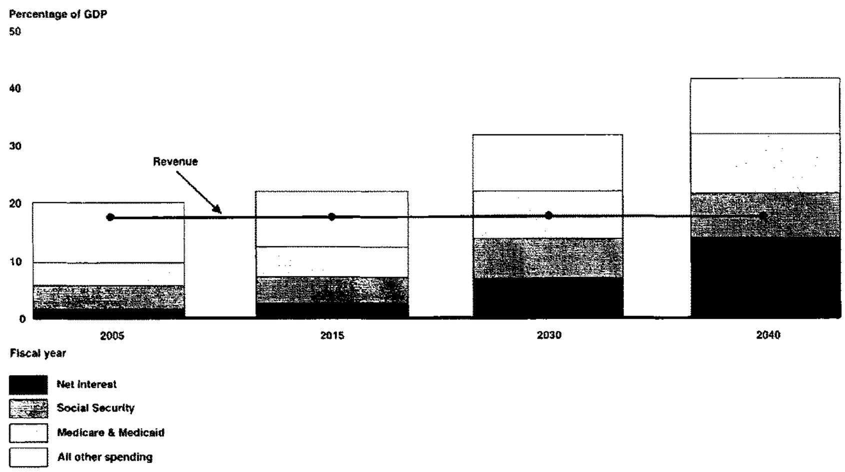


Source: GAO's May 2006 analysis.

Note: Importantly, this simulation does not include the "Tax Increase Prevention and Reconciliation Act of 2005" (P.L. 109-222) enacted on May 17, 2006. Under this scenario, in addition to the expiration of tax cuts, revenue as a share of GDP increases through 2016 due to (1) real bracket creep, (2) more taxpayers becoming subject to the alternative minimum tax (AMT), and (3) increased revenue from tax-deferred retirement accounts. After 2016, revenue as a share of GDP is held constant.

In figure 2, two assumptions are changed: (1) discretionary spending is assumed to grow with the economy after 2006 rather than merely with inflation, and (2) all expiring tax provisions are extended. In this less restrained but possibly more realistic scenario, federal revenues will cover little more than interest on the large and growing federal debt by 2040.

Figure 2: Composition of Spending as a Share of GDP Assuming Discretionary Spending Grows with GDP after 2006 and All Expiring Tax Provisions Are Extended



Source: GAO's May 2006 analysis.

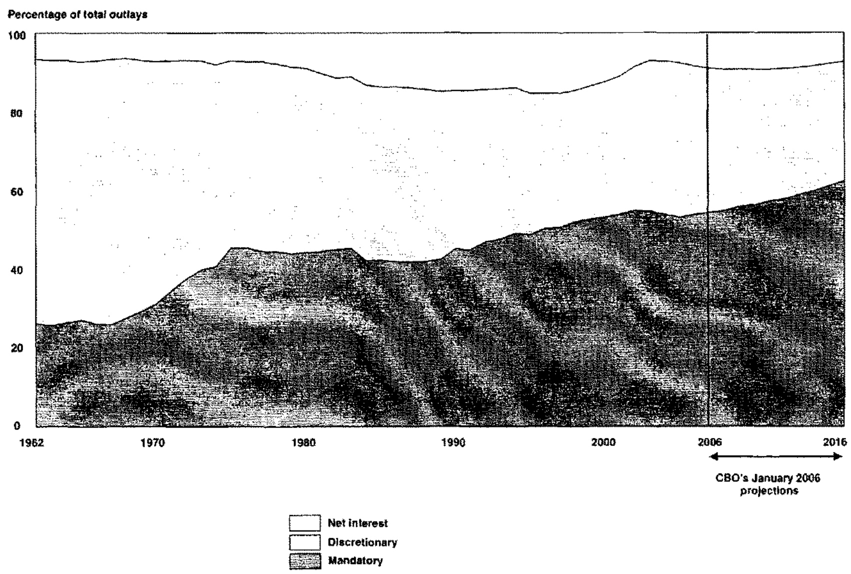
Note: This includes certain tax provisions that expired at the end of 2005, such as the increased AMT exemption amount.

While many alternative scenarios could be developed incorporating different combinations of possible policy choices and economic assumptions, these two scenarios can be viewed as possible "bookends" to a range of possible outcomes.

Budget flexibility—the ability to respond to unforeseen events—is key to being able to successfully deal with the nation's and the world's uncertainties. By their very nature, mandatory spending programs—entitlement programs like Medicare and Social Security—limit budget flexibility.[1] They are governed by eligibility rules and benefit formulas, which means that funds are spent as required to provide benefits to those who are eligible and wish to participate. As figure 3 shows, mandatory spending has grown as a share of the total federal budget. For example, mandatory spending on programs (i.e., mandatory spending excluding interest) has grown from 27 percent in 1965—the year Medicare was created—to 42 percent in 1985 to 53 percent last year. (Total spending not subject to annual appropriations—mandatory spending and net interest—has grown from 34 percent in 1965 to 61 percent last year.) Under both the CBO baseline estimates and the President's Budget, this spending would grow even further.

[1]Similarly, tax expenditures—subsidies provided through the tax system—may limit flexibility on the revenue side; there is a trade-off between tax rates and revenue lost through tax expenditures. In order to raise a given amount of federal revenue, tax rates must be raised higher than they otherwise need to be due to revenue losses from tax expenditures.

Figure 3: Federal Spending for Mandatory and Discretionary Programs

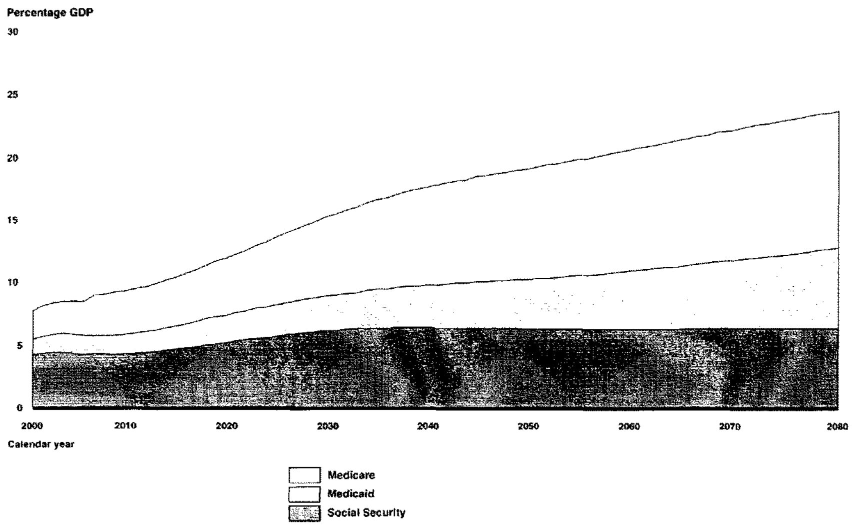


Sources: The Office of Management and Budget and CBO.

Figure 3 illustrates that while it is important to control discretionary spending, the real challenge is mandatory spending. Accordingly, substantive reform of the major health programs and Social Security is critical to recapturing our future fiscal flexibility.

The aging population and rising health care costs will have significant implications not only for the budget but also our economy and competitive posture. Figure 4 shows the total future draw on the economy represented by Social Security, Medicare, and Medicaid. Under the 2006 Trustees' intermediate estimates and CBO's 2005 midrange and long-term Medicaid estimates, spending for these entitlement programs combined will grow to over 15 percent of GDP in 2030 from today's 8.9 percent. It is clear that taken together, Social Security, Medicare, and Medicaid represent an unsustainable burden on the federal budget and future generations. Ultimately, the nation will have to decide what level of federal benefits and spending it wants and how it will pay for these benefits.

Figure 4: Social Security, Medicare, and Medicaid Spending as a Percentage of GDP



Sources: GAO analysis based on data from the Office of the Chief Actuary, Social Security Administration; Office of the Actuary, Centers for Medicare and Medicaid Services; and the Congressional Budget Office.

Note: Social Security and Medicare projections are based on the intermediate assumptions of the 2006 Trustees' reports. Medicaid projections are based on CBO's January 2006 short-term Medicaid estimates and CBO's December 2005 long-term Medicaid projections under midrange assumptions.

While Social Security, Medicare, and Medicaid are the major drivers of the long-term spending outlook in the aggregate, they are not the only promises the federal government has made for the future.[2] The federal government undertakes a wide range of responsibilities, programs, and activities that may either obligate the government to future spending or create an expectation for such spending. Specific fiscal exposures vary widely as to source, likelihood of occurrence, magnitude, and strength of the government's legal obligations. If we think of fiscal exposures as extending from explicit liabilities (like military and civilian pensions) to specific contingencies (like pension, flood, and other federal insurance programs) to the commitments implicit in current policy and/or public expectations (like the gap between the present value of future promised and funded Social Security and Medicare benefits), the federal government's fiscal exposures totaled more than $46 trillion at the end of 2005, up from about $20 trillion in 2000. This translates into a burden of about $156,000 per American, or approximately $375,000 per full-time worker—more than double what it was in 2000. These amounts are growing every second of every minute of every day due to continuing deficits, known demographic trends and compounding interest costs.

What Can Be Done?

Many are beginning to realize that difficult choices must be made, and soon. A crucial first step in acting to improve our long-term fiscal outlook will be to face facts and identify the many significant commitments already facing the federal government. If citizens and government officials come to better understand our nation's various fiscal exposures and their implications for the future, they are more likely to insist on prudent policy choices today and sensible levels of fiscal risk in the future.

How do we get started? Today you are focusing on budget process improvements. That's a good start. While the process itself cannot solve the problem, it is important. It can help policymakers make tough but necessary choices today rather than defer them until tomorrow. Restoration of meaningful budget controls—budgetary caps and a pay-as-you-go (PAYGO) rule on both the tax and spending side of the ledger—is a start toward requiring that necessary trade-offs be made rather than delayed. Although the restoration of caps and a PAYGO rule are important, they are not enough. Among the characteristics a budget process needs for that to happen are

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

- increased transparency and better incentives, signals, triggers and default mechanisms to address the fiscal exposures/commitments the federal government has already made and
- better transparency for and controls over the long-term fiscal exposures/commitments that the federal government is considering.

Let me elaborate.

Better Incentives and Signals

There is broad consensus among observers and analysts who focus on the budget that the controls contained in the expired Budget Enforcement Act constrained spending for much of the 1990s. In fact, annual discretionary budget authority actually declined in real terms during the mid-1990s. I endorse the restoration of realistic discretionary caps and PAYGO discipline applied to both mandatory spending and revenue legislation. But the caps can only work if they are realistic; while caps may be seen as tighter than some would like, they are not likely to bind if they are seen as totally unreasonable given current conditions. While PAYGO discipline constrained the creation or legislative expansion of mandatory spending and tax cuts, it accepted the existing provisions of law as given. Looking ahead, the budget process will need to go beyond limiting expansions. Cost increases in existing mandatory programs cannot be ignored and the base of existing spending and tax programs must be reviewed and re-engineered to address our long-range fiscal gap.

Specifically, as I have said before, I would like to see a process that forces examination of "the base" of the federal government—for major entitlements, for other mandatory spending, and for so-called "discretionary" spending (those activities funded through the appropriations process).

Reexamining "the base" is something that should be done periodically regardless of fiscal condition—all of us have a stewardship obligation over taxpayer funds. As I have said before, we have programs still in existence today that were designed 20 or more years ago—and the world has changed. I would suggest that as constraints on discretionary spending continue to tighten, the need to reexamine existing programs and activities becomes greater. One of the questions this Congress is grappling with—earmarks—can be seen in this context. Whatever the agreed-upon level for discretionary spending, the allocation within that total will be important. How should that allocation be determined? What sort of rules will you want to impose on both the allocation across major areas (defense, education, etc.) and within those areas? By definition, earmarks specify how some funds will be used. How will the process manage them? After all, not all earmarks are bad but many are highly questionable. It is not surprising that in times of tight resources, the tension between earmarks and flexibility will likely rise.

Although mandatory spending is not amenable to caps, such spending need not—and should not—be permitted to be on autopilot and grow to an unlimited extent. Since the spending for any given entitlement or other mandatory program is a function of the interaction between eligibility rules and the benefit formula—either or both of which may incorporate exogenous factors such as economic downturns—the way to change the path of spending for any of these programs is to change their rules or formulas. We recently issued a report on "triggers"—some measure that when reached or exceeded, would prompt a response connected to that program.[3] By identifying significant increases in the spending path of a mandatory program relatively early and acting to constrain it, Congress may avert much larger and potentially disruptive financial challenges and program changes in the future.

A trigger is a measure and a signal mechanism—like an alarm clock. It could trigger a "soft" response—one that calls attention to the growth rate of the level of spending and prompts special consideration when the threshold or target is breached. The Medicare program already contains a "soft" response trigger: the President is required to submit a proposal for action to Congress if the Medicare Trustees determine in 2 consecutive years that the general revenue share of Medicare spending is projected to exceed 45 percent during a 7-fiscal-year period.[4] The most recent Trustees' report to Congress for the first time found that the general revenue share of financing is projected to exceed that threshold in 2012.[5] Thus, if next

[3]GAO, *Mandatory Spending: Using Budget Triggers to Constrain Growth*, GAO-06-276 (Washington, D.C.: Jan. 31, 2006).

[4]For the purpose of the Medicare trigger, general revenue Medicare funding is defined as the difference between Medicare program outlays and dedicated Medicare financing sources. Dedicated Medicare financing sources are defined as Hospital Insurance (HI) payroll taxes; the HI share of income taxes on Social Security benefits; state transfers for Part D prescription drug benefits; premiums paid under Parts A, B, and D; and any gifts received by the trust funds.

[5]The Boards of Trustees, Federal Hospital Insurance and Federal Supplementary Insurance Trust Funds, *The 2006 Annual Report of the Boards of Trustees of the Federal Hospital Insurance and Federal Supplementary Medical Insurance Trust Funds* (Washington, D.C.: May 2006), 27.

year's report again concludes that it will exceed the threshold during the 7-fiscal-year period, the trigger will have been tripped and the President will be required to submit his proposal for action.

Soft responses can help in alerting decision makers of potential problems, but they do not ensure that action to decrease spending or increase revenue is taken. In contrast, a trigger could lead to "hard" responses under which a predetermined, program-specific action would take place, such as changes in eligibility criteria and benefit formulas, automatic revenue increases, or automatic spending cuts. With hard responses, spending is automatically constrained, revenue is automatically increased, or both, unless Congress takes action to override—the default is the constraining action. For example, this year the President's Budget proposes to change the Medicare trigger from solely "soft" to providing a "hard" (automatic) response if Congress fails to enact the President's proposal.[6]

Any discussion to create triggered responses and their design must recognize that unlike controls on discretionary spending, there is some tension between the idea of triggers and the nature of entitlement and other mandatory spending programs. These programs—as with tax provisions such as tax expenditures—were designed to provide benefits based on eligibility formulas or actions as opposed to an annual decision regarding spending. This tension makes it more challenging to constrain costs and to design both triggers and appropriate responses. At the same time, with less than 40 percent of the budget under the control of the annual appropriations process, considering ways to increase transparency, oversight, and control of mandatory programs must be part of addressing the nation's long-term fiscal challenges.

[6]The response would include a sequester if Congress did not act on the President's proposal. The proposed sequester would result in a four-tenths of a percent reduction in all payments to providers beginning in the year the threshold is exceeded. Each year the shortfall continues to occur the reduction would grow by an additional four-tenths of a percent. We have not yet analyzed how this would work.

Increased Transparency and Disclosure of Long-term Costs

Besides triggers, transparency of existing commitments would be improved by requiring the Office of Management and Budget (OMB) to report annually on fiscal exposures—the more than $46 trillion figure[7] I mentioned earlier—including a concise list, description, and cost estimates, where possible. OMB should also ensure that agencies focus on improving cost estimates for fiscal exposures. This should complement and support continued and improved reporting of long-range projections and analysis of the budget as a whole to assess fiscal sustainability and flexibility.

Others have embraced this idea for better reporting of fiscal exposures. Senator Voinovich has proposed that the President report each January on the fiscal exposures of the federal government and their implications for the long-term financial health and Senator Lieberman introduced legislation to require better information on liabilities and commitments. This year Representatives Cooper, Chocola, and Kirk have sponsored legislation also aimed at improving the attention paid to our growing federal commitments. And, in his last few budgets the President has proposed that reports be required for any proposals that would worsen the unfunded obligations of major entitlement programs. These proposals provide a good starting point for discussion. Reporting is a critical first step—but, as I noted above, it must cover not only new proposals but also existing commitments, and it should be accompanied by some incentives and controls. We need both better information on existing commitments and promises and information on the long-term costs of any new significant proposed spending increases or tax cut. Ten-year budget projections have been available to decision makers for many years. We must build on that regime but also incorporate longer-term estimates of net present value (NPV) costs for major spending and tax commitments comprising longer-term exposures for the federal budget beyond the 10-year window. Current budget reporting does not always fully capture or require explicit consideration of some fiscal exposures. For example, when Medicare Part D was being debated, much of the debate focused on the 10-year cost estimate—not on the long-term commitment that was obviously much greater. While the budget was not designed to and does not provide complete information on long-term cost implications stemming from some of the government's commitments when they are made, progress can and should be made on this front. For example, we should require NPV estimates for major proposals—whether on the tax

[7] This figure is as of the end of 2005—it will be higher at the end of this year.

side or the spending side—whose costs escalate outside the 10-year window. And these estimates should be disclosed and debated before the proposal is voted on.

Regarding tax provisions, it is important to recognize that tax policies and programs financing the federal budget can be reviewed not only with an eye toward the overall level of revenue provided to fund federal operations and commitments, but also the mix of taxes and the extent to which the tax code is used to promote overall economic growth and broad-based societal objectives. In practice, some tax expenditures are very similar to mandatory spending programs even though they are not subject to the appropriations process or selected budget control mechanisms. Tax expenditures represent a significant commitment and are not typically subject to review or reexamination. This should not be allowed to continue nor should they continue to be largely in the dark and on autopilot.

Finally, the growing use of emergency supplemental appropriations raises concerns that an increasing portion of federal spending is exempt from the discipline and trade-offs of the regular budget process.[8] Some have expressed concern that these "emergency" supplementals are not always used just to meet the needs of unforeseen emergencies but also include funding for activities that could be covered in regular appropriation acts. According to a recent Congressional Research Service report, after the expiration of discretionary limits and PAYGO requirements at the end of fiscal year 2002, supplemental appropriations net of rescissions increased the budget deficit by almost 25 percent per year.[9] On average, the use of supplemental appropriations for all purposes has grown almost 60 percent each year, increasing from about $17 billion in fiscal year 2000 to about $160 billion in fiscal year 2005. Constraining emergency appropriations to those which are necessary (not merely useful or beneficial), sudden, urgent, unforeseen, and not permanent has been proposed in the past. The issue of what constitutes an emergency needs to be resolved and discipline exerted so that all appropriations for activities that are not true emergencies are considered during regular budget deliberations.

[8] While most budget enforcement mechanisms expired in fiscal year 2002, Congress generally includes overall limits on discretionary spending and PAYGO points of order in its budget resolution to manage its internal budget process.

[9] Congressional Research Service, *Supplemental Appropriations: Trends and Budgetary Impacts Since 1981* (Washington, D.C.: Nov. 2, 2005).

Concluding Observations

We cannot grow our way out of our long-term fiscal challenge. We have to make tough choices and the sooner the better. A multi-pronged approach is necessary: (1) revise existing budget processes and financial reporting requirements, (2) restructure existing entitlement programs, (3) reexamine the base of discretionary and other spending, and (4) review and revise tax policy and enforcement programs. Everything must be on the table. Fundamentally, we need to undertake a top-to-bottom review of government activities to ensure their relevance and fit for the 21st century and their relative priority. Our report entitled *21st Century Challenges: Reexamining the Base of the Federal Government*[10] presents illustrative questions for policymakers to consider as they carry out their responsibilities. These questions look across major areas of the budget and federal operations, including discretionary and mandatory spending and tax policies and programs. We hope that this report, among other things, will be used by various congressional committees as they consider which areas of government need particular attention and reconsideration.

The understanding and support of the American people will be critical in providing a foundation for action. The fiscal risks I have discussed, however, are a long-term problem whose full impact will not likely be felt for some time. At the same time, they are very real and time is currently working against us. The difficult but necessary choices we face will be facilitated if the public has the facts and comes to support serious and sustained action to address the nation's fiscal challenges. That is why if an Entitlement and Tax Reform Commission is created to develop proposals to tackle our long-term fiscal imbalance, its charter may have to include educating the public as to the nature of the problem and the realistic solutions. While public education may be part of a Commission's charge, we cannot wait for it to begin. As you may know, the Concord Coalition is leading a public education effort on this issue and I have been a regular participant. Although along with Concord the core group is the Heritage Foundation, the Brookings Institution, and the Committee for Economic Development, others are also actively supporting and participating in the effort—the state treasurers, auditors and comptrollers, the American Institute of Certified Public Accountants, AARP, and the National Academy of Public Administration. I am pleased to take part in this national education and outreach effort to help the public understand the nature and magnitude of the long-term financial challenge facing this

[10]GAO, *21st Century Challenges: Reexamining the Base of the Federal Government,* GAO-05-325SP (Washington, D.C.: February 2005).

nation. This is important because while process reform can structure choices and help, broad understanding of the problem is also essential. After all, from a practical standpoint, the public needs to understand the nature and extent of our fiscal challenge before their elected representatives are likely to act.

Thank you, Mr. Chairman. This concludes my prepared remarks. I would be happy to answer any questions you may have.

Contacts and Acknowledgments

Contact points for our Offices of Congressional Relations and Public Affairs may be found on the last page of this testimony. For further information on this testimony, please contact Susan J. Irving at (202) 512-9142 or irvings@gao.gov. Individuals making key contributions to this testimony include Christine Bonham, Assistant Director; Carlos Diz, Assistant General Counsel; and Melissa Wolf, Senior Analyst.

Prepared Statement
of
James C. Miller III
before the
Subcommittee on Federal Financial Management,
Government Information, and International Security
of the
Committee on Homeland Security and Governmental Affairs
of the
United States Senate
May 25, 2006

Mr. Chairman and other Members of the Committee: thank you for inviting me to discuss Congress' role and the effectiveness of the federal budget process.

The budget process is clearly dysfunctional. Budget resolutions are passed late and have diminishing relevance. Appropriations burgeon beyond reason, partly because they are larded with earmarks. Entitlements grow, raise unrealistic expectations on the part of beneficiaries, and place impossible demands on future generations – leading to inevitable intergenerational conflict. In the name of "tax reform" the tax code grows longer and IRS interpretations expand exponentially. Few Members of Congress have any idea of the depth and breadth of special-interest provisions in the budget legislation on which they vote. Some of those who do are under investigation for influence-peddling.

The solution is not better people, but better institutional arrangements. If you design a system that is biased toward growing government, making the tax code more complicated, and approving benefits with little care for how they will be financed, that's what you will get -- no matter how angelic are those serving in public office.

There is discipline known as "public choice" – for which economist James M. Buchanan of George Mason University won a Nobel Prize in 1986 for helping to develop. This discipline addresses collective decisionmaking and how efficiently institutions such as Congress allocate resources – in the same way as economists have addressed private decisionmaking in the context of market exchanges. One conclusion of the public choice researchers is that the collective decisionmaking body known as the U.S. Congress tends to grow the federal government beyond the size the American people think appropriate and to tax them more than is acceptable. An ancillary conclusion is that Congress tends to channel Americans' resources into projects that are not the highest priorities and that Congress pays for them with an inefficient and inequitable combination of taxes and debt.

The public choice experts' analysis of the causes of these outcomes is that the institutional arrangements under which Members of Congress operate is far more at fault than the philosophical, ideological, or political preferences of the people elected. This point cannot be overemphasized: it is the *system* that is at fault, and only by reforming the *system* will you solve the problem.

Let me illustrate with two examples. During the 1960s and 1970s a debate raged among economists and political scientists about the causes of the miserable performance of the federal government's economic regulatory agencies – the ICC, the FMC, the CAB, and so forth. On the one side were those espousing the "good man hypothesis." Their notion was that if only Presidents would appoint good men and women and the Senate would confirm them, these agencies would turn around completely. On the other side were those who said the basic regulatory institutions were at fault – indeed, certain agencies did not need to exist. After endless arguments and trying out the good man theory with a notable lack of success, Congress and the President finally ended the debate by abolishing certain agencies. To all who have followed these matters, it is clear that what was wrong was the institutions, not the people appointed to run them. For these people – including the really good ones – were destined to respond to the incentives incorporated in their positions and to follow what the laws required. Given a bad institutional arrangement, you will get bad results.

Closer to home: in 1994, voters elected a Republican House and a Republican Senate. Many of those concerned about the overreaching of the federal government felt that surely the size of government would be checked, priorities would be followed, and the tax code would become less burdensome and more efficient. This hope was stimulated by the election of a Republican president in 2000. Now it must be noted that these party reversals wrought important changes in government behavior. At first the growth of government was curtailed and the deficit was eliminated. Progress was made in reforming counter-productive entitlement programs such as welfare and lowering marginal tax rates. But over time, there has been significant recidivism. Despite a Republican-dominant, conservative-dominant cast of decisionmakers, federal spending in the past half-decade has exploded. So have entitlements. And the tax code is not simpler, it is more complicated and even more wasteful. In short, Republicans are acting like the characteratures of the Democrats they attacked in their campaigns.

Is there no difference between Democrats and Republicans when it comes to budgeting? Between responsible and irresponsible Members? Between idealogues and pragmatists? The data would suggest there is little difference. As long as you have institutional arrangements that are biased toward larger government, you will get larger government. As long as you have institutional arrangements that encourage Members to make the tax code more complicated and larded with exemptions and other special-interest provisions, you will get a more complicated, inefficient, and inequitable tax code. As long as you have institutional arrangements that encourage Members to vote for benefits today and "forget the costs – that's tomorrow's problem," you will get burgeoning entitlement spending. As long as you have institutional arrangements that give incumbents a leg up on challengers when they put pork in appropriations, you will get more earmarks. And as long as you have institutional arrangements that give individual Members extraordinary power to determine the allocation of spending largess, some will succumb to temptation and go astray.

Oratory and the election cycle will not suffice to solve the problem. To solve the problem you must change the institutional arrangements.

Since leaving the Office of Management and Budget in 1988, I have written about the need for reform of the budget institutions.[1] I have noted the importance of the 1974 budget act, which established the budget resolution whereby Congress as a whole has to approve both the overall levels of appropriations, entitlements, and tax revenue and the major dimensions of these elements. I also noted the importance of the Gramm-Rudman-Hollings Act, which cut spending automatically unless certain reduced deficit goals were met. The problem with these worthy reforms is that in the case of the budget resolution, it is honored in the breach; in the case of Gramm-Rudman-Hollings, Congress got cold feet and revised its targets.

To restore the integrity of the budget resolution, you need to make it a joint resolution rather than an concurrent resolution. That would mean the President would be signing on to these overall limits as well as Congress. And, you should include penalties for failure to conclude this instrument on time – such as withholding salaries of Members of Congress and senior members of the Administration until this is done. And why not promulgate a revised Gramm-Rudman-Hollings deficit-reduction schedule, putting at risk spending on non-essential programs?

Give the President a line-item veto. I realize that the Supreme Court has held that the version enacted during President Clinton's tenure is unconstitutional. But you could easily make a line-item veto device constitutional simply by enrolling each and every item appropriated as a separate bill. Moreover, the President himself could "line-item veto" the vast majority of earmarks – those which are specified in the report language accompanying the appropriations bills and not in the legislation itself. Since such earmarks do not meet the presentment clause of the Constitution, they are not law. The President would have to spend the money on the account for which it was appropriated, but not on the earmarked projects. You should also give the President the "enhanced rescission" he has asked for under the name, "legislative line item

[1] See, for example, James C. Miller III, Fix the U.S. Budget!: Urgings of an "Abominable No-Man" (Stanford: Hoover Institution Press, 1994).

veto." As you know, rescissions – Presidential proposals to "de-appropriate" spending -- tend to be ignored on Capitol Hill; at least give them an up-or-down vote.

You should sunset entitlement programs. That would at least force a thoroughgoing review of them periodically. You should also insist on full funding of sensitive programs – list those that would not be eligible for "emergency appropriations." Each year, appropriators play the game of underfunding certain sensitive programs – in order to fund those of lower priority – and then count on an "emergency supplemental" to make the programs whole. "Emergency appropriations" should be precisely that: funding for unforeseeable emergencies.

You should eliminate "budget speak" and communicate straightforwardly with the American people. Only in Washington can an increase in spending less than what was expected or desired be characterized as a "cut." Most Americans think that only if you spend less this year than last year has there been a cut. Because of the way it is abused, I would suggest doing away with the concept of "current services."

End the practice of converting appropriations into entitlements. For appropriators that is a very effective way of getting around limits imposed by the budget resolution, but it amounts to a shell game. As you know, appropriated spending is a shrinking part of total spending.

You need to establish a regulatory budget. That is, just as in the case of the financial budget, where the President outlines his or her spending priorities and Congress responds, the President should be required to itemize, by agency and by program, the regulatory costs to be imposed on the economy during the fiscal year. Congress and the President should then "appropriate" regulatory costs, and the agencies should be required to live within these limits.

The biases in the budget process are to a large extent the result of Members' interests in being reelected.[2] Earmarks help with fundraising and with drawing attention to Members' effectiveness in representing their districts or states. Special-interest appropriations or tax concessions work to enhance Members' support among concentrated constituencies, while those who ultimately will pay for such largess remain ignorant of their new liabilities.

I regret that these musings may be taken by some Members of Congress as being overly critical or even disrespectful. That is not my intent. Indeed, it is my plea that you view this matter not as the failure of character on the part of any or all Member(s) of Congress, but rather as a failure of institutional arrangements. And only by changing the institutional arrangements will you solve the problem this hearing is meant to address.

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[2] See, for example, James C. Miller III, Monopoly Politics (Stanford: Hoover Institution Press, 1999).

Testimony before the Senate Federal Financial Management Subcommittee. May 25, 2006

By Timothy J. Penny, Senior Fellow, University of Minnesota Humphrey Institute

In Congress, the budget process does matter. Past budget reforms have often curtailed spending.

In the 1980s, Gramm-Rudman-Hollings stipulated that Congress must meet certain deficit targets – or automatic cuts would ensue. During the early years of its implementation, deficits fell routinely. Congress essentially gave itself no option except to make the tough decisions or face across the board cuts.

The 1990 Budget Enforcement Act (amended and extended in 1993 and 1997) required a "pay go" approach to tax and entitlement policy. Simply put, "pay go" stipulated that any increase in entitlement spending or decrease in taxes would be deficit neutral. In other words, these costs would be off-set by a corresponding decrease in spending or a revenue increase. In addition, the Budget Enforcement Act required spending in various categories to stay within specific spending levels or caps. It was adjusted - and through an emergency-spending loophole – it was sometimes violated – but, still, spending restraint was the norm for most of the decade of the 1990s.

The Budget Enforcement Act also established a sixty percent majority vote in the Senate before unrelated items could be included in tax or entitlement legislation.

As I stated earlier, budget process matters. Sadly, today, there is no budget discipline in Washington. The Budget Enforcement Act was allowed to lapse, and in the years since its demise, deficits have grown, entitlements have expanded, emergency spending has mushroomed, and porkbarrel spending has grown like topsy.

The first rule of filling holes is to stop digging. However, many politicians in Washington can't seem to put down their shovels.

To fix our broken budgeting system, let's start with the easy stuff: porkbarrel spending. In short, if Congress can not develop the will to eliminate "pork," there is little likelihood that Congress will muster the courage to seriously reduce entitlement expenditures.

What is an "earmark" or "porkbarrel spending?" In short, it can be defined as an expenditure or project that is strictly local or parochial, rather than providing a regional or national benefit. These parochial spending items are typically hidden in the fine print of major spending bills dedicated to truly national needs.

These porkbarrel items are almost never the subject of a hearing in a congressional committee. They are seldom, if ever, subjected to a recorded vote in a committee or on the floor of the House or Senate. These items very often are not even included when legislation initially passes the House or Senate, but are instead added to the legislation during a conference committee.

Earmarks or porkbarrel spending – always a problem on Capitol Hill – are increasingly getting out of control. Congress is often thought of as a partisan institution. But when it comes to porkbarrel spending, bipartisanship is the norm.

For example, the 1998 Highway Bill was – at the time - a modern day monstrosity. It included nearly 1500 porkbarrel projects for Democrats and Republicans alike – totaling over $9 billion. It included more pork than in all the previous highway bills combined going back forty years. That was until the 2005 Highway bill which took porkbarrel spending to even greater heights.

Worse yet, emergency spending for natural disasters is not exempt from the politics of pork. In 1999, Clinton requested an emergency measure related to hurricane relief. In bipartisan fashion, Congress proceeded to lard the emergency bill with $12 billion in unrelated spending, including many porkbarrel projects. Today, the same ugly practice replays itself with the passage of each new emergency spending bill.

In Congress, the budget process does matter. The Budget Enforcement Act included the Byrd rule, named for the senior senator from West Virginia. It placed a point of order against extraneous matters being included in a reconciliation bill (affecting tax and entitlement policy) – unless a sixty percent majority of Senators agrees to allow the practice. The Byrd rule helped to keep reconciliation bills lean and clean. To stop pork, the same budget principle should be applied to all spending bills.

My second point: Any responsible budget process must anticipate the looming Medicare and Social Security crises.

Let's simply look at Social Security. When you hear some politicians and journalists say, "Social Security is fine. The Social Security trust fund will be able to pay all promised benefits until 2042," hold on to your wallet. The fact is that the Social Security Trust Fund contains no cash, just government bonds. When the Social Security payroll taxes coming in to Washington aren't enough to pay promised benefits to existing retirees – beginning in 2017—the Social Security Administration will begin cashing in those bonds.

Those trust fund bonds carry the "full faith and credit of the federal government," and are a first claim on general revenues. Congress will have to then decide whether to cut some existing government programs or increase income taxes.

But if Congress cut government programs to cover the Social Security shortfall, how much would have to be cut? The numbers are mind-boggling, but examples of possible program cuts may be a useful way to understand the magnitude of the problem.

In the first year of the Social Security cash deficit, the shortfall is relatively small, sixteen billion dollars. Using the cost of government programs in 2003, we'd have enough money to make up the shortfall if we eliminated the Environmental Protection Agency, the Head Start Program, and the Federal Drug Administration. The following year, 2019, the shortfall more than doubles. So, added to the first round of cuts, we'd have enough to pay Social Security benefits if Congress also eliminated the WIC nutritional program, the Centers for Disease Control, student loans, Food Safety and Inspections program, and the Small Business Administration. The third year, instead of raising taxes, Congress could make up the deficit by also cutting the entire department of the Interior, including all money for Fish and Wildlife Service, the National Parks and the Bureau of Indian Affairs. Three years later, added to these cuts could be the Food Stamp program and SSI. And on and on, each year. You get the picture.

No one in their right mind believes that Congress will cut the equivalent of these programs to make up the shortfall. Yet, whatever Congress does to meet this Social Security challenge – cut, tax or borrow - represents an unfair burden on our children.

That is why I believe we need an intergenerational PAYGO framework to help align the government's cash flows to demographic trends.

Eight years ago, when times were flush, there was bipartisan agreement to balance the operating budget of the federal government (and to use Social Security surpluses to retire publicly-held debt). Once the budget surpluses evaporated, however, so did that agreed-upon framework. This year policy makers seem unable to agree on any fiscal goals. Foreign policy and military challenges abroad, economic and other security worries at home, and upcoming mid-term elections that will determine next year's congressional majorities all pull in different directions. Consequently, the Congress has yet to adopt a budget resolution for next year.

Meanwhile the time draws closer when a significant increase in resources—public and private—will be needed to support an older population. Policy makers should begin to address the complex policy questions related to the aging of the population. They should consider the consequences the benefits promised by the Social Security, Medicare and Medicaid programs will have on the rest of government. But since they can't agree on priorities for next year, the Congress and the President seem unlikely to address longer term questions.

Current budget decisions matter to future taxpayers. Policy makers can't stop the population from aging. But they can acknowledge the possibility of longer-term fiscal problems and avoid short term actions—like another big tax cut or expensive benefits expansion—that could worsen future budget prospects.

One way legislators could acknowledge the relationship between immediate policy changes and their longer-term consequences would be set a goal of holding future taxpayers (who are our children and grandchildren) harmless. By asking themselves if contemplated changes to policy—when taken together—would make the longer term situation better or worse—the Congress and the President would bring an intergenerational framework to fiscal decision making.

An intergenerational framework would have to be qualitative because it is difficult to estimate accurately fiscal impacts far into the future. However, continued absence of intergenerational considerations allows annual budget deliberations to focus only on immediate concerns and ignore future taxpayers, who already face the greater burden of supporting a population that will be older than today's. The Congressional Budget Office should be asked to develop an Intergenerational Impact Statement to accompany every Budget resolution.

Testimony of Douglas Holtz-Eakin
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before

Committee on Homeland Security and Governmental Affairs
Subcommittee on Federal Financial Management,
Government Information and International Security
U.S. Senate
May 25, 2006

Chairman Coburn, Ranking Member Carper, and members of the committee, thank you for the privilege of appearing today to discuss the federal budget process. This is an important and timely hearing; your leadership in addressing improvements to the way budgeting is conducted by the federal government is to be commended.

Goals for the Budget Process

While there has been a fairly widespread discussion of the budget process, criticism of its failings and suggestions for changes I think it is useful to begin by stepping back a bit and asking the framing question: what should be the goals of the budget process? The answer, I think, is that the budget process should:

- Identify decisions that the Congress must make, and
- Serve to implement the choices that the Congress makes.

Notably missing from this list is both "force the Congress to make decisions" and "substitute for the absence of Congressional decisions." It is a source of understandable frustration to many that contemporary budget policy is devoid of much-needed strategies to slow the growth of mandatory spending for retiree income and health care, to take the most significant example. In these circumstances, it is tempting to impose a budget process that "solves" these problems.

But this is misguided. The budget process cannot be a substitute for policy choices by the Congress. Nor can it be expected to supplant the necessary elements of proposal, counterproposal, discussion, disagreement, and compromise that constitute the politics of policy decisions. Any such efforts to do so will be doomed to ultimately fail.

Desirable Characteristics of a Budget Process

To meet its objectives of identifying decisions and implementing choices, a budget process requires several characteristics. It should be:

- Comprehensive in scope,
- Focused on legislation and policy decisions,
- Accurate and balanced in its presentation, and
- Tied to the financial management system.

Comprehensive in scope. A first requirement of a budget process is that it covers the entire budgetary landscape. That is, there is no place for commitments that require taxpayer resources to be "off-budget" in any real sense. Equally importantly, the budget process should be comprehensive in a second sense – identifying all the decisions that need to be made.

Focused on legislation and policy decisions. A budget is the combination of intended expenditures along with proposals for financing them. However, because the goal is to support policy decisions, the budget process should be focused on policy decisions. One prominent recent budgetary process – the Gramm-Rudman-Hollings procedures – focused on the *outcomes* for spending and revenues, and was ultimately unsuccessful. In contrast, the subsequent focus on discretionary spending caps and PAYGO rules was focused on the legislative actions that Congress takes each year, a more desirable structure for a budget process.

Accurate and balanced in its presentation. Well-constructed budgetary presentations show accurately the fiscal implications of alternative choices. At the heart of such presentations is the ability to bring the lessons of sophisticated government cost-accounting to the projection of future outlays under a variety of scenarios. Similarly, the accumulated experience with alternative tax policies in the past should be the basis of constructing projections of future receipts.

Accurate projections, projections that ultimately encompass the direct budgetary impacts and the responses of the sub-federal governments and private sector into the estimates, have obvious value in presenting budgetary decisions. However, balance may be a more important attribute than accuracy – balance in the sense of treating all policy proposals in an identical fashion. Because the budget process must be comprehensive, it is essential that *all* choices be part of the analysis. In some circumstances, a novel proposal may present real difficulties in estimating the outlays or receipts. Choosing methods that can encompass all proposals – at the potential expense of accuracy in other areas – may ultimately serve the Congress better.

Tied to the financial management system. Ultimately, policy choices must be implemented by federal agencies. It is essential that the choices made by the Congress tie directly to the account structures, payment systems, procurement protocols and other aspects of the financial management system. In this way, the effectiveness of congressional control is enhanced. Moreover, when constructed in this fashion, accounting and audit information is directly amenable to analysis and improved estimates of budget proposals in the future.

Perceived Failures of the Current Budget Process

The current budget process is a source of broad dissatisfaction – some would even go so far as to declare it dead or broken. Placed in the context of the framework outlined above, a non-comprehensive list of complaints would include:

Lack of comprehensiveness. The current budget process does not yield comprehensive decision-making. Congress is widely perceived to undertake too little oversight of existing programs, missing the decision to terminate programs, eliminate duplication, or otherwise enhance the efficiency of operations.

Similarly, in recent years the increasing reliance on omnibus appropriations bills and frequency of supplemental appropriations legislation is rife with the potential for Congress to inadequately assess tradeoffs among alternatives – or fail to consider them at all.

And Congress may be missing the most important decision every year – the decision to allocate taxpayer resources to mandatory spending programs. In the years to come, the rising burden of mandatory spending is *the* central policy issue. At present, however, the budget process does not present Congress with any yearly decision regarding the scale of these programs.

Inaccurate and unbalanced presentations. The current budget process is rife with problems, beginning with the starting points: the congressional budgetary baseline prepared by the Congressional Budget Office (CBO) and the Administration's baseline prepared by the Office of Management and Budget (OMB). The former is prepared under the assumption that current law will be unchanged over the budget window, while the President's budget is presented under the assumption that all of the Administration's proposals are implemented. This, in itself, is a continuous source of confusion.

In principle, it should be possible to prepare both budgetary presentations under common assumptions. However, over time it has become progressively more difficult to do so as the budgetary concepts and assumptions have shifted.

The result is a system in which confusion easily arises about the size of budgetary objectives and the degree of success in reaching them. The decisions made by Congress ultimately fall to the Administration to execute. Thus, the two processes should integrate easily, which is made difficult by the fact that they operate off different starting points.

The current budget process is also riddled with "labeling games." Economically equivalent transfers to individuals are easily called either outlays or (refundable) tax credits. Flows of resources from the private sector to the government are labeled offsetting collections or offsetting receipts – negative spending – instead of revenues, even when there is no business-like transaction involved. Funds are labeled as "emergencies" even when widely anticipated, unrelated to the vagaries of natural disasters or war, or even responding to events in the relatively distant past.

The absence of effective enforcement procedures also leads to inaccurate presentations of tradeoffs. The fiction of an "advance appropriation" is meaningless in the absence of a genuine corresponding reduction the future of funds available to meet policy objectives. Similarly, the process of using fictional "mandatory spending reductions" in future years (which are quickly undone so as never to happen) to meet annual appropriations targets makes a mockery of a level budgetary playing field between either discretionary and mandatory spending or present and future outlays.

A final aspect of the current budget process is the increased use of sunsets and other techniques that take advantage of the 5-year budget window. Congress has long-employed sunsets to lower the apparent costs of provisions, so this aspect is not new. Instead, it has been employed with greater frequency in recent years. This has been most widely associated with tax legislation with the widespread assertion that Congress is mislead about the budgetary impacts. Given the attention paid, for example, to the 2003 tax legislation I find it difficult to believe that this is a large problem.

A more recent incarnation of this approach is somewhat more troubling. The budget resolution for FY2006 contained a point of order that the Budget Chairman could raise against mandatory spending legislation that raised outlays over the long term (5 separate 10-year windows were employed for the test). This had the potential to focus congressional attention on the central problem facing the U.S. budget, but instead it has generated a rising number of artificial sunsets to generate compliance with the provision.

The Way Forward

Even the relatively short list of problems above suggests that there is great potential to improve the budget process. The key question is how aggressive such an effort might be. One could imagine an approach that consists largely of band aids for the current process, or more extensive reconstructive surgery. To belabor the medical metaphor, one might also wish to contemplate wholesale transplant of a new process.

Band Aids. There are a host of provisions that have been suggested as possible improvements to the budget process: restoration of PAYGO rules, a rainy day fund and tighter enforcement of emergency designations, a line-item veto/enhanced rescission authority, a sunset commission, and earmark reform.

- PAYGO rules. Restoration of PAYGO rules is desirable. In some circles, PAYGO is associated with a reduced ability to undertake desirable tax policies. But this need not be the case. The greatest potential advantage to PAYGO rules is the ability to highlight spending disguised as tax credits and other "tax cuts" that have the economic impact of targeting resources toward particular activities. Moreover, the restoration of PAYGO has the potential to *improve* rather than impede pro-growth tax policies. At present, the U.S. income tax code is targeted on high-income individuals and corporations. For both groups it would be desirable to retain low marginal tax rates (indeed the high U.S. corporation income tax is a troubling feature of the tax landscape) and move the tax base to more closely resemble the consumed-income of those entities. PAYGO rules would place a premium on bringing consumption expenditures (for example, gold-plated employer sponsored health insurance for the highly-compensated) into the tax base as a desirable aspect of keeping taxes on the return to saving and investment low.

- Budgeting for emergencies is long-overdue. A straightforward approach is to mimic the mechanics of an insurance policy, an instrument that covers the financial consequences of fire, theft and other emergencies. Insurance policies charge a premium that is the "typical" or average level of losses. In some years, policyholders experience no losses and reserves build. In those years when losses do occur, reserves are drawn down. On average, the policy breaks even.

  Congress could undertake a similar approach. First, it would require a tight and genuine definition of emergency. With this in place, the Congress could budget a fixed amount – say the average for the past ten years – for emergencies in each year, essentially charging itself the cost of an insurance policy against the particular emergencies in the definition. There would be no need for a "reserve" fund – the U.S. economy serves as the reservoir of resources. In those years when emergency spending was above average the result would be a larger deficit or lower surplus – requiring greater issuance of Treasury securities to transfer the resources from the reserve fund. In years when spending was below average, the reverse would be true.

- Line item veto/enhanced rescission authority. The Administration has proposed, and the Senate is considering, an enhanced rescission authority intended to mimic the authority of a line-item veto. To the extent that legislation is successful in granting an item-veto-like authority, on should not anticipate a dramatic impact on the level of outlays. The large body of research examining the impact of the (widely-varying) line item veto powers in the hands of state governors has two broad findings: (a) total outlays are little-affected, and (b) the composition of the outlays is affected by the ability of the governor to veto specific items. In short, the item veto is a powerful, but focused, weapon against the worst sorts of pork-barrel spending.

  However, mimicking the line-item veto may not be the right objective. Rescission authority is in itself a desirable aspect of financial management. In light of the perceived failures of oversight, the Congress may wish to enhance the ability of the executive branch to conduct this activity. If so, it would be desirable to have the legislation permit adequate time to analyze recently-passed legislation for desirable rescissions – speed is less of a focus than getting it right – and fast-track procedures for the Congress to consider the proposed cuts.

- Sunset commission. Some observers have proposed a commission to examine the landscape of federal program and identify those that should be terminated. This is hardly an objectionable goal. However it raises more questions than it answers – what criteria will be used; how will such a commission be constituted; how will the Congress employ and deliberate on its findings; and so forth. More generally, the goal should be for the budget process to include sufficient oversight and review that such a commission is not needed.

- Earmark reform. The Congress is in the midst of earmark reform, and is to be applauded for this effort. The damage of earmarks lies less in the total number or dollars earmarked, and more in the damage to the integrity of the budget process. Budget should be an accurate, balanced, and comprehensive presentation of policy objectives. Earmarks are designed to remove balance and lessen the comprehensiveness of the tradeoffs.

Reconstructive Surgery. The Congress may wish to undertake more ambitious reforms of the budget process to more effectively address its current flaws. (In doing so, it does not preclude also adopting some of the less aggressive measures discussed earlier.) Among the candidates for such changes are creating a budget concepts commission, direct spending caps, stronger long-term points of order, a joint budget resolution, and biennial budgeting.

- A budget concepts commission. Since the passage of the 1974 Budget Act, which was in turn built upon the work of a 1967 budget commission, the array budgetary activities has expanded dramatically. As noted earlier, there has been a profusion of tax credits that have the economic character of mandatory spending provisions. In addition, over time there have been a rising number of accrual-like budgetary treatments – student loans, Pentagon health costs, *etc.* – present in the cash-flow federal budget. Further, the increasing scope of government financial activities – direct loans, loan guarantees, asset purchases and sales – raises the question of how best to present both the typical costs of such programs *and* the risks to which the taxpayer is exposed. The time is overdue for a group of technical experts to review the concepts on which the federal budget is based.

- Direct spending caps and long-term points of order. The most pressing fiscal policy for the federal government is the long-term path of mandatory spending. Budget mechanisms to accurately portray these costs and identify key decisions are desirable. Two approaches to doing so are to impose caps on *direct* spending and to institute stronger points of order against legislation with long-term budgetary impacts. In both instances, the key is to develop effective measures of the long-term consequences – no small feat. The key difficulty is how to treat legislation whose character clearly embodies long-term consequences, but which contains sunset provisions explicitly designed to eliminate the long-run consequences.

- A joint budget resolution. As mentioned earlier, a key difficulty in the current environment is the confusing array of budgetary baselines and proposals that emanate from the Administration and the Congress. A joint budget resolution would be a desirable means to bring the Administration and the Congress to a single set of measures. A second objective – to ensure timely and regular budgeting – is less clearly achieved. The joint budget resolution would carry all of the political difficulties of any piece of legislation that must pass both houses of Congress and be signed into law. Moreover, given its scope it likely carries more. While desirable, it would not be a panacea.

- Biennial budgeting. Proponents of biennial budgeting argue that an alternating cycle of legislating followed by oversight would improve the federal budget. Doubtless this is true, but it is far from obvious that this is what would happen. To my eye, the Congress needs to be involved *more* in budgeting, not less.

Budgetary Transplants. To some, the best approach to federal budgeting is to start over. In this approach, two different strategies stand out. The first is to transplant to the government the full array of private sector financial accounting – balance sheets, income statements, and cash flow statements – and budget on this basis.

This is a bad idea. Quite simply, the government is not like any private sector firm. Its two greatest assets are the sovereign powers to tax and to print money. What value should one ascribe to these assets? How do they change through time? The approach appears an awkward fit at the outset.

On the "liability" side of the ledger ("liability" put in quotes because there is an enormous gap between genuine legal liabilities like Treasury securities and the political promises embedded in federal programs), the largest numbers are associated with the future of health care programs. Under current law and using historic growth rates in health spending, federal outlays for Medicare and Medicaid will rise from just over 4 percent of Gross Domestic Product (GDP) at present to 22 percent of GDP in 2050.

Most observers assert that this "just can't happen," and they are correct. But what *will* happen? The Medicare Trustees assume that spending growth will ultimately slow by over 50 percent, but there is no evidence of such a decline thus far. In order to compute the appropriate balance sheet entry, it is necessary that arbitrary assumptions be made and these assumptions will dominate the outlook for the federal budget. Any approach that makes technical assumptions – not the legislated choices of the Congress – the focus is fundamentally flawed.

A second form of transplant is to adopt an entirely new budget system tailored to the needs of the federal government following the model of the Base Realignment and Closure Commissions. In this approach, a commission of independent experts designs such a system which would take effect unless disapproved by a joint resolution of the Congress. In this approach, the key transplant is not only a budget process, but the politics by which it is adopted.

Conclusion

Mr. Chairman and members of the committee, thank your for the opportunity to testify. Clearly there is great room for improvement in the federal budget process and I commend you for investigating the various approaches. I look forward to your questions.

Transparency and Control: Improving Financial Management in Congress

Statement of Chris Edwards, Director of Tax Policy Studies, Cato Institute

before the
Senate Committee on Homeland Security and Government Affairs,
Subcommittee on Federal Financial Management,
Government Information, and International Security

May 25, 2006

Mr. Chairman and members of the committee, thank you for inviting me to testify today regarding the budget process and federal spending restraint.

Federal outlays have increased 45 percent in the last five years. The government has run deficits in 33 of the last 37 years. The costs of federal programs for the elderly are set to balloon and impose huge burdens on young Americans. Clearly, current budget procedures are not working very well. They are stacking the deck in favor of program expansion without regard to current and future tax burdens.

We can improve federal financial management by focusing on two key budgeting principles: transparency and control. These principles are sorely lacking in today's budget process. Huge spending bills are rushed through Congress, with many members and the general public unaware of the wasteful details. Spending is routinely increased despite massive and ongoing flows of red ink. And under current rules, reform-minded members have been unable to control the appetites of their spendthrift colleagues who devote their efforts to narrow parochial concerns.

The need to find budget savings and cut the waste will be intense in coming years. Members of Congress and the public need better information and more powerful tools to control spending and avoid a fiscal train wreck. Creating a new statutory cap on the growth in total federal outlays would be a good step toward increasing both transparency and control in the budget process.

Improving Transparency in Federal Budgeting

The subtitle of the hearing today asks whether Congress is transparent in the way it appropriates funds. Let me first praise the part of the current process that is quite transparent—the reporting of budget *aggregates* by the Congressional Budget Office and Office of Management and Budget. The regular budget updates from these agencies allow interested citizens to find out how much their government taxes and spends, how big the deficit is, and how fast the budget is growing.

Except for the big-picture data, everything else in the budget process is nontransparent. The process gets very confusing when Congress starts passing frequent supplemental spending bills, throws thousands of earmarks into bills and reports at the last minute, and makes most of the important spending decisions in behind-the-scenes horse-trading. Also, the language of federal budgeting is tough to decipher for average citizens and often has a pro-spending bias—consider phrases such as "spending cuts," "budget baseline," "not fully funded," "entitlement," and "trust fund."

Both liberals and conservatives should support making the federal budget process more transparent. An important reform would be to make information about the recipients of federal largesse more readily available. Whether it's earmarks, farm subsidies, corporate welfare, or grants to nonprofit groups, federal taxpayers deserve to know who is receiving their hard-earned dollars.

A few years ago, the *Washington Post* had to battle the Department of Agriculture with a lawsuit before the agency would reveal the list of farm businesses that received taxpayer subsidies. It shouldn't be that difficult for the public to find out how its money is being spent. The people have a right to know that the government is handing out their tax dollars to Ted Turner, David Rockefeller, Bernie Ebbers, and Ken Lay in the form of agriculture subsidies.[1]

Legislation (S. 2590) introduced by Sens. Tom Coburn (R-OK) and Barack Obama (D-IL) would create a federal database on the Internet that lists the names of the 30,000 groups that receive federal earmarks and other handouts, and the amounts received. That would be an excellent step toward helping the public understand where their tax dollars are going. Enron, for example, received hundreds of millions of dollars in corporate welfare from different federal agencies. Citizens need a comprehensive database so they can find out all the federal giveaways that are going to particular companies, groups, and congressional districts.

With federal corruption in the news these days, making data available is more important than ever. Full disclosure regarding the recipients of federal hand-outs is a good first step to reducing corruption.[2] The issue of transparency is not just about citizens understanding what members of Congress are doing, it is about members being alert to what other members are doing. Many members, for example, said that they were outraged by the pork-for-profit schemes of Rep. Randy "Duke" Cunningham (R-CA). Other members are now under investigation for similar schemes. With greater disclosure of pork spending, members might not get up to such mischief in the first place.

There are other reforms, particularly related to earmarks, that would improve budget transparency. These include requiring earmarks to be included in bill language (not report language), requiring earmark sponsors to be listed in bills, making public all earmark request letters, and making conference reports publicly available a few days ahead of floor consideration.[3] I'd like to see the end of all earmarking, but these reforms would be a good start.

Reformers often note, correctly, that Congress should do more oversight of the executive branch to stop waste, fraud, and abuse. But it is the public that does the oversight of Congress, and in this age of websites, blogs, and computer databases, there is no reason why citizens should not be given access to more comprehensive, real-time information to aid in the oversight of federal budget actions. Proposals like S. 2590 would be a real step forward for getting citizens involved in monitoring government in the Internet age.

New Procedures Needed for Budget Control

Congress is supposed to control spending, but spending has been completely out of control in recent years. Most of the budget consists of so-called entitlement spending, which is growing rapidly on automatic pilot. Discretionary spending is supposed to be under tighter control in the annual appropriations process. But we've seen an explosion in the cost of supplemental spending bills outside the regular budget process in recent years. In addition, some of the budget rules that we do have in place, such as the statutory debt limit, haven't created any serious constraint on spending or deficits.

Some people argue that new restrictions on the budget process are not needed because Congress has the power to restrain spending and balance the budget whenever it wants. But political scientists have long recognized that the self-interested actions of individual members often lead to overall legislative outcomes that undermine the general welfare.[4] Indeed, frequent statements and press releases by many members make it clear that their top priority is to aid targeted interests in their states and districts, not to legislate in the broad interests of all Americans. If left to their own devices, many members essentially become lobbyists and activists for their own narrow causes, and broader concerns, such as the size of the debt imposed on future generations, are ignored.

New and improved federal budget rules are needed to help channel the energies of members into reforms that are in the interests of average citizens and taxpayers. Without tight budget rules, Capitol Hill descends into an "every man for himself" spending stampede—a budget anarchy that creates uncontrolled budget expansion and soaring deficits.

The lack of adequate federal budget rules and constraints contrasts with the tighter budget environment in most states.[5] Virtually all the states have statutory or constitutional requirements to balance their budgets. Governors in 42 states have line-item veto authority. Most state constitutions include limitations on government debt. All the states are fiscally constrained by the need to prevent their bond ratings from falling. In addition, more than half the states have some form of overall budget cap or tax and expenditure limitation (TEL).[6] This form of budget constraint should be implemented at the federal level, as discussed below.

There have been numerous efforts to impose tighter controls on the federal budget. One reform effort was the 1985 Gramm-Rudman-Hollings Act. It established a series of declining deficit targets over five years, which if not met resulted in an automatic cut, or sequester, to a broad range of programs. Congress replaced GRH in 1990 with the Budget

Enforcement Act. The BEA imposed annual dollar caps on discretionary (annually appropriated) spending and "pay-as-you-go" rules on entitlement programs that required the cost of any program expansion to be offset elsewhere in the budget. Those rules contributed to restraint, but they have since expired.

Bolder efforts to control spending and deficits have been debated in Congress but have narrowly failed to pass. A balanced-budget amendment (BBA) to the Constitution was proposed in Congress as far back as 1936. In 1982 the Senate passed a BBA by a vote of 69-31. In addition to requiring budget balance, the amendment would have limited the annual growth rate in federal revenues to the growth rate in national income. Unfortunately, the BBA failed to gain the needed two-thirds approval in the House. At the time, a parallel effort resulted in resolutions being passed in 31 states calling for a constitutional convention to approve a BBA, but that effort came up three states short of the required number. In 1995 Congress again voted on a BBA, and it again failed. The BBA passed the House by a 300-132 margin but fell one vote short of passage in the Senate.

Capping Total Federal Spending

Today, reformers are focusing on statutory rather than constitutional efforts to control the budget. And unlike GRH and the BBA, today's efforts are focused on spending control, not deficit reduction, because of recognition that deficits are simply a byproduct of the more fundamental overspending problem. There are many good proposals to exert greater control over spending, including restoring budget impoundment, a sunset commission, and biennial budgeting.[7]

However, a more direct and powerful way to control the budget is to impose a cap on the growth in total spending.[8] A number of House members, including John Campbell (R-CA) and Todd Akin (R-MO), are considering introducing bills to place a statutory cap on the annual growth in total federal outlays, including both discretionary and entitlement outlays.

Note that the BEA imposed multiyear caps on discretionary spending but did not cap entitlement spending. Yet the rapid growth in entitlement spending is an important factor in today's high deficits and will likely cause a major budget crisis in the future. Entitlements account for more than half of the budget and should be included under any cap.

A cap and sequester mechanism on discretionary spending, as under BEA, is straightforward. But it is more complicated to sequester entitlement programs because spending is driven by formulas, reimbursement rates, calculated benefits, and other criteria. Thus, a spending cap law would need to spell out in some detail the particular procedures that agencies would follow to trim entitlement outlays if ordered by sequester. Legally, there is no problem with Congress capping and sequestering entitlements. Recipients of federal entitlement benefits are not legally entitled to their benefits, and Congress can freeze them or cut them at any time to get the budget under control.[9]

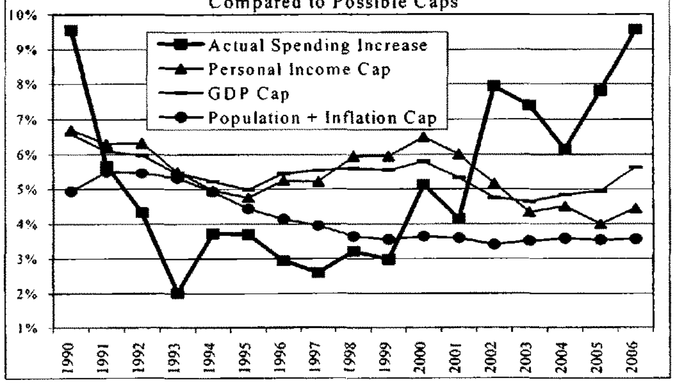
There was substantial interest in capping entitlements in the early 1990s. In 1992, the bipartisan Strengthening of America Commission, headed by Sens. Sam Nunn (D-GA) and Pete Domenici (R-NM), proposed capping all non-Social Security entitlement spending at the growth rate of inflation plus the number of beneficiaries in programs.[10] The Entitlement Control Act of 1994 (H.R. 4593) introduced by Rep. Charles Stenholm (D-TX) would have capped the growth in all entitlement programs to inflation plus one percent plus the number of beneficiaries. Both of those proposals included procedures for sequestering entitlement spending with broad cuts if the caps were breached.

Structuring a Cap on Federal Spending

A simple way to structure a cap is to limit annual spending growth to the growth in an economic indicator such as gross domestic product or personal income. Another possible cap is the sum of population growth plus inflation. In that case, if population grew at 1 percent and inflation was 3 percent, then federal spending could grow at most by 4 percent.

Figure 1 shows actual federal outlay growth since 1990 compared to possible caps. The GDP and income caps would be looser than a cap based on population growth plus inflation. Whichever indicator is used should be smoothed by averaging it over about five years. The basic principle underlying all of these caps is that the government should live within constraints, as average families do, and the government should not consume an increasing share of the nation's income or output.

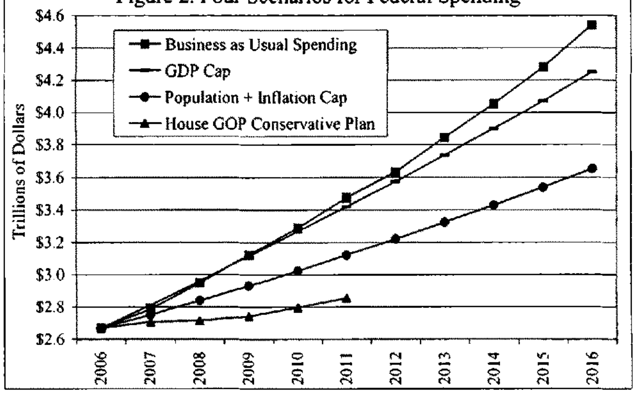
Figure 1. Past Federal Spending Increases Compared to Possible Caps



Source: Author, based on various government data. Spending is fiscal year outlays. 2006 data is estimated. Caps are five-year averages of indicators.

How might a spending cap constrain federal spending in the future? Figure 2 shows that any of the caps would reduce the growth of future spending compared to a business-as-usual scenario.[11] But the lower cap of population plus inflation would offer greater spending constraint. All of the caps would provide protection against a nightmare scenario of continued spending growth similar to the growth of recent years. But it is also true that a cap would not guarantee that Congress proactively made the large spending reforms that we need and eliminated wasteful programs in the federal budget. Note that in Figure 2 the House Republican conservative budget plan is a more responsible spending path that is below the cap amounts.[12] This plan would cut wasteful programs and bring the deficit down to zero over five years.

Figure 2. Four Scenarios for Federal Spending



Source: Author. The two cap lines assume that spending would rise each year by the maximum amount allowed.

With an overall spending cap in place, Congress would pass annual budget resolutions and make sure that discretionary and entitlement spending totals were projected to fit under the cap for the upcoming fiscal year. If needed, reconciliation instructions would be included to reduce spending on entitlement programs to fit under the cap for the upcoming fiscal year and to reduce out-year spending to fit under projected future caps. The process could be strengthened by turning today's concurrent budget resolution into a joint budget resolution signed by the president, as the Bush administration has proposed.

The Office of Management and Budget would provide regular updates regarding whether spending is likely to breach the legal cap, and Congress could take corrective actions as needed. If a congressional session ended and OMB determined that outlays were still above the cap, the president would be required to cut, or sequester, spending across the board by the amount needed to meet the cap. The GRH and the BEA included sequester mechanisms that covered only portions of the defense, nondefense, and entitlement budgets. A better approach would be to cap all spending and subject all programs to a sequester should Congress fail to restrain spending sufficiently. But let's hope that, when sequesters were looming, Congress would make the needed cuts before sequestration actually took place.

The Advantage of Capping Spending

The Colorado Taxpayer's Bill of Rights, or TABOR, is a constitutional cap on state revenue growth. The annual growth in state tax revenues is limited to the growth in state population plus inflation. Any revenues that flow into the government above the cap must be rebated back to state taxpayers. TABOR has worked well in Colorado, but for the federal government a cap on spending is more appropriate than a cap on revenues. One reason is that state governments must balance their budgets each year, and thus a cap on revenues essentially becomes a cap on spending in the states. By contrast, the federal government runs large deficits, and thus a cap on revenue growth would not limit the overall budget or deficits.

One advantage of capping federal spending rather than revenues or deficits is that spending is quite stable and can be directly controlled by Congress. GRH tried to cap deficits, but deficits can swing wildly from year to year, and that can take policymakers by surprise. Indeed, one reason why GRH was scrapped was that there was a swing upward in the deficit projection and Congress was unwilling to allow a large and sudden sequester to occur. Regarding a cap on revenues, one cause of the recent controversy surrounding the TABOR cap in Colorado was the fairly rapid fall in state revenues during the economic slowdown a few years ago. A cap on spending avoids problems related to upswings and downswings in the economy because spending fluctuates less and is controlled directly by Congress.

Another difference between a spending and a revenue cap is that you do not need a taxpayer rebate mechanism under a spending cap. The tax rebate mechanism in Colorado has delivered substantial savings to taxpayers, but it has become a complex part of the state budget process because of special interest pressures to micromanage exactly who gets the rebates. By contrast, under a federal cap on spending, any savings would automatically go toward reducing the federal deficit and debt (just as with any spending restraint without a cap). In years with rapid revenue growth like this year, a spending cap would ensure that the federal deficit was sharply reduced. Congress would continue to have the option of cutting taxes whenever it wanted, but there would be no need for a complex rebate mechanism.

A final note: one shortcoming of a statutory spending cap is that Congress would have the option of rewriting the law if it didn't want to comply with it. In the past, Congress has often rewritten budget laws and found ways to get around budget restrictions when it wanted. But a cap on overall spending would be a very simple and high-profile symbol of restraint for supporters in Congress and the public to rally around and defend. Some budget laws have been too complex and hard for the public to understand. An overall cap on spending growth is easy to understand, and watchdog groups would keep the public informed about any cheating by Congress or the administration. A spending cap creates both transparency and control in federal budgeting. Over time, public awareness and budgetary tradition would aid in the enforcement of a cap.

Conclusion

Federal policymakers need both a change in mindset and tougher budget rules to ward of huge tax hikes or a financial crisis in future years as entitlement costs soar. They need to scour the budget for programs and agencies to eliminate.[13] A spending cap is part of the solution to get the budget under control and avert another federal spending orgy like the one of recent years.

Clearly, current budget rules have not worked very well, and we should experiment with new rules to try and get a grip on the overspending problem. Budget reforms such as biennial budgeting and establishing a sunset commission are good ideas that should be considered. But a cap on overall federal spending is more direct, more powerful, and easier for the public to understand.

Thank you for holding these important hearings. I look forward to working with the committee on its agenda for federal budget reform.

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[1] Chris Edwards and Tad DeHaven, "Farm Reform Reversal," Cato Institute Tax & Budget Bulletin no. 2, March 2002.
[2] Chris Edwards, "Reducing Federal Corruption," Cato Institute Tax & Budget Bulletin no. 34, May 2006.
[3] For a discussion on earmark reforms, see Tom Finnigan, "All About Pork: The Abuse of Earmarks and the Needed Reforms," Citizens Against Government Waste, May 3, 2006.
[4] For a discussion, see Chris Edwards, *Downsizing the Federal Government* (Washington: Cato Institute, 2005), chapter 6.
[5] For background on state budget processes, see National Association of State Budget Officers, "Budget Processes in the States," January 2002.
[6] Michael New, "Limiting Government through Direct Democracy," Cato Institute Policy Analysis no. 420, December 13, 2001.
[7] For some reform ideas, see Brian Riedl, "What's Wrong with the Federal Budget Process," Heritage Foundation, January 25, 2005. See also the Republican Study Committee's Family Budget Protection Act at www.house.gov/ryan/press_releases/2004pressreleases/family_budget_protection_act.htm.
[8] For background, see Brian Riedl, "Restrain Runaway Spending with a Federal Taxpayers' Bill of Rights," Heritage Foundation, August 27, 2004. See also Chris Edwards, "Capping Federal Spending," Cato Institute Tax & Budget Bulletin no. 32, March 2006.
[9] For a discussion, see Susan J. Irving, "Budget Policy: Issues in Capping Mandatory Spending," Government Accountability Office, GAO/AIMD-94-155, July 1994.
[10] The commission was sponsored by the Center for Strategic and International Studies.
[11] The business-as-usual scenario assumes that discretionary spending grows with GDP and that entitlement spending grows per the Congressional Budget Office baseline.
[12] House Republican Study Committee, "Contract with America: Renewed," March 8, 2006.
[13] For detailed discussion of federal programs that should be eliminated, see Chris Edwards, *Downsizing the Federal Government* (Washington: Cato Institute, 2005). See www.downsizinggovernment.com.

NEW AMERICA
FOUNDATION

Testimony of

Maya C. MacGuineas

President, Committee for a Responsible Federal Budget &

Director, Fiscal Policy Program, New America Foundation

On

Congress's Role in Federal Financial Management:

Is it Efficient, Accountable, and Transparent in the Way it Appropriates Funds?

Before the

Senate Homeland Security and Governmental Affairs Subcommittee on Federal Financial Management, Government Information, and International Security

May 25, 2006

TESTIMONY OF MAYA MACGUINEAS ON
CONGRESS'S ROLE IN FEDERAL FINANCIAL MANAGEMENT:
IS IT EFFICIENT, ACCOUNTABLE, AND TRANSPARENT IN THE WAY IT APPROPRIATES FUNDS?

Good morning, Mr. Chairman and Members of the Subcommittee. I have been asked to comment on Congress's role in federal financial management. Thank you for the opportunity to testify. It is a privilege to appear before the Subcommittee on this important topic.

I am the President of the Committee for a Responsible Federal Budget. Our Co-Chairs are Bill Frenzel and Leon Panetta and the Board consists of many past Directors of the Office of Management and Budget, the Congressional Budget Office, and past Chairs of the Federal Reserve Board and the House and Senate Budget Committees. Our focus is the federal budget and related process issues. I am also the Program Director for the Fiscal Policy Program at the New America Foundation, a non-partisan think tank here in DC.

Let me begin by saying that even the best budget process cannot serve as a replacement for responsible budget decisions and proper oversight.

If politicians continue to cut taxes and increase spending, we will continue to run budget deficits—no matter what the rules.

If politicians continue to both build programs into the budget and tax code without scrutinizing the effectiveness of those programs and are unwilling to end programs that are not effective, we will continue to have a budget that is less efficient than it should be—no matter what the rules.

And if politicians continue to make and expand promises for intergenerational programs such as Social Security and Medicare with no plan for how to pay for them, we will continue to face large, unfunded liabilities as well as inflexible budgets that are ill equipped to deal with changing circumstances and emergencies—no matter what the rules.

Ultimately, the most important components of responsible budgeting are the people involved in the process and the decisions they make. No matter what rules we create, what hurdles we develop, or what restrictions we build-in, Congress can always bypass them if they are not consistent with the policy goals to which Congress is committed. We need only to look to the recent tax cut where the some of the revenue loss from the tax cuts was offset by another tax cut, to see that if Congress is determined to bypass limitations, it will find a way to.

But while process cannot do the heavy lifting required to create responsible budgets, sensible and balanced rules do play an important role in improving how the government allocates its resources. The Committee for a Responsible Federal Budget, in a collaboration with experts inside and outside of government, developed a list of budget process reform recommendations that we believe will be helpful in this pursuit. In particular, we believe these reforms will improve the efficiency, transparency, accountability, and outcomes of the budgeting process. These recommendations include:

Joint Budget Resolution – Currently, legislators labor under multiple budgets and multiple baselines. This greatly confuses the budget process and makes competing choices and their related trade-offs more difficult to evaluate. Under a Joint Budget Resolution, Congress and the President would agree on the broad fiscal goals that would guide budget decisions in a given year. Bringing the President into budgetary negotiations earlier in the process would help avoid the showdowns that can occur at the end of the process if Congress and the President are working on different tracks with different priorities. Additionally, the switch to a Joint Budget Resolution would create a higher level of accountability and better define when limits have been breached; thereby making it more difficult to "bust the budget."

Expenditure Limits – The budget resolution should include enforceable nominal dollar limits for both discretionary and direct spending. In the past, statutory limits have proven to be one of the most effective approaches to instilling discipline into the budget process. However, limits must be set at a reasonable level. As we saw in the 1990s, reasonable caps can be extremely effective; unreasonable ones are routinely ignored, contributing to the breakdown of the process. As direct spending continues to grow as a share of the budget, it is important to consider different ways to control this area of the budget.

Pay-As-You-Go – The PAYGO principle, which requires that revenue reductions and direct spending increases be offset so as not to increase the deficit, remains a crucial budgeting principle that should be reinstated in full force. PAYGO will not improve the fiscal imbalances we currently face, but it will prevent them from getting worse. The Committee believes that it is necessary to apply PAYGO to both sides of the budget—spending and taxes. Otherwise, there will always be strong incentives to run spending programs through the tax code in order to avoid the requirement of offsetting the costs.

The prescription drug program would have had to have been paid for rather than debt-financed and revenues lost from the tax cuts would have been offset, had real PAYGO been in place over the past few years. It is worth pointing out that for those who would like to control the growth of government spending, offsetting tax cuts with spending reductions should be seen as a desirable policy, not a problematic one.

Biennial Budgeting – The budget process does not leave nearly enough time for oversight. Congress spends a significant amount of energy trying to meet specific deadlines—which are often missed—and spends too much time during the annual appropriations process repeating work it did the previous year. One potential improvement would be to move budgets, appropriations, and tax cycles to a two-year budget cycle. This would free up more time for program review, strategic planning, oversight, evaluation, and reform. That said, there are legitimate concerns about two-year budgeting regimes. It is quite likely that we would see a dramatic increase in the number of supplemental appropriations bills—something that is already problematic. We believe that strict restrictions should be developed to control supplemental spending. As is the case today, supplementals should only be used in the case of emergencies, not as a means to increase spending in general budget areas—the incentives for mischief could be larger with two-year cycles.

Automatic Continuing Resolution – All too often Congress fails to reach agreement on its regular appropriations bills. We recommend an automatic continuing resolution at or below the level of spending caps contained in Budget Resolution to be used as a stopgap funding measure. Automatic continuing resolutions should be restrictive to create an incentive for Congress and the President to agree on regular appropriations bills rather than falling back on the continuing resolution.

Strict Definitions for Emergencies – The need for changes to our use of supplementals is illustrated by the emergency supplemental that was just passed in the Senate. Emergency supplementals should not be used to pay for normal government operations. In the past few years, many defense-related activities that should have been financed through the normal appropriations process have been funded through emergency supplementals. More and more, non-defense related spending has also been creeping into these bills. As the Chairman of this Subcommittee has highlighted, one merely has to look through the recent supplemental for many egregious examples. "Emergencies" should be carefully and narrowly defined, and there must be strong rules governing related expenditures. Otherwise emergency funds will continue to be employed as a way to add additional spending not contained in the budget. As my Co-Chairman Bill Frenzel has pointed out, supplementals have becoming a money machine. Once it became accepted practice to use supplementals as a money machine for regular defense spending it was only a matter of time before advocates of domestic spending started to look to the money machine for their programs as well.

Rainy Day Funds – The impact that a disaster such as Katrina can have on the federal budget is a reminder that the government should be planning and budgeting for such emergencies. While we never know when and in what form the next natural disaster will occur, we know that they do occur with unfortunate regularity. The Committee strongly supports the use of "Rainy Day Funds." Such funds would require that Congress set aside reserve funds reflecting average costs of past years' disasters to prepare for unforeseen, disaster-related costs. As noted above, what constitutes an emergency would have to be carefully and narrowly defined. While in all likelihood the costs of Katrina would have exceeded the amount in a Rainy Day Fund, the presence of the fund would have left the federal government in a better starting fiscal position to cover these costs. Also, when emergency costs exceed the level in emergency funds, Congress should exercise greater restraint in the rest of the budget to help offset unanticipated costs.

Proper Distinguishing Between Spending and Revenues – We are currently unable to accurately measure the true size of government. We label spending programs as "tax cuts," tax receipts as "fees," and revenues as "negative outlays." This level of complexity greatly decreases the transparency of the budget and the slippery definitions make it virtually impossible to accurately describe the size of government relative to the economy. The true size of government is probably greatly understated. This would never be tolerated for a private company, nor should it be for the federal government. To improve this misleading approach to accounting, there should be strict limits on any receipts scored as negative outlays. Activities that have all the characteristics of spending programs should not be scored as tax expenditures.

Enhanced Rescission – The Committee supports enhanced rescission. The President should be able to identify and suggest the elimination of wasteful or low-priority spending programs while Congress should be given the chance to weigh in before funds are withheld or canceled.

Tracking Long-Term Spending Promises - There should be a greater use of accrual accounting in the federal budget. The federal government is different than private companies when it comes to accounting and certainly, accrual accounting should not replace cash accounting. Accrual accounting is, however, very useful for tracking long-term insurance programs and would greatly enhance our ability to understand the full picture of the government's financial position. Information about the unfunded promises in Social Security and Medicare should be highlighted in budget related documents. The point of order established by the Senate against legislation that would increase long-term spending by more than $5 billion is useful. It is worth considering whether this should also be applied to long-term revenue reductions.

Triggers – Though we do not have an institutional position on when they should be used, many members of the Committee for a Responsible Federal Budget believe that we should increase the use of "triggers" in the budget. The Medicare Modernization Act contains a trigger that is set off when general revenue financing of the program is projected to become too high. Other triggers could be set when spending, deficits, unfunded promises, the debt, or revenues, exceed (or in the case of revenues, fall short of) a pre-set level, leading to either recommendations for how to remedy the problems or defaults, such as freezes on indexing of government programs and taxes.

Budget Reform Commission – If the budget process is not broken, it is getting awfully close. Few budget rules are in place and those that are there are routinely bypassed, deadlines are missed as often as they are met, gimmicks that undermine the integrity of the process are used with frightening regularity, and we do not do a good job of picking and choosing among competing priorities—which of course is one of the main functions of a budget. Thus, it appears that a fundamental rethinking of how we budget in this country is in order. We are working with rules that are decades old and were created when the budget, economy, and policy challenges were dramatically quite different than they are today. The rules and concepts have been amended in an ad-hoc manner resulting in a highly complex process. While there are clearly changes worth making to the existing process, just as important would be to consider more fundamental reforms. Major changes are always difficult in a partisan and politicized environment. Accordingly, we believe Congress should appoint a BRAC-style Commission to grapple with fundamental budget reform. Members of Congress, former Members of Congress, and technical experts should be included and Congress should be required to have an up-or-down vote on the recommendations. Given how much the world and the budget has changed since the last time comprehensive reforms were made, taking a step back from our current process would certainly be useful.

I wish my note of closure were not so gloomy—but this is the reality of our fiscal picture. Budget surpluses have been replaced with structural budget deficits. The debt is growing at an alarming pace. The baby-boomers' retirement is only two short years away and yet there is no indication that Congress will implement a Social Security reform plan, let alone make greatly needed changes to Medicare and our healthcare system. Politicians seem to have no appetite for reconciling their desire to spend with their desire to cut taxes.

While Congress may not be interested in adhering to the principles of basic math, these principles cannot be ignored. We at the Committee worry that the price we pay for a lack of leadership on these issues will be quite high—particularly for younger workers and future generations.

No amount of process reforms will replace the need to grapple with and address these challenges. Process is no substitute for courageous choices. However, once Congress and the Administration come together to confront the hard choices they must make, changes to the budget process can provide procedures to keep the budget on track as well as useful enforcement mechanisms. There is real room for improvement in both the areas of policy and process with regard to the budget. Thank you for holding this hearing today and I look forward to answering any questions you might have.

GAO

Selected Commissions Summary (5/25/06)

	Greenspan Social Security 1983	Kerrey-Danforth Bipartisan Commission on Entitlement and Tax Reform 1994	Breaux-Thomas Commission on the Future of Medicare 1998	Bush Social Security [CSSS] 2001	9/11 Commission 2002	Mack-Breaux Tax Reform 2005
Statutory basis?	No; Exec Order but agreement by Congress	No; Exec Order 12878 11-5-1993	Yes; BBA 97	No; Exec Order	Yes; P.L. 107-306	No; Exec Order
Imminent crisis or other action-forcing event	Yes	No	No	No	Yes	No
Presidential leadership & commitment to success of effort?	Yes	No	No; President strongly disagreed with proposed recommendations	Yes	Partial	No
Within the general charter was scope broad or restricted [and how]	Broad	Broad; entitlement spending and tax reform	Broad	Restricted; had to include individual accounts	Broad	Restricted; required revenue neutrality and keeping incentives for homeownership & charitable giving, & encouraging savings; consider equity & simplicity too
Number of Commissioners [No. of current elected officials / No. of other]	15 [7/8]; 4 Sens., 3 HRs, 8 non-elected (included 2 former Members of Congress; also insurance, labor, business reps.)	32 [22/10]	17 [9/8]	16 [0/16]; Included 3 former Members of Congress	10 [0/10]	9 [0/9]; Chair and Vice-Chair were former Sens.; 1 former HR on panel; also included 4 professors and 2 "tax practitioners"
Appointments by both President and Congress?	Yes; 5 by Pres 5 by Sen.,and 5 by Hse.	No; presidential appointments only	Yes; 1 of 17 (Chair) by both Pres. & Cong.;4 others by Pres; others by Cong'l leadership [Rs appt'd 4 & Ds 2 each house] = 8 by each party	No; presidential appointments only	Yes; 1 by Pres. (Chair); 1 by Sen Min Ldr w/ Hse Min Ldr consult (Vice Chair); 2 ea. by Sen Maj Ldr & Hse Spkr; 2 ea. by Sen & Hse Min Ldrs	No; presidential appointments only

GAO

Selected Commissions Summary (5/25/06)

	Greenspan Social Security 1983	Kerrey-Danforth Bipartisan Commission on Entitlement and Tax Reform 1994	Breaux-Thomas Commission on the Future of Medicare 1998	Bush Social Security [CSSS] 2001	9/11 Commission 2002	Mack-Breaux Tax Reform 2005
Bipartisan?	Yes	Yes; of the 22 Members of Congress, 11 Ds and 11 Rs	Yes; 4 by Pres [D]; 4 by Cong'l Ds; 8 by Cong'l Rs; Breaux by all	Yes; 8 Rs, 8 Ds	Yes	Yes
Co-chairs?	No	Yes, functionally; technically Chair and Vice-Chair	Yes, functionally; technically Breaux = Chair; Thomas = "Administrative Chair"	Yes	Yes, functionally; technically Chair and Vice-Chair	Yes
Open/transparent process including public hearings?	Yes; but found way to do smaller conversations	Yes; all meetings and hearings were televised on C-SPAN. All commission documents, transcripts and reports made public on a CD.	Yes	Yes	Yes	Yes
Commission resulted in report? (month, year issued)	Yes (Jan. 1983)	Yes; but failed to reach consensus on recs (Jan. 1995)	No; proposed recs failed to gain required 11 votes (N/A)	Yes (Dec. 2001)	Yes (July 2004)	Yes (Nov. 2005)
Report set forth specific, actionable recommendations?	Yes	No; but recommended 5 broad principles for crafting "solutions to our fiscal problems"	N/A	Report set forth 3 reform models	Yes	Yes

GAO

Selected Commissions Summary (5/25/06)

	Greenspan Social Security 1983	Kerrey-Danforth Bipartisan Commission on Entitlement and Tax Reform 1994	Breaux-Thomas Commission on the Future of Medicare 1998	Bush Social Security [CSSS] 2001	9/11 Commission 2002	Mack-Breaux Tax Reform 2005
Under establishment of Commission was action required by the President or Congress? Or were there other action-forcing provisions?	No	No	No	No	No; recommended actions to both but not required	No; recommended actions to Pres. but not required
Did President / Congress take required action or some other responsive action?	Yes	No	N/A	N/A	Yes – many were enacted	No
Other relevant info		Interim report widely respected; source for much of what is said today	Outlook for Medicare appeared to change while Commission met	Limit on scope & conditions for membership perceived as having negative impact on acceptance of analyses—even those not related to specific IA issue; Ds appointed not viewed as representative of party point of view		Commission viewed report as starting point for Cong'l consideration of tax reform; no action yet

From: Wilma W Broom
To: Bonham, Christine E
Date: 6/28/2006 10:32:41 AM
Subject: For coburn transcript

Tax Gap: Making Significant Progress in Improving Tax Compliance Rests on Enhancing Current IRS Techniques and Adopting New Legislative Actions, GAO-06-453T (Washington, DC.: February 15, 2006)

Tax Gap: Multiple Strategies, Better Compliance Data, and Long-Term Goals Are Needed to Improve Taxpayer Compliance, GAO-06-208T (Washington, DC.: October 26, 2005)

Tax Compliance: Better Compliance Data and Long-term Goals Would Support a More Strategic IRS Approach to Reducing the Tax Gap, GAO-05-753 (Washington, DC.: July 18, 2005

Tax Compliance Reducing the Tax Gap Can Contribute to Fiscal Sustainability but Will Require a Variety of Strategies, GAO-05-527T (Washington, DC.: April 14, 2005)

Taxpayer Information: Data Sharing and Analysis May Enhance Tax Compliance and Improve Immigration Eligibility Decisions, GAO-04-972T (Washington, DC July 21, 2004)

Internal Revenue Service: Challenges Remain in Combating Abusive Tax Shelters, GAO-04-104T (Washington, DC.: October 21, 2003)

Internal Revenue Service: Challenges Remain in Combating Abusive Tax Schemes, GAO-04-50 (Washington, DC.: November 19, 2003)

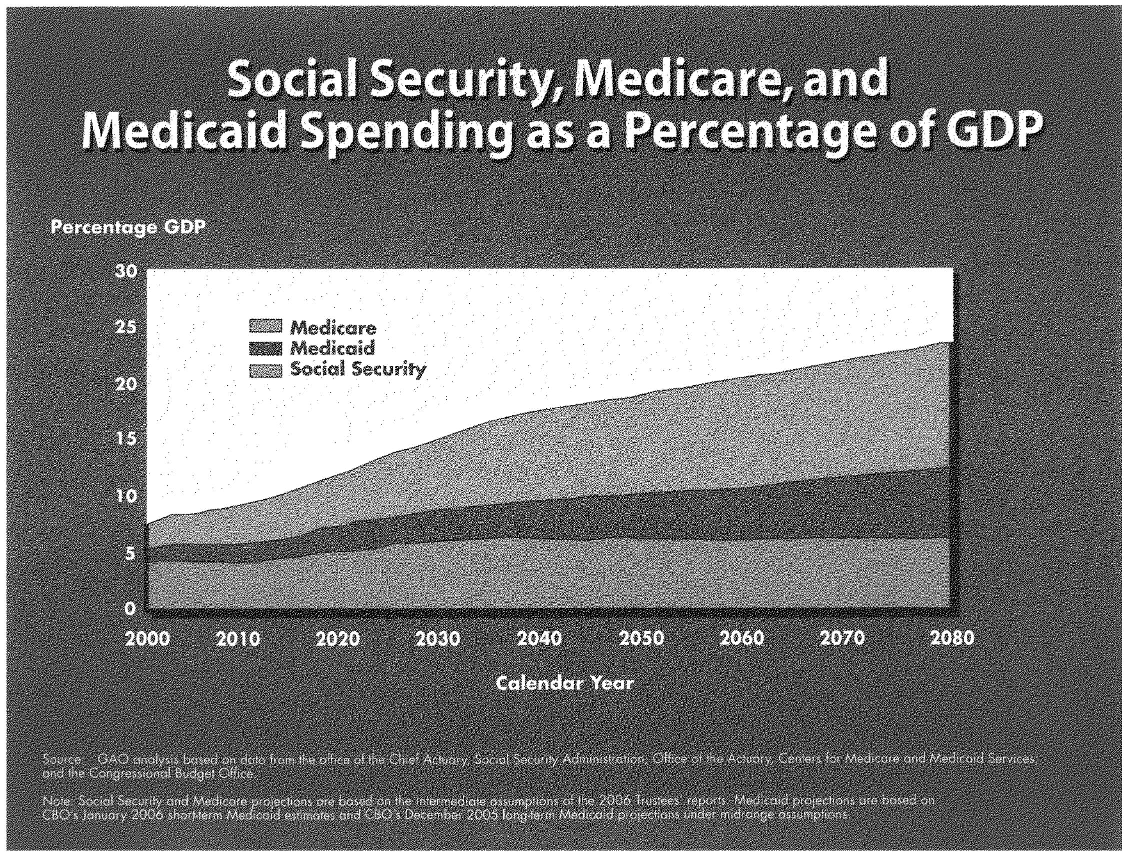
Internal Revenue Service: Efforts to Identify and Combat Abusive Tax Schemes Have Increased, but Challenges Remain, GAO-02-733 (Washington, DC.: May 22, 2002)

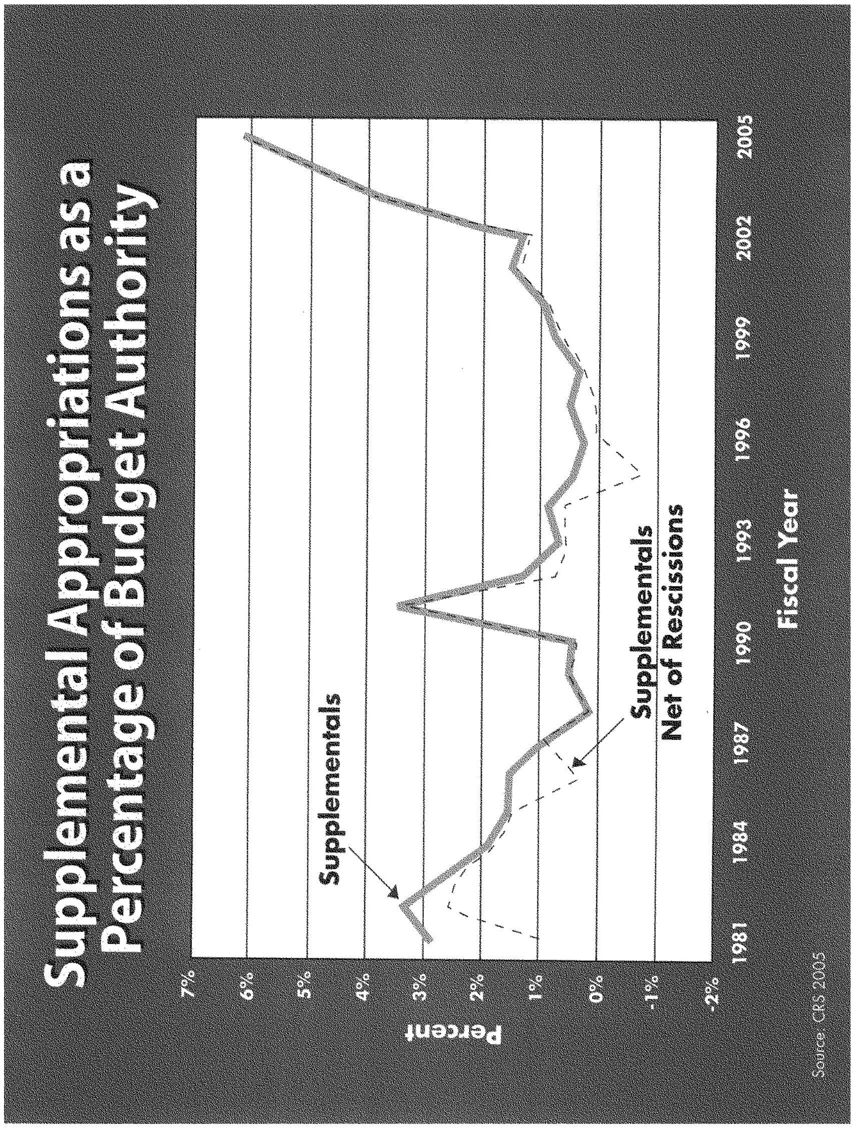
Internal Revenue Service: Enhanced Efforts to Combat Abusive Tax Schemes-Challenges Remain, GAO-02-618T (Washington, DC.: April 11, 2002)

International Taxation: Information on Federal Contractors With Offshore Subsidiaries, GAO-04-293 (Washington, DC.: February 2, 2004)

Federal Contractors Incorporated Offshore, GAO-03-194R (Washington, DC.: October 1, 2002)

CC: Brostek, Michael


Social Security, Medicare, and
Medicaid Spending as a Percentage of GDP
Percentage GDP
30
25
20
15
10
5
0
Medicare
Medicaid
Social Security
2000
2010
2020
2030
2040
2050
2060
2070
2080
Calendar Year
Source: GAO analysis based on data from the office of the Chief Actuary, Social Security Administration; Office of the Actuary, Centers for Medicare and Medicaid Services; and the Congressional Budget Office.
Note: Social Security and Medicare projections are based on the intermediate assumptions of the 2006 Trustees' reports. Medicaid projections are based on CBO's January 2006 short-term Medicaid estimates and CBO's December 2005 long-term Medicaid projections under midrange assumptions.


Supplemental Appropriations as a Percentage of Budget Authority
Percent
7%
6%
5%
4%
3%
2%
1%
0%
-1%
-2%
1981
1984
1987
1990
1993
1996
1999
2002
2005
Fiscal Year
Supplementals
Supplementals Net of Rescissions
Source: CRS 2005

Senator Levin's Questions for the Record for Comptroller General David Walker

1. Do you believe statutory PAYGO was an effective tool in helping return the budget to surplus in the late 1990s?

- **Yes.**

2. Do you support reinstating PAYGO?

- **Yes.**

3. Is it your opinion that PAYGO should continue to be applied to *both* spending *and* revenues?

- **Yes, given our fiscal challenges, I have consistently called for re-instituting PAYGO on both sides of the ledger. It is not sufficient for meeting our long-term fiscal challenge, but it would be a start.**

6. One budget reform that needs to occur around here is the end to the use of gimmicks to get around budget rules. The conference report to the tax reconciliation bill included several gimmicks. It shifted around corporate tax payment dates. It counted short-term savings from a Roth IRA provision that will result in far greater revenue losses in future years. **Has the use of these gimmicks increased in recent years? What do you think we should do to stop these gimmicks?**

- **I cannot say definitively whether the use of such "gimmicks" has increased in recent years since we have not done the work necessary to draw such a conclusion. However, I have noted that one serious problem with the current budget process is its failure to adequately recognize the long-term consequences of various policy choices. In this regard, I have advocated a return to the practice of providing 10-year numbers in the budget. I have also advocated imposing a requirement to disclose the net present value estimates for the cost of all major tax and spending proposals before such proposals are voted upon.**

7. You have previously observed that our tax system is not in line with the distribution of wealth and income in our society. The Senate is expected to consider repealing the federal estate tax in the near future. **Wouldn't allowing the federal estate tax to be repealed exacerbate this situation with respect to the distribution of wealth?**

- **Yes, at the same time, the question of the appropriate distribution of income and wealth in society and how the tax system should affect that distribution are ultimately value questions and hence policy issues for discussion and debate by the people and their elected representatives. Given our long-term fiscal challenge, we should be concerned about any legislation that loses revenue. Furthermore, Congress should consider what the long-term implications on U.S. society, including the gap between the haves and have-nots, would be over time.**

8. The Senate may consider a modified version of the Administration's line-item veto proposal in the near future. **Do you think enactment of such a proposal would substantially reduce the deficit? How much in savings do you believe would be realized annually if this or a similar bill were enacted**

- **It is impossible to estimate the amount of savings that could result from any expedited rescission or Line Item Veto provision such as that proposed by the Administration; that would depend both on what was rescinded and whether the funds were reallocated to other priorities or applied to deficit reduction. Whatever one's views on expedited rescission, by itself it won't come close to addressing our long-term fiscal challenge. Dealing with our long-term fiscal challenge requires a hard look at the base of government entitlement programs, other spending programs, tax policies and operational approaches.**

Senator Levin's Questions for the Record for
Former CBO Director Douglas Holtz-Eakin

1. **Do you believe statutory PAYGO was an effective tool in helping return the budget to surplus in the late 1990s?**

PAYGO was one part of the effort to reduce deficits in the early 1990s. The most important element was the shared determination of the Congress, Administration, Republicans, and Democrats to reduce the budget deficit. This broad commitment was supported by an array of budget process tools: PAYGO rules, discretionary spending caps, longer-term budget planning, and others.

While this effort reduced the deficit, in the end it was the unexpected revenue surge in the latter part of the decade that swung the budget to surplus. Importantly, PAYGO did not expire at the time; rather it was still in place as the budget returned to deficit – evidence that commitment is more important than the details of process.

2. **Do you support reinstating PAYGO?**

I support instituting budget rules that reflect a commitment to addressing the unsustainable outlook for the federal budget. I am not committed to PAYGO *per se*, or any other specific approach. Neither am I opposed.

3. **Is it your opinion that PAYGO should continue to be applied to *both* spending *and* revenues?**

There are many policy objectives that are equally well achieved by programs that generate outlays and those that result in tax credits (often refundable credits). In order to treat these equally, I think it is necessary that PAYGO apply to both sides of the budget.

4. The current Senate PAYGO rule makes it "not in order in the Senate to consider any direct spending or revenue legislation that would increase the on-budget deficit or cause an on-budget deficit." However, by including in the baseline all tax cuts and mandatory spending increases assumed in the most recent budget resolution, legislation to make

those assumptions law will not be subject to PAYGO, no matter how much they increase deficits. **Do you think it makes sense to exclude any legislation from PAYGO rules?**

In general, budgets should be comprehensive and treat all changes in policy on a level playing field. Accordingly, I see no reason to distinguish between "on-budget" and "off-budget" policies – there is no real distinction. Similarly, I think policy proposals on both the revenue and spending side should be treated equally.

Under previous constructions of the PAYGO rules, the Senate and House could override the PAYGO provisions with a 60-vote majority. That is an important safeguard to allow for additional spending, if warranted.

However, perhaps this question is more targeted at the appropriate construction of the baseline against which to measure changes. There are myriad potential problems with the baseline projections – the assumed growth of discretionary budget authority, the classification of receipts, outlays, offsetting receipts, and offsetting collections, asymmetries between mandatory spending and taxes, and so forth. These are worthy of Congress' attention.

5. The ten-year cost of the Bush tax cuts from FY2007 to FY2016 is $2.1 trillion (including the cost of debt service). **What do you think making these tax cuts permanent would do to our fiscal situation? How will it impact our deficits?**

Other things equal, keeping taxes at the current level will accelerate the point at which the budget becomes unsustainable. Outlays – especially those in Social Security, Medicare, and Medicaid – are projected to rise so rapidly and substantially (rising from 9-10 percent of GDP to 20-30 percent of GDP in the next several decades) that no tax policy will be able to "keep up." In the absence of reformed outlay programs, the choice of tax policy is one of timing: when do our fiscal problems become unmanageable?

At the same time, not keeping tax rates low has implications for the efficiency and welfare of the U.S. economy. Those factors need to be weighed against the deficit impacts of allowing current tax rates to sunset.

6. One budget reform that needs to occur around here is the end to the use of gimmicks to get around budget rules. The conference report to the tax reconciliation bill included several gimmicks. It shifted around corporate tax payment dates. It counted short-term savings from a Roth IRA provision that will result in far greater revenue losses in future

years. **Has the use of these gimmicks increased in recent years? What do you think we should do to stop these gimmicks?**

I am unaware of any way to "count" or otherwise quantify the use of budget gimmicks. However, the key feature of the use of budget gimmicks is that they comply with the letter of the rules. To the extent that Congress wishes to make progress in improving our fiscal situation, it must develop a shared commitment to complying with the pursuit of this goal. As the use of any budget gimmick indicates, following the rules not sufficient.

7. The Senate may consider a modified version of the Administration's line-item veto proposal in the near future. **Do you think enactment of such a proposal would substantially reduce the deficit? How much in savings do you believe would be realized annually if this, or a similar bill, were enacted?**

In my view, a line-item veto has limited ability to dramatically reduce overall spending. Instead, its value more likely lies in improving the efficiency and cost-effectiveness of federal spending and serving as a check on the integrity of the appropriation process. Moreover, the Administration proposal is not truly a line-item veto but rather an augmentation of the long-standing practice of rescinding budget authority. I believe it is desirable for Congress to affirmatively act on proposed rescissions.

4. The current Senate PAYGO rule makes it "not in order in the Senate to consider any direct spending or revenue legislation that would increase the on-budget deficit or cause an on-budget deficit." However, by including in the baseline all tax cuts and mandatory spending increases assumed in the most recent budget resolution, legislation to make those assumptions law will not be subject to PAYGO, no matter how much they increase deficits. **Do you think it makes sense to exclude any legislation from PAYGO rules?**

- **No, I have called for reimposing PAYGO on both sides of the ledger—and I believe PAYGO must apply to all proposed changes to current law, including making the tax cuts permanent.**

5. The ten-year cost of the Bush tax cuts from FY2007 to FY2016 is $2.1 trillion (including the cost of debt service). **What do you think making these tax cuts permanent would do to our fiscal situation? How will it impact our deficits?**

   - **Making all such tax cuts permanent will have an adverse impact on our deficit and long-term fiscal imbalance. I have stated that not all tax cuts foster increased growth and productivity and very few, if any, tax cuts pay for themselves. There is broad-based agreement among mainstream economists on this point.**