BUDGETING IN THE IDEAL AND IN THE UNITED STATES

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Government budgeting is one of the most complicated activities undertaken by mankind. If time were free, the value received for a dollar spent on one program would be compared to the value of spending a dollar on every other possible program, and every possible means of finance would also be considered. But that would involve millions of tradeoffs, and time is not free. Indeed, it is severely limited: typically, budgeting is done every year. Consequently, budget preparation requires focusing on those tradeoffs most important to the national interest. After adopting a strategy, budgeting becomes a management challenge. The right information must be delivered to the right people at the right time.

Budget Preparation

The adopted budget strategy might focus on programs that seem to be working well, where expansions might be warranted, or on programs that are working badly, where reductions or total elimination might be appropriate. The strategy should look across agencies or departments so that interactions with other programs can be considered. In the United States, a number of departments are often involved in very similar activities. Take housing. Urban housing is subsidized by the Department of Housing and Urban Development, rural housing by the Department of Agriculture, and military housing by the Defense Department.

The Office of Management and Budget of the U.S. Executive Office of the President (OMB) used to devise the strategy behind the president's budget submission in a spring review.[1] It consisted of a series of formal meetings with the director of OMB seven or eight months before the presentation of the budget in January or early February of the next year. Unfortunately, the spring review has become less formal in recent years. When I worked at OMB, I regarded it as a valuable part of budget preparation.

In the summer preceding the budget, the OMB sends directives to departments and agencies describing the macroeconomic and budget environment and giving them spending targets. Because the state of the economy significantly affects revenues and spending by certain social programs, the assessment of the overall budget environment and of the possible need for countercyclical actions requires an economic forecast. Within the executive branch, that forecast is prepared by the "Troika"—the Treasury Department, the Council of Economic Advisers, and the OMB. The forecast is frequently updated as the budget process proceeds.

Agencies generally respond to their spending targets by saying that it is impossible for them to live within such a meager budget. That begins an adversarial process between OMB budget examiners and department officials in which departments defend their requests in formal hearings while OMB examiners aggressively attack them.

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[1] A classic work on U.S. budgeting is Schick (2007).

Such an adversarial process is important in any budget process. It is lacking in many emerging economies, because budget offices are not well staffed. Budget requests are not critically examined, and the tendency is simply to look at last year's spending and to increase all activities by the same proportionate amount, unless there are powerful reasons for doing otherwise.

Ideally, the adversarial process should be informed by formal program evaluations, but the large number of programs makes it impossible to look at each carefully. Initiatives that attempt to look at everything face almost certain doom, as did President Carter's zero-based budgeting and President Nixon's management by objectives. George W. Bush's administration devised an approach called Program Assessment Rating Tool (PART). It was sensibly designed in that it did not attempt to do everything. Only a portion of the universe of programs was evaluated each year. Although well designed, the approach was not well implemented. Department officials felt that OMB staff paid too little attention to comments and complaints regarding the evaluations. It is natural for department officials to resist all evaluations and complain about negative ones, but it also true that OMB personnel could have been more willing to respond to comments, many of which had merit.

It was also difficult for OMB to explain how the evaluations were used in budgeting. A program might get high marks for efficiency but be treated negatively because OMB decided that it was better located in the private sector. Or an inefficient program might be expanded simply because it was so important to the national interest. These judgment calls were complicated to explain to the press, and, more fundamentally, the administration often ignored evaluations if it was in their political interests to do so. As a result, it was impossible to see much of a relationship between a program assessments and the amount allocated to the activity in the budget.

Whatever impact PART had on the president’s budget, it had even less influence in the legislature where appropriations are finally decided. Many Democratic legislators suspiciously viewed PART as a Bush plot to limit government. Consequently, the incoming Obama administration scrapped PART, but nevertheless emphasizes that they want to do evidence-based budgeting. They are working on processes to fulfill that promise.

After the adversary process is completed, the OMB director holds fall reviews of the budgets of different departments. Staff presents the director with options and the director decides on what to recommend to the president. Most of the recommendations are accepted by the president, thus making the OMB director one of the most powerful officials in the U.S. government. The president’s decisions can be appealed by department heads, but knowing that the president’s time is limited, they are cautious in making such requests.

Although a huge effort goes into preparing the president’s budget, it is, in the end, only a set of recommendations to Congress. A remarkable variety of arrangements exists around the world in the way that budgeting power is divided between government’s executive and legislative branches. The United States lies at one extreme in that the legislature has almost total power over the budget. The president can, however, veto the budget actions of Congress—in which case, a two-thirds majority is necessary to override. At the other extreme is the parliamentary system used in the United Kingdom and many other countries, in which almost all power rests with the executive branch. The typical back bench member of Parliament has essentially no influence over budget policies. Often, budgeting power is shared between the executive branch and the legislature. For example, in some countries and in some U.S. states, the head of the executive branch specifies total spending, but the legislature allocates the spending among different activities.[2]

In the U.S. Congress, the first step in budget-making is when various committees with spending power make their requests to the Budget Committees. These requests are analogous to the budget requests made by various departments within the executive branch. The Senate and House Budget Committees then formulate a budget resolution that specifies aggregate spending and revenues and the deficit, usually for 5 years, but sometimes for 10. The aggregate spending amount is then allocated to various committees. Chief among these is the Senate and House Appropriations Committee, which has responsibility for almost all discretionary spending—that is to say, spending authority for a limited time, usually for one year. The Appropriations Committee divides its allocation among its 12 subcommittees that cover different segments of the U.S. government, such as defense, transportation, etc. Discretionary spending differs from mandatory spending, as discussed below.

Some years, the Senate and the House have been unable to agree on a budget resolution, and often spending and deficit targets are exceeded when a resolution is passed. So-called emergency spending is exempt from the limits, and in the past, "emergency" has been interpreted very imaginatively.

In years when there is a need to reduce the deficit, it is always politically painful for Congress to pass the necessary tax increases and spending restraint. A budget procedure called "reconciliation" attempts to make it easier. The budget resolution can issue reconciliation

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[2] Comparative studies of how different countries budget can be found in Premchand (1990).

instructions to committees. The instructions may require certain tax increases and benefit cuts, and when these are taken to the entire House and Senate, debate is limited. This limit is important because it avoids the need to get the 60 votes normally required to limit debate in the Senate. Only provisions affecting the budget deficit can be included in reconciliation bills.

Reconciliation has sometimes been used to increase the budget deficit. Most recently, that occurred with the Bush tax cuts. When reconciliation was first put into the budget process, it was not intended to be used in this way. However, its impact in increasing the deficit is muted to some degree because it is against the rules to use reconciliation for anything that would increase the deficit beyond the horizon used for the budget resolution. It is frequently suggested that reconciliation be restricted further, so that it can be used only for deficit reduction.

Congress is aided in its budget work by the Congressional Budget Office (CBO), which employs over 200 budget analysts and economists who serve both political parties and both the Senate and the House of Representatives. The CBO provides the economic forecast underlying congressional budget estimates and—its most important function—provides cost estimates for every piece of legislation passed out of congressional committees. The estimates cover the same time horizon the budget resolution covers and play an important role in disciplining the system. The revenue impacts of changes in tax law are estimated by the nonpartisan staff of the Joint Committee on Taxation.

The CBO economic forecast generally differs from the one the administration provides and that causes some confusion. Before the CBO was established in 1974 and during its early history, administrations usually adopted overly optimistic economic forecasts to make the budget situation appear healthier than it really was. But the media and other observers saw the CBO forecast as being more objective, so overly optimistic administration forecasts tended to be discredited. Since the Clinton administration, executive branch forecasts have tended to be more objective and less political.

Budget Execution

Once the legislature enacts a budget, the executive branch must implement it. The process works smoothly and efficiently in the United States. The OMB allocates the spending power decided by congressional vote to the relevant agencies every quarter. Then the budget offices of the departments allocate the power to spend among programs and, within the budgets of the programs, to wages, travel, etc. Sometimes Congress specifies the allocation in great detail. Other times the department has considerable flexibility in allocating the funds. When there are surprises, departments can go back to the relevant committee during the year and ask that funds be reallocated.

It is illegal for any official to commit to spending in excess of what Congress authorizes. The authority to commit to smaller contracts is delegated to officials at fairly low levels of the bureaucracy. Once spending occurs, the Treasurer of the United States, who resides in the U.S. Treasury, provides the necessary cash. The management of the cash flow in and out of government is thus handled centrally, an efficient way to manage borrowing and the debt.

The U.S. process works well largely because the United States has had the ability to borrow money easily if revenues fall short of the level the budget assumes. In many countries, especially poorer ones, that is not the case. If revenues fall short, they may find it impossible to increase borrowing. They must then cut spending, often during budget execution. Credit is sometimes available from the IMF or World Bank, but they are likely to place stringent conditions on spending.

The end result can be chaotic. Projects are often cut off abruptly, and bills are not paid. The budget that is executed can differ markedly from the budget prepared at the beginning of the year. The power to spend often moves to the top. In some countries, the tiniest voucher must be signed by the minister of finance. The power to cut projects and programs arbitrarily and to decide whose bills to pay and whose to ignore often breeds corruption. Despite these serious problems, one often sees poorer countries preparing budgets on the basis of unreasonably optimistic revenue assumptions, making the prepared budget all but impossible to execute.

Often, poorer countries do not have centralized treasuries. Cash is deposited in separate bank accounts for individual departments, an extremely inefficient way to manage cash.

Accounting and Performance Audits

The Government Accountability Office serves as the nation’s auditor. Any member of Congress from either party can ask it to investigate waste, fraud, and abuse. It also audits the performance of particular programs. The Congressional Budget Office and the Congressional Research Service of the Library of Congress can also be asked to evaluate the effectiveness of particular spending programs and tax policies.

Why Current U.S. Budget Policies Are Unsustainable in the Long Run

The U.S. budget processes described above are mainly relevant to budgeting for discretionary spending, almost all of which has to be allocated every year. OMB staff devotes the bulk of its time to this task, even though discretionary spending constituted less than 40 percent of total spending in 2008[3] and bears little responsibility for the severe, long-run budget problems facing the United States. The remaining spending is either mandatory (53 percent of total 2008 spending), consisting of entitlement programs, contractual obligations, and commitments to make certain block grants to states, or related to interest payments (8 percent of 2008 spending).

For entitlements, such as unemployment insurance, the law specifies which people are eligible for the program and the size of their benefits. Payments are then authorized regardless of how many eligible claimants participate in the program. In other words, the budgets of these programs are open ended. Spending goes on unabated unless Congress changes the law. That would not be a major problem if the programs were designed so that spending grows less quickly or at about the same rate as tax revenues. However, three very large entitlements providing public pensions (Social Security) and health care for the elderly, disabled, and poor (Medicare and Medicaid) are all growing far faster than tax revenues and the economy, and in 2008, they made up 40 percent of total spending.[4]

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[3] I use data from 2008 because they are more representative of a typical year than 2009 data, which were distorted by the enactment of a huge stimulus package.

[4] Medicare and total spending are considered net of premiums paid for a portion of Medicare benefits. If Medicare and total spending are defined to include the spending financed by those premiums, the three programs constitute 42 percent of total spending.

The costs of all three programs are adversely affected by the rapid growth of the elderly population as the unusually large number of people born between 1946 and the early 1960s (the baby boomers) age and life expectancy continues to increase. Birth rates fell rapidly after the early 1960s and stayed down. As a result, the tax-paying population is growing more slowly than the elderly population.

The costs of the two largest programs providing health insurance—Medicare and Medicaid—are rising. That's not only because the population is getting older, but because health costs per capita have been rising over recent decades more than 2 percent per year faster than incomes per capita. If the growth of health costs does not soon slow or if the programs are not radically reformed, health insurance costs will eventually become the dominant force propelling total spending upward faster than growth in the U.S. gross domestic product (GDP). Health reform is currently being debated in the United States, but the proposed reform focuses on expanding insurance coverage, which would escalate costs as it increases the demand for health care. The proposed reform also contains provisions that seek to control cost growth, but how well they will work is uncertain. It is safe to say that they will not lower per capita health cost growth below the per capita growth rate of GDP.

On the revenue side of the budget, Congress has kept the tax burden remarkably constant for the past 50 years. Total revenues have averaged a bit more than 18 percent of GDP, and administrations and Congresses have typically cut taxes whenever revenues drift over 19 percent of GDP. The significant tax cuts the Bush administration advocated and Congress passed in the 1981–83 period provide the latest example of this tendency.

Obviously, if tax revenues remain at a relatively constant proportion of GDP and pension and health programs propel spending upward, the deficit and debt will inexorably rise as a percentage of GDP. The most rapid increase will come as baby boomers retire in large numbers. The first one applied for Social Security in 2008 and will become eligible for Medicare in 2011.

When CBO made long-run budget projections in 2007, government debt in the hands of the public looked to total about 40 percent of GDP as baby boomers began retiring in large numbers and wasn't destined to reach 100 percent until about 2030 (CBO 2007). However, the recession has devastated revenues, increased spending on social programs, and provoked Congress into passing a huge stimulus package. Now the rapidly rising debt has already passed 50 percent of GDP. If President Obama's proposed budget policies are followed, the debt will surpass 80 percent of GDP in 2019. Even that forecast may be optimistic because it assumes that the stimulus programs will end as scheduled. In fact, Congress is already in the process of extending various components of the original package and considering new stimulus initiatives.

The president has publicly stated the importance of getting the budget under control several times, and the director of the OMB and the secretary of the Treasury have been even more specific, enunciating a target of lowering the deficit to 3 percent of GDP by 2015. This ambitious goal would imply a debt-to-GDP ratio of about 60 percent in the long run if inflation remains well behaved. Interestingly, that is the ceiling debt-to-GDP ratio imposed by the Maastricht treaty for participants in the Euro zone—a ceiling has often been violated, especially since the beginning of the worldwide recession.

Amending U.S. Budgeting Practices to Deal with the Long-Run Problem

The budget processes described above are very focused on the short run. The budget resolution of the Congress covers 5 or 10 years, but debate centers on the very next year. The CBO and the OMB produce long-run budget projections covering 50 or more years, but the CBO's projection is published separately and at a different time than the CBO's annual report on the budget and economic outlook—the most influential report Congress uses to prepare its budget. The OMB's long-run projection is published in the president's budget, but deep in a volume called *Analytic Perspectives.* Few readers ever get that far.

Long-run projections should be thoroughly integrated into the budget process. It would be useful for Congress to set long-run targets for total spending, revenues, and the debt-to-GDP ratio. Although they would have to be changed often to reflect changing economic forecasts and national needs, the difference between the implications of current law and the targets would be a constant reminder that the budget is in big trouble in the long run and Congress would be forced to estimate the long-run implications of policy changes.

More controversially, some have suggested that the long-run target for the debt-to-GDP ratio be enforced with automatic cuts in spending and increases in revenues if the target for the debt-to-GDP ratio is violated. In 1985, Congress passed the Gramm-Rudman–Hollings law (GRH), which set medium-term targets for the deficit and enforced them with a complicated formula that automatically reduced spending. The law failed because the required automatic cuts became so large that Congress could not endure the political pain. But legislators could not simply abandon GRH without putting something in its place. Congressional leaders got together with President George H. W. Bush and, with considerable difficulty, eventually hammered out a huge, bipartisan deficit-reducing deal that was enacted in 1990. At the same time, Congress passed the Budget Enforcement Act (BEA) to ensure that the hard-won deficit reduction was not eroded over time. The BEA set medium-term limits on discretionary spending and imposed a pay-as-you-go rule that required that any tax cut or entitlement increase be paid for by a tax increase or entitlement cut. These rules worked very well for most of the 1990s and take some credit for the budget surpluses of the late 1990s. Much credit also goes to additional deficit-reducing deals in 1993 and 1997, defense cuts when the Cold War ended, and a surge in revenues related to the growing prosperity of the very rich, who pay very high tax rates.

My colleague Eugene Steuerle and I have suggested a more modest automatic mechanism for reducing deficits in the long run (Penner and Steuerle 2007). We would design triggers that would automatically curb the growth of Social Security benefits and/or raise payroll taxes so long as the system is financially unsustainable, and create a procedure to help reduce spending and/or increase revenues for Medicare. Details aside here, the trick is avoid automatic changes so painful that Congress will override them while making the changes painful enough to encourage rational reform.

A very different idea has been floated recently. There is growing support behind the creation of a bipartisan commission, consisting entirely or predominantly of legislators who would come up with deficit-reducing policies that would be presented to Congress as a package and would have to be voted up or down. The Obama administration supports the creation of such a commission and the director of the OMB has suggested that such a commission might help achieve his goal of reducing the deficit to 3 percent of GDP by 2015.

Many commissions have been created in the past to deal with tough political problems, and many more have failed than succeeded. Nevertheless, the approach may be worth a try. If it fails, it is doubtful that the Congress could simply revert to the status quo. As when GRH failed, legislators may have to put something better in its place.

In the end, any change in budget processes is unlikely to solve the long-run budget problem by itself. Processes can nudge Congress in the right direction and provide political cover, allowing politicians to say that they raised taxes or cut programs only because the budget rules forced them to do it. But before that can happen, a majority of legislators must decide that it is in their interest to get control of the long-run problem. Otherwise, Congress is like the 400-pound gorilla that can do anything it wants. If the rules impose too much political pain, Congress will change the rules.

However, there may be hope. The public is becoming more and more concerned about our growing debt, and Congress is paying attention. Individual voters may still be reluctant to have their own taxes raised or their own programs cut, but this heightened concern might at least help politicians embrace new budget processes that allow the collective good to withstand pressures from special interests.

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