



BIPARTISAN POLICY CENTER



Fixing Fiscal Myopia:

Why and How We Should Emphasize the Long Term in Federal Budgeting

December 2016

DISCLAIMERS

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This report was prepared by a team of budget and fiscal policy experts with extensive experience in the legislative branch, the executive branch, legislative support agencies, the Federal Reserve, international organizations, think tanks, and more.

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Authors

Chapter 1. What Is the Long Term and Why Should We Worry About It?

David Wessel

Director, The Hutchins Center on Fiscal and Monetary Policy, Brookings Institution
Former Economics Editor, *The Wall Street Journal*

Chapter 2. How Budget Offices Should Reframe Our Long-Term Budget Problems

C. Eugene Steuerle

Institute Fellow, Urban Institute
Former Economic Coordinator, Treasury Department's Project for Fundamental Tax Reform

Caleb Quakenbush

Research Associate, Urban Institute

Chapter 3. The Reliability of Long-Term Budget Projections

Rudolph G. Penner

Institute Fellow, Urban Institute
Former Director, Congressional Budget Office

Chapter 4. Experience of Other Nations With Long-Term Budgeting

Barry Anderson

Former Acting Director, Congressional Budget Office
Former Senior Official, Office of Management and Budget

Chapter 5. Goals and Rules for Fiscal Sustainability: Reforming the Budget Process

Philip Joyce

Senior Associate Dean and Professor of Public Policy, University of Maryland
Former Analyst, Congressional Budget Office

G. William Hoagland

Senior Vice President, Bipartisan Policy Center
Former Staff Director, Senate Budget Committee

Senior Advisors

Pete V. Domenici

Former U.S. Senator from New Mexico
Former Chair, Senate Budget Committee

Robert D. Reischauer

President Emeritus, Urban Institute
Former Director, Congressional Budget Office

Alice Rivlin

Former Director, Congressional Budget Office
Former Director, Office of Management and Budget

Broader Advisory Group

Shai Akabas

Director of Fiscal Policy, Bipartisan Policy Center

John Angell

Former Staff Director, House Budget Committee
Chief of Staff, Office of Management and Budget

Steve Bell

Senior Fellow, Bipartisan Policy Center
Former Staff Director, Senate Budget Committee

Sandy Davis

Senior Advisor, Bipartisan Policy Center
Former Associate Director for Legislative Affairs, Congressional Budget Office

Pete Fontaine

Former Assistant Director for Budget Analysis, Congressional Budget Office

Marc Goldwein

Senior Vice President and Senior Policy Director, Committee for a Responsible Federal Budget

Tracy Gordon

Senior Fellow, Urban-Brookings Tax Policy Center

James J. Hearn

Former Deputy Staff Director, Senate Budget Committee
Former Analyst, Congressional Budget Office

Donald Marron

Director, Economic Policy Initiatives, Urban Institute
Former Member, President's Council on Economic Advisers

Kathy Peroff

Former Deputy Associate Director, Office of Management and Budget

Paul Posner

Director, Center on the Public Service, George Mason University
Former Director of Federal Budget and Intergovernmental Relations, Government Accountability Office

Cheri Reidy

Former Staff Director, Senate Budget Committee

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Foreword

America's economic strength is closely tied to its fiscal outlook. A strong long-term fiscal foundation is essential for a healthy economy, with rising incomes, opportunity, and mobility.

Although many policy efforts are focused on the immediate and near term, we are, unfortunately, on an unsustainable and dangerous long-term fiscal path. The non-partisan mission of the Peter G. Peterson Foundation is to increase public awareness of the nature and urgency of the key fiscal challenges threatening America's future and to accelerate action on them.

Consistent with this mission, our foundation asked the Bipartisan Policy Center to propose actionable steps to improve the focus on the long-term budget. Bill Hoagland (former chief of staff of the Senate Budget Committee) and Barry Anderson (former acting director of the Congressional Budget Office [CBO] and assistant director of the Office of Management and Budget [OMB]) recruited 20 respected budget experts, representing deep experience in the executive and congressional budget process, to write and review the report that follows.

The project was guided by three senior fiscal and economic policy experts: Pete Domenici (former chairman of the Senate Budget Committee), Bob Reischauer (former director of the Congressional Budget Office and former president of the Urban Institute), and Alice Rivlin (founding director of the CBO, former director of OMB, and vice chair of the Board of Governors of the Federal Reserve).

We are very grateful for the hard work and dedication of these authors and advisors. Despite their differing individual views, these 22 knowledgeable economic and fiscal policy experts agreed that policymakers and the public should not continue to ignore our nation's long-term fiscal outlook. Our foundation joins them in acknowledging that sound long-term fiscal policy and a growing economy go hand-in-hand.

We thank the participants for their work and hope that this report builds a consensus about the need to secure our nation's long-term fiscal and economic future.

Sincerely,



Peter G. Peterson
Chairman, Peter G. Peterson Foundation

Statement of Support

We, the undersigned, are deeply concerned that federal budget decisions reflect only short-run considerations and fail to address fiscal threats looming ahead.

We share the fear, recently expressed by the Congressional Budget Office (CBO), that the current fiscal path poses “substantial risks to the nation.” To draw attention to this short-sightedness, we undertook this project, *Fixing Fiscal Myopia: Why and How We Should Emphasize the Long Term in Federal Budgeting*, serving as authors and advisors.

While we have each contributed, the chapters themselves reflect the views of the individual authors, and we do not all agree with everything in each chapter. However, we are united in the hope that this project will prompt further progress towards four goals:

- Assuring sharper focus on the long-term budget outlook and its potential impact on our economic and fiscal future.
- Establishing a long-term budget planning framework to support the articulation, development, and implementation of long-term fiscal policy objectives.
- Creating ways to hold policymakers accountable for the long-term consequences of their action or inaction.
- Providing information about long-term budget trends in ways that are accessible to policymakers and the voting public.

To help accomplish these goals, the contributors support the following:

1. In light of predictable demographic trends (especially the aging of the U.S. population and its ramifications for future spending and revenues), it is extremely important to have an assessment of the long term in budgeting—which we define as 25 years, basically a generation.
2. Uncertainty in long-term projections is inherent, but such projections do not have to be precisely accurate to be valuable, particularly those that reflect predictable demographic trends.
3. Agreement on aggregate, long-term fiscal and economic goals is an essential step towards putting the federal budget on a sustainable trajectory.

4. To encourage policymakers' consideration of the long-term implications of budget decisions, long-term projections—especially for major entitlement programs and major revenue sources—should be included in the president's budget, the CBO Budget Outlook, and the congressional budget resolution at the same time as ten-year estimates and projections are made.
5. The president's budget and the congressional budget resolution should describe, in language that ordinary citizens can understand, the long-term implications of the proposed budget and how they relate to the nation's long-term fiscal and economic goals.
6. To provide greater accountability for progress towards a more sustainable long-term fiscal future, the president's Office of Management and Budget and the congressional budget committees should report annually on progress towards the nation's long-term fiscal goals.

David Wessel

C. Eugene Steuerle

Caleb Quakenbush

Rudolph G. Penner

Barry Anderson

G. William Hoagland

Philip Joyce

Pete V. Domenici

Robert D. Reischauer

Alice Rivlin

Shai Akabas

John Angell

Steve Bell

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James J. Hearn

Donald Marron

Kathy Peroff

Paul Posner

Cheri Reidy

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What Is the Long Term and Why Should We Worry About It?

By David Wessel

The federal budget—the \$4 trillion a year that the U.S. government spends, collects in taxes and borrows—serves several purposes. The budget is a tangible manifestation of national priorities: From whom will the government raise money and on what will it spend? How much for defense, for health care, for highways and so on? The budget is one way the federal government reduces the gap between economic winners and losers that an unfettered market would otherwise produce. And it is a powerful stabilizing force that—sometimes automatically, sometimes with explicit decisions to cut taxes or increase spending—offsets some of the swings in private spending over the business cycle.

The budget also embodies policies that influence how well our children and grandchildren will live. Decisions made today will affect the incomes and well-being of today’s younger Americans and their progeny. How much do we tax today and how much do we borrow? How much do we spend on the young and how much on the elderly? How much do we invest for the future in, say, scientific research and how much do we devote to today’s voters on, say, tax breaks for mortgage interest? This aspect of the federal budget is the focus of this volume.

The thesis of this report is that the American people and their elected representatives focus too little on the long-term implications of budget decisions we make, or avoid making, today. From the way tables are presented in the president’s annual budget, to the dysfunction on Capitol Hill, to the less-than-edifying public debate over spending and taxes, we are fiscally short-sighted. The authors don’t agree on everything. They do agree on that much.

“The American people and their elected representatives focus too little on the long-term implications of budget decisions we make, or avoid making, today.”

Some experts try to capture the budget future in a single number, often the size of federal debt relative to the size of the gross domestic product (GDP). By this metric, federal debt is higher than at any time in U.S. history, other than in the immediate aftermath of World War II. Without a course correction, it will keep rising to unprecedented levels. A stable or declining debt/GDP ratio—in other words, federal debt that grows no faster than the overall economy—is a widely shared definition of fiscal sustainability. While there is broad agreement that the U.S. budget is on an unsustainable course, there is little consensus on what level of debt would be truly dangerous.

The federal debt is essentially all the money that has been borrowed over time so that the government was able to spend more than it took in. The budget deficit—the annual gap between spending and revenues—swelled substantially during the Great Recession as revenues fell and spending rose. For four years in a row, deficits exceeded \$1 trillion. In 2009, the deficit amounted to 9.8 percent of GDP, more than triple the level of the previous year. Since then the deficit has been shrinking, largely because the economy has recovered, but also because Congress raised taxes and restrained annually appropriated spending. The fiscal 2016 deficit amounted 3.2 percent of GDP, roughly the 40-year average. But the run of shrinking deficits has ended. When President-elect Trump contemplates the fiscal outlook after the inauguration, the projections will show bigger and bigger deficits over the next decade and beyond, unless Congress and the president act. Without a change in policy, the deficit will again top \$1 trillion (around 4 percent of GDP) before the 2024 presidential election.¹ What better time than the opening months of a new administration to take a longer-term look at budget trends?

The trajectory of deficits and debt tells only part of the story. When the U.S. government spends more than it takes in, the consequences depend, to a significant degree, on what it borrows for: Is it borrowing so Americans can consume more today or is it borrowing to make investments in bridges, R&D, and education that could pay off in stronger economic growth in the future? Unfortunately, that question is usually overlooked because of the way the budget is framed and presented and because of the way Congress makes tax and spending decisions.

There also are lively debates about how, when and how fast we should address the growing imbalances in the budget. Should we lower deficits now, increasing national saving today in the hopes of boosting future economic growth? Or rather should we decide today on spending cuts and tax increases to take effect in the future, as was done in 1983 when cuts to Social Security were legislated far in advance so that taxpayers had time to adjust spending and working decisions?

There is substantial disagreement about the single most pressing fiscal problem that the next president should tackle. Some emphasize the likelihood that unrestrained deficits and

borrowing will lead to economically harmful tax increases, spending cuts or interest rate increases in the future; they see an urgent need to take steps today to reduce current deficits to avoid even harsher measures in the future. Others focus on the disappointing pace of economic growth today and on inadequate levels of public investment that will dampen growth of living standards in the future; in light of today's unusually low interest rates, they would put a higher priority on increasing infrastructure spending now than on negotiating restraints on the growth of future spending. Others believe that the best course is to do both: to invest heavily in future growth now while simultaneously putting in place policies that will restrain spending and/or raise revenues in the future. For different reasons, all of these observers are pleading with the president and Congress to pay more attention to the long term than they do today.

What about economic growth? Authors of this volume agree that if Congress and the president can agree on policies that stand a good chance of quickening the pace of economic growth, they should embrace them. Americans will be better off, and that's reason enough to do so. It's also true that a benefit of faster growth will be to reduce the amount of belt-tightening needed to put the federal budget on a sustainable trajectory. The faster the economy grows, the greater the flow of tax revenues to the government and the less worrisome the burden of debt. However, those who argue that pro-growth policies alone will solve the long-term fiscal challenge have not studied the evidence. Even taking the most optimistic, realistic estimates of the growth-increasing impact of government policies, the U.S. cannot count on faster economic growth alone to put the federal debt on a sustainable trajectory.^a

What Is the “Long Term”?

What do the authors mean by “long term”? They certainly mean more than one year. Congress does its business these days by consulting ten-year forecasts to encourage members to look beyond the next fiscal year and the next election. For many purposes that is a reasonable time frame. In light of predictable demographic trends, such as the aging of the U.S. population and its ramifications for future spending and revenues, however, contributors to this volume generally consider the long term to be a 25-year horizon—basically, a generation, although longer horizons may be appropriate for some programs. The authors recognize that a long-term horizon is particularly important for decisions that are difficult to undo or adjust, such as

^a Consider this calculation by CBO. The agency's primary projections assume that productivity, the output for every hour of work, will grow by 1.8 percent a year for the next 30 years and project the debt/GDP ratio will reach 141 percent for 2046, assuming current laws remain in place and Social Security and Medicare benefits are paid even if their trust funds dry up. Let's say we get lucky, and productivity grows half a percentage point faster each year, by 2.3 percent a year, faster than most economists expect. The debt load in 2046 would then be 112 percent of GDP, still much heavier than it is today and heavier than at any time in U.S. history.

setting Social Security benefits or building aircraft carriers. But it is less important, and often less desirable, to have such a long-term horizon in making decisions about, say, the size of the Army or where to concentrate public-health spending.

As discussed in Chapter Three, the longer the projection horizon, the greater the uncertainty. Imagine how hard it would have been from the vantage point of 1925 to predict accurately what 2000 would look like.^b

Even a 25-year projection made in 1925—with a Great Depression, a World War, and the birth of the nation’s major entitlement programs (Social Security included) in the offing—would not have been very useful for understanding the pressures that would actually drive federal spending and revenues. But limiting ourselves to a ten-year horizon would be imprudent. As the former director of the Congressional Budget Office (CBO), Doug Elmendorf, has said, “The challenges that the country faces are not just short-term challenges, and the policy responses that are being weighed are not just short-term responses. They are gradual responses that, in some cases, wouldn’t have much or even most of their effect until we move beyond the ten-year window that we focus on.” CBO recently began using a 30-year window for its annual long-term projections.²

The Inevitability of Demographics

In a sea of uncertainty—about interest rates, productivity growth, health care spending and the like—there is one sure thing: A growing fraction of the American population will be elderly. The oldest of the baby boomers, that large cohort born between 1946 and 1964, are retiring; every day, 10,000 baby boomers turn 65. Fertility rates are well below pre-baby boom levels. And Americans are living longer. Today, about 15 percent of the population is 65 or older; by 2046, 21 percent will be.³

The baby boom sometimes is described as a demographic pig-in-a-python, which suggests that this phenomenon will pass away when the baby boomers do. This is misleading. This is not a temporary condition. The U.S. is beginning a [demographic transition](#) in which the ratio of retirees to workers will be persistently higher than it has ever been before.⁴ This has enormous implications for the budget, largely because the federal government spends a lot on older individuals. Today, federal spending on Social Security, Medicare and other major health programs amounts to 11 percent of GDP. Even if spending on health care were to grow no

^b For more on this, see David Wessel, “Coping with Budget Uncertainty: Gleanings from a Hutchins Center Conference.” The Brookings Institution, December 17, 2014. Available at: <https://www.brookings.edu/blog/up-front/2014/12/17/coping-with-budget-uncertainty-gleanings-from-a-hutchins-center-conference/>.

faster than the overall economy, CBO projects that aging alone would bring spending on Social Security and major federal health programs to 14 percent of GDP by 2046.⁵ An increase of 3 percentage points of GDP is huge: It's roughly the size of the defense budget.

“The share of Americans who are working and paying taxes is shrinking and the share collecting retirement and health benefits is growing.”

Simply put, the share of Americans who are working and paying taxes is shrinking and the share collecting retirement and health benefits is growing. The federal budget requires a course correction as a result, and the political system, so far, has been unable to achieve that. In one of the most succinct analyses of the nation's predicament, [Elmendorf once](#) said: “The country faces a fundamental disconnect between the services the people expect the government to provide, particularly in the form of benefits for older Americans, and the tax revenues that people are willing to send to the government to finance those services.”⁶

What Long-Term Projections Are Available Today?

The inability or unwillingness of the political system to grapple with long-term fiscal issues—both the consequences of spending too little on investments and of the mounting federal debt—is not caused by an inadequate supply of information. As the inventory below shows, there are plenty of long-term projections. But the presentation of that data and the way it is framed may be inadequate to focus the attention of politicians and voters. Perhaps the forecasters and budget analysts are like a doctor reading lab test results to a patient who doesn't have enough knowledge, experience, or context to use the numbers to make good decisions or change behavior.

As mentioned above, one of the most widely cited metrics is one that compares the federal debt to the size of the economy, a measure that allows for historical and international comparisons. This is the ratio of the federal debt held by the public (which includes Treasury securities held by the Federal Reserve, but excludes the holdings of Social Security and other trust funds) to the gross domestic product. Assuming that current laws remain in place and that Social Security and Medicare benefits are paid even if their trust funds run dry, CBO projects the debt/GDP ratio will rise from about 75 percent of GDP today to 86 percent of GDP in 2026 and 141 percent of GDP by 2046.^c For perspective, the debt/GDP ratio was about 35

^c Any long-term projection rests on a variety of assumptions. Not only does CBO assume that full Social Security and Medicare benefits will be paid even after the trust funds dry up, it also assumes that Congress will adhere to ceilings it has set on annually appropriated spending and, after those ceilings expire in 2026, that annually appropriated spending will grow at roughly the same pace as the overall economy.

percent before the Great Recession and has never exceeded the 106 percent post-World War II peak hit in 1946. Most other projections are similar to those of CBO; different assumptions about the future produce similar upward trajectories, although different levels of debt.

Another often-cited measure is the “fiscal gap.” It is an estimate of the annual increase in taxes and/or reduction in spending, expressed as a percentage of GDP, that would be needed today to reach some debt/GDP ratio at some point in the future. CBO estimates that to ensure that the federal debt as a percentage of GDP in 2046 is roughly where it is today (about 75 percent of GDP) would require cutting non-interest spending or raising revenues (or a combination of the two) each year beginning in 2017 by 1.7 percent of GDP relative to levels estimated in the long-term projections. This works out to about \$330 billion in 2017 or about \$1,000 per person.

The fiscal gap metric also illustrates the consequences of delay; the longer the U.S. goes without a fiscal course correction, the larger the size of the tax increases and spending increases that will be required. CBO estimates that waiting until 2022 to stabilize the debt at today’s levels would require tax increases and/or spending cuts of 2.1 percent of GDP, and waiting until 2027 would bring that to 2.7 percent of GDP. Of course, to achieve a lower debt/GDP ratio, such as reducing the debt/GDP ratio to the 50-year average of 39 percent, would take much more belt-tightening.⁷ OMB’s estimates are similar to CBO’s. Monitoring changes in the fiscal gap over time is one way to track the extent to which developments in the economy or policies adopted by Congress and the president are making the long-term fiscal challenge bigger or smaller.

Table 1.1. Existing Long-Term Budget Reports

Source	Title	Scope	Comments
Government			
Congressional Budget Office	The Budget and Economic Outlook ⁸	10 years, with some estimates for 20 and 30 years	An annual (January) publication that is updated during the year (March and August). Generally assumes current laws remain in place and that Social Security and Medicare spending continues even if trust funds are exhausted.
Congressional Budget Office	Long-Term Budget Outlook ⁹	30 years	An annual summer publication in which CBO updates demographic, health care and other longer-run projections. Generally assumes current laws remain in place and that Social Security and Medicare spending continues even if trust funds are exhausted. Also shows alternative scenarios.
Social Security Trustees	Annual Report ¹⁰	75 years	An annual assessment of long-term solvency of Social Security retirement and disability trust funds based on actuaries' income, demographic and economic projections. Also shows projections with alternative assumptions. Generally issued in late spring or early summer.
Medicare Trustees	Annual Report ¹¹	75 years	An annual assessment of the long-term solvency of the Medicare trust funds and projections for Medicare spending and premiums. Also shows projections with alternative assumptions. Generally issued in late spring or early summer.
Office of Management and Budget	Long-Term Budget Outlook ¹²	25 years	A chapter that accompanies the president's annual (February) budget submission to Congress.
Government Accountability Office	Federal Fiscal Outlook ¹³	75 years	Semi-annual (spring and fall) reports that project federal debt under different sets of assumptions.
Treasury Department	Financial Report of the U.S. Government	75 years	Includes annually updated sustainability measures (present value of social insurance revenues and spending and overall fiscal gap). Generally issued in February or later.

Table 1.1. Existing Long-Term Budget Reports

Source	Title	Scope	Comments
Private			
Committee for a Responsible Federal Budget	Title Varies ¹⁴	75 years	Periodic extrapolations of CBO's 30-year forecasts with different assumptions about current policy.
Center on Budget and Policy Priorities	Title Varies ¹⁵	25 years	Periodic projections based on CBO data, with various adjustments.
William Gale of Brookings & Alan Auerbach of University of California, Berkeley	Title Varies ¹⁶	25 and 75 years	Annually updated estimates of the fiscal gap, the magnitude of changes in taxes and spending needed to stabilize the debt at various debt/GDP ratios.

All projections rely on significant assumptions. In recent years, there have been three major modifications to key assumptions that underlie the long-term projections. The first is that the economy's underlying potential for future growth is a bit slower than was thought previously. The second is that future health care spending growth has and will continue to moderate from the torrid pace experienced before the mid-1990s. And the third is that many economists and central bankers now believe that when the economy is healthy, inflation-adjusted interest rates will be better than had previously been projected. Because the federal government is such a heavy borrower, lower interest rates make the long-term fiscal outlook less frightening.^d

Focusing on a single statistic such as debt/GDP ratio or the fiscal gap reveals nothing about the composition of spending and taxes. On what is the government spending all this money? [CBO routinely reminds](#) anyone who will listen that, without a change in law, Social Security and major federal health care programs and interest on the debt will grow steadily over the next 25 years (both as a share of the federal budget and as a percentage of GDP) and spending on everything else will decline.¹⁷ By 2024, CBO projects that "everything else" category will be smaller, as a percentage of GDP, than any year since 1940, [the earliest for which comparable data are available](#).¹⁸

^d For more on this, see Douglas Elmendorf and Louise Sheiner, "Federal Budget Policy with an Aging Population and Persistently Low Interest Rates," 2016. Available at: https://www.brookings.edu/wp-content/uploads/2016/02/wp18_elmendorf-sheiner_final.pdf.

That shrinking “everything else” category is hugely significant. It includes everything the government spends on national defense, homeland security and foreign aid; on research of all kinds, including education from pre-K to college and the nation’s physical and digital infrastructure; on courts, prisons and law enforcement; on housing and food stamps for low-income families; and on regulating the environment, the financial system, telecommunications and aviation. Nearly all of what could be considered investments in the future, spending that will pay off in more growth in years to come, falls into this category—although there is controversy about which specific spending programs truly constitute investments.

To highlight the shortcomings of a single-minded focus on the debt/GDP ratio and on the way budget data is generally framed, C. Eugene Steuerle of the Urban Institute, a contributor to this book, and his colleague Tim Roper, developed an alternative metric. They call it [the “fiscal democracy index.”](#)¹⁹ It measures the extent to which federal revenues are claimed by programs already in place, such as Social Security and Medicare, as well as interest on the federal debt. In 2009, for the first time ever, every dollar of federal revenue was committed before the new Congress arrived in Washington in January, Steuerle notes.²⁰

Why Worry?

With the exception of the 1998-2001 period, the federal government has borrowed heavily in recent years: Debt owed to the public (that is, excluding government bonds in the Social Security and other trust funds) exceeds \$13 trillion and grows larger every year. Yet lately the U.S. Treasury has been able to borrow huge sums at extraordinarily low interest rates, much of it from foreign investors.

If the bond market isn’t worried about the current and future size of the federal debt, why should ordinary Americans?

Good question. If the federal debt were projected to remain at today’s historically high levels, there might be a lively debate among experts over whether there was an urgent need to act. But the debt under any realistic scenario will keep rising unless taxes are raised or spending is reduced substantially. And the contributors to this book believe that to be a dangerous course.

How come?

- Over time, federal borrowing reduces national saving. A larger debt eventually will mean less private investment, a smaller capital stock, and slower productivity growth. Wages will be lower and interest rates higher than they would otherwise be.

- Even if they remain below historic norms, interest rates will rise from today's extraordinarily low levels, and this will cause the federal government's interest-rate tab to rise. What's more, interest rates could be higher or economic growth could be slower than predicted; either would make the debt burden, relative to the size of the economy, even heavier.
- The U.S. today is very appealing to global investors because the big economies in the rest of the world look so fragile, the U.S. has a large and liquid government bond market, and the country is politically very stable. Despite a few scares such as the showdowns in Congress over raising the debt ceilings, the U.S. Treasury has been able to borrow billions at very low interest rates. But we cannot be sure this low-low-rate environment will last. The more the U.S. government borrows, the greater the risk that someday global investors will grow skittish and demand sharply higher interest rates to lend to the Treasury, which could have significant negative consequences to the U.S.
- During the Great Recession, the federal government borrowed heavily to cushion the blow of a financial crisis even worse than the one that preceded the Great Depression. Debt held by the public grew by more than \$7 trillion between 2007 and 2014 (from about 35 percent of GDP to about 75 percent). If the U.S. were to suffer another big recession, would the president and Congress have what economists call "the fiscal space" to respond with such a large stimulus package? That is a risk the authors of this volume do not want to take.
- Even if the U.S. stays on its present course and manages to avoid a financial crisis, the nation's leadership would be doing harm to future generations if current spending and tax patterns persist: Social Security, health care and interest on the debt will claim a growing share of all federal spending. As a result, there will be less and less room for anything resembling investments that will pay off in higher living standards for our children and grandchildren.

“ Even if the U.S. stays on its present course and manages to avoid a financial crisis, the nation's leadership would be doing harm to future generations if current spending and tax patterns persist: Social Security, health care and interest on the debt will claim a growing share of all federal spending. ”

That's the big picture. Each of the following four chapters examines a different aspect of long-term budgeting. Each reflects the views solely of the author(s) of that chapter.

In Chapter Two, C. Eugene Steuerle and Caleb Quakenbush argue that current framing of budget choices and the conventionally used baselines distort public understanding, interfere with understanding of the long-term consequences of actions taken or not taken, and make it hard to hold elected officials accountable. They observe that almost all of the year-to-year increase in federal spending is built into Social Security, health care and interest on the debt, all of which are the result of legislation approved in years past. As a consequence, Congress offers little control over how new revenues should be allocated in the annual confrontation over the slice of spending that is appropriated. Among other things, they propose an alternative presentation at key moments in the annual budget ritual that would focus on inflation-adjusted increases in spending and tax subsidies for various elements of the budget, identifying which are due to grow automatically under current law and which are proposed policy changes. This would, they argue, hold elected officials accountable for the total change that is taking place rather than changes due exclusively to new proposals.

In Chapter Three, Rudolph G. Penner describes the usefulness of long-term budget forecasts even when they don't always prove entirely accurate. Forecasts over the past couple of decades have been largely correct in anticipating the impact of an aging society on Social Security, Medicare and Medicaid, but have been surprised by a steep decline in interest rates (good for the budget), by a surge in revenues driven by the 1990s stock-market boom (also good for the budget) and by the Great Recession of 2007-9 (which was very bad for the budget.) Surprises in the future are inevitable. Because Congress can more easily raise spending or cut taxes if budget outcomes are better than projected than do the opposite if outcomes are worse, Penner argues for being conservative in setting fiscal goals, such as targets for the debt-GDP ratio. He also favors designing benefit programs so they are easier to alter.

In Chapter Four, Barry Anderson takes a look at the long-term budgeting practices and presentations of Australia, Denmark, the Netherlands, New Zealand, Norway, Sweden, and the U.K.—and finds elements that could be adopted by the U.S. In particular, Anderson recommends that CBO report at the end of each fiscal year on how legislation has affected the long-term projection, as Australia does. Australia's periodic Intergenerational Report by its Treasury, he says, has been influential in framing public debate and focusing attention on the long-term consequences of current policies. While it has no binding constraints, the government is required to evaluate its annual budget in light of these long-term goals.

In Chapter Five, Philip Joyce and G. William Hoagland evaluate the merits of adopting a fiscal rule of some sort to steer the U.S. toward a more sustainable fiscal path. They emphasize that a necessary, although difficult, first step would be for the president and Congress to reach a consensus to pursue fiscal sustainability and then adopt a rule to define and help achieve that goal. They offer several suggestions for better presenting information early in the annual budget process to encourage a longer-term perspective and evaluate a variety of reforms that would create institutional incentives to the same end.

2

How Budget Offices Should Reframe Our Long-Term Budget Problems

By C. Eugene Steuerle and Caleb Quakenbush

Bad framing of fiscal policy contributes to a poor allocation of money collected and spent. Today, almost all real growth in government goes automatically to health, retirement, and tax subsidy programs. Meanwhile, spending on children, education, workers, and public goods like infrastructure and defense—mainly programs without automatic growth—are effectively scheduled for decline as a share of national income. But policymakers don't see this.

That's because today's budget frame distorts the true tax and spending changes taking place. It creates an uneven playing field for programs competing for resources and gives inadequate attention to long-term budget considerations. It discourages investment in people and infrastructure and encourages game-playing by ducking responsibility for shifting costs to future generations. It understates requirements for sustainability and takes democracy away from future voters and elected officials. This inevitably leads to inefficiency because officials who pre-ordain the direction of almost all future spending cannot know the future well enough to do it properly.

Voters and elected officials mistakenly see our time as one of austerity rather than of opportunity to engage new efforts. Yet with roughly constant tax rates, the federal government will raise more than \$6,000 per household of additional taxes and increase spending and tax subsidies by more than \$13,000 annually within a decade.²¹ Rather than a time of austerity, it is a time in which government must make better choices with the increased resources at its command.

The Office of Management and Budget (OMB) and the Congressional Budget Office (CBO) produce a lot of numbers, but the way they present them has at least two shortcomings. First, too little attention is paid to the allocation of the total growth in spending, most of which is due to past legislation, not new proposals. Second, it is highly misleading to measure program

growth by the nominal change in spending and tax subsidies, because programs can increase nominally and appear to be sharing in overall economic growth, when in fact they are declining in real terms.

This chapter proposes a better way to frame budget choices that would ideally occur alongside other process reforms. But, as this is merely an issue of presentation, it could be implemented immediately and independently. Neither CBO nor OMB needs to wait for process reforms to use this presentation.

To summarize, our proposal is this:

“ CBO, OMB, and other budget offices should prominently and timely show all projected changes in after-inflation spending and taxes, clearly delineating automatic changes due to past legislation from new legislation, and thereby hold the president and Congress more accountable for both. ”

The Long-Term Budget Challenge and Opportunities for Reframing Choices

This volume is hardly the first to point out the nation’s long-term fiscal imbalance. Budget experts also know that autopilot health and retirement entitlement programs drive future spending levels and that the tax code, itself riddled with expensive subsidies, will not pay for that growth.

Less clearly articulated by budget analysts is the extent to which these permanent programs dominate changes in real spending and tax subsidies. These programs’ growth is now the primary, sometimes exclusive, way that government “increases” spending and subsidies. Yet the president and Congress aren’t held responsible for passively accepting these increases.

Prime Opportunities for Reframing Budget Choices

The two most important occasions for using our presentation are 1) when the president submits the Administration’s annual budget proposal; and 2) any time Congress makes comprehensive budget decisions, including the annual Congressional Budget Resolution, budget reconciliation bills, and major tax reform. These occasions already focus on changes in spending and revenues that Congress and the president desire, so they are ideal for showing how proposed changes combine with passively accepted changes.

This reframing should also be used at the start of the fiscal year, when projections inform budget thinking; at the end of each session of Congress, when a complete accounting should be made of what was achieved over that period; and when CBO does its long-term economic projections. In these latter cases, the focus is not on new proposals but on the aggregate size and direction of government.

Reframing to Focus On Changes Over the Long Term

The Basic Table

How can budget offices like CBO give decision-makers and budget observers a clearer picture of the budget's path? The foundation is a simple but powerful "Changes in Money Spent and Raised" table that clearly shows what the government will do with the additional money it collects and how it will finance increased spending from current versus future resources (Table 2.1).²²

A quick calculation from Table 2.1 shows that under current law a \$1,373 billion increase in mandatory spending of \$936 billion plus and interest spending of \$437 billion (that is, everything but discretionary spending) will absorb 176 percent of the \$781 billion revenue growth expected between 2016 and 2026! Even with dramatic deficit increases required to pay for higher mandatory spending, there is almost nothing for expanding discretionary programs, which lose ground to inflation. Remember, this is estimated under CBO's assumption that the economy will be more than 20 percent larger in real terms.⁹

CBO's annual reports, such as *the Budget and Economic Outlook, Analysis of the President's Budget*, and *Long-Term Budget Outlook*, should show up-front a version of Table 2.1 to explain the real effects of maintaining current law. The table would show changes in inflation-adjusted annual spending relative to today's level over different periods, such as one year, ten years, 25 years, or longer. Because the most detailed data currently published by CBO is for the ten-year budget window, most tables presented in this chapter adhere to that standard.

⁹ The estimates used in this chapter are based mainly on CBO's March *Updated Budget Projections: 2016 to 2026* and January economic forecast for the *Budget and Economic Outlook* in order to have a consistent basis for showing changes in the current law outlook and analyzing the President's FY 2017 budget proposal, which CBO analyzed using its March and January projections. CBO updated both its budget baseline and economic forecast in August 2016, but not the president's proposal, to reflect new assumptions about economic factors. The August update does not alter our conclusions: While interest costs were projected to be lower, they still comprise over one-quarter (26.5 percent) of the increase in scheduled spending by 2026 and will continue to compound in the longer term.

Table 2.1. Changes in Money Spent and Raised Under Current Law, 2016 to 2026
(Numbers Presented in Billions of 2016 Dollars)

Money Spent	Changes in Annual Spending Levels by 2026	Money Raised	Changes in Annual Revenue and Deficit Levels by 2026
Mandatory Health Programs	+471	Income Taxes	+564
Social Security	+421	Payroll Taxes	+210
Other Mandatory Spending	+44	Corporate Taxes	+35
Subtotal: Mandatory Programs	+936	Other Revenues	-28
Defense Discretionary	+3	Subtotal: All Revenues	+781
Nondefense Discretionary	-24		
Subtotal: Discretionary Spending	-21		
Net Interest	+437	Deficit (Borrowing)	+571
Total: Change in Money Spent	+1,352	Total: Change in Money Raised	+1,352
Addendum:	Spending	Revenues	Deficit
Total 2016 Level	3,897	3,364	534
Total Change	+1,352	+781	+571
Total 2026 Level	5,249	4,145	1,104

Source: Authors' calculations from Congressional Budget Office March 2016 *Updated Budget Projections* and January 2016 economic baseline forecast.

Note: See chapter appendix for a walkthrough of how the table is constructed.

However, examining longer-term changes is recommended. Long-term analysis requires showing periods like 25 years, while shorter-term comparisons are also required because the dominance of past legislation now appears even in current one-year changes.

Congress and the president are responsible for the allocative consequences across programs, not just the level of dependence on borrowing. And the public is entitled to know what lawmakers' choices mean for next year, over their elected leaders' terms of office, and for their children when they become adults.

Later examples will show how to adapt the presentation when new budget laws are considered. In both cases, it's important that the initial presentation concisely shows lawmakers the changes that occur without new enactments.

Why Real Dollars?

Using inflation-adjusted dollars as the main unit for showing changes in spending and revenues is a significant departure from current practice, which uses nominal dollars and percentages of GDP. Nominal figures are misleading for examining changes even over short periods, as significant growth in programs can occur simply because of wage and price inflation.

For example, in March 2016 CBO projected a \$102 billion nominal increase in annual outlays for nondefense discretionary programs between 2016 and 2026, a 16.7 percent nominal increase. This seemingly implies an increase in the capacities of those government programs. But this is not so. After projected 21 percent inflation over ten years, nondefense discretionary outlays face a \$24 billion, or 4 percent, *cut*.^f That is, investments in education and training, infrastructure maintenance, and advancements in science and technology (among other critical priorities) will decline absent changes to current law.

Percentage-of-GDP presentations avoid the inflation problem, and are useful particularly for long-term comparisons. Still, they are inadequate by themselves. First, the appropriations process will always focus on dollars, not shares of GDP. Here we merely suggest that the appropriators should have some sense of how inflation affects dollars allocated. Second, percentage-of-GDP numbers hide the opportunities made available by increased revenues and are not usually an appropriate way to evaluate economically the benefits versus costs for various programs.

Understanding and discussing real figures requires adjustment, but the enhanced clarity is worth it. And nominal budget tables would still be developed for reporting on levels of spending and revenues for individual fiscal years. When the focus turns to *changes over time*, however, real numbers are required. In this case, nominal figures not only cannot suffice, they mislead.

Reinforcing Incremental Budgeting

This new presentation represents nothing more than the frame that would accompany incremental budgeting, where spending is largely discretionary and where inflation is not a major factor. Budget decision-making has always been largely incremental. Comparisons by

^f Deflation, a current threat, would also make nominal figures quite misleading, as when a program had real but no nominal growth.

legislators are usually made marginally, not comprehensively, in no small part because it is hard to both suddenly change what programs are doing and to open up fights each year over everything that government does.

Documents currently prepared for budget deliberations stress only the tiny increment Congress considers through legislation, therefore, neither legislators nor the public see a clear picture—actually any picture—of the total increment in real dollars being allocated through the combination of both past and new legislation.

Measuring only newly legislated changes might have sufficed 60 years ago and throughout earlier U.S. history—when spending was more discretionary—because there was little or no built-in spending growth put into the law itself.^g Legislated changes would dominate the total changes that were taking place each year. If tables comparing legislative and total changes had been prepared, they would largely have shown similar results. Even though mandatory spending started increasing rapidly by the 1950s, it still comprised a smaller share of spending than today. There often was room to increase spending or cut taxes without threatening continual deficits over the next decade or longer.

After all, as long as revenues grew with an expanding economy—and even faster before income taxes were indexed for inflation—they would increase more than total automatic mandatory spending growth. The larger base of discretionary spending would have comprised commitments with no built-in growth, and often reduction after some task was completed. To avoid short-term drag on the economy, Congress and the president would want to return some of the growing surpluses to the public by cutting taxes or increasing spending—a much easier process than cutting back on unsustainable promises.

Not to be overly sanguine about past budget policy. Policymakers often failed to address social problems, provided no assessment of the long-term direction of policy, and made little use of economic evidence.^h They just didn't face today's problem of a budget so driven by decisions from the past that some had to be overturned. The fear factor was reversed: they were afraid not to enact a budget.

^g Of course, there are always exceptions. Most importantly, permanent subsidies built into the tax codes, such as for homeowners or charitable contributions, did increase over time as the economy expanded. These were included on the revenue, not spending, side of the budget.

^h See the recommendation of the 2016 National Academy of Science report, *Advancing the Power of Economic Evidence to Inform Investments in Children, Youth and Families*, which suggested that budget offices should at least report for programs on whether economic evidence was available or being developed. One of the authors of this study served as chair of that committee.

Addressing the Demand for Certainty and Tackling Unsustainable Growth

The federal government's role of providing direct supports to individuals creates a strong demand for certainty, like maintaining Social Security benefits so that aging workers can plan for retirement and making sure people's government-subsidized health insurance is not yanked away arbitrarily. Our proposed budget presentations might seem to threaten this promise of certainty because it shows clearly the unequal plane on which different programs operate within the budget process.

Government can and should reduce risk and provide greater certainty for some households against some events, especially when it can spread risks in ways unavailable and unlikely to happen in the private sector. But when promises of certainty, particularly for future growth in benefits and low taxes, exceed projected growth in government resources, newer voter demands and needs cannot be met without cutting back on those past promises. When programs automatically grow faster than the economy, they pose both macro-economic and allocation problems.

Balance and discretion, therefore, are needed when making promises for the future. Yes, vulnerable groups need protections, and short-term changes cannot be too drastic. For instance, protecting after-inflation benefit levels for the elderly can be distinguished from promising each succeeding generation ever more years of retirement support. With 176 percent of revenue growth over the next ten years already committed, it's easy to recognize how too many promises increase rather than reduce uncertainty for most households. What other spending will be cut? Whose taxes will be raised? How will the budget respond to the next recession? In general, what promises will not be kept?

Lawmakers need some budget flexibility and discretion. And they need to understand the nature and cause of restrictions on that flexibility. Table 2.1 revealed the consequences of staying on a current law path over the next ten years, but an annual table would also show that by fiscal year 2017, every single dollar of the roughly \$93 billion inflation-adjusted increase in federal spending scheduled under current law is devoted to mandatory or interest spending, with discretionary programs headed for real decreases absent offsetting legislation.

Reframing for Proposed Reforms and New Legislation

Table 2.1 summarizes all budgetary changes taking place. When considering new proposals, of course, officials need to understand not just total changes built into current law, but how those changes combine with proposed changes, including the president's budget proposal

and Congress's actions over the past year. Table 2.2 shows how the president's FY 2017 budget proposal would be presented using our reframing. The first columns show the path implied under current law. The next columns show incremental changes proposed, and the last columns show the combined changes due to both existing law and the new legislation.

When the president's budget is presented, the simpler format used in Table 2.1 (for various time periods) would show the overall direction of the budget—in this case, however, from the combination of current law and the president's proposals—and then how those total changes are allocated among categories. It is still useful to present a summary Table 2.1 initially as a first step for readers, even though the same information is included in Table 2.2. Table 2.1 represents what should be the primary focus of accountability: the overall direction that would come about if the president's budget submission were accepted by Congress, not just some of the pieces. Table 2.2 clearly parses how much of that total change derives from current law versus the president's new proposals.

With these big-picture views, these tables would ground discussion at the very beginning of any budget process since the president's proposed budget sets the stage for discussions throughout the year. The tables could also be incorporated into separate communications to the public, such as an OMB-generated "Citizen's Guide" to the federal budget (see Joyce and Hoagland, Chapter 5).

Note that Table 2.2 condenses summary tables already included in the president's budget: the baseline from which the White House measures its budget (in the FY 2017 Budget, Table S-4), proposed changes in mandatory spending and receipts (Table S-9), and levels of appropriated sources (Table S-10). It adds together different items for summary purposes, adjusts for inflation, and then shows how total changes would be allocated.

Our presentation avoids many of the problems with today's incomplete framing: The extent of change under current law is explicitly listed, as are the sources of those changes; the playing field is leveled by directly showing the trade-offs among all sources and uses of money; and the focus on the total extent of additional resources to be spent or returned to taxpayers reveals to the democratic process just how much is in play.

Table 2.2. Changes in Money Spent and Raised in the President's Proposed Budget, 2016 to 2026

(Numbers Presented in Billions of 2016 Dollars)

Money Spent	Changes in Annual Spending Levels by 2026 Under Current Law	President's Proposed Changes	Total Changes Under the President's Budget	Money Raised	Changes in Annual Revenue and Deficit Levels by 2026 Under Current Law	President's Proposed Changes	Total Changes Under the President's Budget
Mandatory Health Programs	+471	-49	+421	Revenues	+781	+285	+1,067
Social Security	+421	+0	+421				
Other Mandatory Spending	<u>+44</u>	<u>+153</u>	<u>+198</u>				
Subtotal: Mandatory Programs	+936	+104	+1,040				
Defense Discretionary	+3	-51	-48				
Nondefense Discretionary	<u>-24</u>	<u>-5</u>	<u>-29</u>				
Subtotal: Discretionary Spending	-21	-56	-77				
Net Interest	+437	-63	+374	Deficit (Borrowing)	+571	-301	+270
Total: Money Spent	+1,352	-15	+1,337	Total:	+1,352	-15	+1,337
Addendum	Current Law			President's Budget			
	Spending	Revenues	Deficit	Spending	Revenues	Deficit	
Total 2016 Level	3,897	3,364	534	3,897	3,369	529	
Total Change	<u>+1,352</u>	<u>+781</u>	<u>+571</u>	<u>+1,337</u>	<u>+1,067</u>	<u>+270</u>	
Total 2026 Level	5,249	4,145	1,104	5,234	4,435	799	

Source: Authors' calculations from Congressional Budget Office March 2016 *Updated Budget Projections*, March 2016 *Analysis of the President's FY2017 Budget*, and January 2016 economic baseline forecast.

Note: Revenues were not presented by source in CBO's March 2016 *Analysis of the President's FY2017 Budget*.

Additional Applications

Our proposed reframing can and should be adapted for other uses. Four examples follow: changes as a share of GDP; budgetary consideration of tax subsidies; combined spending and tax program areas; and growth rates.

Changes as a Share of GDP

As noted before, Tables 2.1 and 2.2 should also be displayed in terms of changes in shares of GDP (Table 2.3). Shares of GDP are especially helpful when looking at longer trends, such as 25 years or in the 75-year projections accompanying programs like Social Security.

There is a parallel here with the accounting done in Australia's Intergenerational Reports, each of which analyzes the direction of debt and deficits (although less the composition of spending) under "previous policy" before the last budget, recently enacted laws, and proposed law.²³ Anderson, in Chapter 4, suggests that this modest comparison seems to influence long-term decision-making by the Australians.¹

Budgetary Consideration of Tax Subsidies

The two sides of Tables 2.1 and 2.2 show both taxes and spending. But sometimes only one side of the balance sheet is considered, for instance, tax reform.

More detailed tables analyzing just spending or tax changes should accompany the high-level tables above. Table 2.4 provides a rough example showing major tax expenditures. Tax expenditures like the mortgage interest deduction and health insurance subsidies have similar budget effects to direct spending, yet are currently given appendix treatment by the Treasury Department for the president's budget, while studies by the Joint Committee on Taxation (JCT) are also little noted. Neither report focuses directly on real changes over time. Yet because most tax subsidies are permanent fixtures of the tax code, their increases from year to year are akin to automatic increases scheduled in mandatory programs. They aren't cheap: Housing tax subsidies exceed the Department of Housing and Urban Development's entire budget and grow over time as people buy more expensive homes.

¹ There is at least one technical challenge to retrospective analysis based on numbers that change over years versus analysis at a point in time under a consistent set of economic and technical assumptions. Over time, some changes in estimates are due to economic changes occurring in intervening years, while others occur because of improvements in projection or scoring techniques or new data. Official budget scorekeepers would need some way to control for and describe these other factors, similar to how CBO describes how economic and technical factors change between its baselines for reasons other than change built into the law or new laws passed by Congress. See Penner, Chapter 3.

Table 2.3. Changes in Money Spent and Raised in the President’s Proposed Budget, 2016 to 2041

(Numbers Presented as Percentage of GDP)

Money Spent	2016	Change	2041	Money Raised	2016	Change	2041
Social Security	4.9	+1.2	6.1	Income Taxes	8.8	+1.6	10.4
Major Health Programs	5.4	+2.7	8.1	Payroll Taxes	5.9	-0.2	5.7
Other Mandatory Spending	<u>2.9</u>	<u>-1.1</u>	<u>1.8</u>	Corporate Taxes	1.8	+0.0	1.8
Subtotal: Mandatory Programs	13.2	+2.8	16	Other Revenues	<u>1.7</u>	<u>-0.2</u>	<u>1.5</u>
Defense Discretionary	3.2	-0.7	2.6	Total Revenues	18.2	+1.3	19.5
Nondefense Discretionary	<u>3.3</u>	<u>-0.8</u>	<u>2.6</u>				
Subtotal: Discretionary Spending	6.5	-1.5	5.2				
Net Interest	1.5	+2.8	4.3	Deficits (Borrowing)	2.7	+3.2	6.0
Total Money Spent	20.9	+4.5	25.4	Total Money Raised	20.9	+4.5	25.4
Addendum	Spending	Revenues	Deficit				
Total 2016 Level	20.9	18.4	2.5				
Total Change	<u>+4.5</u>	<u>+1.1</u>	<u>+3.4</u>				
Total 2041 Level	25.4	19.5	5.9				

Source: Authors’ calculations from Congressional Budget Office March 2016 *Updated Budget Projections* and July 2016 *Long-Term Budget Outlook*.

Note: Totals may not sum due to rounding. Revenue estimates by source from 2041 projected by authors from CBO’s 2040 estimates.

Table 2.4. Changes in Top 10 Individual Income Tax Expenditures, 2016 to 2026
(Numbers Presented in Billions of 2016 Dollars)

Tax Expenditure	2016 Level	2026 Level ^a	Change (\$)	Change (%)	Real growth rate (%)
Tax Exclusion for Employer-Sponsored Health Insurance ^b	211.0	307.9	+96.9	+45.9%	+3.9%
Net Exclusion of Pension Contributions and Earnings ^c	176.2	228.1	+51.9	+29.5%	+2.6%
Exclusion of Net Imputed Rental Income	101.1	117.7	+16.6	+16.4%	+1.5%
ACA Premium Assistance Credits (Including Outlay Effects)	40.4	111.4	+71.0	+176.0%	+10.7%
Mortgage Interest Deduction	62.4	109.0	+46.6	+74.6%	+5.7%
Special Rates for Capital Gains (Except Agriculture, Timber, Iron Ore, and Coal)	92.8	106.5	+13.7	+14.7%	+1.4%
Step-up Basis of Capital Gains at Death	58.3	86.0	+27.7	+47.6%	+4.0%
Deductibility of Nonbusiness State and Local Taxes Other than on Owner-occupied Homes	51.4	75.6	+24.2	+47.1%	+3.9%
Charitable Deduction (All Purposes)	51.4	75.5	+24.1	+46.9%	+3.9%
Capital Gains Exclusion on Home Sales	40.6	64.5	+23.9	+59.0%	+4.7%
Addendum					
Sum of Top 10 Tax Expenditures ^d	886	1,282	+397	+44.8%	+3.8%
Sum of All Tax Expenditures ^d	1,287	1,811	+524	+40.7%	+3.5%

Source: Authors' calculations from OMB *Analytical Perspectives, Budget of the U.S. Government, FY 2017* and CBO January 2016 economic baseline forecast.

Notes:

^a Estimates for 2026 projected from OMB 2025 estimates using constant shares of GDP.

^b Excludes reductions in payroll tax revenue that result from the exclusion.

^c Includes defined-benefit and defined-contribution employer plans, individual retirement accounts, and self-employed plans.

^d Totals do not take into account the interaction between tax expenditures, for example, when a household is eligible for two or more subsidies but must choose only one.

If Congress was engaged in a revenue-neutral tax reform, proposed changes to tax subsidies could be compared to changes under current law on the “spending” half of a table similar to Table 2.2. Changes to overall taxes or tax rates could be shown on the revenues half of the table so that the changes in tax expenditures could be compared to the changes in tax revenues.^j

Even outside of major tax reforms, the JCT and the Treasury Department occasionally should report how tax subsidies automatically change over time. Such reports ideally would not be relegated to an appendix that few besides tax experts know exists. If people spend more on housing over time, the analysis would reveal how housing tax subsidies increase in real and relative terms compared with other tax subsidies. By the same token, it would show how the child credit, which is not indexed for inflation, declines in real value and relative to GDP. The congressional and presidential decision implicitly to favor housing over child tax credits would be much more transparent.

Combined Spending and Tax Program Areas

Both spending and tax provisions affect many broad program areas, but the two are rarely shown together. This hides the overall direction of government policy in these areas. Health care, housing, and income maintenance are ripe sectors for combined scrutiny. Importantly, analyses would cut across congressional jurisdictions, not just the tax and spending sides of government accounts.

Again, the problem extends beyond assessments of current law to times when reform is on the table. For instance, tax expenditures are considered separately or not at all during major “spending” reform efforts, despite their enormous size. At other times, such as the debate over the Patient Protection and Affordable Care Act of 2010 (Obamacare), taxes and tax subsidies are considered alongside spending changes, but the framing lacks a comprehensive view of how total changes in health spending and tax subsidies relate to each other.^k

^j Here again technical issues must be given some consideration. Tax provisions interact, so that changing one can affect the cost of others. For instance, if mortgage interest payments were limited, there would be an increase in number of taxpayers itemizing deductions and a decrease in number taking charitable contributions. At the same time, similar considerations are less noted but apply to direct spending programs. For instance, if cash welfare subsidies become limited, they increase the level of housing benefits provided. These issues arise with current budget displays already, at times dealt with by simply not adding up provisions and at others by providing additional numbers on the size of interaction effects.

^k To its credit, CBO created a combined measure of federal support for health insurance during the ACA debate. See for example, Congressional Budget Office, *Federal Subsidies for Health Insurance Coverage for People under Age 65: 2016 to 2026*, March 24, 2016. Available online at <https://www.cbo.gov/publication/51385>.

Putting related tax and spending programs together in a way similar to the spending side of Table 2.1 or 2.2 would give policymakers a better grasp of all tools at their disposal when weighing trade-offs to potential policies. A simple version of this, to which other smaller items could be added, is shown in Table 2.5. It demonstrates, for instance, how the growth in the new premium assistance credits under Obamacare relates to other sources of health spending growth. During reform processes, the additional columns for proposed changes that are incorporated in a Table 2.2 can be added.

	2016	2026 ^a	Change (\$)	Change (%)	Real growth rate (%)
Medicare ^b	597.6	892.4	294.8	49.3%	4.1%
Medicaid	370.9	512.8	141.8	38.2%	3.3%
CHIP	12.6	4.7	-7.9	-62.8%	-9.4%
ACA Premium Assistance Credits ^c	40.4	111.4	71.0	176.0%	10.7%
Tax Exclusion for Employer-Sponsored Health Insurance					
Income Tax Exclusion	211.0	307.9	96.9	45.9%	3.9%
Payroll Tax Exclusion	<u>131.4</u>	<u>172.0</u>	<u>40.7</u>	<u>30.9%</u>	<u>2.7%</u>
Total Tax Exclusion	342.4	479.9	137.6	40.2%	3.4%
Self-employed medical insurance premiums	7.1	9.2	2.2	30.6%	2.7%
Total: Major Health Insurance Initiatives^d	1,370.9	2,010.4	639.4	46.6%	3.9%

Source: Authors' calculations from Office of Management and Budget, *Analytical Perspectives, Budget of the U.S. Government, FY 2017*; Congressional Budget Office, March 2016 *Updated Budget Projections*; Congressional Budget Office, March 2016 *Analysis of the President's FY2017 Budget*; and Congressional Budget Office, January 2016 economic baseline forecast.

Notes:

^a Estimates for 2026 projected from OMB 2025 estimates using constant shares of GDP.

^b Net of offsetting receipts.

^c Includes both outlays and reductions in tax liabilities.

^d Excludes interactions between health programs, for example, when a household is eligible for two or more subsidies but must choose only one. For instance, limiting the tax exclusions would likely lead more employers to drop insurance and affected employees to switch to premium assistance credits.

Growth Rates

One final way to describe changes over time is to show real growth rates, starting with the largest programs, built into the “current law” estimates. The president’s proposals and congressional decisions could be added to this growth rate table, just as in the tables on real increments to spending and tax subsidies. Table 2.6 gives an example.

Table 2.6. Annual Real Growth Rates Under President's Proposals, 2016–2026

	Changes Implied Under Current Law	President's Proposed Changes	Total Changes Under the President's Budget
Revenues	2.1%	+0.7%	2.8%
Deficits	7.5%	-3.3%	4.2%
Mandatory Health Programs	3.8%	-0.3%	3.4%
Social Security	3.9%	+0.0%	3.9%
Other Mandatory Spending	0.9%	+2.6%	3.5%
Defense Discretionary	0.1%	-0.9%	-0.8%
Nondefense Discretionary	-0.4%	-0.1%	-0.5%
Net Interest	10.6%	-1.1%	9.5%
Total Spending	3.0%	+0.0%	3.0%

Source: Authors' calculations from Congressional Budget Office March 2016 *Updated Budget Projections*; Congressional Budget Office, March 2016 *Analysis of the President's FY2017 Budget*; and Congressional Budget Office, January 2016 economic baseline forecast.

Note: The growth rate is calculated as the annual geometric rate of growth between 2026 and 2016 or $[(2026 \text{ level} / 2016 \text{ level})^{\frac{1}{10}} - 1]$, expressed as a percentage.

Conclusion

Budget reform requires reframing budget presentations to draw attention to the true extent of all spending and tax changes, not just newly proposed changes. Our framing holds elected officials accountable for the overall direction of government—not just for whether it is on a sustainable path, but also for how priorities are set for today and for the long term.

Our recommendations concern how information is framed, but better framing, in turn, could spur process reform. A better process would focus more on the budget's overall direction, on total taxes and spending (discretionary *and* mandatory), and allocating increased revenues among different spending and tax subsidy possibilities, without privileging programs with built-in growth.

“ A better process would focus more on the budget's overall direction, on total spending and taxes (discretionary and mandatory), and allocating increased revenues among different spending and tax subsidy possibilities, without privileging programs with built-in growth. ”

Suppose process reform does occur and creates significantly greater discretion in the budget.²⁴ In particular, suppose that a significant share of long-term revenue growth remains to be allocated on a discretionary basis to new spending or lower taxes. And suppose that future Congresses were prevented by the new budget process from retreating backward into the current morass by removing discretion in the budget for future elected officials.

Then our proposed reframing fits neatly into a workable budget process with which elected officials would want to engage.

First, a Table 2.1 would be produced. It would show rising revenues to be allocated and, in this world of restored discretion, budget surpluses once revenues outpaced automatic spending growth. The budget process could easily start with congressional leadership seeking a resolution, perhaps with presidential concurrence, on some overall level of increase in spending, tax subsidies, or tax reduction. Those totals would then be parceled out to particular committees for further allocation and distribution.

In many ways, today's process already attempts this, but with the budget so overcommitted, members are asked not to allocate additional resources but to renege on unsustainable "promises" to a disgruntled public. Unsurprisingly, this political hot potato continually gets passed around without decision, and the budget process fails to function properly.

Next, a Table 2.2 would compare proposed changes against current law, and, while the president and Congress could do more if the proposed changes included significant structural reform, they would have strong incentives to enact a budget in almost any case. After all, they would need to allocate any surpluses soon before reduced government demand slowed the economy. Unlike today, they would be debating what to "give away" as spending increases or tax cuts rather than what to "take away" from the public.

In sum, reframing the budget clarifies the consequences of the lawmakers' lack of discretion to respond to new emergencies and opportunities. Even those more sanguine about today's deficits might more likely consider alternative paths if they recognized and were held accountable for the real programmatic changes that are occurring. Not only would the reframing proposed here encourage process reform, but it would fit neatly into that process.

Process reform is crucial, but framing matters, and it matters a lot. CBO and related budget offices can and should lead in such reframing, and in most cases, they require no new legislative authority to act.

Appendix

How Table 2.1 Was Derived From CBO Data

This appendix walks through the steps to arrive at Table 2.1 in this chapter. CBO typically begins its budget updates with a summary table of the annual projected aggregate spending, revenues, and deficits for the ten-year budget window in nominal terms, that is, unadjusted for inflation. It also includes actual historical aggregates for the most recent completed fiscal year. More recently, it has begun to show longer-term horizons in its analyses.

The categories in CBO's summary tables vary from year-to-year and grow more detailed over time. Its most detailed tables show receipts by source (income taxes, payroll taxes, etc.) and levels of mandatory, discretionary, and net interest spending. For simplicity, Table A1 keeps to the categories presented in this chapter, which can be derived from supplementary data CBO helpfully provides with each update.²⁵

One could simply display nominal changes over the ten-year period, as done in Table A2. CBO presented similar information in graphic form in a recent report.²⁶ However, this is misleading, as inflation greatly diminishes the value of a dollar in 2026 as compared to 2016—by a bit more than 20 percent with 2 percent per year inflation (about what CBO typically assumes in its economic forecast). This is also why the summation of annual figures for five- and ten-year periods totals often used by CBO, OMB, and other fiscal analysts are not included in our examples: The dollars being added are not of the same value.

Table A1. Nominal Aggregate Receipts and Outlays Under CBO's March Baseline
(Numbers Presented in Billions of Nominal Dollars)

	2016	2017	2018	2019	2020	2021	2022	2023	2024	2025	2026
Receipts (Sources of Funds)											
Income Taxes	1,626	1,744	1,835	1,913	1,998	2,092	2,191	2,297	2,412	2,536	2,664
Payroll Taxes	1,099	1,140	1,180	1,223	1,266	1,316	1,366	1,419	1,473	1,532	1,592
Corporate Taxes	329	357	366	372	400	395	401	407	417	429	444
Other Revenues	<u>309</u>	<u>267</u>	<u>264</u>	<u>263</u>	<u>267</u>	<u>278</u>	<u>289</u>	<u>301</u>	<u>313</u>	<u>328</u>	<u>342</u>
Total Revenues	3,364	3,508	3,645	3,772	3,931	4,082	4,247	4,423	4,615	4,825	5,042
Deficits (Borrowing)	534	550	549	710	798	890	1,043	1,080	1,094	1,226	1,343
Outlays (Uses of Funds)											
Mandatory Health Programs	1,055	1,094	1,125	1,216	1,291	1,371	1,496	1,552	1,603	1,742	1,856
Social Security	911	947	1,003	1,067	1,135	1,206	1,282	1,360	1,442	1,529	1,620
Other Mandatory	483	505	496	540	553	562	592	586	577	602	641
Defense Discretionary	588	592	593	609	623	638	657	669	680	702	719
Nondefense Discretionary	608	614	611	613	625	638	650	664	679	695	710
Net Interest	253	306	365	437	501	557	613	673	728	782	839
Total Spending	3,897	4,058	4,194	4,482	4,729	4,972	5,290	5,504	5,709	6,051	6,385

Source: Authors' calculations from Congressional Budget Office, March 2016 *Updated Budget Projections*; and Congressional Budget Office, January 2016 economic forecast.

Table A2. Changes in Nominal Money Spent and Raised Under CBO’s March Baseline, 2016 to 2026
(Numbers Presented in Billions of Nominal Dollars)

Money Spent	Changes Implied Under Current Law	Money Raised	Changes Implied Under Current Law
Mandatory Health Programs	+800	Income Taxes	+1,038
Social Security	+709	Payroll Taxes	+493
Other Mandatory Programs	+158	Corporate Taxes	+114
Subtotal: Mandatory Programs	+1,667	Other Revenues	+32
Defense Discretionary	+131	Subtotal: All Revenues	+1,678
Nondefense Discretionary	+101		
Subtotal: Discretionary Spending	+232		
Net Interest	+586	Deficits (Borrowing)	+810
Total	+2,488	Total	+2,488

Source: Authors’ calculations from Congressional Budget Office March 2016 *Updated Budget Projections* and January 2016 economic baseline forecast.

As explained in this chapter, only changes in inflation-adjusted terms give policymakers and the public a true idea of the real shifts occurring in budget policy over time. As a starting point, Table A3 therefore presents the ten-year aggregate totals in constant 2016 dollars. The particular price deflator to make the adjustment can be debated, but we use the GDP price deflator adjusted to 2016 dollars because it represents a broad “basket” of goods that includes government purchases (as opposed to the consumer price index or personal consumption expenditures, which focus only on price changes for household goods and services). Also, many program costs increase as prices increase, so inflation-adjusted estimates are often more accurate than nominal estimates.

Table A3. Real Dollar Aggregate Receipts and Outlays Under CBO's March Baseline
(Numbers Presented in Billions of Nominal Dollars)

	2016	2017	2018	2019	2020	2021	2022	2023	2024	2025	2026
Receipts (Money Raised)											
Income Taxes	1,626	1,715	1,771	1,811	1,854	1,903	1,953	2,007	2,065	2,128	2,190
Payroll Taxes	1,099	1,121	1,139	1,157	1,175	1,197	1,218	1,240	1,262	1,286	1,309
Corporate Taxes	329	351	353	352	371	360	358	356	357	360	365
Other Revenues	309	263	255	249	248	253	258	263	268	275	281
Total Revenues	3,364	3,450	3,517	3,570	3,647	3,713	3,787	3,866	3,952	4,049	4,145
Deficits	534	540	529	672	740	810	930	944	937	1,029	1,104
Outlays (Money Spent)											
Social Security	911	931	968	1,010	1,053	1,097	1,143	1,189	1,235	1,283	1,332
Mandatory Health Programs	1,055	1,076	1,086	1,151	1,198	1,247	1,334	1,357	1,373	1,462	1,526
Other Mandatory	483	497	479	511	513	511	528	512	494	505	527
Defense Discretionary	588	582	572	576	578	580	586	584	582	589	591
Nondefense Discretionary	608	604	590	581	580	580	579	580	581	583	584
Net Interest	253	301	353	414	465	507	546	588	624	656	690
Total Spending	3,897	3,990	4,047	4,242	4,388	4,523	4,717	4,810	4,889	5,078	5,249

Source: Authors' calculations from Congressional Budget Office, March 2016 *Updated Budget Projections*; and Congressional Budget Office, January 2016 economic forecast.

Finally, Table A4 is the same as Table 2.1 in the main body of this chapter. It shows, in 2016 dollars, changes in spending levels for key government functions and how those changes will be financed. Note the contrast with Table A2, which showed a \$131 billion nominal increase in annual defense spending by 2026 and a \$102 billion nominal increase in nondefense discretionary spending. After adjusting for inflation, growth is modest or negative: an increase of only \$3 billion for defense, and for nondefense discretionary budget, a \$24 billion decrease.

Table A4 (2.1). Changes in Money Spent and Raised Under Current Law, 2016 to 2026
(Numbers Presented in Billions of 2016 Dollars)

Money Spent	Changes in Annual Spending Levels by 2026	Money Raised	Changes in Annual Revenue and Deficit Levels by 2026
Mandatory Health Programs	+471	Income Taxes	+564
Social Security	+421	Payroll Taxes	+210
Other Mandatory Spending	+44	Corporate Taxes	+35
Subtotal: Mandatory Programs	+936	Other Revenues	-28
Defense Discretionary	+3	Subtotal: All Revenues	+781
Nondefense Discretionary	-24		
Subtotal: Discretionary Spending	-21		
Net Interest	+437	Deficit (Borrowing)	+571
Total: Change in Money Spent	+1,352	Total: Change in Money Raised	+1,352
Addendum	Spending	Revenues	Deficit
Total 2016 Level	3,897	3,364	534
Total Change	+1,352	+781	+571
Total 2026 Level	5,249	4,145	1,104

Source: Authors' calculations from Congressional Budget Office, March 2016 *Updated Budget Projections*; and Congressional Budget Office, January 2016 economic baseline forecast.

3

The Reliability of Long-Term Budget Projections

By Rudolph G. Penner

“All models are wrong, but some are useful.” – George Box

Forecasting is a perilous activity. Forecasters often make big mistakes, whether they are forecasting the economy, the weather, or the outcome of the World Series. Budget forecasts are no better than any other²⁷ and revenue forecasts are particularly difficult.²⁸ Errors occur even when forecasting with a one-year time horizon. Does that mean that long-term budget forecasts of 25 years or more are totally worthless?

Forecasts do not have to be right—although they sometimes are—to be valuable. It may be difficult to forecast a variable’s exact value, but getting information on the direction it is moving can be very useful. Even if the forecaster gets the direction of a particular variable wrong, there may be other components of a forecast that provide valuable information.

“ It may be difficult to forecast a variable’s exact value, but getting information on the direction it is moving can be very useful. ”

Long-term forecasters actually have a few advantages over short-term forecasters. In the short term, the economy is buffeted by the turbulence of business cycles, oil shocks, political upheavals, droughts, etc. Over the longer term, however, more fundamental forces exert themselves and there is some tendency for variables to return to long-term trends. Regression to the mean^l is the long-term forecaster’s best friend and policy makers often react to surprises with policy responses that keep variables within bounds.^m

^l Defined as the tendency for statistical aberrations to disappear in the long term, for example, abnormally tall fathers are likely to have sons closer to average height.

^m A strong example of this phenomenon will be discussed later—the remarkable constancy of the revenue-GDP ratio.

Unfortunately, the advantages enjoyed by long-term forecasters are not sufficient to make long-term forecasts more accurate than short-term forecasts. They are not. But they are not worthless either.

Long-term budget forecasts done by different groups may contain significant errors, but they generally reach the same conclusion. Unless they adopt combinations of very optimistic assumptions, they almost always forecast debt-GDP ratios that rise indefinitely at an increasing rate.⁸ This may be less a testimony to the accuracy of long-term projections than it is to the seriousness of our long-term budget problem.

So far, I have used the word “forecasts.” Those working on long-term budget issues prefer the word “projections” and the Government Accountability Office (GAO) talks about “scenarios.” Whether it is a projection or a scenario, it purports to show the consequences of a certain combination of economic, demographic, and policy assumptions. The projection will not be very valuable if the many underlying assumptions are not realistic and any effort to make them realistic involves making a forecast. That diminishes the difference between a projection and a forecast. One difference remains, however: People making projections make them along with a wish that their policy assumptions will not come true, because the projections inevitably imply a fiscal disaster. A major reason for making projections is to persuade policy makers to change policies.

“ People making projections make them along with a wish that their policy assumptions will not come true, because the projections inevitably imply a fiscal disaster. ”

Notwithstanding the problems with making long-term projections, there is no shortage of them. They are provided by the Congressional Budget Office²⁹ (CBO), the GAO³⁰ and the Office of Management and Budget (OMB).³¹ These government efforts are complemented by private analyses. For example, Auerbach and Gale³² periodically produce long-term budget projections. They focus on estimating a fiscal gap. That is defined as the increase in revenues and/or decrease in noninterest spending as a percent of GDP necessary in each and every year to end up with the same debt-GDP ratio after a certain number of years as when the period begins.⁹

⁸ The administration's long-term forecast is an anomaly. It shows a rising debt-GDP ratio through 2040, but one that declines after that.

⁹ In Chapter 2 Steuerle and Quakenbush argue that aiming for the same debt-GDP ratio in some future year is not sufficient, because it is unlikely to be sustainable. They feel that policy makers should aim at a lower ratio to provide a cushion. A similar point is made later in this article.

The Committee for a Responsible Federal Budget also does numerous long-term analyses,^p and Jeffrey Miron³³ examines the difference between the present value of noninterest spending and the present value of receipts over the next 75 years. He does this for each year beginning in 1965 and finds a strong upward trend in the gap, broken only by the recovery after the Great Recession and the end of the stimulus program.

The different groups making projections use different methods and assumptions. Most produce more than one path for the budget aggregates, although they typically pay most attention to one path that might be called their base case. All do sensitivity analysis based on varying the value of certain key assumptions, but this is done in very different ways. Often the analysis is for different time periods, and that makes comparisons difficult. Policy projections are often based on extending “current law” or “current policy.”^q A major difference between these two concepts is that current law often contains temporary provisions that are scheduled to expire, but in fact have been extended year after year. Current policy assumes that many will in fact be extended. However, considerable judgment is required to translate these broad terms into precise policies for the next 25 years, and all of this results in significant differences among various projections. CBO is the only one that investigates the effects of ever increasing deficits on the future growth of incomes.

CBO’s base estimate is called the “extended baseline” and is essentially based on current law. This leads to a relatively small fiscal gap for the 2017-2041 period of 1.7 percent of GDP and a debt-GDP ratio in 2040 of 122 percent. Auerbach-Gale project current policy and their projection results in larger medium-term deficits than derived by CBO. They estimate a fiscal gap of 3.0 percent and a 2040 debt-GDP ratio of 152 percent. They do a large number of variants on this base case. OMB’s “current policy”^r estimates a fiscal gap of 1.7 percent of GDP, identical to CBO’s by coincidence, and a 2040 debt-GDP ratio of 115 percent. GAO provides a 75-year fiscal gap estimate of 3.0 percent for an extended baseline case, but no estimate for 25 years. The estimated debt-GDP ratio in 2040 is very close to that of CBO’s. Although the individual estimates vary, the bottom line is almost always the same. The debt-GDP ratio is on its way to an explosion.^s A notable exception is OMB’s very long-term projection. Their debt-GDP ratio rises toward the middle of the century and then starts a decline after baby boomers have passed from the scene.

^p For example, see Committee for a Responsible Federal Budget, “The Very, Very Long-Term Budget Outlook,” July 19, 2016. Available at: <http://crfb.org/blogs/very-very-long-term-budget-outlook>.

^q The administration refers to one of its projections as being based on current policy, but the policy assumptions differ little from what CBO calls baseline extended.

^r OMB’s definition of “current policy” is close to what others call “current law.”

^s See Figure 3.1 for the history of the debt-GDP ratio and for a typical long-term projection.

Looking Backward

The most important single force driving the debt-GDP ratio upward in essentially all long-term projections is the rapid growth of the elderly population. It propels the growth of three large spending programs—Social Security, Medicare and Medicaid—to the point that their spending growth exceeds that of the rest of the budget and the GDP. As shown in Figure 3.2, the growth in the number of retirees, which exceeds the growth in the working-age population, also slows economic growth and the growth in revenues. In addition, the projections assume that the resulting increase in debt rapidly increases the interest bill facing the government relative to GDP.

The accuracy of these basic predictions will be examined for the past 20 years. That also happens to be the length of time that CBO has been making long-term projections, while GAO has done it for a slightly longer period.

For a time horizon of 20 years, the aging of the population is quite predictable, even though there are minor uncertainties surrounding mortality rates and immigration. Health costs are more difficult to forecast. Costs per beneficiary have been growing faster over the long term than GDP per capita. The growth is greater than would be expected looking only at the aging of the population. The growth above that due to aging is known as “excess cost growth.” It has slowed unexpectedly in recent years and it is hard to know how much of the slowdown, if any, will continue. Interest rates are even more uncertain than excess cost growth, thus making the interest bill facing the government especially difficult to project.

Despite being too pessimistic in projecting excess cost growth, those making long-term projections have been basically right that the growth of spending on Social Security, Medicare, and Medicaid would exceed the growth of the rest of spending and the growth of GDP. In 1996, spending on Social Security, Medicare, and Medicaid amounted to about 40 percent of total spending and 8 percent of GDP. By 2015 the importance of the three programs had risen to 51 percent of total spending and 10.6 percent of GDP.

The generally correct prediction about the growth of Social Security, Medicare, and Medicaid has been overwhelmed by three very big surprises—two good and one bad. First, contrary to past projections, a precipitous fall in interest rates caused the interest bill facing the government to fall as a percent of GDP from 3.0 percent in 1996 to 1.3 percent in 2015 despite a very large increase in the debt-GDP ratio.¹ Note that the fall in the interest bill

¹ While the low interest rate may have been good news for the budget, it reflected bad news regarding economic growth all over the world.

relative to GDP offsets approximately two-thirds of the rise in spending on Social Security, Medicare and Medicaid relative to GDP. The second surprise involved a huge unexpected surge in revenues related to the dot-com boom. As a result, budget surpluses emerged for four years following 1997. The debt-GDP ratio fell substantially from 48.6 percent in 1996 to 31.4 percent in 2001 instead of rising, as almost all long-term projections had predicted. Third, the Great Recession and the associated stimulus program caused a doubling of the debt-GDP ratio from 35.2 percent in 2007 to 73.6 percent in 2015. Only a small part of that increase was the result of the growth of Social Security, Medicare and Medicaid.

Looking Forward

It was earlier said that a wrong projection can have a valuable component. That is true about the projected increases in spending on Social Security,^u Medicare, and Medicaid, even though projections of the debt-GDP ratio have not been very accurate. As we look forward, the effect of aging on spending will grow over the next 25 years because of longer expected life and the large number of baby boomers that will become beneficiaries of the three programs. The people affected are already with us and therefore, it is unlikely that projections of the future number of beneficiaries will be very far off. As the three programs grow as a proportion of total spending, it also becomes less probable, although not impossible, that their bad effects on total spending and the deficit will be overwhelmed by good surprises. The fact that two important variables, excess health cost growth and interest rates, are remarkably low relative to levels experienced over past decades would seem to reduce the probability that they could go very much lower. However, we have seen negative interest rates in Europe and Japan and brief periods of health cost growth in the United States falling far below forecasts, so it is true that very surprising good things can happen. But saying that surprising good things can happen is very different from saying that we should count on them.

The analysis will now shift to what those making projections assume about the future of the many variables underlying their analysis. CBO provides considerable detail regarding their assumptions and they will be examined most carefully. Space limitations prevent a detailed examination of all relevant assumptions and only a sampling will be discussed.

Macroeconomic Uncertainty

All major projections show rising deficits and debt through 2040. It is important to understand how this affects the macroeconomy and how those effects have secondary feedback effects on the budget. This is no simple task and only CBO attempts it explicitly. CBO assumes that

^u All projections assume that scheduled Social Security benefits will be paid after trust funds are emptied around 2030. This will require a change in current law.

increased deficits increase aggregate demand and GDP growth in the short term, but because this analysis focuses on the long-term, the short-term impact of deficits will not be analyzed.

In the long term, deficits represent a reduction in national saving. This implies increased interest rates and a reduction in investment with an accompanying negative effect on economic growth and the growth of wages. These effects are mitigated by borrowing from foreigners. CBO assumes that a one dollar increase in federal government borrowing attracts 24 cents in foreign private capital. Although the borrowing from foreigners reduces the fall in wages that would otherwise occur if all borrowing were done within the United States, it does mean that more of Americans' future income must be used to pay interest and dividends abroad.

Increased interest rates are assumed to induce more private saving, thus reducing the fall in national saving caused by the deficit. There are other complicated, but probably minor, effects on private saving and work effort because of changes in after-tax income, transfer payments, and worries about large policy changes induced by growing deficits.

The CBO analysis of the macroeconomic effects of larger deficits assumes that the relationship between deficits and increased foreign capital inflows remains as in past history. That may not be true if a continually rising debt-GDP ratio begins to affect foreign confidence in the United States. If foreigners reduce their investments in the United States, or—in a worst-case scenario—begin to withdraw their capital, it will have negative consequences for economic growth and future government deficits. This may be an area in which CBO is overly optimistic. In addition, our heavy reliance on foreign investors may reduce our flexibility in foreign policy.

Policy Uncertainty

In previous years CBO provided projections based both on their extended baseline and on an alternative fiscal path. In its most recent report of July 2016, CBO decided that there was not a sufficient difference between the two policy scenarios to warrant doing projections for both, so the report now only includes the extended baseline. This assumes that certain temporary tax cuts will not be extended beyond their current expiration date. In fact, in the past such temporary cuts have been extended routinely and some that were once temporary, such as the research and experimentation tax credit, have been made permanent. The extended baseline also assumes that Congress will, through 2021, abide by the caps placed on discretionary spending in 2011 and reduced in 2013. From 2022 through 2025 discretionary spending is assumed to rise with the rate of inflation and after that to remain constant relative to GDP. Subsequent legislation relaxed the caps in 2014, 2015, 2016, and 2017. It is probably reasonable to assume that they will be relaxed further before 2021 and may rise with both

inflation and the population during 2022-2025. The extended baseline also assumes that revenues will increase faster than GDP because of real bracket creep. As will be discussed later, Congress has never allowed that to happen over extended periods.

If the extended baseline assumptions prove accurate, defense spending after 2025 will be at the lowest level relative to GDP since before World War II and nondefense discretionary spending will be 2.6 percent, the lowest level since at least 1962—the first year for which comparable data is available. Over the past 54 years, nondefense discretionary peaked relative to GDP in 1980 when it was 5.2 percent.

It is difficult to believe the discretionary numbers projected for the next decade will be realized. Could defense sink so low when there so many threats in the world, especially from Russia and China—whose defense budget has been rising at double digit rates? It is also difficult to be confident about the nondefense numbers given strong calls for additional infrastructure and education spending. Of course, spending in excess of the levels being assumed might be paid for with increased taxes, but Congress is not good at that.

There are other reasons to think that the extended baseline deficits may be exceeded. It is believed by some that remarkably low interest rates make deficits less harmful than they would be otherwise and that we should be more relaxed about borrowing for things like infrastructure investments.³⁴ The amount gained from this strategy depends on:

1. How easy it will be to reverse the extra borrowing if interest rates again rise toward historical norms; and
2. On allocating the extra spending efficiently—something that we have not done well in the past.

Revenues

Since World War II revenues have been remarkably constant relative to GDP, almost always varying between 17 and 19 percent. When the ratio went below 17 percent it was usually because of recessions. There were some temporary tax increases in the past 50 years related to war and a few permanent tax increases. Otherwise, the tax burden was pressured upward by inflation and real growth that pushed income tax payers into higher tax brackets. The effects of inflation were neutralized in the early 1980s when individual income tax brackets, exemptions and standard deductions were indexed to the CPI. But whatever the cause, every time the total tax burden was pushed above 19 percent, a tax cut followed. That happened after World War II and after the Vietnam War. It happened again after the effects of the high inflation of the late 1970s were countered by the Reagan tax cuts, and yet again with the Bush

tax cuts after the turn of the century. Just before the Bush tax cuts, the tax burden had been above 19 percent for three successive years (1998-2000)—the longest period in U.S. history.

In the CBO analysis, the tax burden reaches 19 percent in 2040 and will surpass it later as real bracket creep continues. Given the past aversion to such a high tax burden, it is reasonable to ask whether this is a realistic assumption. On the other hand, the debt will be rising inexorably and that may deter the tax cuts necessary to keep the burden below 19 percent. If tax cuts do occur, the debt-GDP ratio will rise above the 122 percent estimated for 2040 in the base case.

Health Costs

There has been a significant slowdown in the rate of excess health cost growth in recent years. For the 38 years between 1975 and 2014 it averaged 1.8 percent per year, but in the last 23 years of the period, from 1990 to 2014, it slowed to 1.2 percent per year. Because the slowdown is not well understood, it is not known if it will be a lasting phenomenon or one that is reversed in the near future. CBO assumptions for the long term are that Medicare excess cost growth rises from 0.7 to 0.9 percent per year over the next 10 years. Medicaid excess cost growth starts at 1.4 percent per year as more states cooperate with the Affordable Care Act and then falls to 0.7 percent per year. In the very long term, excess cost growth in both Medicare and Medicaid slowly converges to 1.0 percent, reaching that level in 2046. If excess cost growth is 1.0 percentage point higher per year, all else equal, the estimate of the debt-GDP ratio for 2040 is 130 percent instead of 122 percent in the base case. If it is 1.0 percentage point lower, the estimated debt-GDP ratio becomes 99 percent.

Economic and Demographic Assumptions

Table 3.1 provides the value that CBO assumes for important economic and demographic variables. Because of space limitations I shall briefly discuss only a few assumptions. CBO provides a much more detailed discussion in their 2016 report on the long-term budget outlook.

Immigration

CBO assumes that the rate of legal and illegal immigration per 1,000 U.S. residents will mimic that of the past two centuries. They admit that past data is highly variable. There is a wave of anti-immigrant fervor now sweeping Europe and indications that it is spreading to the United States. If immigration falls short of assumed levels, estimates of potential economic growth will also be lowered and the long-term budget outlook will deteriorate.

Inflation

CBO assumes that the inflation rate stays low through 2040 at near the Federal Reserve's target of 2.0 percent. In a separate analysis CBO shows that a rate above that assumed has negative consequences for the budget deficit over the next ten years because it would increase the assumed growth of discretionary spending and the amount that has to be spent on cost-of-living adjustments (COLAs) for indexed entitlement programs. The negative effect is offset as inflation reduces the nominal debt-GDP ratio by increasing nominal GDP. If the average maturity of the debt is lengthened, that reduces the negative effects of higher inflation by reducing the need for refinancing at higher nominal interest rates. Inflation's beneficial effect on the deficit and the debt would be even greater, if the rate brackets, personal exemptions, and the standard deductions in the personal income tax had not been indexed for inflation in the early 1980s. Analyses of the fall in the national debt from slightly above 100 percent of GDP at the end of World War II to 23 percent in 1974 attribute much of the fall to inflation.

“ If the average maturity of the debt is lengthened, that reduces the negative effects of higher inflation by reducing the need for refinancing at higher nominal interest rates. ”

Interest Rates

Interest rates are extraordinarily low compared to past history and the once unthinkable prospect of negative nominal interest rates has now become thinkable because of European and Japanese experience. CBO assumes a steady rise through 2019, but to levels below historical averages. Over the past few years CBO has continually lowered its interest rate assumptions. If actual interest rates do not increase as much as currently assumed, long-term budget problems will become less dangerous. For example, in an alternative to their base case that adopts CBO assumptions, Auerbach and Gale assume no interest rate increase from current levels. Their estimate of the fiscal gap falls from 3.0 percent of GDP to 1.8 percent. The budget problem is lessened, but it does not go away.

Productivity

CBO assumes that labor productivity will increase at a steady pace of 1.7 percent through 2040. Since 2010 the growth of labor productivity in the business sector has been abysmal. It has varied year-to-year between 0.1 and 0.7 percent. It is dangerous to place a large weight on recent experience, but five years of very bad experiences tend to make one nervous. If CBO is significantly too optimistic about future productivity growth, it will have significantly underestimated the seriousness of our long-term budget problems.

Sensitivity Analysis

CBO does an elaborate sensitivity analysis, but on only four of the variables included in Table 3.1—labor force participation rates, productivity growth, the interest rate on the government debt, and excess cost growth for spending on Medicare and Medicaid. CBO shows how deviations of the individual variables from assumed values affect the debt-GDP ratio projected for 2040. I shall focus on their example where the four variables jointly become more or less optimistic.

To decide on an appropriate range of possible values for the variables going forward, CBO examines their actual values over the past 30 years. CBO's base assumption for the labor force participation rate has it gradually declining from 63 percent in 2015 to 58 percent in 2046. The range of uncertainty is based on different paths that end up in 2046 three percentage points higher or lower than 58 percent. The plausible range for the interest rates on the debt and for excess cost growth in Medicare and Medicaid is one percentage point above or below base-case values. The range for productivity growth is 0.5 percentage point above or below. CBO then takes 60 percent of the ranges and asks what happens if labor force participation is on the lower path described above, excess cost growth and interest rates are 0.6 percentage points above the assumed values, and productivity growth is 0.3 percent per year below assumed values. With these most pessimistic values, the debt-GDP ratio reaches 160 percent rather than the 122 percent reached in the extended baseline case. With all four variables at the most optimistic end of the range the debt-GDP ratio in 2040 is 88 percent.

The range of uncertainty used by CBO is quite narrow. It would be interesting to see how vulnerable the nation is to more extreme events. For example, CBO could “stress test” their results by assuming another Great Recession and stimulus program, or assuming another Iraq War.

Coping with Uncertainty

The previous discussion has identified numerous reasons to be uncertain about the long-term outlook and it merely skimmed the surface, discussing but a small portion of the multitude of assumptions necessary to make a long-term projection. One could think of many budget targets for the next 40 years, but if there is any concern over the possibility of a fiscal crisis, it is important to have a target for the debt-GDP ratio. Let us suppose that Congress decides that 60 percent is an appropriate goal for the debt-GDP ratio in 2040. That was the frequently-violated upper limit imposed by the Maastricht Treaty for Eurozone countries. Should policymakers design policies that put us on a track for 60 percent given long-term projections or should policies aim at something lower, like 50 or 40 percent, in order to increase the probability that 60 percent or better will be achieved?

A strong case can be made for aiming for something below 60 percent because the risks associated with doing better or worse than expected are not symmetrical.³⁵ Assume that we are aiming at 60 percent and we do better than expected. There may be a brief period when we have unnecessarily deprived people of benefits and imposed too high a tax burden, but it should be the easiest thing in the world to persuade policymakers to correct by increasing benefits and cutting taxes. Moreover, while we are adjusting, the deficit will be below the expected level and that will be good for the growth of incomes.

“ A strong case can be made for aiming for something below 60 percent (debt-GDP ratio) because the risks associated with doing better or worse than expected are not symmetrical. ”

Contrast that with a situation in which we are doing worse than expected. It will be excruciatingly difficult to persuade politicians to increase taxes and slow the growth of benefits. The situation may get out of hand and leave us heading for a fiscal crisis. We have seen from recent experience in Europe that fiscal crises are horribly painful as countries respond with abrupt cuts in social benefits and public pensions and taxes are raised quickly and sometimes arbitrarily.

Conservatism in setting goals can be accompanied by conservatism in interpreting deviations from the target path to the goal. Presumably the assumptions underlying the long-term projections will be re-evaluated frequently—perhaps every year. When there is a negative deviation from the optimum path, it may be because of a statistical aberration that does not require corrective action or a structural change that does. Often it will be uncertain which it is. A conservative approach would lean in the direction of assuming that it is a structural change that demands attention.

The effects of uncertainty can also be mitigated by carefully designing programs. For example, if programs and taxes are reformed to put us on a path to a 60 percent debt-GDP ratio, triggers can be built into programs, especially those that are growing rapidly, to automatically make them more or less generous or change revenues if there is a deviation from the desired path. For example, the indexing of Social Security can automatically be made less generous with some notice if benefits are growing faster than planned. If benefits later grow more slowly, some or all of the cuts can be restored.³⁶

Unfortunately, triggers have often failed, because they have been waived by Congress when they turn out to be too painful. That means that they have to be designed with care. They cannot be too painful, but they must be stringent enough to have a good chance of correcting deviations from the desired spending or revenue path.³⁷

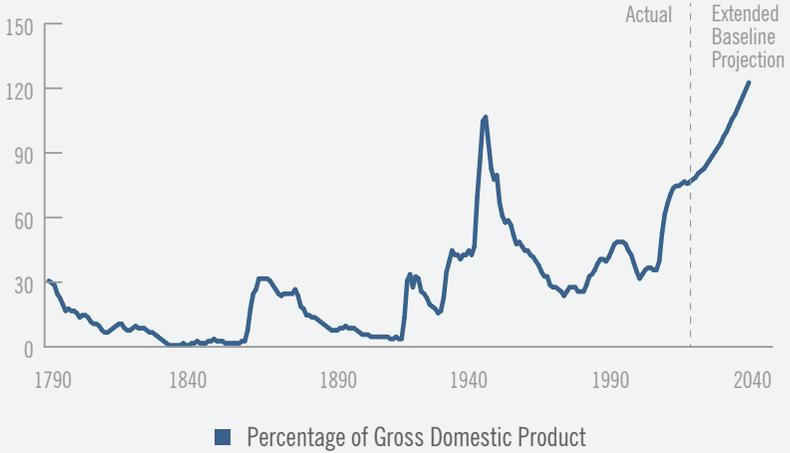
A more fundamental approach would initially design programs so that they are easier to reform. Before Social Security's initial benefits were indexed to wages and existing benefits were indexed to the CPI, Social Security's actuary would predict soaring surpluses in future years. Congress then had the happy task of increasing benefits to absorb the surpluses.^v Since indexing they face the painful task of limiting benefit growth or increasing revenues, if they wish to make the program sustainable financially.

Conclusions

Long-term budget projections may not be very reliable, but they are valuable. They identify the most predictable force driving us toward a fiscal crisis: the aging of the population. Aging's effect on Social Security, Medicare, Medicaid, and the future debt may be offset for limited periods by pleasant surprises. But negative surprises are just as likely. In the longer term, the dire effects of aging might be offset by large efficiencies in the delivery of health care, by robust economic growth, by extraordinarily low interest rates, or by the coincidental movement of a whole array of less important variables in an optimistic direction. But such events would be outside the realm of historical experience. It would be extremely foolish to count on them.

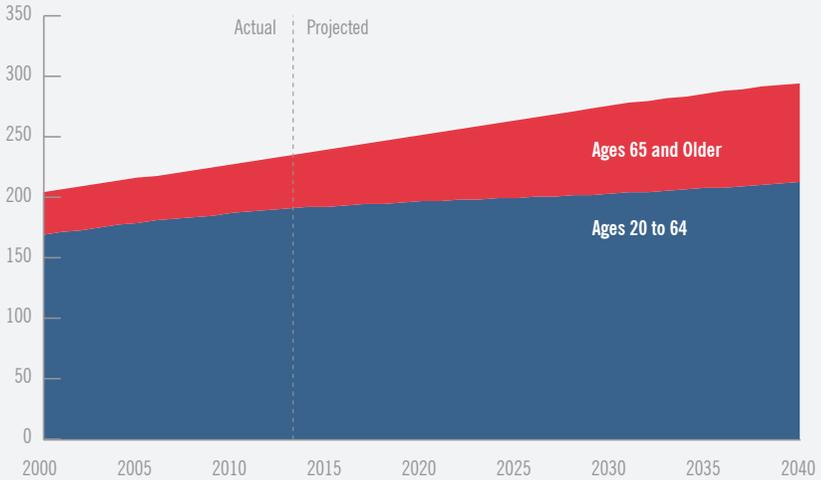
^v Ironically, indexing was first introduced in the hope that it would save money. It was thought that Congress could not resist being too generous when it periodically raised benefits. That was because of some very large increases passed in the late 1960s and early 1970s. In retrospect that appears to have been an unusual time. Congress had not been nearly as generous earlier in the program's history and has not increased benefits relative to wages since indexing began.

Figure 3.1. Federal Debt Held by the Public



Source: Congressional Budget Office. For details about the sources of data used for past debt held by the public, see Congressional Budget Office, *Historical Data on Federal Debt Held by the Public* (July 2010). Available at: www.cbo.gov/publication/21728.

Figure 3.2. Population, by Age Group, in Millions



Source: Congressional Budget Office, *The 2016 Long-Term Budget Outlook*, July 2016, at 26.

Table 3.1. Average Annual Values for Economic and Demographic Variables That Underlie CBO’s Extended Baseline

	2016– 2026	2026– 2040	Overall, 2016–2040
Economic Variables (Percent)			
Growth of GDP			
Real GDP	2.1	2.0	2.1
Nominal GDP	4.1	4.1	4.1
Growth of the Labor Force	0.6	0.3	0.4
Unemployment			
Unemployment Rate	4.9	4.9	4.9
Natural Rate of Unemployment	4.8	4.7	4.7
Growth of Average Hours Worked	-0.1	-0.1	-0.1
Growth of Total Hours Worked	0.5	0.3	0.4
Earnings as a Share of Compensation	81	81	81
Growth of Real Earnings per Worker	1.2	1.3	1.3
Share of Earnings Below the Taxable Maximum	80	77.5	78.4
Growth of Capital Services	2.4	1.8	2.0
Growth of Productivity			
Total Factor Productivity	1.3	1.3	1.3
Labor Productivity	1.6	1.7	1.7
Inflation			
Growth of the CPI-U	2.3	2.4	2.4
Growth of the GDP Price Index	2.0	2.0	2.0
Interest Rates			
<i>Real Rates</i>			
On 10-year Treasury Notes and the OASDI Trust Funds	1.6	1.9	1.8
On All Federal Debt Held by the Public	0.8	1.6	1.3

(Table 3.1 continues on next page.)

Table 3.1. Average Annual Values for Economic and Demographic Variables That Underlie CBO's Extended Baseline

	2016– 2026	2026– 2040	Overall, 2016–2040
Economic Variables (Percent)			
<i>Nominal Rates</i>			
On 10-year Treasury Notes and the OASDI Trust Funds	3.9	4.4	4.2
On All Federal Debt Held by the Public	3.1	4.0	3.6
Demographic Variables			
Growth of the Population (Percent)	0.8	0.7	0.7
Fertility Rate (Children per Woman)	1.9	1.9	1.9
Immigration Rate (Per 1,000 People in the U.S. Population)	3.9	3.9	3.9
Life Expectancy at Birth, End of Period (Years) ^a	80.6	81.4	80.8
Life Expectancy at Age 65, End of Period (Years) ^a	20.2	20.7	20.3

Source: Congressional Budget Office, *The 2016 Long-Term Budget Outlook*, July 2016, 96.

Note:

^a Life expectancy as used here is period life expectancy, which is the amount of time that a person in a given year would expect to survive beyond his or her current age on the basis of that year's mortality rates for various ages.

4

Experience of Other Nations With Long-Term Budgeting

By Barry Anderson

As stated in Chapter 1, the thesis of this paper is that the American people and their elected representatives focus too little on the long-term implications of today's budget decisions. But what about other countries? Do any do a better job on focusing on the long-term implications of their budget decisions? The short answer is yes—not many perhaps, but a few developed countries have built long-term projections into their budget processes and fiscal rules, and another couple use their long-term projections to affect budget decisions in other important ways.^w And even some developing countries are building the capacity to do long-term projections and to consider their implications. A World Bank official put it this way: long-term projections have become important to developing countries as they are trying to get rich before they get old.

“ A few developed countries have built long-term projections into their budget processes and fiscal rules. ”

As part of its 2012 survey of International Budget Practices and Procedures, the Organization on Economic Development and Cooperation (OECD) asked: “Is it required that the budget be based on long-term fiscal projections?”³⁸ 15 of the 34 OECD countries—but not the United States—gave a positive response: Belgium, Canada, Chile, Denmark, Estonia, Greece,

^w Note, however, that the success in utilizing long-term projections depends on government acceptance of the trends indicated by the projections and, especially, government support of the reporting mechanisms, caps, and other fiscal rules that utilize the projections.

Iceland, Mexico, the Netherlands, Portugal, Slovakia, Slovenia, Spain, Turkey, and the United Kingdom.^x However, the meaning of “based on” varies considerably from country to country. All of these countries—and perhaps some who did not respond positively—probably take into account their long-term projections when constructing their annual budgets, but Australia, Denmark, the Netherlands, and Norway have the most explicit procedures and rules that force the consideration of long-term projections during their annual budget processes.^y Although their budgets may not be explicitly based on their projections at this time, New Zealand, Sweden, and the United Kingdom utilize long-term projections in other important ways. This chapter will discuss each of those seven countries and then conclude with recommendations on how to apply some of their practices to the United States.

Countries That Use Long-Term Projections in Their Budget Processes

Australia

Australia³⁹ produces an Intergenerational Report to “assess the long-term sustainability of current Government policies and how changes to Australia’s population size and age profile may impact economic growth, workforce and public finances over the following 40 years.”⁴⁰ In 2009, OECD reported that the Australian “government considers the intergenerational reports to have been influential in framing public debate on economic policy and focusing attention on the long-term consequences of current policies. [Proposed legislation to increase the pension eligibility age from 67 to 70 is a current example.] The intergenerational reports are widely used by the executive, ministers and cabinet to inform debates on a range of public policy

^x The European Commission (EC) regularly publishes a Fiscal Sustainability Report that contributes to the discussion and assessment of the sustainability of public finances by examining fiscal sustainability challenges faced by Member States over the short, medium, and long term. The 2015 Report (Institutional Paper 018, January 2016) states: “Even when the fiscal position of a country appears to be sound, sudden episodes of fiscal stress may occur following the materialization of fiscal or macro-financial risks. Medium-term sustainability challenges are assessed by having regard to the underlying country’s initial budgetary position, the level and projected evolution of the country’s public debt and projected implicit liabilities related to an ageing population. In the long run . . . it is not the level of debt that matters most, but its projected evolution, taking also into account the projected cost of an ageing population. The identification of the nature, the scale and the urgency of the challenges faced by individual Member States is provided . . . as a key ingredient to support the formulation of appropriate policy responses.” The Report may have great influence over near-term policy responses (see, for example, the discussion of Denmark); however, as difficult as it is to assess the impact of country-specific long-term assessments on individual country political actions, it is even more so for the potential impact of the EC’s long-term assessments.

^y In 2009, OECD reported that long-term projections in Denmark, Netherlands, Norway, and Sweden either trigger adjustments to the government’s fiscal strategy and/or are required for program proposals and reforms. See “Fiscal Futures, Institutional Budget Reforms, and Their Effects: What Can Be Learned?,” by Barry Anderson and James Sheppard, *OECD Journal on Budgeting*, Organization on Economic Cooperation and Development, Paris, Vol. 2009, No. 3, 2009, 38.

areas including health, education, family benefits, welfare, [Social Security], and pensions. In addition to the work of the Treasury's Budget Policy Division to prepare the IGR, issues of fiscal sustainability are now considered by a number of other units within the Treasury and the Department of Finance and Deregulation."⁴¹

The reports have also generated changes to the regular budget practices and procedures. Long-term fiscal projections have been embedded into the annual budget document through the inclusion of 20-year projections of the underlying cash balance and net debt as part of the medium-term (four years) fiscal outlook for the federal budget.

“ In Australia, long-term fiscal projections have been embedded into the annual budget document through the inclusion of 20-year projections of the underlying cash balance and net debt as part of the medium-term (four years) fiscal outlook for the federal budget. ”

Australia passed legislation in 1998 that helped institutionalize sound and transparent fiscal policies and made it difficult for future governments to deviate from them. The law's provisions included a regime for setting fiscal objectives, and an extensive system of fiscal reporting to monitor the consistency of the government's fiscal actions with its stated fiscal objectives.

Setting fiscal objectives is a two-step process involving certain legislated “Principles of Sound Fiscal Management” and an annual “Fiscal Strategy Statement” prepared by the government. The Principles of Sound Fiscal Management require the government to:

- Manage Australia's financial risks prudently, in light of economic circumstances, with a focus on maintaining general government debt at prudent levels;
- Ensure that its fiscal policy contributes to achieving adequate national savings and to moderating cyclical fluctuations in economic activity, as appropriate, taking account of the economic risks facing the nation and the impact of those risks on the government's fiscal position;
- Pursue spending and taxing policies that are consistent with a reasonable degree of stability and predictability in the level of the tax burden;
- Maintain the integrity of the tax system; and
- Ensure that its policy decisions have regard to their financial effects on future generations.

These Principles are translated into specific government objectives through an annual Fiscal Strategy Statement, which in turn provides a benchmark for evaluating the government's fiscal policy performance. In the statement, which is published as part of the budget, the government is required to:

- Specify the government's long-term fiscal objectives within which shorter-term fiscal policy will be framed;²
- Specify the key fiscal measures that the government considers important and against which fiscal policy will be set and assessed;
- Specify for the budget year and the following three fiscal years the government's fiscal objectives and targets and the expected outcomes for the specified key fiscal measures; and
- Explain how the fiscal objectives and strategic priorities specified relate to the principles of sound fiscal management;
- Specify fiscal policy actions taken or to be taken by the government that are temporary in nature, adopted for the purpose of moderating cyclical fluctuations in economic activity, and indicate the process for their reversal.

In cases of non-compliance, the law mandates a comprehensive set of reports to monitor the consistency of the government's fiscal actions against its stated fiscal objectives, although it does not call for legal penalties. These reports ensure that the "court of public opinion" is able to make the necessary judgments on the government's fiscal management. One of these reports—the intergenerational report—was designed to assess the long-term sustainability of current government policies and must be produced at least every five years.^{aa}

The report focuses on the implications of demographic changes for economic growth and assesses the financial implications of continuing current policies and trends over the next four decades (two generations). The report outlines the government's fiscal sustainability objectives and its approach to achieving them, and gives details on Australia's long-term demographic and economic projections. Based on the projections, the report provides detailed estimates for future revenue and spending and the resulting budget balance.

² In practice the various government fiscal strategies have tended to be rather non-specific, focusing on achieving budget balance or surpluses on average over the medium term or over the course of the economic cycle. Parliamentary Budget Officer, Australian Parliamentary Budget Office, June 8, 2016.

^{aa} It was reported that Ken Henry, the former chairman of the National Australia Bank, said with respect to the Australian elections in July 2016 that political leaders preferred to see the challenges the nation faced as distant and not requiring urgent action, while most Australians knew that was not the case.

The reports attract much public and media attention. The five-year interval for the reports allows a narrative to be written of policy changes in the intervening period and of their impact on fiscal sustainability. It also coincides with Australia's population census that occurs every five years. Although demographics change slowly, annual fiscal policy decisions can and frequently do affect the long-term outlook every year. As stated in the most recent report, "The Intergenerational Report is the social compact between generations—with our children, grandchildren, parents, grandparents and each other."⁴²

Denmark

In Denmark,⁴³ Government believes that its 60-year fiscal projections serve as a "consistency check" as to whether the Government's eight-year medium-term fiscal strategy is sustainable over the long term. The medium-term fiscal strategy forms the basis for the annual fiscal policy setting, fiscal policy bill negotiations, and the government's fiscal rules. Even before the first medium-term fiscal strategy was published in 1999, internal projections prepared since the early 1990s had been considered by the Ministry of Finance as a cornerstone in its fiscal planning.^{bb}

Denmark's fiscal projections play an important role in the government's three fiscal rules: an expenditure rule that limits real public consumption growth; a budget balance rule that targets a structural balanced budget or surplus; and a tax freeze that covers both central and sub-national governments and prevents an increase in taxes. In addition, Denmark's adherence to the European Union's debt rule is explicitly built into its intertemporal fiscal gap indicator. The goal of Denmark's expenditure ceilings is to support fiscal stability in the medium term and sustainability in the long term.

The Netherlands

The Netherlands Bureau for Economic Policy Analysis^{cc} regularly publishes forecasts about macroeconomic developments in the next year, in the next period of government (four or five years—the medium term), and for the long term (50 years). "These forecasts play a central role in official decision-making in the Netherlands."⁴⁴ Key elements of the Dutch budget

^{bb} Competing fiscal projections have also been published on several occasions by the Welfare Commission and by the independent Danish Economic Council.

^{cc} The Netherlands Bureau for Economic Policy Analysis (formerly known as the Central Planning Bureau) was founded in 1945 as a fully independent organization that conducts research on its own initiative, or at the request of the government, parliament, individual members of parliament, national trade unions or employer federations. It is a part of the Ministry of Economic Affairs and its director is appointed by the minister in consultation with other members of the government. It has its own legal mandate and an independent executive and advisory committee.

framework are: expenditure ceilings set in real terms and covering all types of spending;^{dd} a requirement that new tax measures must be offset by compensating revenue measures; and a general government^{ee} deficit limit of 2 percent of GDP. The long-term fiscal projections have supported this framework through the formulation of medium-term^{ff} fiscal goals. For example, the first long-term fiscal projection in 2000 was translated into a medium-term fiscal policy to amortize the outstanding government debt within one generation. The 2006 fiscal projection was used to formulate a medium-term fiscal goal to close one-third of the sustainability gap^{gg} during the 2008-11 period and to introduce accompanying policy measures. Attention to three types of policies were put on the agenda following the most recent report: enlarging participation rates in social programs—especially among the elderly and women; redressing expenditure related to aging populations; and generating budget surpluses in order to amortize government debt.

The Netherlands also uses long-term projections in a way found in no other country: the forecasts are used to evaluate the economic effects of election platforms of those political parties that make a request to be evaluated by the Bureau.^{hh} Each evaluation provides a transparent and comparable overview of the policy measures proposed by the various political parties and their fiscal effects. By subjecting their election platforms to an independent analysis, Dutch parties force themselves to specify and increase the credibility of their policy plans, and help themselves in negotiations over coalition agreements. After the Bureau's long-term analysis, political parties have also adjusted their plans so that, for example, their public finance or income targets will be met. For example, does a party prefer focusing on: reducing income inequality or increasing long-term economic growth; education for the young or more care for the elderly; a cleaner environment at the cost of smaller long-term economic growth?

^{dd} There are actually three expenditure ceilings covering “the ‘core’ central government sector, the social security sector, and the health care sector. While the two last sectors usually are the responsibilities of a single minister respectively, the responsibilities for the ‘core’ are divided between many ministers and the medium-term budget framework also contains projections of expenditure on these different policy areas.” Barry Anderson and James Shephard, *OECD Journal on Budgeting, Vol. 2009/3*, “Fiscal Futures, Institutional Budget Reforms, and Their Effects: What Can Be Learned?,” 107. Available at: <https://www.oecd.org/gov/budgeting/46051529.pdf>.

^{ee} Includes all levels of government.

^{ff} Although the Stability and Growth Pact individually calculates a medium-term budgetary objective for each member state as the medium-term sustainable average-limit for the country's structural deficit, medium term generally is about five years.

^{gg} “The 2006 aging report defined current policies as sustainable ‘if they can be maintained in the future without incurring financial problems’. Moreover, sustainability is achieved if tax rates do not have to be raised in the future to finance the increasing burden of aging (intergenerational efficiency); and that future generations will not be burdened by the cost of aging in a disproportionate manner (intergenerational equity).” Barry Anderson and James Shephard, *OECD Journal on Budgeting, Vol. 2009/3*, “Fiscal Futures, Institutional Budget Reforms, and Their Effects: What Can Be Learned?,” 66. Available at: <https://www.oecd.org/gov/budgeting/46051529.pdf>.

^{hh} In 2006, eight political parties made such a request; of the political parties represented in the Dutch parliament, only the Party for Animal Rights was not interested in such an evaluation. *Ibid.*

“ By subjecting their election platforms to an independent analysis, Dutch parties force themselves to specify and increase the credibility of their policy plans, and help themselves in negotiations over coalition agreements. ”

Norway

Norway⁴⁵ integrates its long-term fiscal projections into its annual budgeting process perhaps more than any other country. This may be a function of the importance that energy revenues play in Norway’s fiscal structure, and the strong political support for fiscal guidelines Norway has constructed so that energy revenues are used wisely for both current and future generations.ⁱⁱ

The fiscal guidelines state that petroleum income from the Government Pension Fund Global should be phased into the economy consistent with its expected real return, which is estimated at 4 percent. Considerable emphasis is also put on stabilizing the economy, which permits the government to use this fiscal rule with some flexibility. In practice this translates into a medium-term deficit rule, which states that the structural non-oil budget deficit should be kept at 4 percent of the Fund’s assets at the beginning of the budget year. As such, the budget is prevented from fluctuating due to short-term oil price changes. Norway’s fiscal policy guidelines thus promote the smoothing of the growth in public expenditures over a long-term time period.

As current conditions and long-term projections change, Norway reviews how it uses its projections in its budget process. Last year, Norway established a commission “to consider how to apply the guidelines for petroleum revenue spending (including the fiscal rule). The [commission’s] mandate was designed to reflect a number of factors: the strong growth of the Government Pension Fund Global, the challenges facing the Norwegian economy in the short and longer term, and the interests of future generations. The commission was asked to examine whether the current guidelines need to be supplemented.”⁴⁶

The commission agreed on a number of conclusions, including:

- **The fiscal rule adds a long-term perspective to the management of Norway’s petroleum wealth.**

ⁱⁱ It is also important to note that the Norwegian Parliament has a strong position in the budget process: it has unlimited power to propose amendments to budgets and is able to decide on them with a simple majority.

- **Petroleum revenue spending may peak in just a few years' time, depending on the pace of spending increases in the years ahead.** The possibility of a fairly imminent peak represents a marked change from 2001, when it was forecast that the 4 percent path would entail rising petroleum revenue spending until at least 2050.
- **If petroleum revenue spending is rapidly escalated up to the 4 percent path, spending will peak before the sharp rise in age-related expenditures.** The aging of Norway's population is expected to increase public spending on pensions and health and care services substantially, with a sharp rise anticipated to begin in 10 to 15 years. If current welfare and tax levels are maintained, a large, increasing gap between public revenues and expenditures will develop. Although the fiscal rule is no substitute for necessary adjustments to both public spending and revenues, it can ease adjustments during a transitional phase. In the longer term, the need for adjustments will be even greater if public welfare services are expanded in the years ahead. That the petroleum revenue spending peak may be passed in just a few years' time increases the risk of an uneven development in public services and tax levels. This suggests that Norway should save a greater proportion of its petroleum revenues during the next 10 to 15 years.
- **More expansive fiscal policy is not the solution to a persistent decline in Norway's petroleum industry.**
- **Norway's fiscal policy must continue to meet the key objectives identified at the 2001 adoption of the fiscal rule.** The objective of ensuring that future generations also benefit from Norway's petroleum wealth is met by spending the expected real return on the fund while leaving the principal untouched. In isolation, the objective of a smooth development in public services suggests moderation in petroleum revenue spending before the increased costs associated with an aging population begin to put public finances under serious pressure. Norway's economic policy should not be based on rising direct and indirect tax levels over time. To support a sound and transparent budget process, any guideline on petroleum revenue spending should be simple and easy to communicate, like all other fiscal policy rules. The objectives outlined above must be met even when uncertainty prevails.
- **Fiscal policy rules have little purpose if they are circumvented.** Many countries have stretched binding rules by creative budgeting. If budget estimates of revenues and expenditures are too optimistic, the bottom line may be systematically overestimated. If circumvention becomes common, the budget balance and the public balance sheet will give a misleading picture. A particular risk in Norway's case is measures whose costs are charged directly to the state's net cash flow from petroleum activities.

Countries That Use Long-Term Projections in Other Ways

New Zealand

New Zealand uses two models for its longer-term forecasts, although neither is linked to the budget process. The Fiscal Strategy Model (FSM) goes out ten years beyond the immediate five-year forecasts used in the regular budget presentation. These projections are used to support the Government's Fiscal Strategy Report and are consistent with the government's approach to fiscal management in that new initiatives are modeled through assumed operating and capital allowances. The Long-Term Fiscal Model (LTFM) is used to produce 40-year projections of economic and fiscal variables, such as nominal GDP and net debt, used in New Zealand's Long-Term Fiscal Statements, which are produced at least every four years. This model is constructed and operated independently of the current government and its fiscal strategy.

Despite the fact that the long-term fiscal model and associated statement are not fully linked into the budget process, the government has considered New Zealand's fiscal projections a success in raising the awareness of issues of fiscal sustainability. As evidence of this, the LTFM impacts current policy decisions by:

- Helping set objectives for the next 10-15 years;
- Making links between medium- and long-term projections;
- Driving wider policy work on settings and reform options; and
- Influencing wider debate on expenditure and revenue.

An example of this last point is a new budget process called the Social Investment Approach. While it is in the early stages of development, New Zealand is currently looking at this process to focus more on getting long-term results by applying rigorous, evidence-based investment practices to social services. It would use information and technology to better understand who needs public services and what works in achieving better long-term results, and then adjust services accordingly. What is learned through this process would then inform the next set of investment decisions.

Sweden

OECD research supports that the best system to promote economic growth is through a long-term sustainable fiscal plan that sets multi-year debt-to-GDP goals and then achieves those goals through enforceable caps on all spending, including entitlement spending and tax expenditures.⁴⁷ With respect to caps on entitlement spending, Sweden⁴⁸ provides a relevant and applicable precedent for the U.S.ⁱⁱ

After enjoying the largest budget surpluses of any OECD country in the late 1980s, Sweden incurred the largest budget deficits in the early 1990s. In a span of just five years, Swedish debt nearly doubled. However, by the late 1990s, the budget had been brought back to balance. Importantly for the U.S., the Swedish budget process itself influenced both the deterioration of public finances and, after reform, its stabilization.

Key elements of the reforms included the adoption of a multi-year budget framework and a top-down budget process that was made more comprehensive by the inclusion of entities that had previously operated off-budget, primarily in the social security field. All open-ended permanent appropriations (mostly entitlement programs) were abolished and became subject to annual scrutiny and authorization.

Fiscal projections are an important component of Sweden's fiscal framework, together with three-year expenditure limits and a budget balance rule, which targets a primary budget surplus of 2 percent of GDP over the business cycle. Moreover, the Swedish Parliament requires compulsory reporting on the expected long-term costs of new policy proposals. Although long-term (50 year) fiscal projections are not used to trigger adjustments to the medium-term expenditure and budget balance rules, the Swedish public pension system uses them through an automatic balancing mechanism to support the sustainability of the country's system.

ⁱⁱ Sweden has been able to successfully cap spending despite its having much higher levels of general government spending (including sub-national governments) than the U.S.: 49.3 percent of GDP in Sweden versus 35.7 percent in the U.S. in 2015. Sweden's gross debt in 2015 was only 44.1 percent of GDP compared to 105.8 percent in the U.S. International Monetary Fund, *Fiscal Monitor*, April 2016, 80-81.

The Swedish budget contains about 500 appropriations, including separate appropriations for operating costs, transfer programs, and capital outlays. An important budget reform was to group all appropriations, including entitlements, into 27 expenditure areas.^{kk} These areas were proposed by Parliament, which wanted a clearer presentation than was afforded by a division by ministry. It was also designed to reflect Parliament's committee structure.

Sweden's multi-year budget framework operates on three levels. The first level articulates the government's fiscal policy objectives in macroeconomic terms—the level of surplus or deficit as a percentage of GDP. Parliament then approves the maximum level of total nominal expenditures, and finally provides an indicative level of funding for each of the 27 expenditure areas. The sum of these indicative levels is less than the maximum level of total expenditures, the difference being a budget margin, whose purpose is to provide a buffer against any forecasting errors so that the maximum level of total expenditure approved by Parliament is not exceeded. For example, the margin might be 1.5 percent in year one; 2 percent in year two; and 2.5 percent in year three.

“The most serious source of . . . pressure [on both the spending ceilings and the margin] has, unsurprisingly, been unexpected cyclically-related surges in unemployment benefits expenditure, firstly in the early 2000s and subsequently during the global financial crisis (GFC). However, . . . it has repeatedly proven difficult to accurately forecast expenditure on sickness leave benefits, early retirement benefits and disability benefits. . . . The first time this occurred was between 1997 and 2003 when, after trending down over many years to exceptionally low levels, spending in these areas surged significantly for a time, absorbing a large portion of the contingency margin and putting considerable pressure on the ceilings. A similar problem arose from 2010, when once again major errors arose in forecasts of expenditure in these areas added to the GFC-related pressures on the system.”⁴⁹

ⁱⁱ The distribution of the 349 seats in Sweden's parliament, the unicameral Riksdag, among the leading parties has been relatively stable over the past 45 years. See Wikipedia, “National apportionment of MP seats in the Riksdag.” Available at: https://en.wikipedia.org/wiki/National_apportionment_of_MP_seats_in_the_Riksdag.

^{kk} The 27 expenditure areas are: Swedish political system; Economy and fiscal administration; Tax administration and collection; Justice; Foreign policy administration and international co-operation; Defense; International development assistance; Immigration and refugees; Health care, medical care, and social services; Sickness and disability benefits; Old-age benefits; Family and children's benefits; Unemployment benefits; Labor market; Study support; Education and university research; Culture, the media, religious organizations, and leisure; Planning, housing supply, and construction; Regional development; General environment and development; Energy; Communications; Agriculture, forestry, and fisheries; Business sector; General grants to municipalities; Interest on debt (not capped); and Contribution to the European Union budget.

Upon reviewing the reasons behind the excess spending and looking at the long-term projections under current operating procedures, the Swedish government closed loopholes, improved administration of the programs, and made other programmatic changes to curb future spending growth.⁵⁰

OECD concluded that Sweden's "budget process has shown itself to be quite effective in maintaining aggregate fiscal discipline."⁵¹ It is marked by Parliament's acceptance of the binding budgetary constraints.⁵² Increased funding deemed necessary for certain areas have been financed by reductions in other expenditure areas and by increases in revenue. For over 20 years, Sweden's spending caps have worked: lower debt; faster recovery from economic downturns; more fiscal flexibility; and most of all, better than average economic growth.

“ OECD research supports that the best system to promote economic growth is through a long-term sustainable fiscal plan that sets multi-year debt-to-GDP goals and then achieves those goals through enforceable caps on all spending, including entitlement spending and tax expenditures. ”

The United Kingdom

In the United Kingdom,⁵² since 1999, its Long-Term Public Finance Reports have presented 50-year fiscal projections. These reports focus only on the fiscal challenges of demographic change. Long-term challenges and opportunities such as the environment, globalization and technical changes, and global uncertainty are discussed in other reports that draw upon the government's fiscal projections.

Fiscal projections constitute one component of the government's "Code of Fiscal Transparency." While there is no explicit ex-post link between the fiscal indicators used in the Report and the principles-based approach to fiscal policy, the government's two fiscal rules are reflected in the Report's constrained baseline projections. A number of examples of the report's utility and impact have been cited over the last several years. The report and its projections provided a macroeconomic framework in which the Treasury prepared its internal analysis and input into the government's pension reform discussions between 2005 and 2007. The framework used to prepare the report has supported analysis surrounding the government's 2007 comprehensive spending review and the Cabinet Delivery Unit's 2008 work on strategic challenges. Moreover, the report led the Treasury to commission a detailed

long-term cash-flow projection of public service pension spending from the Government Actuary's Department to better understand future fiscal pressures.

In addition to the issues discussed above, the long-term projections have led the Treasury to engage more closely with a number of government departments. These include the Department of Work and Pensions' modeling department to develop micro-simulation models to project social transfer spending (including on state pensions); the Office of National Statistics on population assumptions; the Home Office on migration assumptions; and the Department of Health on long-term care trends. Moreover, to support Treasury's analysis, a small long-term unit has been established within the Treasury to serve as a knowledge center on work elsewhere within the Treasury and in government on long-term issues, to provide modelling advice and to discuss policy issues.

Implications for the U.S.

The wide-ranging and successful—in terms of addressing their fiscal, social, and economic goals—experiences of Australia, Denmark, Norway, the Netherlands, New Zealand, Sweden, and the United Kingdom in utilizing their long-term budget projections provide valuable precedents for the U.S.

- Australia extensively uses its Intergenerational Reports to assess the Government's actions in making the 40-year fiscal forecast better or worse, and by so doing helps shape those actions.
- Denmark's 60-year fiscal projections serve as a consistency check as to whether the government's eight-year medium-term fiscal strategy is sustainable over the long term.
- Norway explicitly uses its 50-year projections through its fiscal rules to impact current taxing and spending decisions.
- The Netherlands uses its 50-year projections both as part of its fiscal rules and to better assess the fiscal implications of Dutch candidates' platforms.
- New Zealand is expanding its use of its 40-year projections to assess the fiscal implications of current policy proposals.
- Sweden's 50-year projections impact its major fiscal rule: caps on 27 expenditure areas, including all entitlement programs.
- The United Kingdom's 50-year projections allow it to better assess internal proposals and Parliament's actions.

Long-term projections affect public policies in all of these countries: some more through the presentation of the long-term data, and some by being directly integrated into budget policy processes and fiscal rules.

Table 4.1. Characteristics of Seven Countries That Use Long-Term Projections			
Country	Length of Projection	Form of Projection	Projections Used for Policy and/or Presentation
Australia	40 years	Periodic Intergenerational Reports	Presentation: “Framing the public debate” “Attracts much public & media attention”
Denmark	60 years	Part of Annual Convergence Program Report to the European Commission	Policy: A role in all three fiscal rules (expenditure growth rule; structural balanced budget rule; tax freeze rule) Presentation: “Serves as a consistency check”
Netherlands	50 years	Bureau of Economic Policy Analysis (CPB) regular reports	Policy: A role in all three fiscal rules (expenditure ceilings; 2 percent/GDP deficit limit; tax offset rule) Presentation: Assessments of long-term fiscal impacts of the policy proposals made by political parties
New Zealand	50 years	Long Term Fiscal Model produced every four years	Presentation: Helps set medium term objectives and influences wider policy debate
Norway	40 years	Part of Annual Budget	Policy: Fiscal rule limiting spending to taxes + the expected real return from the Government Pension Fund Global (petroleum profits)
Sweden	50 years	Required reports on long-term costs on new proposals	Policy: Long-term projections used to assess policy actions that impact the caps on 27 expenditure areas
United Kingdom	50 years	Long-Term Public Finance	Presentation: Long-term projections impact comprehensive spending reviews & macroeconomic framework

In the past, long-term projections have not been a significant part of the U.S. budget process, and U.S. fiscal rules—deficit and debt limits, spending caps, and the pay-as-you-go process—have not been closely tied to the projections. But consistent with the experiences

of other countries and taking into account the rapid growth in age-related expenditures and the difficulties in reforming the tax code, the U.S. should prepare for growing long-term fiscal imbalances by adopting two of the most relevant experiences of other countries, namely:

- Australia has had success in periodically presenting the impact of policy decisions on its long-term fiscal projections. As part of its assessment of the president's budget, **CBO should measure the impact of the past year's policies on the long-term projections**, particularly of entitlement programs and tax expenditures, and, to the extent practicable, the long-term impacts of the president's proposals.
- The Netherlands and, especially, Sweden have had success in capping spending—the Netherlands imposes caps on three spending sectors and Sweden imposes caps on 27 expenditure areas. **The U.S. should impose separate caps on programs and categories of spending—not just defense and nondefense discretionary spending, but also Medicare, Social Security, and the other major entitlement programs (perhaps excluding those few that function as automatic stabilizers) and tax expenditures.**^{mm} The caps should cover the medium-term (five years or so) and use long-term projections to both reassess the path of the caps and to assess the long-term impact of any policy changes (particularly important for entitlement programs and tax expenditures) required to ensure projected spending does not exceed the caps.

The success in utilizing long-term projections in all of the countries mentioned above heavily rests on their governments' acceptance of the trends indicated by the projections and, especially, their governments' support of the reporting mechanisms, caps, and other fiscal rules that utilize the projections. The success of any presentation or process change in the U.S. that utilizes long-term projections will likewise heavily depend on the acceptance and support from the president and Congress.

^{mm} Some, but not all, tax expenditures are currently capped through the alternative minimum tax mechanism, the personal exemption phase-out, and the Pease limitation, which limits some tax expenditures reported in Schedule A of IRS Form 1040. Although the original intent of these provisions may have been to increase the taxes paid by certain classes of taxpayers, they currently function as a cap on tax expenditures. A "look-back" enforcement mechanism might be applied to both the tax expenditure and entitlement caps. Such a mechanism would look back at the most recently completed year to see if any of the specific tax expenditure or entitlement caps were exceeded, and if one or more of them were exceeded, then the relevant future year(s) benefits could be adjusted downward accordingly. This mechanism would not change the basic entitlement nature of the tax expenditures or entitlement programs, but it could alter the amounts to be paid or made available under those programs, just as Congress has done in the past.

5

Goals and Rules for Fiscal Sustainability: Reforming the Budget Process

By Philip Joyce and G. William Hoagland

The federal budget process is not known for its focus on the long term, nor for anything other than limping along from one fiscal year to the next. In many ways the near-term focus of the federal budget process is a simple reflection of human nature. That is, we all have difficulty resisting the temptation to forgo an immediate reward to wait for a later, possibly larger reward that might require sacrifice up front. Human nature in general reflects the strong tendency for immediate satisfaction instead of deferring or delaying gratification. This tendency puts human nature at odds with long-term budgeting, since a successful long-term focus requires making sacrifices in the near term to achieve longer-term benefits.

While analysts produce significant information on the out-year effects of current policies and alternative policies (see Chapter 1 and Chapter 3), in practice there is not much emphasis placed on that information by legislators and other policymakers. The Congressional Budget Office (CBO) routinely provides ten-year baseline projections and cost estimates of legislation. In addition, the pay-as-you-go (PAYGO) processes established in the 1990s have focused on enforcement using a ten-year window, as has the budget process in general. And there are several sources of information (cited in Chapter 1) on longer-term budget estimates that build off of the ten-year estimates. Despite all of this information, there is little evidence that the electorate and their legislators think beyond a narrow time horizon, such as the next election, when making decisions. In spite of the constraints imposed by human nature, however, there are still changes in the budget process that might assist in promoting fiscally sustainable policies. This chapter, then, focuses on the role of the budget process in supporting changes that can spur more action with an eye toward the long-term consequences of policy choices.

As outlined in Chapter 4, attention to the medium- and long-term effects of budget policies has become somewhat of a budgeting “best practice” in other countries in recent years. This effort has been spurred by organizations such as the International Monetary Fund, the World Bank, and the Organization for Economic Cooperation and Development. The U.S. is a laggard

in that regard; given the documented long-term fiscal challenges facing the country, budgeting with our heads in the sand is no longer a viable strategy.

“ Given the documented long-term fiscal challenges facing the country, budgeting with our heads in the sand is no longer a viable strategy. ”

Long-Term Budgeting and Consensus Goals

Besides citizens who tend to be more concerned about their immediate, daily financial issues, one reason that the federal budget process has failed to focus on long-term sustainability is that there is no political or procedural consensus around what has become known internationally as a “fiscal rule.”⁵³ In effect, fiscal rules represent a nation’s consensus aggregate goal for fiscal policy. The absence of such a goal leads to a situation where the budget process has no specific focus. We must note, nonetheless, that international experience, as well as experience in the United States, suggests that establishing such a goal does not necessarily create the political will to enact fiscally responsible long-term budgets. Instead, where they exist, these fiscal goals are a byproduct of a fiscally responsible stance that has already been agreed to, and that stance has legitimacy with the public. Governments then use that stated goal to establish a specific measure or target that becomes the focus of the budget process.⁵⁴

Today there is bipartisan agreement that the country is on the wrong path. What is lacking is an agreement on what approaches should be taken to alter that path. The first step, then, in setting the framework for discussing alternative approaches would be to have the U.S. adopt a consensus goal for overall fiscal policy.⁵⁵

If the U.S. were to establish such a goal (or goals), there are various alternatives that might be considered:

- An annually-balanced budget, or a budget that is balanced over the business cycle. Alternatively, the goal might be to balance the federal budget by a particular point in time

⁵³ The 1980s and 1990s was a period when it could be argued that there was a negotiated political consensus on deficit reduction and enforcement mechanisms. The 1980s budget agreements were driven largely by the two budget committees, while the 1990’s were driven importantly by the congressional leadership and the president. Hence during these decades, the process was enabled by bipartisan consensus.

⁵⁴ The term “goal” here is used to describe some numerical or economic objective for the budget process; it need not be a single goal, but if there are multiple goals they should be reinforcing and consistent.

(such as ten years into the future); or to reduce deficits so that they fall below (and stay below) a target limit, such as 1 percent or 2 percent of GDP (under current law, the deficit is projected to average about 4 percent of GDP over the next ten years).

- A targeted debt-to-GDP ratio. For example, given the current projected trajectory of the public debt, the U.S. might set a goal of attempting to move to 70 percent of GDP within ten years, or 60 percent within 25 years. (Debt held by the public is currently equal to about 75 percent of GDP, and is projected to rise, under current law, to about 85 percent of GDP in the next ten years.) As suggested above, a variation of this rule would focus on the deficit as a percentage of GDP on an annual basis, as a percentage of potential (standardized employment) GDP, or as the debt to GDP less the valuing of assets.
- A spending limitation. This might prohibit spending from exceeding a set percentage of GDP—the assumption being that limiting spending might put less pressure on debt.

We make no attempt in this chapter to identify the specific fiscal goal that might be employed by the U.S., rather, we note that the absence of consensus around an overall stance for fiscal policy means there are no incentives for a president or Congress to enact policies that focus on fiscal sustainability. Developing this consensus is by far the most important step that can be taken toward establishing a responsible fiscal stance in the long term. Agreeing to a fiscal rule (or rules) remains the single most important determinant to developing and implementing long-term budgeting processes. Even absent developing a consensus between the president and Congress, getting each to articulate their long-term sustainability goal (the president in the executive budget; Congress in the budget resolution) would be a step forward.

“ Developing this consensus is by far the most important step that can be taken toward establishing a responsible fiscal stance in the long term. Agreeing to a fiscal rule (or rules) remains the single most important determinant to developing and implementing long-term budgeting processes. ”

Assuming that there is commitment to some fiscally responsible stance, there are two types of budget process reforms that might be considered to promote adherence to such a path. The first focuses on the types of information that is presented in the budget process, both to decision-makers and the public (Chapter 2). The second is to create greater and stronger institutional incentives to use that information.

Reforms Focused on Information

Herbert Stein, in his classic book *Governing the \$5 Trillion Economy*, posited that there are two factors that can lead to better budget decisions—“better people and better information.”⁹⁰ He argued that, given the substantial challenges involved in producing better people, “the budget-reform movement in the United States . . . has always been primarily about information.”⁵⁴

When we think back on reforms to the budget process, many of them have focused on the kinds of information that are presented to policymakers when they make decisions—whether that is information about the budget baseline, or unfunded mandates on state and local governments, or government performance. The assumption is that knowledge can be an important spur to action. Where multi-year budgeting is concerned, most of these reforms have attempted to provide information on the possible effects of policies beyond the short time horizon—of the next fiscal year.

In the U.S. system, since the president and Congress are both relatively equal and important players in the budget process, it is useful to discuss both information about the long term that can be provided by the executive branch (for example, in the president’s budget) and information that can become part of the legislative process.

The Executive Branch

Presidents submit budget proposals to Congress on an annual basis. Presidential budget proposals contain volumes of information on the trajectory of the budget under current policy conditions, as well as the effects of the president’s proposals to change current policies.⁹¹ To date, such information and presentations do not appear to have sufficiently enhanced long-term budget planning. The information flowing out of the executive branch needs to be rethought and reworked in order to ensure that it fits the particular long-term policy challenges facing the country. We argue that the following kinds of changes would be useful:

- The president’s budget should put forward policies that would meet whatever goal is articulated under new fiscal rules, and do so in the time period set by those rules. The policy proposals should be specific, and not rely on unspecified policies that appear to meet the targets without articulating how that would occur. In the absence of a consensus fiscal rule, the president’s budget should articulate the fiscal goal on which the budget is based.

⁹⁰ For reference, today the size of the U.S. economy exceeds \$18 trillion.

⁹¹ The President’s Budget has included a chapter, in the Analytical Perspectives volume, on the long-term effects of the president’s policies. See the White House’s “FY2017 Long-Term Budget Outlook.” Available at: https://www.whitehouse.gov/sites/default/files/omb/budget/fy2017/assets/ap_3_long_term.pdf.

- The budget should explicitly discuss the leading fiscal risks to current and future generations. These could include, but would not be limited to, unfunded liabilities for entitlement programs such as Social Security and Medicare. It should also include implied higher taxes that would be necessary in the future in order to cover/fund those liabilities that are currently unfunded. The budget could also explicitly focus on difficult long-term policy problems, such as national security concerns, infrastructure, or climate change. Practically speaking, this would result in a chapter in the president’s budget being explicitly focused on generational threats, in the same way that the current budget focuses on effects of the budget on state and local governments, or federal investment. It would, however, be more prominently displayed than these current analyses, which are largely buried in a little-read volume included with the budget.
- The president’s budget proposal should present, in addition to ten-year estimates of current policies, at least a 25-year current policy projection for major entitlement and revenue provisions of law (including tax expenditures), defined as any program/source where the cost or revenue in the prior fiscal year is equal to more than one-half percent of GDP (in 2016 this would be approximately \$90 billion). While we do not recommend a full 25-year baseline projection, the president’s budget proposal should provide a thorough snapshot of the budget outlook covering at least 25 years.
- In addition to looking out 25 years for these major programs and policies, it would be useful if domestic agencies followed the lead of the Department of Defense (DOD) and presented a current policy baseline, covering at least five years. In the case of DOD, this has historically been reflected in the Future Years Defense Program (FYDP). The FYDP is a significant departure from the typical baseline approach in that it reflects the specific future costs of a strategy that reflects judgments about future policy. It is not, as most baseline estimates are, simply a reflection of the impact of inflation. It would be useful if other domestic agencies engaged in the same exercise and presented these estimates in the president’s budget.
- The budget should include a plain language “Budget in Brief” (B in B—sometimes called the “Citizen’s Guide to the Federal Budget”); this would represent a return to a practice that was abandoned in 2002. This relatively short volume should not only focus on presidential short-term policy proposals, but should also include a plain language discussion of the long-term fiscal challenges facing the country and how the president’s proposed policies would contribute to addressing those problems. The B in B should be made widely available to schools and universities and the general public. It should be provided to all individuals wishing to become U.S. citizens. It should be made available

through social media and budget applications to reach a generation that has adopted these outlets as their normal communication tool. It should be viewed as the main vehicle through which the president's fiscal stance is communicated to the public.

- The president, within three months of the publication of the GAO's high risk list,¹⁷ either in his budget or elsewhere, should be required to articulate a specific response to the items on that list, addressing how it is that the president proposes that such risks should be addressed, either through executive action or legislation.
- The Government Performance and Results Modernization Act of 2010 (GPRMA) should be amended to require the president to propose a government-wide performance plan as part of the budget, which focuses on both short- and long-term performance challenges facing the country.

The Legislative Branch

Once a fiscal rule has been proposed by the president and agreed to by Congress, processes within the legislative branch must be established to ensure its enforceability. Existing budget enforcement rules and procedures should be reevaluated and streamlined to provide the kinds of information necessary to support a responsible fiscal stance:

- The Congressional Budget Office (CBO), in consultation with the Joint Committee on Taxation (JCT), should develop annually both a ten-year (as presently) and 25-year projection for major entitlement and revenue provisions of law (including tax expenditures), defined to include any program/source where the budgetary effect is greater than one-half percent of GDP in the most recently completed fiscal year. While we do not recommend a full 25-year baseline projection, the CBO annual budget outlook should provide a thorough snapshot of the trajectory of the budget covering at least 25 years.
- CBO's and JCT's analysis of the president's budget should also analyze the effect of the president's policies on the spending for these major entitlement and revenue provisions not only for the next ten years (as at present) but also for 25 years.
- The budget resolution should be required to show how Congress would meet the fiscal goals implied by the fiscal rule, covering the same time period covered by that goal. If no consensus fiscal goal has been established, the budget resolution should be explicit about the long-term sustainability goal underlying the budget resolution.

¹⁷ The GAO since 1990 has been producing, now every other year, a report on the programs that present the greatest fiscal risks to the country. The most recent list includes 32 items. See United States Government Accountability Office, *Fiscal Year 2017 Performance Plan* (Washington, D.C.: U.S. Government Printing Office, 2016).

- CBO and JCT cost estimates of changes to the major entitlement and revenue programs should include 25-year estimates, in addition to the ten-year ones. Special PAYGO rules should be established that require deficit neutrality annually (as occurred between 1991 and 2002), in addition to over each of these three time periods. Current rules in the Senate theoretically cover ten years using points of order but are waived when it is not convenient to follow them.
- The budget should promote flexibility in budgeting by treating all spending alike, thus ending the practice of “protecting” Social Security by privileging spending for this program above other spending. This could also be accompanied by a serious review of mandatory expenditures, with an eye toward reclassifying some of them as discretionary, presumably by changing underlying laws.
- The Budget and Accounting Act of 1921 should be amended to require GAO to produce its high-risk list, and should explicitly define high-risk programs as all large programs or revenue sources equivalent to one-half percent of GDP in the most recent fiscal year, as well as other programs that GAO deems worthy of including on the list in a given year. Further, committees of jurisdiction should be required, within three months of the publication of the GAO high-risk list, to articulate a specific response, addressing how it is that Congress plans to address these issues.
- The House and Senate Budget Committees should be required to prepare, with the assistance of CBO and JCT, an “End of Congress” report. This report would summarize the budgetary actions of the Congress. This would include, but not be limited to: a) presenting data on the differences between the ten-year baseline estimates at the beginning of Congress and the projections after Congressional actions (including economic, technical, and policy changes); and b) a specific summary of changes made to major spending and revenue programs, as defined above.

This additional information, both on the executive and legislative side, carries with it some drawbacks. More information can provide valuable data on the effects of policies, but it also can result in additional confusion. Even at present, the different estimates presented by OMB and CBO are confusing to some and lead to disagreements over whose numbers are “right” and should be used as a basis for policy changes and enforcement. Moreover, estimates covering 25 years carry with them a greater degree of uncertainty—in other words, are more likely to be wrong, and by a larger degree, than five-year or ten-year estimates. This may make it particularly important that both CBO and OMB communicate the degree of uncertainty surrounding their estimates (see Chapter 3). Despite these drawbacks, it is our judgment that reforms such as the ones suggested above will, on balance, do more good than harm.

Reforms Focused on Institutional Incentives

In addition to “information” reforms, which are intended to provide data to encourage more attention to the long term, there are other reforms that focus more directly on institutional incentives. These include both reforms that change budget concepts, and therefore, may affect how and when the budget records budgetary costs of programs, and those that change the power relationships between the legislative and executive branches, thus affecting the incentives that program administrators and policymakers face.

Budget Concepts

Budget concepts—the seemingly boring and dry rules that govern how spending and revenues are accounted for in the budget—matter. They matter largely because they dictate the approach to estimating how costly various policies are, and when those costs are recognized. To cite one example, the 1990 Federal Credit Reform Act (FCRA) was important because it actually changed the presentation of the budgetary effect of federal guaranteed loan programs such that those programs no longer appeared to seem “free” (actually, they used to appear as if they were making money for the federal government in the near term); meanwhile, for a direct loan that used to appear very costly, under FCRA estimates it could be shown in some cases that a direct and a guaranteed loan might have the same ultimate net cost to the government.⁵⁵

To this end, changes in budget concepts could change behavior by changing the budgetary treatment of certain policy changes. Much of the current treatment of programs in the budget stems from decisions made by the 1967 President’s Commission on Budget Concepts. Rivlin and Domenici⁵⁶ and Anderson and Penner⁵⁷ have suggested that perhaps it is time for another budget concepts commission, given changes that have occurred in the budget, and the budget outlook, over the past half century. We agree with their call for such a commission, and suggest that among the many issues that might be considered by a new concepts commission include the expansion of accrual concepts to other programs in the budget; the way that tax expenditures are reported in the budget; appropriateness of capital budgeting, and the role of the Federal Reserve in fiscal policy. We consider the first two of these below.

Expanding Accrual Concepts

Credit programs constitute the relatively small subset of federal programs that are currently treated on an accrual (non-cash) basis;⁵⁸ the cost reported in the budget represents the present value of the long-term cost to the government associated with a loan or loan guarantee.

⁵⁵ In accrual budgeting, costs are recognized when the commitment is made to provide resources to them in the future (to the extent that resources are needed), as opposed to when those resources flow out of the Treasury.

Thus, the signal being sent to policymakers when a decision is made to change a program is (at least in theory) equal to the eventual cost to the government.⁵⁸ Government insurance programs, such as veterans' life insurance and pension guarantees, are not credit programs and therefore are still treated on a cash basis, but may be particularly good candidates for accrual treatment. The notion here is that, without an accrual treatment, the eventual cost of these programs is not recognized at the point in time when decisions are made to create or expand them. Accrual budgeting is a reform that has been embraced by many industrialized countries in recent years.⁵⁸

Tax Expenditures

Currently, tax expenditures are relatively invisible. That is, they are treated as revenue not collected, and therefore their cost is not transparent in the budget. If there are two options for conveying a benefit—one through a spending program and one through a tax expenditure—the budget will continue to show the spending program as an annual cost—as, in effect, a line-item in the budget—while the tax expenditure will disappear as an identifiable budget item and become just one component of revenue not collected. Anyone who wanted to know about the cost of such a tax provision would be free to consult the chapter on tax expenditures in the Analytical Perspectives volume of the president's budget, but this hardly represents a similar level of transparency to what exists for a spending program.⁵⁹ Consider the example of a program that provided a \$1,000 grant to families to reduce the cost of college versus a program that provided a \$1,000 income tax credit to those same families. The spending program would show up in the budget on an annual basis; the tax expenditure would not. It would enhance transparency substantially if they were treated in an equivalent way.⁵⁹ In the end, the budgetary treatment of tax expenditures should be equivalent to the budgetary treatment of a mandatory spending program that conveys a benefit of the same value.

“ The budgetary treatment of tax expenditures should be equivalent to the budgetary treatment of a mandatory spending program that conveys a benefit of the same value. ”

⁵⁸ It is important to point out that, even in the case of credit scoring, there continue to be debates among the priesthood of budget technicians about the appropriate way to account for these costs; hence the debate over “fair value” accounting in the student loan program and elsewhere, which will not be rehashed here. See Donald Marron's suggested “net returns” approach, an alternative to BOTH the current credit reform treatment and the fair-value approach: Donald Marron, “Budgeting for Federal Lending Programs Is Still a Mess,” March 2, 2016. Available at: <https://dmarron.com/2016/03/02/budgeting-for-federal-lending-programs-is-still-a-mess/>.

⁵⁹ The Joint Committee on Taxation, similarly, produces an annual report on tax expenditures. The most recent one can be found at <https://www.jct.gov/publications.html?func=startdown&id=4857>.

The relationship between the scoring of tax expenditures and long-term budget impact is perhaps most evident in estimates of legislation involving retirement plans. The tax code incentivizes retirement savings through two types of savings accounts: tax-deferred accounts, in which contributions are tax-free but withdrawals are subject to income taxes; and Roth accounts, in which contributions are subject to income tax but withdrawals are tax-free. Current budget scoring procedures do not adequately measure the true costs of these tax expenditures because they only measure the impact of a policy over the first ten years. Contributions to retirement accounts mostly appear within the ten-year window while withdrawals do not, making savings in Roth accounts appear relatively cost-free while tax-deferred accounts appear very expensive for the federal government. This scoring, however, does not include the lost revenue from Roth withdrawals outside the ten-year window nor does it include the revenue gained from tax-deferred account withdrawals. The Bipartisan Policy Center, in a recent report, recommended changing the budget estimating rules for retirement tax expenditures to better account for budgetary impacts beyond the 10-year window.⁶⁰

Institutional Relationships and Rules

In addition to provisions that might affect how the budgetary effect of policies is presented, there are changes that might promote better institutional attention to the long-term effects of programs in both the executive branch and the legislative branch.

Within the executive branch, greater attention to long-term budgeting issues requires an investment, in time and resources, by both OMB and agencies. Redburn suggested that attention to long-term strategic issues would require OMB and agencies to reallocate analytical staff from routine tasks such as short-term forecasting to longer-term scenario building, including examining future threats and opportunities.⁶¹

Within Congress, comprehensive attention to the long term implies strengthening its institutional capacity to engage in this kind of thinking. This is promoted neither by the normal, decentralized, committee structure, focused on narrow sets of issues that are within the jurisdiction of various congressional committees, nor the two-year election cycle. Three specific types of reforms might affect the way that Congress deals with these long-term issues—committee reform, portfolio budgeting, and stricter budget enforcement focused on a longer time period.

Committee Reform

It has been almost a quarter of a century since Congress last considered any comprehensive reform of congressional committees, and that 1993 reform effort was unsuccessful in creating any lasting change. The basic congressional committee structure has remained essentially

unchanged since the creation of the Budget Committees in 1974. While a complete overhaul of the committee structure—for example, combining authorization and appropriations committees⁶²—would seem to be a change that is worth public discussion, one need not go that far in order to make changes that would encourage more attention to long-term budgeting.

One of the authors has suggested elsewhere⁶³ the replacement of the Budget Committees with Committees on National Priorities. This follows from a proposal first introduced as a Senate committee reform by former Sen. Nancy Kassebaum in 1987. The notion is that the budget resolution would be under the jurisdiction of “leadership” committees, which would be comprised of the chairs and ranking members of the major tax and spending committees in each chamber. These committees would be more likely to focus seriously on the longer-term challenges facing the country, and to implement the changes envisioned by the budget resolution since they would explicitly include the members of Congress responsible for making those changes.

Portfolio Budgeting

The notion of “portfolio” budgeting is related to, but separable from, these committee reform ideas. At present, the budget is balkanized by the types of policy actions—discretionary spending, mandatory spending, or revenues—even though many policy areas employ each of these types of policy “tools.” For example, we can promote higher education goals through discretionary grants, through mandatory spending (grants and loans) or through tax credits. Because these different types of policies are considered separately in the budget process, however, it is difficult to make effective tradeoffs among them. “Portfolio” budgeting would, at least in the process of drafting the budget resolution, attempt to take a more comprehensive approach to policy within a given area by explicitly considering the trade-offs between all of the programs or policies focused on achieving a particular outcome. Chapter 2 of this volume presents illustrations of how different tools to effect change in health, education, and other policy areas could be presented together to inform trade-offs among and between them.

Budget Enforcement

Finally, institutional incentives could be changed by creating new budget enforcement procedures that are more explicitly focused on the long term. These could include, but are not limited to, the following:^{vv}

- Points of order against bills failing to comply with budget targets established, either in legislation (such as a law creating a fiscal rule and a path for debt reduction) or in the budget resolution.

^{vv} See the following for more on these ideas: Committee for a Responsible Federal Budget, Better Budget Process Initiative, “Improving Focus on the Long Term,” January 2015.

- An explicit enforcement focusing on the budgetary effect of legislation beyond the current ten-year estimating window. For example, if CBO or JCT are required to estimate costs into the second decade for major entitlement and revenue programs or changes, a point of order could be created against bills with costs that are not paid for in the second decade. These estimates might be expressed as a percentage of GDP. If this is not feasible, it might be possible to explicitly focus on costs in year ten, under the assumption that if a program is not paid for in year ten, it is unlikely that it will be in years beyond.
- The Senate currently has a point of order (established in a budget resolution) against any legislation that would increase the deficit by more than \$5 billion in any of the four decades beyond the current ten-year estimating window. While the specifics might be debated (for example, does it need to cover four decades, is \$5 billion the right number, and should it be adjusted for inflation?), extending the point of order so that it applies in the House would be a positive step. If it were going to have any effect, of course, there would need to be a commitment to its enforcement.

Conclusion

Agreeing to an aggregate, long-term goal for the budget remains the single most important determinant to developing and implementing long-term budgeting processes. Focusing the budget process on only one or two years invites short-sighted decisions, as well as budgetary games that shift costs to points that are beyond the normal ten-year budget window. If the budget process is to focus more effectively on the long term, a fiscal goal should be agreed to by the president and Congress.

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What would follow then would be appropriate information to policymakers, and the right incentives to those policymakers to make decisions that can focus on the longer-term effects of policies to achieve the fiscal objectives implied by the goal. But none of these changes will force a president or a congress to make fiscally sustainable decisions, if they are not inclined to do so. Many of the changes suggested above, however, can make a difference both in terms of providing appropriate information on the long-term effects of policies, as well as making budgetary costs more accurate and transparent and creating incentives for policymakers to act in the long-term interest of the country. Given the magnitude of the future fiscal challenges facing the United States, any reforms that focus attention to fiscal effects further in the future represent a step in the right direction.

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