

CBO TESTIMONY

Statement of
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before the
Committee on the Budget
U.S. House of Representatives

June 3, 1992

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Mr. Chairman and Members of the Committee, thank you for inviting me to testify today on how a balanced budget amendment to the Constitution might be enforced. In previous testimony before this Committee, I have noted that, by itself, a balanced budget amendment will not accomplish much. It is simply a statement of principle. To be effective, there must also be a mechanism for achieving and maintaining budgetary balance.

If a balanced budget amendment is approved and sent to the states for ratification, the deficit will need to be brought down substantially between now and 1997, which is the likely effective date of the two leading proposals--House Joint Resolution 290 (sponsored by Representative Charles Stenholm), and Senate Joint Resolution 18 (sponsored by Senator Paul Simon). Then, actions will be necessary to maintain a balanced budget after the amendment takes effect. Preferably, the Congress should simply enact the policy changes needed to balance the budget. Experience suggests, however, that enforcement legislation will be necessary to ensure that the reductions in the interim period will be realized and that the balanced budget requirement can be met once it takes effect.

In my testimony today, I will discuss both the magnitude of the reductions necessary to achieve balance and the principles that could be used to guide the enactment of legislation to enforce the amendment. The remainder of my remarks will expand on the following two points:

- o Approximately \$600 billion in policy actions (discretionary spending cuts, entitlement changes, and tax increases) would be necessary to achieve a balanced federal budget by fiscal year 1997; and

- o Any legislation to enforce a balanced budget amendment should adhere to certain basic principles. It should promote policy agreement, maintain accountability for budget actions, discourage gimmickry and undesirable policy actions, and allow for flexibility in managing the budget.

DESIGNING A PLAN TO BALANCE THE BUDGET

If the 102nd Congress approved a balanced budget amendment and the states took three years to ratify it, the budget would have to be balanced by fiscal year 1997. Balancing the consolidated budget in five years would be a difficult, but not an impossible, task. For example, spending decreases and tax increases totaling \$40 billion in 1993, \$80 billion in 1994, and building to \$200 billion by 1997, together with the resulting saving in debt-service costs, would do the trick. Over five years, the additional required deficit-reduction measures would total about \$600 billion, which is a bit more than 40 percent larger than the five-year savings called

for in the 1990 budget summit agreement. The illustrative policy changes unveiled last week by Chairman Leon Panetta would each achieve the amount of deficit reduction assumed in this path.

Some people have expressed a concern that balancing the budget could seriously undermine the economy in the short term, even though it will pay long-term dividends in the form of greater productivity, increased incomes, and higher standards of living. Several factors will determine the intensity of the pain; these factors include the definition of the deficit, the speed with which balance is achieved, and the stance of monetary policy. If balance in the consolidated budget is the objective, the short-run loss in output and increase in unemployment could be relatively small if the Congress begins moving toward budgetary balance at least five years before the deadline, and if the Federal Reserve provides an accommodative monetary policy. Under those conditions, balancing the budget should not stop the economy's recovery from recession and will enhance the prospects for sustained long-run growth.

To be sure, deficit reduction will inevitably reduce aggregate demand, lower incomes and employment, and impair tax collections. The impact of these changes on the budget deficit, though, would be offset somewhat if interest rates and the government's cost of borrowing fell. Although these two effects will not precisely offset each other, the budgetary feedback is likely to be small.

The economic situation would be a bit more problematic if the goal were to balance the budget excluding Social Security receipts and payroll tax receipts, as is required by House Joint Resolution 496 (sponsored by Majority Leader Richard Gephardt). Choosing this measure of budgetary balance would require an additional \$200 billion in deficit-reduction measures over the 1993-1997 period.

Of course, the economic situation, with or without a balanced budget amendment, is highly uncertain. Some contend that the Congressional Budget Office (CBO) has underestimated the underlying strength of the economy and, therefore, that the policy changes needed to balance the budget total less than the \$600 billion in the previous example. Using a more optimistic economic forecast, however, such as that of the Office of Management and Budget (OMB), would not make much of a dent in the deficit.

CBO estimates that the rate of growth of potential output will average 2.1 percent a year from 1994 through 1997--an estimate close to that of most other forecasters. OMB's estimate of potential growth is about 0.3 percentage points per year faster than CBO's. Using OMB's economic forecast instead of CBO's would reduce the projected 1997 baseline deficit by only one-fifth and would still leave a gap of almost \$200 billion. The policy changes necessary to eliminate the deficit would still amount to about \$500 billion over five years.

PRINCIPLES FOR EFFECTIVE ENFORCEMENT LEGISLATION

The Congress and the President do not begin their search for appropriate enforcement mechanisms in uncharted territory. The Balanced Budget and Emergency Deficit Control Act of 1985 (Gramm-Rudman-Hollings I, or GRH I), the Balanced Budget Reaffirmation Act of 1987 (GRH II), and the Budget Enforcement Act of 1990 (BEA) have all attempted to enforce deficit reduction.

Experience with these laws suggests four principles for an effective mechanism to enforce a balanced budget amendment:

- o First, the mechanism for enforcement should encourage agreement on policy actions to reduce the deficit, without having to resort to automatic, formula-based solutions.
- o Second, participants in the budget process should be held accountable for those actions that are under their direct control.
- o Third, opportunities to evade the balanced budget rule and to distort policies in response to the rule should be minimized.

- o Fourth, the legislation should, to the extent possible, maintain the flexibility necessary for managing the economy and responding to national emergencies.

These principles are reflected to some degree in the two proposals to enforce the amendment that have been introduced in the past two weeks--H.R. 5253 (sponsored by Representative David Obey) and H.R. 5272 (sponsored by Chairman Panetta). They rely on similar means to enforce a balanced budget rule, combining across-the-board spending cuts (or sequestration) and tax surcharges.

Encourage Agreement

Enforcement mechanisms are fail-safe procedures and should be used only when agreement cannot be reached through the regular political process. As such, they should be drafted to encourage, rather than impede, achieving a consensus. Most participants must be given a strong interest in reaching an agreement. If important groups believe it to be in their interest to allow the automatic enforcement mechanism to take effect, agreement on an alternative is unlikely.

Perhaps the most important means to encourage consensus is to ensure that the effects of any actions to enforce the amendment are spread broadly. The Balanced Budget Act has exempted Social Security and most other entitlement programs from sequestration and does not require that tax surcharges be used for enforcement. Therefore, it is in the interest of the supporters of these exempted programs to block achieving any consensus on policy changes, since their programs might be adversely affected. Enforcement legislation that spreads the budgetary pain broadly, then, is preferable to that which singles out specific programs for large reductions.

A broad base also lessens the size of a sequestration on individual programs and makes the threat more credible. Budgetary actors are more likely to believe that a 10 percent reduction will be carried out, for example, than a 50 percent reduction. The sequestration required under GRH I and II ultimately became so large that it ceased to be credible and was no longer an effective spur to action.

Both the Panetta and Obey bills get high marks for encouraging agreement for two reasons. First, each of the bills subjects a greater portion of federal expenditures to sequestration than is the case under either GRH or the BEA, although H.R. 5253 would still exempt Social Security. Second, the threat of an automatic income tax surcharge that would be triggered by the failure to agree on

specific deficit-reduction actions should provide significant incentives to reach such an agreement.

Promote Accountability

The Budget Enforcement Act improved the credibility of the enforcement process by eliminating fixed deficit targets and introducing the concept of categorical sequestration, which provides separate enforcement procedures for discretionary appropriations and for mandatory spending and receipts (pay-as-you-go actions). In this system, for example, the appropriations committees are held accountable only for discretionary spending. Political actors are thus punished only for the budgetary consequences of their own actions or inactions, but not for the sins of others.

The reintroduction of fixed deficit targets necessarily means that punishment may be meted out for reasons that are beyond anyone's direct control, such as a slowdown in the economy. H.R. 5272 would allow the Congress to apportion the required deficit reduction among the various areas of the budget, however, with categorical sequestration of any area where the required savings are not achieved. This procedure holds committees accountable to achieve savings in programs under their control and eliminates the incentive to hold back on potential

savings, safe in the knowledge that any shortfall would be made up by a general sequestration applied equally to all areas of the budget.

Minimize Evasion

As has been well documented, the fixed deficit targets set out in GRH I and GRH II were evaded, in part, through budget gimmickry. Similarly, a balanced budget amendment could lead to evasion and gimmicks on a titanic scale. An important characteristic of any enforcement legislation is that it anticipate the possibilities for getting around the balanced budget requirement through such means as creative accounting, moving activities off-budget, and changing definitions to affect the composition of the budget covered by an amendment.

The Budget Enforcement Act limited the ability of the Administration and the Congress to play games with the budget, primarily by eliminating fixed annual deficit targets, requiring five-year budget enforcement, introducing credit reform, and establishing categorical sequestration. H.R. 5272 maintains some of the enforcement advantages of the BEA. For example, it would keep the focus on five-year budget targets for discretionary spending and pay-as-you-go actions. It would also retain the practice of carefully defining budget concepts in the context of the procedures for enforcement.

There are pitfalls in that annual deficit targets are inherent in any balanced budget amendment; no enforcement mechanism can eliminate these pitfalls. Even if outright gimmickry could be completely controlled, fixed deficit targets would encourage distorted policies. These would include myopic budgeting (forgoing current expenses even if they result in long-run savings), shifting burdens and responsibilities to businesses or other governments through mandates or regulation, and expanding tax expenditures to confer benefits. In addition, fixed targets could encourage inappropriate uses of accrual accounting, including some forms of capital budgeting. The Administration's recent proposals to claim savings for future reductions in pension and deposit insurance provide a good illustration of the possibilities. No statute can prevent such shenanigans.

Allow Flexibility

Requiring that the budget be balanced in each fiscal year would keep the federal government from engaging in countercyclical fiscal policy, or from responding to unforeseen emergencies short of war. In addition, the automatic stabilization that goes on when a recession temporarily lowers revenues or increases spending would be compromised. Enforcement legislation cannot provide much help in this area; flexibility is simply inconsistent with requiring fixed deficit targets.

Both of the current legislative proposals, however, would provide some latitude. H.R. 5272 would not focus on fixed deficit targets between fiscal years 1993 and 1996; the first fixed target occurs in 1997. Moreover, it would require \$2 billion to be paid annually into a Stabilization Reserve Fund (or rainy-day fund), giving the federal government the flexibility to dip into those reserves during recessions. This rainy-day fund, which is a good idea in concept, does not go far enough to be meaningful for two reasons. First, there is no requirement that more money be paid into the fund during good economic times. Second, the accumulated fund is likely to be much too small to deal with a recession, which could easily add \$50 billion or more to the deficit. It might help during misty days, but not rainy ones. H.R. 5253 also attempts to provide flexibility by enabling the President to propose a declaration of national economic urgency, which would cause the sequestration process to be waived.

CONCLUSION

Passing a constitutional amendment to balance the budget cannot substitute for the heavy lifting that is necessary to cut the deficit. If a balanced budget amendment is enacted, however, it must be accompanied by both a plan to balance the budget and a mechanism to enforce that plan. The illustrative policy changes developed by Chairman Panetta and the enforcement legislation currently under consideration

are steps in that direction. Even if a balanced budget amendment is not passed, deficit reduction will still be necessary, and revision and extension of the BEA will be desirable.

A stand-alone constitutional amendment risks transferring substantial authority over the budget to the executive branch and the judiciary. For example, requiring that actual outlays not exceed actual receipts might imply some Presidential power (such as impoundment) to achieve such a balanced budget. The courts could also become heavily involved in budgeting if processes and definitions were subject to dispute. Even if there were enforcement legislation, Congressional prerogatives could be compromised, as the enforcement mechanism would transfer power to the President or establish some formula for automatic sequestration. The only way for the Congress to maintain its authority over the budget would be to enact the policy changes needed to control the deficit, without having to resort to a delegation of power to the President or to a formula-based solution.

Experience with the Gramm-Rudman-Hollings legislation showed the serious problems entailed by fixed deficit targets, and the Budget Enforcement Act of 1990 largely dropped them. Even if the Congress successfully resists the urge to restore fixed targets, as I think it should, many of the provisions included in the Panetta and Obey bills are useful building blocks for the next revision of the

budget process. As I have told this Committee previously, at least three types of legislative changes should be considered:

- o First, some version of the discretionary caps and pay-as-you-go requirement should be extended past 1995, in order to prevent deferring costs beyond the horizon of the BEA.
- o Second, ways must be devised to slow the growth of health care spending; solving the deficit problem may not be possible otherwise.
- o Third, deficit-reduction targets--for example, \$40 billion annually in additional deficit reduction--could be required (as a substitute for fixed deficit targets) until a deficit target is reached. Failure to comply with deficit-reduction targets could trigger an automatic tax surcharge and a broad-based sequestration, as is reflected in the bills under consideration.

To be sure, very real benefits would accrue from reducing government borrowing. Deficit reduction, therefore, should be of paramount importance to this Congress and future Congresses until the job is done. Making hard choices about taxing and spending accomplishes that, in contrast to enshrining a balanced budget

goal in the Constitution. The bottom line is that real policy changes and enforcement are both necessary for deficit reduction; a constitutional amendment alone is not.

