

*CONTROLLING THE DEFICIT:  
THE DEBATE CONTINUES*



John L. Palmer and Rudolph G. Penner



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# Controlling the Deficit: The Debate Continues

Members of the electorate spoke loudly in November 2010, when their votes added 63 Republicans to the House of Representatives, resulting in a historical change in its party composition. A major concern of voters was the ballooning federal debt, which the Congressional Budget Office projected would grow in the long run at an increasing rate (Congressional Budget Office 2011b). Health programs and, to a lesser extent, Social Security lie at the root of the long-term problem. Their costs are approaching 50 percent of noninterest federal spending, and both will continue to grow faster than tax revenues and the economy.

The president's budget for fiscal year 2012 issued in February 2011 did not attack the main sources of spending growth or propose sufficient tax increases to finance such growth. According to the Congressional Budget Office (CBO), his budget implied rising deficits relative to GDP after 2015 and a national debt that increases from 62.1 percent of GDP in 2010 to 87.4 percent in 2021 (CBO 2011a).

A number of private groups were more concerned about the budget situation, concluding that current fiscal policies were not sustainable. They put forward several different policy options that would put the budget on a healthier path. An early effort, sponsored by the National Academies of Science and Public Administration and co-chaired by the authors of this report, described four packages that ranged from one in which fiscal sustainability was achieved entirely by cutting spending to one that relied entirely on tax increases, with two intermediate packages relying on different mixes of tax increases and spending cuts (National Research Council and National Academy of Public Administration 2010). A Bipartisan Policy Center Deficit Reduction Task Force (DRTF) put forward a detailed plan that was evenly balanced between tax increases and spending cuts (Domenici and Rivlin 2010). The Peter G. Peterson Foundation sponsored six think tanks, including the Bipartisan Policy Center, to develop plans to restore fiscal stability that spanned the ideological spectrum (Peter J. Peterson Foundation 2011).

However, plans from private sources seldom get the same attention as those with official backing. In early 2010, the president appointed his own National Commission on Fiscal Responsibility and Reform. Its report, "The Moment of Truth," was issued in December 2010 (Palmer and Penner 2011). The plan cut about \$4 trillion from the projected cumulative deficit through 2021. Not counting interest savings, cuts in spending accounted for about 70 percent of the deficit reduction, while revenue increases



accounted for about 30 percent. The debt-GDP ratio would be cut to 60 percent of GDP by the early 2020s and would continue to decline in the very long run, falling below 40 percent by 2040 (Palmer and Penner 2011).

Although praised by large numbers of outside budget experts, the report was not greeted with great enthusiasm by elected officials. Republicans generally objected to the commission's proposed increase in the overall tax burden while Democrats generally opposed the commission's Social Security reforms and were concerned about the constraints on Medicare and Medicaid spending. The president remained aloof from his own commission's recommendations, neither giving them support nor opposing them strongly.

House Republicans passed a budget in April 2011, largely based on the proposals of Chairman Ryan of the House Budget Committee (HBC). The president responded with his own budget framework. This paper spends considerable time describing these two approaches to long-term deficit reduction because they starkly illustrate the ideological gap between the president and the Republican Party on this matter. It is also fair to say that many congressional Democrats feel that the president's proposals are not liberal enough, thus further heightening the contrast between the two parties.

This paper also addresses the summer's debate over the debt limit—an irrational law that limits federal borrowing in a manner unrelated to and totally inconsistent with spending and taxing decisions already made. This law, however, gives legislators enormous bargaining power, because a failure to raise the limit means either a default on the national debt or draconian cuts in spending or increases in taxes. The highly confused debt limit debate led to the Budget Control Act of 2011, which will be discussed in detail.

## **The House Republican Budget and the President's Framework**

The first comprehensive budget plan from a prominent elected official came from Paul Ryan, chairman of the House Budget Committee.<sup>1</sup> The plan was incorporated into the House Concurrent Budget Resolution (HBR) for fiscal year 2012 and passed by the Republican majority with only four Republicans dissenting and no support from Democrats.

In analyzing the size of the deficit cuts proposed by different plans, it is always important to ask "Compared to what?" because different groups tend to use different baselines in their analyses. The choice of revenue and spending baselines also affects computations that purport to show the amount of deficit reduction coming from tax increases

compared with that coming from spending reductions. Unless otherwise stated, this analysis will use the numbers estimated by the Committee for a Responsible Federal Budget (CRFB). The CRFB compares various plans to a baseline that is very similar to what the CBO calls an adjusted baseline. That baseline does not assume that tax and spending laws will remain the same forever—as does the CBO's unadjusted baseline—because many tax and spending policies have been routinely continued, even though the law says they are temporary. For example, every year Congress alters the alternative minimum tax to prevent it from afflicting a rapidly growing portion of the population and suspends a law calling for drastic cuts in physician reimbursements in Medicare. The adjusted CBO baseline assumes that these policies as well as the Bush tax cuts, currently scheduled to expire at the end of 2012, are all continued. The CRFB numbers follow the CBO adjusted baseline except for assuming that the Bush tax cuts will continue only for the non-rich—that is, couples with less than \$250,000 of income and singles with income under \$200,000. The CRFB baseline also assumes the wars in Iraq and Afghanistan end.

The HBR adhered to the target set by the fiscal commission and cut the deficit by a cumulative \$4 trillion over 10 years. The president responded with his own "framework" for deficit reduction, which took 12 years to accomplish the same goal.<sup>2</sup> Over 10 years, CRFB estimates that the president's framework would cut the deficit only \$2.5 trillion; that is to say, its largest deficit cuts occur in the last two years of his 12-year horizon. By 2020, the total federal tax burden would equal 18 percent under the HBR and 19.5 percent under the president's framework. Spending would be 20.0 percent under the HBR and 22.5 percent under the president's framework. The former would bring the debt-GDP ratio down to 70 percent, and the latter would bring it to 76 percent. By 2040, the HBR would have the debt-GDP ratio at 48 percent. CRFB does not estimate a comparable figure for the president's framework. However, Obama has stated that his goal is to have the ratio on a declining path in the last half of this decade and, we presume, to continue to reduce it in the very long run.

Neither the HBR nor the president's framework includes highly detailed policy prescriptions. Budget resolutions generally set broad goals and leave the details up to various congressional committees. The HBR is, in fact, more specific than usual. The president's proposals are vaguer and only provide a general framework for how he would accomplish his deficit reduction goals—just as he labeled his approach. The HBR, however, provides quite a bit of detail regarding the reforms that it advocates for health programs, and the president's framework is also more detailed on this

**Table 1** 10-Year Savings under the President's Framework and the House Budget Resolution for Fiscal Year 2012 against an Adjusted Baseline (\$ billions)

	President's framework	House Budget Resolution
Security spending changes	\$130	-\$90
Nonsecurity discretionary cuts	\$450	\$1,680
Social Security reform	N/A	N/A
Repeal of select provisions		
of health reform	N/A	\$590 <sup>a</sup>
Other health spending reductions	\$340	\$800
Other mandatory spending cuts	\$290	\$980
Tax reform and revenue changes	\$760 <sup>a</sup>	-\$610
Interest savings	\$510	\$650
<b>Total deficit reduction</b>	<b>\$2,480</b>	<b>\$4,020</b>
<b>Total deficits</b>	<b>\$6,990</b>	<b>\$5,450</b>

Source: Committee for a Responsible Federal Budget (CRFB), *Analyzing the President's New Budget Framework* (Washington, DC: CRFB, 2011), fig. 4.

Notes: Negative numbers represent costs as opposed to savings. Numbers may not sum to totals because of rounding. All numbers are estimated by the CRFB using data from the Congressional Budget Office, the National Commission on Fiscal Responsibility and Reform, and the Obama administration. Estimates should be considered rough and are subject to considerable uncertainty.

N/A not applicable

a. Includes revenue and outlay effects.

topic than on other issues. Both plans are extremely vague about how they would reform Social Security—testimony to the extreme political popularity of the program (table 1).

## Health Care

Health care–related deficit savings figure prominently in the president's framework but far more so in the HBR, since it calls for repealing certain deficit-increasing portions of last year's health reform legislation and, in conjunction with a radical restructuring of the federal role in Medicare and Medicaid, imposes highly stringent limits on future rates of growth of program costs. In contrast, the president builds on last year's health reforms and proposes relatively modest further changes to Medicare and Medicaid, several of which were also recommended by his presidential commission and the DRTF (Palmer and Penner 2010). As a result, health care in the HBR accounts for \$1.4 trillion in total deficit savings over the next decade and a huge annual amount—perhaps as much as 9 percent of GDP (the equiv-

alent of \$1.3 trillion in *annual* savings in today's terms)—by midcentury, whereas in the president's framework it accounts for only \$320 billion in total deficit savings over the next decade and no more than 2 percent of GDP annually by midcentury.<sup>3</sup> There is ample reason to question the credibility of the health-related deficit savings promised by each plan, particularly over the long run. However, both attempt to impose a budget constraint on federal spending for health care spending, while offering very different approaches to achieving it.

## House Budget Resolution

Virtually all the HBR deficit savings in health care comes from three major components:

- **Repealing health reform.** The coverage expansion in the Affordable Care Act (ACA), estimated to decrease the number of uninsured people by 32–34 million annually over the next 10 years, would be repealed along with the new sources of revenues to help finance the expansion. The plan would also repeal the Independent Payment Advisory Board (IPAB), created under the ACA to help restrain long-term Medicare spending growth, which HBR severely criticizes as a heavy-handed regulatory approach to cost control. However, ACA provisions that cut Medicare provider reimbursement considerably in the near term would be retained and the savings dedicated to deficit reduction instead of coverage expansion.
- **Converting Medicare to premium support.** Medicare would be converted from a defined benefit program to a premium support system for those now under age 55. Beneficiaries initially would receive an average subsidy equivalent to currently projected per capita Medicare spending in 2022 (\$8,000) for the purchase of any of numerous private plans participating in a new Medicare exchange that offers benefit packages meeting at least a specified minimum standard, accepts all applicants, and charges the same price for everyone of the same age.<sup>4</sup> (The subsidies would be lower for high-income beneficiaries, and low-income beneficiaries would receive additional federal funds through medical savings accounts.) In future years, the premium subsidies would be indexed to the general rate of inflation, which CBO projects to be well below the growth rate of the costs of Medicare-covered services per beneficiary—thus accounting for the lion's share of long-term health care savings to the federal government in the HBR plan. Additional savings would come from gradually increasing the age of eligibility for the subsidies from 65 to 67.



- **Converting Medicaid to a block grant.** The federal role in Medicaid would be transformed by converting current open-ended federal cost-sharing to closed-ended block grants to the states and allowing states considerably more flexibility in the design and management of their programs. The federal block grants would grow each year starting in 2013 only with inflation and population—or about 4 percentage points less than the currently projected average annual growth rate in federal spending for the program. Total savings would be nearly \$800 billion by 2022, at which point CBO estimates the federal government would be spending 35 percent less annually for Medicaid than it would absent this change; by 2030, the federal government would be spending 49 percent less annually (CBO 2011c, 26).

### The President's Framework

The president would achieve most of his 10-year savings through various measures affecting both Medicare and Medicaid, including a new patient safety initiative to reduce avoidable medical complications, steps to cut unnecessary spending on prescription drugs, and efforts to stem abuse and fraud. Specific to Medicaid, the president proposes replacing the current federal matching formulae with a single rate for all program spending that would reward states for efficiency and increase during recessions. He proposes to work with state governors to enact further reforms, especially to encourage more efficient, higher quality care for high-cost beneficiaries.

To further constrain long-term spending growth, the president would reduce the ACA's target for Medicare spending growth and strengthen the role of the IPAB as a backstop to other Medicare reforms. Under the ACA, beginning in 2018, whenever per beneficiary Medicare costs are projected to grow faster than per capita GDP + 1 percent annually (over the subsequent five years), the advisory board must recommend policies to Congress to constrain the growth rate to that of GDP + 1 percent; these recommendations cannot alter the benefit structure and are essentially restricted to changes in provider reimbursement. Congress is then to enact either these policies or others achieving equivalent savings; failing such action, the Secretary of Health and Human Services must implement measures to the same end. The president now proposes to lower the spending target to the annual rate of growth of per capita GDP + 0.5 percent—a rate consistent with currently projected Medicare spending and the additional program reforms outlined in his framework—and to provide IPAB with additional “tools to improve the quality of care

while reducing costs, including . . . value-based benefit designs” and “enforcement mechanisms, such as an automatic sequester”<sup>5</sup> if policymakers fail to act to adequately control cost growth.

### Discussion

The HBR and the president's plan for Medicare share a goal essential to the ultimate success of any deficit reduction plan: to substantially slow the growth of program spending relative to GDP over the long term. But the plans differ starkly on two key related issues: just how tightly should such spending be constrained, and by what method?

The premium support method directly controls total program spending and relies on competition among plans in the Medicare exchange, along with greater beneficiary skin in the game, to promote efficiencies in the marketplace that would slow cost increases for Medicare-covered services without compromising quality of care. In contrast, the strengthened ACA approach controls total program costs indirectly, with less certainty (except to the extent sequestration is effectively employed), and relies primarily on regulating the reimbursement of health care providers and changing their incentives. Both approaches have their problems.

The major concern with premium support is that beneficiaries could face extraordinarily large increases in out-of-pocket expenses if the cost of the minimum standard package of Medicare-covered services is much greater initially under a private plan and/or increases much faster than do the per capita federal subsidies. According to CBO, this would be a severe problem under the HBR proposal<sup>6</sup> and, along with it effectively “ending Medicare as we know it,” accounts for most of the harsh criticism the plan has encountered. However, these concerns could be greatly ameliorated while still retaining a premium support structure—though not without sacrificing on deficit savings. For example, the DRTF proposed converting Medicare to a premium support program but recommended indexing the government subsidies to the growth rate of per capita GDP + 1 percent rather than to the general rate of inflation, which is expected to average much less annually. The DRTF also recommended that Medicare enrollees be able to continue in the traditional fee-for-service program, rather than choose a private plan, if they prefer. (However, if federal spending per enrollee in traditional Medicare for the benefits specified in the legislation were to rise faster than GDP + 1 percent, beneficiaries would have to pay an additional premium to cover the difference.)<sup>7</sup>

Both the HBR and DRTF plans reflect the hope that converting Medicare to a premium support approach will result in the more efficient delivery of health care, but a significant portion of their associated cost saving is bound to come from shifting costs from the public sector to beneficiaries, especially those who are better off. Although it is common to compare beneficiary costs under reform proposals to costs under the current Medicare program, it should be emphasized that retaining the current Medicare program in all its details is not a viable option. Fiscal sustainability will not be attained without slowing health costs, and slowing health costs will require Medicare reform. Medicare “as we know it” is bound to change; the only debate is over how drastically.

The major concern with the strengthened ACA method of constraining Medicare program costs is that regulating the prices providers can charge Medicare beneficiaries is a blunt instrument for promoting efficiencies and cost savings, and the future strictures on Medicare reimbursement rates already promulgated under the ACA have been deemed highly unlikely to be viable over the long term by the program’s chief actuary because they will probably decrease beneficiary access to care, among other concerns.<sup>8</sup> Thus, achieving an even-lower long-term spending target for Medicare—that is, one tied to the growth of GDP + 0.5 percent—by further empowering the IPAB and reducing provider reimbursement rates is highly questionable. Such an approach also runs the risk of stifling, rather than spurring, innovation. Plus, the political process is likely to have a hard time dealing with the kind of rationing of low-effectiveness procedures it might eventually entail.

The President’s Fiscal Commission report notably mentioned both premium support and a strengthened ACA as promising ways to restrain Medicare’s long-term cost growth within prescribed bounds, though without any discussion of their relative merits. But the commission also recommended a target rate of growth indexed to GDP + 1 percent, not GDP + 0.5.

The differences between the HBR’s and president’s approaches to restraining the long-term growth of federal Medicaid spending parallel those pertaining to Medicare: the HBR proposal would explicitly limit federal Medicaid spending and index it in a way that would decrease spending sharply over time relative to current law, whereas the president seeks to indirectly restrain the growth in such spending far less dramatically and more indirectly within the existing program structure. Here, too, both approaches have their problems.

The major concern with the HBR block grant (beyond elimination of the ACA provision to expand Medicaid

eligibility to millions more uninsured low-income Americans) is that any cost-saving efficiencies the states might achieve will likely be overwhelmed by the huge reduction in the share of federal funding over time, thus forcing states to greatly reduce the scope of their programs and their low-income populations to face much more limited access to care. As for the minor tinkering with Medicaid proposed by the president, unless the federal government chooses to regulate state Medicaid programs much more highly in the future as a condition of continued open-ended cost-sharing (or to completely take over Medicaid as part of a future comprehensive health reform), some sort of closed-ended federal funding formula—such as already employed for the State Children’s Health Insurance Program (SCHIP)—may be essential to establish meaningful limits and predictability to the long-term growth of federal spending.<sup>9</sup> This still could be accomplished, of course, with a much more generous indexing formula for the federal grants than in the HBR proposal.<sup>10</sup>

## Social Security

Although both the president’s framework and the Ryan HBR include discussion of Social Security reform, neither advances specific proposals nor assumes any contribution from the program to future deficit savings in its projections or targets. Indeed, consistent with the president’s fiscal commission and DRTF recommendations for Social Security, neither favors reforms that would reduce the program’s basic benefits for current recipients or those near retirement. But both also emphasize the need for bipartisan agreement sooner rather than later on reform measures to ensure continued program solvency over the long term—a need further reinforced by the subsequent issuance of the 2011 Social Security trustees’ report projecting further deterioration in the program’s financial status.<sup>11</sup> Accomplishing this goal inevitably would entail a major contribution to long-term deficit savings, since Social Security is now projected to run annual cash flow deficits well above 1 percent of GDP in 2036 (when its reserves will be exhausted) and beyond.<sup>12</sup>

Despite these areas of general agreement, the president and Congressman Ryan clearly differ on the reform particulars they favor. Not surprisingly, Ryan eschews large tax increases, such as would ensue from lifting the cap on earnings subject to Social Security payroll taxes, and supports reforms that substantially slow the rate of benefit growth for most future recipients. In contrast, Obama rules out “an approach that slashes benefits for future generations”<sup>13</sup> and has in the past signaled support for

higher taxes, at least for some with earnings above the current cap.

## Other Mandatory Spending

Mandatory spending includes spending related to contractual obligations of the federal government, such as paying for goods and services already purchased, and entitlement spending. The latter refers to programs where the law defines an eligible population and the benefits to which they are entitled and then the government pays the bill for all who apply for benefits. These are sometimes referred to as uncontrollable programs, but that is not quite accurate because Congress can always change the law that defines eligibility or the level of benefits. Entitlements providing health insurance and Social Security have already been discussed above. The following examines how other, much smaller entitlements are handled in the House Budget Resolution and the president's framework.

## House Budget Resolution

Food stamps, now known as the Special Nutrition Assistance Program (SNAP), would be reformed in the same way that welfare was reformed in the late 1990s: the program would be financed with a block grant, states would be given considerable freedom to design the program to suit their eligible population, and beneficiaries would be expected to get jobs or participate in job training programs. The budget for the block grant would be increased with the CPI and the size of the eligible population starting in 2015, when it is presumed that unemployment has reached more normal levels. Housing assistance would be made less generous and also subjected to work requirements.

Direct payments to farmers (other than price supports) would be reduced, and crop insurance would be reformed. Reforms would be implemented when farm programs are reauthorized, and the expected saving over the next decade would be \$30 billion out of \$153 billion.

The HBR also advocates cutting fringe benefits for civil servants, but no details are provided.

Total savings in other mandatory programs are estimated at \$719 billion for 2012–21 compared with the CBO baseline. The implied cut from the baseline is a little less than 20 percent. The HBR does not provide enough detail to accurately apportion all the targeted savings between income security or safety net programs and mandatory payments to more affluent recipients, such as owners of large farms.

## The President's Framework

The president proposes to save \$360 billion from other mandatory programs from 2012 to 2023. The framework mentions reforming agricultural subsidies and the federal pension insurance system while restoring solvency to the federal unemployment insurance trust fund and attacking fraud. No details are provided, but the framework does say that reforms should “protect and strengthen the safety net for low-income families and other vulnerable Americans.”

## Discretionary Spending

The CRFB estimates that the president's framework would reduce discretionary spending over a 10-year period by \$580 billion, compared with CRFB's adjusted baseline. The HBR is much more ambitious, cutting \$1,590 billion.

## House Budget Resolution

Former Secretary Gates identified \$178 billion in defense cuts over 10 years. The HBR would accept these cuts, allocating \$100 billion of the saving to “higher military priorities” and using \$78 billion for deficit reduction. Between 2011 and 2021, defense appropriations would rise 2.3 percent a year on average, marginally above the assumed rate of inflation. If spending related to the Iraq and Afghan wars declines, as expected, that would allow for a greater increase in regular, inflation-adjusted defense spending. Although the HBR estimates that its net cut in defense spending reduces the deficit \$78 billion, it actually increases defense spending by \$90 billion relative to the CRFB baseline. The difference occurs because the CRFB baseline eliminates war spending whereas the savings estimate proposed by Secretary Gates and accepted by the HBR does not.

The HBR cuts budget authority for non-security discretionary spending below 2008 levels and then freezes it for five years. By 2017, outlays are 30 percent below the stimulus-enhanced level of 2011. A significant portion of the savings is focused on the civil service. Its numbers are cut 10 percent over three years through attrition, and pay is frozen for five years.

Few other details are provided for the non-security cuts. The House Appropriations Committee is left with the challenging task of filling in the details. However, most appropriations cover only one year—in this case, 2012. The real challenge will be maintaining the severe budget austerity recommended by the HBR for the years following 2012. As described later, long-run spending discipline would be enforced by spending caps using sequesters.

## The President's Framework

The president proposes significant cuts in discretionary spending that would bring the totals in line with levels proposed by his fiscal commission. No details are provided, but the administration estimates 10-year cuts in security spending of \$290 billion and 12-year cuts of \$400 billion. Non-security spending would be cut \$620 billion over 10 years and \$770 billion over 12 years. Using a somewhat different baseline, CRFB has lowered the estimate of 10-year saving from \$290 to \$130 billion for the security budget and from \$620 to \$450 billion for non-security spending. The differences in the estimates again illustrate the crucial importance of specifying what the cuts are from when estimating "savings."

## Tax Policy

Superficially, the HBR and the president's framework appear to be on the same page philosophically when it comes to tax policy. Both endorse the basic approach of the president's fiscal commission to greatly simplify the tax code by eliminating many deductions, exclusions, and credits; and both want to use some or all revenues derived from simplification to lower marginal tax rates. Moreover, the HBR and the president want to use the same approach for both the individual and corporate income tax systems.

However, the superficial similarities between the two approaches mask profound differences in the long-run tax systems envisioned. Most important, roughly \$1 trillion of the president's proposed \$4 trillion in deficit reduction comes from increasing taxes. This is on top of his desire to end the Bush tax cuts for the more affluent. In contrast, the HBR starts with the presumption that all the Bush tax cuts are continued. As the tax base is broadened and rates lowered, the overall federal tax burden stays between 18 and 19 percent of GDP.

According to CRFB calculations, the overall burden in 2020 would be 18 percent under the HBR and 19.5 percent under the president's framework—a difference of a little more than 8 percent. Further HBR computations show the tax burden under its plan rising in the very long run to an apparent cap of 19 percent.<sup>14</sup> It is unclear what the president's framework intends for the very long run, but it is probably safe to say that the overall tax burden would continue to grow relative to that in the HBR. There would also be important differences in how the tax burden is distributed between savings and investment on the one hand and consumption on the other, with the HBR plan much more lenient toward the former.

As the Bush tax cuts expire at the end of 2012, the president's proposal would raise the top rate on capital gains and dividends from 15 to 20 percent. The Affordable Care Act imposes an additional surtax of 3.8 percent on the investment income of more affluent taxpayers and a luxury tax on especially expensive employer-financed health insurance. The HBR eliminates the surtax, and while it does not specify the rate on capital gains and dividends—that is the job of the Ways and Means Committee—it does state that "Tax reform should favor savings and investments because more savings and investments mean a larger stock of capital available for tax reform." It is probably safe to assume that a Republican tax reform would eliminate the current exclusion from taxable income of the value of employer-financed health insurance. The luxury tax imposed by the ACA is an imperfect substitute for this more radical reform.

Because the HBR tax reform process starts with a lower presumed top rate than the president's reform and because it is very likely to favor investment income, the end result is almost certain to be a less progressive tax system than under the president's framework. This reflects differences in the beliefs of the two political parties regarding the proper role of government in redistributing income and how strongly lower marginal tax rates stimulate saving and investment.

## Budget Process and Rules

Both the HBR and the president's framework depend on automatic mechanisms to enforce fiscal discipline. The HBR imposes separate caps on total spending and on discretionary spending, consistent with the totals specified for 10 years by the resolution, which would be enforced with automatic across-the-board cuts. Any increase in the debt limit would have to be accompanied by legislation that reaffirms the spending targets outlined in the HBR. In addition, there would be points of order (requiring a supermajority to override in the Senate) against any legislation increasing mandatory spending beyond the 10-year budget horizon used by the HBR. Finally, Congress would be required to review mandatory spending programs regularly and move toward requiring appropriations for mandatory programs. This would be a radical change if the appropriations were used to restrict cost growth in the programs, but it would also be pro forma if Congress simply appropriated whatever sums the programs were expected to cost and added supplementals when the estimates proved to be too low. That has happened in the many years that the Food Stamp Program has been an appropriated entitlement.

This failsafe mechanism also involves automatic cuts in the deficit that would be triggered if budget projections



do not show the debt-GDP ratio declining in the second half of the decade. The cuts would be designed to lower the deficit to an average 2.8 percent of GDP over that period.

There are several important differences between the mechanisms designed by the HBR and the president:

- The president's approach cuts spending *and* raises revenues automatically by cutting tax expenditures.
- The president exempts Social Security, low-income programs, and benefits for Medicare enrollees from automatic spending cuts. But there is a separate sequester mechanism for Medicare if its expenditure growth exceeds the president's GDP + 0.5 percent target. Presumably, this sequester would focus on provider reimbursement and not on beneficiary cost-sharing.
- The president's trigger would include a mechanism to ensure that it does not exacerbate an economic downturn or interfere with the nation's ability to respond to a national security emergency.

The history of fiscal policy shows that automatic mechanisms often fail. They are generally abandoned when they become too painful to be tolerated politically. That happened to the automatic spending cuts embedded in the Gramm-Rudman-Hollings law of 1985, whose main provisions were abandoned in 1990. Similarly, as noted earlier, a provision intended to cut physician reimbursements under Medicare is routinely waived because the required cuts are now so large that they would drive physicians out of the program. But some automatic mechanisms have worked quite well. For example, Part B standard Medicare premiums are raised each year so they continue to finance 25 percent of the overall cost of the program.

Are the mechanisms designed by HBR and the president likely to suffer the same fate as Gramm-Rudman-Hollings? In some respects, the president's automatic trigger is less likely to be abandoned because it spreads the pain of deficit cutting over both the tax and spending sides of the budget and it has an escape clause in the event of an economic downturn. Yet, the diffusion of some pain to the tax side of the budget is countered to some degree because large exemptions focus the pain on only a portion of total spending.

The goal of the cuts in the president's plan is to lower the five-year average deficit to 2.8 percent of GDP. The deficit is highly volatile, affected by numerous random variables other than overall economic activity. It could soar and force very large cuts even in the absence of an economic downturn. By focusing on spending levels, HBR has a much less volatile and therefore more predictable target. Nevertheless, spending levels are also affected by cyclical factors to some degree.

It is very challenging to design an automatic mechanism that can survive a bit of bad luck. It may be wise to place limits on the pain imposed by a sequester. An automatic mechanism is more likely to survive if automatic cuts are not allowed to exceed some absolute amount, such as 1 percent of GDP.

## The Budget Control Act

The debate over the debt limit was a low point in the history of U.S. budgeting. There were many starts and stops with aborted deals and much posturing. It was impossible to predict from day to day where the debate would go, and at times, the unthinkable—a default on U.S. sovereign debt—seemed quite possible. House Speaker Boehner held fast to a goal of reducing the deficit dollar for dollar for any increase in the debt limit. (It was never clear over what period the deficit cut was supposed to occur.) For most of the negotiations, the Speaker insisted that the entire deficit reduction come from spending cuts, although for a brief period he and the president were discussing a very large deficit-reduction package that would have included some tax increases. Meanwhile, the president wanted a big enough increase in the debt limit that the issue would not have to be revisited before the next presidential election.

In the end, Congress and the president agreed to the Budget Control Act of 2011 (BCA), which has two parts. The first imposes caps on discretionary appropriations through 2021 that save a cumulative \$756 billion starting in 2012<sup>15</sup> and makes changes in student loans and Pell grants that save a cumulative \$5 billion over the same 10 years. For 2012 and 2013, the BCA has separate caps on appropriations for security and non-security spending. After 2013, a single cap will apply to total discretionary appropriations. The discretionary caps in the BCA are somewhat more lenient than the caps in the HBR. The BCA's discretionary caps and education reforms will result in additional interest savings of \$134 billion.<sup>16</sup> In total, the first part of the BCA will reduce the cumulative deficit by \$895 billion from 2012 through 2021.

The second part of the BCA created a Congressional Joint Select Committee on Deficit Reduction, dubbed the super committee, which consisted of 12 members: 3 Republicans and 3 Democrats from each of the House and Senate. The committee was instructed to reduce the deficit by a cumulative \$1.5 trillion from 2012 through 2021. In the end, it could not agree to any deficit reductions at all. According to the BCA, the super committee's failure implies that there will be an automatic, across-the-board cut in budget authority<sup>17</sup> of \$1.2 trillion over 10 years starting in January 2013. Half the cut is to come from defense budget authority

and half from nondefense budget authority. However, Social Security and a number of programs focused on poor people are exempted from the cut. The cut to Medicare is capped at 2 percent and limited to provider reimbursement.

CBO has provided approximations of the cuts in appropriations and in mandatory programs that will occur if the sequester goes through. These are approximations because CBO will not administer the automatic cuts. That will be done by the Office of Management and Budget (OMB), and in some areas the automatic cuts could be administered several different ways. Note that automatic cuts are applied to budget authority, not to outlays. Outlay cuts will be less severe because outlays tend to lag budget authority.

The automatic cut in appropriations for defense discretionary spending would be 10 percent in 2013 and then gradually fall to 8.5 percent by 2021. The cumulative reduction over 10 years is \$492 billion. The cuts in nondefense discretionary spending and in the non-exempted, non-defense mandatory programs would be 7.8 percent in 2013, falling to 5.5 percent in 2021. The total reduction in budget authority is \$492 billion, identical to that in the defense budget. The 2 percent cut in Medicare saves \$123 billion of this amount. Indirect debt service savings amount to \$169 billion. In total, the automatic cut in budget authority leads to outlay savings of \$1.1 trillion cumulatively. The cut in outlays is less than the required \$1.2 trillion cut in budget authority because of the aforementioned time lags.<sup>18</sup>

Since the failure of the super committee, a number of Republicans and Democrats have argued that the across-the-board cuts that are now supposed to occur in the defense budget would dangerously weaken the nation. Senator John McCain has introduced legislation that would suspend those cuts. It is hard to believe that the defense cuts could be suspended without doing the same for the nondefense budget.

The president has responded that the cuts must be implemented and has vowed to veto any legislation that would suspend them. He hopes that this threat will force Congress to return to the bargaining table and to agree to something more sensible than across-the-board cuts.

Although it is hard to find anything to be encouraged about after the super committee's abysmal failure, there is a very slight chance that a return to the bargaining table could yield some success. The most important positive development during the committee's deliberations was an offer by the Republicans to open the door a tiny crack to tax increases. It was particularly significant that the vehemently anti-tax committee member Senator Pat Toomey put the offer on the table. He joins Republican Senators Crapo and Coburn and then-Senator Gregg who endorsed tax increases as members of the president's fiscal commission. The expiration of the Bush tax cuts at the end of

2012 creates another reason to bargain productively. If the adamant Republican opposition to tax increases continues to weaken and Democrats can be persuaded to accept meaningful reforms in Social Security, Medicare, and Medicaid, there is some hope of a balanced solution for America's fiscal woes in the near term. However, the hope is a slim one. The two parties are still very far apart, and it will require much compromising to reach a viable solution.

If negotiations are resumed, it becomes relevant that in responding to the BCA the president urged the super committee to "go big" and exceed the goal of deficit savings of \$1.5 trillion over 10 years. The plan he provided the committee is generally consistent with his earlier framework and would probably serve as his initial bargaining position in any further negotiations. Obama claimed his plan would save \$4.4 trillion, but unfortunately that total included savings from ending the wars in Iraq and Afghanistan, thus reducing the credibility of his proposal. The CRFB estimates Obama's plan would save \$1.9 trillion, not counting the \$900 billion saved by the spending caps already put in place by the BCA. Although the president's plan would save somewhat more than the super committee's goal of \$1.5 trillion, it falls short of stabilizing the debt-GDP ratio. CRFB estimates that the ratio would be 74 percent in 2021 under the president's plan compared with the 66 percent achieved by the HBC and the president's fiscal commission. This ratio was 62 percent at the end of 2010.

The president's new plan yields roughly the same magnitude of deficit saving as his framework described earlier, although some saving is used to pay for a newly designed jobs initiative. (That initiative will not be discussed here, because the spending portions of the initiative are modest and short term.) But the new plan is much more detailed (except with respect to Social Security, about which it is silent). For example, there are very specific recommendations for reducing payments to providers and subsidies to medical schools under Medicare. Considerable amounts are saved for Medicare Part D by having drug companies provide rebates similar to those in the Medicaid program. Newly enrolled Part B recipients would face higher deductibles, and the more affluent would pay higher Part B and D premiums. Over three years starting in 2013, civil servants are expected to contribute an extra 1.2 percent of wages to their defined benefit retirement plans, and military personnel and retirees and their dependents are expected to pay a higher cost share for their health plan. Numerous increases in fees and insurance premiums are proposed as are sales of government properties. It is impossible to convey the richness of the plan's details in a short discussion; for that, the reader is referred to the official document describing the plan (OMB 2011).



The new plan accepts the caps on discretionary spending stipulated by the BCA and counts the associated spending cuts toward its saving target. The president repeats the call for radical tax reform that appeared in his earlier framework, but recognizing that tax reform will take a long time, he advocates \$1.5 trillion in revenues by limiting itemized deductions and adopts other base-broadening initiatives for both individuals and corporations.

The new presidential plan has a somewhat different enforcement mechanism than the framework. The latter focused on sequesters that would hit a deficit goal. In the new plan, enforcement is centered around goals for the debt-GDP ratio. To set goals, the baseline debt-GDP ratio is estimated for 2013 and then reduced 0.2 percentage points a year. If Congress does not adopt policy changes that achieve the goals for the debt-GDP ratio, a sequester of spending modeled on the one designed by the BCA goes into effect. An equal amount is obtained from the revenue side by a proportional reduction in itemized deductions and exclusions for couples with more than \$250,000 in income and singles with more than \$200,000. The total amount of the required adjustment is limited, whether it is achieved by deliberate policy actions or automatically. As noted in our earlier discussion of the automatic mechanism contained in the framework, such a limit is useful because it reduces the likelihood Congress will abandon the enforcement process altogether. The enforcement process is temporarily suspended in times of economic weakness.

As noted previously, the CRFB has estimated that the specific program proposals in the president's plan would increase the debt-GDP ratio to over 70 percent by 2021. In contrast, the above enforcement mechanism requires a continual reduction in the debt-GDP ratio. Thus, Congress would have to pass spending cuts and/or tax increases that go considerably beyond those in the president's plan.

### **The BCA's Bias against Discretionary Spending**

As a result of its spending caps and the design of the sequester, the BCA focuses on reducing the deficit by constraining discretionary spending when discretionary spending has not played an important role in causing the long-run budget problems. While discretionary spending has recently been bloated by the stimulus program, the caps and the sequester imposed by the BCA would far more than make up for this bloat. It is very likely that if all

the rules are followed, nondefense discretionary spending would fall below 3 percent of GDP—the lowest level since World War II.

Given that Social Security and health spending are responsible for essentially all the long-run spending problem, it is ironic that the BCA totally exempts Social Security and Medicaid from the sequester and limits the cut in Medicare to 2 percent. The act formalizes a phenomenon that has been under way for years. The automatic growth in health and Social Security is squeezing out all other functions of government.

### **Conclusion**

It is an understatement to say that this has been a discouraging year for anyone hoping for a more responsible fiscal policy. The chaos surrounding the debate over the debt limit in midsummer and the total failure of the super committee that emerged from that chaos show that the country's fiscal policy-making machinery is terribly broken. That is not to say there has been zero progress. The cumulative saving of almost \$900 billion associated with the discretionary spending caps imposed by the BCA is a significant sum. If \$1.2 trillion is added either by a sequester or a more rational deficit reduction plan, the total deficit reduction of \$2.1 trillion gets the nation about halfway to the roughly \$4 trillion deficit reduction generally associated with stabilizing the debt-GDP ratio in the long run.

Unfortunately, it is difficult to be confident that \$2.1 trillion in deficit reduction will actually materialize. It is spread over 10 years and a number of different Congresses. Any rules imposed by one Congress can be broken by another. Indeed, past Congresses have not been shy about breaking their own rules.

Because the nation will make some progress against the deficit *if* the rules of the BCA are followed, and because Republicans are showing some signs of weakening their total opposition to tax increases, the future is not totally bleak. Negotiations that build on the deficit reductions imposed by the BCA could be productive. But a huge ideological gap remains between the two political parties, and progress will be elusive unless both sides show more willingness to get things done for the good of the country. Without more progress, the nation will continue its march toward a sovereign debt crisis of Greek proportions. No one can predict when that might occur, but the risks are enormous, and it is time our leaders begin to lower them.

## Notes

1. Rep. Paul Ryan, *The Path to Prosperity: Restoring America's Fiscal Promise*, Fiscal Year 2012 Budget Resolution, House Committee on the Budget, 2011.
2. The White House, "Fact Sheet: The President's Framework for Shared Prosperity and Shared Fiscal Responsibility," press release, April 13, 2011.
3. The 10-year deficit savings estimate for the HBR plan is from CRFB (2011a), and its estimated annual impact by midcentury is from CBO (2011c), table 2. The \$320 billion in 10-year savings is the OMB estimate for health care in the president's plan; the authors have estimated the midcentury annual impact of the same on a basis consistent with the methodology used in CBO (2011c), table 2.
4. Problems of adverse selection would be addressed by cost-neutral (in the aggregate) risk subsidies and tax levies applied by the Department of Health and Human Services to the private insurance plans based on the characteristics of their actual enrollees.
5. The White House, "President's Framework," April 13, 2011.
6. For example, CBO estimates that by 2030 the out-of-pocket share of health care spending for a typical Medicare beneficiary would be 68 percent under the HBR, as opposed to 25 to 30 percent under current law (CBO 2011c, figure 1).
7. For a brief discussion of how the HBR might be improved upon written by an advocate of converting Medicare to premium support, see Wilensky (2011). For a brief criticism of the various versions of premium support currently in vogue by one of its initial proponents, see Aaron (2011).
8. See the "Statement of Actuarial Opinion" by Richard Foster in Board of Trustees (2011). Both this statement and the body of the report note that the long-term viability of these strictures would require fundamental changes in the health care delivery system.
9. SCHIP provides health insurance coverage to uninsured children living in families with low incomes that have too much income to qualify for Medicaid. As in Medicaid, the federal government matches state spending in accordance with a formula. Unlike Medicaid, annual federal funding is set at a fixed level, and each state receives an allotment based on an estimate of the target population and the cost of providing medical services there.
10. For a general discussion of a federal block grant for Medicaid, see Kaiser Commission on Medicaid and the Uninsured (2011).
11. The trustees had expected several years of near-term annual cash flow surpluses for the program, but they now expect continuous cash flow deficits because of a downward revision in projected economic growth. Several other factors, including an increase in assumed life expectancy, have worsened the long-term outlook.
12. Annual cash flow deficits are now projected to grow to 1.38 percent of GDP by the time program reserves are depleted in 2036 and exceed 1.45 percent of GDP by the end of the 75-year period (Board of Trustees, Federal Old Age and Survivors Insurance and Federal Disability Insurance Trust Funds 2011).
13. White House, "President's Framework," April 13, 2011.
14. The CRFB estimate of 18 percent is based on slightly different assumptions than the 19 percent long-run cap implied by the HBR, but the difference is very small (CRFB 2011b).
15. Caps can be increased for war spending, disaster relief, other emergencies, and monies spent to reduce improper benefit payments in several programs providing transfer payments. The law also requires that the Congress vote on a balanced budget amendment to the Constitution.
16. The estimate of interest saving is based on CBO's interest forecast of August 2011 and therefore differs from the March 2011 baseline assumptions used in the first part of this paper. See CBO (2011b).
17. For discretionary programs, budget authority is provided by appropriations that are most often passed annually. For entitlements, budget authority is often created by dedicated revenues, such as the payroll tax that finances Part A Medicare.
18. Proportionate cuts are applied equally to every defense and nondefense budget account in 2013. The percentage cut is somewhat larger in defense than in nondefense accounts. After 2013, cuts are not equalized at the account level for discretionary spending. Separate overall caps are established for defense and nondefense budget authority.

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