Process Reforms to Restrain Leviathan

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In the past 10 years, the burden of federal spending has jumped from 18.2 percent of GDP to about 25 percent of GDP. But that's just the tip of the iceberg. Over the next several decades, the combination of demographic changes and poorly designed entitlement programs could cause the burden of federal spending to double as a share of economic output.

This fiscal tsunami already has resulted in record deficits. Left unchecked, it suggests even more debt, along with rising tax burdens, in the future. And since the academic evidence is very clear that there is a negative relationship between the size of government and economic performance, this does not bode well for American prosperity and competitiveness.

The only solution is to restrain the growth of spending, and today's hearing is very well designed, asking us to consider "How fiscal rules can restrain federal overspending."

What Are We Trying to Fix?

This is a critical question. Many people think deficits and debt are the problem. Excessive red ink surely is not a good thing, as places such as Greece and Portugal demonstrate, but deficits and debt generally should be seen as symptoms, while the real problem is that governments are too big and spending too much.

The true fiscal tax is the amount of money that government diverts from the productive sector of the economy. In other words, government spending – at least beyond a certain level – undermines economic vitality, and that is true if the spending is financed by taxes and that is true if the spending is financed by borrowing.

This doesn't mean that "deficits don't matter." It just means that "taxes also matter," and that the real issue is the overall burden of government spending.

Realistic Goals

Perhaps the most important caveat in my presentation is that no process reform will be perfect. The appropriate analogy is that fiscal rules are like anti-crime mechanisms. Locks on your doors are a good idea, but they don't guarantee that you won't be victimized. Bars on your window, an alarm system, and gun ownership also would help deter crime, but even those steps are not a guarantee.

But the perfect should not be the enemy of the good – particularly when the alternative is to let the nation slowly sink into Greek-style fiscal chaos.

In addition, my testimony will focus only on policies that might make a difference in restraining spending. There are many proposed reforms, such as biennial budgeting, that would be akin (with a full-time legislature) to rearranging the deck chairs on the Titanic.

Balanced Budget Amendment

The ultimate budget process reform would be some form of balanced budget amendment. But the devil is in the details. How would such an amendment be written? How would it be enforced? And, most important, is it realistic?

These are not simple questions. A balanced budget amendment can be a watered-down requirement that says nothing more than deficits (in peacetime) require a supermajority vote. Or a balanced budget amendment can be a comprehensive package that requires supermajorities for both taxes and borrowing, and thus is really a spending limit amendment. Senator Lee's proposal is a good example of such a proposal.

Enforcing a balanced budget is another challenge. Is it self-enforcing, meaning that the supermajority requirements are all that's needed? Is it necessary to have something in place for the period of time between an amendment being approved by Congress and its ratification?

Last but not least, there is a special challenge with reforms that require changes to the U.S. Constitution. Simply stated, it is extremely difficult – and deliberately difficult – to amend the Constitution. A proposal has to achieve $2/3^{rds}$ support in both the House and Senate, and then it must be ratified by $3/4^{ths}$ of the states.

Line-Item Veto

Over the years, there have been many proposals to give presidents some sort of line-item veto or enhanced-rescission authority. Interest in these proposals often is stimulated by stories of corrupt earmarks and specific wasteful spending items. And there is some evidence that governors have effectively used such authority to trim spending.

But, just as is the case with a balanced budget amendment, the details are important since not all proposals are created equal. It also appears that such an initiative might require a constitutional amendment, which imposes a very high bar to its enactment.

Current Services Budgeting

There is a form of funny math in Washington. Lawmakers can increase spending, but then tell voters that they cut spending because outlays didn't rise even faster. Let's take the Ryan budget as an example. Legislators and journalists routinely talk about that proposal imposing trillions of dollars of cuts, yet CBO numbers show that spending would rise by an average of 2.6 percent each year if it was implemented.

This is because Congress starts with an assumption that all spending should automatically increase for reasons such as inflation, built-in program expansions, and changes in beneficiary populations.

All of that information is very useful in the budgeting process, but it is dishonest to tell the American people that spending is being cut when it is being increased – particularly when that process is used to frighten people into thinking that proposals to slow the growth of spending are actually plans filled with "savage" and "draconian" cuts.

Some form of zero-based budgeting would address this problem. If spending is rising by, say, 3 percent next year, that's the information that should be presented. And by giving the American people accurate data, that will alleviate the current system's bias for bigger government.

Spending Caps

I would like to spend most of my time on the issue of spending caps. This is the notion that there will be an upper limit on spending for some – or all – parts of the federal budget. The spending cap(s), whether broad or narrow, would be enforced by a process known as sequestration, which is an automatic spending cut if outlays rise above the cap.

As with the BBA and line-item veto, it's very important to specify how a spending cap would operate. There are two important decision points – how is the upper limit defined and what spending will be covered by the cap.

<u>Defining a spending limit</u>

There are two ways of defining the upper limit of spending. The first option is to select a nominal spending target and the second is to require that spending not exceed a certain percentage of GDP. In theory, both options generate similar results, but lawmakers generally have gravitated to proposals that specify that spending should not exceed a certain share of economic output.

But once that decision is made, there's another important choice: How to define GDP. The obvious answer is to use GDP, but which GDP? If you select estimates of future GDP, you create an opening for gimmickry since lawmakers might pressure CBO or OMB for an exaggerated estimate to facilitate more spending.

Another option would be to use an average of the past couple of years of GDP. That would give a firm number, but it might create complications if the economy is coming out of boom or recovering from a downturn. This is why "potential GDP" might be the best option. Potential GDP is a technical concept based on what GDP would be at full employment without price inflation. It is a widely used number that CBO calculates for 10 fiscal years into the future.

Why use "potential GDP"? A spending cap based on traditional GDP allows spending to rise rapidly under booms only to force large spending cuts during recessions. That tends to be politically unsustainable, as we saw under Gramm-Rudman. Moreover, state spending caps tied to some measure of state GDP have largely failed because of this reason. Potential GDP eliminates this problem by smoothing out the fluctuations of the business cycle and thus curbing excessive spending growth during booms and not attempting to force politically difficult spending restraint during recessions.

<u>Defining what spending to cap</u>

The other key decision is what parts of the budget should be subject to cap. Some lawmakers focus only on so-called discretionary spending – i.e., annual appropriations. Considering the massive increase in spending in this category over the past 10 years, there certainly is a strong argument for discretionary caps.

But America's real fiscal problem is entitlements. So-called mandatory spending already is the lion's share of the federal budget and entitlement programs will consumer ever-larger shares of our economic output as the baby boom generation retires and outlays skyrocket for Social Security, Medicare, and Medicaid. A cap that only applies to discretionary spending would be akin to visiting a doctor after an auto accident and getting treated for a sprained wrist while ignoring a ruptured spleen.

So does that mean a spending cap should apply to all spending? That certainly would be a better option than a discretionary cap, but that means net interest – payments to service the publicly-held debt – would be included. Notwithstanding recent threats by the Treasury Secretary to deliberately and unnecessarily default on those obligations, interest on the debt is the one part of the budget that is truly uncontrollable.

It is more reasonable, therefore, to target "primary spending," which is everything other than net interest. One bid advantage of this approach is that a cap on all spending creates a "tax trap" that may prevent the extension of current tax policy or future tax cuts. This is because a tax cut will be scored as a spending increase thanks to higher interest outlays. In other words, including interest in the spending cap hinders good tax policy. A non-interest cap on primary spending not only focuses lawmakers on the spending they can control, but it also avoids creating an inadvertent obstacle to good tax policy.

Moreover, it's also worth noting that, with a total spending cap, Congress and the President may press the Federal Reserve to have an overly loose monetary policy that keeps interest rates artificially low in order to lower interest payments on the debt and allow for increased spending on discretionary and entitlement programs. A non-interest spending cap eliminates this perverse incentive for inflationary monetary policy.

Conclusion

Thank you for the opportunity to testify. I would be happy to answer any questions.