

ECONOMIC COMMENTARY

Federal Reserve Bank of Cleveland

Some Fiscal Advice for the New Government: Don't Let the Sun Go Down on BEA

by David Altig

In mid-February, President Clinton will outline his administration's first, and much anticipated, economic plan. Although the exact nature of the package is still speculative as of this writing, it is clear that any short-run stimulus will be accompanied by long-run deficit reduction measures. For this, the administration is being praised in advance, not the least by financial markets, which have responded with a nearly 40-basis-point decline in long rates since the election. But whether the markets — and by inference the American public — stay on board depends on the administration's ability to follow through with a clear and credible long-term plan to accomplish the deficit reduction it and the new Congress clearly desire.

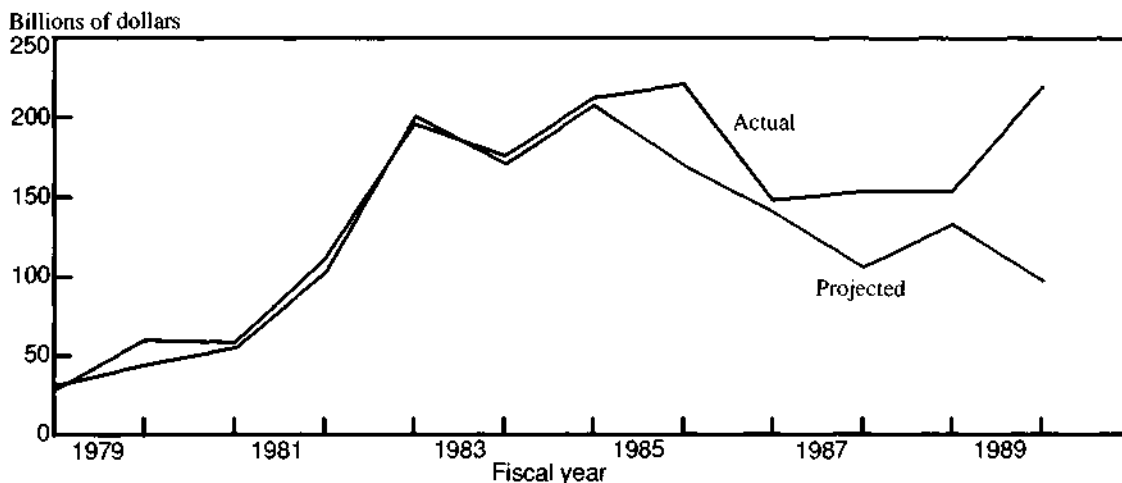
At the outset of what will surely be extended and heated debate about the details of the Clinton proposals, it is essential to recognize that the deficit is no longer the controlling element of the budget process. Since passage of the Budget Enforcement Act of 1990 (BEA), the primary discipline exerted by budgetary rules emanates not from deficit targets but from legislative limits on certain classes of expenditure. This shift was intentional and fundamental, reflecting as it did the weaknesses inherent in the original Gramm-Rudman-Hollings (GRH) deficit reduction mechanism as a tool for managing the federal budget.

The fact that BEA effectively makes expenditure targets the constraining elements of the current fiscal environment is one reason for increasing the public's awareness of the Act's provisions as well as its history. But this is not the only reason. Because BEA was largely a response to the failure of the original GRH process, a clear and careful examination of its provisions would help to clarify the rationale for the de facto abandonment of deficit targeting and would concentrate debate on the task of developing an effective and efficient budget process.

The goal of this *Economic Commentary* is to contribute to that discussion. The first step is to briefly review the broad history of fiscal policy from the inception of GRH through its evolution in BEA. The essential point is that GRH, as first constructed, was fundamentally flawed for two reasons. First, because objectives were stated in terms of deficits rather than more basic expenditure and revenue targets, GRH was inadequate in focusing debate on specific spending and taxation programs. Second, and more important, GRH was a "let bygones be bygones" policy in that it provided no ex post enforcement mechanism for addressing inevitable failures to meet prescribed targets.

The Budget Enforcement Act of 1990 (BEA) was a significant improvement in the federal budget process because it replaced deficit targets that were essentially unenforceable with explicit spending targets that are, in principle, binding after the fact. This article contends that the deficit reduction efforts of the new administration and Congress would be greatly aided by extending BEA through 1996, maintaining distinctions among different categories of discretionary spending, and introducing caps on mandatory expenditures.

FIGURE 1 ACTUAL AND PROJECTED DEFICITS



NOTE: Projected deficits for each fiscal year are taken from the final congressional budget resolution.

SOURCE: Congressional Budget Office.

The remainder of this article is devoted to examining the degree to which flaws in the GRH legislation were addressed by BEA. I argue that, by superseding essentially nonbinding deficit commitments with spending limits that are enforceable after the fact, BEA is a vast improvement in the process that governs federal budget policy. However, it does not go far enough. By failing to extend spending caps to mandatory expenditures such as Medicare and Social Security, the Act leaves an important part of the job undone. Furthermore, because the distinctions among different classes of discretionary spending are removed beginning in fiscal year (FY) 1994 and the legislation expires in 1996, BEA will become extinct before it can truly be tested.¹

■ The Beginning and End of GRH as We Knew It

By 1985, the U.S. economy was well into the longest peacetime expansion on record, and the two-headed dragon of high unemployment and excessive inflation had been, if not slain, at least seriously wounded. In this environment, public attention began to focus on the new bad news in town — large and increasing federal deficits.

To the rescue came the GRH deficit reduction plan, more formally known as the Balanced Budget Act of 1985. The essence of GRH was a series of ever-smaller deficit targets, a baby-steps program to tame the newly developed federal deficit addiction. But in fact, GRH never required that the legislated targets actually be met, only that the deficits implied by congressional budget resolutions meet the mandated targets. If actual deficits exceeded the targets after the fact, so be it.

It is perhaps not surprising, then, that realized deficits exceeded the GRH targets in every year from FY1986 through FY1990, even after the targets were adjusted upward in 1987. Indeed, as illustrated in figure 1, one clear effect of the process was to weaken substantially the close relationship between actual and projected deficits that had existed in the years prior to implementation of GRH.

Still, it would be inaccurate to claim that GRH had no influence on the fiscal policy process. Nominal deficits either fell or barely rose in every year from 1986 to 1989. Because the economy was expanding in each of these years, deficits actually dropped as a percentage of gross domestic product (GDP). Although the original GRH deficit schedule was

amended in 1987 after having been in effect for only two years, with the target date for a balanced budget set back from FY1991 to FY1993, this modest progress allowed many to cling to the illusion that the GRH process was in good working order and would eventually, if belatedly, reduce the deficit to zero.²

In 1990, growth in the deficit accelerated and GRH finally became untenable as a deficit containment framework. Even in the best of circumstances, it would likely have been necessary to alter the deficit reduction time schedule, as had been done three years earlier. But circumstances were anything but the best. In the year of the Iraqi invasion of Kuwait, the onset of the recession, and an early installment of what would be a long string of payments for savings and loan failures, such tinkering was no longer a viable option.

KEY ELEMENTS OF BEA

Deficit and Spending Targets

- Set maximum deficit ceilings and discretionary caps for FY1991–95
- Mandated separate caps for domestic, defense, and international spending in FY1991–93

Sequester Provisions

- Introduced three-step sequester process, pertaining to discretionary spending, entitlement spending, and deficits
- Provided for “look-back” sequester in the event of legislation that violated discretionary spending caps subsequent to original budget agreements
- Mandated “pay-as-you-go” conditions for most mandatory spending programs requiring that tax or benefit changes not add to the deficit
- Effectively eliminated the probability that the sequester mechanism would be triggered by violation of deficit targets

Adjustment Clauses

- Provided for the adjustment of spending and deficit limits based on changes in economic and technical conditions
- Excluded Social Security and deposit insurance transactions from deficit calculations used in sequester decisions
- Allowed enforcement provisions to be suspended in the event of war or recession
- Permitted spending caps and deficit ceilings to be relaxed through “emergency” appropriations

Essentially, the inherent flaws in the GRH process had finally and irreversibly manifested themselves. In making deficits the centerpiece of the policy debate, fundamental issues about fiscal priorities were allowed to go unresolved. Should deficits be slashed primarily by spending reductions? By tax increases? By some combination of the two? In the context of an administration and Congress with different agendas and biases, the failure to definitively address these issues virtually promised what was delivered: continuing divisiveness, untimely and ad hoc decisionmaking, and plenty of fudging of the numbers and the process.

Further, without an ex post enforcement mechanism, GRH effectively had no teeth, forcing neither the executive branch nor the legislature to confront the underlying pressures that built with each target miss. Although the events that led to the run of record-setting deficits beginning in FY1990 were to a large extent unanticipated, policymakers, having conveniently let slide their past GRH transgressions, were ill positioned to assert that these extraordinary events were merely temporary setbacks on the road to fiscal responsibility.

■ The Birth of BEA

The final breakdown of GRH resulted, after considerable haggling between the Congress and President Bush, in the BEA, part of the Omnibus Budget Reconciliation Act of 1990. Some of BEA's key elements are summarized in the box above.³

Although technically an extension of GRH, BEA goes far beyond the adjustments that were made to GRH in 1987. The most important innovation was shifting the focus of the process toward expenditure policy, a change manifested in the revision of GRH's sequester, or automatic expenditure reduction, procedures.⁴

BEA introduced into GRH two new sequester triggers, one applying to discretionary expenditures and one applying to entitlement expenditures. The provisions associated with the former have two important features. First, through the current fiscal year, separate spending caps pertain to three distinct categories of discretionary spending: domestic, defense, and international. The legislation does not allow for surpluses in one category to be shifted into another in order to avoid the sequester trigger. For example, reductions in the defense budget cannot be used to finance domestic spending in excess of the legislated limit.

Second, discretionary spending caps can, to some extent, be enforced after the fact. In particular, although the FY1993 budget was passed without triggering the BEA sequester mechanism, any legislation passed by the new Congress that causes outlays to exceed the caps in the current fiscal year would, without specific legislation enabling “emergency” appropriation, trigger a sequestration.⁵

Also, unlike the original GRH bill, BEA introduced “pay-as-you-go” (PAYGO) requirements on direct, or mandatory, federal programs, which include entitlement expenditures. The PAYGO conditions require that new legislation involving mandatory outlays not contribute to the deficit at the margin. Any new entitlement commitments, for example, would trigger automatic spending cuts unless offset by revenue increases or matching spending reductions in other programs, as would legislation reducing revenues from existing programs.⁶

**TABLE 1 PROJECTED DISCRETIONARY
OUTLAYS AND BEA CAPS**
(Billions of dollars)

<u>Fiscal Year</u>	<u>Projected Outlay</u>	<u>BEA Cap</u>
1993		
Domestic	229.6	229.6
Defense	287.1	296.8
International	20.3	20.6
1994	537.4	539.9
1995	539.1	542.3

SOURCES: Outlay caps, deficit caps, and FY1993 outlay projections are taken from the Office of Management and Budget's Final Sequestration Report to the President and Congress, issued in October 1992. Outlay projections for FY1994 and FY1995 are baseline estimates from the Bush administration's January 1993 budget report.

Although BEA maintained the original sequester procedures associated with deficits themselves, these procedures are no longer effective. In theory, expenditure reductions can be triggered if the budgeted deficit exceeds its target in a given fiscal year *after* automatic cuts from the other two sequester mechanisms have been exhausted. In practice, procedures for adjusting the deficit targets in FY1992 and FY1993 rendered the GRH sequestration mechanism moot. The recent decision by President Clinton to retain these adjustment procedures for the duration of BEA guarantees that maximum deficit caps will continue to be irrelevant as a potential trigger to automatic spending cuts.

■ Does BEA Matter?

BEA's *expenditure* caps, however, are not irrelevant, as indicated in table 1. Under current programs — that is, abstracting from any of the expanded spending plans endorsed by President Clinton during the campaign — all three categories of discretionary spending are at or near their limits for the current fiscal year.⁷ Thus, it is highly unlikely that any significant federal spending initiatives during the balance of FY1993 are feasible within the boundaries set by this year's expenditure caps. In other words, unless altered by vote of Congress, BEA's discretionary spending limits are an immediate constraint on the expenditure options available to the federal government.

Such alterations of the BEA targets are, of course, possible. In addition to adjustments associated with changing economic and technical conditions, the spending and deficit caps that could trigger sequestration can be rescinded in the event of war, poor economic performance (for example, GDP growth below a 1 percent annual rate for two consecutive quarters), or specific appropriation of emergency expenditures. Although neither the war nor the low-growth escape clause was invoked during the first three fiscal years that BEA was in force, emergency appropriations were passed for FY1992.⁸ Nonetheless, expenditure totals remained close to the required caps.

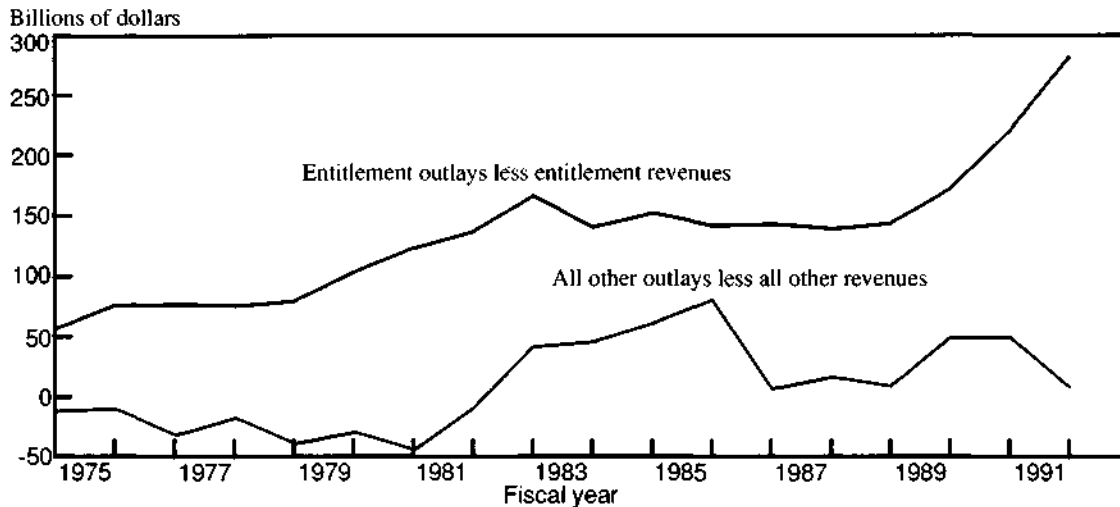
This flexibility might be viewed as a loophole engineered to allow the legislation to be largely ignored, as GRH had been prior to 1990. Undoubtedly this assessment is to some degree true, but it is equally true that the 1985 GRH process was a failure in part because it was not flexible enough. For example, the setting of *nominal* targets independent of the inflation rate or *real* targets independent of economic growth makes little sense. If done credibly, adjusting deficit and expenditure caps in light of changing economic circumstances that are largely independent of the budget process guarantees that fiscal goals will be defined in terms that are economically meaningful.

More problematic is the fact that BEA was not extensive enough in its coverage. This applies both to the categories of spending to which limits were applied and to the time horizon over which the legislation is effective. The obvious omission of expenditure caps on entitlement spending guaranteed that BEA would not result in substantial reductions in the deficit. As shown in figure 2, the intransigence of the deficit in recent years is largely attributable to the fact that entitlement expenditures have outpaced revenues collected to finance them: If contributions to social insurance funds had equaled spending on health, Medicare, Income Security, and Social Security in FY1992, the federal budget would have been nearly in balance.

But even the more modest goals of restraining discretionary outlays will disappear unless the new administration and Congress act to extend BEA. As of FY1994, the "budget walls" that placed separate limits on the individual categories of discretionary spending in FY1991-93 will be gone. This is a decided step backward. During the budget discussions for FY1993, there was a significant movement to tear down the existing walls and to use "excess" funds from the defense budget to increase domestic expenditures. Because of the BEA rules, however, this movement was successfully repelled, and total appropriations almost surely ended up lower than they would otherwise have been.

More important, requiring limits on individual categories of expenditure forces the President and Congress to set and articulate *specific* multiyear spending priorities; that is, to think of budget policy as a collection of actions aimed at specific ends rather than as an amorphous money pie to be divvied up until gone. Given the uncertain nature of the world, it may indeed be sensible to revisit these priorities periodically. But this argues for the construction of new walls as the old ones come down, not an abandonment of the fortress altogether.

FIGURE 2 THE ENTITLEMENT DEFICIT



NOTE: Entitlement outlays are defined here as the sum of expenditures for health, Medicare, Income Security, and Social Security. Entitlement revenues are defined as social insurance taxes and contributions.

SOURCE: Congressional Budget Office.

Worse yet, BEA is set to expire in two years. Whatever the rationale for this timetable in 1990, there is little to recommend it now. At a time when policymakers' task is to implement coherent and consistent fiscal objectives, it would be extremely unfortunate to eliminate, without alternative, the only vestige of legislative discipline that exists, imperfect as it might be.

■ Four More Years

It has become popular to speak cynically of the GRH legislation as a thin veil of respectability behind which the usual budget chicanery and fiscal irresponsibility were allowed to continue apace. This characterization goes too far. GRH was fundamentally flawed, but that is not the same thing as irrelevant. There is little doubt that BEA owes its existence to GRH, for it was forged when Congress and the Bush administration were struggling with the contradiction between feasible policy choices and legislated deficit promises.

BEA may have come at a high price — after all, former President Bush bought the plan at the expense of his “no new taxes” pledge — but the fiscal policy process was well served. The budget principles implemented by the Act were sound, specifying clearly stated spending objectives with explicitly articulated rules for seeing that those objectives were met. Nevertheless, as most observers (including many in the new administration) have concluded, restoring order to U.S. fiscal policy will require restraining mandatory, as well as discretionary, spending. Furthermore, permanent progress will almost certainly require systemic change — an alteration of the process and rules governing these particular expenditure decisions. The logical starting point is extension of the BEA process to mandatory spending categories.

That the decisions required in setting caps on mandatory spending will be unpopular in some circles is more than an understatement, and it is probably unrealistic to insist that such potentially divisive issues be addressed once and for all in President Clinton's first budget. However, there is much to recommend that BEA be preserved, at least over the term of the new

administration, and that the practice of legislating separate spending limits on discretionary appropriations be reinstated.

Congress and the President have indicated a strong desire to tame the federal budget beast. Their task will be complicated if, as appears likely, President Clinton's first economic proposals include stimulative short-run spending plans that violate the BEA spending caps. Reasonable people can disagree about the need for such a policy in the current environment, but coupling short-run strategy with serious long-run fiscal reform would almost certainly soften the concerns of deficit reduction advocates. Extending BEA through FY1996 in the form that has governed the budget process through the current fiscal year would be an excellent place to start.

■ **Footnotes**

1. Fiscal years run from October of the preceding calendar year through the following September.
2. Modifications were made to GRH prior to the 1987 amendments, largely in response to constitutional challenges to the bill's original sequester provisions. The deficit targets were unaffected by these changes, however.
3. A comprehensive—and comprehensible—review of the details of GRH and BEA can be found in Part 3, Section 3 of the 1992 *Greenbook*. Committee on Ways and Means of the U.S. House of Representatives, U.S. Government Printing Office, Washington, D.C.
4. Sequester provisions mandate the implementation, by presidential order, of automatic spending cuts based on prespecified formulas that identify the expenditure categories affected.
5. Depending on the timing of the offending outlays, the sequester order could take the form of offsetting spending cuts in the current fiscal year or a compensating reduction in the spending cap applied to the budget for the subsequent fiscal year.

6. The PAYGO requirements do not apply to Social Security or to deposit insurance commitments that existed when BEA was passed. However, separate legislation was enacted with respect to Social Security in order to maintain actuarial balance in the trust funds in the event of benefit or tax changes.
7. The spending caps reported in table 1 are taken from the Office of Management and Budget's "Final Sequestration Report to the Congress and the President for Fiscal Year 1993," submitted October 23, 1992.
8. Expenditures associated with Operation Desert Storm were explicitly accounted for in the initial legislation.

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