THE FEDERAL BUDGET

POLITICS, POLICY, PROCESS

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THE BROOKINGS INSTITUTION

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Foreword

Determining the federal budget is one of the most important political processes of our time. The budget has become the measuring rod by which much contemporary legislation is judged and presidential performance is often assessed. It is both opportunity and obstacle, as was demonstrated by Bill Clinton's success in reducing the deficit and his failure to reform health care financing. The budget's importance is partly a matter of size: it allocates more than $1.5 trillion a year in spending, an amount equal to almost one-quarter of the nation's gross domestic product. But the importance is also a matter of programs and policies, for the budget is one of the principal means by which government priorities are established or redirected.

Another side to the budget is less well known, but no less significant. Budgeting entails complex rules and procedures that affect government policies and their outcomes. As concern has mounted over the size of the budget deficit, these rules have become more prominent and constraining. In this book Allen Schick, a visiting fellow in the Brookings Governmental Studies program, explains how budgeting works at each stage of executive and legislative action, from preparation of the president's budget through the appropriation and expenditure of funds, and assesses the effects of the procedures on budget politics and policies. He shows why the budget is both controlled and out of control, and contends that many of the reforms proposed to deal with these problems will not accomplish their stated objectives.

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Bruce K. MacLaury
President

Washington, D.C.
November 1994

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Budgeting at the Close of the Twentieth Century

The federal budget is an enormously complex undertaking. It demands the active participation of the president and most members of Congress and the efforts of tens of thousands of staff persons in the executive and legislative branches. It entails thousands of big and small decisions, regard for countless rules and procedures, and conflict over how the government raises and spends public funds. The process could hardly be otherwise because so much is at stake when budget decisions are made. The budget controls more than $1.5 trillion a year in spending, an amount equal to almost one-quarter of the nation's gross domestic product. Federal budget receipts are about one-fifth of GDP. The budget deficit, which results from the imbalance between revenues and expenditures, makes the federal government the largest single borrower in capital markets.

The budget is, however, much more than a matter of dollars. It finances federal programs and agencies that are important means by which the government establishes and pursues national objectives. The budget assists millions of households in meeting basic expenses, and it provides a safety net for the sick and the elderly. It enables the country to invest in its future through physical improvement, such as highway construction, and human improvement, such as education and training. It signals to allies and adversaries the role of the United States in the world. And it is one of the principal instruments by which the federal government steers economic activity and stabilizes household incomes.

With so much at stake, it is not surprising that budgeting is a difficult and contentious process. Allocating more than $1 trillion a year is anything but a routine task, for as big as the budget is, there is never enough money to satisfy all the claims on it. To budget is to fight over money and to fight over the things that money buys. The conflict sprawls between the Democratic and Republican parties (and often within them as well) and between the legislative and executive branches. Budgeting causes friction among congressional committees, and between those who make tax policy and those who control spending.

As the scope of this conflict has expanded and the budget has grown and become more important in the economic and political life of the United States, it has attracted more attention. Thousands of budget makers and influencers now work in Washington, many on the staffs of members of Congress or congressional committees and many more representing national corporations, trade associations, state and local governments, and other groups mobilized to expand or protect their share of the budget's largess. News media of all types cover budget issues and actions, reporting on developments in both executive suites and legislative chambers. In some years the budget is the president's agenda as well as the vehicle for much of Congress's legislative effort, a large part of which is packaged into an omnibus revenue and spending bill. In national politics, it seems, now is the age of budgeting.

But as the budget has grown, it has become more constraining and less supple and responsive. An end-of-the-century president inheriting a $1.5 trillion budget may have fewer easy options than did predecessors who worked with budgets that had not yet reached $100 billion. A generation ago, in 1970, I collaborated in the Brookings Institution project, Setting National Priorities. The title and tone of that series optimistically intimated that by means of the budget the government could set priorities and establish policies each year and mold the economy and federal programs to achieve its objectives. The budget was an empowering process; it enhanced the capacity of the government to govern. Today the budget often appears to be a limiting process, imprisoned in old priorities that narrow the opportunities available to the government. The budget crowds out genuine choice; it forces tomorrow's programs to give way to yesterday's decisions.

How can this be? How can the budget be both bigger and weaker? How can it have more resources but less capacity, more programs but fewer options, more effort to control spending but less effective control? A full consideration of these questions would lead to an inquiry into the condition of American national government in the late twentieth century. Budgeting is not the only process that has suffered a loss in capacity; governing also has come upon hard times. It has been weakened by a long period of divided power, a loss of public trust and confidence, a mismatch between what Americans want of government and what they are willing to give it in political and financial support, conflict over the role of the government in the economy, social ills that seem irremediable through governmental action, and more. Budgeting cannot be confident and efficacious when government is not.

To say that the federal government and the machinery of budgeting are weaker than they once were is not to conclude that initiative or change is impossible. Ronald Reagan demonstrated in 1981 and Bill Clinton in 1993 that governing and budgeting are potent forces for redirecting national policies and reallocating public resources. They showed that the budget can be made into an instrument of change, that the opportunities to govern can be expanded, and that the processes of budgeting can be deployed in pursuit of the administration's objectives. They took advantage of the rules and procedures of budgeting to press ahead, even when the easiest course might have been to settle for much less than they finally got. Both presidents invested a lot of scarce political capital in their first budget, with the result that they had much less with which to fight subsequent budget battles.

Inaugural years such as 1981 and 1993 offer bigger opportunities for budgetary action than do the more routine years of a presidency. But every budget provides some opportunities for government to chart its course and mobilize resources for desired ends. To do so, it must come to grips with critical budget issues of the times. As the next century approaches, these issues include the persistent deficit, the adequacy of the tax structure, the ongoing shrinkage in defense forces, limits on discretionary spending, and the built-in escalation of medicare and other entitlements. This is not a full list of the issues vexing the federal budget; it does not include the many choices that the president and Congress make each year in deciding which programs to fund and how much to allot. The handful of issues discussed here are the ones the president and Congress return to year after year, the ones by which the performance of contemporary leaders and institutions is judged.

This chapter examines each of these issues from the perspective of the early years of the Clinton presidency. For each, the discussion focuses on actions already taken, particularly those incorporated in the 1993 budget legislation, and the outlook for the years ahead.

The Deficit

For the foreseeable future, one issue looms above all others: the huge federal deficit. It constrains presidential and congressional actions and has spawned complex rules that affect all budget legislation, as well as some measures that have only an incidental impact on the budget.

Two weeks before he left office in January 1993, George Bush issued budget projections indicating a $327 billion deficit for the 1993 fiscal year then in progress, lower deficits for each of the next three years, and markedly higher deficits near the end of the century. Clinton's first official projections, presented to Congress after he had been in office for a month, showed even higher deficits in 1995 and subsequent fiscal years. Clinton's projections, like Bush's, assumed that no changes would be made in budget policy.

Clinton's options at the start of his presidency would have been far broader if the budget had increments to parcel out rather than deficits to cut. With increments he could have financed the ambitious new programs and expansions he talked about during the 1992 presidential campaign: a new national service corps, more money for Head Start and other children's programs, and the expansion of job training, welfare reform, investment in new technologies, and more. With the budget awash in red ink, Clinton was barred by both the politics and the rules of budgeting from proposing actions that would add to the deficit. It was not tenable for him to insist that coveted initiatives be funded despite the budget's dire condition. Nor could he wish away the deficit the way Ronald Reagan did—with rosy economic forecasts that overestimated future revenue and underestimated the program cuts or tax increases needed to close the budget gap.

Clinton entered office following half a dozen years of prevarication about the deficit (induced by unworkable deficit reduction rules) by politicians of both parties and both branches. He could not risk discrediting his new administration by pretending that the deficit would go away by itself. And he could not assume that journalists, who had become increasingly skeptical about budget promises and more knowledgeable about the budget's arithmetic than they had been when Reagan came to Washington, would ignore bad news. He also had to reckon with second-guessers at the Congressional Budget Office who had become accustomed to challenging the president's numbers.

Clinton turned the constraints of high deficits into an opportunity to bolster the government's tax resources and to shift some funds from inherited programs to his initiatives. In a February 17, 1993, address to Congress, he described unending deficits as a political albatross that had to be removed so that his administration could get on with its work. "Large deficits," his "A Vision of Change for America" warned, "have virtually assured that each legislative session has been dominated by the deficit debate, encouraging budgetary quick fixes that have shortchanged the nation's long-term public investment and created a deficit of trust."

Clinton's inaugural budget called for almost $500 billion in deficit reduction from fiscal years 1994 to 1998 through a combination of tax increases and spending cuts. The proposed reductions were calculated against a baseline that assumed future spending increases would keep pace with inflation and participation in various entitlement programs would expand. Some critics of the Clinton plan complained that the estimates of deficit reduction were exaggerated, but regardless of how they were viewed, the proposal promised major decreases in the deficit.

To win enactment, Clinton's plan survived a series of close calls in the House and the Senate. It had to go through two rounds of votes, one on the overall plan, another on implementing legislation. Both rounds drew solid Republican opposition, but congressional Democrats held ranks during the major votes, and the plan passed by a comfortable margin. The House and Senate then got down to the business of enacting specific tax and spending changes to meet Clinton's $500 billion target. Because some of the proposals were unacceptable to conservative Democrats, the president had to accept changes in his package. The give-and-take between the White House and congressional Democrats produced a 219-213 majority in the House and a 50-49 tiebreaking vote by the vice president in the Senate. These close votes were repeated, 218-216 in the House and 51-50 in the Senate, when Congress approved the conference report on the deficit reduction bill.

Although Congress made some major changes, the enacted legislation reduced the deficit by approximately the amount that Clinton had requested. The Congressional Budget Office estimated that the baseline deficit had been lowered by $433 billion over five years, beginning with a $33 billion reduction in fiscal year 1994 and building up to $143 billion four years later (table 1-1).

Despite this accomplishment, Clinton has not put the deficit problem behind him. The longer he serves as president, the greater the likelihood that he will have to seek additional reductions. In fact, the problem is likely to persist long after he has left office. In 1994 the CBO forecast that the deficit will remain between $170 billion and $200 billion through the rest of this century and then increase in the early years of the next century, reaching $365 billion in 2004, more than double the estimate for the mid-1990s. This forecast assumes sustained but moderate economic growth and no change in revenue or spending policies. It does not take into account the potentially enormous costs of health care reform.

The further ahead one looks, the more dismal the outlook becomes. Although projections extending twenty or more years ahead are very uncertain, the pressure on future budgets cannot be doubted. When the first wave of baby boomers retires, federal pension and health care spending will soar, and social security, which now has an annual surplus, will incur sizable deficits. The baby boomers will not affect the budget for another fifteen to twenty years, but there is a good chance that the next drive to reduce the deficit will come in Clinton's second term, if he has one. The battle is likely to be tougher than the one fought in 1993.

The deficit has many causes but few solutions. It has been blamed on a weak economy, the surging cost of health care, protracted conflict between the president and Congress over the budget, and the mixed messages sent politicians by voters who want more from government but are unwilling to pay more. Regardless of the causes, no solution will be durable unless it includes significant revenue increases. Clinton recognized this in 1993; he and his successors will face the same predicament in the future.

Taxes

Despite ups and downs, revenues have been a remarkably stable share of GDP for a long time: 18.3 percent of GDP in 1960, before the Great Society and the Vietnam War, and 18.3 percent in 1993. But although this revenue base may have been adequate thirty years ago, it is not today. Medicare and medicaid did not exist in 1960, nor did food stamps, supplemental security income, earned income tax credits, federal support of elementary and secondary education, and dozens of other programs that now have secure niches in the federal budget. The elderly constituted a smaller proportion of the population, and the benefits provided them were a smaller proportion of federal spending. Interest on the national debt was a much smaller burden. And although defense expenditures made up a much larger share of both GDP and total expenditures, their decrease has been more than made up by increases in other expenditures. It is possible to compile a list of program cuts that would bring federal spending into alignment with revenues, but there is no possibility that Congress will approve enough reductions to cover the structural shortfall in revenues.

That shortfall was at least 3 percent of GDP–more than $180 billion–when Clinton became president. This crude estimate is based on a simple assumption: that the ratio of spending to GDP will not, under any foreseeable scenario, fall below the lowest level reached in the almost two decades that the congressional budget process has been in operation. That level–

Table 1-1. Budgetary Impact of 1993 Deficit Reduction Legislation, Fiscal Years 1994-98
Billions of dollars

Actions	*1994*	*1995*	*1996*	*1997*	*1998*	*Five-year total*
			Revenue increases			
Increased tax rate on high-income individuals[a]	15.4	22.8	25.7	24.6	26.3	114.8
Motor fuels taxes	4.4	4.5	7.4	7.5	7.5	31.3
Repeal of medicare tax cap	2.8	6.0	6.4	6.8	7.2	29.2
Increase in taxable portion of social security benefits	1.9	4.6	5.3	6.0	6.7	24.6
Increased corporate tax rate	4.4	2.8	2.9	3.1	3.2	16.4
Other[b]	-2.5	2.7	3.8	12.7	8.2	24.4
Total revenue increases	26.4	43.5	51.5	60.7	58.5	240.6
			Spending cuts			
Medicare[a]	2.1	5.5	11.6	16.4	20.2	55.8
Federal employee benefits	0.4	0.8	2.9	3.7	4.0	12.0
Medicaid	*	1.0	1.6	2.1	2.5	7.1
Other mandatory programs	1.2	1.7	3.5	4.6	5.4	16.4
Discretionary spending caps[a]	0	0	7.7	23.0	37.9	68.5
Spending increases[b]	(0.2)	(2.2)	(4.8)	(6.9)	(7.4)	(21.6)
Total program cutbacks	3.5	7.0	22.5	42.9	62.6	137.9
			Other deficit reduction			
Lower debt service[a]	0.9	3.4	7.5	13.6	21.3	46.8
FCC electromagnetic spectrum auction	1.7	1.8	1.7	1.0	1.0	7.2
Total deficit reduction	32.6	55.5	83.3	118.1	143.4	432.9

Source: Congressional Budget Office, *The Economic and Budget Outlook: An Update* (September 1993), table 2-2.
* Less than 0.5 billion.
a. Four items, the tax on high-income individuals, lower medicare expenses, discretionary spending caps, and lower debt service, account for two-thirds ($286 billion) of the net deficit reduction.
b. Spending increases are shown in parentheses because they add to the deficit; they are netted in the totals.

21.3 percent of GDP–was achieved in fiscal years 1977 and 1978.

The inadequacy of the revenue base received repeated legislative attention during the Reagan and Bush presidencies. Between 1982 and 1990 Congress enacted a dozen tax increases that augmented fiscal year 1990 revenue by $250 billion. But these measures were preceded by a huge tax reduction in 1981 that subtracted more than $300 billion from fiscal 1990 revenue. So all the tax increases enacted from 1982 to 1990 did not restore the revenue forgone by the 1981 legislation. When Clinton became president in 1993, the government would have had more revenue if Congress had done nothing by way of tax legislation during the previous dozen years. Of course, it would have been politically impractical for Congress to have been so inactive. But the point remains that Clinton inherited a smaller revenue base than Reagan did.

Clinton's options for expanding the revenue base were limited by his campaign pledge not to raise taxes for the middle class. He would, he had promised, generate new revenue by making millionaires and multinational corporations pay their fair share. As president, however, he quickly learned (if he did not already know) that he would have to produce much more additional revenue than could be extracted from these sources.

The deficit reduction package Clinton prepared strayed from his campaign promises but still paid lip service to them. According to the CBO, most of the new money was to come from high-income earners, redefined to include couples with taxable incomes higher than $140,000 ($115,000 for individuals). The marginal tax rate for taxpayers in this bracket would be raised from 31 percent to 36 percent. Those with taxable incomes above $250,000 faced a 10 percent surcharge that could boost their highest marginal rate to 39.6 percent. Clinton also proposed a hike in the corporate income tax rate, expansion of the medicare tax to cover all earned income, and an expansion of the portion of social security benefits subject to taxation. These and other increases on business and high-income earners accounted for more than five-sixths of the additional revenue the president sought. The remainder was to come from a broad-based tax on the heat content of coal, oil, and other energy sources.

Clinton previewed the energy tax increase in a prime-time television address on February 15, 1993, two days before his deficit reduction plan was officially presented to Congress. He had hoped, he told middle-class Americans, to avoid taxing them more. "I've worked harder than I've ever worked before in my life to meet that goal. But I can't–because the deficit has increased so much, beyond my earlier estimates and beyond even the worst official government estimates from last year. We just have to face the fact that to make the changes our country needs, more Americans must contribute today."

Clinton's choice was not as clear cut as he portrayed it. Although the energy tax would have provided only a small part of the revenue, it generated most of the controversy in Congress. The House passed a watered-down version, but some important Democratic senators refused to vote for it, jeopardizing passage of all the budget legislation. Congress finally dumped the new energy tax and settled for a small increase in the tax on motor fuels.

The 1993 tax legislation boosted federal revenue by about 1 percentage point of GDP, enough to cover one-third of the estimated revenue shortfall. The deepening deficits projected for the end of this century and the beginning of the next indicate that the 1993 tax increases will not suffice. Taxes probably will be raised again, although not right away. The odds are that Clinton will defer major new tax legislation until the political system has digested the financial implications of the 1993 legislation and until he has enough political strength to tackle the issue.

When the necessity for increasing taxes is once again a prominent budgetary issue, it will be difficult to confine the increase to the most wealthy Americans. To produce enough new revenue, it will be necessary to tax a broad swath of the population. As the 1993 battles demonstrated, this will not be an easy task.

Defense Spending

President Clinton steered his deficit reduction legislation through Congress by claiming that every dollar of tax increase would be matched by a dollar of spending reduction. The actual ratio was tilted toward more taxes, even if savings in debt service are counted as spending cuts (table 1-1). The proportion of deficit reduction achieved through tax actions would be substantially greater if only program reductions were counted as spending cuts.

During his presidency, Clinton faces four problems that dramatically affect spending: 1 the pace at which defense spending is reduced, 2 limitations on discretionary spending, 3 the growth of entitlements, and 4 health care costs. Of these, defense offers the easiest means to achieve spending reductions, but many of the easy cuts were made before Clinton arrived. New defense spending peaked in fiscal year 1985; adjusted for inflation, it has decreased every year since then. Adjusted for inflation, it was 28 percent below the peak when Clinton became president and 35 percent below the peak eighteen months later. Fiscal year 1994 was the ninth consecutive year of attrition in the defense budget (table 1-2). The drop-off has been particularly sharp in defense procurement, which lost two-thirds of its buying power between 1985 and 1994. This decline was not immediately reflected in production levels because the Defense Department drew on unspent resources appropriated in previous years. By the early 1990s, however, these resources had been depleted and procurement plummeted.

The decrease in defense dollars has been accompanied by a shrinkage in defense forces. Table 1-3 shows that these forces have gone through cycles of expansion and contraction since 1980. The buildup began in the late 1970s and accelerated when Ronald Reagan became president. In 1987 the army had more divisions, the air force more air wings, and the navy more combat vessels than they had had seven years earlier. High budget deficits, reports of wasteful defense spending, and shifts in public opinion led to a halt in the buildup in the late Reagan years. With the end of the cold war during the Bush administration, the Pentagon undertook a planned decrease in its force structure. The fiscal year 1994 column in table 1-3 shows the force programmed by the Defense Department near the end of the Bush presidency. This force would have had 33 percent fewer army divisions, 46 percent fewer active air wings, and 20 percent fewer ships than had been operational during the peak years. The final column in table 1-3 shows the force structure planned in the "bottom-up review" conducted by the Defense Department during President Clinton's first year. It shows further attrition in all defense forces with the exception of the Marine Corps, which is scheduled to grow slightly. However, the decrease planned by Clinton is smaller than that achieved by Bush.

Beyond a certain point, it is increasingly difficult to shrink defense forces without crippling the ability of the United States to respond to world events. Although the bottom-up review did redefine defense missions, it assumed that this country will continue to have worldwide responsibilities that would require large, mobile, and technologically advanced forces.

Discretionary Spending

Defense accounts for half of all discretionary spending, the portion of the budget controlled by annual appropriations decisions. Discretionary programs have been a shrinking part of federal spending for many years. They now account for 35 percent of total outlays, only half the share they had in the early 1960s. By the turn of the century, they are likely to comprise less than 30 percent of federal spending. As table 1-4 shows, both total discretionary spending and discretionary domestic spending have decreased as a share of GDP.

Discretionary domestic spending is now slightly lower than defense spending but is expected to surpass it by the end of the century. Real (inflation-adjusted) discretionary domestic spending was reduced at the start of the Reagan era, regained some resources and stabilized in later