COMMITTEE FOR A RESPONSIBLE FEDERAL BUDGET

What We Expect From the Upcoming Fiscal Discussions
May 30, 2013

Currently, Washington lacks a clear path forward for enacting FY2014 appropriations or increasing the nation's debt ceiling. Yet, both of these issues will need to be resolved (temporarily or permanently) before this fall, and in the process policymakers should also work on a bipartisan basis to address our mounting long-term debt.

At present, there is substantial disagreement between the House, Senate, and the Administration over how to deal with the sequestration. As a result, House and Senate appropriators are a full $91 billion apart on next year's funding levels and will need to resolve this difference by October 1st. Meanwhile, the Treasury Department will likely run out of extraordinary measures to avoid hitting the nation's debt ceiling sometime this fall, and the necessary step of raising the debt ceiling may prove difficult without a broader agreement to address the debt.

Any discussion over how to deal with the debt ceiling or FY2014 discretionary levels is likely to be coupled with an important conversation over how to address our country's unsustainable long-term debt burden. Historically, these "fiscal speed bumps" have helped to facilitate or accompany many important pieces of legislation. At the same time, policymakers should not wait until the last minute to begin having these conversations, and certainly must not take the country over the brink by allowing a default on any of our obligations.

Instead, policymakers should act soon and seek a solution that:

1. **Raises the debt ceiling** well before extraordinary measures run out
2. **Addresses the sequester** by agreeing to defense- and non-defense levels for 2014 and sustainable levels thereafter, without increasing long-term debt
3. **Agrees to a comprehensive fiscal framework** that sets future discretionary levels and calls for spending and revenue changes sufficient to put the debt on a clear downward path relative to the economy
4. **Enacts some combination of specific changes and a credible process** to implement the agreed-to framework

Policymakers would be wise to avoid last minute showdowns and find a way to act now for the benefit of future generations.

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Understanding the State of Play

Policymakers currently face two unresolved short-term fiscal speed bumps along with a substantial number of medium and long-term challenges. Most importantly for the short term is the state of the FY2014 appropriations levels and their interaction with sequestration, as well as the approaching statutory debt ceiling.

FY2014 Appropriations and the Sequester

Under current law, FY2014 appropriations levels are set by the sequestration, which went into effect this year due to the failure of the Super Committee in 2011. Although the FY2013 sequestration cut spending levels across the board, for FY2014 and beyond sets lower spending caps for appropriators to meet. Specifically, appropriators will be required to authorize no more than $967 billion in new discretionary funds, which is $76 billion lower than what they appropriated for 2013, $21 billion lower than what was authorized after sequestration for FY2013, $91 billion lower than the intended caps for 2014 as a result of the fiscal cliff legislation, and $99 billion lower than the original caps set for FY2014 in the Budget Control Act of 2011.

Although the sequestration calls for significant defense and non-defense reductions for FY2014, neither the House nor the Senate currently intends to abide by them. Senate appropriators will soon be marking up funding bills at pre-sequester levels; $91 billion higher than what current law allows. House appropriators, although they are abiding by the topline sequester number, are currently set to blow through the defense-side cap by roughly $50 billion and put the difference into deeper non-defense cuts.

Fig. 1: Base Discretionary Funding under FY2014 Budget Proposals (Billions)

	Fiscal Year 2013		Fiscal Year 2014		
	Pre-Sequester	Post-Sequester	Current Law	House Budget	Senate Budget
Defense	$544	$518	$498	$552	$552
Non-Defense	$499	$469	$469	$415	$506
Total Base Funding	**$1,043**	**$988**	**$967**	**$967**	**$1,058**

Note: Figures reflect budget authority excluding disaster, war, and program integrity adjustments.
Correction: The FY 2013 post-sequester numbers have been corrected from the original version of this paper.

That neither side currently intends to abide by the sequester caps is not surprising. After all, the sequestration was designed to be unattractive so that policymakers would be willing to make hard choices in order to avoid it. However, because both the Senate and the House intend to violate the sequestration in different ways, some type of resolution will be necessary.

The Debt Ceiling

A temporary agreement in early February of this year suspended the debt ceiling through May 18th, with the debt ceiling reinstated on May 19th at the existing level of debt subject to the limit.[1] The U.S. Treasury has already begun employing extraordinary measures to avoid breaching the

[1] Debt subject to the limit is a very similar measure to "gross debt," which includes debt held by the public as well as intra-governmental debt.

limit – including suspending investments in Civil Service Retirement and Disability Fund and the Postal Service Retiree and Health Benefits Fund.[2] Several other extraordinary measures are also available to the Treasury, such as suspending State and Local Government Securities and suspending daily reinvestment of securities in the Government Securities Investment Fund (G Fund), if needed to avoid a default.

Treasury Secretary Jack Lew has stated that the use of extraordinary measures should allow the Treasury to make good on all payments until at least early September, whereas the Congressional Budget Office (CBO) has indicated that the Treasury would likely exhaust its additional resources sometime later in October or November.[3] At that point, an increase in the debt limit would be necessary to avoid a debt default.

Continued Fiscal Challenges

Beyond the need for policymakers to address the sequester and raise the debt ceiling this year, the country faces continued fiscal challenges over the medium and long term.

In light of the deficit reduction accomplished to date, along with improved budgetary projections, debt is expected to remain under control for the next few years. However, much of this improvement is due to the sequestration, which represents poor policy that may be difficult to sustain. Moreover, the long-term fiscal situation remains in peril and recent deficit reduction efforts have done little to improve that situation.

According to CRFB's Realistic Baseline projections, debt will fall to a low of about 72 percent of GDP in 2018, but rise to almost 76 percent by 2023. If sequestration remains in effect, debt will fall to a low of below 70 percent of GDP in 2019, but then begin to rise exceeding 71 percent by 2023. The long-term situation is far worse, when a combination of population aging and rising health costs threaten to balloon debt levels.

In addition to concerns of the debt, a number of deadlines and fiscal speed bumps will need to be addressed. At the end of 2014, funding for the highway bill will run out and need to be renewed and paid for. By 2016, Social Security Disability Insurance will exhaust the assets in its trust fund, prompting a 20 percent across-the-board cut in disability benefits under current law. The Medicare Part A trust fund will follow in 2024, and the Social Security old age program in 2035 (2033 if money is reallocated between the old age and disability funds).

Addressing these long-term challenges now would be both easier and preferable to waiting for the deadlines to act. The longer lawmakers wait to fix these problems, the available options will be fewer and more painful.

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[2] See Treasury Secretary Lew letter to House Speaker Boehner, May 20, 2013. (http://www.treasury.gov/initiatives/Documents/Debt%20Limit%20Letter%202%20Boehner%20May%2020%202013.pdf).

[3] See Secretary Lew letter to Speaker Boehner and CBO's May baseline projections (http://www.cbo.gov/sites/default/files/cbofiles/attachments/44172-Baseline2.pdf).

What We Hope to See This Fiscal Year

Policymakers have four full months between now and October 1st, when the current continuing resolution (CR) funding the government is set to expire. There is no reason to delay starting work today on a bipartisan plan or plans to address the CR, raise the debt ceiling, and address our unsustainable debt trajectory.

The following is what CRFB hopes to see come out of productive bipartisan discussions:

1. **Raise the Debt Ceiling.** To avoid any adverse effects on confidence in our political system and in our ability to make good on our debts, policymakers should raise the debt ceiling well in advance of the deadline.
2. **Address the Sequester.** In agreeing to defense and non-defense funding levels for 2014 and potentially later years, policymakers will need to address the sequester, but should do so without increasing long-term debt.
3. **Agree to a Comprehensive Fiscal Framework.** Policymakers will need to go beyond addressing only the sequester and discretionary levels to put the debt on a downward path relative to the economy and must look to smart spending and revenue changes.
4. **Enact Some Combination of Specific Changes Upfront and a Credible Process.** Ideally, an entire bill could be passed at once. However, some combination of a down payment and credible process for future savings may be necessary.

Raise the Debt Ceiling

Congress and the President must raise the debt ceiling before the Treasury exhausts its use of extraordinary measures this fall. There should be no question about doing so. A default on U.S. debt payments would be unprecedented and would surely have rapid and unpredictable adverse economic consequences. A signal that the world's biggest and most stable borrower is unable to make good on its debts would likely be devastating to markets and the global economy.

Prioritizing payments to avoid a debt default, whether through legislative statute or executive prerogative, would also carry tremendous danger. Prioritization would represent a default on various other obligations – including those to beneficiaries, contractors, and employees of the federal government – and it could still roil financial markets by calling into question the ability of the U.S. to meet all obligations, undermine the credibility of the U.S. government, and depress economic demand. In recent weeks, one of Standard & Poor's top credit rating analysts said that while prioritization legislation could help avoid an actual default on an interest or principal payment of market debt, it could lead to further downgrades depending on how the economic, financial, and political situation appeared.[4] The Fitch Rating agency has affirmed this

[4] Kaper, Stacy. "Q&A: The U.S. Is Not 'Credit Positive." *National Journal*. May 16, 2013. http://www.nationaljournal.com/article/500727. Schroeder, Peter. "Credit raters wary of GOP debt limit bill." *The Hill*. May 9, 2013. http://thehill.com/blogs/on-the-money/economy/298739-credit-raters-wary-of-gop-prioritization-plan.

view, stating that anything short of a timely increase in the debt ceiling, combined with a credible debt reduction plan, would likely result in a downgrade.

Not only must the debt ceiling be increased, but policymakers should not wait until the last minute to enact this increase. Taking the country to the brink would unnecessarily raise the risks of an actual default, erode market confidence, and would most likely lead to inferior policy outcomes as compared to acting in advance.

In the weeks leading up to the eleventh hour agreement to raise the debt ceiling in August of 2011, markets weakened and became more volatile. The Dow Jones Industrial Average fell by over two thousand points (roughly 15 percent) between July 21 and August 10, 2011, over 900 points alone from a few days before the August 1st Budget Control Act agreement to only a few days after. In addition, consumer confidence plummeted over the few months leading up to the debt ceiling increase, falling more than 12 percent in July alone, just as economic volatility measures were rising noticeably in late July and early August of 2011. While a number of factors besides the debt agreement were at work in the summer of 2011, including economic crises in Europe, the debt showdown likely played a significant role. Even after the debt ceiling was raised, consequences continued. The S&P downgraded our debt from a AAA rating to AA+ in part because of the brinksmanship involved in that increase.

While the debt ceiling must be raised and cannot be held hostage, we believe it can be used as an opportunity to take stock of and address our growing debt. In several instances over the past few decades, raising the debt ceiling has accompanied notable legislation aimed at controlling present deficits, future deficits, or both.

In 1985, the need to raise the debt ceiling helped produce the Gramm-Rudman-Hollings legislation creating a balanced budget target for 1991 (and again in 1987 for revised Gramm-Rudman-Hollings targets), and although those targets were not achieved, it set the stage for improved budget enforcement measures in subsequent years. Again in the 1990s, the debt ceiling was raised along with the 1990 deficit reduction agreement, and 1993 deficit reduction agreement, and the 1997 Balanced Budget Act. More recently, debt limit increases in 2009 and 2010 led to the reinstitution of statutory PAYGO and indirectly to the creation of the Fiscal Commission. And of course, the debt limit increase in 2011 was accompanied by the Budget Control Act, which capped discretionary spending, created the so-called Super Committee, and led to the sequestration currently in effect. **Appendix I** discusses these and other cases in more detail.

Importantly, in many of these cases – particularly the earlier cases – it was the debt agreement that opened the door for a debt ceiling increase; not a debt ceiling increase conditioned on a debt agreement. When the reverse is true, policymakers are more likely to wait until the last minute, which not only increases the chance of default and results in other adverse economic consequences, but also leads to blunt and less thoughtful policy outcomes (for example, sequestration).

Address the Sequester

The Senate and the House are in very different places on FY2014 spending levels, with neither side intending to abide by sequestration cuts on the defense side, the Senate intending to violate sequester on the non-defense side as well, and the House intending to (based on its budget resolution) spend about 12 percent *below* sequestration on the non-defense side.

Absent a fiscally responsible replacement for sequestration, we do not believe policymakers should spend in excess of the sequester. Policymakers may find the path of least resistance to be an equal-sized increase in the defense- and non-defense spending levels above sequestration but below the prior caps. Doing so for 2014 would only modestly increase debt levels, but seriously undermine Washington's credibility on fiscal issues.

Using gimmicks to undermine or partially repeal the sequester would be equally problematic. Declaring additional funds as emergency, offsetting sequester reductions with savings from an already-anticipated war drawdown, or reducing the effect of sequestration now by increasing it in future years would all represent clever but, ultimately, counterproductive and irresponsible ways to mitigate the effects of the sequester.

While repealing or reducing the sequester by adding to the debt would be unacceptable, relying on the sequester as our primary means of deficit reduction would also be a mistake. The sequester was meant to incentivize policy changes, not be the policy changes, and it is too poorly designed to effectively address the country's debt trajectory or support strong economic growth. CRFB explained the shortcomings of the sequester in a recent analysis:[5]

> **The sequester is too small to control the debt this decade**, producing only $1 to $1.2 trillion in savings over the next ten years, whereas CRFB has calculated that an additional $2.2 trillion in additional savings are needed to put the debt on a clear downward path relative to the economy this decade.
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> **The sequester does not alter the long-term debt trajectory** because the cuts do not grow over time, do not tackle the entitlement programs, which are driving growing spending and debt, and in fact end in 2021 so as to provide almost no savings over the long term.
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> **Lawmakers may be unable to sustain the sequester**, given that both sides already intend to violate it this year and that tight spending caps not backed up with substantive cuts have a history of losing their effectively as time goes on.
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> **The sequester is bad growth policy** since it rapidly imposes cuts at a time when the economy continues to recover, targets the more investment-focused parts of the budget instead of making pro-growth reforms, and fails to control long-term debt to produce stronger growth.

[5] See Committee for a Responsible Federal Budget. "Our Debt Problems Are Still Far from Solved." May 15, 2013.

For FY2013, the sequestration also cuts spending mindlessly across-the-board, and it will continue indiscriminate cuts to various mandatory programs throughout the decade. Moreover, because it does not impact Social Security, Medicaid, or tax expenditures and it barely affects Medicare, it is forced to make deeper-than-necessary cuts to a small portion of the budget – which has already been cut substantially and is not the cause of our rising debt.

Given these shortcomings, there is a strong case for replacing some or all of the sequester with a more gradual, intelligent, and sustainable set of policies. Any agreement to reverse the sequester for any period of time should come with a bipartisan understanding on discretionary spending levels for 2014 and beyond that are sustainable and acceptable to both sides. In addition, any agreement must include at least enough deficit reduction to offset any reversed cuts, and savings from sequestration changes or replacements cannot rely on gimmicks or empty promises.

Agree to a Fiscal Framework

By this fall, at the latest, policymakers of both parties should agree to a comprehensive fiscal framework to truly put the debt on a downward path relative to the economy. Although the savings codified in the Budget Control Act of 2011 and the American Taxpayer Relief Act early this year, along with improvements in underlying budget projections, have led to a substantial improvement in the nation's fiscal picture, they have not solved our long-term problems. In essence, policymakers have agreed to discretionary caps (largely requiring future Congresses to make appropriations decisions), raised tax rates on wealthy Americans, and allowed a mindless sequester to generate additional savings. The tough work of making targeted structural reforms to entitlement programs and the tax code still remains.

According to CRFB's latest analysis, at least another $2.2 trillion in further savings over ten years is needed to ensure debt in on a clear downward path, relative to our Realistic Baseline.[6] This $2.2 trillion would ensure debt levels will not be pulled off course by minor projection changes and give policymakers some flexibility to respond to future needs and crises. Assuming the sequestration remains in effect through 2021 (our baseline assumes it stays in effect only for 2013), as much as $1.6 trillion would still be necessary. But the total amount of savings is not the only factor – the composition of savings and the extent to which they grow overtime will dictate the true ability of reforms to control the debt over the long term.

Policymakers must thus agree to further deficit reduction over the next ten years and beyond. A comprehensive framework should agree to targets within each budget area to accomplish this deficit reduction.

The core elements of any new deficit reduction framework should be comprehensive tax reform and structural entitlement reforms. To be sure, there is room for spending cuts in other areas of government, particularly if sequestration is repealed. However, without real tax and

[6] CRFB's Realistic Baseline assumes the sequester remains in place for FY2013, but is repealed for later years, war spending continues to decline, yearly doc fixes continue, and refundable tax credits are continued past 2017.

entitlement reform there is little that can be done on the fiscal side to keep the long-term debt trajectory under control or promote long-term economic growth.

Tax reform should focus on reducing and reforming various tax preferences to finance both rate reduction and deficit reduction in order to promote simplicity, fairness, efficiency and economic growth. Designing such a tax reform plan will be an arduous task, but one which Chairmen Camp and Baucus have encouragingly begun to undertake and one which we believe is worth pursuing and could have substantial dividends. Importantly, though, tax reform should complement, not substitute, entitlement reform.

On the entitlement side, policymakers should agree to address the drivers of our long-term debt accumulation – the aging of our population and continued rising health care costs. This will require a combination of changes that modify payments to individuals and providers as well as structural changes to slow health care cost growth and encourage more work and savings.

Implement Policy Changes

Agreeing to a framework for a fiscal deal that includes top-line numbers in areas such as revenue, health care, discretionary spending, and the like will not be easy, but it also will not be sufficient. Policymakers must agree to a strategy for implementing that framework.

Ideally, policymakers in Washington would agree to a single comprehensive piece of legislation, which not only increases the debt ceiling and addresses the sequester on a permanent basis, but also makes specific legislative changes to reduce spending, slow entitlement cost-growth, and reform the tax code. This would mean making specific and detailed policy changes throughout the budget.

Such a package may be difficult to put together, however, given the technical work necessary to reform the tax code and entitlement programs. An alternative approach might be to enact a small number of large and relatively blunt tax and spending changes that would represent a directional improvement in policy, but fall short of artful policymaking. Committees of jurisdiction could then be given time – perhaps on a fast-tracked basis – to improve these policies and replace them with better-constructed alternatives.

If this approach still proves too challenging, yet another alternative would be to give the committees of jurisdiction savings targets and some level of policy guidance in order to put together the necessary deficit reduction by a specified date. These assignments could be given through reconciliation instructions coming out of the normal budget process, or a new specialized process. They should be preceded by a "down payment" of upfront policy changes, enforced through one or several failsafe mechanisms to ensure the savings materialize even if the committees fail.

Policymakers could also pursue a combination of approaches that include a mix of specifics and process. The more specifics policymakers are able to enact upfront the better, and the longer they wait to begin negotiations the less likely it is that such specifics will be possible.

Conclusion

While lawmakers have taken some notable steps at controlling deficits and debt, substantial work remains. This fall, at least two fiscal speed bumps – the debt ceiling and the post-sequester appropriations process – should turn attention back to this issue. Although it would not be uncharacteristic for Washington to wait to address these issues, it would be a major mistake.

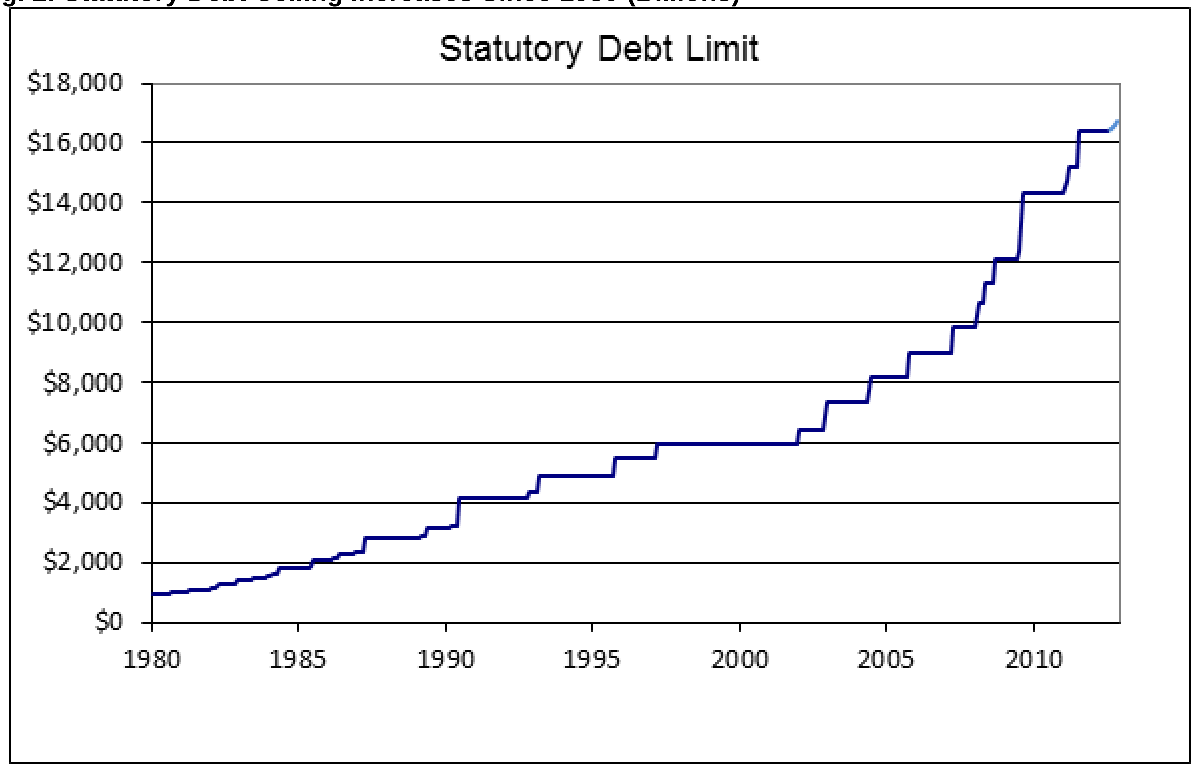
For every reason, policymakers should begin acting now to find a way to raise the debt ceiling, address sequestration and the FY2014 spending levels, and begin to put a comprehensive fiscal plan in place. Such a plan should include gradual and intelligent deficit reduction that reforms the tax code and slows the growth of our unsustainable entitlement programs.

In many ways, the approaching debt ceiling and appropriations deadlines represent a microcosm for the larger long-term fiscal issues. The longer we wait to address these issues, the harder it will be to do so, and the more economic risks we will be taking in the process.

Appendix I: How the Debt Ceiling Has Been Used in the Past

Lawmakers have enacted nearly 100 debt ceiling increases since 1940 and 47 debt ceiling increases since 1980 (counting the three-tranche increase contained in the Budget Control Act as one). In that time period, debt ceiling increases have been as long as nearly five years (late 1990s and early 2000s) and as short as a single day (September 30, 1981). Excluding the waiving of the debt ceiling for a few months this year, the average increase has lasted slightly less than 9 months since 1980.

Fig. 2: Statutory Debt Ceiling Increases Since 1980 (Billions)



Source: Office of Management and Budget.

Many of these debt ceiling increases have not been stand-alone measures. It can sometimes be politically difficult for Members of Congress to enact a debt ceiling increase without also addressing the budget. Often, Members of Congress have attached a debt ceiling increase to budget resolutions or continuing resolutions, reconciliation packages, or other substantive policy changes. A discussion of the various types of debt ceiling increases is available at http://crfb.org/document/understanding-debt-limit. Importantly, 15 of the 47 debt ceiling increases were accompanied by deficit reduction in the same piece of legislation.

Indeed, most of the major deficit reduction agreements made since 1980 have been accompanied by a debt ceiling increase. Causality has moved in both directions; sometimes the debt limit has been used successfully to help prompt deficit reduction and other times agreed-to debt reduction efforts attached debt ceiling increases. Among the examples include:

- **The Gramm-Rudman-Hollings Act in 1985**: The Gramm-Rudman-Hollings Act in 1985 raised the debt limit by $175 billion and also set a target for a balanced budget target in FY1991 with across-the-board cuts in spending under sequestration designed as an enforcement mechanism. Although the deficit-reduction goals under the GRH Act were not achieved, the experience gained under the act contributed to the development of more workable and effective procedures five years later.

- **Omnibus Budget Reconciliation Act of 1990:** The Omnibus Budget Reconciliation Act of 1990 raised the debt limit by $915 billion, the largest increase up until that point, but also contained nearly $500 billion in debt reduction over the next five years as well as enforcement procedures in the Budget Enforcement Act (BEA), which helped lead to the budget surpluses in the late 1990s. The BEA created adjustable limits for separate categories of discretionary spending and the pay-as-you-go (PAYGO) procedure that required tax cuts or increases in mandatory spending to be offset.

- **Omnibus Budget Reconciliation Act of 1993:** The Omnibus Budget Reconciliation Act of 1993 raised the debt limit by $600 billion, an increase that lasted for about two and a half years. OBRA '93 was the second major deficit reduction of the 1990s, also containing nearly $500 billion in deficit reduction over five years. The agreement extended the original spending caps from 1990 and raised taxes on high earners, among other reforms.

- **Balanced Budget Act of 1997:** The Balanced Budget Act of 1997 included a $450 billion debt limit increase which, thanks to the surpluses of the late 1990s and early 2000s, enabled it to last until 2002. At the time, the legislation called for about $125 billion of net deficit reduction over five years and $425 billion over ten years. It did so mainly through reductions in health care spending via provider payment reductions and increased premiums. The Act also created a few new programs – Medicare+Choice (now known later renamed Medicare Advantage or Medicare Part C) and the State Children's Health Insurance Program (SCHIP).

- **Statutory PAYGO Act of 2010:** The Statutory PAYGO Act of 2010 contained a debt limit increase of $1.9 trillion, the largest nominal increase until that point ever enacted. The legislation also, not surprisingly, reinstituted statutory PAYGO that requires tax cuts and spending increase to be full offset (with some exemptions). Informally, the agreement to raise the debt ceiling also led to the creation of a National Commission on Fiscal Responsibility and Reform, to which President Obama later appointed Erskine Bowles and former Senator Al Simpson as co-chairs.

- **Budget Control Act of 2011**: The Budget Control Act gave the President the authority to increase the debt limit in tranches – subject to a Congressional motion of disapproval – by a total of **$2.1 trillion.** The BCA also contained $917 billion over ten years in debt reduction primarily from through caps on discretionary spending. In addition, the bill established the Joint Committee on Deficit Reduction ("the Super Committee") to produce deficit reduction legislation of at least $1.2 trillion in savings with sequestration beginning in 2013 as the enforcement. The bill also required Congress to vote on a Balanced Budget Amendment, though it did not pass.

- **No Budget No Pay Act of 2013:** The No Budget No Pay Act passed in late January of 2013, temporarily suspended the debt ceiling through May 18th, 2013 and then set an automatic "catch up" in May 19th that allowed for a **$300 billion** increase in the debt ceiling. The agreement would have also withheld the pay of Members of Congress pending the passage of budget resolutions in each House (though there was no requirement that the resolutions being agreed to jointly, which is necessary to go forward with the budget process).

Appendix II: Fiscal Speed Bumps