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Testimony of Robert Greenstein

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Before the Senate Budget Committee
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I appreciate the invitation to testify today on current budget trends and opportunities in light of the recent bipartisan budget agreement and the improving budget outlook. The budget agreement, while modest, helped to mitigate some of the worst effects of sequestration this year and restore some normality to the appropriations process. In addition, the fiscal outlook over the medium and long term has improved markedly over the past several years. Challenges remain to put the budget on a sustainable path over the long term, but these recent changes in the fiscal landscape (which exceed what any of us expected) give Congress a chance to move away from the gridlock over budget battles that have preoccupied Washington but failed to produce a "grand bargain," and to begin focusing to a greater degree on addressing other pressing problems that have been neglected in recent years.

My testimony begins with a review of the budget outlook and then turns to several issues to which Congress should give high priority: promoting job creation and addressing significant problems looming as a result of the seriously inadequate levels of funding available for non-defense discretionary programs, particularly starting in 2016. I conclude with an overview of issues related to our long-term budget challenges.

I. The Budget Outlook

The deficit peaked both in dollar terms and as a share of the economy (gross domestic product, or GDP) in 2009. The spike was due to the Great Recession and our efforts to combat its negative effects: federal spending rose because of "automatic stabilizer" programs such as unemployment insurance and SNAP, as well as temporary stimulus measures; tax revenues declined as individuals and businesses earned less and because of tax-cut stimulus measures; and GDP declined as the economy slowed.

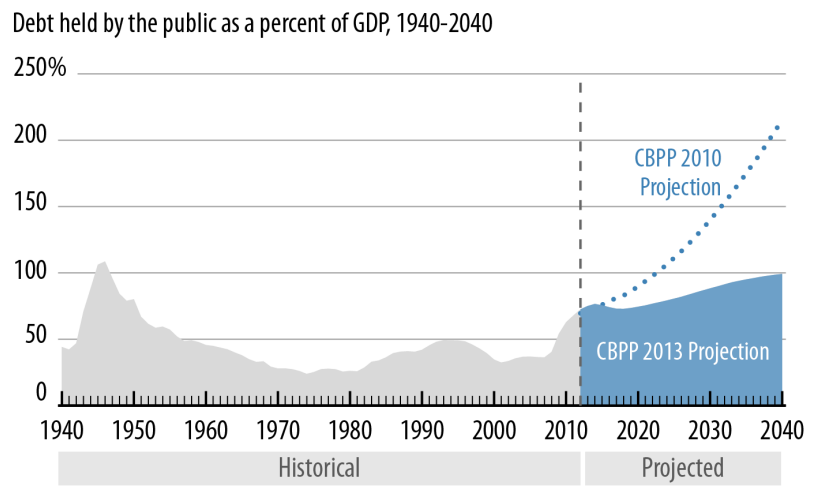
Since then, deficits have been on a marked downward path. In 2013, the deficit fell to about 4 percent of GDP — less than half of its peak — and the debt held by the public stood at 72 percent of GDP. The Congressional Budget Office (CBO) will release new budget projections today, but using last year's CBO estimates, we project that the deficit will fall to about 2 percent of GDP in 2015 — less than the average of the four decades from 1969 to 2008. Through the end of the

decade, deficits as share of the economy will continue to remain low, although they will begin to rise modestly toward the end of the decade and gradually climb to significantly higher levels.

It is important to note that the near-term deficit reduction steps taken in recent years, while contributing to the improvement in the long-term fiscal outlook, were not good for our near-term economic growth and reflected a "too much, too soon" approach to deficit reduction. It is good news that our longer-term fiscal issues have eased. But it would be preferable to have substantially *less* fiscal contraction while the economy is struggling to produce enough jobs — indeed, more stimulus is still called for — coupled with *greater* emphasis on longer-term deficit reduction.

Last June, we released an analysis of the budget over the next three decades.[1] We found that by 2040, the debt would grow to 99 percent of GDP. These estimates were in line with those released by other organizations such as CBO, the Committee for a Responsible Federal Budget (CRFB), and the Center for American Progress. None of these estimates predicted the explosive debt trajectory that was common in previous long-term projections, including our own. (See Figure 1.)

Figure 1
Debt to GDP Ratio



Source: Historical data from the Office of Management and Budget; projections from CBPP based on Congressional Budget Office, Joint Committee on Taxation, and Social Security and Medicare Trustees data

The improvement in the long-term projections primarily reflects two factors. First, health care cost growth has slowed considerably. It's not yet clear what portion of that slowdown is ongoing and what portion is temporary, but most analysts — including CBO — see accumulating evidence that a significant portion is due to reasons other than the weak economy and is likely to continue. Furthermore, current health care costs — the base level from which future cost growth will occur — are substantially below projections from only a few years ago. CBO has lowered its estimate of Medicare and Medicaid spending over the decade from 2010 to 2020 by *$1.2 trillion*, relative to its March 2010 estimate.

The second and more significant factor is that policymakers have enacted substantial deficit reduction since 2010. The 2011 Budget Control Act (BCA) has sharply cut projected discretionary spending. The American Taxpayer Relief Act (ATRA) enacted in January 2013 increased tax revenues. These changes have reduced projected deficits by $2.8 trillion between 2014 and 2023, not counting the future cuts from sequestration. If the sequestration cuts are included, the total

[1] Richard Kogan, Kathy Ruffing, and Paul Van de Water, "Long-Term Budget Outlook Remains Challenging, But Recent Legislation Has Made It More Manageable," Center on Budget and Policy Priorities, June 27, 2013, http://www.cbpp.org/cms/?fa=view&id=3983.

grows to $4 trillion over the decade, with 79 percent of the non-interest savings coming from spending cuts and 21 percent from revenue increases.

Our long-term projections treated some future policy uncertainties cautiously; for instance, we assumed that policymakers would abide by the original BCA caps after 2013 but would not allow any additional sequestration cuts to take effect. However, with December's bipartisan budget deal, which paid for cancelling part of the sequestration of discretionary funding in 2014 and 2015 with spending cuts and fees, any further easing of sequestration will likely have to be offset with other savings.

Similarly, we had assumed that policymakers would continue to prevent deep cuts in Medicare physician payments caused by the Sustainable Growth Rate (SGR) formula but would *not* offset these costs. But there appears to be strong bipartisan support for offsetting the cost of a permanent solution to the SGR problem (as well as for offsetting temporary relief if a permanent solution isn't enacted).

Paying for easing sequestration and for a permanent SGR fix (or a series of temporary fixes) would have a significant impact on the long-term outlook. We estimate that it would reduce the debt from 99 percent of GDP in 2040 to roughly 90 percent.

The other major policy uncertainty is whether policymakers will offset the cost of extending a group of largely corporate tax expenditures (the "tax extenders") that expired at the end of last year. We strongly recommend that policymakers commit themselves to offsetting the cost of the extenders.[2] Policymakers should apply to legislation to continue the tax extenders (which, as the term "tax expenditures" implies, are largely spending in the form of subsidies delivered through the tax code) the same principle they are applying to SGR relief and sequestration relief and now appear certain to apply to any extension of federal unemployment relief — that it must be paid for.

As you know, Congress has failed to agree to date on extending expired federal emergency unemployment insurance (UI), with the issue of offsets being the primary stumbling block, even though this is a temporary program that poses almost no long-term budgetary risk and thus has a negligible effect on the long-term budget outlook. In contrast, the tax extenders are temporary in name only, as Congress extends them year after year, typically without much scrutiny because their costs haven't had to be offset. In this case, the impact on our long-term fiscal problems is large. Paying for continuing these provisions also would create an opportunity to pare inefficient tax subsidies, with which the tax code is replete.

If policymakers paid for the cost of extending these tax provisions, we estimate that it would (in combination with offsetting the cost of sequestration and SGR relief) reduce the debt in 2040 from roughly 90 percent of GDP to about 80 percent. That would only be slightly higher than today's debt-to-GDP ratio and would represent a marked improvement. In fact, given political gridlock,

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[2] Chuck Marr and Nathaniel Frentz, "Paying for "Tax Extenders" Would Shrink Projected Increase in Debt Ratio by One-Third," Center on Budget and Policy Priorities, December 9, 2013, http://www.cbpp.org/cms/?fa=view&id=4058; and Chuck Marr, "Paying for Jobless Benefits But Not 'Tax Extenders' Has It Backwards," Off the Charts Blog, Center on Budget and Policies Priorities, January 13, 2014, http://www.offthechartsblog.org/paying-for-jobless-benefits-but-not-tax-extenders-has-it-backwards/.

this is likely to be the only step policymakers will have a shot at enacting in 2014 that would substantially improve the long-term outlook.

We will update our long-term budget estimates in coming weeks, incorporating the CBO projections being released today, and we expect that they will continue to show the budget as being significantly more manageable than the projections of a few years ago. At the same time, more deficit reduction will ultimately be needed. If the projected debt ratio in 2040 were 90 percent or even 80 percent of GDP, it would still be higher than in recent decades and than what most analysts think would be best for the economy. At these debt levels, interest costs would consume too much of the budget, squeezing out other priorities. We also recognize that projections far into the future can be off by large margins.

On the one hand, the improvement in the outlook has diminished the urgency around these issues. On the other hand, policymakers will eventually need to do more to address our long-term fiscal challenges. In due course, policymakers will likely need to take additional steps to address the rising debt-to-GDP ratio at the end of the decade and eventually to put the debt ratio on a downward path. To do that successfully, and in a way that protects poor and vulnerable families and individuals, avoids further exacerbating the economic trends spawning ever-widening income disparities, and invests adequately in the building blocks of our economy will require *both* additional revenues *and* further spending reductions. There isn't a sound path to lower debt in future decades that doesn't include contributions from both revenues and spending.

In the near term, however, the increased certainty that the December budget agreement brings for the next two years — which would be significantly enhanced by a prompt, crisis-free resolution on the debt ceiling — gives Congress the opportunity to focus on a number of pressing issues important for both future economic growth and Americans' well-being that have been neglected in recent years.

The next section of this testimony focuses on two issues that I recommend Congress address in the coming two years: job creation and adequate funding for non-defense discretionary programs.

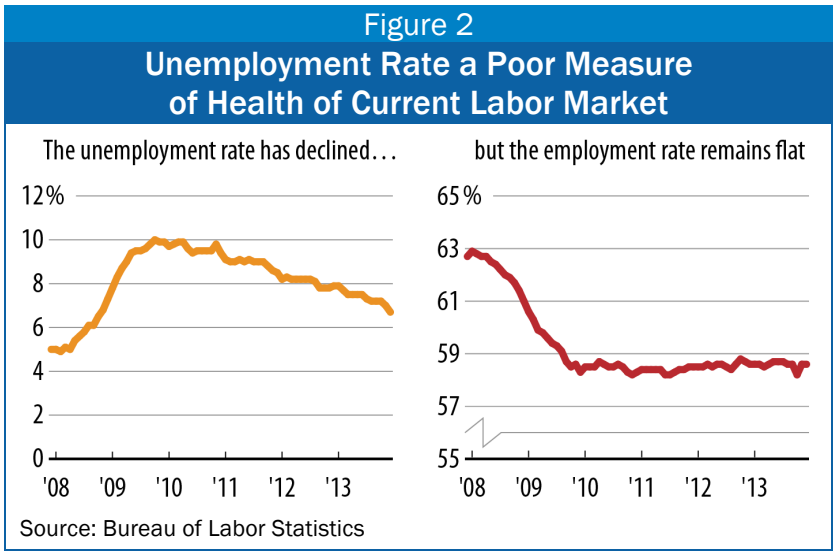
II. Next Steps for Congress

Congress should turn its attention to the issue of jobs. We need to do more now to promote stronger job growth, as well as to promote opportunity and mobility. This section discusses four specific job-related policies: a temporary UI extension that keeps demand higher, an increase in the minimum wage, an expansion of the Earned Income Tax Credit (EITC) for childless workers, and a modest program of subsidized jobs, primarily in the private sector. It then focuses on non-defense discretionary programs, which include key investments in basic research, infrastructure, and education that can boost the nation's future productivity but that will face significant funding shortfalls.

Extend Expired Unemployment Benefits

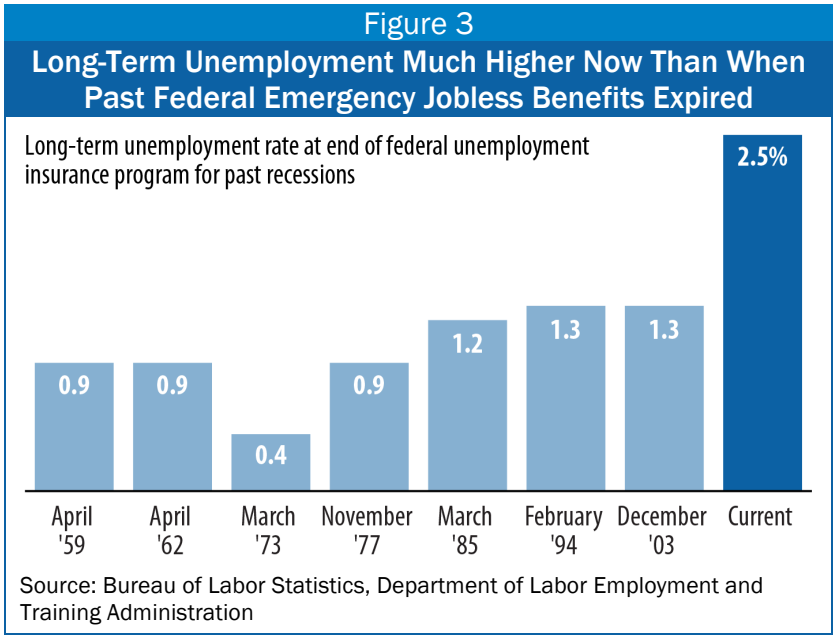
To ensure that poverty doesn't get worse in the near term and to support the still-sluggish economic recovery, policymakers should temporarily extend federal jobless benefits for long-term unemployed workers, a program known as Emergency Unemployment Compensation (EUC). Although the unemployment rate has fallen to 6.7 percent, much of that decline reflects abnormally

slow growth in the labor force due to limited job opportunities. The more telling metric is the percentage of people aged 16 and over who have jobs, which fell markedly during the recession and has recovered only modestly since. (See Figure 2.)



Further, the long-term unemployment rate — the percentage of the labor force that has been out of work more than six months — is nearly *twice* as high as when *any* of the emergency federal UI programs enacted in the previous seven major recessions expired. (See Figure 3). While Emergency Unemployment Compensation is a temporary program, economic conditions haven't yet improved enough to end it.

Another piece of evidence that illustrates this reality is that, even when EUC benefits were still being provided in the fall, *the number of long-term unemployed workers receiving no unemployment benefits was higher than at the depths of the recession*,[3] because so many unemployed workers had exhausted their benefits, Congress had reduced the duration of benefits, and some states had done so, as well. Furthermore, the percentage of unemployed workers receiving regular state UI benefits — the only benefits available if EUC benefits aren't reinstated — has fallen to historically low levels of roughly 26 percent.[4]



[3] National Employment Law Project, "More Than Two Million Unemployed Workers Will Lose Jobless Aid by Early 2014 If Congress Allows Federal Benefits to Shut Down at Year's End," November 2013, p. 4, http://www.nelp.org/page/-/UI/2013/Issue-Brief-Two-Million-Unemployed-Lose-Federal-Jobless-Aid-Shut-Down.pdf?nocdn=1.

[4] Council of Economic Advisers and Department of Labor, "The Economic Benefits of Extending Unemployment Insurance," January 2014, Figure 4, p.10, http://www.whitehouse.gov/sites/default/files/docs/updated_ui_report_-_final.pdf.

Unemployment insurance is one of the most cost-effective ways to help a weak economy. Jobless benefits go to people who need the assistance to make ends meet, they spend the funds quickly, and the spending ripples through the economy. Without the consumer spending that those benefits generated, the Great Recession would have been even deeper and the recovery even slower. CBO estimates that the economy will have *up to 300,000 more jobs* in the fourth quarter of 2014 if the federal UI benefits are extended than if Congress doesn't reinstate them.

While December's bipartisan budget agreement provides a modest boost to the economy in 2014, the economic drag caused by expiration of federal emergency jobless benefits will likely negate that effect.

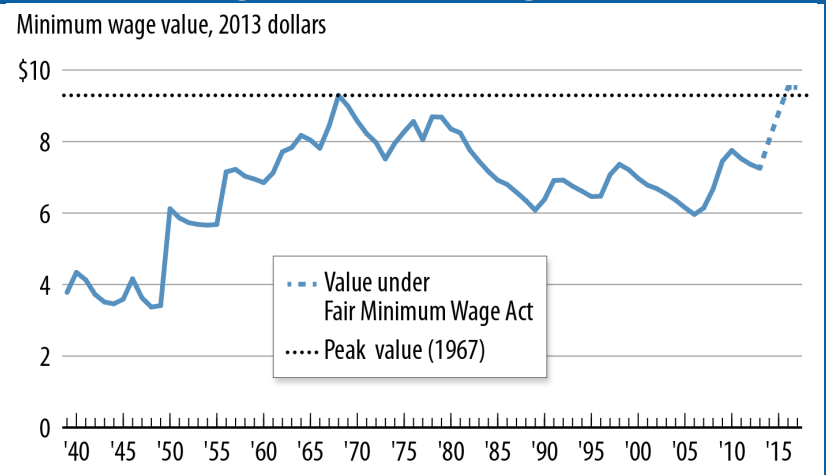
Increase the Minimum Wage

Policymakers should help low-wage workers by strengthening the minimum wage.[5] Today's minimum wage is 22 percent below its late 1960s peak, after adjusting for inflation. Increasing the minimum wage to the $10-an-hour range would help in addressing some of the unfavorable trends facing low-wage workers, including stagnant or falling real wages, too little upward mobility, and a deficit of bargaining power that leaves them solidly on the "have-not" side of the inequality divide.

The Fair Minimum Wage Act of 2013 (FMWA) would raise the minimum wage from $7.25 to $10.10 in three annual increments and then index it to inflation. This would restore the purchasing power of the minimum wage to about its late-1960s peak. (See Figure 4.)

Figure 4

Fair Minimum Wage Act Would Restore Wage's Lost Purchasing Power



Note: Inflation adjustments reflect CPI-U-RS (Research Series)

Sources: Fair Minimum Wage Act, Congressional Budget Office, Bureau of Labor Statistics

The question of whether raising the minimum wage reduces employment for low-wage workers is one of the most extensively studied issues in empirical economics. The weight of the evidence is that for minimum wage levels in the range now being discussed, such impacts are small, and that increases of the size that's been enacted in the past — and would occur under the proposals now being discussed — are a significant net benefit to low-wage workers as a group. Raising the

[5] Jared Bernstein and Sharon Parrott, "Proposals to Strengthen Minimum Wage Would Help Low-Wage Workers, With Little Impact on Employment," Center on Budget and Policy Priorities, January 7, 2014, http://www.cbpp.org/cms/?fa=view&id=4075.

minimum wage also would lower poverty to some degree[6] and help push back against rising inequality.

Some opponents of raising the minimum wage argue that it would primarily benefit teenagers working for extra money, but the large majority of those who would benefit are adults, most of them women. Indeed, the average worker who would benefit brings home half of the family earnings. This reflects the fact that the low-wage workforce has gotten older (and more educated) in recent decades: the share of low-wage workers (those earning less than $10 per hour in 2011 dollars) who are between ages 25 and 64 grew from 48 percent in 1979 to 60 percent in 2011. The share with at least some college education grew from 25 percent to 43 percent.

But while we strongly support an increase of this magnitude in the minimum wage, that's only one step.[7] As discussed below, an expanded Earned Income Tax Credit (for workers not raising children) could be effectively combined with an increase in the minimum wage. While some suggest that the EITC obviates the need for a minimum-wage increase, both a strong EITC and an adequate minimum wage are needed to ensure that work "pays" for those in low-wage jobs and to avoid placing too great a burden on either employers or taxpayers (as would occur if policymakers tried to "make work pay" by relying largely or exclusively on just one or the other of these two policies). The two policies are complements, not alternatives.

Strengthening the EITC for Childless Adults

Policymakers have made substantial progress in recent years in "making work pay" for low-income families with children by strengthening the EITC and Child Tax Credit. Yet low-income workers *not* raising minor children receive little or nothing from the EITC. For example, a childless adult working full time at the minimum wage is ineligible for the EITC, because his earnings exceed the very low income limit for the tiny EITC for workers not raising minor children. Partly as a result, childless workers are the sole group of workers whom the federal tax system taxes into — or deeper into — poverty.

Moreover, all childless workers under age 25 are flatly ineligible for the EITC, so young people just starting out receive none of the EITC's proven benefits, such as promoting work,[8] alleviating poverty, and supplementing low wages.

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[6] See, "Minimum Wages and the Distribution of Family Incomes," Arindrajat Dube, December 2013, https://dl.dropboxusercontent.com/u/15038936/Dube_MinimumWagesFamilyIncomes.pdf.

[7] To reduce poverty and increase opportunity, there are a number of other policy and program changes we also should pursue, including extending high-quality early education to more low-income children and providing help paying for child care to more low-income parents so they can look for and accept jobs and make ends meet. Another area where there are new, promising results from demonstration projects is in initiatives to help more low-income students not only attend, but successfully complete, two-year and four-year college degrees, which generally translates into better jobs and higher earnings. And just as it is important to improve children's preparation for school and what happens after high school, continued efforts to help low-income children succeed in elementary, middle, and high school are important as well. Education will not solve every problem. But it certainly can make a significant difference in children's future prospects.

[8] For a summary on research on the EITC, see Chuck Marr, Jimmy Charite, and Chye-Ching Huang, "Earned Income Tax Credit Promotes Work, Encourages Children's Success at School, Research Finds," Center on Budget and Policy Priorities, Revised April 9, 2013, http://www.cbpp.org/cms/?fa=view&id=3793.

The average credit for those eligible childless workers who do qualify for the credit is very small: just $270, or one-tenth the average $2,790 credit for filers with children. In addition, the childless workers' EITC begins phasing out when earnings exceed $7,970, or just 55 percent of full-time, minimum-wage earnings.

As a result, a childless adult working full time throughout the year at the current minimum wage, and thus earning $14,500, receives no EITC. This worker has a federal income and payroll tax burden of $2,669 in 2013 (counting the employer share of the payroll tax), or $1,560 (not counting it), which is a very large tax burden for someone with income this low. And a childless adult with wages equal to the Census Bureau's poverty line (projected at $11,905 in 2013) faces a federal income and payroll tax burden of $1,826 ($915 not including the employer share of the payroll tax), while receiving an EITC of only $186. *Such workers are literally taxed into poverty*.

Providing a more adequate EITC to low-income childless workers and lowering the eligibility age so younger workers can qualify would have several important benefits beyond raising these workers' incomes and helping offset their federal taxes. Some leading experts from across the political spectrum believe that an expanded credit would help address some of the challenges that less-educated young people (including young African-American men) face, including low and falling labor-force participation rates, low marriage rates, and high incarceration rates.

President Obama called for expanding the EITC for these workers in his recent State of the Union address, and support for this policy is broad. In part because an expanded EITC for childless adults is pro-work and pro-marriage, it has gained substantial support among a growing number of conservative, as well as among centrist and progressive, analysts. For example, former George W. Bush economic advisor Glenn Hubbard wrote recently, "Increasing the credit for childless workers to an amount closer to that for families with children would augment the direct work incentive and help counter poverty among the working poor."[9]

Similarly, the American Enterprise Institute's (AEI) Michael Strain recently noted that the EITC "gives very little help to childless workers" and called for amending the EITC "to offer more support to childless workers."[10]

Such bipartisan interest in the EITC isn't surprising; the credit has enjoyed broad bipartisan support over the years. President Ford signed it into law, and President Reagan lauded it as one of our best anti-poverty programs and proposed and signed a major EITC expansion because the credit helps low-income people struggling to make ends meet while encouraging work and personal responsibility.

Subsidized Employment

Policymakers should also look to create subsidized jobs, primarily in the private sector. The Recovery Act provided modest funding to states that they could use for several purposes, including

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[9] Glenn Hubbard, "Tax reform is the best way to tackle income inequality," *Washington Post*, January 10, 2014, http://www.washingtonpost.com/opinions/tax-reform-is-the-best-way-to-tackle-income-inequality/2014/01/10/112710ea-68ca-11e3-a0b9-249bbb34602c_story.html.

[10] Michael Strain, "More than the Minimum Wage," *National Review*, December 11, 2013, http://www.nationalreview.com/article/365999/more-minimum-wage-michael-r-strain.

subsidized jobs. Thirty-nine states and the District of Columbia, representing a real cross-section of the country, established subsidized jobs programs for jobless low-income parents and youth. About half of those states had Republican governors; the other half had Democratic governors.

States worked with private and non-profit employers, as well as government agencies, to create these subsidized job positions — but most of the job placements were in the private sector. Many of the programs worked directly with private employers and required them to contribute to the costs of providing a subsidized job placement. States adopted a variety of approaches regarding the maximum wage level that could be subsidized and how long the wage subsidy could last per employee.[11] Typically, employers created positions that low-income parents or youth filled for temporary periods such as six months to a year.

The program proved highly successful. Over a 1½ year period, these states placed 260,000 low-income parents and young people in subsidized jobs. Moreover, the Economic Mobility Corporation (EMC) studied what happened to participants in these subsidized jobs programs and found the programs did exactly what they were supposed to do — help disadvantaged jobless individuals find work during hard economic times. The study also provides evidence that the jobs programs improved some participants' chances of finding *unsubsidized* jobs when their subsidized job position ended.[12] And the study indicated that the long-term unemployed benefitted most.

The Recovery Act funding for the subsidized jobs program expired in 2010, but there is growing support among analysts across the political spectrum for this type of strategy, as it helps to address several fundamental problems — too few jobs (especially in the current economy) for less educated workers, a substantial number of workers who have been out of work a long time, and the lack of sufficient work experience among significant parts of the low-income population. Conservatives who recommend such an approach include Ron Haskins, co-director of the Brookings Center on Children and Families and former White House advisor to George W. Bush,[13] and Kevin Hassett, Director of Economics at the American Enterprise Institute.[14]

Non-Defense Discretionary Funding

Non-defense discretionary (NDD) programs provide a broad set of public services, including education, environmental protection, border security, veterans' health care, scientific and medical research, transportation, economic development, low-income assistance, law enforcement, and international humanitarian and development assistance. This budget category provides grants to

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[11] For more information on how these programs were structured and the different approaches that states adopted, see "Creating Subsidized Employment Opportunities for Low-Income Parents: The Legacy of the TANF Emergency Fund," by the Center on Budget and Policy Priorities and the Center for Law and Social Policy, February 2011, http://www.cbpp.org/cms/?fa=view&id=3400.

[12] Ann Roder and Marc Elliot, "Stimulating Opportunity: An Evaluation of ARRA Funded Subsidized Employment Programs," Economic Mobility Corporation, September 2013, http://economicmobilitycorp.org/uploads/stimulating-opportunity-full-report.pdf.

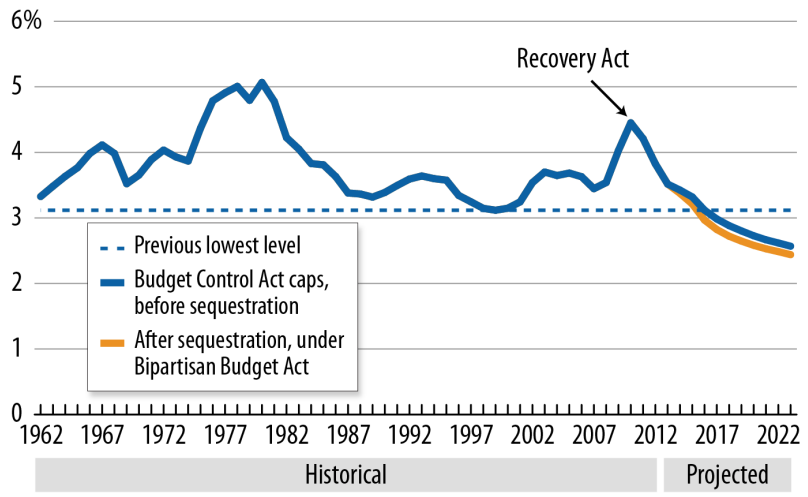
[13] Ron Haskins, "No Way Out: Dealing with the Consequences of Changes in Family Composition," Washington, DC: Brookings Institution, forthcoming.

[14] Kevin A. Hassett, Testimony Before the Joint Economic Committee, "Long-Term Unemployment: Consequences and Solutions," American Enterprise Institute, April 24, 2013, http://www.aei.org/files/2013/04/24/-hassett-testimony-on-long-term-unemployment_155831757059.pdf.

states, support for low-income families, and important investments in the nation's economic future. As a result of the caps imposed by the Budget Control Act, spending for NDD programs is set to decline over the next decade to its lowest level on record as a share of GDP, with data going back to 1962 — even *without* the additional cuts required by sequestration. (See Figure 5.)

Figure 5

Non-Defense Discretionary Spending As Share of GDP



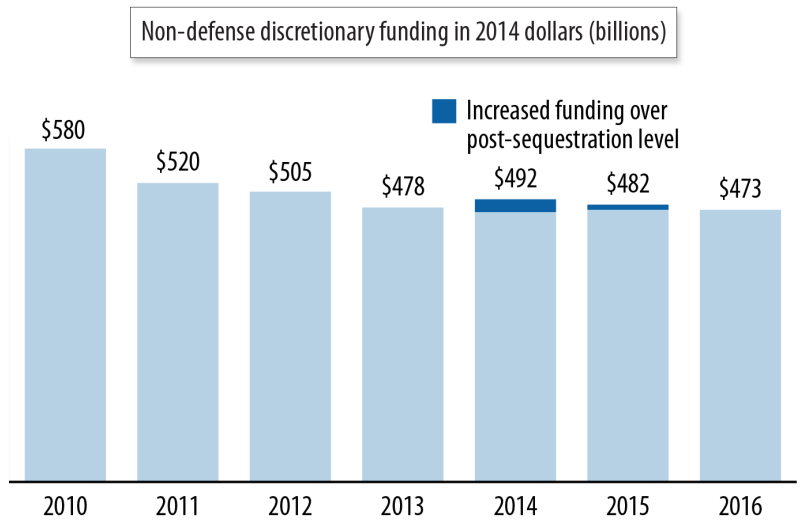
Source: Center on Budget and Policy Priorities based on Office of Management and Budget and Congressional Budget Office data.

The December budget agreement provides $45 billion of relief from sequestration in 2014, evenly divided between defense and non-defense discretionary programs. For non-defense programs, that halts a sharp downward trend in funding — which fell by nearly 18 percent between 2010 and 2013, after adjusting for inflation — and reverses a modest amount of the cuts.

But the downward trend begins again next year. After accounting for inflation, NDD funding is slated to fall in 2015 nearly back to the 2013 post-sequestration level. *By 2016, funding will have dropped below the 2013 post-sequestration level, adjusted for inflation, meaning that all of the gains from the budget agreement will be gone, and then some.* (See Figure 6).

Figure 6

Budget Agreement Provides Only Temporary Respite from Non-Defense Discretionary Cuts



Notes: 2013 figure represents Congressional Budget Office (CBO) estimate of actual funding after sequestration. All amounts exclude funding for disasters, emergencies, program integrity, and Overseas Contingency Operations.

Source: Congressional Budget Office

Further, looking only at the effects of inflation significantly *understates* the funding pressures that NDD programs will face. Many need additional funds to keep pace with population growth; grants to school districts and the administration of programs like Social Security and Medicare are just two examples. And for more than a decade, veterans' medical care has traditionally grown a much faster rate than inflation, reflecting in part the high rate of growth of health care costs in the economy.

The Pell Grant program, which is crucial to providing opportunity to children from low-income families, is a special case. Because of the way it operates, eligible students are not turned away and qualifying students receive the grant amount for which they are eligible under the program's grant schedule, as long as sufficient funds are available. Over the past few years, discretionary appropriations have been set artificially low — significantly lower than the actual cost of Pell Grants — because other legislation has provided temporary additional funding. *But that temporary funding runs out by 2016*. In that year alone, appropriations for Pell Grants will need to increase by about $6 billion, and the additional amounts needed through 2023 will be about $30 billion.[15]

Moreover, these funding increases reflect the size of individual Pell Grants under current law. While the Pell Grant maximum award rises with inflation through 2017, it is frozen thereafter at the 2017 dollar level. (The cost of indexing Pell Grants for inflation through 2017 is borne on the mandatory side of the budget and is not constrained by the tight NDD caps.) Therefore, even if the $30 billion gap in discretionary funding for the programs is somehow filled, students will still face ever-growing tuition bills with a frozen Pell Grant after 2017. If policymakers do not provide relief from sequestration for 2016 and subsequent years, either large cuts in Pell Grants will occur that place college out of reach for many aspiring children from low-income families, or else other non-defense discretionary programs will have to be cut still more deeply to close the Pell Grant funding shortfalls.

These funding problems highlight that, after the two years that the current budget deal covers, we will badly need a new budget agreement. The nation can ill afford to neglect funding for Pell Grants, elementary and secondary education, public health, environmental protection, and basic scientific research, as will occur if the funding levels required under sequestration remain in effect. Failure to make these basic investments will slow long-term economic growth — and hence make our long-term fiscal problems greater — and likely increase poverty and hardship and reduce opportunity.

These low funding levels will also undermine our ability to conduct basic government functions effectively and efficiently. The IRS budget this year is a case in point. In inflation-adjusted terms, the IRS budget has eroded steadily since 2010, even as its workload has increased. Its 2014 funding level failed to keep pace with inflation and did little to mitigate the effects of the previous year's sequestration cuts. Yet starving the IRS budget is highly counterproductive. A large part of its budget goes to curbing tax fraud, tax evasion, and other illegal activities. The Treasury estimates that every dollar spent on enforcement yields six dollars in revenue. In addition, these cuts hamper the IRS' taxpayer services. According to the National Taxpayer Advocate, because of budget cuts, "the IRS has been significantly hampered in its ability to provide 'top quality service' and maintain effective enforcement programs that minimize noncompliance."[16]

Finding the offsets to pay for needed sequestration relief will be a challenge. The recent budget agreement shows that an incremental approach, tackling more narrowly defined problems, has the

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[15] Our calculations assume that in the absence of a new budget deal providing additional relief from sequestration, discretionary appropriations for Pell Grants will grow at the same pace as the NDD caps, as reduced by scheduled sequestration from 2016 on.

[16] Taxpayer Advocate Service, "National Taxpayer Advocate 2013 Annual Report to Congress," December 31, 2013, Vol. I.

potential to succeed where broader "grand bargains" have failed. But even that deal showed the difficulty of reaching agreement when policymakers must rely entirely on cuts to programs outside the major entitlements and tax expenditures, along with user fees. Such offsets, while sometimes portrayed as "low-hanging fruit," are in fact not without controversy — as evidenced by efforts by both Republicans and Democrats to repeal the deal's modest change to military pensions, a component in the delicate balance achieved in the agreement.

The final section of this testimony returns to the issue of putting the budget on a more sustainable path, laying out some key factors policymakers should keep in mind when formulating proposals (even if such plans are unlikely to be acted on in the near future).

III. Long-Term Fiscal Problems

If we look at how we got from where we appeared to be in 2001 — when CBO projected budget surpluses for decades to come — to where we are today, the Bush-era tax cuts, unpaid-for wars, the Medicare drug bill, and the Great Recession all played central roles.[17] At the same time, if we ask what will cause deficits to start rising again as a share of GDP at the end of the decade, the answer is that spending on Social Security, Medicare, and Medicaid — driven by rising health care costs and the aging of the population — will increase significantly as a share of GDP under current policy, while revenues will rise little. This will produce a growing fiscal imbalance and a steadily increasing debt — which, in turn, will result in steadily increasing interest costs, which then will push deficits and debt still higher.

We have long maintained that stabilizing the debt-to-GDP ratio over the coming decade is a minimum appropriate budget course. Enacting more significant deficit reduction that puts the debt ratio on a modest downward path after the economy has recovered would bring additional advantages *if* policymakers can achieve it without slowing the recovery, shortchanging important investments for the future, increasing poverty and inequality, or jeopardizing the quality of Americans' health care. Policymakers should consider creative solutions to these problems and work to lay the groundwork for developing a consensus around policies that would slow spending growth, raise more revenues, and invest in the nation's future.

As policymakers consider approaches to put the budget on a more sustainable path over the longer term, it's important to keep the following in mind:

The Projected Rise in Spending

Contrary to some impressions, the rise in spending as a share of GDP projected for coming decades is not due to *entitlements in general*. It is concentrated in the programs affected by health care costs and population aging: Medicare, Medicaid, and Social Security.

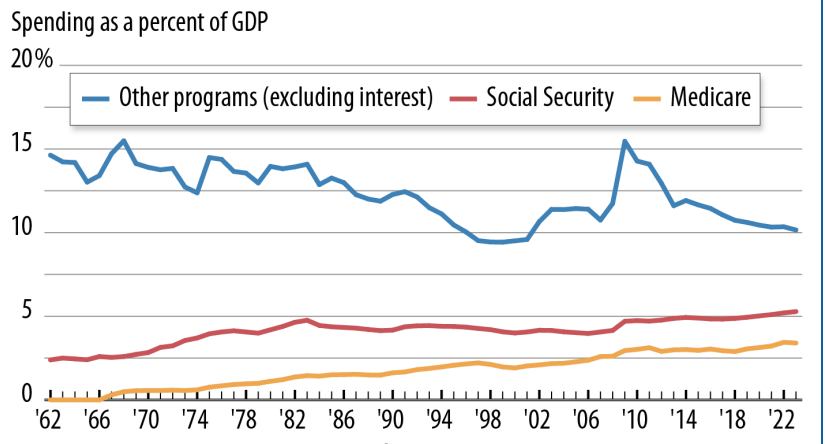
Over the 50 years from 1963 through 2012, non-interest spending averaged 18.0 percent of GDP. Based on CBO projections, it will equal 18.8 percent of GDP in 2023 under current policy and higher levels after that. But non-interest spending *outside Social Security and Medicare,* which averaged

[17] Kathy Ruffing and Joel Friedman, "Economic Downturn and Legacy of Bush Policies Continue to Drive Large Deficits," Center on Budget and Policy Priorities, February 28, 2013, http://www.cbpp.org/cms/?fa=view&id=3849.

12.6 percent of GDP over the prior 50 years, is projected to equal only 10.2 percent of GDP in 2023 — significantly *below* the historical average. (See Figure 7.)

Figure 7

Non-Interest Spending Outside Medicare and Social Security Set to Fall in Coming Decade



Note: program spending includes all federal expenditures other than net interest on the debt.

Source: OMB through 2012; CBPP analysis of CBO data thereafter.

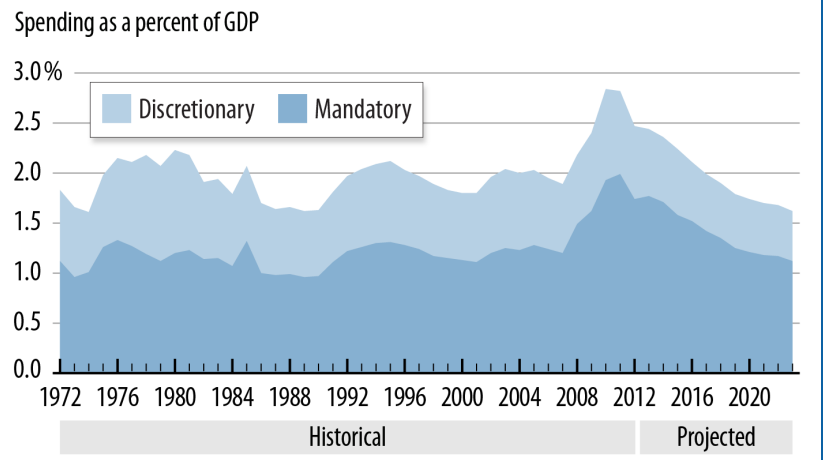
This drop is due primarily to the decline in discretionary spending as share of GDP, discussed above. That said, the growth in the remaining entitlement spending outside of Social Security and Medicare is due largely to growth in Medicaid. Spending on mandatory programs other than Social Security, Medicare, and Medicaid will equal its 50-year average in 2023 (2.7 percent of GDP) and is projected to shrink somewhat as a share of GDP in subsequent decades. This means that mandatory spending outside health and Social Security isn't the driver of coming spending increases.

Low-Income Programs

Nor are programs for low-income individuals and families outside health care the driver of coming spending increases. Means-tested entitlements (those targeted on people with incomes below prescribed levels) outside of health care averaged 1.2 percent of GDP over the past 40 years (we look back 40 years here because many of these programs didn't exist 50 years ago); they are projected to cost 1.1 percent of GDP in 2023 — a bit *below* the 40-year average — and to shrink further as a share of the economy after that. Low-income *discretionary* programs outside health care averaged 0.8 percent of GDP over past 40 years; they are expected to equal 0.5 percent of GDP in 2023 under the BCA caps, and even less if sequestration remains in place. (See Figure 8.)

Figure 8

Low-Income Expenditures Outside Healthcare Set to Fall Below Average of Last 40 Years



Source: OMB through 2012; CBPP analysis of CBO data thereafter.

The reason that some people assume means-tested entitlement costs are surging and are a significant part of the long-term fiscal problem is two-fold. First, people sometimes look at *all* means-tested

programs as a group, including Medicaid. Medicaid costs have risen with health care costs generally and will grow further in the years and decades ahead because of continued increases in health costs, the aging of the population, and health reform's Medicaid expansion to shrink the ranks of the uninsured (the cost of which was offset by various deficit-reduction measures included in the Affordable Care Act).

Second, means-tested entitlements other than health care programs have indeed grown substantially in recent years, amounting to 1.7 percent of GDP in 2012, well above their historical average. But the recent increases were driven by the weak economy and the Recovery Act's temporary increases in several of these programs and will recede in the years ahead.

The above facts do *not* mean that entitlement programs other than health care programs and Social Security should be off-limits for cuts. All parts of the budget should be evaluated on their merits.

Need for Caution When Addressing Health Care and Social Security

That Social Security, Medicare, and Medicaid are slated to rise as a share of GDP in the coming decades does not mean that long-term deficit reduction should feature deep cuts in these programs that leave would seniors, people with disabilities, families, and individuals without health care and less financially secure. With an aging population, we will inevitably need to spend somewhat more in these areas. Policymakers must be careful that changes in these programs do not leave low- and moderate-income seniors, people with disabilities, and low-income Americans poorer and in worse health.

Projected increases in per-capita health care costs will continue to put considerable pressure on federal health and retirement programs and on the budget as a whole. But there are major unknowns in the health care arena. While the growth of both public and private health costs has slowed appreciably in the past few years, experts do not agree on how much of this slowdown is likely to continue over the long term. The answer affects the size of the long-term fiscal problem and the magnitude of the measures that will be needed to further slow health-care cost growth.

More fundamentally, we currently lack needed information on how to slow health cost growth substantially without reducing health care quality or impeding access to necessary care. Demonstration projects and other experiments to find ways to do so are now starting and should generate important lessons. By later in the decade, we will know more about what works and what doesn't and how to build upon the changes already starting to slow health cost growth.

It is also worth keeping in mind that most Medicare beneficiaries aren't well off. Some 60 percent have household incomes below $30,000, and five-sixths have incomes below $50,000. That implies policymakers must take care to ensure any policy changes have adequate protection for low-income seniors. (It also helps explain why policies that seek to achieve savings solely from upper-middle and upper-income beneficiaries typically do not yield as much savings as people sometimes assume they will.)

In Medicaid, opportunities for savings that don't reduce access to care or the quality of care are quite limited at the present time. Medicaid beneficiaries are poor or near-poor, and Medicaid pays health care providers significantly less than Medicare or private insurance. Most states already use

managed care for Medicaid beneficiaries who aren't elderly or disabled. As a result, Medicaid spends 20 to 30 percent less per beneficiary than private sector health coverage.

Caution is also warranted in Social Security. Changes made to shore up its financing in coming years must be designed carefully to maintain the program's critical social insurance structure and protect low- and moderate-income seniors and people with disabilities. Social Security benefits cut the elderly poverty rate (as measured by the federal government's Supplemental Poverty Measure) from 55 percent to 15 percent. This means that without Social Security, more than half of seniors would be poor.[18]

Tax Expenditures

Ultimately, bringing down longer-term deficits and debt also will require higher revenues than are currently projected. The best place to secure them is to address tax expenditures, many (but certainly not all) of which are inefficient and do not serve a broad public purpose effectively.

Policymakers should recognize that, when tackling long-term deficits, much of the distinction between programs carried out on the spending or revenue side of the budget is essentially artificial. In many cases, there is little difference between benefits or subsidies provided through the tax code and those provided through spending programs.

Education is one example. On the spending side of the budget, the federal government provides Pell Grants to help low- and moderate-income students afford college. On the tax side of the budget, so-called 529 accounts help parents pay for college by providing tax subsidies that are most generous for upper-income households. Both of these policies are government subsidies to promote higher education; the tax/spending distinction is not meaningful here.

Child care provides another example of why tax expenditures generally are the equivalent of spending programs and essentially operate as entitlements. Low- and moderate-income working families with federal child care subsidies receive them through spending programs, such as the Child Care and Development Block Grant (CCDBG). CCDBG funding is capped, so it serves only as many low-income families as its funding allows. As a result, only about *one in six* low-income working families with children that meet the qualifications for a federal child care subsidy actually receives one. Middle- and upper-income families with federal child care subsidies get them through the tax code, through the Dependent Care Tax Credit (DCTC). Unlike CCDBG, the DCTC has no cap on its cost, so any tax filer who qualifies can receive the credit. This tax-based subsidy for middle- and upper-income families thus operates as an open-ended entitlement, unlike the child care subsidies delivered through spending programs to low- and moderate-income families.

Efforts to reduce spending should therefore also address spending in the tax code. Harvard economist (and former chief economic advisor to Ronald Reagan) Martin Feldstein has written that "cutting tax expenditures is really the best way to reduce government spending," while former

[18] This figure shows that a large share of seniors have only modest income other than Social Security. If Social Security did not exist, many elderly individuals likely would have saved somewhat more and worked somewhat longer, and many might live with their adult children rather than in their own households. Studies confirm however, that Social Security has reduced poverty dramatically.

Federal Reserve Board Chair Alan Greenspan has referred to tax expenditures as "tax entitlements" and said they should be looked at alongside spending entitlements.

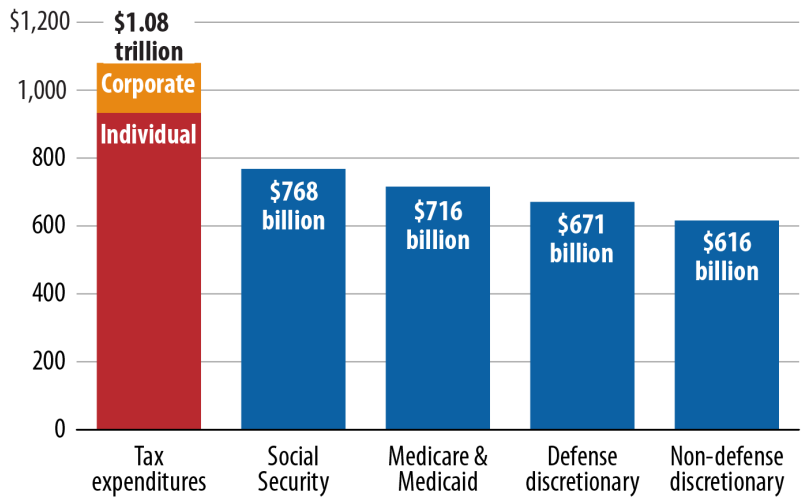
There is also an equity issue here. "Spending" entitlements provide most of their benefits to middle- and lower-income households, while tax-expenditure benefits — or "tax entitlements" — go heavily to high-income households. Specifically, the distribution of federal entitlement expenditures tracks fairly closely to the distribution of the population — nearly 60 percent of their benefits go to the middle 60 percent of the population, and about 30 percent go to the bottom fifth. In contrast, tax expenditure benefits are skewed much more to the top of the income spectrum, with the top fifth receiving over half of the benefits and the top 1 percent receiving 17 percent, while the bottom fifth receives only about 8 percent of the tax expenditure benefits.

If policymakers exempt tax expenditures from deficit reduction, that will likely place the onus of further deficit reduction entirely on spending programs, and almost certainly result in regressive outcomes that further widen income disparities and magnify poverty.

Figure 9

Tax Expenditures Are Very Costly

Tax expenditures and major categories of federal spending in 2012, in billions



Notes: Tax expenditure estimates do not account for interaction effects; estimate does not include associated outlays ($94 billion) or the effects on excise and payroll receipts ($112 billion).

Source: Office of Management and Budget, Historical Tables 8.5 and 8.7 and Analytical Perspectives Table 16-2.

Tax expenditures are costly, reducing revenues by over $1 trillion annually, and often are poorly designed for achieving their desired policy goals. (See Figure 9.) Some would prefer to use all savings from tax expenditure reform to cut tax rates without shrinking deficits, but that would be ill-advised. The current political environment remains inhospitable to a new tax such as a carbon or a value-added tax and, after the "fiscal cliff" deal, further tax-rate increases. This leaves only tax expenditures as a politically plausible source for a meaningful revenue contribution to deficit reduction to accompany reductions in certain programs.