APRIL 20, 2016

FIXING THE BUDGET PROCESS & RESTORING STABILITY TO GOVERNMENT OPERATIONS

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Statement before the Senate Budget Committee
Fixing Broken Budget Process and Restoring Stability to Government Operations

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April 20, 2016

The views expressed in this testimony are those of the author alone and do not necessarily represent those of the American Enterprise Institute.

Chairman Enzi, and Members of the Committee, I thank you for inviting me to talk about the negative effects of uncertainty and dysfunction in the budget process. In my testimony, I will discuss the latest economic research investigating the impact of uncertainty on the overall economy, and relate uncertainty about the budget to this literature.

Few topics in Washington engender consensus among economists from both sides of the political spectrum. The existence of negative effects of budget uncertainty and dysfunction, however, seems likely to be one of them.

Uncertainty is, of course, with us every day. We don't know if it will rain tomorrow, or if a drought might begin that would cause severe harm to crops. A car manufacturer might wake up one day and find that Tesla has invented something new that fundamentally affects the demand for internal combustion engines. When uncertainty is higher, then economic agents become more cautious. If, for example, a manufacturer in a rapidly evolving industry came to you for a loan, you might be wary of making it, and charge a higher interest rate if you do.

There are many types of uncertainty that we cannot have much of an impact on, but there are some that are under the control of policymakers. If our citizens believe that tax and spending policies are unpredictable, then they will act as if the world is more uncertain, and be wary of making purchases and investments that they might otherwise make.

As we think about policy, there are two ways we should think about uncertainty increasing. First, suppose that we have a two party system, and the two parties have different views about the best level for the corporate tax rate. If one party is sure to have power, then there is not much uncertainty. Its desired rate will likely prevail. But if the odds of either party controlling the government move towards a true 50-50, then we can say that uncertainty has increased relative to a world the odds were, say, 70-30. Second, if the beliefs of the two parties concerning the best tax rate grow farther apart, with one party favoring much lower rates, while another favors much higher rates, then the widening of the spread between things that might happen is another form of increased uncertainty.

If we have become more evenly divided politically, and at the same time, the policy views of the parties have grown farther apart, then we can say with a great deal of confidence that the political situation has evolved in a way that could increase the harmful effects of economic uncertainty.

This is not just an abstract theoretical observation. As I will discuss in my testimony below, there has been an explosion of research that has suggested that the negative effects of policy uncertainty may be quite large indeed. In what follows, I will divide my testimony into an analysis of two types of uncertainty that policymakers should consider when designing optimal policies. Short-term uncertainty in a budgetary context concerns uncertainty likely to arise from events that happen at predictably shorter time horizons, like spending authorizations or the "fiscal cliff" of 2011, or even elections. Long-term uncertainty, by contrast, concerns the trajectory of events that occur over lengthier horizons. An example of such long-term uncertainty would be uncertainty about the fiscal trajectory of the United States more broadly, or, to take a concrete example, the solvency of the Social Security program.

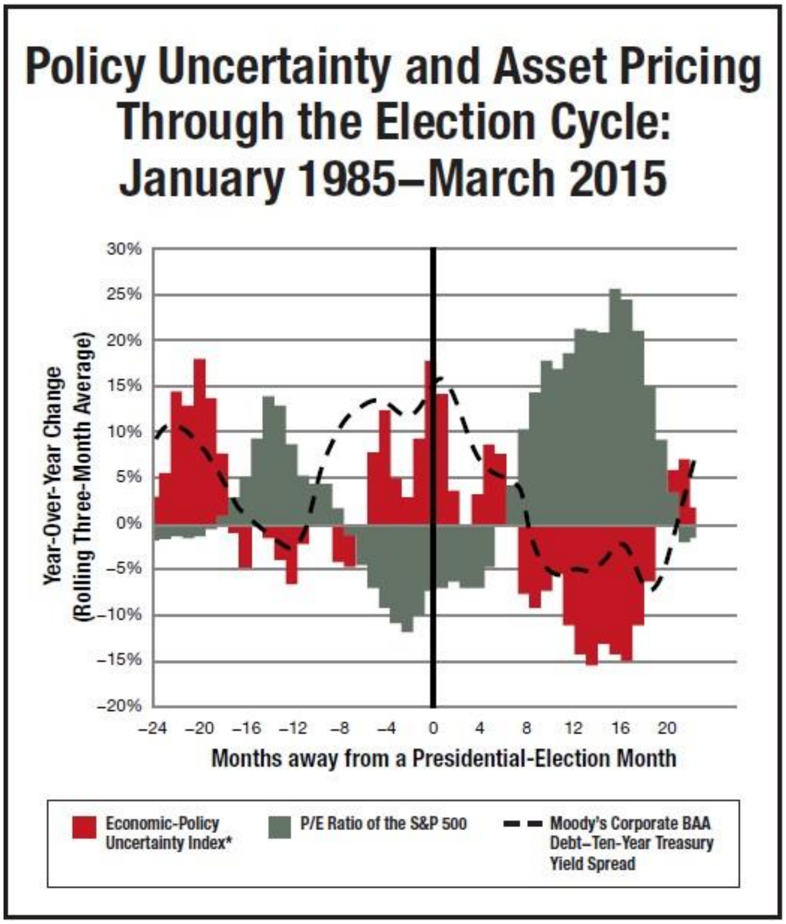
Both of these types of uncertainty, distinct in theory, but interrelated in practice, are germane to the United States. On the long-run front, the CBO's March 2016 baseline project projections forecast that the deficit as a share of GDP will have increased by more than 60% over its 2015 level by 2026, and in the years that follow, deficits will remain on a trajectory that quite quickly could make the United States see a fiscal situation as bad as that of Greece today. When a path is unsustainable, policies must change. Uncertainty about how they might change is a major factor for decision makers. And on the short-run front, Congressional bottlenecks like the 2011 fiscal cliff seem almost as a much a part of Washington as the cherry blossoms. As importantly, the wide disagreements between the parties about policy, and the potential for wild swings in key fundamentals around elections have clearly had a big impact on markets.

Short-term uncertainty and its negative effects

There now exists a large and still growing academic literature on the effects of uncertainty. Economists disagree about how to quantify uncertainty, how to best identify its effects, and on their magnitude. But they have developed a number of innovative measures, and found that uncertainty has a major impact on the economy.

Perhaps the best-known recent work on uncertainty has been performed by two economists at Stanford along with their colleague at the University of Chicago. [1] Baker, Bloom and Davis (2016) construct a measure of the uncertainty about policy by scraping through web sites and news stories to track the frequency with which observers mention the possibility of policy changes. They employ sophisticated econometric techniques to identify the link between uncertainty and economic activity, finding that the link is a powerful one. For example, they find that policy uncertainty around the Great Recession likely accounted for about an extra 1 percent drop in production. The harmful impact of policy uncertainty can be seen even without the sophisticated econometrics. The chart below, which draws from a paper my coauthor and AEI colleague Joseph Sullivan and I presented at a conference last year, plots both an index of economic policy uncertainty developed by Baker, Bloom and Davis, along with a measure of credit spreads and a measure of equity valuations throughout the four-year presidential election cycle. To make the data easy to interpret we changed the time scale over this sample period to "election time." Time zero is the November of a presidential election year, Time -1 is the October before said election, and time -24 is the midterm election.

[1] This work is summarized and updated at: http://www.policyuncertainty.com/, a website that hosts the index created by Scott Baker of Northwestern University's Kellogg School of Business (and who was a graduate student at Stanford when the index was first created), Nicholas Bloom of Stanford, and Steve Davis of the University of Chicago Booth School of Business, and links to a number of academic works that explore the impact of uncertainty on the overall economy.



The equity valuation metric, the price-to-earnings ratio of the S&P 500, measures the price a firm can charge an investor in exchange for the claim on the firm's earnings that a share of its stock represents. A relatively high P/E ratio serves as an indication that the firm can raise capital at a relatively low cost: When the P/E is higher, it means the market perceives the equity to be less risky. The spread between the yield on Moody's BAA-rated debt and the ten-year Treasury yield is an alternative measure of the risk premium. It indicates how much market participants demand in exchange for holding bonds that, according to Moody's, come with "moderate credit risk" and have "certain speculative characteristics." A larger spread indicates that market participants are charging businesses more for buying their bonds instead of the "risk-free" bonds of the U.S. government.

As the chart shows, stock valuations and debt spreads both respond adversely to the increases in uncertainty that seem to come with the election cycle. The effects are large. So the fact that the parties have grown so far apart, adds significantly to uncertainty, raising the cost of funds for investors and consumers. This higher cost of funds reduces economic activity, which may explain some of the large impact on jobs and growth found in the literature.[2]

The broader literature has documented similar effects in many different corners of financial markets. For example, public security markets exhibit higher volatility in close proximity to U.S. elections. Li and Born (2006) find that U.S. equity markets become more volatile as presidential elections approach.[3] In a pivot to the state level, Gao and Qi (2012) find that municipal bonds floated by state governments immediately before an election pay a premium of six to eight basis points due to this electoral proximity.[4] Jens (2013) estimates that gubernatorial elections reduce state-level investment by between 5% and 15%.[5] Finally, Julio and Yook (2013) find that flows of cross-border foreign direct investment but not portfolio flows are sensitive to proximity to the timing of foreign elections.[6]

Think about it this way. Suppose you were running a firm, and you were contemplating making a billion dollar investment in a new factory. As we look ahead toward this November, there is no question that there is a great deal of uncertainty concerning who might win, and what policy might look like depending on the victor. Given the wild swings in policy that are conceivable, one could easily imagine that you might decide to postpone making that investment until after you see the election results. The data suggest that these effects are very important for understanding the evolution of the economy, and in all likelihood, the weakness of the economy today.

It would not, of course, be advisable to seek to reduce uncertainty by eliminating elections. But if the Senate, in particular, could move more toward a policy consensus based on science and evidence, then markets would worry less that policy would change course on a dime at each presidential election. The reduction in uncertainty would likely, given the literature, have significant positive economic benefits.

The same authors have recently created indices that focus specifically on the prospects of a government shutdown or a failure to raise the debt ceiling. As with the broader uncertainty index, the chart measures uncertainty about the debt ceiling or a government shutdown by counting the fraction of articles in major newspapers that have language on the subject. The chart below plots how these metrics have changed through time. The events that one would expect to

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[2] See https://bfi.uchicago.edu/sites/default/files/research/hassett-sullivan.pdf for more on the literature and this chart.

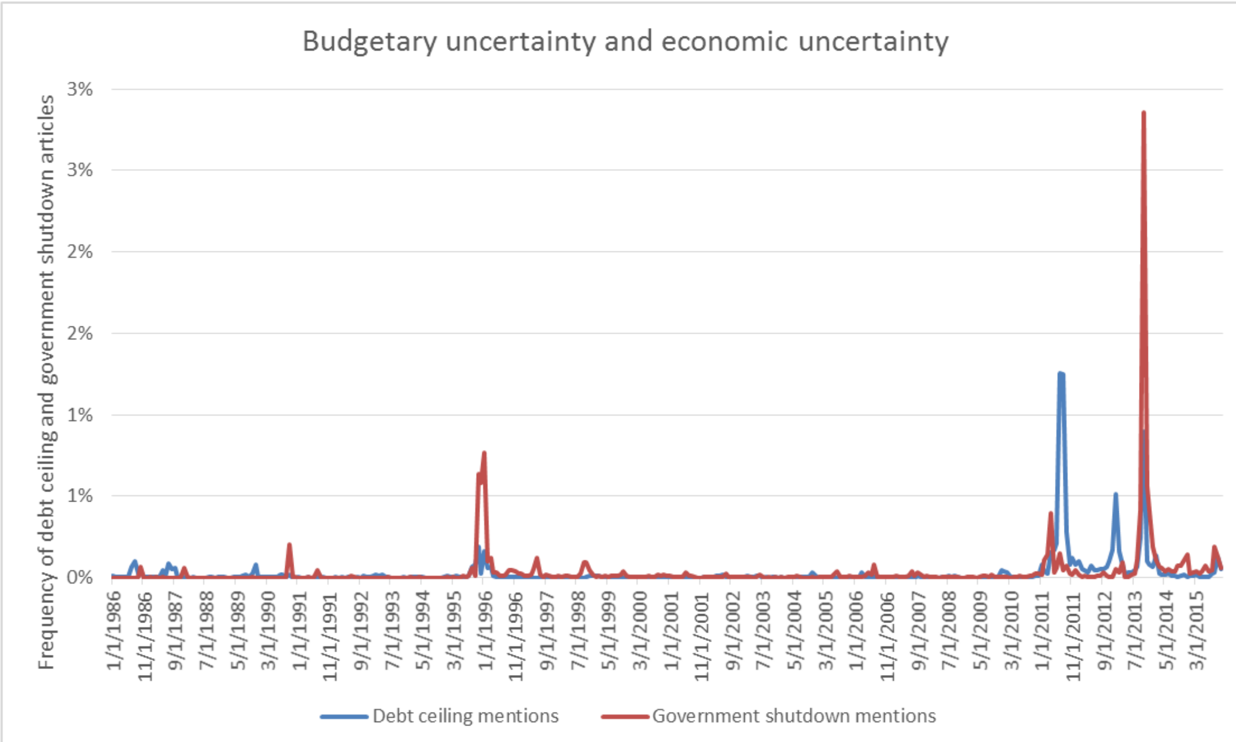
[3] Li, Jinliang, and Jeffery A. Born. 2006. "Presidential election uncertainty and common stock returns in the United States." *Journal of Financial Research* 29 (4): 609-622.

[4] Gao, Pengjie, and Yaxuan Qi. 2012. "Political uncertainty and public financing costs: Evidence from US municipal bond markets." http://extranet.isnie.org/uploads/isnie2012/qi_gao.pdf

[5] Jens, Candace. 2013. "Political uncertainty and investment: Causal evidence from US gubernatorial elections." http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2176855

[6] Julio, Brandon, and Youngsuk Yook. 2013. "Policy Uncertainty, Irreversibility, and Cross-Border Flows of Capital." http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2024612

observe—the 1995 government shutdown, the 2011 flirtation with the debt ceiling, and the 2013 fiscal cliff—are all visible on the chart.



Interestingly, my own analysis performed while preparing this testimony finds that these spikes in uncertainty have negative effects that are quite similar in magnitude to those already linked to policy uncertainty more generally. To link this to presidential uncertainty, we estimated the average values of our measure of credit spreads and our mesaure of equity valuations when either the debt ceiling or government shutdown series were more than two standard deviations above their average values. When debt ceiling uncertainty rose two-standard deviations or more above its average, the S&P 500 P/E ratios were 28.9% lower than in normal periods and credit spreads were 8.75% higher.[7]

Longer Term Uncertainty and Fiscal Consolidation

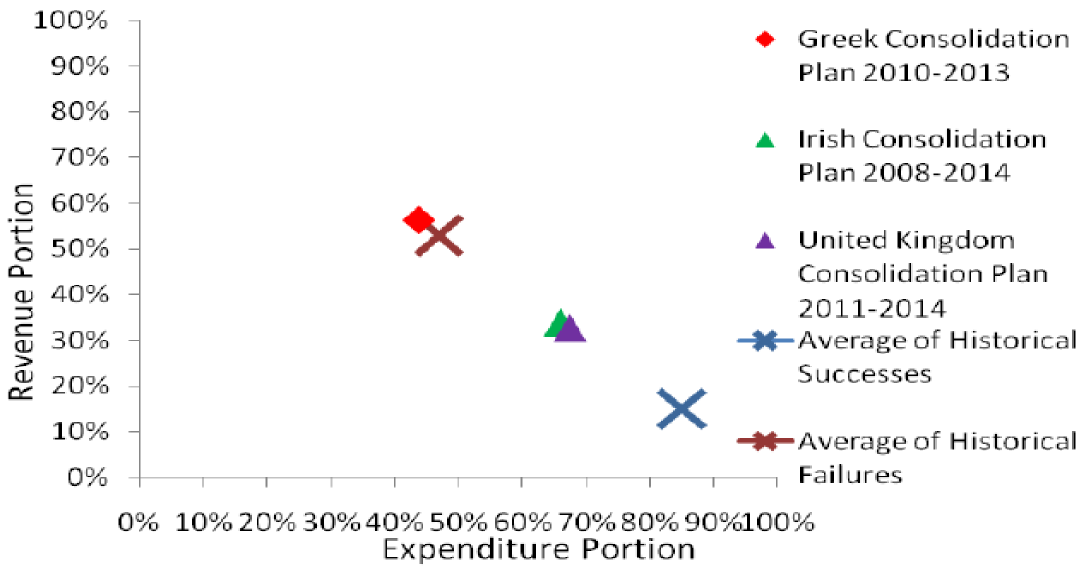
Uncertainty surrounding the budget stems, at least in part, from the unsustainable deficits that the government seems to run year-after-year. If the U.S. exhibited at least some capacity to make the combination of spending and tax adjustments necessary to eliminate or even reduce its deficit, uncertainty about the long-term fiscal trajectory of the United States would be diminished. In such a world, after all, budget fights would be less complex and consequential: if tax revenue funded government spending, merely keeping existing policy in place would suffice. The

[7] The sample for this estimate runs from January 1986 to November 2015.

interconnected web of spending authorizations and expiring tax cuts that beguiled legislative attempts at resolving the fiscal cliff would no longer make their regular appearance.

Other countries have undergone fiscal consolidation in the past, providing us examples of policies that are successful and as well as examples of those that have failed. Along with two colleagues, I have written an analysis[8] exploring policy mixes in successful and failed fiscal consolidations in 21 OECD countries, with the measure of success simply being that the consolidation accomplishes the objective of stabilizing the debt. We found that fiscal consolidations based more heavily on expenditure cuts than revenue increases are more likely to be successful at producing lasting reductions in debt.

Using a range of different methodologies, we find that the average unsuccessful fiscal consolidation relied upon 53 percent tax increases and 47 percent spending cuts, while a typical successful consolidation consisted of 85 percent expenditure cuts. We also found that cuts to social transfers were more likely to reduce deficits than other expenditure cuts. The chart below shows the composition of average successful and unsuccessful consolidation plans, along with a few measures taken recently by other countries.



Other research has reported similar findings, most notably an earlier paper by Alesina and Perotti[9], which found that consolidations successful in reducing debt consisted of 64 percent spending cuts and 36 percent tax increases. Similarly, McDermott and Wescott found in a survey

[8] Andrew G. Biggs, Kevin A. Hassett, and Matthew Jensen, "A Guide for Deficit Reduction in the United States Based on Historical Consolidations That Worked," AEI Economic Policy Working Paper 2010-04 (2010) http://www.aei.org/paper/100179.

[9] Alberto Alesina and Roberto Perotti, "Fiscal Adjustments in OECD Countries: Composition and Macroeconomic Effects," *NBER Working Paper* 5730 (1996)

of fiscal consolidations that expenditure-based consolidations had a 41 percent chance of success, while revenue-based consolidations have only a 16 percent success rate. [10]

Normally, tax increases and spending cuts might be expected to have near-term negative effects on the overall economy. The tendency of successful fiscal consolidation to at times even have positive short term growth effects likely reflects the positive effects on sentiment, consumer spending and investment that accompany reduced uncertainty. Such positive effects are quite intuitive. For example, one might not have a great deal of confidence in an investment in Greece precisely now. Your successful factory might well be served by a rotting infrastructure poorly supported by a bankrupt government, and still be taxed with abandon in the future. But if Greece could restore fiscal sanity, an investment might be a good deal more attractive. That's why consolidations can lead to positive economic developments.

Looking ahead: entitlement reform

The data suggest that the U.S. is overdue for a fiscal consolidation.

The "trust fund" share of federal outlays—the share attributable to Social Security or Medicaid funds—has steadily risen since World War II. In 1946, these were only 2.2% of federal outlays. By 2015, however, they have become no less than 45.3% of federal outlays, according to data from the Office of Management and Budget.[11]

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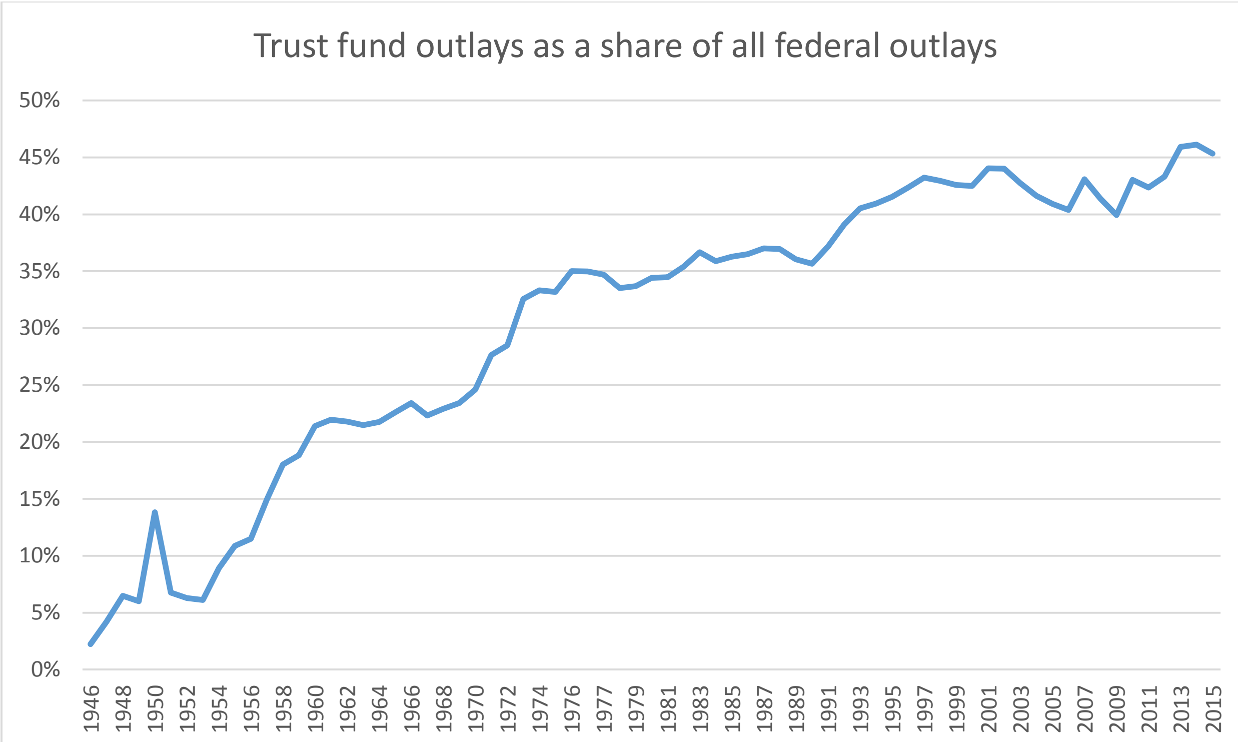
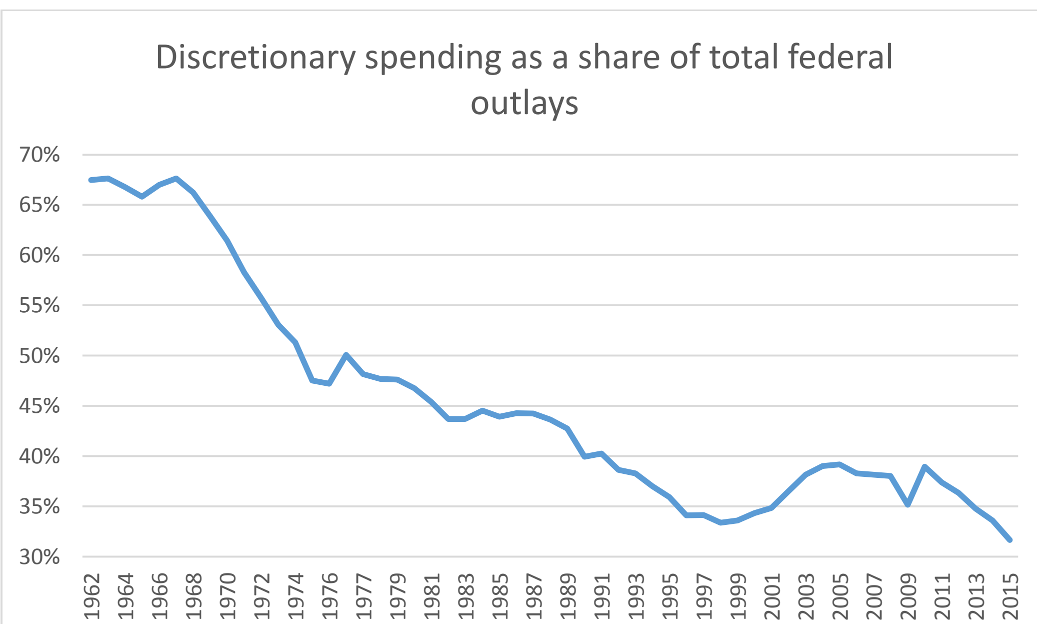
[10] McDermott, C. John and Wescott, Robert, An Empirical Analysis of Fiscal Adjustments (June 1996). IMF Working Paper, Vol. pp. 1-26, 1996. Available at SSRN: http://ssrn.com/abstract=882959

[11] The data come from Table 1.4: Receipts, Outlays, and Surpluses or Deficits (-) by Fund Group: 1934-2021, available at: https://www.whitehouse.gov/omb/budget/Historicals.



Perhaps as a consequence, then, the share of federal outlays attributable to discretionary spending has also fallen considerably. Though discretionary spending constituted 67.4% of outlays in 1962, today that number has fallen to 31.6%, according to the Office of Management and Budget.[12]



[12] The data come from Table 8.7: Outlays for Discretionary Programs: 1962-2021, available at: https://www.whitehouse.gov/omb/budget/Historicals

Neither of these trends seem sustainable: just as it is difficult to imagine trust fund spending as a share of the federal budget continuing to increase in the 21st century in the same way that it increased during the second half of the 20th century, it is difficult to imagine discretionary spending continuing to shrink as a share of the federal budget at the same rate as it has over the last half of the 20th century during the 21st century.

It is clear, then, that the situation of America's entitlement programs generates substantial long-run uncertainty. Either we will face solvency issues or policymakers will need to undertake bold and politically difficult entitlement reform.

Clearly, Ben Franklin's famous saying should be modified. Today, nothing can be said to be certain except death, taxes, and uncertainty. The latest economic literature suggests that this uncertainty is harmful in both the long and short runs, and that the benefits of policies to address it could be significant.

UNIVERSITY OF MARYLAND

SCHOOL OF PUBLIC POLICY

Testimony of Philip G. Joyce

Professor of Public Policy and Senior Associate Dean

University of Maryland, School of Public Policy

Before the Committee on the Budget

United States Senate

on

"Tap-dancing on the Razor's Edge: Restoring Stability to Government Operations"

April 20, 2016

Chairman Enzi and members of the Committee:

Thank you for asking me to testify today on this important topic. I congratulate this committee for deciding to highlight the subject of the apparently invisible, yet insidious, effects that budget uncertainty creates for both federal agencies and the recipients of government funds. My comments today are informed by my own 30 years of observing the federal budget process, and some recent research that I have done culminating in a report written in 2012 for the IBM Center on the Business of Government.[1]

No one paying even casual attention to the routine dysfunction of the federal budget process in recent years-from "fiscal cliffs" to sequestration to government shutdowns and threats of shutdowns--could avoid coming away with the impression that the federal budget process is not working well. It would be somewhat reassuring to think that this recent experience was exceptional, and that we could now return to normal. Unfortunately, however, it is just the latest example of a system where we limp along from one crisis and missed deadline to another.

While actual government shutdowns are rare, "government by continuing resolution" is now the normal way of doing business, creating costs and problems of its own. The insidious effects of the chronic uncertainty that routine CRs create for federal agencies and recipients of government funds are at least as worthy of attention, and may indeed be more damaging, than the more high profile instances of sequestration or brief government shutdowns. Some of these costs are financial, and some represent inefficiencies and compromised effectiveness for federal programs. All of these negative impacts are self-inflicted, however, and are entirely preventable.

In my testimony today, I will do four things:

- Review the practice of late appropriations and other actions that create uncertainty in the federal budget process;
- Discuss the specific costs and effects of this dysfunction on federal agencies;
- Describe some of the effects of uncertainty that trickle down to recipients of government funds; and
- Offer suggestions as to how these costs and effects might be reduced in order to promote more efficiency and effectiveness in government programs and agencies.

[1] Philip Joyce, *The Costs of Budget Uncertainty: Analyzing the Impact of Late Appropriations* (Washington: IBM Center for the Business of Government, 2012).

Shutdowns and Continuing Resolutions—Past Experience

The 1974 Congressional Budget and Impoundment Control Act, which created the modern congressional budget process, moved the start of the federal fiscal year from July 1 to October 1. This occurred in part to accommodate the additional steps created by the 1974 Budget Act, and in part because the Congress had a difficult time enacting appropriations prior to the start of the fiscal year. Ironically, however, the appropriations process has not gotten more timely since the 1974 Act. In fact, in only 4 of the 40 fiscal years since 1977 (the first year under the new process) have all appropriations bills been passed and signed into law prior to the start of the fiscal year.

In the first years following the advent of the new process, there were limited consequences of late appropriations, because agencies continued to operate normally even in the absence of funding. Agencies assumed that the Congress intended for them to continue operating, and that the required funding would be forthcoming. This changed in 1980 when Attorney General Benjamin Civiletti issued an opinion stating that agencies did not have legal authority to spend money in absence of appropriations. After the Civiletti opinion, continuing resolutions became the norm, since they were necessary (in the absence of appropriations) in order for agencies to continue to operate. Short funding gaps were relatively routine, but many of these occurred over holiday weekends and the impacts were not widely felt. Between fiscal year 1982 and fiscal year 1988, there were nine such funding gaps (sometimes two in a single year) but their average duration was two days. While technically these might have been government shutdowns, they had a very small impact.

The fiscal year 1996 budget process, however, yielded the longest government shutdowns in history, totaling 26 days. The first lasted from November 14th to November 19th, 1995, and resulted in the furlough of 800,000 federal employees in agencies covered by appropriation bills that had not been enacted. A second, much longer, shutdown commenced on December 16th, 1995, and lasted for three weeks—until January 6, 1996. This second shutdown only furloughed 284,000 federal employees; the number was reduced mainly because several more appropriation bills had been enacted in the interim.

While a thorough discussion of this shutdown is beyond the scope of this hearing, later studies estimated a financial cost of $1.4 billion (mostly resulting from paying employees retroactively for work that was not done), in addition to substantial negative effects on service delivery. For example, almost 400 National Park Service facilities were closed, affecting 7 million visitors. Further, the Social Security Administration did not process about 200,000 applications for benefits, and 800,000 toll-free calls went unanswered. More recently, the fiscal year 2014 budget process resulted in a government shutdown that commenced on the first day of the fiscal year (October 1, 2013), and lasted for 16 days. An analysis by the Office of Management and Budget estimated a number of costs associated with this shutdown. They included a loss of $2 billion to $6 billion in domestic economic output, and another $2 billion in costs associated with paying federal employees retroactively for work that was not done.[2]

While there were no shutdowns between the fiscal year 1996 shutdown and the one affecting fiscal year 2014, and no shutdowns for fiscal year 2015 or fiscal year 2016, this does not mean that the appropriations process has operated smoothly in the absence of a shutdown. In fact, we have experienced government by continuing resolution every year since 1997; increasingly there have been more of these per year, and they have extended further in to the fiscal year. For the 19 fiscal years between 1998 and 2016, there were an average of almost 6 CRs per year (the high point was fiscal year 2001, when there were 21) and CRs, on average, covered an average of 3 months (excluding the three years—2007, 2011, and 2013--in which there were full-year CRs). [3]

<u>Effects of Budget Uncertainty and Crisis Budgeting on Federal Agencies</u>

The failure to enact timely appropriations creates an environment of substantial uncertainty for federal agencies and for recipients of federal funds. The focus—by the public and the news media—tends not to be on this routine dysfunction and the problems that it creates, but on the immediate crisis: How do we avoid going over the fiscal "cliff"?; How do we avoid a government shutdown?; How do we prevent a debt default? The effects of funding delays caused by routine CRs, however, are significant.

Budgeting is about planning for the future. Any organization—whether it is the federal government, a state or local government, or a business—needs to have some notion of the funds that it will have available in order to effectively budget, and manage. The more certainty that exists, the better informed the decisions are, and the more effective the result. For the federal government, late appropriations and "government by CR" have created a number of specific problems:

- CRs have various effects on government personnel, including hiring freezes that create skill gaps in crucial areas, and morale and turnover problems, often as a direct result of employees feeling as if they are pawns in a larger political game over which they have no control.

[2] Clinton Brass, *Shutdown of the Federal Government: Causes, Processes, and Effects,* Congressional Research Service, September 8, 2014.
[3] James Saturno and Jessica Tollestrup, *Continuing Resolutions: Overview of Components and Current Practices*, Congressional Research Service, January 16, 2016.

- Because CRs require the continuation of current activities, agencies have trouble responding to many new problems and are required to keep funding outdated or ineffective programs.
- CRs may require agencies to engage in short-term contracting, which significantly increases contracting workload and overhead costs. In addition, delays in contracting can lead to higher costs for individual contracts and also higher costs resulting from less competition.
- Investments that are not made—in people (as training is cancelled or deferred) or infrastructure (in the form of deferred maintenance) lead to higher future costs.
- Agencies waste a great deal of time preparing for potential government shutdowns and CRs, and then complying with them after the fact.

<u>Delayed Hiring and Personnel Actions, and Morale Issues.</u> Because personnel costs are such a substantial portion of many agency budgets, managing delays in funding necessitates reducing personnel spending. This often leads to hiring freezes or across-the-board cuts. Hiring freezes can create skill gaps in parts of the agency where turnover is greatest. This means that a hiring freeze can end up robbing the agency of personnel working in higher priority programs, or can have an unintentional differential effect if vacancies are concentrated in particular programs, projects, or activities.

In cases where funding delays lead to concerns that a shutdown or sudden budget reduction may follow (as occurred in 2011 and 2013) agencies may be required to prepare furlough plans and to send out furlough notices to employees. This can have unintended consequences, even in cases where the furloughs are unlikely to actually take effect. Some employees may respond to furlough notices by spending otherwise productive time seeking other employment. Those who end up leaving (because of fear of furlough, or because they are just fed up) are likely to be those who were just hired or who have other options. In either case, they are not necessarily the ones that an agency would choose to terminate if the agency was focused on performance considerations.

<u>Freezing Priorities in Place.</u> Continuing resolutions also create problems in cases where agencies are attempting to shift priorities to respond to some immediate challenge facing them. If an agency has identified a need to shift personnel from one area to another, to address some area of immediate concern, this can delay its ability to respond. This is complicated further by the sheer amount of time that it can take to fill a position. A position that is approved in February or March might not be filled until August or September.

A 2009 GAO report on the effect of CRs cited numerous examples of this behavior.[4] For example, the Federal Bureau of Investigation (FBI) delayed filling existing positions in order to fund annual pay raises, annualize pay for previous year's hiring, or to cover increased costs of retirement, health insurance, or other employee benefits. GAO found other examples where hiring delays affected the number of FDA food inspections, the ability to maintain or improve the ratio of corrections officers to inmates, and the ability to process claims for veterans' benefits.

The fiscal year 2011 budget delays, leading up to a final agreement that was not reached until April 2011, is illustrative of the compromises to government effectiveness that can occur. Media reports indicated that DOD needed to raid procurement budgets in the first half of the year in order to fund pay and benefits, resulting in deployed troops not getting needed equipment, the cancellation of 20 ship overhauls by the Navy, and deferred aircraft maintenance. There were nondefense effects as well. In State College, Pennsylvania, a newly built $7.5 million air traffic control tower, sat empty in the spring of 2011 because the Federal Aviation Administration lacked the funding to hire the air traffic controllers to staff it.

In addition to preventing new starts, CRs typically require activities that are ongoing to be continued. In other words, in addition to prohibiting agencies from doing NEW things, CRs also prohibit them from ceasing funding for OLD things. In one case the Department of Justice had decided to stop funding the National Drug Intelligence Center in Johnstown, Pennsylvania. Since they could not plan for a specific date to cease operations, the passage of a CR required them to continue operating until the regular appropriation became law.

<u>Changes in Contracting Practices.</u> Because late appropriations have become the "new normal" for agencies, they have adjusted their spending patterns to accommodate. The agencies interviewed by GAO in 2009 each reported that they delayed contracts. The Veterans Health Administration (VHA) said that they did not start nonrecurring maintenance projects, but instead waited until the regular appropriation was received. Delays can also lead to a rush to obligate at the end of the year. VHA reported to GAO, for example, that in 2006 they obligated 60 percent (about $248 million) of a $424 million nonrecurring maintenance budget in September, the last month of the fiscal year. This rush creates a greater potential to make mistakes, which may lead to wasted funds and adverse audit findings.

[4] Government Accountability Office (2009). *Continuing Resolutions: Uncertainty Limited Management Options and Increased Workload in Selected Agencies*, September.

In addition to delaying contracts, many agencies also are forced to enter into multiple contracts for a much shorter time period (instead of one yearly contract), so that the duration of the contract can more-or-less match the duration of the CR. For example, BOP awarded a contract in 1997 to an optometrist to provide care for a prison. Under a regular appropriation, this would have been a one-year contract. Instead, there were three contracts covering only the first quarter of the year: 1) October 1 to November 16; 2) November 19 to December 14; and 3) December 17 to December 21. This kind of short-term contracting creates substantial additional workload—more contracts means more work, higher administrative costs, and greater opportunity for errors and waste.

These changes in contracting practices often lead to increases in costs. The Bureau of Prisons (BOP) reported to GAO that a CR lasting longer than 3 to 4 months typically negatively affects the quality of competition. In addition, delayed contracts may have higher prices. BOP said that awarding contracts later prevented the agency from locking in prices and therefore increased costs. In one case (the McDowell Prison facility in West Virginia), this resulted in about $5.4 million in additional costs. The precision of this estimate is exceptional; most agencies know that costs are higher, but are unable to confirm specific dollar amounts of increased costs.

Along these same lines, it seems quite likely that many contractors dealing with the federal government include a “risk premium” in the rate that they charge for contractual services, because they cannot negotiate reliable multi-year commitments without fear of funding interruption. Federal agencies pay more for services than an equivalent private firm would pay for the same service. While the existence of such a premium is widely assumed, it is difficult, if not impossible, to estimate it with any precision.

<u>Failing to Invest in Training, Travel and Maintenance.</u> Travel and training, as areas where agencies typically have discretion to delay funding, are frequent candidates for cutbacks. One agency representative reported that the agency simply avoided sending staff to training in the first quarter of the calendar year. The later that the final appropriation is received, the more that training budgets (and therefore training) is likely to be reduced. In DOD, for example, training and the agency’s key challenge of maintaining force readiness are inexorably related. The various forms of budget uncertainty (the threatened government shutdown, and the debt ceiling impasse) led, in some years, to measurable reductions in DOD training. The Air Force, for example, predicted that CRs and planning for a shutdown in 2011 reduced flying hours by ten percent, and other active duty personnel interviewed in 2011 reported that the near shutdown led to the cancellation of training exercises.

Foregone maintenance also increases costs. There is little question that failing to properly maintain any asset reduces its useful life. This can have two possible impacts. It could simply take the asset in question out of service, thus depriving citizens of the benefits that would otherwise be received. Perhaps more likely, it will lead to future costs as the asset wears out more quickly. A very clear example of this potential comes from the 2011 funding delay, when the Navy cancelled seven ship-repair contracts, at a savings of $62 million (McCabe, 2011). Even if these repairs occurred in a later fiscal year, their deferral could clearly have operational and cost implications.

Wasted Time and Effort, Leading to Reduced Effectiveness and Efficiency. Aside from increasing costs, continuing resolutions and funding delays invariably created additional work and cause agencies to take actions that compromise their efficiency and effectiveness.

A good place to start here is with the process of preparing for shutdowns, and for living with CRs. Staff in federal agencies, OMB, and the Congress spend a non-trivial amount of time preparing for things that usually do not happen (in the case of shutdowns) or which do happen, but which waste a lot of time in trying to lessen counterproductive or even illegal effects (in the case of a CR). In recent years in which there have been threats of shutdowns (especially in 2011 and 2013), OMB asked agencies to prepare shutdown plans. When this happens, both the OMB and federal agencies spent a great deal of time developing these plans and reviewing them, which is a complete waste of time unless the shutdown actually takes effect.

Preparing for CRs can also frequently be time consuming. One of the most time-intensive processes involves dealing with anomalies, which are specific exceptions to the general limitation on funding in CRs. Since, by definition, these anomalies are exceptions to the general rules governing a CR, many agencies invariably think that their peculiar circumstances deserve exceptional treatment. It is often quite difficult, however, to get the Congress to go along with anomalies. This leads to lots of negotiations between OMB and agencies over which things can and cannot be appropriately be included as anomalies.

These inefficiencies do not stop the moment that the CR is enacted. Agency budget offices, and OMB, are involved in lots of conversations around budget execution once the CR is law. Many of these discussions are designed to determine what can and cannot be done, and when something is a continuation of a current activity and when it represents something new. Agency budget officials often have to spend inordinate time responding to inquiries about what is and is not permitted under a CR. The

GAO case study agencies indicated that there were four types of administrative tasks most often affected by CRs:

- Issuing guidance to programs and offices;
- Providing information to Congress and OMB;
- Creating, disseminating and revising spending plans; and
- Responding to questions and requests for additional funding above the amount allotted.

There are no precise estimates of the costs of these tasks. GAO reported that VHA estimated that a one-month CR results in over $1 million in lost productivity at VA medical facilities and over $140,000 in additional costs for the VA contracting office.

Effects of CRs on State and Local Governments and the Private Sector.

The federal government provides substantial funds to state and local governments, in the form of grants, and to the private sector, in the form of contracts. The increased uncertainty, and the increasing length of time covered, by CRs has created increased costs and uncertainty for these sectors as well.

Federal grantmaking agencies reported to GAO, for example, that CRs that extended beyond about mid-February tended to delay discretionary grant announcements, thus pushing back both application reviews and awards. In some cases, grants were cancelled, even though the funds were eventually provided. A compressed application period can also decrease the quality of application and review, and discourage some potential recipients from applying for grants out of fear that they will have insufficient time to prepare grant applications, which can be complicated and time-consuming.

Agencies that award grants must decide, if operating on a long-term (more than three months but less than a full year) CR, whether to suspend grant application processes until an appropriation is received or to go ahead with them, pending a final appropriation. In the former case, there may not be enough time available for potential recipients to prepare applications and for agencies to process them in the second half of the year. Therefore, what appears to be a delay may result in a cancellation of the grant program, at least for the current year. In the latter case, there is a risk that, if the funds are not ultimately provided, the agency could have applications in hand but no funding for the program. This occurred in fiscal year 2011 with the Department of Education's Teaching American History program.

A similar story exists for contractors. When stories began to emerge in 2012 that speculated about the effects of sequestration, the first effects that were discussed were the impacts on federal contractors who had already started to react to the threat of across-the-board cuts. If contractors believe that an actual shutdown, or contract cancellation, is imminent, they face difficult questions concerning whether or not to continue work, and how long they can afford to keep employees on board. Whether late appropriations ultimately lead to layoffs depends on the contractor, and particularly on the rate of turnover. There certainly are cases, especially for small contractors, where layoffs are necessary. In 2011, for example, Penn State University's Applied Research Laboratory, heavily funded by a contract with the Navy, reported having to lay off 13 engineers due to funding reductions from the Navy associated with federal budget delays.

It is likely that the effects of uncertainty are felt more acutely by firms with the following characteristics:

- small businesses that may have less of a cushion against the delay in funding for an apparently small contract. Smaller businesses are less likely to have the capacity to "ride out the uncertainty" associated with funding delays;
- firms that work only for the government;
- firms that are funded from agencies that have primarily one-year money;
- firms funded by agencies that are more likely to receive late appropriations (some appropriation bills are more chronically late than others);
- contractors that are (especially within DOD) in the delivery stage of a given project (as opposed to development) because delivery involves higher personnel costs.

According to contractors who deal with both sectors, the biggest difference between commercial and federal work is that for commercial work the contractual firm can make long-term commitments, whereas with a federal agency the commitment is year to year. To the extent that there are capital costs, those capital costs can be captured with certainty over a three-to-five year period. A federal contract, conversely, may be a base contract with 10 one-year options.

In the end, it is true that, in general, government work tends to be more risky than commercial work. It is made even more risky in cases where there may be some interruption in funding as a result of a shutdown or default. A 2007 study, for example, of DOD contracting delays found that nine out of twelve companies included in the study experienced a decline in company stock values as a result of these delays. It is likely that there are a significant number of contractors who are unwilling to work with the government, thus reducing competition and increasing costs.

What to Do About the Problem of Late Appropriations

Ultimately, the greatest impediment to fixing the problem of late appropriations is that their negative consequences seem to be largely invisible. Many of the same people who decry waste in government, however, may themselves be contributing to that waste by failing to provide a predictable funding stream to federal agencies and recipients of federal funds. No state of local government would be able to get away with this, without consequences, as chronic funding delays would result in lowered bond ratings, increased borrowing costs, and likely political fallout. Despite this, of course, both the states of Illinois and Pennsylvania have operated much of the current fiscal year without a budget. These cases are notable because of how unusual they are, and in both of these cases, the result has had the predicted result of higher bond ratings. These market signals do not seem to exist in the federal budget process.

Despite the apparent invisibility of these effects, however, it should be clear that routine timely appropriations would have many positive effects on budget formulation and execution, including the following.

1. If appropriations were timely, it would improve budget planning for future years. The clearest example of this has to do with the President's budget, where if the current year appropriations are not enacted by around mid-December, it makes it virtually impossible to have reliable information on which to base proposed funding for the budget year.
2. If decisions in budget execution did not have to be made in such compressed time frames, it would lead to better decisions since agencies would not be (at least to the same extent) rushing to make choices on contractors, grants, etc.
3. Agencies could begin to plan for hiring earlier in the year which (given how long it can take to fill a position) increases the chance that they will have a full complement available to deliver priority services.
4. Investments in employees and in physical assets would be able to be protected by permitting adequate funds to be provided for employee training and maintenance of this physical capital.
5. Both the cost of contractual services and their quality would be improved if appropriations were received in a timely manner. Predictability would enable agencies

to negotiate contracts at a lower price and contractors would likely deliver higher-quality service.

How can we encourage these positive effects? It is hard to avoid starting with the obvious conclusion**: Given all of the negative consequences of late appropriations, the Congress should discharge its most basic responsibility and routinely enact appropriations before the beginning of the fiscal year.** It is hard to imagine that, the roughly eight months available between the delivery of the President's budget and the beginning of the fiscal year would not provide sufficient time to enact appropriations bills, provided that the Congress viewed it as a significant priority. The fact that the federal government is a large, complicated enterprise, and the federal budget process is a complex process is not a sufficient excuse for this failure.

To begin and end with this conclusion seems particularly unhelpful. For this reason, it is useful to consider some recommendations that start from the assumption that the Congressional appropriations process will not suddenly operate on schedule. If we are stuck with late appropriations, what can be done to minimize their effects?

1. <u>The Congress could make more funding available on a multi-year or no-year basis.</u> At present, many agency salary and expense budgets are provided using one-year money. If agencies had the flexibility to obligate funds over multiple fiscal years, many of the specific problems caused by late appropriations would be reduced. This is not to suggest that all appropriations should permit multi-year or no-year obligations, but it would be useful to specifically review current practice with an eye toward increasing the percentage where such multi-year obligations are necessary. This might assist, in particular, those agencies with lots of grant and contract funding.

2. <u>The Congress might consider prohibiting continuing resolutions, or making them more difficult to enact than regular appropriations.</u> This may seem like an odd recommendation, as it increases the probability of a government shutdown. In fact, it flies in the face of a more common recommendation, which is that failure to enact appropriations should result in an automatic continuing resolution (ACR). The problem is that ACRs may just become the norm; that is, this might reduce the urgency of enacting appropriations even further. Given the problems created by CRs, this would not be a good outcome. Conversely, prohibiting CRs or (for example) requiring a supermajority to pass them would tend to lead to a situation where the options might be either a

full-year appropriation or a government shutdown. Perhaps if there were MORE urgency in enacting appropriations, it would increase the odds of them being enacted.

3. If CRs are to continue, it would be useful if, instead of CRs that freeze spending at the prior year level, the Congress should enact CRs that permit inflationary increases to the prior year level. For those members of Congress and Presidents who believe that spending should be frozen or reduced, this would provide an incentive to reach agreement on appropriations in a timely manner, since the default would be a higher level of spending. For federal agencies, however, this would reduce the necessity of counterproductive actions having to be taken in order to live within a CR that requires spending at the prior year level. This recommendation would also reduce, but not eliminate, the need for anomalies, which should be held to a minimum in the interest of lessening the substantial effort that goes into identifying and negotiating them.

4. The Congress should avoid the temptation to micromanage the budget execution process, particularly if late appropriations are to continue to be the norm. Requirements imposed on some agencies to have spending plans approved by Congressional committees are, in the context of late appropriations, a costly "luxury". If appropriations were timely, such a review could potentially be justified. In cases where a final appropriation is not received until 3 to 6 months into the fiscal year, there is no justification for the additional delay that such a requirement imposes on federal agencies and their ability to manage funds.

5. Moreover, the Congress and President should limit CRs to only one or two per year that do not extend past the end of the calendar year. It is important to recognize that all CRs are not created equal. It matters how many there are, and it matters how long agencies have to operate under them. Short CRs (especially where there are multiple CRs lasting weeks, as opposed to months) create all sorts of problems for federal agencies that increase the odds of agency officials unwittingly violating some law or engaging in counterproductive management practices. Problems created by attempting to manage through CRs lasting 4 months, or 6 months (or more) are also well documented. If CRs are to be enacted, it is important for them to be enacted in a way that minimizes their negative effects.

It seems particularly important to focus on these improvements at the present time, for two reasons. First, the problem is becoming worse, not better. While historically the problem with late appropriations has been more one of timing than of uncertainty of the eventual funding level, recently federal agencies have found themselves in a position where both the timing and the amount are in serious question. The recent threat of the Budget Control Act's reductions in discretionary appropriations ratchets up this level of uncertainty to a higher level. Independent of these prospective cuts, the need to reduce federal debt will result in a less than "zero-sum" game for federal agencies; having sufficient time to plan for these budget reductions will be even more important than ever.

My main message, then, is that funding delays have costs. Some of these costs are financial, and others are felt through compromised government effectiveness. Either way, these are completely self-inflicted wounds. The negative impacts are unacceptable given the importance of the federal budget to the overall performance of the U.S. economy and the delivery of services to citizens. The Congress should do what it can to minimize these costs, even if they cannot be eliminated.

TESTIMONY ON “TAP DANCING ON THE RAZOR’S EDGE:

RESTORING STABILITY TO GOVERNMENT OPERATIONS”

SENATE COMMITTEE ON THE BUDGET

APRIL 20, 2016

NORMAN J. ORNSTEIN

Mr. Chairman and members of the Committee, it is both an honor and a privilege to testify before you today on the need to get our budget and appropriations processes, indeed the broader way we deal with fiscal policy, in order. I am particularly honored to appear alongside two scholars I admire deeply, Philip Joyce and Kevin Hassett.

I come to you as a scholar who has also worked inside the Senate on reform issues, and worked over many decades with senators of both parties on these issues. Indeed, forty years ago, I was the staff director for a committee that reorganized the Senate’s committees, one whose formal name still makes me cringe: The Senate Select Committee to Study the Senate Committee System. Among those I worked with closely were Adlai Stevenson, Gaylord Nelson, Barry Goldwater, Bill Brock and Pete Domenici.

In that effort, we succeeded in eliminating some committees and subcommittees, streamlining jurisdictions, reducing assignments and modernizing information systems. But, as is pretty evident looking around the Senate today, those changes, worthwhile though they were, did not transform the Senate into a focused and efficient body. That experience, along with other reform efforts in the years since, have left me with a healthy skepticism about the limits of structural reform in a body that is inherently political, and with a deeper realization that in many if not most cases, the norms of the body and its members—their willingness to follow the regular order, even while gritting their teeth, to put, at least occasionally, the long term needs of the polity ahead of short term political gains or points scored—trumps structural change.

Of course, there is no doubt that our processes are now profoundly dysfunctional. When it comes to manipulation of the debt ceiling, we are not just playing with fire—we are playing with nuclear weapons. The typical and costly uncertainty attached to spending bills has been replaced with deeply destructive swings that often make it impossible for federal executives to plan for the next day or week, much less for a single year or to develop reasonable five or ten year plans. The periodic threats of shutdown mean that almost every year, managers have to stop managing or planning the implementation of their programs to plan instead for a stoppage. No organization, public or private, would opt to function without some reasonable level of certainty and predictability in budgeting, much less with the regular threats of turning out the lights. But for years, now, agencies have had to cope not just with these uncertainties but with mindless across-the-board budget cuts that hurt most the efficient, lean and mean programs and that hamper national security, homeland security and economic security, among other essential things. And frankly, if we add to those challenges the attacks on the integrity of federal workers, including the pay freezes and bans on attending conferences or doing continuing education, the threat to effective governance is multiplied.

I am less concerned with the erratic pattern of passing budget resolutions, which are often far more symbolic than real, and which have turned into hyper-partisan exercises that become even more embarrassing when the majority party can't even find a majority among their own members. I am aware that budget resolution deadline day was five days ago, with no resolutions in sight. But to get to a point now where a broad, bipartisan budget deal like the one recently enacted is held hostage in the House by a small ideologically driven faction is simply cringeworthy for one who wants to see a functioning legislative process making rational decisions about policy and priorities.

It is understandable that the Budget Committee wants to find ways to change things, to move from dysfunction to functionality, to enable a process where whatever one's views about the appropriate size of government and size of the federal budget, the government that we have functions well and serves the collective interests of the American people. But the members of the committee need to be aware about the limits of reform and the underlying nature of the problem even as you work towards change.

The limits of structural change on fiscal policy are made evident by a point Professor Joyce makes in his paper, "The Costs of Budget Uncertainty," a point I make regularly when talking about reform. Before the 1974 Budget and Impoundment Control Act, the fiscal year began July 1, leaving less than six months to enact spending bills for the coming year. The Budget Act added three months, moving the date to October 1, with reformers assuming that the extra time would make it much easier for Congress to complete the 13 appropriations bills on time. The opposite happened. Why? Because spending bills are at base core priority decisions, which are driven as much or more by politics and ideology as they are by objective or technical criteria. That means that strategic endgames often take precedence over artificial timetables. I should note here that this reality should make us a bit cautious about the impact of a very popular reform, moving to two-year appropriations. I would be perfectly happy to have many spending decisions taken off the roller coaster with longer-term appropriations, but also believe that it could and probably would lead to manipulation of assumptions and probably higher stakes end-game negotiations and brinksmanship.

In some ways, the starker reality of the limits of structural remedies emerges with the advent of the sequester. The process that framed the most significant budget negotiations in many years was designed specifically to force broad bipartisan agreement on long-term fiscal policy—by creating an automatic alternative if negotiations failed so stupid and destructive that it would simply be unacceptable to all parties. Those mindless, across-the-board cuts in defense that would over time absolutely cripple national security would push Republicans to compromise;

the mindless, across-the-board cuts in agencies like NIH and CDC would push Democrats to an agreement as well.

It was a powerful theory. But the failure to find that common ground—driven especially by the unwillingness to consider significant revenue increases as part of a package of budget cutbacks in both discretionary and entitlement programs-- showed that the theory was hijacked by the ideological and partisan reality of our time. Thus, I have to conclude that any reforms designed to make the outcome disastrous if Congress does not belly up to the bar and do the right thing—including eliminating continuing resolutions—would in the current dynamic lead to more disastrous outcomes.

So, what to do? There are, in fact, some reforms that would be highly beneficial to enact. The most important is on the debt ceiling. We all know that both parties have played politics with the debt ceiling for decades, with roles switching depending on the party of the president. But it is also clear that for most of the period since the debt ceiling was created in 1917, the games were basically fixed. All the party leaders, and most of the rank-and-file members of Congress knew that when push came to shove the votes would be there to insure that the full faith and credit of the United States was preserved and the debt ceiling would be lifted; I had many party leaders tell me that they had the votes in reserve from those who had scored political points back home by declaring their fiscal discipline and vowing not to increase the debt via an increase in the ceiling in case they actually needed them.

But in the Obama years, the game changed. I found it particularly disturbing when, in 2011, Senator McConnell said, “I think some of our members may have thought the default issue was a hostage you might take a chance at shooting,” he said. “Most of us didn’t think that. What we did learn is this — it’s a hostage that’s worth ransoming.” I was even more disturbed when CNN reported that Representative Jason Chaffetz, running to be Speaker of the House, noted in an interview that “Republicans should be prepared to see a debt default and a government shutdown in order to pursue their party's agenda.”

I understand political games. But this is potentially catastrophic for the country and indeed for the global economy. So I would urge you to institutionalize the so-called McConnell Rule, one the Majority Leader to his credit instituted in both 2011 and 2013 when he decided it was more beneficial to punt on the issue, to enable the president to increase the debt ceiling, with Congress having the power to pass a resolution blocking the action and the president able to veto the resolution. Our national debt is shaped by the actions taken by Congress on spending and taxing; those actions raise the debt, and an artificial ceiling, a practice shunned in almost all other mature economies, is deeply unwise and subject to very bad consequences.

On other reforms, including those proposed by Professor Joyce, I particularly commend the idea of ensuring that CRs include inflation adjustments; the failure to do so not only punishes programs the way sequesters do, but provide incentives for members who are less concerned with the regular order and more concerned with slashing spending, no matter how mindlessly, to block appropriations and go for CRs.

I want to conclude with a broader plea. The big problem we have in our politics right now is not polarization. As the longstanding example of the odd couple partnership between Ted Kennedy and Orrin Hatch proved, you can make good public policy with partnerships from the poles. It is the breakdown in norms and in what we mavens of the legislative process call the regular order. The changes in the use of the filibuster over the past decade occurred while a version of Rule XXII that had been in effect since 1975, and worked well for more than 30 years, began to be distorted for purposes for which the rule had not been intended. The breakdown in the budget process, including budget resolutions, enhanced brinksmanship, government shutdowns, failures to meet deadlines, the decline of broadly bipartisan appropriations bills, and the use of the debt ceiling as a hostage, was more because longstanding norms of behavior deteriorated than because the process was faulty.

Indeed, you now have a near perfect chance to show how a change in norms to focus on the regular order will dramatically improve things. We have a two-year budget deal set with broad bipartisan approval, one that creates workable caps around which to build a dozen appropriations bills, with the time to complete them before October 1. There are no structural impediments in either the House or Senate. Of course, we know the House is a bigger challenge, but the votes are there for majorities for the spending bills—although they cannot likely be done with one party alone. The Senate, however, should be able to pass these bills by broad majorities with ample time for conferences, to show the House an example of how Congress can make the process work when the will is there.

So feel free to consider and make salutary structural changes. But please, at the same time, look inward and change behavior.