

*"They write politics, we write government"*

## FISCAL POLICY, PART II

Where does it all go?

*"It's a popular delusion that the government wastes vast amounts of money through inefficiency and sloth. Enormous effort and elaborate planning are required to waste this much money." – P.J. O'Rourke*

All of that sweet, sweet Federal tax revenue – and proceeds from borrowing– is going somewhere. Given how much of it there is, a lot of somewheres.

The nearly four trillion dollars of annual Federal spending represents approximately 21% of total US economic output. Federal money is everywhere – and yet most people have a difficult time seeing it. In a famous example, surveys show the average American thinks 31% of all Federal spending is on foreign aid. In fact, aid makes up less than 1% of the Federal budget. All of the spending that you usually think of – what's called "discretionary spending" – makes up a surprisingly small amount of total outlays.

- How is Federal Government spending policy determined?
- Where does all that money go?
- What if the process doesn't work?

### How is Federal Government spending policy determined?

This is going to shock you: the Federal Government spends money based on a series of complex, interminable, arcane parliamentary maneuvers, which serve largely as a front for completely opaque discussions which have previously occurred between Members of Congress and Federal agencies, with a heavy sprinkling of input from industry lobbyists and special interest groups. Considering this, the system works fairly well.

Federal spending comes in two basic flavors: *mandatory* and *discretionary*. They follow an almost entirely distinct process. Let's tackle mandatory

spending first, it's simpler from a process perspective.

Mandatory spending is that which happens without specific, annual, Congressional action. This is where the name comes from: mandatory spending runs on autopilot based on what previous Congresses have done. The money will be spent even if the current Congress does nothing. In order to change mandatory spending, Congress must pass a new law (or equivalently, amend the current law). These new spending levels will then be mandatory for future years.<sup>1</sup>

Most mandatory spending is on entitlement programs like Social Security, Medicare and

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<sup>1</sup> Tax law is similarly "mandatory." Last year's tax code will be applied to this year unless Congress takes specific action.

Medicaid. But another significant portion is on means-adjusted programs intended to provide basic necessities to those who can't afford them. The largest of these programs are unemployment insurance and the Supplemental Nutrition Assistance Program. The mandatory portion is the majority of today's Federal spending – and it's the part that is growing.<sup>2</sup>

Legal details aside, I include interest on the national debt as part of mandatory spending. From a process perspective, it operates the same way: interest is paid automatically, without Congressional action. The key difference, of course, is that Congress can pass a new law that changes spending on other mandatory programs. Changing the interest rate paid on Federal debt instruments is not a great idea; doing so would probably be a default of the US Government.

All other spending done by the Federal government is discretionary, subject to an annual, multi-step process. Congressional supremacy in Federal spending is enshrined in the Constitution. However, the Constitution helpfully omits any guideline as to process, leading to a constantly ongoing evolution.<sup>3</sup>

<sup>2</sup> Chart from [Congressional Research Service](#). CRS data from OMB, Budget and CBO. Note the small spike in the period 2008-2010. These are the automatic stabilizers coming into effect via unemployment insurance and other programs. Comparing this to the nearly non-existent spikes from previous recessions gives an idea of their relative impacts.

<sup>3</sup> The [2011 Budget Control Act](#) (aka "Sequestration") and [Bipartisan Budget Act of 2013](#) were significant recent changes.

<sup>4</sup> If you are looking for a law that has had a huge impact on society but is little known, the 1974 CBA must be near

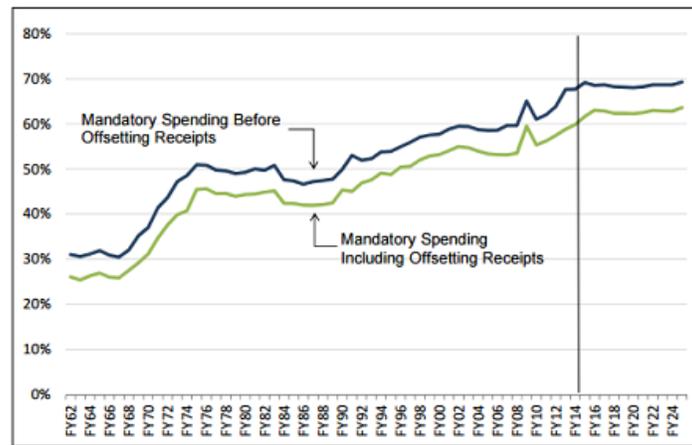
Until recently, the Federal spending process was informal, and Congress's role was squishy. Despite its nominal power, the Legislative branch had little ability to enforce its actions. This changed after President Nixon, claiming deficits were a cause of inflation, refused to spend all of the money that Congress had appropriated. In order to take back control, the Congressional Budget Act of 1974 was passed. It created Budget Committees in both

Chambers and the Congressional Budget Office, or "CBO", the arbiter of the costs of bills. Formalizing the process had the mechanical effect of increasing Congress's power, at the expense of the President's.<sup>4</sup>

In today's process, the first step is when the **President's Budget** is

sent to Congress. This document is created by the White House's Office of Management and Budget (OMB) and is due on the first Monday in February for the following fiscal year.<sup>5</sup> Generally, in preparing the budget, OMB will work with the Federal departments to get their detailed requests for funds. But, the President's Budget has absolutely no legal standing; it is basically a symbolic document, a statement of principles.<sup>6</sup> When it has been received by Congress, the CBO will "score" the President's

**Figure 1. Mandatory Spending and Offsetting Receipts as a Percentage of Total Outlays (FY1962-FY2025)**



the top of the list. Read more about it [here](#) and [here](#) and [here](#) (I can't believe I linked to the Peterson Foundation either...but it is a good overview).

<sup>5</sup> The Federal fiscal year starts on October 1<sup>st</sup>. So the 2018 fiscal year will run from October 1<sup>st</sup>, 2017 to September 30<sup>th</sup>, 2018.

<sup>6</sup> President Obama asked for \$7.4 billion to fund clean energy investments and \$12.9 billion to modernize the IRS as well as funds to make more community colleges free [in his 2015 budget](#). If you listen carefully, you can still hear the echoes of laughter of GOP Congressional leadership.

Budget to see how much all the goodies cost.<sup>7</sup> It will also get referred to the Budget Committees, who, if not of the President's Party, generally place it directly in the circular file.<sup>8</sup>

The next step is the **Congressional Budget**. In theory, each of the Chambers is supposed to consider and review the President's Budget, and pass their own Budget resolution before April 1<sup>st</sup>. Each Chamber then can amend the other's resolution, hopefully passing identical versions through each chamber by April 15<sup>th</sup>. But, of course, there is no way to force Congress to agree, and this deadline is frequently missed.<sup>9</sup>

Believe it or not, Congress's budget is also mostly symbolic. It is what's called a "concurrent resolution" which means that while the two Chambers have agreed, it is not sent to the President for a signature and therefore does not become law. If the President's budget is a blueprint, Congress' is a working drawing. It's getting closer, but still not a physical structure.

For discretionary spending monies to actually leave the government's hands, they must be included in the **Appropriations Process**. Each year, twelve Appropriations Bills must be signed into law to fund Government expenditures. This is no longer a drill, these are real dollar amounts that will really be spent.

Most of the work for appropriations occurs in each Chamber's Appropriations Committee. Each of the Committees has twelve sub-committees, one for each appropriations bill.<sup>10</sup> The Appropriations Committees have such power that the chairmanships of these sub-committees are as desirable as those of many full Committees.

Sometimes, multiple (or even all twelve) Appropriations Bills are passed as a single piece of legislation; these are called **Omnibus Spending Bills**. To proponents of using the Omnibus, it is just an efficient way to get through the tedious Appropriations process. To detractors, they are massive bills, generally passed at the last possible moment with few Members having read them.

Once the Appropriations Bills have gone through committee, they must be passed on the floor of their respective Chambers. If there are differences between the Chambers' Bills, these must be reconciled before going to the President.<sup>11</sup> Because these Bills require the force of law, the President must sign them. Or veto them, in which case they go back to Congress to override the veto or create new bills.<sup>12</sup> But they must be passed before the new Fiscal Year starts on September 30<sup>th</sup>; unlike the Budgets, and there are real problems if this deadline is missed.

In recent years, Congress has frequently passed **Continuing Resolutions** ("CR"), rather than true Appropriations Bills. Theoretically, these just

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<sup>7</sup> The CBO helpfully [maintains a web portal](#) for analysis of Presidents' Budgets.

<sup>8</sup> While it is a good fun to laugh at the President's Budget, it is an important communication tool for the Executive Branch. The first document in a process like this is always going to be heavily revised; the President just got unlucky that the law says he has to go first.

<sup>9</sup> As far as I can tell, the only recent Budget resolution that was completed on time was FY2014, which passed on March 23, 2013. This was the year the "No Budget, No Pay" Act withheld Congressional pay if a budget wasn't passed on time. This was also a weird year because President Obama's budget wasn't sent to Congress until mid-April – after Congress had already passed theirs.

There was no Congressional budget passed at all for FY 2011, 2012 or 2013.

<sup>10</sup> This common sense structure came into place in 2007, a mere thirty-three years after the 1974 CBA created the modern budgeting process.

<sup>11</sup> Hey! We talked about how that happens [a few Volumes ago](#).

<sup>12</sup> For more on the Appropriations Process, see the [Congressional Research Service](#). I intentionally skipped one step, "Authorization." You also might find it interesting to see what Appropriations Bills look like – here is [HR 5325](#) (a Continuing Resolution, but same structure). Look at the level of detail – I just think it's incredible that this gets figured out at all.

continue the Appropriations from the previous fiscal year, hence the name. Sometimes they are written in language explicitly linking spending levels to the previous years, increased or decreased by a percentage. A big difference with CRs is that they have flexibility of duration. For example, if the September 30<sup>th</sup> deadline is approaching, Congress could pass a CR covering just a few days while they finish the Appropriations Bills. But, CRs have become more common in recent decades, leading to some Fiscal Years being funded largely with a series of short-term CRs.<sup>13</sup> This is not a sign of good governance.

### Where does all that money go?

Now that we see how the decisions are made, we can get into the details – where the Federal Government actually spends its money. The Government does a lot of things, some of which you probably think are wonderful and some terrible. For the next few pages, we won't care about what the Government does, only where it spends its money.

It is surprisingly difficult to find a simple, clear list of exactly where the money is going. One reason for this comes from the process described above: there is the President's Budget, Congress's Budget and Appropriations Bills. And of course, even the Appropriations don't match spending exactly – it's impossible to predict down to the penny where each dollar will be spent. If you spend a couple hours searching around for "definitive" figures, you'll just end up with a big spreadsheet of numbers that don't quite tie out and knowledge of what a "federal subfunction code" is.<sup>14</sup>

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<sup>13</sup> [A list of recent CRs](#). 2001 was especially troubling.

<sup>14</sup> Source: Well this is how I spent my morning. In order to make some sense of how it spends its money, the Government creates a hierarchy, and subfunction is one level of the hierarchy. Federal subfunction codes are more frequently referenced by a number than a name (e.g. "959" rather than "Other undistributed offsetting receipts").

This is a long-winded way of saying that I'm just going to take a mess of sources and do my best with them.<sup>15</sup> There are two basic ways to look at spending: by function (e.g. Health) or by department (e.g. Treasury). We will use the former because I think it gives a clearer picture; if the money for Air Transportation comes from programs in several different departments, it's going to the same place.

- *Medicare and Health: \$1,106 Billion, 29% of total*

This is the biggest and the fastest growing. Most (\$1,069 billion) of health spending is mandatory. The largest amount of this is spent on Medicare, \$594 billion. The rest is on Medicaid, CHIP, some smaller programs, and the subsidies on the exchanges for the ACA (\$33 billion).<sup>16</sup> There is also \$31 billion for health research, almost all of which goes to the National Institutes of Health.<sup>17</sup> Veterans health care is not included here.

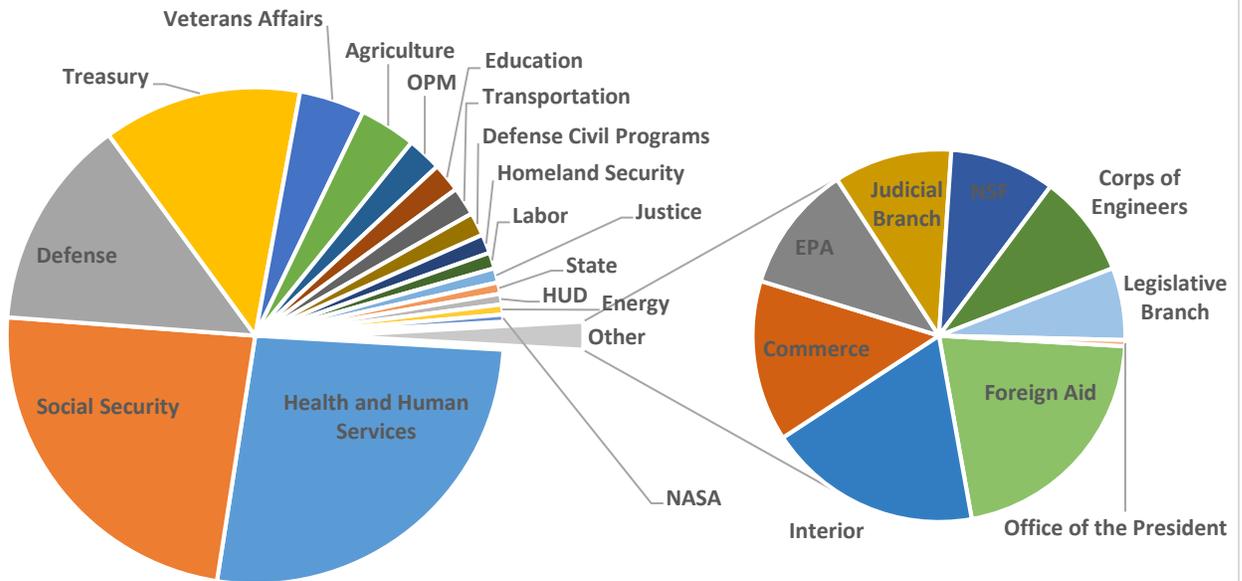
This is enough money to fill the Empire State Building with \$1 bills – with a few singles to spare.

<sup>15</sup> So don't audit me here. Sources (all 2016 unless noted): [insidegov.com](#); [CBO](#); [OMB via Wikipedia](#) (2013); [CBPP](#); [usfederalbudget.us](#); [Obama White House archives](#). I believe that these are all reputable; which one is "right" depends on the **exact** question you are trying to answer.

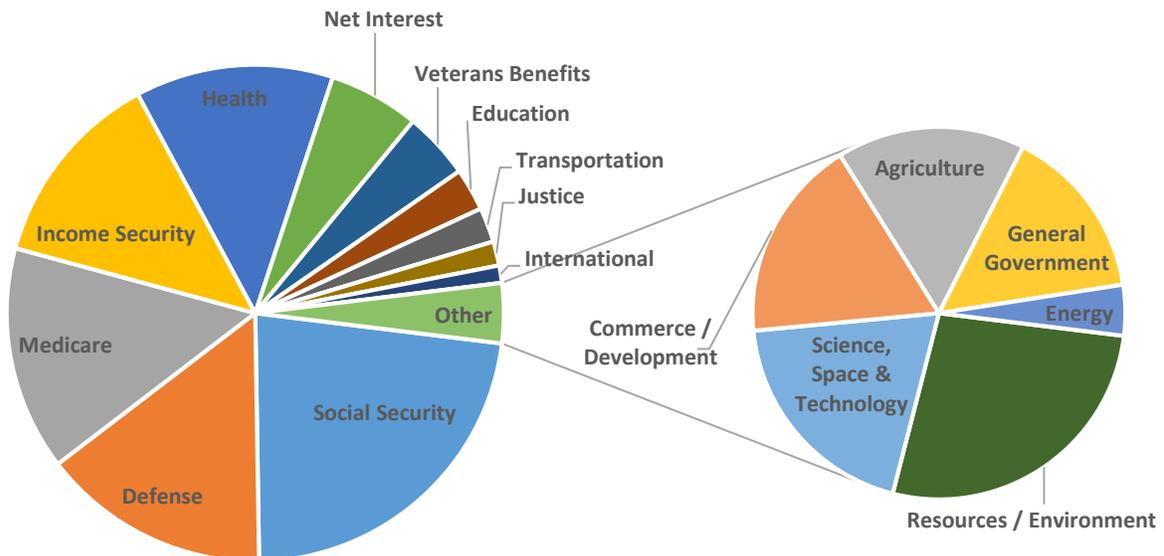
<sup>16</sup> [We've talked a lot about these programs in previous Volumes](#).

<sup>17</sup> Which, in turn, [awards about 80%](#) of this to external researchers via a competitive grant process.

### 2016 OMB Estimates - by Department



### 2016 OMB Estimate - by Function



- *Pensions: \$984 Billion, 26%*

Pretty simple:<sup>18</sup> this is Social Security. \$832 billion goes to the Old Age and Survivors program, the rest to Disability. Again, veterans’ benefits are still to follow.

If you convert this to \$20 bills, \$984 billion would weigh as much as 20 Olympic-sized swimming pools. Filled with water.

- *Defense: \$595 billion, 15%*

As I’m sure you are aware, the United States spends as much on defense as the next six or seven countries combined. The breakdown is also interesting; the salaries (“personnel”) portion is smaller than I expected.<sup>19</sup>

Function	Spending (\$B)	Percent of Total
Personnel	148	24%
Operation and Maintenance	248	41%
Procurement	103	17%
R&D	65	11%
Construction, Housing, Other	11	2%
Nukes	19	3%
Other non-DoD	9	1%

Again, this doesn’t include spending on Veterans’ benefits. I promise I’m not ignoring them, they will be coming up soon. It also doesn’t include foreign aid.

It’s enough money to give every Syrian an amount of money sixteen times their country’s average income.

<sup>18</sup> OK, not really that simple. We wrote [a Volume](#) on this one too.

<sup>19</sup> These numbers don’t quite add up to the \$595 billion shown above. This chart is from Pres. Obama’s OMB vs. the total which is from Appropriations. Note that the

- *Welfare: \$368 billion, 10%*

This is a catch-all for means-tested programs other than Medicaid. The Supplemental Nutritional Assistance Program, aka “Food Stamps,” costs \$105 billion. Unemployment insurance cost \$35 billion and housing assistance \$48 billion. Disability insurance is another \$44 billion. What you think of as “Welfare” – called Temporary Assistance for Needy Families – costs \$18 billion. The rest is made up of tax rebates, with the Earned Income Tax Credit and Child Credit being the largest.<sup>20</sup>

You could build your own International Space Station with this money. And a spare, just in case.

- *Interest: \$240 billion, 6%*

No real way to get around this one. In longer-term projections showing high debt-to-GDP ratios in the future, increased interest spending is a large portion of the problem. The CBO and OMB (and others) expect US Government borrowing costs to rise significantly.

Amazingly, Apple has about this much cash on its balance sheet. It’s also enough to buy an iPhone 7 for every man, woman and child in the USA.

- *Veterans: \$174 billion, 5%*

See, just like I promised. We actually spend more direct money on our veterans than our active-duty personnel. This is because we currently have 2,800,000 Department of Defense employees (1,300,000 active-duty, 800,000 reservists and 700,000 civilian) against around 22 million veterans. Veterans benefit spending is split exactly down the middle between pensions and health care.

nuclear arsenal is largely managed by the Department of Energy.

<sup>20</sup> [This is a good overview](#) of federal subfunction 609 which includes “Other Welfare” spending. Almost no welfare spending today consists of cash payments directly made to lower-income people.

You could buy a very inexpensive cellular phone plan for everybody in the world. That actually isn't that impressive.

- *Education: \$120 billion, 3%*

This sounds like a lot – but the Federal input to US education spending is only 11% of the total. Education is mostly a state and local issue. Federal spending is split roughly in thirds. Primary and Secondary education get money for Head Start and various grants. Tertiary education spending goes mostly towards Pell Grants. Then there is \$44 billion dollars that go into a catch-all for job training, vocational schools and many smaller programs.

It's enough money to build around 7,000 new elementary schools each year.

- *Transportation: \$92 billion, 2%*

The majority, \$68 billion, of this goes to ground transportation, mostly roads. Air transport makes up \$21 billion and water the remainder.

This \$92 billion is equivalent to building around 4500 miles of new Interstate Highways.

- *Foreign Relations: \$61 billion, 1.5%*

About \$15 billion each to foreign military aid and running the State Department (e.g. maintaining embassies). The balance, \$33 billion, goes to foreign aid, representing less than 1% of the federal budget.

It's also what we spent annually on the Iraq War.

- *Government Operations: \$43 billion, 1%*

The Federal Court system cost us \$24 billion last year, and the Legislative and Executive branches added on \$13 billion.

It's enough money to buy a membership at Mar-a-Lago for every resident of Boise. At the new price.

- *Protection: \$33 billion, 1%*

The FBI, ATF and other Federal law enforcement costs \$27 billion. Federal prisons were only \$6 billion – this one surprised me too, I would have guessed much more.

If you had \$33 billion, the Walton siblings would still be slightly richer than you.

- *Other: \$52 billion, 1%*

A bunch of smaller budget items. Farm subsidies cost \$19 billion, slightly more than we spend on NASA. Land management and other environmental programs cost \$20 billion, and an additional \$7 on water.<sup>21</sup> Community development takes up \$21 billion and the National Park System \$3 billion. This is offset by around \$50 billion of profit from government programs to insure mortgages (FHA) and deposits (FDIC).

There it is - \$3,853,000,000,000 goes a long way.

What if the process doesn't work?

Going back to our process, there are clearly some ways that it can go off the rails. They range in severity from Pundits Clutch Their Pearls to Wow Isn't This Annoying to We Might Be Living in the 18<sup>th</sup> Century Again.

- Congress fails to pass a budget: "Pundits Clutch Their Pearls"

As we said, the Federal budget is important but mostly symbolic. As Washington has become more partisan and more dysfunctional over the last two decades, the cerebral budget process has become harder to complete. Practically, this hasn't mattered to the everyday American. Do you even know if a budget was passed this year?<sup>22</sup>

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<sup>21</sup> Seems like a steal at \$20 per person per year.

<sup>22</sup> It was, but only because it was a vehicle used to repeal the ACA. Before 2015, there were five consecutive years without a budget.

The budget should be an important planning document; it should set out priorities for our government for longer periods than the annual Appropriations Bills. The process should help departments to think about their true funding needs, which are then prioritized by the Administration and codified in Congress. But, the process has clearly evolved, with appropriations becoming more important at the expense of the budget. We really should amend the 1974 CBA to account for how things really work. But in today's world, major concerns about the lack of a symbolic document seem a tad quaint.

- Appropriations bills aren't signed into law: "Wow Isn't This Annoying"

As you now know, appropriations bills<sup>23</sup> are where the rubber meets the road and the decisions made. If they are not passed by Congress and signed by the President before the hard deadline, the Government is not funded. This is a "government shutdown".

The possibility of government shutdowns exists because of the separation of powers between our Executive and Legislative branches. According to the Constitution, the Legislative branch must approve all spending. If they are unable (or refuse) to do so, then the Executive branch – in theory – can't spend any money. In practice, until about thirty-five years ago, Congress had little way to force the President to stop spending; after all, the President is the guy with an army behind him. Amendments to what was called the Antideficiency Act put some teeth behind Congress's power of the purse.

Today, if the government is not funded, all departments must stop "non-essential" work. Many

employees are furloughed and agency activities halted.<sup>24</sup> In theory, a shutdown should affect only programs funded by the discretionary spending contained in the appropriations bills. In practice, if the employees of the Social Security Administration are not considered essential (and they aren't) then the mandatory-spending Social Security checks won't go out.

Government shutdowns are more unhealthy than unpassed budgets. Government employees are especially affected – they may not get repaid the salaries lost during their furlough.<sup>25</sup> Television always shows popular attractions like National Parks being closed. But critical portions of the government that you never see are also halted: processing NIH grants, infrastructure work, even the court system, if the shutdown lasts long enough. If the shutdown is brief, maybe a couple days, then a shutdown should be just a high-level nuisance. That said, we have never faced a shutdown of more than a month; at that point, it could start to create significant economic effects.

- We breach the debt ceiling: We Might be Living in the 18<sup>th</sup> Century Again

We've never breached the debt ceiling. We don't know what would happen. But for once, I don't take a circumspect view and try to see both sides: I am a debt ceiling alarmist.

The debt ceiling is a piece of legislation that sets a hard cap on the total amount of debt that can be issued by the U.S. Treasury. Sounds like a reasonable way to constrain the debt – but there is a problem. The level of the debt ceiling is set without taking into account the obligations taken on through mandatory spending and the

not really overpaid. They aren't underpaid either; it depends on how you value cash compensation against benefits and job security, and control for various factors like education level. [Here is a short piece](#) discussing it, or you can find 1000 pieces of evidence to support whatever your personal view is on this topic.

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<sup>23</sup> Or, alternatively, continuing resolutions.

<sup>24</sup> Obviously, there is [a long document](#) describing exactly how furloughs will work.

<sup>25</sup> Yes, they usually get them back after it is settled, but no, this is not a good thing. These employees are a big part of the economy, which suffers due to government shutdowns, hurting you. Also, government employees are

Appropriations Bills. This sets up the possibility of a conflict.<sup>26</sup>

The first version of what evolved into today's debt ceiling was passed in 1917. Since then, it has been raised around 100 times, in various forms. Many of these have been simple and clean, especially when one party controlled the entire government.

However, on several occasions, both parties have taken the debt ceiling hostage in an attempt to achieve some policy goal. Most critically, in 2011, the Republican Congress took the game of chicken too far, rattling financial markets and causing the Federal debt to be downgraded by S&P.

What would happen if we breached the debt ceiling? Again, we don't know – but here is what I think.

If we reached the debt ceiling, the government would be unable to pay some of its bills on time. This is true even if a deficit is not being run; Federal cash accounts vary over the year due to the nearly random nature of inflows and outflows. Now, if the debt ceiling breach only lasted a short period, maybe this wouldn't be such a big deal. Maybe, the Federal government could act as if in a government shutdown: pay the critical bills and delay others until the crisis is averted. Federal District Judges will be upset to have their paychecks delayed by a couple days, but this could theoretically avert disaster.

But there is a serious problem. In the lead-up to the 2011 Debt Ceiling Crisis, President Obama's Treasury Department made clear that they did not have the ability to prioritize payments in this way. Legally, the Treasury was required to pay the bills as they came due; technically, they just didn't have a system to prioritize outflows. If, like me, you don't think it was a bluff, then a debt ceiling breach will

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<sup>26</sup> The House made some attempt to solve this problem during the period 1980-2010, when the [Gephardt Rule](#) was in effect. This parliamentary rule caused the debt ceiling to be raised automatically when spending was approved in the House; a separate vote wasn't necessary.

necessarily cause a default on some pieces of US Government debt.

Banks depend on the treatment of this debt as default-proof; this assumption is the bedrock of how they are capitalized. A default – even if just technical, even if only on some debt, even if just for a day – would cause at a minimum a breakdown in all of the mechanisms that fund our economy in the short-term. Commercial paper markets, repo markets, short-term asset financing – I think that these would freeze completely.

Do you know who relies on these types of funding? The utility that generates your electricity and the one that provides your running water. The company that owns the trucks bringing food to your grocery store. The city and state that you live in and the public services they operate like Fire and Police Departments. Hospitals, doctors' offices, airlines, and seaports.

Maybe I'm wrong and a one-day debt ceiling breach wouldn't cause our entire country to stop in its tracks. Do you want to find out?

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Well that was a pleasant little ending.

Seriously, the debt ceiling is a completely pointless instrument. It allows politicians to grandstand against government borrowing without actually doing anything. To grandstand with an economic suicide vest strapped on.

If a politician is worried about the long-term fiscal picture, then they should do something. Convince the public that they don't need those new roads or that new health care or that we should raise the taxes on investment income. Then write this into

Rules like this in both Chambers would largely defuse the the debt ceiling time bomb. Of course, Congress makes its own rules, so the bomb could be rearmed. In fact, the original Gephardt Rule was waived or temporarily repealed for 11 of the 30 years it existed.

the tax code and Appropriations Bills and pass them. The debt ceiling has never forced this to happen.

Many people, politicians and civilians, talk about cutting government spending. They talk about the perils of debt and ask why we spend money on this and that instead of the other thing. You can make arguments that we should tax and spend less; you can also make arguments that we should spend more or at least create a tax policy allowing for current spending. This is a decision we need to make as a society: what services do we want to pay for.

But I'll close with a word of warning. Maybe you knew this, or maybe you were surprised, but 85% of Federal spending is on health, pensions, military or interest on the national debt. The old saying is true: the government is just an insurance company with an Army. When a politician says that they want to cut spending by eliminating the famous trio of "waste, fraud and abuse" they are not being honest with you. If we want to cut spending in a way that is meaningful to the big picture, you are either putting seniors into poverty (cut Social Security or Medicare), preventing the working poor and children from getting food and medical care (cut Medicaid, CHIP or SNAP) or cutting the military. All other spending combined is peanuts.

Or, I guess you could just not pay the interest. But as we saw, that might not work out so well.