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Portfolio Budgeting: How a New Approach to the Budget Could Yield Better Decisions

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Executive Summary

The process now used to develop the federal budget is biased toward the incremental, the short term, and the familiar. It also is piecemeal and fragmented, considering issues in narrow programmatic categories and giving most scrutiny to marginal changes in spending, largely ignoring tax policies. The way budgets are developed is too often blind to the major shifts sweeping over the nation's economy and social structure. The result is little change and inadequate focus on national priorities or how to achieve them more efficiently.

An alternative, goal-focused "portfolio budgeting" approach would group together and thus look broadly across sets of closely related programs, tax provisions, and regulatory policies affecting common policy goals. Building on growing executive branch experience with strategic analysis and reviews, this approach would use policy makers' time more efficiently by helping them focus on the biggest opportunities to adjust policies and resources to accelerate the achievement of major national goals and identifying breakthrough gains in productive use of resources.

For a selected policy objective, budgeting would begin by identifying the set of federal policies, spending programs, regulations, tax preferences, and other activities that constitutes the relevant *policy portfolio* for analysis and budgeting. The relevant portfolio would cut across agency boundaries and congressional committee jurisdictions. As illustrated here for higher education policies, analysis would assess how effectively resources are being used to achieve a given policy goal and whether alternative policies could yield a better result at lower cost. The unit of analysis for budgeting would shift from programs to strategies, using a longer time horizon to estimate benefits and costs and new methods to analyze the behavior of complex systems.

Much has been written about the broken congressional budget process and the need to fix it, or at least to get it working again. Less attention has been paid to the executive branch's budget process, which begins almost a year before Congress's and sets the stage for what follows. Both can be improved in ways that will lead to better budget decisions and smarter use of resources. We offer a specific suggestion for a new approach, one that ideally would be introduced at the beginning of the next Administration. This paper summarizes the approach we developed in a recent study (Redburn and Posner, 2015).

Today the annual federal budget process is largely on automatic pilot. In those increasingly rare times when Congress in fact passes a full set of appropriations—which accounts for just about one-third of all spending — typically the funding decisions only marginally adjust past resource allocations. Moreover, these are usually focused on modest and ameliorative policy adjustments, or political disputes, rather than on the bigger choices that could produce breakthrough gains in resource productivity or set course towards a national goal. In short, the process is biased toward the incremental, the short term, the familiar, the bird in the hand. It is tactical and narrow, not strategic and global.

The current budget process also is piecemeal and fragmented. Congress considers issues in narrow programmatic categories. In the current process, it is rare to see similar programs compared within or across agencies to measure their effectiveness or whether, together, they pursue a coherent and clear objective. Moreover, while spending programs receive close scrutiny in the development of the President's budget proposals, so-called "tax expenditures" typically receive far less (Burman and Phaup, 2011; GAO 1994). They are, for the most part, reviewed in a separate process led by the Treasury Department. In Congress as well, revenue provisions are in the domain of separate committees and are only rarely considered in relation to spending for the same policy objectives.

It could be said that these procedures simplify the task in some ways, and in a sense make it more manageable, but the result is little change and a budget process that fails to keep a sharp focus on national priorities and how to achieve them more efficiently. It is also too often blind to the major shifts sweeping over the nation's economy and social structure, whether it be climate change, the nation's infrastructure, or the aging of the population. Budgeting today is more of an exercise in hindsight than foresight, building on the familiar and ignoring large opportunities to better match resources with emergent policy goals and problems.

An Alternative: Portfolio Budgeting

A different organization of proposals and information on budget choices presented to Congress in the President's budget could help address these shortcomings. It could provide a more effective template for reorganizing the way Congress considers fiscal choices and help lawmakers, the press and the public to focus much more on major policy goals. This alternative, goal-focused approach would group together and thus look broadly across a range of closely related programs, tax provisions, and regulatory policies affecting common policy goals. The process we have in mind would assess the collective impacts of what are today fragmented initiatives and examine the likely benefits and costs of budget alternatives. Under our proposal, these elements would be considered as a system in the budget process, and could be more easily seen as a strategy to achieve a particular policy goal. This approach would use policy makers' time more efficiently by helping them focus more attention on the most important national goals and positioning them to seize the biggest opportunities to adjust policies and resources to accelerate the achievement of broad goals.

Refocusing the budget process on strategic priorities would require a two-track budget development process. Each year:

- **On Track 1**: The administration and Congress would continue to formulate budgets in some areas using current procedures.
- **On Track 2**: The administration and Congress would employ a "portfolio" approach for a handful of major policy objectives as described below, allowing it to consider certain strategic policy choices more comprehensively and in more depth.

The approach we suggest would begin by identifying the set of federal government policies, spending programs, regulations, tax preferences, and other activities that constitutes the relevant *policy portfolio* for analysis and budgeting. For any major policy objective, the relevant portfolio would cut across agency boundaries and congressional committee jurisdictions. It also would interact with the activities of other levels of government and nongovernmental actors. It is the policy portfolio, operating in a larger system of relationships, that needs to be analyzed for Congress and the public to see clearly how effectively resources are being deployed to achieve a given policy goal and whether an alternative set of policies could yield a better result at lower cost.

Higher Education: An Example

Let us use federal support for higher education as an example of how the portfolio approach would work. The federal budget includes an array of separate grant and loan programs and tax expenditures to help students pay for college, including such items as special programs for veterans. The government also conducts many grant programs for university research and for other higher education purposes. Collectively, these programs are intended to expand access to higher education and to strengthen educational institutions, with the aims of enhancing economic mobility and opportunity for students and of achieving better national economic performance and competitiveness. Recent analyses suggest this set of policies is ripe for review (Elliott and Lewis, 2015).

This fiscal year, federal spending for higher education will exceed $75 billion, slightly more than the states are expected to spend for their public higher education institutions (Pew Charitable Trusts, 2015). An additional $30 billion of revenue losses will result from 11 provisions of the tax code that favor income used to support higher education. These tax expenditures convey subsidies that are very similar to spending programs. As shown in figure 1 for the most recent actual year's data available, the federal budget provides over $100 billion annually to support higher education, much of it intended to expand access by directly subsidizing tuition and other expenses or by supporting investments in research and facilities.

Figure 1

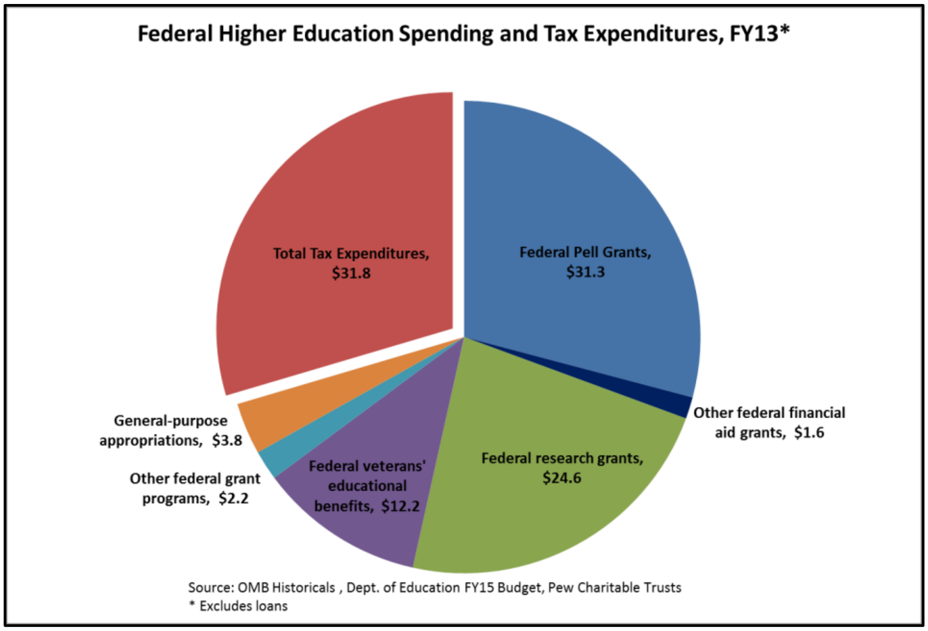
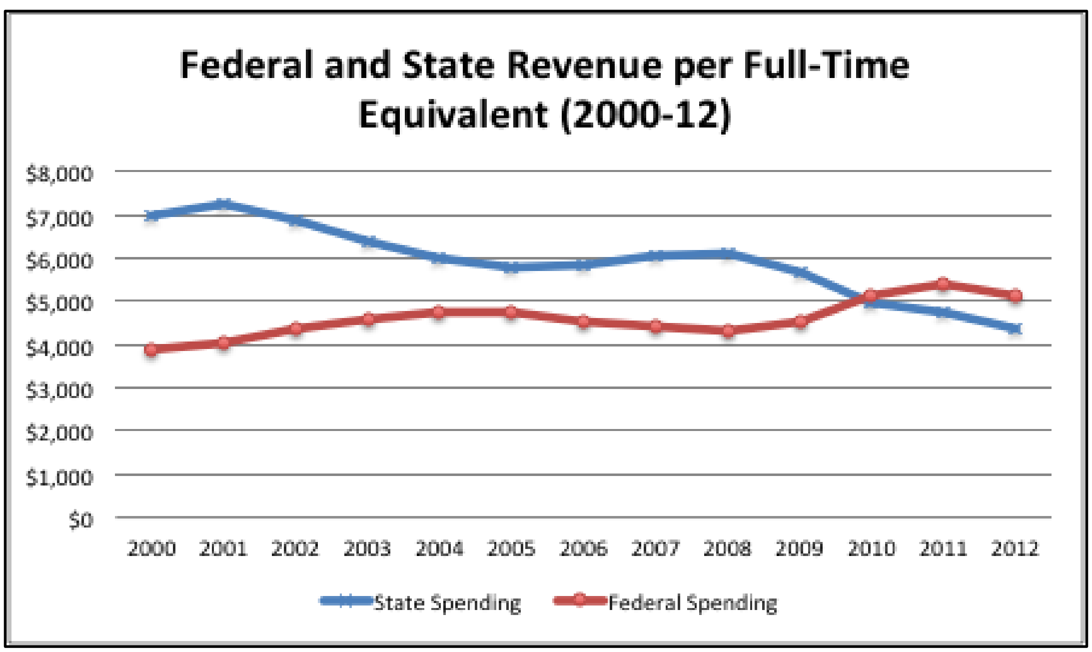


Figure 2 shows the trend in spending by the federal and state governments per student for the fiscal years 2000 - 2012. As federal higher education spending has increased, it has surpassed states' combined spending.

Figure 2

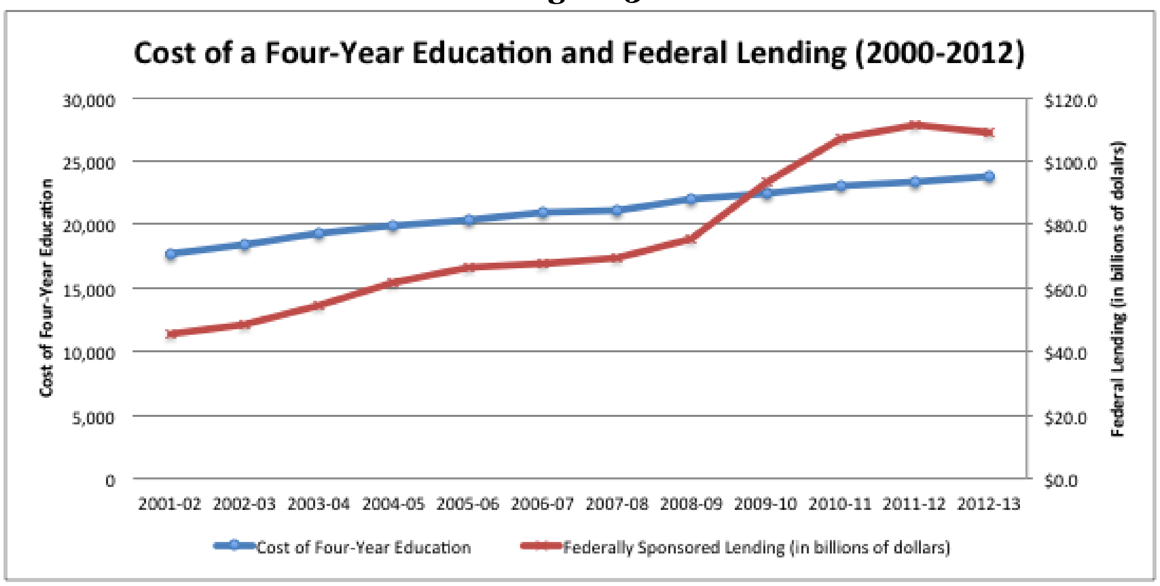
State and Federal Funding for Higher Education (FY 2000-2012)



Sources (from Pew): Pew's analysis of data from the U.S. Department of Education, State Funding History Tables (FY2007-13); National Science Foundation, Survey of Federal Funds for Research and Development (2007-13); State Higher Education Executive Officers Association, State Higher Education Finance Report: FY 2014 (April 2015); National Association of State Student Grant and Aid Programs, Annual Survey Report on State-Sponsored Student Financial Aid (2007-13); and U.S. Department of Veterans Affairs, Annual Budget Submission (FY2009-15)

The largest component of federal support is direct federal lending to help students and their families pay for college. When these funds are combined with grants and tax subsidies to support college costs, the federal government was the source of roughly two-thirds of all higher education financing in 2012 and 2013 (Pew, 2015). The government's cost for its lending, including costs when loans are not repaid, is offset by fees, so in most years the budget records these loans as producing net receipts that reduce deficits. However, this does not measure the full impact of federal lending; currently the outstanding volume of college loans totals over $1 trillion, and in most recent years over 20 million new student loans have added at least $100 billion annually to college debt. As shown in figure 3, while the volume of federal lending has increased over time so have college costs — making it harder for students to pay for college without going into debt. Unlike past generations, few people of modest means today have the ability to pay for or work their way through college. More start their post-college careers burdened by debt, and many default. Income used to repay college debts cannot be used to build wealth, reducing the economic returns to higher education. Default can have disastrous financial consequences for students and their families. Often, students end up with disappointing personal returns and debts that they are unable to repay.

Figure 3



Sources (left axis): U.S. Department of Education, National Center for Education Statistics. (2015). Digest of Education Statistics, 2013 (NCES 2015-011), Chapter 3.

Sources (right axis): Pew's analysis of data from the College Board, Trends in Student Aid (2014), based on original data from the U.S. Department of Education, Office of Postsecondary Education, National Student Loan Data System

Federal funding, with its associated regulations and administrative requirements, helps support and shape a robust and flourishing array of public and private colleges and universities, competing for students based on price, educational offerings, amenities, location, and other benefits. In many ways, U.S. higher education is the envy of the world. But at the same time, many questions have been raised about how effectively the current system of federal grants and loans is actually contributing to access by those who otherwise would not attend college and whether the increasing reliance on debt is reducing the personal economic returns that otherwise would accrue to those receiving federal support (Gorman 2015; Fry 2014). A body of research and empirical evidence raises questions about the effectiveness of current federal strategy when compared with alternatives (Elliott and Lewis, 2015). One common finding is that both the range of options and the interactions among student loan and grant programs are difficult to understand and challenging for students to calculate how best to use them. A Government Accountability Office (GAO) report showed that the interactions among programs can often be perverse for families, as participation in one program can triggers a corresponding reduction in aid from others (GAO, 2012).

The Portfolio Approach

While federal aid has grown, the myriad of subsidies and programs has not been considered holistically in the budget process, but rather has grown up in an ad hoc fashion, with programs incubated in different congressional committees and federal agencies. The time is ripe to review the many programs and subsidies together in relation to clearly specified policy goals.

To do that properly, Congress needs to conduct a deep, comprehensive and systematic examination of the entire portfolio, beginning with a reconsideration of the appropriate national policy goals for that system. Using the best available evidence and analysis, Congress would then proceed to ask whether these goals are being met as effectively as they could be by current federal tax, spending and regulatory policies. This portfolio review, which would be broader than traditional reauthorizations and cut across multiple committee jurisdictions, would ask such questions as:

- How effective has federal funding and tax policy been in achieving national policy objectives – including increased access to higher education that leads to better employment and increased earnings, support for specialized curricula for teachers and science and engineering education, and various research topics?

- How does achievement of these policy goals contribute to other policy objectives, such as national economic growth and competitiveness?

- How much federal support actually goes to people who otherwise would not attend college and how much to families who can afford to pay for their children's college?

- What is the net return to students on their own investments, and how many are unable to pay off their debts after graduation?

- To what extent has federal support been offset by tuition increases by universities and by reductions in state spending?

- What would increase the accountability of colleges and universities for producing results that have economic value to their graduates?

- What is the return to federal investment in university research?

- How do universities and colleges use their funding from federal subsidies, and is this use mainly supportive of national purposes?

Tracing these flows and their net effects is challenging, given the complexity of the federal government's implicit and rather ill defined strategy for higher education and the complexity and diversity of the nation's higher education system. Proper analysis requires assessment of the whole system of interactions, including regulation and other policy tools, rather than merely evaluation of individual programs.

The final stage of a portfolio review would identify alternative strategies for federal support that evidence suggests could yield higher returns relative to the federal government's policy objectives and improve outcomes for those receiving federal aid.

Higher education is just one of many examples of portfolios directed to major national policy objectives where systemic analysis conducted periodically on a rolling basis could identify ways to substantially increase the productivity of limited public resources, shifting from lower return to higher return uses.

Implementing a Portfolio Approach

Is it feasible to reform the budget process in this way? Fortunately, the change would build on a growing base of agency experience over the last two decades with strategic planning, targeting of measurable outcomes, and use of evidence to inform budget choices. This includes the spread of quadrennial strategic review processes, which began in the Department of Defense (QDR 2014) and are now used as precursor to more detailed planning and budgeting by the Departments of Homeland Security, State, and Energy.

The Government Performance and Results Act Modernization Act (GPRAMA), enacted in 2010, provides a statutory framework on which to build portfolio budgeting. It requires federal agencies to conduct annual data-driven strategic reviews of their goals and objectives and to use the results to inform policymaking, budget formulation, management strategies, and near-term agency actions. The enhanced strategic goals focus of this legislation is now fostering a more networked governance approach to achieving strategic objectives, largely managed by the Office of Management and Budget (OMB), but it is overlaid on the traditional bureaucratic hierarchy, which raises complicated issues of accountability, loyalty, incentives, legitimacy, communication, and conflict management. Moreover, the current process lacks explicit connection to budget process. Nevertheless, it has laid in place important building blocks, including a comprehensive set of explicit policy objectives and select performance targets. With some modifications it can be used to develop a portfolio approach.

Necessary Steps

What steps would be needed to make this kind of budgeting a practical alternative to the current process? As part of the transition to a new two-track budgeting process in the executive, the portfolio approach could be organized by policy objective, changing the unit of analysis from program to strategies. New modes of analysis for strategic budget reviews could be developed and applied to the budgeting for major policy objectives. New methods would have to be developed to estimate long-term public productivity gains in relation to these objectives. More specifically:

1. Change the unit of analysis and decision. Budgeting by major policy objective and associated policy subsystems requires reorganizing part of the information supporting executive budget development around portfolios of programs and policies relevant to selected major national policy objectives. This would enable analysts to model and estimate the combined and interactive benefits and costs of the associated policies and programs, including tax expenditures, and of alternatives to current policy and resource uses. Rather than presenting individual programs for decision, in other words, the budget would present the portfolio of policies most directly contributing to an important policy objective, and would quantify their interactions and joint effects, including the marginal benefits and costs of increased or decreased resources. The budget also would present evidence comparing benefits and costs of the current strategy/portfolio with alternative strategies that represent dramatically different approaches.

2. Change the timeframe of analysis and decision. Because major policy goals take years to achieve or even to show progress, the timeframe for analysis of portfolio budget and policy alternatives for these major national goals would have to be commensurately longer. Strategic analytics could bridge from long-range visioning and foresight exercises to practical questions of program design, management, and budgeting. A handful of major strategic policy questions would be taken up every year or so, with enough lead-time to conduct deep analysis of alternative strategies prior to the time when budget decisions are required.

3. Change modes of analysis. To tackle big and difficult policy problems and achieve breakthrough gains in goal achievement requires the ability to model the behavior of complex systems, including causal relationships and interactions. New methods to address uncertainty and risk would help estimate the projected effects of alternative strategies. Sophisticated and varied policy scenarios would be developed and combined to estimate their long-term fiscal effects relative to a baseline projection of current policies.

The Best Timing

The best time to reformulate the executive budget process in this way would likely be in the first year of a new presidential administration. Because agencies' strategic planning is now synchronized with the presidential election cycle, an incoming administration could set the stage for this approach to the budget by committing itself to a specific set of policy achievements over the four years of an administration or for a longer period. Thus, a new President and agency leaders could use the first year to set new policy directions and then to conduct portfolio reviews for some of the largest national goals, introducing the recommended shifts in policy and resource use in the first full President's budget to be presented to Congress in February 2018.

Those who have been involved in developing the President's budget or viewed it at close range see an opportunity to reform it in ways that could improve the choices made about how to use resources to help achieve the largest public policy goals. Because its process is not defined by statute, it is easier for the executive to restructure its budget processes than it is for Congress to agree on and adopt comparable changes, so it makes sense to start with the executive.

It would be wise, we believe, for a new administration to engage with Congress as it begins the proposed reform. In addition to being mandated by GPRAMA, prior consultations with relevant congressional committees and leaders would increase the probability Congress would address some of the policy objectives selected for portfolio review in its own legislative and budget processes, taking advantage of the Administration's work on alternatives to the extent it chooses.

If, over time, portfolio budgeting demonstrates it can yield better decisions, Congress should use it as a template for their own reforms. Congressional committees could participate in setting targets for policy and committing in advance to consider the recommendations of major portfolio reviews. In its own budget process, Congress could institutionalize parallel portfolio reviews within the budget resolution for selected policy goals. Should Congress move to a biennial budget process, as some have recommended, portfolio reviews could be conducted by the budget committees in the off years. Such changes would become even more feasible if the budget committees were strengthened to become instruments of House and Senate leadership in setting priorities and shaping the annual budget process.

Payoffs of a Portfolio Approach

The payoffs of reforming the budget process to devote more focus and energy to analysis of strategies to achieve major national policy objectives would be considerable. It would bring forward for decision major policy shifts that would better address the nation's longer-term challenges and complex, difficult problems. It would sharpen and clarify national policy objectives by resolving long standing problems spawned by our highly fragmented program structures. Unlike the current process, a portfolio approach promises to identify breakthrough gains in more productive use of resources. This might identify budget savings that could be reinvested in the same or other policy priorities or uses that promise higher long-term returns. In short, portfolio budgeting could help leaders and the nation to achieve our most important policy priorities.

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