

Chapter 2

Getting to Balance: Three Alternative Plans

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When a budget is in deficit there are only two ways—other than faster growth in the economy—to bring it into balance. Spending must be cut or revenue increased. Both are difficult to achieve politically and sure to cause pain. After all, deficits do not happen accidentally. Spending programs are enacted because a majority of Congress deems the activities they support to be necessary or at least desirable. Beneficiaries of federal spending—whether they receive Medicare or a contract to build Navy airplanes or work in a local Head Start program—are sure to oppose cuts in their particular program. Moreover, they are likely to be more vocal than those who might benefit marginally from the corresponding cut in the deficit. Similarly, tax increases are certain to be unpopular. Even if the group whose taxes are raised is small, its members will argue strongly that the increase is damaging and unfair, while the larger group that stands to benefit from deficit reduction is unlikely to express support for the increase.

In this chapter we illustrate three plans for reaching balance in the unified budget over the next decade—plans that differ in the way they mix spending cuts and revenue increases to get to balance (table 2-1). For convenience we call them the smaller government plan, the larger government plan, and the better government plan. All three plans start from the adjusted baseline projections described in chapter 1. These projections indicate that, in the absence of policy change, the deficit in 2014 will be about \$687 billion. Balancing the unified budget by that year will produce interest savings of around \$153 billion, leaving a deficit of \$534 billion to be eliminated by spending reductions or revenue increases. Choosing the more stringent criterion of balancing the budget excluding the federal retirement programs necessitates additional deficit

Table 2-1. *Illustrative Changes in 2014 by Plan Type*
Billions of dollars

<i>Item</i>	<i>Smaller Government Plan</i>	<i>Larger Government Plan</i>	<i>Better Government Plan</i>
Total deficit reduction	687	687	687
Interest payment reduction	-153	-153	-153
Tax increase	134	629	401
Programmatic spending net change	-400	95	-134
Defense net change	0	-60	-60
Increase	0	0	0
Decrease	0	-60	-60
Non-defense net change	-400	155	-74
Increase	0	185	41
Decrease	-400	-30	-115

Source: Authors' calculations and Congressional Budget Office, "The Budget and Economic Outlook: An Update," August 2003.

reduction of \$316 billion. As the plans amply illustrate, even meeting the less ambitious target requires tough choices that are sure to be unpopular.

Our three plans reflect three contrasting views about the role of the federal government. The smaller government plan emphasizes spending reduction and is likely to appeal to people who believe that

- the federal government is too big and has taken on too many responsibilities;
- with the exception of national security, the objectives of many federal programs could be attained more effectively by states, localities, or private organizations and individuals;
- the economy would operate more productively if the federal government were smaller and less intrusive.

The larger government plan, by contrast, emphasizes revenue increases and cuts in defense spending to fund existing domestic programs and new initiatives. It will appeal to those who believe that

- most domestic programs of the federal government should be continued;
- new initiatives should be added to achieve such goals as helping low-income people, preserving the environment, or improving education;
- taxes must be raised to fund a more activist government in a fiscally responsible way.

The better government plan is likely to appeal to those who believe that

- government performance could be improved by reducing less effective programs to make room for higher-priority activities such as making work more attractive and

rewarding to low-income people, increasing health care coverage, supporting the states in improving education, and preserving the environment;
—these objectives should be met without increasing the size of government and with as much reliance on market forces as possible.

The plan involves a restructuring of both defense and non-defense spending. To achieve balance in 2014 the plan relies on modest net spending reduction combined with tax increases to restore revenues to their historic share of GDP.

The Smaller Government Plan

This plan achieves balance over ten years by cutting \$400 billion (about 75 percent of the projected deficit minus interest savings) from projected domestic spending in 2014. It also includes revenue increases of \$134 billion (about 25 percent of the projected deficit), achieved without changing either tax rates or tax brackets (table 2-2). The smaller government plan would reduce total spending as a share of GDP from 20.2 percent in 2003 to 18.3 percent in 2014. That might sound like a modest reduction. But rising wages and prices, especially the price of medical care, tend to increase the cost of government faster than the economy grows, while beneficiaries of retirement programs are increasing. Hence, quite drastic program cuts are required to reduce government's share of GDP by even 1 percentage point.

The programs reduced or eliminated in the smaller government plan have passionate defenders and strong political support. That is why they were enacted and have remained in the

Table 2-2. A Smaller Government Plan to Balance the Budget in 2014 Primarily by Cutting Spending

<i>Item</i>	<i>Billions of dollars</i>
Total deficit reduction	687
Minus debt service savings	-153
Subtotal: tax increases and spending cuts to eliminate deficit	534
Plus funding for new initiatives	0
Total: tax increases and spending cuts to eliminate deficit	534
 Changes in the budget	
Revenue change	134
Spending cuts	-400
Commercial subsidies	-138
Devolution	-123
Wasteful spending	-7
Non-defense discretionary	-58
Entitlement	-74

Source: Authors' calculations and Congressional Budget Office, "The Budget and Economic Outlook: An Update," August 2003. See other tables in this chapter. Note that sums do not add to totals because of rounding.

budget. Indeed, putting together a deficit reduction plan that relies heavily on spending cuts illustrates the political difficulty—some would say impossibility—of achieving balance this way. But unless political leaders are prepared to take unpopular actions on either the spending or the revenue side of the budget or both, fiscal responsibility will not be restored. Politicians who talk vaguely of “reducing big government” must get specific about the programs that must be cut if their approach is to be taken seriously.

Over much of the past century, the federal government enacted thousands of new spending programs. Some no longer have a persuasive rationale. Maybe they were enacted to shield an industry whose protection can no longer be justified. Maybe they were undertaken to encourage state or local governments to pay attention to problems they were neglecting or groups they were not serving. By now, however, these programs have ardent defenders, and the need for federal funding has diminished. Moreover, the plethora of federal grants and mandates, with their onerous and sometimes conflicting requirements, impedes the effective execution of legitimate state and local government functions. Still other programs may simply be ineffective, wasteful, or badly managed. The smaller government plan illustrates how the federal budget might be balanced by weeding out inappropriate, obsolete, and low-priority federal activities.

Reducing Commercial Subsidies

Public subsidies to commercial activities, while sometimes justified by temporary emergencies, tend to postpone needed adjustments to economic and technological change and lead to misallocation of capital and ultimately to a lower standard of living. If public subsidies to commercial activities were eliminated from the federal budget, the deficit would decline and economic growth would likely increase.

Examples of commercial subsidy programs that could be eliminated or privatized—meaning that service would continue but fees would cover the costs—abound. In 2001 the Cato Institute drew up a list of eighty such programs.¹ Eliminating or privatizing those eighty programs would save a total of about \$137.5 billion in 2014 (see table 2-3 for an illustrative list). The commercial subsidies take a variety of forms. For example, the Export-Import Bank provides subsidized services to American companies that do business outside the United States. These activities are of questionable value and, in any case, should be paid for by the businesses that use them. Eliminating this bank would save \$2.7 billion in 2014. The Energy Department subsidizes applied research for fossil fuels although energy markets provide ample incentives for companies to develop new ways to find fossil fuels and bring them to market. About \$0.7 billion could be

Table 2-3. *The Smaller Government Plan: Illustrative Cuts in Commercial Subsidies*
Billions of dollars

<i>Item</i>	<i>2014</i>
Export-Import Bank	\$2.7
Energy Department applied research for fossil fuels	0.7
Airport improvement program	3.4
Agriculture commodity price supports	23.0
Army Corps of Engineers	7.2
Department of Energy science and research	4.7
Community Development Block Grants	8.0
Air traffic control	10.4
Agency for International Development	3.8
Total cuts in Cato proposal^a	\$137.5

Source: Stephen Silvinski, "The Corporate Welfare Budget: Bigger Than Ever," Cato Institute Policy Analysis 415, October 10, 2001. See table 1.

a. This list is illustrative of the total \$137.5 billion in possible cuts. Our estimate is based on adjusting the total savings of the Cato cuts by our inflation and population adjuster.

saved in 2014 by eliminating the fossil fuels program. Similarly, the Federal Aviation Administration provides grants to large and medium-sized hub airports to expand runways, improve security, and make other capital improvements when it would be far more efficient to pay for these activities through user fees charged to the airplanes and passengers who use the facilities. Terminating this program would save \$3.4 billion in 2014.

Returning Functions to the States

In the 1930s, Congress began setting up agencies and programs to carry out activities such as health, housing, education, and transportation that had hitherto been state responsibilities. Hundreds of "categorical grants" influenced state and local spending priorities by providing federal funds to be spent in conformance with strict guidelines, often accompanied by the requirement that the state or local jurisdiction come up with money to match the federal contribution.

The explosion of federal categorical grants arguably led to excessive paperwork; overlapping, conflicting, and inappropriate federal requirements; and wasteful, ineffective spending. Presidents Nixon and Reagan both tried to clarify the responsibilities of the different levels of government and combine categorical grants into block grants to give states more flexibility. Neither appreciably reduced either the blizzard of grant programs or the confusion of responsibilities.

Eliminating federal spending for a range of activities more appropriate to state and local governments would help reduce the federal deficit. It would also encourage citizens to hold their state and local governments accountable for performing these functions without turning to the

federal government for help. State and local dollars would no longer flow through the costly federal bureaucracy before returning to state and local governments in the form of grants. State and local governments would also be relieved of the costs of conforming to federal requirements. Services might also improve, because responsibility for delivering them would rest with governments that are more in touch with what citizens need than Washington is.

The smaller government plan would eliminate all federal discretionary spending for elementary and secondary education, housing and urban development, manpower training and related programs, environmental protection, and law enforcement. Eliminating Department of Education programs for elementary and secondary education would save \$55.6 billion in 2014. Eliminating all discretionary spending programs in the Department of Housing and Urban Development would save another \$42.4 billion in 2014. Eliminating Labor Department spending for training and employment services, Employment Service/one-stops, community service for older Americans, veterans training, and disability programs would save \$9.9 billion. Cutting all Environmental Protection Agency spending for clean water, drinking water, brownfields, targeted water infrastructure, Superfund, and related programs would save another \$11.2 billion. And eliminating Justice Department spending for state and local law enforcement assistance would save \$3.9 billion.

Devolving all these activities to the states and their localities would reduce federal spending in 2014 by \$123 billion (table 2-4). It would radically reduce the role of the federal government in aiding states and localities and pass the deficit down to lower levels of government already struggling to maintain budget balance. States and localities would have to decide whether to continue the services no longer supported by the federal government and, if so, how to pay for them. Lower federal taxes would make it somewhat easier for states and localities to raise revenue. Poorer states would be harder hit than wealthier ones because federal grants tend to compensate for interstate inequalities in resources. Some would argue for replacing the

Table 2-4. *The Smaller Government Plan: Cuts through Devolution*
Billions of dollars

<i>Item</i>	<i>2014</i>
Elementary, secondary, and other education	\$55.6
Housing programs	42.4
Manpower training programs	9.9
Environmental Protection Agency programs	11.2
Justice: state and local	3.9
Total	\$123.0

Source: Executive Office of the President, *Budget of the U.S. Government: Fiscal Year 2004* (February 2003).

categorical grants with a new program of federal revenue sharing for general purposes distributed on the basis of a formula that would favor poorer states. We have not included such a program here because doing so would offset much of the deficit reduction that spending cuts promise.

Reducing Wasteful Spending

The 2003 congressional budget resolution required the General Accounting Office and all authorizing committees of the House of Representatives to identify waste, fraud, and abuse in mandatory spending programs within their jurisdiction. The GAO and the committees were then required to summarize their findings in a written report to the House Budget Committee. On October 2, 2003, committee chairman Jim Nussle released a report summarizing the findings from these reports.² Most of the major savings proposals uncovered by this exercise are listed in table 2-5. The total savings, most of which were based on estimates either by CBO or by GAO, is \$7 billion in 2014.

Of course, one person's waste is another person's absolutely necessary spending. Few of these proposals for savings would be politically popular; indeed, if there were no resistance to making these cuts, they would have been made long ago. But if Congress were under pressure to reduce spending, most of these proposals would be less painful than other cuts in the smaller government plan.

Additional Cuts in Non-Defense Discretionary Spending

Rapid increases in discretionary spending, which amounted to nearly 40 percent of total federal spending in 2003, illustrate the absence of federal budget discipline in recent years. In the six years between 1994 and 1999, discretionary spending rose about 1 percent a year on average, and in 1996 it declined. During four of those years, defense spending fell, with the average for the period -1 percent. But even non-defense discretionary spending increased an average of only

Table 2-5. *The Smaller Government Plan: Cuts in Wasteful Spending*
Billions of dollars

<i>Item</i>	<i>2014</i>
Competitive bidding in Medicare	\$1.0
Reduce overpayments in Supplemental Security Income program	2.0
Reduce overpayments in Unemployment Compensation program	2.0
Require states to comparison shop for Medicaid drugs	2.0
Total	\$7.0

Source: House Budget Committee, "Sampling of Waste, Fraud, and Abuse from Committee: GAO Submissions," October 2, 2003 (press release).

around 3 percent. By contrast, the five years between 2000 and 2004 have seen explosive growth—averaging 9.5 percent a year—in discretionary spending, according to the CBO. Defense led the way with average increases of 10.5 percent, but non-defense discretionary spending also rose rapidly, with yearly increases averaging well over 8.5 percent and reaching an amazing 12 percent in 2002. Increased spending on homeland security after the attacks of September 11, 2001, undoubtedly played an important role in this remarkable rise in discretionary spending. Even so, this brief review of the budget figures shows that offsetting cuts in other spending categories were few and negligible. In other words, our policy is now not just simultaneous increases in spending on guns and butter, but increases in spending on homeland security as well.

Most of the programs eliminated in the smaller government plan for commercial subsidies and all the programs ended under the devolution proposals are domestic discretionary programs. Three additional cuts in domestic discretionary spending are listed in table 2-6. These include terminating the National Aeronautic and Space Administration’s program of manned flight, ending earmarks for local projects in the highway construction program, and slowing the rate of growth of the National Institutes of Health. The combined savings from these three cuts is \$22.9 billion in 2014.

According to our adjusted baseline projections for non-defense discretionary spending (based on the assumption that annual growth over the next decade will equal inflation plus population growth), such spending will increase an average of less than 3.6 percent a year. Given the annual average increase of more than 8.5 percent in recent years, even achieving 3.6 percent would be remarkable. Nonetheless, in an effort to balance the budget by holding down the size of government, a more stringent cap would be plausible. Imposing a 2.5 percent annual cap on nominal growth in non-defense discretionary spending would force hard choices. If growth were allowed in a few programs, others would have to grow at less than the rate of inflation, some would be cut in nominal dollars, and some might be terminated. The saving in 2014 from the 2.5

Table 2-6. *The Smaller Government Plan: Cuts in Non-Defense Discretionary Spending*
Billions of dollars

<i>Item</i>	<i>2014</i>
Reduced National Aeronautics and Space Administration	\$9.0
Highway earmarks for local projects	1.9
Slow growth of National Institutes of Health (2 percent in real terms)	12.0
Cap on remaining discretionary spending	35.5
Total	\$58.4

Source: Executive Office of the President, *Budget of the U.S. Government: Fiscal Year 2004* (February 2003).

percent cap against the baseline that remains after the other cuts in discretionary spending is \$35.5 billion (table 2-6).

Reducing Entitlement Spending

Politicians and voters are understandably reluctant to cut Social Security, Medicare, or Medicaid benefits, because elderly, disabled, and low-income people depend heavily on these programs. Moreover, it seems unfair to cut benefits for current retirees—or those eligible to retire in the near future—who have planned their retirement on the expectation of receiving these benefits. Nevertheless, although few elected officials are willing to say so, retirement programs must be modified to avoid their consuming the entire federal budget. Over the next thirty years, as more and more baby boomers retire, longevity continues to increase, and medical costs rise, the liabilities of Social Security, Medicare, and Medicaid will explode. If the current budget problem is a gale, the long-term problem is a hurricane.

Because of the importance of advance notice, proposals to constrain spending for the retirement programs do not generate large budget savings in the near term, so it is tempting to postpone them. Delaying the reductions, however, just makes the necessary changes larger. The smaller government plan contains a list of reductions in entitlement benefits (primarily in Social Security, Medicare, and Medicaid) that contribute roughly \$74 billion to budget balance in 2014 and generate much larger savings in the years that follow (see table 2-7). Several of these proposals are described in chapter 5; the rest are to be found in the CBO publication *Budget Options*.³

The reform that would save the most involves revising the way Social Security benefits are adjusted for inflation. As explained in more detail in chapter 5, the Census Bureau has known for many years that the consumer price index (CPI), which is now used to adjust Social Security benefits each year, overstates growth in the cost of living. Substituting a more accurate index developed by the Bureau of Labor Statistics would reduce Social Security spending in 2014 by \$17 billion while fully protecting the elderly against inflation. If the new index were also applied to the personal exemption, the standard deduction, and the income levels that define tax brackets, another \$18 billion could be saved in 2014 through increased income taxes and reduced spending in a few additional programs (these latter savings are listed in table 2-8 under revenue increases.)

An additional \$16 billion could be saved in 2014 by reducing the federal subsidy for supplemental medical insurance (SMI) premiums for most Medicare enrollees. When Medicare was enacted in 1965, the SMI premium was set to cover half of program costs, but the share of

Table 2-7. *The Smaller Government Plan: Cuts in Entitlements*
Billions of dollars

<i>Item</i>	<i>2014</i>
Medicaid	
Reduce enhanced match for administration	\$2.0
Reduce spending for Medicaid administration	4.5
Social Security	
Raise retirement age starting in 2012	1.4
Consumer price index adjustment: benefits	17.0
Medicare	
Indirect teaching payments	5.0
Reduce direct payments for medical education	1.1
Premium increase in supplemental medical insurance	16.0
Payments to managed care	5.0
Convert Graduate Medicare Education to block grant	2.0
Convert DSH payments to block grant	3.0
Partially reduce prospective payment system update factor	4.1
Simplify cost sharing	2.0
Reduce payments to home health care	3.5
Reduce copayments on home health episodes	1.5
Other Programs	
Voucher for federal employees health benefit	3.9
Limit cost-of-living adjustment for federal employees	2.0
Total	\$74.0

Sources: Henry J. Aaron and Peter R. Orszag, chapter 5 of this volume, and Congressional Budget Office, *Budget Options* (March 2003).

costs covered by premiums has declined over the years to 25 percent. Under the proposal discussed in chapter 5, the fee would gradually be raised to a minimum of 35 percent of cost for Medicare enrollees other than those with low incomes, rising to 80 percent for couples with incomes greater than \$400,000.

Another major savings proposal, discussed in detail in the CBO volume, *Budget Options*, would decrease Medicare payments to hospitals through the prospective payment system. Savings of more than \$4.1 billion can be produced in 2014 by slightly reducing the update factor, a policy justified by the substantial profit that hospitals make on the average Medicare recipient who receives inpatient care.

These and the other savings proposals outlined in the table achieve our goal of \$400 billion in 2014. These cuts involve drastic changes in what the federal government does and its

Table 2-8. *The Smaller Government Plan: Revenue Increases*
Billions of dollars

<i>Item</i>	<i>2014</i>
Tax credit for exclusion of interest income on state and local debt	\$2.0
Include employer-paid life insurance in taxable income	2.0
Include in adjusted gross income all income earned abroad by U.S. citizens	5.0
Eliminate some rules for inventory sales	7.0
Increase excise tax on cigarettes by 50 cents	7.0
Increase alcohol tax to \$16 per proof gallon	6.0
Increase tax on motor fuel by 12 cents a gallon	20.0
Freeze estate tax at 2009 level	30.0
Consumer price index adjustment	18.0
Improve enforcement	37.0
Total	\$134.0

Sources: Henry J. Aaron and Peter R. Orszag, chapter 5 in this volume, and Congressional Budget Office, *Budget Options* (March 2003).

relation to the state, local, and private sectors. Whether the political system could adopt these changes—or even a substantial portion of them—depends heavily on whether the Republican Party returns to its historic goal of reducing the size of government.

Under normal circumstances, cuts as large as those proposed in the smaller government plan would be deemed impossible. But circumstances are not normal. Action must be taken to control unsustainable deficits. If spending cuts are to dominate the anti-deficit action, Republicans, both because they control Congress and the presidency and because their tax cuts contribute importantly to future deficits, will have to lead the way. The spending cuts in the smaller government plan are not the only possible cuts, but they illustrate the magnitude of the challenge.

Revenue Increases

The spending cuts illustrated above are drastic, but still they do not generate enough savings to balance even the unified budget in 2014—not to mention the budget excluding retirement program surpluses. The authors have therefore resorted to revenue increases to achieve balance, even though advocates of smaller government generally oppose any tax increases.

In recent years, tax cutting (especially reducing income tax rates) appears to have become more important to Republicans than balancing the budget, so most tax increases would likely be opposed by most Republicans in Congress as well as by the Bush administration. Nevertheless, only a few years ago Republicans were vehement about the importance of a balanced federal budget. Indeed, they felt so strongly about it that they sponsored, and came within a few votes of

passing, legislation to amend the Constitution to require Congress to balance the federal budget each year. If the consequences of large deficits were to create pressure to balance the budget, some Republicans might recapture the budget-balance fervor of the 1990s and support modest revenue increases as part of a package that depends primarily on spending cuts.

To maximize appeal to advocates of smaller government, this package avoids two kinds of tax increases. It includes no changes in the tax rates or tax brackets enacted in the tax legislation of 2001 and 2003. Nor does it change the capital gains tax, which was also modified in 2003. Few elected Republicans would support such changes. Moreover, low tax rates increase economic activity and are consistent with the Republican philosophy of small government.

A set of tax code changes consistent with these criteria is shown in table 2-8. Six have modest revenue effect, but the other four produce significant additional revenue in 2014. The first would raise the federal tax on motor fuels 12 cents a gallon, bringing the total federal tax to 30.4 cents a gallon for gas (36.4 cents a gallon for diesel fuel.) In addition to raising more than \$20 billion in 2014, these increases in the cost of motor fuel would decrease fuel consumption, reduce pollution and traffic congestion, and persuade some Americans to purchase more fuel-efficient cars and trucks. They would also, however, increase trucking and other transportation costs, contributing to higher prices for many goods and services. And the price increases would fall disproportionately on lower-income consumers.

A second substantial increase in revenue could be achieved by partially reversing the estate tax changes enacted in the tax legislation of 2001. As discussed in more detail in chapter 6 (see table 6-2), estates are taxed based on the value of assets transferred at death. The 2001 tax law reduced the estate tax by raising the amount of estate value exempted from the tax. The amount exempted was set at \$1 million for 2002 and then gradually increased until it reached \$3.5 million in 2009. The 2001 tax act also decreased the estate tax rate from a maximum of 55 percent to 45 percent. In 2010, the entire tax would be repealed. Retaining the 2009 version of the tax and dropping the tax rate to 35 percent would still greatly reduce the estate tax from its 2001 level, and only about 10,000 estates would pay the tax. Yet federal revenues would increase by about \$30 billion in 2014. Ironically, the biggest revenue producer in our plan, worth \$37 billion in 2014, is simply to give the Internal Revenue Service the resources it needs to enforce the tax laws we already have (see chapter 6 for details).

The Larger Government Plan

Many people will find unpalatable the kind of retrenchment required by the smaller government option. Indeed they argue that the federal government should be doing more not less than it now

is to address various national problems. They point to the many citizens who lack health insurance, to the schools that fail to educate children, to global warming and other environmental problems that are not being adequately addressed. They argue that too many children are growing up in poverty and too many adults are out of work or earning too little to support a family. They emphasize that the distribution of income in the United States is not only less equal than it is in other advanced countries but that the gap between rich and poor has widened in recent decades and been exacerbated by recent tax cuts that have favored the affluent over the middle class or the poor. They believe that U.S. military strength needs to be supplemented by efforts to address world poverty, disease, and lack of literacy and by greater sharing of the burden with our allies.

Those who favor a more robust federal role note that the private sector has no incentive to address the above-mentioned problems. State and local governments could, in principle, pick up some additional responsibilities but lack the fiscal capacity to do so and will face increased demands on their limited resources as baby boomers increase Medicaid costs that have been rising at double-digit rates for more than a decade. Furthermore, states are constrained in their ability to raise taxes by their need to remain competitive with other jurisdictions.

The issue is not just whether it is desirable to address some or all of these problems but also what the effects would be on the nation's economy, on the social fabric, and on the well-being of the average citizen. Unlike those who favor smaller government, advocates of a stronger federal role believe that it is possible to design effective programs to accomplish various social objectives without compromising growth or international competitiveness. They point to other advanced countries that have far larger public sectors and higher tax burdens than the United States, along with more public amenities, less inequality, and fewer social problems, and whose rates of growth and ability to compete have not been significantly affected as a result. While few argue that the United States should adopt a European-style welfare state or that programs don't need to be carefully crafted to avoid unintended consequences, these advocates of a more activist government reject the idea that individual welfare could not be greatly improved through collective action.

This vision is not an entirely partisan affair. Many members of the public and their elected representatives from both parties share at least some of these concerns and want to see them addressed. Still, a natural place to look to see how an advocate of this point of view might address various social priorities and simultaneously deal with looming deficits is to review what the various candidates for the 2004 Democratic presidential nomination have proposed. Different candidates have espoused different agendas, of course, but those agendas share several common themes, including extending health care to more of those who now lack it; providing states with

funds for homeland security, education, and infrastructure; providing access to higher education and to a preschool experience for the young; and preserving or enhancing Social Security and Medicare benefits for the elderly. On foreign policy, most candidates favor more sharing of costs with our allies to rebuild Iraq and more humanitarian assistance to poorer countries.

Because candidates who are specific about their plans open themselves to criticism of all sorts, they rarely offer sufficient detail to assess the cost of their agendas and their impact on long-term deficits. Still, it is instructive to look at the broad outlines of these Democratic campaign platforms and assess their effect on fiscal balance. As detailed below, the conclusion has to be that, whatever their other merits, none of the Democratic candidates' plans released to date manages to close the fiscal gap and pay for proposed new initiatives. This is especially true of candidates who raise taxes only on the wealthy and not on the middle class as well. In fairness, it should be noted that they face an incumbent president who has also failed to address the deficit and who continues to argue for tax cuts that would produce still more red ink.

Several major candidates have proposed a temporary stimulus package. Governor Howard Dean proposes a two-year \$100 billion "Fund to Restore America" that would provide grants to the states for homeland security and infrastructure and thereby create more jobs. To some extent such spending has effects on short-term economic growth similar to if not greater than the Bush administration's tax cuts and can thus be expected to produce more revenue as well. But it will also increase the deficits accumulated over the next decade and add to the burden of the debt.

The biggest split within Democratic ranks is between those who favor rolling back all the Bush tax cuts and those who want to eliminate only the cuts that went to the wealthiest Americans, generally those with more than \$200,000 a year in income. This difference has major implications for the nation's ability to reduce longer-term deficits. Although scaling back tax cuts for the wealthy can provide resources to fund *some* new initiatives, these resources are far too small to fund *all* the new initiatives and also reduce the deficit.⁴

Some candidates have tried to identify savings in other parts of the budget. Examples include investing in information technology to reduce health care costs (John Kerry) and reinstating then-Vice President Al Gore's National Performance Review to find savings by making government work better (Dean). But, not surprisingly, several candidates have not come up with a list of budget cuts to help pay for their top priorities. (Some have discussed addressing corporate loopholes and avoidance in the tax system, which affects revenues, not spending.)

Health care is the "big spending" item in virtually every Democratic plan.⁵ But other costly items include extending access to college and preschool for most if not all Americans.⁶

spending included would pay for many of the proposed investments in health and education and would offer more modest amounts for assistance to the states, safety net programs, the environment, and humanitarian-oriented international assistance. We assume that some of these costs would be offset by savings elsewhere in the budget. But even this assumption may be overly optimistic. Liberals are unlikely to want to cut existing programs deeply, and, as argued in chapter 3, opportunities to shift funds from defense to domestic spending are likely to be limited. The bulk of the resources needed to achieve fiscal stability and pay for new priorities would have to come from new revenues, whose possible sources are detailed in table 6-10. These revenues are derived from many tax measures, including scaling back the 2001 tax cuts that went to the affluent, raising payroll taxes for this same group, and creating a new value-added tax that would affect almost everyone.

It is worth noting here that we are assuming that the Bush tax cuts will be extended beyond their current expiration dates. If the cuts were not extended, much smaller revenue increases would be needed. But no one expects the tax cuts to “sunset.” Any Democratic president elected in 2004 would find it politically difficult to raise taxes on the middle class and implement the other revenue changes contemplated here. If at least one house of Congress remained in Republican hands, the task would be much harder. Democrats would be forced either to scale back substantially their domestic promises, including perhaps their current commitment to maintain Social Security and Medicare benefits, or to live with large deficits indefinitely.

The Better Government Plan

The two plans just discussed—one that might be favored by advocates of small government and the other by those who think government isn’t doing enough—illustrate the difficulty of closing the fiscal gap over the next decade and preparing for the baby boom’s retirement. The first plan implies spending cuts that are unlikely to be approved, even if Republicans control the White House and both houses of Congress. The second envisions tax increases that are not likely to be politically feasible, even for a Democratic president and a more Democratic Congress.

But in addition to their political infeasibility, these two plans may miss the point. The issue should not be the size of government but its effectiveness. The better government plan is based on the view that government can be more effective without absorbing an increasing share of GDP. In that view, the goal of eliminating the deficit provides a powerful incentive to weed out ineffective and outmoded programs while meeting new objectives.

Unfortunately, not enough is known about the effectiveness of various government programs. And even where such information exists, reallocating resources in response to such

evidence—or in response to changing national needs—is extremely difficult. The beneficiaries of existing programs, though sometimes relatively few in number, are usually knowledgeable and often organized to defend their programs. The general public is less well-informed and has little ability or incentive to work toward scaling them back. Members of Congress and other political leaders know that staying in office requires being responsive to the specialized constituencies that benefit from particular programs even at the cost of increasing the deficit. The result is that new programs are layered on top of old ones and budgetary resources are rarely reallocated to make government more effective. Analogous arguments can be made about tax cuts that favor particular groups at the expense of others and about persistent deficits that benefit the current generation at the expense of the next.

Budget rules that discipline the political process can help to correct these perverse political incentives and are discussed in the final section of this chapter. But in the end, rules are no substitute for making the hard choices. Table 2-10 sketches a third way of making those choices—the better government plan for balancing the budget in 2014 while funding a few limited new initiatives. That plan relies on revenue increases of \$401 billion, spending cuts of \$175 billion, and new spending of \$41 billion. It would keep the share of total federal spending at about its current relationship to GDP (19.7 percent in 2014).

In the remainder of this volume the authors suggest what a restructured government that

Table 2-10. A Better Government Plan to Balance the Budget in 2014 While Funding New Initiatives

<i>Item</i>	<i>Billions of dollars</i>
Total deficit reduction	687
Minus debt service savings	-153
Subtotal: tax increases and spending cuts to eliminate deficit	534
Plus funding for new initiatives	41
Total: tax increases and spending cuts to eliminate deficit	575
 Changes in the budget	
Revenue change	401
Spending cuts	-175
Defense	-60
Social Security, Medicare, and Medicaid	-47
Other domestic	-68
New spending	41
Foreign affairs	11
Non-defense homeland security	9
Other domestic	21
Net decrease in spending	-134

Sources: Authors' calculations; Congressional Budget Office, "The Budget and Economic Outlook: An Update," August 2003; and chapters 3, 4, 5, and 6.

is no different in size from the present one might look like. The choices are difficult indeed. While the authors believe that the better government plan is both preferable to and more feasible than the other two, not all the authors agree with components of the plan. Some of us think that defense spending needs to increase more or less than recommended in chapter 3. Some of us would provide more funding for the various domestic priorities, such as education and health care, discussed in chapter 4. Some of us think that more should be done sooner to curtail the growth of Social Security and Medicare discussed in chapter 5. And although we agree that revenues have to be an important part of the picture, we didn't try to forge a consensus on which parts of the tax system need to be modified. Still, we all believe that it is important to show that it is possible to balance the budget—and produce a better government in the process.

Some observers will conclude that all we have demonstrated is the enormous difficulty of achieving this objective and that the nation might as well learn to live with deficits. The authors of this volume argue that the task is indeed difficult and that, in the end, the nation may not achieve the goal of reducing the deficit to zero. Reducing the deficit to 1 percent of GDP, for example, would be far better than leaving it at 3 percent of GDP. Even so, the authors think it would be a mistake to *plan* to run even modest deficits on a permanent basis. The goal of a balanced budget is well understood by the public, and giving up on this goal would erode fiscal discipline still further.

Improving the Budget Process

The authors believe that reform of the budget decision process is essential to restoring fiscal discipline. Reducing budget deficits is primarily a matter of political will, but a process that forces politicians to confront hard choices can help. The current process has no teeth and is providing no restraint on spending increases or tax cuts.

Politicians find it easy to vote for more spending and less revenue. Voters who will benefit from these actions are always eager to make their desires known, and the pressure is hard for politicians to withstand. Elected leaders who believe in fiscal discipline and want to avoid deficit spending can benefit from imposing rules on themselves that will force them to consider the deficit consequences of their votes. Conservative politicians have frequently argued that a constitutional amendment requiring Congress to balance the budget would provide political cover that would help politicians resist deficit-increasing actions. It would allow a member of Congress to tell constituents, “I really wanted to vote for your program or your tax cut, but it would have been unconstitutional to do so.”

In the mid-1970s Congress implemented budget reforms intended to increase budget discipline by requiring Congress to pass a budget resolution specifying total desired spending, revenues, and deficit or surplus. Debating and passing a budget resolution forced Congress to consider trade-offs among spending programs and tax changes and to decide how large the deficit (or surplus) ought to be. The budget resolution was enforced by various procedures, such as allocations of spending ceilings to appropriations subcommittees, requiring supermajorities to override spending limits, and “reconciliation instructions” that required committees to bring spending and taxing measure into conformity with the budget resolution. Despite these efforts, the reforms did not become successful tools for controlling deficits until they were supplemented by the Budget Enforcement Act (BEA) in 1990. That act established caps in discretionary spending, as well as a set of rules, known as the PAYGO rules, which restrained both mandatory spending and revenue-reducing actions. Essentially, no increase in mandatory spending or tax cut could be brought to the floor for a vote without offsets of an equal amount.

The BEA rules proved extremely effective—helping Congress and the president turn the huge deficits of the early 1990s into substantial surpluses by the end of the decade. The caps made it much harder for Congress to increase discretionary spending. Although caps could be raised—and circumvented by “emergency” spending that did not count against the caps—reluctance to raise them was an effective brake against increases in discretionary spending. The PAYGO rules also restrained increases in mandatory spending and reductions in revenues. The original rules required offsets to any deficit increases over a five-year period—a provision designed to reduce the temptation to enact legislation with modest initial cost (or revenue loss) and larger negative effects on the deficit in the future. When Congress began pushing the deficit impact beyond the five-year window, the period was lengthened to ten years.

Both the Clinton administration and Congress were committed to reducing the deficit, although they differed on how to do it. The discipline of the BEA, combined with the strong economy of the 1990s, helped them make the decisions that eliminated the deficits and produced surpluses for the first time in decades. When the surpluses appeared, however, fiscal discipline soon vanished. Congress began loading up emergency spending bills with items that were in no way emergencies. When the caps and PAYGO rules expired at the end of fiscal year 2002, they were not extended. Congress is now facing huge deficits without an enforcement process to help it make the hard choices.

Budget process reform should involve at least three elements. First, caps on discretionary spending should extend for ten years to discourage pushing costs into the future. In fact, however, caps cannot bind future Congresses if they vote to change them. Second, PAYGO rules should

apply both to mandatory spending and to revenue reductions—and should also require ten-year offsets. Moreover, entitlement increases and tax cuts should not be allowed to sunset to make them appear less expensive in the long term. Tax and entitlement changes should normally be considered permanent for purposes of estimating their budget impact. And, third, “emergency” spending should be strictly defined. Spending that could have been foreseen should not be allowed to breach the caps or suspend the PAYGO rules. Contingency funds should be budgeted to handle recurrent emergencies, such as forest fires and flooding. Emergency appropriations should require supermajority votes unless accompanied by tax or spending measures that offset their cost.

Variations on these rules are, of course, possible. For example, some favor turning the budget resolution into a law requiring presidential signature. Some would cap total spending, not just discretionary spending. Others would broaden the PAYGO rules so that a tax cut, for example, could be offset by either mandatory or discretionary spending reductions. Many believe that an item veto, if it could be designed to be constitutional, would help the president enforce budget discipline. The main point, however, is that spending and tax-cutting are out of control and the budget process needs to be reinvigorated to help stiffen the resolve of politicians to act in a fiscally responsible manner.

Moreover, as detailed in chapter 5, deficit pressures will mount rapidly as the baby boom generation claims its retirement benefits and longevity continues to increase. These future liabilities, which can be quite accurately estimated in advance, should be reflected in the budget to underline the importance of taking immediate steps to bring future budgets into balance.

ENDNOTES

1. Stephen Silvinski, "The Corporate Welfare Budget: Bigger Than Ever," Cato Institute Policy Analysis 415, October 10, 2001. We derive the savings for 2014 specified in table 2-3 by adjusting the savings of the Cato cuts by inflation and population growth.
2. Committee on the Budget, U.S. House of Representatives, "Government Waste, Fraud, and Abuse Update" (October 2003).
3. Congressional Budget Office, *Budget Options* (March 2003).
4. This conclusion is arrived at as follows. Reducing the deficit in 2014 would require \$534 billion in new revenues or spending cuts. Most of the candidates have proposed health care plans that would cost roughly \$100 billion a year or more by that date. Their proposals to provide greater funding for education ("full funding for special education, more access to preschool and higher education") would likely cost another \$60 billion at a minimum. Added to the funds needed for deficit reduction and for other proposed initiatives, the total cost is in the neighborhood of \$700 billion a year. Rolling back all of the tax cuts enacted since 2000 would produce roughly \$375 billion a year in 2014 (see table 6-10 in chapter 6).
5. The costs of these proposals over a ten-year period are estimated to vary from \$6.1 trillion for Dennis Kucinich's plan to \$2.5 trillion for Richard Gephardt's and a little under \$1 trillion for both the Dean and Kerry plans. Kucinich creates a single-payer plan that would extend Medicare benefits to the entire population and pay for it with a 7.7 percent payroll tax on employers. Gephardt's plan requires employers to provide health insurance to their employees but provides generous tax credits to offset these costs. Dean and Kerry rely more heavily on augmenting existing public programs, such as Medicaid and the Children's Health Insurance Plan (CHIP), and provide individual tax credits to offset premium costs among the middle class. See Sara R. Collins, Karen Davis, and Jeanne M. Lambrew, "Health Care Reform Returns to the National Agenda: The 2001 Presidential Candidates' Proposals," Commonwealth Fund, September 2003 (updated November 17, 2003), p. vii.
6. Edwards's proposal to bolster the Pell grant system of financial assistance to college students costs about \$3 billion annually. [available at www.johndwards2004.com/education.asp] Providing high-quality preschool to all low-income children would cost about \$30 billion a year. Isabel Sawhill, "Investing in Children," Brookings Children's Roundtable Policy Brief 1 (Brookings, April 1999), p. 7.
7. National Education Association, "IDEA Funding Coalition Offers Proposal" [www.nea.org/specialed/coalitionfunding2002.html]. NEA data through 2010; for 2011-14 annual spending growth of 3.5 percent is assumed.