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The Size and Role of Government

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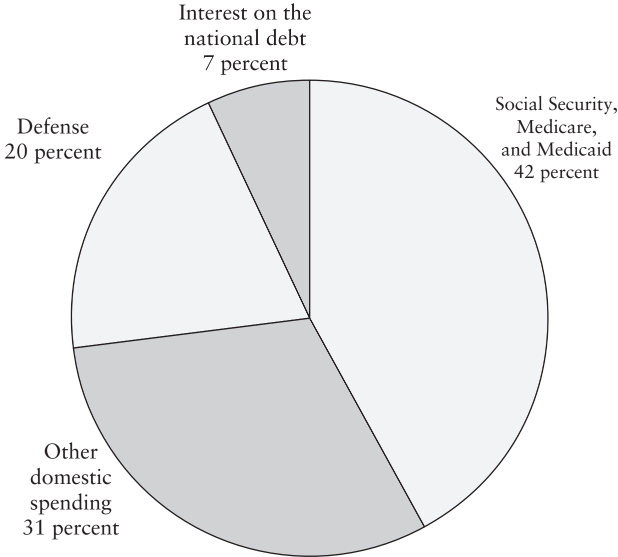
Americans face serious budget choices over the coming decade and far more daunting ones afterward. This chapter first examines three illustrative plans for achieving balance in the unified budget over the next ten years and then turns to the options for meeting the larger, longer-term challenge: how to balance the budget as the population ages and medical care grows more effective and more expensive. As the baby boom generation retires, average life spans continue to increase, and medical costs continue to rise, federal spending will accelerate rapidly unless current policy changes drastically. There are only three choices. Americans can reduce existing government commitments to the elderly, slash other government programs, or accept higher taxes.

Current Federal Spending

Federal spending in 2004 is projected to be $2.3 trillion, or about 20 percent of GDP. Social Security, Medicare, and Medicaid together make up

We are deeply indebted to Daniel Klaff and Nathan Meath for their extensive assistance with this chapter.

Figure 2-1. *Federal Spending, 2004*



Source: Congressional Budget Office, "The Budget and Economic Outlook: Fiscal Years 2006 to 2015" (January 2005).

42 percent of total federal spending (figure 2-1).[1] These big programs, which benefit primarily the elderly, will drive increases in federal spending over the longer run, but they reflect only a small part of what the federal government does. National defense, international affairs, homeland security, law enforcement, education, scientific research, public lands and the environment, veterans' affairs, agriculture, welfare, child care, job training, and a host of other program areas make up the rest of government.

National defense accounts for 20 percent of total federal spending, and domestic spending outside of the big three entitlement programs accounts for 31 percent (figure 2-1). Within domestic spending, "discretionary spending," which is appropriated annually, accounts for about 19 percent of all federal spending and "mandated" programs, which are not subject to annual appropriation, account for about 12 percent. It is not realistic to attempt to shrink the deficit by focusing on any one of those categories of spending alone. For example, balancing the budget in 2015

by cutting domestic discretionary spending alone would require cutting each program 86 percent in 2015, or virtually closing down the government.[2] Cuts of that magnitude in, say, national parks, federal prisons, or education of children with special needs would outrage the public, and few politicians would remain in office if they supported such cuts. Moreover, defense spending is already close to historic lows relative to the size of the economy, and cutting it is especially difficult in wartime. Domestic mandatory programs include agricultural subsidies, veterans' benefits, and other programs with strong political support. Social Security, Medicare, and Medicaid present a tempting target for budget-cutters because they are so large and are likely to grow rapidly if no changes are made. Chapters 3 and 4 explore the potential for reducing the growth of these programs. However, achieving substantial savings in entitlements over the next decade would necessitate immediate cuts that have been ruled out of bounds by most politicians because they would threaten the well-being of those who currently are retired or near retirement. In sum, there is no quick or easy way to curb government spending. Raising taxes is equally difficult.

Budgetary Options for the Next Decade

Last year, in *Restoring Fiscal Sanity: How to Balance the Budget,* we illustrated the tough choices required to reach budget balance over the next decade. We described three deficit-reduction packages, each of which was designed to achieve balance in the unified budget by 2014 but reflected different views about the size and role of government. Given last year's projections, meeting this goal required finding $534 billion in spending reductions or revenue increases by 2014. Interest saved by reducing the debt over the period would contribute another $153 billion in that year, to close a total gap of $687 billion.[3]

The "smaller government plan" illustrated choices that would appeal to those who believe that the federal government does too much, especially in the domestic arena, and that the budget should be balanced primarily by reducing spending. This plan cut federal expenditures as a share of GDP from 20.2 percent in 2003 to 18.3 percent in 2014.To accomplish

the reduction, we focused on federal programs that have been identified by conservatives as candidates for elimination, privatization, or devolution to state and local governments. We cut $400 billion from projected expenditures in 2014 by eliminating commercial and agricultural subsidies ($138 billion); devolving all responsibility for education, housing, job training, the environment, and law enforcement to the states ($123 billion); reducing wasteful spending ($7 billion); and slowing the growth of other domestic spending ($58 billion) as well as the growth of the big three entitlements, Social Security, Medicare, and Medicaid ($74 billion).[4] Commercial subsidies include farm price supports and grants for energy research and development; airports and air traffic control; community development; the Agency for International Development; and the Export-Import Bank, which provides services to companies that do business abroad. Eliminating all of the grants to state and local governments for education, housing, job training, the environment, and law enforcement would force those levels of government to cut back services, deliver them more efficiently, or raise their own taxes. Other major savings in the smaller government plan came from reducing funding for the space program and for health research, raising the Social Security retirement age in 2012, changing the way cost of living increases are calculated, and increasing premiums for Medicare recipients.

The process of selecting programs to be cut in the smaller government plan made clear that reducing the size of the federal government by even a couple of percentage points of GDP requires extremely painful political choices. Those choices would have major impacts on state and local governments and the private sector. Many of the programs cut in the smaller government plan have powerful political support among voters and their elected representatives. Moreover, even though we ignored the political consequences, we were unable to reach balance in 2014 with spending reductions alone and had to resort to revenue increases to attain that goal.

The "larger government plan," by contrast, was designed to appeal to those who believe that the federal government is not doing enough to improve education, help people pay for health care, or support low-income working families. In crafting this plan, we left most federal domestic activities intact, made modest cuts in defense spending, and

allowed some additional spending for health, education, and other domestic priorities favored by most Democrats. We financed the additional spending and balanced the budget by rolling back recent tax reductions for high-income taxpayers and adding a new national consumption tax. By the end of the period, total federal spending as a share of GDP climbed to 20.9 percent, from 20.2 percent in 2003.

We also described a "better government plan," designed to keep the size of government roughly at its current level but to reallocate spending to improve government performance. It included a mix of spending cuts and tax increases as well as a major reallocation of spending toward high-priority areas, including international assistance to fight global poverty and spur economic development in regions of the world that have become seedbeds for terrorism. Also included was funding to make the homeland more secure, restructure the safety net to encourage and reward work, improve preschool programs for children, extend health care coverage to lower-income families, and help states fund the No Child Left Behind Act of 2001. Funding these priorities *and* eliminating the deficit required a combination of tax increases and steep cuts in other spending for everything from farm subsidies to manned space flight, but the cuts were not as drastic as the ones included in the smaller government plan.

Table 2-1 summarizes the amount of deficit reduction accomplished by each plan and the different ways in which balance was achieved in each case. The table was taken from last year's book, and greater detail on each of the plans can be found in that volume.

Not much has changed since last year. Our projected deficit for 2015 is only slightly higher than it was in 2014 ($715 billion versus $687 billion), the result of a number of offsetting changes. Revenues are a little higher but so are spending and interest on the debt.[5]

Long-Term Scenarios

For about fifty years, Americans have acted as though they wanted to prevent total federal spending from rising to much more than 20 percent of GDP.[6] At the end of the cold war, when defense spending fell as a percent

Table 2-1. *Three Plans to Balance the Budget by 2014*
Billions of dollars

Change	*Better government plan*	*Larger government plan*	*Smaller government plan*
Total deficit reduction	687	687	687
Interest payment change	–153	–153	–153
Revenue change	401	629	134
Programmatic spending net change	–134	95	–400
Defense net change	–60	–60	0
Increase	0	0	0
Decrease	–60	–60	0
Nondefense net change	–74	155	–400
Increase	41	185	0
Decrease	–115	–30	–400

Source: Alice M. Rivlin and Isabel Sawhill, eds., *Restoring Fiscal Sanity: How to Balance the Budget* (Brookings, 2004).

of GDP, domestic spending—especially Medicare, Medicaid, and Social Security—rose to keep total spending at approximately 20 percent of GDP.

But in coming decades Americans will face a new situation. The combined impact of the baby boomers' retirement, increased longevity, and more effective but more expensive medical care will push federal spending (less interest) to almost 25 percent of GDP by 2030. The stark reality is that if Americans honor their current promises to older people without reducing other federal responsibilities, they will have to increase the federal spending share of GDP by at least 6 percent and add that much to their tax bill. If they choose to keep the federal share close to its historic 20 percent, they will have to choose between substantially reducing the benefits promised to older people and drastically cutting back on projected spending for other federal programs. Many of those programs (education, transportation, and scientific research) are investments in younger people and the future growth of the economy. Those decisions will be made gradually and many compromises are possible, but basic choices must and will be made.

We have constructed four budget scenarios for 2030 that illustrate different ways that Americans might decide to restructure the federal government in the face of the strong upward pressure on federal spending coming from an aging population and the rising cost of medical care (table 2-2). Two of these scenarios build on the larger and smaller government

Table 2-2. *Projected Federal Spending, 2030*[a]
Spending as a percent of GDP

Category	*Current (2005)*[b]	*Baseline*[c]	*Smaller government*[d]	*Maintaining the Social Contract*[e]	*Investing in the Future*[f]	*Larger government*[g]
Medicare and Medicaid[h]	4.2	11.5	5.7	11.5	8.4	11.5
Social Security[i]	4.2	5.9	5.5	5.9	5.7	5.9
Defense	3.8	2.8	2.0	2.0	2.8	2.8
Other federal spending[j]	6.2	4.3	2.9	2.4	6.1	5.8
Total primary spending	**18.4**	**24.5**	**16.2**	**21.8**	**23.0**	**26.0**
Interest spending[k]	1.5	2.0	2.0	2.0	2.0	2.0
Total spending	**19.8**	**26.5**	**18.2**	**23.7**	**24.9**	**28.0**

Sources: Congressional Budget Office, "The Budget and Economic Outlook: Fiscal Years 2006 to 2015" (January 2005); Congressional Budget Office, "The Long-Term Budget Outlook" (December 2003); Social Security Administration, "Estimates of Financial Effects for Three Models Developed by the President's Commission to Strengthen Social Security" (January 2002); Social Security Administration, "2004 OASDI Trustees Report" (March 2004).

a. Sums may not add to totals because of rounding.

b. Authors' categorization of Congressional Budget Office, "The Budget and Economic Outlook" (January 2005).

c. Scenario 1 from Congressional Budget Office, "The Long-Term Budget Outlook" (December 2003): 2.5 percent excess cost of growth of medical services; Social Security benefits paid as due; defense spending follows FYDP through 2022 and then grows at rate of CPI; nondefense discretionary spending phases down to 3.6 percent of GDP by 2008 (CBO high-spending path).

d. No excess cost of growth of medical services (CBO low-spending path); Social Security benefits indexed to prices; defense spending phases down gradually to $380 billion (2003 dollars) in 2022 and then grows at rate of CPI (CBO low-spending path); a proportional decrease in discretionary spending is added based on *Restoring Fiscal Sanity's* smaller government plan.

e. Two and a half percent excess cost of growth of medical services (CBO high-spending path); Social Security benefits paid as due; defense spending phases down gradually to $380 billion (2003 dollars) in 2022 and then grows at rate of CPI (CBO low-spending path); proportional decrease in discretionary spending is added based on *Restoring Fiscal Sanity's* smaller government plan. Despite the fact that under this plan "other federal spending" is shown to be 0.5 percent less of GDP than under the smaller government plan, both plans have the same amount of money available for programs. The difference occurs because of the different excess cost growth of medical care assumptions under each scenario and their corresponding effects on the Medicare premium offsets accounted for by CBO in the other federal spending category.

f. One percent excess growth of medical cost (CBO intermediate-spending path); Social Security benefits indexed to wages and prices; nondefense discretionary spending phases down to 3.6 percent of GDP by 2008 (CBO high-spending path); 1.5 percent of GDP for additional spending on domestic social programs and international aid.

g. Two and a half percent excess cost of growth of medical services (CBO high-spending path): Social Security benefits paid as due; defense spending follows FYDP through 2022 and then grows at rate of CPI (CBO high-spending path); 1.5 percent of GDP for additional spending on domestic social programs and international aid.

h. As noted in chapters 1 and 4, major uncertainties exist about the future costs of Medicare and Medicaid.

i. The outlays of the price indexing plan were estimated using the SSA memo on the President's Commission to Strengthen Social Security Model 2 as a basis for scaling the change in spending resulting from a pure price indexing plan. The hybrid wage and price indexing plan outlays are assumed to be halfway between pure price indexing and the baseline.

j. This number for "other federal spending" varies depending on the excess cost growth of medical services assumed. This occurs because "other federal spending" includes offsets for Medicare premiums.

k. Interest spending will depend heavily on revenue assumptions over the period. Interest spending in 2030 is approximated by taking the average percentage of GDP interest spending over the next ten years using the adjusted baseline. If deficits are not eliminated over the next decade, interest spending will be larger.

plans developed for the coming decade and illustrate the implications of extending them to 2030. The third scenario, "Investing in the Future," shows the consequences of restraining spending on the elderly in order to maintain programs designed to invest in young people and enhance economic growth. The fourth scenario, "Maintaining the Social Contract," shows the drastic cuts in other programs that would be necessary to fund current promises to seniors while keeping taxes from rising as much as under the larger government plan. Total federal spending in 2005 is expected to be almost 20 percent of GDP. Subtracting out interest on the debt, spending is 18.4 percent of GDP. (Interest payments reflect past decisions about deficit financing combined with the level of interest rates—not current decisions about desired levels of government spending. So looking forward we focus on "primary spending" only.) If current policies are not radically changed, primary spending is projected to rise to about 25 percent of GDP by 2030, as shown in column 2 of the table. This huge increase, equal to 6 percent of GDP, is driven by the increased cost of Medicare and Medicaid. If medical care costs continue to rise at their historical rate of 2.5 percent above the rate of increase of per capita GDP, these two programs alone will rise by more than 7 percent of GDP. Social Security, by contrast, will rise by less than 2 percent of GDP, even if current benefits are continued. Other federal spending, both defense and domestic, will rise in real terms, but it is projected to decline as a share of GDP.

While spending is projected to grow to unprecedented levels, revenues are not scheduled to keep pace. In the post–World War II period, revenues have averaged about 18 percent of GDP.[7] Since 2000, revenues have fallen sharply because of the federal tax cuts enacted over the past four years; they are estimated at 16.8 percent of GDP in 2005. Under the progressive U.S. income tax system, revenues gradually creep up as a share of the economy as higher incomes push people into higher tax brackets—so-called real bracket creep. Revenues also will rise as the retirement population grows and pays taxes on distributions of income from their IRAs or 401(k) plans. But the effects of bracket creep or pension distributions are modest compared with those of widely anticipated legislative actions to extend the tax cuts. Over the next decade and beyond, what happens to revenues will depend critically on whether the Bush administration's tax

cuts are allowed to expire as provided in current law or whether they are extended as the administration has proposed. The estimated annual cost by 2015 of extending all expiring tax cuts is $520 billion (including debt service), or 2.6 percent of GDP. If one adds in a further amount for adjusting the alternative minimum tax (AMT), the costs are still higher, and the loss of revenues from both extending the tax cuts and "fixing" the AMT would be $583 billion, or close to 3 percent of GDP.

The bottom line is that even if it is assumed that a number of existing tax provisions—such as lower income tax rates, a higher child tax credit, the elimination of the estate tax, and lower rates on capital gains and dividends—will be allowed to expire, the nation faces a growing gap between spending and revenues over the next few decades. If, as many expect, these provisions are made permanent, the gap becomes a yawning chasm. Without any extension of the aforementioned tax cuts, the primary deficit in 2030 amounts to 4.9 percent of GDP. If the tax cuts are extended, it balloons to 7 percent of GDP.[8]

Smaller Government Scenario

The smaller government scenario assumes that the political process works to hold primary federal spending at approximately its current share of GDP because voters simply refuse to accept higher taxes. Restraining spending will require dramatic departures from current policy, especially in Medicare and Medicaid, and the elimination of many government activities. This scenario depends on the emergence of a strong political consensus that the federal government should not grow faster than the economy, along with a willingness to restructure current programs to restrain their growth.

Advocates of restraining government growth believe that higher taxes would be burdensome to individuals and companies and risk damaging economic growth. They also believe that public spending undermines individual responsibility and initiative and that the private sector spends money more efficiently and effectively than any level of government. Many advocates of restricting federal growth also believe that Washington has usurped functions that would be better performed at the state and local level, where governments arguably are in closer touch with their citizens and know what they want.

In constructing the smaller government scenario, we took the specific cuts suggested for the smaller government plan over the next decade and extended them to 2030 (see column 3 of table 2-2). Relative to the 2030 baseline, this reduced "other federal spending"—everything except defense and the big three entitlement programs—by 1.4 percent of GDP. We achieved another 0.8 percent reduction by not allowing defense spending to grow with the economy. Finally, we placed far more responsibility on individuals to prepare for—and pay the costs of—their own health care and retirement. Initial Social Security benefits were increased to keep up with inflation but not with the projected rise in real wages.[9] As a result, benefits would fall by about 18 percent in 2030 and more steeply thereafter. We also assumed that the political process would set strict limits on the amount of health care expenses subsidized by the government. If health care costs continued to grow more rapidly than the economy, individuals and not government would bear the costs. As a result, seniors, low-income people, and the disabled would find their medical expenses absorbing increasing fractions of their incomes. Chapter 4 suggests some ways in which such limits might be crafted and spells out the likely consequences for beneficiaries.

The medical spending reductions combined with the much smaller Social Security checks envisioned in this plan would hit the elderly hard. In fact, it is difficult to imagine such a scenario being acceptable in a society in which large numbers of senior citizens vote. Yet, even with all of these changes, it is not possible to bring costs in line with revenues unless taxes are allowed to return to at least their historical levels as a share of the economy—that is, about 18 percent.

Still, because of bracket creep, tax revenues would eventually be higher than under our baseline assumptions (see chapter 5), so rates could be cut somewhat if desired. Under this scenario, the federal government would remain roughly as large as it is now despite the elimination of most farm and business subsidies, devolution of major federal functions to the states, cutbacks in many allegedly wasteful or ineffective federal programs, and drastic reductions in now-promised benefits under Social Security, Medicare, and Medicaid. This surprising finding simply reflects the fiscal pressures created by a growing elderly population. Even with no increase in spending per elderly person to accommodate the increased health care

costs and higher standards of living that will prevail in the future, the sheer size of the older population means that federal programs will absorb an additional 3 percent of GDP. For that reason, in order to keep taxes at their historical levels, it is necessary to restrict defense and the rest of government spending in ways that currently are politically unthinkable.

Larger Government Scenario

At the other extreme, the larger government scenario assumes that the upward pressure on federal spending over coming decades will induce Americans to accept higher taxes as they call on their government to do more. As they contemplate the choices, Americans may reject reductions in currently promised Social Security benefits. They may also be unable to accept the consequences of shifting the rising costs of medical care from the federal government to individuals. At the same time, they may not want to cut back on other federal services to make room in the budget for the growing retirement programs. Indeed, as incomes rise, citizens may demand more support for education, research, and cultural programs; environmental protection; transportation; and other public goods. Concern about growing divisions in U.S. society also may increase. The distribution of income has become more unequal in recent decades, child poverty rates are much higher than in other industrialized countries, and there is emerging evidence that opportunities to move up the ladder have shrunk for those born into lower-income families.[10] Welfare reform has succeeded in moving many of the poor into jobs, but their incomes remain very low.[11] The public may see government support for low-wage workers (the earned income tax credit, child care, worker training, wage insurance) as necessary to maintain support for a free market economy without European-style labor market regulation, such as high mandatory minimum wages and restrictions on laying off workers.

It may also prove exceedingly difficult to cut other government spending to make room for the retirement programs because many government services are labor intensive and their costs rise as real wages increase. Capital investment and the increased use of technology can improve government efficiency, but there is no way to fully automate bedside nursing,

the training of military personnel, preschool education, or managing a national park. In the case of medical care, much greater efficiencies in delivery are certainly possible (see chapter 4), but history does not provide encouragement that cost growth will diminish. Medical advances have created highly effective means of improving health and longevity, but they have generally increased the demand for health care and per capita health care costs.

Increasing global interconnectedness and threats to national security may make it impossible to reduce the share of GDP devoted to defense and international affairs and may even force significant increases. Fighting terrorism and ensuring the safety of the United States and its allies is a clear federal responsibility. It is impossible to predict how threats to American security might evolve over the next several decades or how Americans might respond. An optimistic view would be that current efforts will succeed in reducing terrorist threats to a low level and that no unfriendly superpower or nuclear-armed rogue state will emerge to challenge U.S. hegemony. The United States might then be able to maintain forces sufficient to handle occasional regional threats to the peace around the world and contribute to multilateral peacekeeping, humanitarian, and economic development efforts while maintaining defense and international spending at less than their current share of GDP. A pessimistic view could include continued escalation of militant Islamic terrorist activity; credible nuclear threats from North Korea, Iran, or elsewhere; or the emergence of a hostile government in China intent on military confrontation with the United States. A less frightening, but no less expensive alternative might include the realization that the best hope for American security lies not in more weaponry, but in massive investment designed to raise the standard of living in the poorer parts of Asia, Africa, and Latin America.

The larger government plan spends an additional $420 billion (2004 dollars), as detailed in table 2-3.[12] The plan, which is intended to illustrate what could be accomplished with that level of funding, includes providing a high-quality preschool education for all children under the age of five, with fees based on parental income (estimated cost, $47 billion). It also includes additional federal funding to improve elementary and secondary education. A large portion of those funds would be used to

Table 2-3. *Larger Government Scenario*

Category	*Billions of dollars*
Higher education[a]	10
K–12 education[b]	40
Pre-K[c]	47
Child care[d]	51
Health care[e]	167
Wage supplements[f]	14
Official development aid[g]	79
Revenue sharing with states	12
Total	420

a. Increases the existing Pell grant program by 75 percent so that, maintaining current eligibility, every grant recipient will get a 75 percent larger grant than under the current system.

b. Primarily devoted to increased funding for teacher quality and training, with about $10 billion left over for other increases in funding for K–12 initiatives. Source: Matthew Miller, *The 2 Percent Solution* (New York: Public Affairs, 2003).

c. Establishes a full-year program with income-related fees and demand-based hours for all children under five years of age. Source: Richard N. Brandon, "Financing Access to Early Education for Children Age Four and Below: Concepts and Costs," paper prepared for the Brookings–University of North Carolina Conference on Creating a National Plan for the Education of Four-Year-Olds," September 9–10, 2004 (revised October 2004).

d. After-school child care for children five to thirteen years of age from families in the bottom four deciles of the income distribution (below about $34,000).

e. Provides federal funding for voluntary, open-access, state-operated insurance pools allowing individuals the option of various privately run health plans at various premium levels. Reduced premiums would be available to low- and middle-income participants. The plan would be open to both employers and individuals and would base its premium on average costs for the non-Medicare population throughout the community. Source: Economic and Social Research Institute, "Covering America: Real Remedies for the Uninsured," June 2001 (www.esresearch.org/covering_america.php [March 17, 2005]).

f. Increase the earned income tax credit so that a full-time, minimum wage worker with two or more children would receive an increase of 14 percent.

g. Implement the recommendations of the UN Millennium Project by devoting 0.7 percent of GNP to official development aid by 2015 and then holding spending constant with inflation and population.

improve the quality of teaching through in-service training and much higher salaries for new teachers combined with reforms that link pay to performance more closely (estimated cost, $40 billion).[13] Access to post-secondary schooling is enhanced by increasing the amount of funding for Pell grants by 75 percent (estimated cost, $10 billion). For an average recipient, the federal grant would increase from about $2,500 a year to more than $4,300. Federal grants to the states for child care are expanded to cover all children under the age of fourteen in families with an income of below four-fifths of median income that are not already covered by other programs (estimated cost, $51 billion). The earnings of low-income

working families are given a boost by increasing the earned income tax credit (estimated cost, $14 billion).

By far the most expensive item on this list is health care (estimated cost, $167 billion), which represents the provision of subsidized insurance to low- and moderate-income families through state-run, voluntary insurance pools. Private insurers would compete to provide a basic package of health care services to the non-elderly, thereby improving the efficiency of the system and sharply reducing the number of uninsured Americans.

To reduce human suffering and global poverty while countering the spread of terrorism, the plan provides additional international assistance sufficient to achieve the Millennium Development Goal of 0.7 percent of GNP by 2015 (estimated cost, $79 billion). This goal was set with the objective of halving extreme poverty in developing countries.[14]

Finally, the plan allocates $12 billion for grants to the states based on their population, their wealth, and their own tax-raising efforts. They could then choose whether to spend more on education, highways or mass transit, urban or rural housing or redevelopment, the environment, crime, or other high-priority needs. The advantage of this kind of flexible grant program is that it raises the funds using a broad-based, progressive tax system at the federal level and distributes them to the areas most in need while allowing governors and other state leaders the freedom to set priorities and find more innovative solutions to their problems.

To pay for this plan, people would have to be willing to pay higher taxes. As described in chapter 5, the required revenues could be raised by allowing recent tax cuts to expire, closing loopholes, and creating a new, broad-based consumption tax, such as a 10 percent value-added tax on most expenditures.

A big drawback of this scenario is its cost. Revenues as a share of GDP in 2030 would be about 10 percentage points higher than under the smaller government scenario. The needed revenues could be raised as described in table 5-1 of chapter 5. To put these additional revenues in context, it should be noted that other industrialized countries currently live with much higher taxes than the United States. For example, in 2005 total taxes collected in each of seventeen countries—including the United Kingdom, Germany, the Netherlands, Belgium, and France—will amount to at least 10 percent more of GDP in those countries than do total taxes

in the United States.[15] (Including all taxes collected at the local, state, and federal level, the ratio of taxes to GDP is 31 percent in the United States.)

It also is worth noting that with continued growth in the economy, incomes will be much higher in 2030 than they are now. Specifically, real average household income will grow from $67,000 a year in 2005 to about $96,000 in 2030. So even though taxes will take a bigger bite out of people's incomes, because their incomes will be so much higher, after-tax incomes will still increase by 25 percent under the larger government scenario.[16] The issue is not whether this level of government is affordable; it is whether citizens want to devote some of their additional income to the kinds of public uses outlined in this scenario.

Maintaining the Social Contract

This scenario maintains the social contract with senior citizens by downsizing the rest of government. The emphasis is on keeping existing commitments to the elderly by continuing to provide the benefits currently promised under Social Security, Medicare (including prescription drug coverage), and Medicaid. But to do so without a very large increase in tax rates requires major cutbacks in defense and domestic spending programs. Indeed, the rest of government would need to have its funding cut to the bone.[17] By 2030, domestic spending outside of homeland security would be at its lowest level since data were first collected in 1960. That would mean far fewer resources for the environment, public safety, research, education, housing, unemployment insurance, child care, school lunches, farm subsidies, clean water, law enforcement, and most other such needs.

Although it is unlikely that such a scenario would ever come to pass, it illustrates the enormous fiscal pressures associated with the rising costs of health care and retirement—what some have called "the big squeeze."[18] Because they are entitlements, these health care and retirement programs are now on automatic pilot, whereas most of the programs that serve younger families and their children are vulnerable to cutbacks during the annual appropriations process in Congress. Moreover, because of the political clout of the elderly, it is harder to constrain spending on the health and retirement benefits that they receive. In one manifestation of that clout, one regularly hears elected officials, including

the president, say that they will not cut benefits for those who have already retired or are about to retire. No such commitment is made to working-age families that rely on various government benefits, from child care subsidies to health care, even though they often have far fewer resources to fall back on than many of the elderly.

Investing in the Future

This scenario is the mirror image of the plan to maintain the social contract. It curbs spending on the elderly, although not nearly as much as in the smaller government scenario, but it invests more generously in the future-oriented programs and policies, as does the larger government plan. In the end, it imposes a lower tax bill than does the plan to maintain the social contract, and if one believes that future-oriented investments have longer-term payoffs for the economy, then it might cost even less. For example, if investments in education and in better functioning transportation systems lead to more productive workers with higher incomes, those investments would produce higher revenues at any given set of tax rates. The key to making this scenario a reality lies in finding ways to control the growth of health care costs (in our scenarios, from 2.5 percent "excess medical cost inflation" to 1.0 percent). Doing so could involve some combination of guaranteeing a controlled level of subsidy for health care insurance ("premium support"), providing catastrophic coverage only, or rationing care based on more evidence about its effectiveness (see chapter 4). Beyond that, some savings can be gleaned by indexing initial Social Security benefits so that they continue to rise in real terms but not as rapidly as real wages. That approach would put a floor under retirement incomes but place greater responsibility on individuals to save during their working years. However, the budgetary savings from these changes in Social Security benefits pale in comparison to what can be achieved through lower health care costs.

Conclusion

The task of balancing the budget over the next decade is formidable. As illustrated in this chapter, it would take deep spending cuts or substantial

new revenues. A more rapid rate of economic growth than currently anticipated or a much slower rate of increase in health care costs could ease the task, but counting on such fortuitous developments would not be wise. Indeed, the next decade will mark only the beginning of what promises to be an unprecedented challenge: how to balance the budget over the longer term as the population ages. To achieve that goal will require Americans either to pay higher taxes than in the past (at least another 6 percent of GDP) or to sharply reduce current levels of support for the elderly by asking them to pay far more for their own health care and retirement. A third alternative—which is to squeeze down most other government programs—will prove inadequate to the task and detrimental to the well-being of younger families and children.

For those who believe that taxes are already too high and government too large and intrusive, we have illustrated the kinds of specific cuts in both entitlements and the rest of government spending that will be required to both balance the budget over the next decade and prevent it from expanding as the population ages. The startling reality here is that even draconian cutbacks in promised benefits to the elderly are insufficient to offset the fiscal pressures created by the sheer increase in their numbers.

For those who find this path of deep spending cuts distasteful, we have crafted a scenario that requires paying substantially higher taxes (an additional 8 percent of GDP, compared with the historical average). That scenario would move the United States closer to accepting the tax levels that prevail in most other industrialized countries but permit greater investment in a range of priorities including education, health care, and assistance to poorer countries and local communities here at home.

Notes

1. The federal government also pursues various objectives through the tax system. For more discussion of these "tax expenditures," see chapter 5.

2. Spending cuts were calculated by assuming an equal reduction in total spending each year between 2004 and 2015 so that the deficit would be eliminated by 2015. About 75 percent of the spending cuts came from discretionary programs; the remainder of the reduction in spending is due to lower interest costs.

3. If we had excluded surpluses in Social Security and Medicare from the budget, we would have set ourselves a deficit reduction target of $1 trillion, but the lower target seemed difficult enough.

4. For a related effort, see Chris Edwards, "Downsizing the Federal Government," Policy Analysis 515 (Washington: Cato Institute, June 2, 2004). Edwards argues that federal spending can be reduced to 17.6 percent of GDP by 2009 by terminating some programs, devolving responsibilities to state or local governments, and privatizing other functions. He cuts a total of $300 billion in FY2004 outlays.

5. These deficit figures are adjusted to extend expiring tax provisions, to adjust the AMT, and to keep discretionary spending per capita constant. Defense spending includes supplementary spending on Iraq, Afghanistan, the global war on terror, and domestic military operations for homeland security.

6. Spending as a proportion of GDP has averaged 20 percent for the past fifty years. Congressional Budget Office, "The Long-Term Budget Outlook" (December 2003), p. 2.

7. Congressional Budget Office, "The Budget and Economic Outlook" (January 2005), figure 4-1.

8. While the effects of interest costs are difficult to predict exactly, it is safe to say that adding interest into the mix will exacerbate the problem.

9. In computing initial benefits, earnings in past years are increased by the amount that average real wages have risen since the wages were earned. After retirement, benefits are indexed to consumer price changes.

10. Gary Burtless and Christopher Jencks, "American Inequality and Its Consequences," in *Agenda for the Nation,* edited by Henry J. Aaron, James M. Lindsay, and Pietro S. Nivola (Brookings, 2003), pp. 61–108.

11. Isabel V. Sawhill and others, *Welfare Reform and Beyond: The Future of the Safety Net* (Brookings, 2002).

12. This represents an extra 1.5 percent of GDP in 2030, together with a "growth dividend" (the additional dollars yielded from keeping constant the ratio of "other federal spending" to GDP).

13. Matthew Miller, *The 2 Percent Solution* (New York: Public Affairs, 2003), p. 126.

14. UN Millennium Project, *Investing in Development: A Practical Plan to Achieve the Millennium Development Goals* (New York: United Nations Development Program, 2005).

15. Organization for Economic Cooperation and Development, Economic Outlook 76 Database, Annex table 26 (www.oecd.org/dataoecd/5/51/2483816.xls [March 14, 2005]).

16. At 18 percent of GDP, taxes are roughly $14,000 per household (.18 × 1.2 × $67,000). By 2030, under the larger government plan, taxes would need to be about $30,000 (.26 × 1.2 × $96,000). The 1.2 multiplier is the estimated ratio of GDP to personal income.

17. Despite the fact that under this plan "other federal spending" is shown to be 0.5 percent less of GDP than under the smaller government plan, both plans

have the same amount of money available for programs. The difference occurs because of the different excess cost growth of medical care assumptions under each scenario and their corresponding effects on the Medicare premium offsets accounted for by CBO in the other federal spending category.

18. C. Eugene Steuerle, "The Incredible Shrinking Budget for Working Families and Children," National Budget Issues Policy Brief 1 (Washington: Urban Institute, 2003).