THE FEDERAL BUDGET OUTLOOK

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Mr. Chairman and members of the Committee, thank you for the opportunity to testify on the President's Fiscal Year 2005 Budget and the budget outlook. My testimony makes several key points:

- The nation is on an unsustainable fiscal path – and the Administration's budget makes the long-term fiscal problem substantially worse.

- Assuming that we extend expiring tax provisions, maintain a constant level of real per capita discretionary spending, and reform the alternative minimum tax, the unified budget deficit over the next 10 years amounts to $5 trillion or more, according to a wide variety of independent analysts.

- The unified budget projections include large cash-flow surpluses accruing in trust funds for Social Security, Medicare, and government pensions over the next 10 years. In the longer term, Social Security and Medicare face significant deficits. Outside of the retirement trust funds, the adjusted budget now faces a deficit of more than $8 trillion over the next decade.

- Sustained budget deficits have damaging economic consequences. Ongoing fiscal deficits will reduce future national income, reduce flexibility to respond to unforeseen events in the future, and increase the risk of fiscal and financial disarray, with potential costs far larger than those presented in conventional economic analyses:

    - Using conventional economic tools and conservative assumptions that have previously been adopted by the Bush Administration's Council of Economic Advisers, the deterioration in the official CBO projections since January 2001 will, by 2012, raise interest rates by 125 basis points, reduce

[1] The views expressed are those of Dr. Orszag alone and should not be attributed to the trustees, officers, or staff of the Brookings Institution or the Tax Policy Center. Much of this testimony draws directly upon joint work with William Gale of Brookings, Robert Rubin of Citigroup, and Allen Sinai of Decision Economics, Inc. See, in particular, William G. Gale and Peter R. Orszag, "The Budget Outlook: Updates and Implications," Brookings Institution, January 29, 2004, and Robert Rubin, Peter R. Orszag, and Allen Sinai, "Sustained Budget Deficits: Longer-Run U.S. Economic Performance and the Risk of Financial and Fiscal Disarray," Paper presented at the AEA-NAEFA Joint Session, Allied Social Science Associations Annual Meetings, The Andrew Brimmer Policy Forum, January 2004. My co-authors should not be held responsible for the views expressed in this testimony, however.

annual national income by more than $300 billion, and increase U.S. indebtedness to foreign investors. The adverse effects would persist and grow over time.

  - The conventional analysis may well understate the costs from large, sustained budget deficits such as the ones we now face in the United States. As Robert Rubin, Allen Sinai, and I recently concluded, "The scale of the nation's projected budgetary imbalances is now so large that the risk of severe adverse consequences must be taken very seriously, although it is impossible to predict when such consequences may occur."

- The Administration's budget substantially understates the fiscal imbalance likely over the next decade or so, because it ignores many likely costs:

  - Among other factors, under the Administration's policies, more than 33 million taxpayers would be on the Alternative Minimum Tax (AMT) by 2010 – and 34 percent of the 2001 tax cuts would be erased by the AMT. For households with incomes between $100,000 and $200,000, the AMT would take back almost two-thirds of the 2001 tax cuts by 2010.

  - The Administration's budget does not fully finance the Future Year Defense Plan and other likely defense costs.

  - Because it leaves out many likely costs, the Administration's claim to cut the budget deficit in half over the next five years is not credible.

  Even if the Administration's claim for the unified budget were credible, furthermore, the deficit outside Social Security under the Administration's own projections would remain 3.4 percent of GDP in 2009. And after 2009, according to the Administration's own projections of its extended policies, the budget would deteriorate rapidly.

- The tax cuts are a major fiscal issue for the next decade and thereafter. If the 2001 and 2003 tax cuts were extended, they would contribute significantly to the nation's long-term fiscal imbalance:

  - Making the 2001 and 2003 tax cuts permanent would increase the deficit by $1.7 trillion over the next decade. The Administration's budget shows a lower cost, but that is mostly because it assumes that the AMT "takes back" a growing part of the 2001 and 2003 tax cuts over time.

  - The total budget cost (with interest) from extending the 2001 and 2003 tax cuts, along with other expiring provisions such as the R&E credit, exceeds $2 trillion. If these tax provisions are worth extending, they should be paid for.

  - Over the next 75 years, the tax cuts would cost more than three times the actuarial deficit in Social Security.

- Fixing the budget problem at this point will require both spending reductions and revenue increases. *Both* are necessary to create an atmosphere of fiscal discipline, and abandoning fiscal discipline on one side of the budget likely induces a period of fiscal irresponsibility on the other side of the budget – exactly the opposite of what the "starve the beast" theory suggests.

- A new Brookings study, entitled *Restoring Fiscal Sanity,* illustrates the tradeoffs that the nation now faces in balancing the budget. The study puts forward three different plans for reaching balance in the unified budget by 2014: One approach primarily involves spending cuts and smaller government, another relies more heavily on tax increases to support an activist government, and the third suggests a balanced mix of spending cuts and tax increases along with a reallocation of government priorities. All three are designed to restore fiscal sanity over the coming decade and reach balance by 2014.

- To help create and enforce the steps needed to close the deficit, policy-makers should reinstate a set of workable budget rules. Unfortunately, the Administration's proposal to apply pay-as-you-go rules to mandatory spending only, and not to revenue changes, is counterproductive:

    - First, it would fail to foster the atmosphere of fiscal discipline that can come only from restraining both sides of the budget.

    - Second, it would create strong incentives for accelerating the trend of disguising spending changes as revenue provisions, thereby creating "tax entitlements."

  The Congress should restore pay-as-you-go rules to both mandatory spending and revenue changes, and should adopt more protections against gaming the rules with sunsets. It should also impose discretionary spending caps, although care must be taken to choose an appropriate level of spending allowed under such caps.

- In conclusion, the Administration's budget is most notable for what is *not* in it, rather than what is. It doesn't contain serious entitlement reform. It doesn't contain serious reform of the tax system or the Alternative Minimum Tax. And it doesn't contain a serious plan to reduce the nation's budget deficit over the next 10 years, let alone over the long term.

I. The Changing Budget Outlook

Table 1 examines the actual decline in budget outcomes between fiscal years 2000 and 2004. Despite recent assertions that domestic spending is skyrocketing out of control, the table shows that the vast majority of the recent increase in budget deficits is due to lower revenue, not higher spending. Between 2000 and 2004, the budget changed from a surplus of 2.4 percent of GDP to a projected deficit of 4.2 percent of GDP. Of this 6.6 percentage points of GDP change, 5.0 percentage points -- slightly more than 75 percent -- is due to lower revenues.

Much attention has been focused in particular on the growth of domestic discretionary spending. The table shows, however, that non-defense discretionary spending (which includes international assistance and pieces of homeland security) can account for less than 10 percent of the increase in the deficit as a share of GDP. The share of the deterioration attributable specifically to non-homeland security domestic spending (i.e., excluding both international assistance and non-defense homeland security) is well under 10 percent.

Table 1: Sources of Change in Unified Budget, 2000 to 2004
(Percent of GDP)

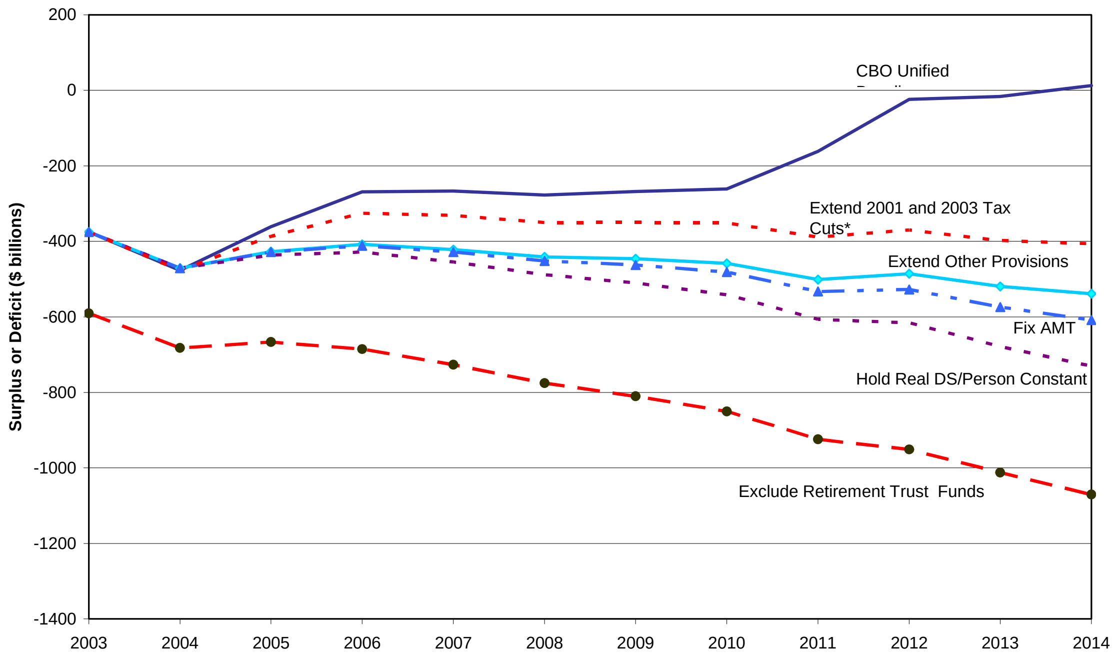
	2000	2004	Difference	Share of Change
Unified Budget Surplus (or Deficit)	2.4	-4.2	-6.6	100
Revenues	20.8	15.8	-5.0	76
Spending	18.4	20.0	1.6	24
Net Interest	2.3	1.4	-0.9	-14
Non-Interest Spending	16.1	18.6	2.5	38
Mandatory	9.8	10.8	1.0	16
Discretionary	6.3	7.8	1.5	23
Defense	3.0	3.9	0.9	14
Non-Defense	3.3	3.9	0.6	9

Other perspectives also support the view that revenue declines, not spending increases, are the main driving force behind the increase in deficits. Federal revenue in 2004 will be a smaller share of the economy than at any time since 1950. Spending, in contrast, is at its average share of GDP over the past 40 years.

II. 10-Year Budget Projections

The Congressional Budget Office recently issued a new set of 10-year budget projections. These new projections again underscore how dramatically projected budget outcomes have deteriorated since January 2001. Under the official CBO baseline projections, the unified budget now shows a cumulative decline of $8.5 trillion over the 2002 to 2011 horizon, the equivalent of 6.5 percent of projected GDP over the same period. The changes are not temporary -- they clearly represent a fundamental downward shift in fiscal trajectories. For example, the projected outcomes for 2005 and 2011 have each fallen by about 6.6 percent of projected GDP in that year.

Figure 1: CBO Baseline and Adjusted Budget Outcomes, 2003-2014



Source: William G. Gale and Peter R. Orszag, "The Budget Outlook: Updates and Implications," Brookings Institution, January 29, 2004.
* Excluding bonus depreciation provision.

The official CBO projections, furthermore, are not predicated on credible assumptions about the current thrust of budget policy, since statutory and other restrictions prevent the CBO from adopting more reasonable assumptions in its baseline. Figure 1 shows the sizable effects of adjusting the CBO projections in various ways. The CBO unified budget baseline for FY 2005-2014 projects a ten-year deficit of $1.9 trillion, with deficits falling sharply over time. Adjusting the CBO baseline by extending expiring tax provisions, reforming the Alternative Minimum Tax, and maintaining a constant level of real discretionary spending per capita generates a unified budget deficit to the tune of $5.5 trillion over the next decade.[2]

[2] William G. Gale and Peter R. Orszag, "The Budget Outlook: Updates and Implications," Brookings Institution, January 29, 2004. Note that these calculations assume that the bonus depreciation provisions from the 2002 and 2003 tax cuts are extended. The Administration has indicated that it will not support extension of these provisions. As Table 3 below shows, if these provisions were not extended, the unified budget deficit over the next 10 years would be roughly $600 billion lower.

Other recent estimates are similar. The Center on Budget and Policy Priorities, for example, estimates a 10-year unified deficit of $5.2 trillion.[3]

Note also that the unified budget includes retirement trust fund surpluses of almost $3 trillion. The estimates in Figure 1 suggest that taking the retirement funds off-budget generates a ten-year deficit, other than retirement funds, of $8.5 trillion.

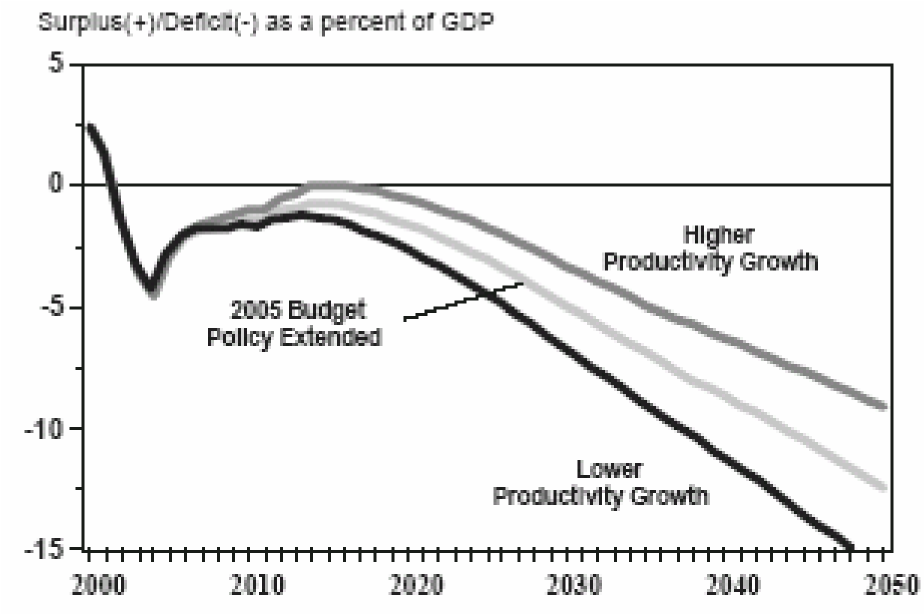
These figures, although based on the CBO baseline projections, underscore why the Administration's budget substantially understates the fiscal imbalance likely over the next decade or so:

- The Administration's budget ignores many likely costs, such as:
  - Fixing the Alternative Minimum Tax (see below). Preventing tens of millions of taxpayers from becoming subject to the AMT would reduce revenue by about $70 billion in 2009.
  - Funding likely defense costs. The Center on Budget and Policy Priorities, using estimates from the Center on Strategic and Budgetary Assessments on the costs of financing the Future Year Defense Plan and other likely defense needs, recently concluded that defense discretionary outlays would total 3.8 percent of GDP in 2009.[4] The Administration's budget, by contrast, shows defense discretionary outlays that are roughly half a percent of GDP lower in 2009. The difference amounts to about another $70 billion.
  - The Administration's budget likely excludes other costs, such as in international discretionary spending, raising the gap between a realistic projection and the figures in the Administration's budget.
- The budget also includes proposals, such as those creating Retirement Savings Accounts and Lifetime Savings Accounts, whose long-term costs are masked in the short term.
- Finally, the budget does not include the cost of diverting Social Security revenue into private accounts, a step that the President has embraced. Over the next ten years, such a proposal could expand the unified deficit by more than $1 trillion.
- In summary, the Administration's claim to cut the budget deficit in half over the next five years is not credible.

[3] Richard Kogan, David Kamin, and Joel Friedman, "Deficit Picture Grimmer than new CBO Projections Suggest," Center on Budget and Policy Priorities, revised February 1, 2004.
[4] Based on calculations in Richard Kogan, David Kamin, and Joel Friedman, "Deficit Picture Grimmer than new CBO Projections Suggest," Center on Budget and Policy Priorities, revised February 1, 2004.

Even if the Administration's claims about the unified budget were credible, two further points are worth noting. First, according to the Administration's own numbers, the budget outside Social Security would still be running a deficit of 3.4 percent of GDP in 2009. Second, the unified deficit would deteriorate rapidly after 2009, again as the Administration's own figures show. Figure 2 is taken from the *Analytical Perspectives* part of the Administration's FY 2005 Budget. It shows that even with somewhat faster productivity growth than assumed in the central projections, an extension of the Administration's 2005 budget policies would be associated with large and growing deficits over time.

Figure 2: Long-term budget outlook under the Administration policy



Source: *FY 2005 Analytical Perspectives*, Chart 12-5.

III. Expiring tax provisions

As the figure suggests, the extension of expiring tax provisions has a substantial effect on the budget outlook over the coming decade. All of the tax cuts enacted in 2001, 2002, and 2003 expire or "sunset" by the beginning of 2011. A variety of other tax provisions that have statutory expiration dates are routinely extended for a few years at a time as their expiration date approaches. Making all of the provisions in the 2001 and 2003 tax cuts permanent would reduce revenues by about $2 trillion over the next decade. Counting the added interest payments to service higher levels of federal debt, the total increase in the deficit would be $2.35 trillion.

Table 2 shows that about $600 billion of the cost associated with extending the tax cuts is attributable to the 50 percent bonus depreciation provision. The Administration has indicated that it does not support extension of the bonus depreciation provision. Excluding the bonus depreciation provision, extension of the other provisions in the 2001 and 2003 tax cuts would reduce revenue by $1.5 trillion over the next 10 years and add $246 billion in debt service costs, for a total budget cost of $1.8 trillion. Extending other expiring provisions would cost another $400 billion, for a total cost of more than $2 trillion excluding the bonus depreciation provision.

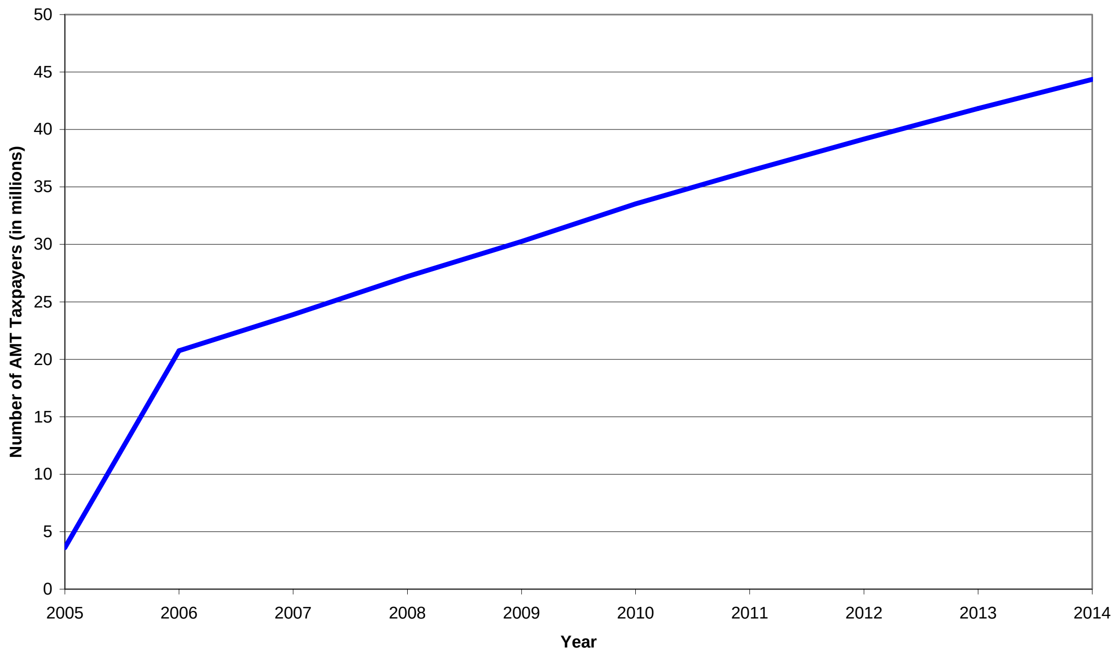
Table 2: Effects of extending tax cuts, $ billion

	2005	2009	2014	2005-2014
Expiring 2001 And 2003 Tax Cuts*				
Extend Estate and Gift Tax Repeal	-1	-2	-61	-206
Extend Other Non-AMT Provisions of EGTRRA, JGTRRA	-13	-16	-182	-748
Extend AMT Provisions of EGTRRA, JGTRRA	-10	-51	-99	-564
Interest	-1	-13	-77	-246
Subtotal	*-25*	*-81*	*-419*	*-1,764*
Extend 50 Percent Bonus Depreciation from 2002 and 2003 Tax Cut				
Revenue	-41	-48	-28	-440
Interest	-1	-14	-28	-148
Subtotal	*-42*	*-62*	*-56*	*-588*
Other Expiring Provisions				
Revenue	1	-31	-59	-342
Interest	0	-3	-18	-61
Subtotal	*1*	*-34*	*-77*	*-403*
All Expiring Tax Provisions				
Revenue	-65	-148	-429	-2,299
Interest	-1	-30	-123	-455
Total	*-66*	*-178*	*-551*	*-2,754*

* Excluding bonus depreciation provision.

The Administration’s budget displays a smaller cost of extending the 2001 and 2003 tax cuts (even excluding the bonus depreciation provision), but that is mostly because the Administration’s budget does not extend the temporary Alternative Minimum Tax (AMT) relief included in the recent tax cuts beyond 2005. The result is that an increasing share of the 2001 and 2003 tax cuts are “taken back” by the AMT over time. Figure 3 shows estimates from the Tax Policy Center of the number of taxpayers on the AMT under the Administration’s proposal. As the Figure shows, more than 33 million taxpayers would be on the AMT by 2010 under the Administration’s policies.

Figure 3:
AMT Taxpayers, 2005-2014, Administration Budget Policy



Source: Tax Policy Center estimates

Table 3 shows that under the Administration's policies, 34 percent of the tax cuts from the 2001 tax legislation would be erased by the AMT by 2010. For households with incomes between \$100,000 and \$200,000, the AMT would take back almost two-thirds of the 2001 tax cut by 2010. These shares would grow thereafter. The Administration's estimates assume that the AMT substantially reduces the cost of extending the tax cuts in this manner.

Table 3: Effect of the AMT on 2001 Income Tax Cuts, 2010

AGI Class (thousands of 2001\$)	Percent of Tax Filers With No Cut Due to AMT	Percent of Cut Taken Back By AMT
All	5.1	33.8
Less than 30	0.0	0.0
30-50	0.7	1.2
50-75	4.0	15.3
75-100	4.8	37.2
100-200	24.1	65.0
200-500	45.1	71.8
500-1,000	9.3	15.9
More than 1,000	8.1	8.2

Source: Urban-Brookings Tax Policy Center Microsimulation Model.

Assuming an AMT reform, the projected 75-year cost of the 2001 and 2003 tax cuts over the next 75 years is more than three times the projected 75-year actuarial deficit in Social Security. The tax cuts would cost more than 2 percent of GDP over the next 75 years in present value; the Social Security actuarial deficit over the next 75 years amounts to 0.7 percent of GDP in present value.

In evaluating the policy choices surrounding extension of the expiring tax cuts, it is worth emphasizing that they are highly regressive -- they provide a much larger percentage cut in after-tax income for high-income households than for low-income households.[5] If the tax cuts were made permanent, the top 1 percent of the income distribution in 2011 would experience an 8.6 percent increase in their after-tax income, whereas the middle quintile of the income distribution would experience a 2.7 percent average increase in their after-tax income.

Is extension of the provisions expiring in 2010 necessary to ensure economic prosperity? In the short run, the answer is clearly no. Reducing taxes after 2010 can actually hurt the economy today because financial markets are forward-looking; larger projected deficits in the future can therefore raise long-term interest rates in the short term. In the long run, the answer is also clearly no. The tax cuts themselves may have a modest positive effect on the economy, but they also increase the budget deficit, which has a negative effect on the economy.

The net effect of the tax cuts, according to a variety of estimates, is likely to be negative, not positive, in the long run:

- Gale and Potter (2002) estimate that the 2001 tax cut will likely reduce GNP over the next ten years; that is, they find that the negative effect of the decline in national saving outweighs the positive effect of reduced marginal tax rates.[6]

- Elmendorf and Reifschneider (2002) use a large-scale econometric model developed at the Federal Reserve and find that a reduction in taxes that appears similar to the personal income tax cuts in the 2001 law reduces long-term output and has only a slight positive effect on output in the first 10 years.[7]

- Auerbach (2002) estimates that the 2001 tax cut will reduce the long-term size of the economy unless it is financed entirely by spending reductions -- that is, unless it has no net effect on the surplus or deficit.[8]

[5] This section draws upon William Gale, Matthew Hall, and Peter Orszag, "Key Points on Making the Bush Tax Cuts Permanent," The Brookings Institution, January 21, 2004. These distributional estimates assume that the AMT exemption remains at $58,000 and the nonrefundable credits are allowed against the AMT.

[6] William G. Gale and Samara R. Potter, "An Economic Evaluation of the Economic Growth and Tax Relief and Reconciliation Act of 2001," *National Tax Journal*, March 2002, pp. 133-86.

[7] Douglas W. Elmendorf and David L. Reifschneider, "Short-Run Effects of Fiscal Policy with Forward-Looking Financial Markets," *National Tax Journal*, May 2002, pp. 357-386.

[8] Alan J. Auerbach, "The Bush Tax Cut and National Saving" *National Tax Journal*, May 2002, pp. 387-

- Orszag (2001) concludes that the net effect of legislation resembling the 2001 tax cut would be to reduce GNP by 0.1 to 0.5 percent after a decade.[9]

- JCT (2003) found that the 2003 jobs and growth package would generate zero or negative effects on jobs and growth in the second half of the decade.[10]

Finally, the Administration has claimed that the tax cuts need to be made permanent to reduce the uncertainty that taxpayers face. This argument is misleading. Making the tax cuts permanent would not help resolve the fundamental uncertainty about future tax rates or future policy. The reason is that the true underlying source of uncertainty in fiscal policy is how the fiscal gap is going to be closed—what combination of revenue increases and spending cuts will be used. Enacting another fiscally unsustainable policy (making the tax cuts permanent) on top of the already unsustainable fiscal situation does not make the situation more stable, only less so. This instability is particularly relevant given the risk of disarray that could ensue if financial markets become more concerned about how the fiscal gap will be addressed.

IV. Economic implications of budget deficits

The projections above indicate that the nation faces substantial deficits in the short-term and the medium-term, with no apparent relief within the next 10 years. Thereafter, the fiscal picture just gets worse as the baby boomers increasingly retire and ongoing health care cost increases drive up expenditures on Medicare and Medicaid. Several recent studies -- including from the International Monetary Fund -- have similarly warned about the unsustainable fiscal conditions in the United States.

If allowed to persist, the nation's fiscal gap will impose significant and growing economic costs over the medium term and potentially devastating effects over the longer term. The conventional economic analysis of sustained budget deficits emphasizes that ongoing budget deficits decrease national saving, which reduces domestic investment and increases borrowing from abroad. The reduction in domestic investment (which lowers productivity growth) and the increase in the current account deficit (which requires that more of the returns from the domestic capital stock accrue to foreigners) both reduce future national income, with the loss in income steadily growing over time.

As an example of the conventional analysis of budget deficits, President Bush's Council of Economic Advisers reported in the *Economic Report of the President 2003* that "one dollar of [public] debt reduces the capital stock by about 60 cents" and "a conservative rule of thumb based on this relationship is that interest rates rise by about 3

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[9] Peter R. Orszag, "Marginal Tax Rate Reductions and the Economy: What Would Be The Long-Term Effects of the Bush Tax Cut?" Center on Budget and Policy Priorities, March 2001.

[10] Joint Committee on Taxation, Macroeconomics Analysis of H.R. 2, The "Jobs and Growth Reconciliation Tax Act of 2003, "108th Congress, 1st session, 2003.

basis points for every additional $200 billion in government debt." Applying the CEA calculations to the $8.5 trillion decline over the past three years in official CBO baseline projections for 2002-2011 implies that interest rates will rise by 125 basis points. The CEA calculations also imply that the domestic capital stock will fall by $5.1 trillion by 2012 because of the deterioration in the fiscal outlook, even allowing for foreign inflows of capital. This means that the stock of net assets owned by Americans at the end of 2011 will fall by more than $5.1 trillion, and assuming a 6 percent return to capital, national income in 2012 would be more than $300 billion lower than it otherwise would have been.

An alternative set of assumptions used in the recent Brookings volume suggests the fiscal deterioration since January 2001 will raise interest rates by much more than 125 basis points, and that the reduction in national income would amount to $340 billion in 2012. This translates into a cost of more than $2,900 per household *in that year alone*. The adverse effect of deficits would persist (and grow) over time.

Robert Rubin, Allen Sinai, and I recently noted that the conventional analysis may understate the costs associated with large, ongoing deficits. As we wrote, "The adverse consequences of sustained large budget deficits may well be far larger and occur more suddenly than traditional analysis suggests, however. Substantial deficits projected far into the future can cause a fundamental shift in market expectations and a related loss of confidence both at home and abroad. The unfavorable dynamic effects that could ensue are largely if not entirely excluded from the conventional analysis of budget deficits. This omission is understandable and appropriate in the context of deficits that are small and temporary; it is increasingly untenable, however, in an environment with deficits that are large and permanent. Substantial ongoing deficits may severely and adversely affect expectations and confidence, which in turn can generate a self-reinforcing negative cycle among the underlying fiscal deficit, financial markets, and the real economy…Although it is impossible to know at what point market expectations about the nation's large projected fiscal imbalance could trigger these types of dynamics, the harmful impacts on the economy, once these effects were in motion, would substantially magnify the costs associated with any given underlying budget deficit and depress economic activity much more than the conventional analysis would suggest. Indeed, the potential costs and fallout from such fiscal and financial disarray provide perhaps the strongest motivation for avoiding substantial, ongoing budget deficits."[11]

V. Addressing the fiscal problem

Given the scale of the nation's budget problems and the need to reduce our reliance on borrowing from abroad, the time has come to move beyond merely not digging the budget hole deeper. Balancing the budget over time will require a

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[11] Robert Rubin, Peter R. Orszag, and Allen Sinai, "Sustained Budget Deficits: Longer-Run U.S. Economic Performance and the Risk of Financial and Fiscal Disarray," Paper presented at the AEA-NAEFA Joint Session, Allied Social Science Associations Annual Meetings, The Andrew Brimmer Policy Forum, January 2004.

combination of expenditure restraint and revenue increases. On the revenue side, a key issue is the treatment of legislation that contains expiring tax provisions. As one of the tables above indicates, extending the expiring tax provisions would cost in excess of $2 trillion over the next decade alone. *If these tax cuts are worth extending, they should be paid for.*

On the expenditure side, let me emphasize that although spending restraint is critical to restoring fiscal discipline, it is unrealistic at this point to expect it to generate the lion's share of the adjustment over the next 10 years. Indeed, a recent Brookings volume edited by Alice Rivlin and Isabel Sawhill presents several possible avenues for restoring fiscal balance in the medium-term.[12] These proposals combine spending cuts and tax increases, phase in gradually over time, and avoid budget gimmicks.

Even the "smaller government" plan devised by the more conservative members of the Brookings budget team required revenue increases (relative to a baseline in which the tax cuts were extended). The smaller government plan includes extremely aggressive reductions in federal spending -- including elimination of all federal discretionary spending for elementary and secondary education, housing and urban development, manpower training and related programs, and Environmental Protection Agency spending for clean water, drinking water, brownfields, targeted water infrastructure, Superfund, and related programs, as well as termination of the NASA's program of manned flight and all earmarks for local projects in the highway construction program. Yet even with these dramatic spending reductions, revenue increases were still necessary: The smaller government plan therefore includes measures such as an increase in the federal gas tax of 12 cents a gallon and reform rather than repeal of the estate tax.

The Rivlin-Sawhill volume should be required reading for those serious about balancing the budget over the medium term. To be sure, people may disagree with the options presented in the volume. The fundamental point of the book, however, is to provide insight into the types of steps necessary; *some other* change would have to substitute for any objectionable provisions in order to restore balance by 2014.

Moving toward budget balance over the medium term should be coupled with more serious discussion of reforming our long-term entitlement programs. Given the scale of the long-term budget deficit, it is imperative that long-term entitlement reform not be predicated on accounting gimmicks or massive assumed general revenue transfers from the rest of the budget to the entitlement programs.[13]

Finally, to help create and enforce the steps needed to close the budget deficit,

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[12] A. Rivlin and I. Sawhill, eds, *Restoring Fiscal Sanity: How to Balance the Budget,* Brookings Institution, January 2004.

[13] As one possible example, Professor Peter Diamond of MIT and I have recently proposed a Social Security reform plan that involves no transfers from the rest of the budget to Social Security. See Peter A. Diamond and Peter R. Orszag, *Saving Social Security: A Balanced Approach* (Washington, DC: Brookings Institution Press, 2004).

policy-makers should re-institute a set of effective budget rules that include both discretionary spending caps and pay-as-you-go constraints. The budget rules must apply to *both* sides of the budget, however. The Administration's proposal to apply pay-as-you-go rules to mandatory spending only, and not to revenue changes, is counterproductive. By exempting revenue changes from the rules, the proposal has two fatal flaws. First, it would fail to foster the atmosphere of fiscal discipline that can come only from restraining both sides of the budget. Second, it would create strong incentives for accelerating the trend of disguising spending changes as revenue provisions, thereby creating "tax entitlements." The Congress should restore effective pay-as-you-go rules to both mandatory spending and revenue changes, and adopt tighter restrictions against gaming the rules with sunsets.