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How to Balance the Budget

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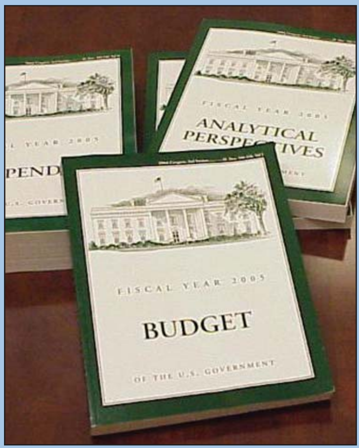
The federal government is spending about $500 billion a year more than it is raising in taxes. If nothing is done, that gap will widen to around $700 billion annually by 2014 and accelerate rapidly thereafter, as baby boomers begin to retire.



Persistent deficits of this magnitude are likely to lower standards of living, make us dangerously dependent on the rest of the world, and pass on large fiscal burdens to future generations. Balancing the budget, while politically difficult, must be a priority. In an effort to stimulate debate over a compromise that would appeal to different groups, we present three ways to achieve balance over the next ten years. One option emphasizes spending cuts and leads to a smaller government. A second relies on tax increases and leads to bigger government. The third maintains government's current size, but makes it more effective, and contains a mix of spending reductions and tax increases, sufficient to achieve balance in ten years while preserving room for some high-priority new initiatives.

We conclude that neither political party currently has a workable plan for reducing the long-term deficit, that both spending cuts and tax increases will be needed, and that stronger budget process rules would help members of Congress be more fiscally responsible.

AN OVERVIEW OF THE FEDERAL BUDGET

In 2003, the federal government spent $2.2 trillion. Over two-fifths of this spending was for just three large programs: Social Security, Medicare, and Medicaid. About a third of current spending is for other (primarily) domestic programs—everything from unemployment insurance and farm subsidies to national parks, education, and programs for the poor. Many of these programs are funded through the annual appropriations process and, as a result, are referred to as "discretionary" since the funding for them is less

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Related Brookings Resources

- *Restoring Fiscal Sanity: How to Balance the Budget*
  Alice M. Rivlin and Isabel V. Sawhill, eds. (2004)
- *Defense Policy Choices for the Bush Administration*, second edition
  Michael E. O'Hanlon (2002)
- *The Federal Budget: Politics, Policy, Process*, revised edition
  Allen Schick, Felix LoStracco (2000)

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automatic than spending on "mandatory" programs, such as Social Security or unemployment insurance. A significant chunk of the budget goes for defense (19 percent) and for interest on the debt (7 percent).

Why Sustained Deficits are Harmful

Not all budget deficits are bad—indeed, recent deficits accelerated recovery from the recession that began in 2001. But longer-term deficits of the current magnitude are harmful for five reasons:

They slow economic growth. By 2014, the average family's income will be an estimated $1,800 lower because of the slower income growth that results when government competes with the private sector for a limited pool of savings or borrows more from other countries.

They increase household borrowing costs. A family with a $250,000, thirty-year mortgage, for example, will pay an additional $2,000 a year in interest.

They increase indebtedness to foreigners, which is both expensive and risky. The United States is the largest net debtor in the world. The income of Americans will ultimately be reduced by the interest, dividends, and profits paid to foreigners who have invested in the United States. Moreover, if foreigners lose confidence in the American economy—or begin to worry that the United States is not managing its fiscal affairs responsibly—they may reduce their investment. This can decrease the value of the dollar and raise the prices we have to pay for imported goods. If the dollar's fall were precipitous, it could cause rapid increases in interest rates, recession, or even a serious financial crisis.

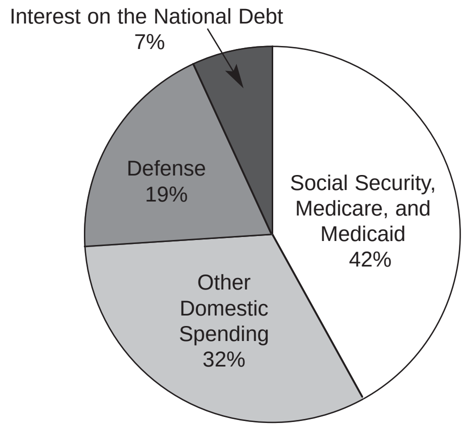
They require that a growing proportion of federal revenues be devoted to paying interest on the national debt, which is estimated to increase by more than $5 trillion over the next decade. By 2014, this increase in government borrowing will cost the average household $3,000 in added interest on the debt alone. One out of every five tax dollars will need to be set aside for this purpose.

They impose enormous burdens on future generations. Today's children and young adults and their descendants will have to pay more because this generation has been fiscally irresponsible. At the same time, deficits and rising interest costs are likely to put downward pressure on spending for education, nutrition, and health care that could make today's children more productive and thus better able to pay these future obligations.

THE BUDGET OUTLOOK

Less than three years ago, in fiscal year 2001, the federal budget was running a surplus of $127 billion. But a weak economy, tax cuts, spending increases, and a lack of concern for fiscal discipline turned the surplus into a deficit predicted to be over $500 billion in 2004. This shift in federal finances from deficit to surplus would not be a serious concern if it were temporary. Unfortunately, however, the current deficits are projected to continue for the next decade, rising to around $700 billion in 2014. Indeed, if the temporary surpluses in Social Security, Medicare, and federal retirement programs were not masking the size of the deficits in the rest of the budget, the deficit estimate for 2014 would exceed $1 trillion. These projections are based on those of the Congressional Budget Office (CBO), but they assume that the tax cuts enacted in recent years are made permanent, as the president has proposed, and that Congress will amend the alternative minimum tax (AMT) to prevent an increase in the number of taxpayers subject to the AMT. They also assume discretionary spending increases in line with population growth as well as with inflation—that is, real discretionary spending per person is held constant—and include the cost of the prescription drug benefit and other changes in Medicare enacted at the end of the first session of the 108th Congress.

Figure 1: Federal Spending, 2003 estimate



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

DEFICITS BEYOND 2014

A major additional reason for concern about continuous large deficits is that pressures on the budget are certain to escalate rapidly as the baby boom generation retires and longevity continues to increase. The CBO projects that even if medical care costs rise only 1 percent faster than per capita GDP—an optimistic assumption in view of recent increases—expenditures for providing existing benefits under Social Security, Medicare, and Medicaid would rise from 9.0 percent of GDP in 2010 to 14.3 percent in 2030 and to 17.7 percent in 2050. These exploding future costs highlight the need to address the challenge of reforming these entitlement programs as soon as possible. They also make clear the importance of fiscal policy that contributes to future economic growth by enhancing national saving—not reducing both growth and saving by running continuous deficits over the coming decade.

Can Growth Solve the Problem?

Deficits are very sensitive to the rate of economic growth. Should the economy grow faster than the 3 percent rate, in real terms, assumed by the CBO and most private forecasters, deficits will be smaller. If the economy grows more slowly than this, they will be still larger. Some believe that recent changes in tax law will lead to higher rates of economic growth. But as long as these tax cuts are deficit financed, the weight of professional opinion suggests that they will not lead to higher growth.

This policy brief is based on a report issued by the Brookings Institution on January 13, 2004 (www.brookings.edu/budget), and reflects updates following the release of the Bush administration's budget for FY 2005 on February 2. Along with Alice M. Rivlin and Isabel V. Sawhill, the authors of the report are: Henry J. Aaron, Lael Brainard, William G. Gale, Ron Haskins, Michael E. O'Hanlon, Peter R. Orszag, and Charles L. Schultze, who are all senior fellows at Brookings.

The authors have also collaborated on a new book, *Restoring Fiscal Sanity: How to Balance the Budget* (Brookings, 2004).

> "Balancing the unified budget by 2014 will produce interest savings of around $153 billion, leaving a deficit of $534 billion to be eliminated by spending reductions or revenue increases in that year."

THE ADMINISTRATION'S PLAN

In the administration's fiscal year 2005 budget, released in February of this year, the president proposes to reduce the deficit, as a share of GDP, by half over the next five years. If the recovery continues and the economy performs well, the deficit should decline for this reason alone. However, many analysts are skeptical that it will decline as much as the administration predicts. The full costs of the wars in Afghanistan and Iraq are not included. The AMT that will hit millions of middle class families with higher tax bills over the next five years is not fixed. And the assumptions about the government's ability to restrain domestic discretionary spending are very optimistic.

But even if some combination of policy actions and a strong economy reduces deficits over the next few years, they are almost certain to balloon again after that; and the administration has no long-term plan for restoring fiscal balance. The president's budget proposal for fiscal year 2005 recognized the importance of deficit reduction by announcing a goal of cutting the deficit in half (as a percent of GDP) in five years. However, after the five-year period, the red ink would flow even faster if the administration's plans were adopted. In addition to proposing to make the recently enacted tax cuts permanent (assumed in our own estimates of future deficits), the president's budget advocated new tax-preferred savings accounts and a Social Security plan that, if adopted, would increase deficit spending far beyond the projections in this study.

THREE DIFFERENT WAYS OF GETTING TO BALANCE

In our book, *Restoring Fiscal Sanity*, we propose three alternative plans for balancing the budget over the next ten years. They differ in the mix of spending cuts and revenue increases used to achieve balance (table 1). All three plans start from our adjusted baseline projections, which indicate that in the absence of policy change, the deficit in 2014 will be about $687 billion. (This estimate and others in the table are based on the Congressional Budget Office's August 2003 report, adjusted in the ways described above. CBO revised their forecast in December 2003 but these revisions do not materially affect our analysis in any important way.)

Balancing the unified budget by 2014 will produce interest savings of around $153 billion, leaving a deficit of $534 billion to be eliminated by spending reductions or revenue increases in that year. If we chose the more stringent criterion of balancing the budget excluding the federal retirement programs, it would be necessary to reduce the deficit by another $316 billion. Although achieving the larger goal would be desirable, the plans amply illustrate that even meeting the less ambitious target requires tough choices that are sure to be unpopular.

THE SMALLER GOVERNMENT PLAN

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. It balances the budget primarily by cutting $400 billion from projected domestic spending in 2014.

Table 1: Illustrative Changes in 2014 by Plan Type
(billions of dollars)

Item	Better Government Plan	Larger Government Plan	Smaller Government Plan
Total deficit reduction	687	687	687
Interest payment reduction	-153	-153	-153
Tax increase	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: Authors' calculations and Congressional Budget Office, "The Budget and Economic Outlook: An Update," August 2003.

These cuts are achieved by reducing government subsidies to commercial activities ($138 billion); returning responsibility for education, housing, training, environmental, and law enforcement programs to the states ($123 billion); slowing the growth of other nondefense discretionary spending ($58 billion); cutting entitlements such as Medicaid, Social Security, and Medicare ($74 billion); and eliminating some wasteful spending in these entitlement programs ($7 billion).

Revenue increases of $134 billion are added to the package, primarily by raising the gas tax, lowering but not repealing the estate tax, and improving enforcement of existing tax laws. Although tax increases are unpopular with those who favor smaller government, no one has suggested how to achieve balance without them. Moreover, the revenue measures included in this plan are relatively modest, they are focused on compliance with existing laws, and they avoid changes in the tax rates or brackets enacted in 2001 and 2003.

THE LARGER GOVERNMENT PLAN

A larger government plan would increase total spending as a share of GDP from 20.2 percent in 2003 to 20.9 percent in 2014. The increase occurs partly because some existing programs are slated to grow rapidly over the coming decade, as the population ages and the costs of health care rise, and partly because the plan includes additional spending for health care, education, and some other priorities that are only partially offset by savings in existing programs. Paying for this new spending and balancing the budget requires that taxes be raised substantially. Revenue measures that would accomplish this objective include scaling back the 2001 tax cuts that benefited the affluent, eliminating the Social Security earnings ceiling so that all earnings would be taxable, and creating a new value-added tax that would affect almost everyone.

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THE BETTER GOVERNMENT PLAN

The better government plan is based on the assumption that government has a positive role to play in improving people's lives but could perform this function far more effectively than it does now. What distinguishes the better government plan from the other two is that instead of changing the size of government, it reallocates spending in ways designed to improve government performance. The plan is likely to be more politically feasible than the other two over the next few years, no matter what the outcome of the 2004 presidential election. The next president will face a huge fiscal hole that cannot realistically be filled by spending cuts or revenue increases alone, and so a very substantial amount of both will be needed.

National Security

Brookings experts Lael Brainard and Michael O'Hanlon, who wrote the portion of our budget report that addresses national security, argue that the United States can use the tools of hard power (military force), soft power (diplomacy and foreign assistance), and domestic counterterrorism (homeland security). These tools are complementary and the national security budget is best viewed as a unified whole. The better government plan calls for cuts in defense spending, but these are only possible because it is assumed that the reconstruction of Iraq will have been completed by 2014. The world is likely still to be a dangerous place in 2014, defense costs per uniformed member of the armed forces have generally risen by 2 to 3 percent a year, major weapons systems are aging and need to be modernized, and health care costs for military personnel are rising rapidly. Thus containment of defense spending to the levels assumed in this plan will only be possible if weapons modernization is very selective, if privatization of military support operations is more cost effective than it has been in the past, and if it proves feasible to share more of the defense burden with our allies.

While some cuts in defense spending are possible under this scenario, the plan calls for more spending on homeland security and foreign assistance. In the wake of the September 11 terrorist attacks, air travel is safer, more intelligence is being shared, and ports and public infrastructure are better protected, but additional steps are needed in these areas as well as in some others, such as protecting private infrastructure (chemical plants and trucking, for example). Finally, U.S. foreign assistance is arguably as important as military power in making the world a safer place. This assistance should be increased, but it could be allocated and organized far more effectively than at present, including combating global poverty.

Domestic Programs

In the domestic arena, it is possible to trim spending on existing domestic programs sufficiently to both fund some new initiatives and contribute savings toward the goal of balancing the budget. The plan proposes modest additional outlays in a number of areas, including restructuring the safety net to encourage and reward work, improving preschool opportunities for disadvantaged children, extending health care coverage to lower-income families, and helping states fund the costs of the extensive testing and teacher training required by the No Child Left Behind Act of 2001. These kinds of public investments, if appropriately structured, can increase productivity and growth as much or more than private investments in new technologies, facilities, and equipment, while simultaneously creating opportunities for everyone to participate more fully in a stronger economy. There must also be more attention given to energy efficiency and a clean environment, but this need not increase budgetary costs. The best way to achieve these goals is to use taxes or a system of auctioned and tradable emissions permits to align the price of energy use with its social costs. The added revenue can then be used to help close the fiscal gap.

To fund the new initiatives and contribute savings toward balancing the budget, our proposal contains a menu of spending cuts that is far more selective than that of the smaller government plan. But like the smaller government plan, it attempts to identify programs, like farm subsidies, that provide unwarranted assistance to commercial activities or to state and local governments (for example, construction grants for wastewater and drinking water). It also includes cuts to programs—such as manned space flight—that have not produced benefits commensurate with their costs and to programs—such as student loans—that could be administered more efficiently.

Entitlement Programs

Social Security, Medicare, and Medicaid are badly in need of long-term reforms, which will be less disruptive if they are made soon. But because significant cuts in benefits for retirees or people who are already close to retirement age are not desirable, such reforms will produce few budgetary savings over the next decade. Nonetheless, some savings are identified, primarily from accelerating (to 2012) implementation of the already enacted increase in the retirement age under Social Security, from more accurate inflation adjustments to Social Security benefits, and from increased premiums for Medicare.

Revenue Increases

Despite its reliance on a number of very controversial spending cuts, the better government plan necessarily depends heavily on revenue increases to achieve balance in 2014. Revenues as a share of GDP fell from 20.8 percent to 16.6 percent between 2000 and 2003, so all three plans—including the smaller government plan—must use revenue increases to fill at least some of the fiscal gap. The better government plan relies on revenue increases to fill 75 percent of this gap. The biggest increases in revenue come from returning the top four income tax rates to 2000 levels, raising the Social Security earnings ceiling so that 90 percent of earnings are taxable, repealing the 2003 capital gains and dividend tax reductions, and retaining the estate tax with a higher exemption. We refer to these changes as tax increases, but many are only increases relative to our adjusted baseline. Compared with the official tax code, which assumes that the tax cuts enacted in 2001, 2002, and 2003 will expire in 2010 or before, for most people

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the changes will still result in a tax reduction.

IMPROVING THE BUDGET PROCESS

Reform of the budget process is essential to restoring fiscal discipline, and should involve at least three elements:

- Caps on discretionary spending that extend for ten years;
- "Pay-as-you-go" rules requiring that any tax cut or increase in mandatory spending be fully "paid for" by offsetting spending or tax changes over a ten-year period, and that these changes normally not be assumed to sunset;
- A stricter definition of "emergency spending."

While process reform alone will not restore fiscal responsibility, it can strengthen the resolve of politicians to do the right thing as well as provide political cover for resisting deficit-increasing actions.

CONCLUSION

America's fiscal situation is out of control and could do serious damage to the economy in the coming decades. It could sap U.S. economic strength—making it much more difficult to respond to unforeseen contingencies—and pass an unfair burden to future generations. However, no one in a political position to do something about the problem has thus far crafted an adequate solution. Unless policymakers move quickly to find a compromise and enact reforms, the budget problem will only get worse.

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