Executive Summary

Federal spending and taxation have a large impact on the economy and on the lives of individuals and families. Good budget choices can strengthen the economy; bad choices can weaken it. Decisions about the federal budget are always difficult. People differ on what government should do and how to pay for it. Some people believe that the federal government should do more, others less. Many believe that government spending priorities are wrong or that taxes are burdensome or unfair. People also differ on how much deficits matter and on how quickly they need to be addressed.

One fact is indisputable: the federal government is spending about $500 billion a year more than it is raising in taxes. On reasonable assumptions, the gap will widen to nearly $700 billion a year by 2014 and accelerate rapidly thereafter, as the baby boom generation begins to retire.

This book argues that deficits matter a lot and that better policies are possible and urgently needed. Not all budget deficits are harmful—indeed, recent deficits have ameliorated the recession that began in 2001.

However, large persistent deficits weaken the economy and lower family incomes. The authors also believe that passing on large and unnecessary fiscal burdens to future generations is unfair and irresponsible. More specifically, deficits 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 abroad.

—*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 we are not managing our fiscal affairs responsibly—they may reduce their investment here. This can reduce the value of the dollar and raise the prices we have to pay for imported goods. If the fall in the dollar were precipitous, it could cause rapid increases in interest rates, possibly recession, or even a serious financial crisis.

—*They require that a growing proportion of revenues be devoted to paying interest on the national debt,* estimated to increase by $5.3 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.

—*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 chosen to be irresponsible. Meanwhile, 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 challenge is daunting, but not impossible to address. The United States is a wealthy, resourceful country that has solved plenty of tough problems before. In a democracy, it is important to identify alternative courses of action that might appeal to different groups and try to find a compromise that all can agree on. In an effort to stimulate that debate, this book presents three alternative ways of balancing the federal budget over the next ten years. We offer one set of choices that might appeal to those who believe that the federal government should be smaller and another to those who believe it should do more. We also present, in more detail, a budget that keeps government the same size but makes it more effective. This plan contains enough spending reduction to achieve balance in ten years, while preserving room for some high-priority new initiatives.

In presenting these alternative budgets, our goals are threefold. First, we show that balancing the budget is feasible (although politically difficult). Second, we show the implications of different strategies that are normally discussed only in general terms. Third, we aim to stimulate a more honest and informed debate about the pros and cons of various fiscally responsible choices in the hopes that others will offer their own detailed proposals for achieving fiscal balance.

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 lack of concern for fiscal discipline turned the surplus into a deficit of almost $400 billion in 2003, and the deficit is expected to be even larger 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 an estimated $687 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.

Budget Assumptions

The adjusted baseline projections in table 1 show larger deficits than the most recent official projections of the Congressional Budget Office, but that is because the CBO is required by Congress to assume that current law remains unchanged. The tax reduction legislation enacted in 2001, 2002, and 2003 was designed to minimize the appearance of revenue loss associated with the tax cuts by phasing the cuts in slowly and making them expire within ten years. Congress also chose to ignore the fact that the tax changes would subject millions of additional taxpayers to the alternative minimum tax (AMT). In making our adjusted baseline projections, we assumed that Congress will extend temporary tax provisions now on the books and make the 2001, 2002, and 2003 tax changes permanent, and that Congress will amend the alternative minimum tax to prevent an increase in the number of taxpayers subject to the AMT. We also assumed discretionary spending increases in line with population growth as well as with inflation—that is, real discretionary spending per person is held constant—and added the cost of the prescription drug benefit and other changes in Medicare enacted at the end of the first session of the 108th Congress. To be clear, we are not advocating any of these proposals; we are simply assuming that they will be enacted. These assumptions could turn out to be wrong, but they seem more probable than the assumptions underlying the CBO projections.

Deficits beyond 2014

A major additional reason for concern about continuous large deficits is that pressures on the budget are certain to escalate rapidly in subsequent decades, 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.

Table 1. Adjusted Baseline Budget, Fiscal Years 2003–14
Billions of dollars

Item	2003	2004	2005	2006
Adjusted spending	2,171	2,312	2,423	2,559
Adjusted revenue	1,770	1,821	1,988	2,129
Adjusted deficit	–374[a]	–491	–435	–430
Excluding Social Security, Medicare, and federal retirement	–590	–711	–669	–665
Item	*2007*	*2008*	*2009*	*2010*
Adjusted spending	2,709	2,872	3,034	3,199
Adjusted revenue	2,260	2,393	2,535	2,678
Adjusted deficit	–449	–479	–499	–521
Excluding Social Security, Medicare, and federal retirement	–695	–739	–773	–806
Item	*2011*	*2012*	*2013*	*2014*
Adjusted spending	3,386	3,530	3,745	3,954
Adjusted revenue	2,810	2,949	3,119	3,267
Adjusted deficit	–576	–581	–626	–687
Excluding Social Security, Medicare, and federal Retirement	–872	–888	–930	–1,003

a. See note 3 at the end of chapter 1.

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 a higher rate of economic growth. But, as detailed in chapter 1 of this book, as long as these tax cuts are deficit financed, the weight of professional opinion suggests that they will not lead to higher growth.

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

Item	*Smaller government plan*	*Larger government plan*	*Better government plan*
Total deficit reduction	687	687	687
Interest payment reduction	–153	–153	–153
Tax increase	134	629	401
Programmatic spending net change	–400	95	–134
Defense net change	0	–60	–60
Increase	0	0	0
Decrease	0	–60	–60
Non-defense net change	–400	155	–74
Increase	0	185	41
Decrease	–400	–30	–115

Source: See table 2-1 in chapter 2.

Three Different Ways of Getting to Balance

In the hope of stimulating serious debate about how to balance the budget, we constructed three alternative plans that differ in the mix of spending cuts and revenue increases used to achieve balance in ten years (table 2). We call them the smaller government plan, the larger government plan, and the better government plan. All three 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 tables are based on the CBO's August 2003 report, adjusted as described above. The CBO revised its forecast in December 2003, but the revisions do not materially affect our analysis).

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, additional deficit reduction of $316 billion would be necessary. Although achieving the larger goal would be desirable, as the plans amply illustrate even meeting the less ambitious target requires tough choices that are sure to be unpopular.

Table 3. *Smaller Government Plan*

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

Source: See table 2-2 in chapter 2.

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 3). These cuts are achieved by reducing government subsidies to commercial activities ($138 billion); by returning responsibility for education, housing, training, environmental, and law enforcement programs to the states ($123 billion); by slowing the growth of other non-defense discretionary spending ($58 billion); by cutting entitlements such as Medicaid, Social Security, and Medicare ($74 billion); and by 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, by lowering but not repealing the estate tax, and by better 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.

Table 4. *Larger Government Plan*

Item	*Billions of dollars*
Total deficit reduction	687
Minus debt service savings	–153
Subtotal	534
Plus funding for new initiatives	95
Total: tax increases and spending cuts to eliminate deficit	629
Changes in the budget	
Revenue change	629
Spending cuts	–90
Defense	–60
Non-defense	–30
New spending	185
Health	100
Education	60
Other	25
Net increase in spending	95

Source: See table 2-9 in chapter 2.

The Larger Government Plan

The larger government plan would increase total spending as a share of GDP from 20.2 percent in 2003 to 20.9 percent in 2014. This 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 (table 4). To both pay for this new spending and balance the budget requires that taxes be raised substantially. A package of revenue measures that would accomplish this objective is described in chapter 6 of this book. It includes 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.

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 at present. 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. In addition, this third 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 election. Whoever is elected president in that year will face a huge fiscal hole that cannot realistically be filled by spending cuts or revenue increases alone. A very substantial amount of both will be needed.

Chapters 3 through 5 of this book discuss the specific restructuring called for by the better government plan to meet international responsibilities (chapter 3), to meet domestic responsibilities (chapter 4), and to honor essential commitments to the elderly or those who are about to retire (chapter 5).

While the authors generally prefer the better government plan, it should be emphasized that not every author agrees with every aspect of the plan. Some authors prefer aspects of the smaller or larger government plans to aspects of the better government plan. Indeed, our disagreements on such matters reflect, in microcosm, the disagreements in the country at large. Nonetheless, we have all taken seriously the desirability of balancing the budget while simultaneously trying to make government more effective. The overall plan is summarized in table 5.

In the national security area, the authors of chapter 3 argue, 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 budget for national security 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. However, the world is likely still to be a dangerous place in 2014, defense costs per uniformed member of the armed forces have generally

Table 5. *Better Government Plan*

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

Source: See table 2-10 in chapter 2.

risen by 2 to 3 percent a year in real terms, 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, more spending on homeland security and foreign assistance is called for. In the wake of 9/11, 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. Chapter 3 calls for more to be spent on stimulating economic development and reducing world poverty.

In the domestic arena, the authors of chapter 4 suggest, 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. They call for modest additional outlays in a number of areas, such as 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 as or more than private investments in new technologies, facilities, and equipment, while simultaneously opening up opportunities for everyone to participate more fully in a stronger economy. The authors also call for more attention to energy efficiency and a clean environment, but note that 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, chapter 4 offers a menu of spending cuts that are far more selective than those discussed in the smaller government plan. But like the smaller government plan, it attempts to identify programs that provide unwarranted assistance to commercial activities (for example, farm subsidies) or state and local governments (for example, construction grants for wastewater and drinking water). It also includes cuts in programs that have not produced benefits commensurate with their costs (for example, manned space flight) and in programs that could be more efficiently administered (for example, student loans).

Chapter 5 addresses three large and rapidly growing programs: Social Security, Medicare, and Medicaid. The authors show that these programs are badly in need of long-term reforms, which will be less disruptive if made quickly. However, since significant cuts in benefits for those already retired or approaching 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.

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. As noted in chapter 6 of this book, revenues as a share of GDP fell from 20.8 to 16.5 percent between 2000 and 2003. For this reason, 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. Throughout this book we refer to these changes as tax *increases*, but many are only increases relative to the adjusted baseline presented in chapter 1. 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 the changes will still result in a tax *reduction*.

Improving the Budget Process

As chapter 2 of this book argues, reform of the budget process is essential to restoring fiscal discipline. Budget process reform should involve at least three elements: first, caps on discretionary spending that extend for ten years; second, PAYGO 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; and third, a stricter definition of "emergency spending." While process reform alone will not restore fiscal responsibility, it can stiffen the resolve of politicians to do the right thing and provide political cover for resisting deficit-increasing actions.

Conclusion

The authors of this book believe that the nation's fiscal situation is out of control and could do serious damage to the economy in coming decades, sapping our national strength, making it much more difficult to respond to unforeseen contingencies, and passing on an unfair burden to future generations. Yet no one in a political position to do something about this situation has so far come up with an adequate solution. The purpose of this volume is to document the enormity of the problem, to inform citizens about why deficits matter, to suggest the kinds of specific steps that need to be taken, and to challenge others to do the same.