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BALANCING THE BUDGET BY 2008 WHILE CUTTING TAXES, FUNDING DEFENSE, AND CREATING A PRESCRIPTION DRUG BENEFIT

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The federal budget picture is worsening by the day. Soaring spending, stagnant tax revenues, and the costs of a likely war with Iraq will probably push the 2003 budget deficit over $400 billion.

The current fiscal crisis is the predictable result of overspending. The federal government will spend over $21,000 per household in 2003—a level exceeded only during World War II.[1] Overall, Washington will spend $782 billion more between 2000 and 2003 than it did during the previous four years.[2]

Contrary to popular belief, defense spending represents less than a quarter of that increase. Massive spending increases for education, health, farm subsidies, unemployment benefits, highways, and dozens of small, low-priority programs combine to add more new spending than defense.

This excessive government spending is creating large budget deficits. Eventually, Congress will have to raise taxes to repay this debt, and those higher taxes will harm families and businesses and decrease economic growth for future generations. Restraining spending enough to balance the budget is the only way to prevent future tax increases.

Budgets are about setting priorities. The current priorities for the federal government are (1) fully funding defense, (2) providing immediate tax relief to help the economy, and (3) assuring that taxes can remain low in future years by balancing the budget. If Washington focuses on its priorities, it is possible to write a budget that:

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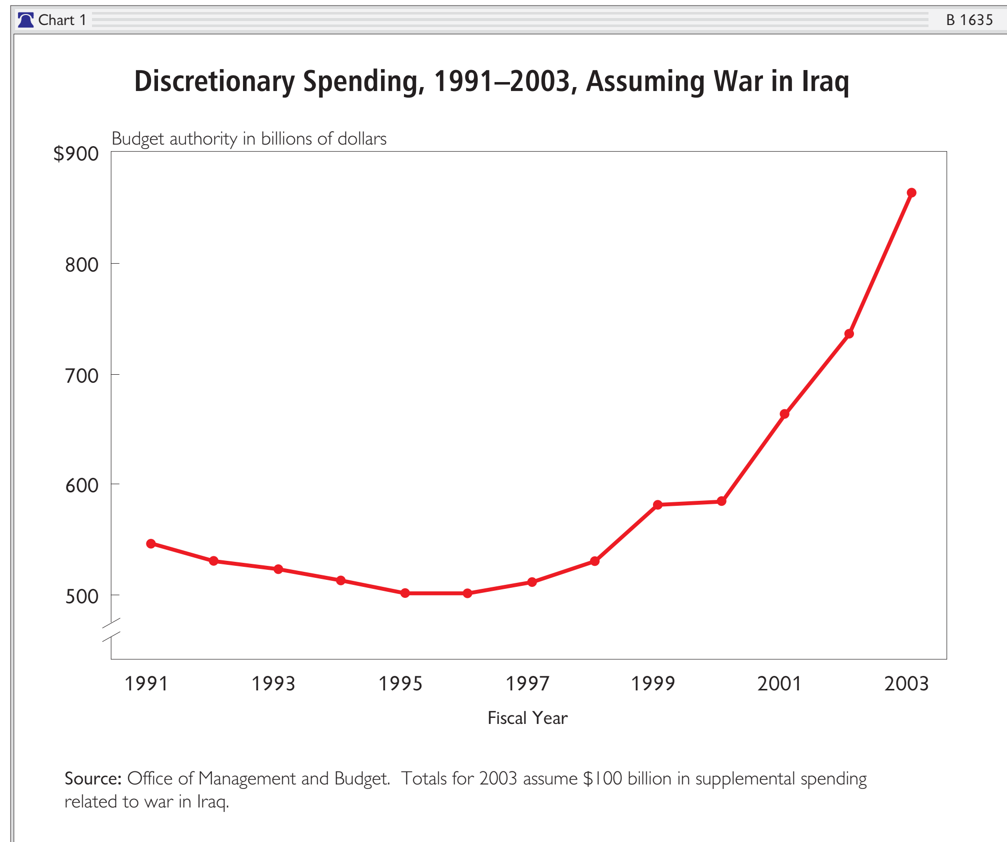
1. Adjusted for inflation.
2. In 2001 dollars, adjusted for inflation. See Brian M. Riedl, "How Washington Increased Spending by Nearly $800 Billion in Just Four Years," Heritage Foundation *Backgrounder* No. 1581, September 4, 2002, at *www.heritage.org/Research/Budget/BG1581.cfm*.

- **Enacts** all of the tax reductions in President Bush's 2004 budget proposal,[3]
- **Fully funds** the President's defense requests for the next several years,
- **Fully funds** a war with Iraq,
- **Allows** for a Medicare prescription drug benefit, and
- **Still balances** by 2008.



Eliminating the budget deficit by 2008 while still protecting these priorities will not be easy. It will require discipline and difficult decisions. But it is possible if Congress is willing to:

- **Limit** the average annual growth of mandatory spending to 4.6 percent per year instead of the 5.6 percent proposed by President Bush, and
- **Freeze** non-defense discretionary spending at the 2003 level of $418 billion.

Limiting Mandatory Spending Growth. Growing at a rapid rate since the 1970s, mandatory programs now comprise nearly two-thirds of all federal spending. Social Security, Medicare, and Medicaid continue to grow at rates that, in the absence of reform, will eventually require large tax increases or benefit reductions. The 2002 farm bill and other recent mandatory spending expansions have accelerated this growth.

President Bush's budget seeks to raise mandatory spending by an average of 5.6 percent over the next five years, in part by creating a new Medicare prescription drug benefit.[4] Yet mandatory spending includes tens of billions of dollars in waste and overpayments in programs such as Medicare, food stamps, and student loans. Billions are also spent on well-intentioned but failed programs such as farm subsidies, mass transit assistance, and public works. If Congress really wants to balance the budget, it can reduce the growth rate of mandatory spending by 1 percent, to 4.6 percent per year.

Freezing Non-defense Discretionary Spending. The portion of the discretionary budget allocated to non-defense spending has grown by 41 percent since 1999. This includes massive increases not only for education and health research, but also for corporate welfare, pork-barrel projects, and dozens of small, lower-priority programs like the Denali Commission, Power Marketing Administration, and Foreign Agriculture Service.

Many of these programs can afford to wait a few years before receiving additional spending

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3. This includes not only the $694 billion tax package unveiled in January 2003, but also the other tax proposals in the President's 2004 budget, such as tax breaks for health insurance, education, energy, and charitable giving.
4. Additional savings are possible if Congress also reforms and modernizes Medicare rather than just adding a prescription drug benefit to the current program.

NOTE: Nothing written here is to be construed as necessarily reflecting the views of The Heritage Foundation or as an attempt to aid or hinder the passage of any bill before Congress.

Table 1 B 1635

How to Balance the Budget by 2008 While Funding Tax Relief, Defense, and Prescription Drugs

	2003	2004	2005	2006	2007	2008
REVENUES			(amounts in $Billions)			
CBO Baseline	$1891	$2024	$2205	$2360	$2504	$2647
President's tax proposals	-35	-117	-105	-87	-71	-74
Revenue feedback effect	3	16	25	33	37	40
Total revenues	1859	1923	2125	2306	2470	2613
MANDATORY SPENDING						
CBO Baseline	1177	1223	1277	1332	1403	1484
Medicare prescription drugs		6	10	33	38	43
Medicaid/S-Chip reform		8	7	9	8	9
Other presidential mandatory proposals	6	6	16	13	17	16
Subtotal with President's proposals	1183	1243	1310	1387	1466	1552
******1% growth rate reduction*		*-12*	*-25*	*-39*	*-55*	*-72*
Total mandatory spending	1183	1231	1285	1348	1411	1480
NON-DEFENSE DISCRETIONARY SPENDING						
******2003 level frozen*	*418*	*418*	*418*	*418*	*418*	*418*
Total non-defense discretionary spending	418	418	418	418	418	418
DEFENSE DISCRETIONARY SPENDING						
CBO Baseline	386	402	411	418	425	440
President's new defense proposals	0	-1	3	7	13	22
Iraq conflict cost estimate	100	25	10	10	5	5
Total defense discretionary spending	486	426	424	435	443	467
NET INTEREST SPENDING						
CBO Baseline	155	164	197	217	224	226
Added cost from proposals	2	3	14	17	20	22
Total net interest spending	157	167	211	234	244	248
Total Revenues	1859	1923	2125	2306	2470	2613
Total Spending	2244	2242	2338	2435	2516	2613
Surplus/Deficit	-385	-319	-213	-129	-46	0

Source: CBO baseline estimates, as well as cost estimates of the President's tax, mandatory spending, and defense spending proposals are from the Congressional Budget Office's March 2003 "Analysis of the President's Budgetary Proposals for Fiscal Year 2004." Cost for an Iraq conflict and added net interest were estimated by the Heritage Foundation. Tax revenues from the "feedback effect" were provided by the Heritage Foundation's Center for Data Analysis using the DRI-WEFA U.S. Macroeconomic Model.

increases. By freezing non-defense discretionary spending at its current level of $418 billion, Congress could still increase funding for priority programs as long as increases for such programs are balanced with equal reductions in wasteful and lower-priority programs.[5]

INCORPORATING REVENUE FEEDBACK

A realistic budget projection recognizes that tax rates affect economic growth. Reducing tax rates creates greater incentives to work, save, and invest and therefore increases national income. The tax revenue collected from this higher national income, known as the "feedback effect," recovers a portion of the revenue lost from the tax cut. Although virtually all economists acknowledge their existence, feedback effects are oddly excluded from Congress's budget projections. This budget blueprint corrects that omission.

Feedback effects vary wildly, depending on the type of tax reduction. For example, tax rebates do not significantly alter people's behavior; therefore, they have little or no feedback effect. Capital gains tax reductions, such as the one enacted in 1997, strongly affect investors' behavior and therefore often have a feedback effect of over 100 percent—meaning that tax revenues actually increase.[6] In between these extremes, the 2001 tax cut combined rebates and pro-growth tax rate reductions to create a feedback effect of approximately 33 percent.[7]

President Bush focuses most of his current tax proposals on reducing tax rates for workers, businesses, and investors. Tax rate reductions typically have a relatively high feedback effect that will recover much of the lost revenue.

This is confirmed by a macroeconomic model of the U.S. economy known as the DRI–WEFA model. After analyzing the President's Economic Growth and Jobs Creation Proposal, this model estimated an average feedback effect of 38 percent from 2003 through 2008. (No feedback effect is assumed for other proposed tax breaks in areas such as health, education, energy, and charitable giving.) Other macroeconomic models, such as those used by PricewaterhouseCoopers, have produced similar results.[8]

Incorporating this feedback effect into the budget projections in Table 1 produces a more realistic picture of the budget.

NO EASY SOLUTIONS

Some lawmakers are counting on a strong economic recovery and the accompanying tax revenues to balance the budget. They point to the 8.4 percent annual revenue increases from 1993 to 2000 that helped bring the budget from deficit to surplus. But those sharp revenue increases were a historical anomaly, created in part by a colossal stock market bubble that led to record capital gains tax revenues. Although President Bush's proposed tax plan is likely to unleash new economic growth, sustained 8.4 percent revenue growth is not likely to return soon.

Furthermore, even annual revenue increases of 8.4 percent would not balance the budget in the absence of spending restraint. The revenue increases from 1993 to 2000 helped balance the

5. The Heritage Foundation has identified more than $100 billion in potential savings from wasteful and ineffective discretionary programs. See Brian M. Riedl, "Ten Guidelines for Reducing Wasteful Government Spending," Heritage Foundation *Backgrounder* No. 1622, February 12, 2003, at *www.heritage.org/Research/Budget/BG1622.cfm*. See also The Heritage Foundation's Budget Information Site at *www.heritage.org/research/features/budgetcalculator*.

6. See Daniel J. Mitchell, Ph.D., "Lowering Marginal Tax Rates: The Key to Pro-Growth Tax Relief," Heritage Foundation *Backgrounder* No. 1443, May 22, 2001, at *www.heritage.org/Research/Taxes/BG1443.cfm*.

7. See Appendix B in D. Mark Wilson and William W. Beach, "The Economic Impact of President Bush's Tax Relief Plan," Heritage Foundation *Center for Data Analysis Report* No. CDA01–01Rev, April 27, 2001, at *www.heritage.org/Research/Taxes/CDA01-01.cfm*.

8. The PricewaterhouseCoopers studies are available at *www.brt.org/press.cfm/812* and *www.brt.org/pdf/PWC20030130/PWCMarylandStudy.pdf*.

budget because spending was held to a 3.5 percent annual growth rate. Now spending is growing by nearly 8 percent per year. If this pace continues, balancing the budget would require revenues to increase 73 percent over the next five years—a very unlikely occurrence.

This leaves lawmakers with one option: restrain federal spending. If congressional spenders refuse to distinguish between necessities and luxuries, budget deficits will grow even larger. These budget deficits are harmful not because they significantly raise interest rates (the effect is minimal), but because they will require Congress to raise taxes in the future to repay the debt. Higher taxes will harm families and businesses and decrease economic growth for future generations.

TOO BOLD?

Regrettably, many in Congress will consider this budget-balancing blueprint too bold. Lawmakers have grown accustomed to always spending more, and priority-setting means finally limiting that appetite. Yet past Congresses have showed the courage to restrain spending when necessary. To fund World War II, domestic spending was reduced by 36 percent. To fund the Korean War, domestic spending was reduced by 25 percent in just one year.

Addressing the current budget shortfall requires nothing so drastic. Limiting the average annual growth of mandatory spending to 4.6 percent instead of 5.6 percent could be done mostly by eliminating waste, overpayments, and corporate welfare. Increases in non-defense discretionary spending would need to be offset by reductions in other programs.

This would be a small price to pay for pro-growth tax relief, an improved military, a Medicare prescription drug benefit, and a balanced budget. Otherwise, Congress can wait until the budget deficit grows even larger—and then see what painful budget decisions *really* look like.

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