Backgrounder

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The Five-Step Solution: Cutting the Budget Deficit in Half by 2009 While Extending the Tax Cuts and Rebuilding Iraq and Afghanistan

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President George W. Bush has pledged to cut the budget deficit in half by 2009. While this is a laudable goal, the budget deficit is only a symptom of the larger problem of runaway spending. Government spending harms the economy by diverting resources from the productive private sector into the less efficient government sector and by requiring high tax rates that reduce incentives to work, save, and invest. The best way to reduce the budget deficit is to reduce this excessive spending, and this paper outlines a blueprint to do just that.

The President's budget proposal has a lot of strong components: It reduces non-defense discretionary spending by 1 percent, terminates or reduces over 150 wasteful programs, and begins to rein in entitlements such as Medicaid and farm subsidies. However, it will not halve the budget deficit by 2009 because it does not account for the costs of rebuilding Iraq and Afghanistan and the reduced revenue from fixing the Alternative Minimum Tax.

While there may be good reason to exclude these costs from current projections, they eventually will affect the budget deficit. Incorporating tax cut extensions and the costs of Iraq and Afghanistan brings the projected 2009 budget deficit close to $400 billion.

Reducing spending to cut the deficit in half is a good goal, but focusing on the deficit can be like shooting at a moving target. The President's original proposal to cut the deficit in half was based on a preliminary 2004 deficit estimate, taken as a percent of GDP rather than dollars, resulting in a deficit target of

Talking Points

- The President has pledged to cut the deficit in half by 2009. Because deficits are just a symptom of the larger problem of runaway spending, lawmakers should focus on cutting spending to reduce the budget deficit.
- It is possible to cut the deficit in half by 2009—in actual dollars, not just as a percent of GDP—while extending all tax cuts and rebuilding Iraq and Afghanistan.
- This would require five steps: (1) freezing discretionary spending, (2) reducing subsidies for large farms, (3) limiting Medicaid to 5 percent annual growth, (4) replacing the unaffordable Medicare drug benefit with the drug discount card, and (5) reducing 3 percent of entitlement spending by eliminating waste, fraud, and abuse.

This paper, in its entirety, can be found at:
www.heritage.org/research/budget/bg1833.cfm

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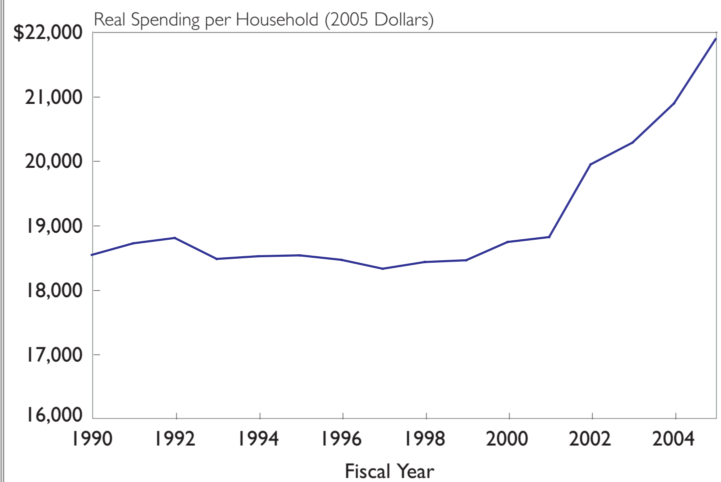
$340 billion by 2009. This will be hard work, but given growing entitlement options, it is imperative. An even better choice would be to start with the final 2004 deficit of $412 billion and use the dollar amount rather than percentage of GDP to set a target of $206 billion by 2009.

It is possible for Congress to write a budget resolution that cuts the budget deficit in half by 2009—in actual dollars—without excluding any costs or resorting to any gimmicks.[1] Congress could do it in five steps:

1. **Freezing** non-defense discretionary spending through 2009,
2. **Capping** farm subsidies for wealthy farmers,
3. **Reducing** the Medicaid growth rate to 5 percent,
4. **Replacing** the Medicare drug benefit with the drug card, and
5. **Reducing** entitlement spending by 3 percent by targeting waste, fraud, and abuse.

Chart 1 B 1833

Washington Now Spends More Than $20,000 per Household



Source: Heritage Foundation calculations based on data from the Office of Management and Budget and the U.S. Census Bureau.

These reforms will not be easy. Each spending reform will affect somebody, and any easy cuts would surely have been made by now. Lawmakers who are serious about cutting spending should focus on the millions of taxpayers—both current and future—forced to sacrifice their financial well-being to fund ineffective federal programs. Delay merely adds to the avalanche of debt that will fall on the next generation. The following five recommendations represent a strong step toward a responsible budget policy.

Recommendation #1: Freeze non-defense discretionary spending through 2009.

Budgets are about setting priorities. Despite the higher priorities of funding national defense, addressing the recession, and dealing with runaway entitlement costs, lawmakers have hiked non-defense discretionary spending by 36 percent since 2001. Clearly, these bloated budgets can afford to level off for a few years.

Those who consider such a freeze politically unrealistic need only examine the 1990s. From 1991 to 1998, all discretionary outlays (including defense) grew by an average of just 0.5 percent annually, and the $269 billion budget deficit was completely eliminated.[2] Under the proposed scenario, modest defense increases and a non-defense freeze would increase discretionary spending by approximately 1 percent annually.

There is bipartisan support for such restraint. President Bush's budget request calls for (roughly) freezing non-defense discretionary spending through 2010. He has also proposed statutory caps limiting total discretionary spending growth to approximately 2.5 percent annually.[3] The House

1. Continuing these reforms (and even allowing a 1 percent annual increase in non-defense discretionary spending after 2009) would nearly eliminate the budget deficit by 2015.
2. Office of Management and Budget, *Budget of the United States Government, Fiscal Year 2006: Historical Tables* (Washington, D.C.: U.S. Government Printing Office, 2005), p. 125, at *www.whitehouse.gov/omb/budget/fy2006/pdf/hist.pdf* (March 11, 2005).

Table 1 B 1833

Spending Is Increasing Across Government

Spending Category	Total Outlays 2001	Total Outlays 2005	2001-2005 Increases Amount	2001-2005 Increases Percentage	2001-2005 Increases Average Annual Increase
National Defense	$304,882	$465,871	$160,989	53%	11.2%
Social Security	432,958	519,686	86,728	20%	4.7%
Medicare	217,384	295,432	78,048	36%	8.0%
Income Security Programs	152,640	211,929	59,289	39%	8.6%
Medicaid	129,374	188,497	59,123	46%	9.9%
Education	35,203	70,520	35,317	100%	19.0%
Health Research and Regulation	42,896	69,035	26,139	61%	12.6%
Veterans Benefits	45,039	68,161	23,122	51%	10.9%
International Affairs	16,493	31,961	15,468	94%	18.0%
Federal Retirement and Disability	80,972	94,312	13,340	16%	3.9%
Justice Administration	30,205	40,657	10,452	35%	7.7%
Community and Regional Development	11,773	20,141	8,368	71%	14.4%
Unemployment Benefits	30,242	38,066	$7,824	26%	5.9%
Natural Resources & Environment	25,623	30,960	$5,337	21%	4.8%
Housing and Commerce	5,739	10,653	$4,914	86%	16.7%
Other Spending	142,454	210,551	68,097	48%	10.3%
Undistributed Offsetting Receipts	-47,011	-64,976	-17,965	-38%	-8.4%
Net Interest	206,167	177,948	-28,219	-14%	-3.6%
Total Spending	**1,863,033**	**2,479,404**	**$616,371**	**33%**	**7.4%**

Note: All amounts in millions of dollars. National defense and international affairs totals exclude additional 2005 supplemental spending.

Source: Heritage Foundation calculations based on Office of Management and Budget, *Budget of the United States Government, Fiscal Year 2006: Historical Tables* (Washington, D.C.: U.S. Government Printing Office, 2005), pp. 53-70, Table 3.2, at *www.whitehouse.gov/omb/budget/fy2006/pdf/hist.pdf* (March 11, 2005).

Democrats' Blue Dog Coalition has gone even further by proposing total discretionary spending caps at 2.1 percent annual growth.[4]

Freezing non-defense discretionary spending does not mean freezing every program equally. High-priority programs could receive spending increases as long as they are offset by reductions in lower-priority programs. To say that offsets cannot be found is to assume that every federal program is justified, successful, and operates with maximum efficiency.

Lawmakers could start this process by taking scissors to the $23 billion spent annually on special-interest pork-barrel projects, such as grants for Therapeutic Horseback Riding and the Baseball Hall of Fame.[5] Congress and the President should do what millions of families do: set priorities and balance each high-priority spending increase with a low-priority spending cut.[6]

Recommendation #2: Cap farm subsidies for wealthy farmers.

This year, lawmakers will spend more money on corporate welfare than on homeland security, and America's largest corporate welfare program is farm subsidies. Despite rhetoric about aiding struggling family farmers, subsidy formulas are deliberately written to bypass most family farmers and instead lavish millions on large agribusinesses.

Two-thirds of all farm subsidies are distributed to the wealthiest 10 percent of farmers. The U.S. Department of Agriculture reports that farmers on "large" and "very large" farms—the types that receive the bulk of the subsidies—report an average household income of more than $135,000.[7] Are these the "poor family farmers" lawmakers are talking about?

It gets worse: 78 farms received over $1 million in subsidies in 2002. The $110 million received by Riceland Foods that year was more than Washington gave to every farmer in 12 states combined. Not to be outdone, a dozen *Fortune* 500 companies—including John Hancock Mutual Life Insurance, Westvaco, Chevron, and Caterpillar—have pocketed farm subsidies as much as 510 times larger than the amount received by the median farmer. Farm subsidy checks are also sent to celebrity "hobby farmers" such as David Rockefeller, Ted Turner, Scottie Pippen, and former Enron CEO Ken Lay.[8]

The case against farm subsidies extends beyond who has received them. The continued existence of farm subsidies displays an appalling degree of economic ignorance, even by government standards. These programs attempt to remedy overproduction and low prices by paying farmers to produce more, thereby driving crop prices down even further. Then, while paying some farmers to grow more crops, Washington turns around and pays other farmers to grow fewer crops. Farm subsidies promote consolidation by providing agribusiness with large subsidies that are then used to

3. Office of Management and Budget, *Budget of the United States Government, Fiscal Year 2006: Analytical Perspectives* (Washington, D.C.: U.S. Government Printing Office, 2005), p. 236, at *www.whitehouse.gov/omb/budget/fy2006/pdf/spec.pdf* (March 11, 2005).
4. The Blue Dog proposals are summarized in Brian M. Riedl, "The Blue Dog Democrats' Budget Process Proposal: An Emerging Bipartisan Consensus," Heritage Foundation *WebMemo* No. 670, February 18, 2005, at *www.heritage.org/Research/Budget/wm670.cfm* (March 11, 2005).
5. For a sample list of recent pork-barrel projects, see Brian M. Riedl and Keith Miller, "Another Pork-Laden Omnibus Spending Bill," Heritage Foundation *WebMemo* No. 613, November 22, 2004, at *www.heritage.org/Research/Budget/wm613.cfm*.
6. For specific spending-cut recommendations, see Brian M. Riedl, "How to Get Federal Spending Under Control," Heritage Foundation *Backgrounder* No. 1733, March 10, 2004, at *www.heritage.org/Research/Budget/bg1733.cfm*.
7. Ashok K. Mishra, Hisham S. El-Osta, Mitchell J. Morehart, James D. Johnson, and Jeffrey W. Hopkins, "Income, Wealth, and Economic Well-Being of Farm Households," U.S. Department of Agriculture, Economic Research Service, *Agricultural Economic Report* No. 812, July 2002, p. 52, at *www.ers.usda.gov/publications/aer812* (March 11, 2005).
8. Brian M. Riedl, "Another Year at the Federal Trough: Farm Subsidies for the Rich, Famous, and Elected Jumped Again in 2002," Heritage Foundation *Backgrounder* No. 1763, May 24, 2004, at *www.heritage.org/Research/Budget/bg1763.cfm*.

buy out small farms. Worst of all, these programs harm international trade and undercut Third World farmers, thereby increasing global poverty.

President Bush has proposed reducing the annual farm subsidy cap from $360,000 to $250,000 and closing the loopholes that allow farmers to bypass these limits altogether. While this is a good start, lawmakers should go much further. If they really want farm subsidies to help struggling farmers, just $4 billion per year would guarantee every full-time farmer in America a minimum income of 185 percent of the federal poverty level ($35,798 for a family of four in 2005).[9] Subsidized crop insurance could shield low-income farmers from the unpredictability of weather and crop yields. Phasing in these reforms would save nearly $70 billion over the next decade while strengthening the farm economy.

Recommendation #3: Reduce the Medicaid growth rate to 5 percent.

Since 1999, federal Medicaid spending has leaped from $108 billion to $186 billion—an average annual growth rate of 9.5 percent. The Congressional Budget Office (CBO) projects 7.8 percent annual growth rate over the next decade. Bringing spending under control is extremely difficult when the third largest entitlement expands at this rate. Reducing the growth rate to 5 percent is a reasonable goal in an era of tight budgets.

Rising health care costs have played a role in Medicaid's growth, but the program's design has also encouraged overspending. Washington sets minimum eligibility and benefit standards (states have the option to go further) and then reimburses an average of 57 percent of each state's costs. This matching formula encourages state overspending in two ways:

1. It costs the typical state just 43 cents to expand Medicaid by $1. (Washington provides the other 57 cents.) On the flip side, cutting $1 from Medicaid would save that state only 43 cents. (Washington saves the other 57 cents.) Economically, this operates like a massive subsidy on state Medicaid expansions and an equal tax on Medicaid cuts. States looking to expand their budgets can get more "bang for the buck" by expanding Medicaid, while states looking to cut spending have incentives to exempt Medicaid.

   Not surprisingly, states expanded Medicaid during the high-flying 1990s and have been hesitant to scale back these increases even when running budget deficits. As a result, approximately 60 percent of the average state's Medicaid budget is for optional services and populations beyond the federal minimum (including covering services such as weight-loss help and substance-abuse treatment).[10]

2. This open-ended entitlement also gives states an incentive to overreport their Medicaid expenditures in order to receive larger federal reimbursements. Not surprisingly, the U.S. Government Accountability Office (GAO)[11] has identified state schemes that shift money

9. Linda Ghelfi, Craig Gundersen, James Johnson, Kathy Kassel, Betsey Kuhn, Ashok Mishrok, Mitchell Morehart, Susan Offutt, Laura Tiehen, and Leslie Whitener, "A Safety Net for Farm Households," U.S. Department of Agriculture, Economic Research Service, *Agriculture Outlook*, January–February 2000, pp. 19–24, at *www.ers.usda.gov/publications/agoutlook/jan2000/ao268.pdf* (March 11, 2005). The authors estimated a cost of $7.8 billion when including everyone who reports any farm income, including "hobby farmers" who have other full-time jobs. Giving subsidies only to full-time farmers—defined as lower sales, higher sales, and large family farms, as well as a fraction of limited-resource farms that are also full-time—would cost approximately $4 billion. The eligibility threshold for several federal income-assistance programs, like Women, Infants, and Children (WIC), is 185 percent of the federal poverty level.

10. Raymond C. Scheppach, Executive Director, National Governors' Association, "Unfunded Mandates: A Five-Year Review and Recommendations for Change," testimony before the Subcommittee on Energy Policy, Natural Resources, and Regulatory Affairs, Committee on Government Reform, U.S. House of Representatives, and Subcommittee on Technology and the House, Committee on Rules, U.S. House of Representatives, May 24, 2001.

11. Formerly known as the U.S. General Accounting Office.

Table 2 B 1833

How to Halve the Budget Deficit by 2009

	2004	2005	2006	2007	2008	2009
Revenues						
CBO Baseline	$1,880	$2,058	$2,212	$2,357	$2,508	$2,662
Alternative Minimum Tax			-12	-34	-41	-50
Other tax extenders			-5	-16	-30	-45
Total Revenue	**1,880**	**2,058**	**2,195**	**2,307**	**2,437**	**2,566**
Mandatory Spending						
CBO Baseline	1,237	1,317	1,380	1,450	1,529	1,620
Farm subsidy limits			-4	-5	-6	-6
Medicaid 5% limit			0	-2	-10	-18
Repeal Medicare drug benefit			-25	-38	-44	-48
Expand Medicare drug card			4	5	6	7
3% savings from waste			-39	-40	-42	-44
Total Mandatory	**1,237**	**1,318**	**1,317**	**1,369**	**1,434**	**1,512**
Discretionary Spending						
CBO Baseline	454	464	438	435	447	457
Non-Defense Frozen	441	466	466	466	466	466
Total Discretionary	**895**	**930**	**904**	**901**	**913**	**923**
Future Supplemental Spending						
CBO Estimate		**30**	**70**	**75**	**65**	**45**
Net Interest Spending						
CBO Baseline	160	178	213	249	274	289
Effect of proposals				1	2	1
Total Net Interest	**160**	**178**	**213**	**250**	**276**	**290**
Total Revenue	**1,880**	**2,058**	**2,195**	**2,307**	**2,437**	**2,566**
Total Spending	**2,292**	**2,456**	**2,504**	**2,595**	**2,688**	**2,771**
Deficit	**-412**	**-398**	**-309**	**-288**	**-251**	**-205**

Note: All amounts are in billions of dollars. These proposals will nearly eliminate the budget deficit by 2015.

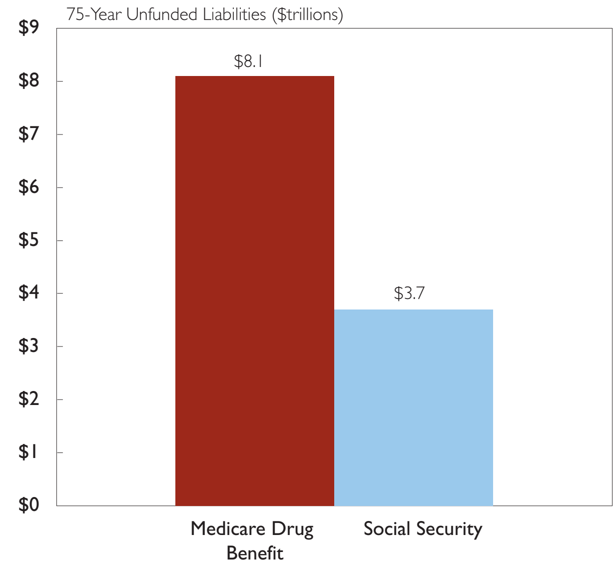
Sources: CBO baseline estimates, as of January 2005. Budgetary effects of proposals calculated by The Heritage Foundation.

among state accounts to create an illusion of higher Medicaid expenditures.[12] Similarly, some states have spent their federal Medicaid dollars on non-Medicaid purposes. Tight state budgets, which most states are currently experiencing, have increased the pressure to employ such deceptive tactics.

There are several options for reducing Medicaid's growth rate, and the best of them address the foregoing issues. President Bush's budget proposes cracking down on Medicaid waste, fraud, and abuse, such as the state overreporting schemes. Congress and the governors should also examine options to convert Medicaid into a capped block grant (similar to the 1996 TANF welfare reforms) or at least to cap the federal match. This would give states stronger incentives to spend their Medicaid dollars wisely. Finally, in exchange for capping federal contributions, states should be given wide flexibility to experiment with different Medicaid structures in order to discover the most efficient ways to deliver health care services to poor families.

Chart 2 B 1833

The Medicare Drug Benefit's Unfunded Liability Is More Than Twice As Large As Social Security's



Sources: Centers for Medicare and Medicaid Services, *2004 Annual Report of the Boards of Trustees of the Federal Hospital Insurance and Federal Supplemental Insurance Trust Funds,* March 23, 2004, p. 109, at *www.cms.hhs.gov/publications/trusteesreport/2004/tr.pdf* (March 11, 2005), and Social Security Administration, 2004 Social Security Trustees Report, March 23, 2004, p. 2, at *www.ssa.gov/OACT/TR/TR04/tr04.pdf* (March 11, 2005).

Recommendation #4: Replace the Medicare drug benefit with the Medicare drug card.

In its current form, the Medicare drug benefit is completely unaffordable. Although less than a quarter of Medicare recipients have no drug coverage, lawmakers created a universal benefit that will benefit even millionaires.[13] The drug benefit is currently projected to cost $720 billion over the next decade, and perhaps double that in the following decade.[14] Overall, the drug benefit's $8.1 trillion shortfall over the next 75 years is more than *double* the $3.7 trillion Social Security shortfall. (See Chart 2.) Simply put, Congress cannot rein in spending and maintain tax relief without reforming the drug benefit.

Yet reform does not mean that Congress cannot help seniors in need. The Medicare Discount Drug Card Program, created to assist seniors until the drug benefit's 2006 implementation, could perma-

12. Dara Corrigan, Acting Principal Deputy Inspector General, U.S. Department of Health and Human Services, testimony before the Committee on the Budget, U.S. House of Representatives, July 9, 2003, and David M. Walker, Comptroller General of the United States, "Federal Budget: Opportunities for Oversight and Improved Use of Taxpayer Funds," testimony before the Committee on the Budget, U.S. House of Representatives, June 18, 2003.

13. Joint Economic Committee, U.S. Congress, "Medicare Beneficiaries' Link to Drug Coverage," April 10, 2003, at *jec.senate.gov/_files/MedicareLinks.pdf* (March 11, 2005).

14. Douglas Holtz-Eakin and Jeff Lemieux, "The Cost of Medicare: What the Future Holds," Heritage Foundation *Lecture* No. 815, December 15, 2003, at *www.heritage.org/Research/HealthCare/HL815.cfm*.

nently replace the drug benefit. The drug card provides seniors with discounts typically ranging from 10 percent to 25 percent and provides low-income seniors with an additional $600 annually to help with their drug costs. A study by the Centers for Medicare and Medicaid Services found that the drug card could save low-income seniors 32 percent to 85 percent off their drug costs.[15]

Even if the drug card program were expanded to cover more seniors and provide substantially more generous benefits, it would still cost only $4 billion to $7 billion annually. This easy reform would wipe out nearly the entire $8.1 trillion unfunded liability, reduce the budget deficit, and protect tax relief—all while still helping needy seniors.

Recommendation #5: Reduce entitlement spending by 3 percent by targeting waste, fraud, and abuse.

The easiest place to trim runaway federal spending is in waste, fraud, and abuse. In the 1980s, the Grace Commission focused lawmakers' attention on the vast amount of waste littered across government, such as the Department of Defense's $640 toilet seat and $436 hammer. Over the following two decades, layers of waste have once again built up as Congress has largely abandoned its constitutional duty of overseeing the executive branch.

Lawmakers who lack the will to clean up government are clearly not ready to undertake the larger reforms necessary to bring the budget under control. A goal of identifying and eliminating 3 percent of entitlement spending as waste, fraud, and abuse is achievable for lawmakers who are willing to make spending restraint and efficient government a priority.[16]

Lack of information is not the problem. Today, government waste investigations and clean-up recommendations can be found in hundreds of GAO reports, the Congressional Budget Office's "Budget Options" books, the President's Program Assessment Rating Tool (PART) program reviews, inspector general reports, and the Government Performance and Results Act reports.

After only a cursory review of these documents, The Heritage Foundation identified nearly $300 billion in entitlement waste that could be trimmed over the next decade. For example:

- Medicare overpayments top **$12 billion** annually.
- Medicare also pays up to **eight times** what other agencies pay for the same drugs and medical supplies (which also raises co-payments for Medicare beneficiaries).
- Accounting tricks used by states to secure additional Medicaid funds cost taxpayers **several billion dollars** annually.
- Medicare contractors owe the federal government **$7 billion**.
- The Department of Education recently gave **$55,000** in student aid to a fictitious college.
- Food stamp overpayments cost **$600 million** annually.
- School lunch program abuse costs **$120 million** annually.
- Veterans program overpayments cost **$800 million** annually.
- Earned Income Tax Credit (EITC) overpayments cost **$9 billion** annually.
- Better tracking of student loan recipients would save **$1 billion** annually.[17]

Conclusion

Reducing runaway spending is never easy. However, current spending trends threaten to saddle future generations with crushing debt and steeply

15. Centers for Medicare and Medicaid Services, "Medicare-Approved Drug Discount Cards Offer Important Benefits for 7.2 Million Low-Income Medicare Beneficiaries," June 14, 2004, at *www.cms.hhs.gov/media/press/files/realsavings.pdf* (March 11, 2005).

16. The goal of 3 percent savings is an overall target for entitlement spending. The exact savings from each program would be determined by how wasteful it is. Furthermore, the target refers to 3 percent of remaining entitlement spending *after* farm subsidies, Medicare, and Medicaid have been reformed as described above.

rising tax burdens that are likely to result in a lower standard of living. Responsible lawmakers must address this challenge by enacting positive reforms to make government more effective, more efficient, and less expensive.

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17. See Brian M. Riedl, "How to Get Federal Spending Under Control," Heritage Foundation *Backgrounder* No. 1733, March 10, 2004, at *www.heritage.org/Research/Budget/bg1733.cfm*, and "How Congress Can Achieve Savings of 1 Percent by Targeting Waste, Fraud, and Abuse," Heritage Foundation *Backgrounder* No. 1681, August 28, 2003, at *www.heritage.org/Research/Budget/bg1681.cfm*.