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The Elements of a Responsible Budget Proposal

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Early reports suggest that President Obama will propose a budget that reduces the budget deficit to $533 billion by 2013.[1] This is hardly ambitious. Given the budget's assumptions of peace (deep cuts in spending on the global war on terrorism) and prosperity (the economy should be recovered by then), a $533 billion budget deficit should not be a heavy lift. By contrast, President Bush oversaw budget deficits that typically ranged between $150 billion and $450 billion even while fully funding wars in Iraq and Afghanistan.

Furthermore, early indications suggest that tax increases would trump spending restraint in reducing the deficit. Indeed, spending would remain above 22 percent of GDP—a level that has been reached only eight times in the past 62 years. Yet tax rates would reportedly rise for individuals and businesses in order to finance items such as a down payment on national health care. And the President is reportedly considering statutory Pay-as-You-Go (PAYGO) rules, which are biased in favor of tax increases over spending restraint.[2]

A responsible federal budget proposal would contain these elements.

Limit Overall Spending. A temporary recession should not lead to a permanent expansion of the federal government. Since federal spending totaled 20 percent of GDP before the recession, Obama should aim to bring spending back to that level as soon as the economy recovers, likely within two years. To do this, the budget should:

- *Keep the "stimulus" temporary.* The President should pledge to oppose any attempts to make permanent any stimulus provisions that are not fully offset by lower-priority spending cuts. This spending was sold to the American people as temporary, and that promise should be kept. Extending this spending would require permanently raising taxes by nearly $3,000 per household.
- *Resist false promises of a free lunch in health care.* Some have suggested that Obama can expand Medicare drug subsidies for seniors as well as add millions of Americans to government health care rolls without increasing the health care budget. While Washington's health programs certainly contain large inefficiencies—a good reason not to expand government-provided health care—it is completely unrealistic to assume that simple efficiencies can immediately offset hundreds of billions of dollars in new health spending. Such government expansions are thus totally unaffordable in today's economic and budgetary climate.[3]
- *Address Social Security, Medicare, and Medicaid.* These three programs already comprise 40 per-

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cent of all spending and are growing 7 percent annually on autopilot as 77 million baby boomers begin retiring. Simply put, there is no way to bring the federal budget under control—or even close to balance—until these programs are reformed.[4] At minimum, President Obama should call on Congress to pass legislation creating a bipartisan entitlement reform commission that would write legislation for Congress to vote up-or-down.[5]

- *List the unfunded obligations in the budget.* President Obama should also incorporate the massive long-term unfunded obligations of programs such as Social Security and Medicare into his budget and require Congress to focus on the long-term fiscal implications of their policies. This is especially important while Congress considers a Medicare drug subsidy expansion that would likely cost future generations trillions of dollars.[6] The President should work with Congress to put Social Security, Medicare, and Medicaid on a fixed long-term budget with periodic review and action to keep spending within the budget.
- *Support spending caps.* In each of the past two years, Congress has passed budgets expanding discretionary spending by 8 percent. On top of that, they enacted $333 billion in "emergency" spending in 2008 and passed a $1.1 trillion "stimulus" this year.[7] Clearly, the budget process created to help lawmakers set priorities and make trade-offs has collapsed. Even the current PAYGO rules—which apply to only a very narrow class of spending and are routinely ignored—have proven woefully insufficient to rein in the escalating budget. Enforceable spending caps can provide the structural rules necessary to make the difficult but necessary budget choices. President Obama should embrace spending caps as part of an overall budget process reform agenda.

Be Realistic About Iraq Savings. Any goal to reap savings from an Iraq drawdown must be based on military progress with the understanding that if events were to deteriorate on the ground, continued funding would be necessary. It is essential that major defense policy decisions—including U.S. strategy in Iraq and Afghanistan—not be dictated by the requirements of the budget calendar.[8]

Because emergency spending bills fall outside the normal budget process, they are not subject to domestic discretionary budget caps. This has made the war bills for Iraq and Afghanistan over the last eight years an attractive target for Congress to add on unrelated domestic spending programs with no debate, prioritization, or restraint.[9] Given that the scope and cost of these operations has become more predictable, it would be fiscally prudent to move

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1. Lori Montgomery and Ceci Connolly, "Obama's First Budget Seeks to Trim Deficit," *The Washington Post*, February 22, 2009, at *http://www.washingtonpost.com/wp-dyn/content/article/2009/02/21/AR2009022100911_pf.html* (February 24, 2009).
2. *Ibid.*
3. Dennis G. Smith, "Note to Congress: Expanding Health Care Entitlements Is Bad Policy," Heritage Foundation *Backgrounder* No. 2240, February 12, 2009, at *http://www.heritage.org/Research/HealthCare/bg2240.cfm.*
4. Brian M. Riedl, "A Guide to Fixing Social Security, Medicare, and Medicaid," Heritage Foundation *Backgrounder* No. 2114, March 11, 2008, at *http://www.heritage.org/Research/Budget/bg2114.cfm.*
5. The Heritage Foundation, "Statement on the Fiscal Responsibility Summit," February 19, 2009, at *http://www.heritage.org/Press/NewsReleases/nr022009.cfm.*
6. Robert E. Moffit and Alison Acosta Fraser, "Congress Must Pull the Trigger to Contain Medicare Spending," Heritage Foundation *WebMemo* No. 1796, February 4, 2008, at *http://www.heritage.org/Research/Budget/wm1796.cfm.*
7. Brian M. Riedl, "Emergency Spending: $333 Billion Tab Busted the Budget in 2008," Heritage Foundation *WebMemo* No. 2127, November 10, 2008, at *http://www.heritage.org/Research/Budget/wm2127.cfm.*
8. Baker Spring and Mackenzie Eaglen, "Quadrennial Defense Review: Building Blocks for National Defense," Heritage Foundation *Backgrounder* No. 2234, January 28, 2009, at *http://www.heritage.org/Research/NationalSecurity/bg2234.cfm.*
9. Brian M. Riedl and Baker Spring, "Time to Move Iraq and Afghanistan Funding into the Regular Budget Process," Heritage Foundation *WebMemo* No. 2068, September 19, 2008, at *http://www.heritage.org/Research/Budget/wm2068.cfm.*

war funding into the regular budget process as Congress has directed.

The Congressional Budget Office (CBO) is currently projecting that the deficit this year will total $1.2 trillion—and that is before enactment of the recently passed stimulus legislation. Potential savings achieved by reducing the amount of emergency supplementals for Iraq will be only a fraction of the proposed deficit reduction efforts. While important, the potential to save up to $90 billion over the next three years is only one piece of any larger deficit reduction plan.

Further, any potential war-related savings will not be realized within the next year. If U.S. military force levels are reduced in Iraq, the cost of redeploying combat forces from Iraq will likely be significantly more expensive than maintaining current force levels. According to scenarios run by CBO, the cost of reducing the number of forces deployed in and around Iraq by 50,000 one year and declining until all troops are withdrawn within two years would require an additional $166 billion over a nine-year period.[10]

In addition, force levels are currently scheduled to grow in Afghanistan even before any troops have been scheduled to return from Iraq—also increasing war-related costs for the rest of 2009 and undoubtedly 2010.

Any discussion of the federal budget should begin by acknowledging that defense spending has not caused the federal government's current and projected fiscal woes. Excluding war-related costs, the military's annual core budget should not become the default billpayer for domestic initiatives or new unfunded, permanent entitlement programs. Spending on the armed forces represents only about one-fifth of the federal budget and approximately half the average level of defense spending during the Cold War (measured as a percentage of gross domestic product, or GDP). Defense has gradually declined as a percentage of GDP since the 1960s, while spending on the major entitlements (now about half the federal budget) have usually exceeded economic growth rates over the same period. Further, current projections show that entitlement spending will far outpace economic growth and all components of government spending in the decades to come. Addressing entitlement spending, not defense expenditures, is the key long-term challenge for lawmakers.[11]

As the situation in Iraq continues to improve, the number of U.S. combat forces will likely decline. As combat forces leave Iraq, funding for operations will fall correspondingly. In the meantime, Congress has directed the Department of Defense to begin shifting some of the recurring costs into the baseline defense budget with the goal of eliminating the use of emergency supplemental spending bills.

Lawmakers should support the eventual absorption of predictable supplemental spending needs into the regular budget process. Press reports indicate that the service chiefs and Secretary Gates have proposed shifting some of these emergency funds in the 2010 draft defense budget. The rumored topline of $535–540 billion for the core defense budget in FY 2010 would adequately meet not only military requirements but also the federal government's fundamental responsibility to provide for the common defense.

Avoid Harmful Tax Hikes. Based on statements made during the campaign and since, President Obama will propose to increase taxes on those making over $250,000 by raising the top two income tax rates from 33 percent and 35 percent to 36 percent and 39.6 percent. He is also expected to propose raising tax rates on capital gains and dividends.

In addition, he is also expected to propose a punitive new death tax structure. Under current law, the death tax is abolished in 2010 but then restored to include a minimal exemption amount and a 55 percent tax rate in 2011.

10. Donald B. Marron, CBO letter to Rep. John M. Spratt, Jr., Ranking Member, Committee on the Budget, U.S. House of Representatives, July 13, 2006, at *http://www.cbo.gov/ftpdocs/73xx/doc7393/07-13-IraqCost_Letter.pdf* (February 24, 2009).

11. Baker Spring, Mackenzie Eaglen, and James Jay Carafano, "4 Percent of GDP Defense Spending: Sustained Spending, Not Economic Stimulus," Heritage Foundation *WebMemo* No. 2243, January 26, 2009, at *http://www.heritage.org/Research/HomelandSecurity/wm2243.cfm.*

Every year the Alternative Minimum Tax (AMT) threatens taxpayers with a massive tax hike and, so far, every year Congress has prevented that tax hike. President Obama is expected to propose either that a significant portion of that tax hike take effect or that taxes be raised on other high income taxpayers in lieu of the AMT hike.

Higher tax rates discourage work, investment, saving, entrepreneurial activity, and the taking of economic risks. Obama's likely proposals promise a slower economy, lower wages, and diminished economic competitiveness. Though he may propose that these tax hikes not take effect until 2011 (the same time the 2001 and 2003 tax cuts expire), the fact is the threat of these higher taxes is already depressing economic activity in the middle of the recession. For example, businesses buy new equipment for the earnings they will generate in the future, and investors and savers make decisions today to earn returns in the future. Facing higher future taxes, businesses, investors, and savers are reducing their activities today.

President Obama supports some forms of tax relief, as he showed when he proposed and signed into law the Making Work Pay credit as part of the stimulus package.[12] However, the $7.70 per week per worker tax savings is nearly empty of incentive effects and so will have almost no consequence for economic growth. Worse, even the benefit of lower taxes will be more than wiped out as workers suffer a relative loss of income due to the weakened economy if President Obama pursues tax-raising policies.

President Obama and the nation would be better served by disavowing tax hikes.[13] Instead, he can help achieve his own goal of creating 3.5 million new jobs by cutting tax rates.[14] A plan formulated by Senator Jim DeMint (R–SC) and The Heritage Foundation would create nearly 500,000 jobs this year, 1.3 million next year, and 7.5 million by 2013 by eschewing tax increases while cutting tax rates on individuals and businesses further.[15]

Do Not Raise Taxes on Investment. An increase in taxes on capital gains and dividends means that new investments will be discouraged because the final return on an investment will be reduced by higher taxes. Lower taxes on capital are vital to economic growth, because they reduce the cost of investment. With lower investment costs, new investment activity that would not be undertaken otherwise is now profitable and will be started. These additional investments boost the capital stock of the United States, which will generate economic growth in the short-term and the future.

Permanently extending the tax cuts on capital gains and dividend income permanently reduces the cost of capital to business. Real, non-residential fixed investment responds positively, climbing an average of nearly $9 billion annually between 2011 and 2016. The economy's stock of productive capital is bolstered as a result that increases GDP.

Costs of Higher Taxes. Beyond tax increases on investment, President Obama will likely propose increasing tax rates on income generally. For example, if the 2001 and 2003 tax cuts expire, an average of 709,000 fewer jobs will be created from 2011 to 2016. Real personal income will be reduced by an average of $200 billion each year due to slower economic growth and higher taxes.[16]

If all of the tax cuts enacted during the Bush Administration expire, families would see a tax increase of $2,000 per year on average and an addi-

12. Curtis S. Dubay, "'Making Work Pay' Credit Will Not Stimulate the Economy," Heritage Foundation *WebMemo* No. 2240, January 26, 2009, at *http://www.heritage.org/Research/Taxes/wm2240.cfm.*
13. Alison Acosta Fraser and Curtis S. Dubay, "Cutting Taxes to Promote Growth and Restore Fairness: A Memo to President Obama," Heritage Foundation *Special Report* No. 29, December 2, 2008, at *http://www.heritage.org/Research/Taxes/sr29.cfm.*
14. J. D. Foster, "Cut Tax Rates and Create 2.5 Million—No, 3.5 Million New Jobs," Heritage Foundation *WebMemo* No. 2218, January 13, 2009, at *http://www.heritage.org/Research/Economy/wm2218.cfm.*
15. Senator Jim DeMint, "The American Option: A Jobs Plan that Works," *Heritage Lecture* No. 1108, January 29, 2009, at *http://www.heritage.org/Research/Economy/hl1108.cfm.*
16. Tracy Foertsch and Ralph Rector, "The 2001 and 2003 Bush Tax Cuts: Economic Effects of Permanent Extension," Heritage Foundation *WebMemo* No. 1361, February 15, 2007, at *http://www.heritage.org/Research/Taxes/wm1361.cfm.*

tional loss of $1,800 per year due to slower economic growth.[17] The average job growth for each congressional district would be reduced by over 2,000 jobs. With weaker job growth, the labor market will not be as tight, which means that wages will not increase as fast.

If President Obama increased only taxes on capital gains and dividends, there would be 270,000 fewer job opportunities in 2011, and personal income would fall by $113 billion the same year.

Making Bad Policies Worse. President Obama has an opportunity to bring responsible budgeting back to Washington. To this end, the Administration should ensure the out-of-control spending in the stimulus package is not made permanent, address the looming tsunami of entitlement spending, and abandon its harmful plans to raise taxes. In addition, Obama should not shortchange the efforts to stabilize Iraq and Afghanistan in the name of economic "stimulus." Overall, the President must ensure that his budget proposal protects America's security abroad and economic security at home.

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17. Shanea Watkins, "The House Budget Resolution: Tax Hikes Would Harm the Economy, Taxpayers," Heritage Foundation *WebMemo* No. 1844, March 11, 2008, at *http://www.heritage.org/Research/Budget/wm1844.cfm*