Senate Democratic Policy Committee Hearing

"Do Deficits Matter?
The Impact of Long-Term Deficits on Economic Growth and Job Creation"

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Mr. Chairman and members of the Committee, thank you for inviting me to testify today on the topic of federal budget deficits.

Budget projections that include continuation of current revenue and spending policies show large amounts of red ink as far as the eye can see.[1] The Bush administration is downplaying the importance of the deficit, and it supports a modest reduction, not elimination, of the deficit in coming years.

I would agree with the White House that today's high deficits are not a serious problem if these were normal times and the budget could be expected to balance as the economy expanded. But we are moving into an extraordinary time for the federal budget in the years ahead. As this committee knows, the baby boom generation begins retiring in 2008, putting enormous and increasing stress on the budget every year thereafter.

To illustrate the coming entitlement budget squeeze, consider that combined Medicare, Medicaid, and Social Security spending is currently rising at roughly $50 billion every year. But 10 years from now, spending on these three programs without reforms will be rising by more than $100 billion every year.[2] Regardless of when the Social Security and Medicare Trust Funds run out, or when these programs start running cash-flow deficits, the financial squeeze begins just a few years from now when the entitlements start consuming ever larger shares of the budget and the nation's gross domestic product.

Neither Congress nor the administration has moved forward with a solution to the coming entitlement crisis. But I think the White House, in particular, needs to take the lead and propose serious budget cuts to offset the large spending increases it has supported in recent years. While I strongly support President Bush's tax cut program, his tax and spending policies have been hugely inconsistent. The president has cut government on the revenue side, but has consistently supported Big Government on the spending side.

Indeed, President Bush's big spending is headed for the record books. Bush has presided over three of the top five largest increases in real discretionary outlays in the last 40 years.[3] President Bush rarely even talks about the need to restrain spending. By contrast, when faced with a $200 billion deficit, President Clinton argued in his FY1995 budget message that “except in emergencies, we cannot spend an additional dime on any program unless we cut it from another part of the budget.”[4]

I’d love to hear President Bush lay down such a challenge in his new budget, but it does not look like he is going to. Indeed, the president does not seem to “get it” with respect to today’s fiscal realities. Last week, he announced new plans to go to the Moon and Mars, which could cost tens or hundreds of billions of dollars over the long term. He continues to tout wasteful new proposals such as a $1.5 billion federal marriage initiative.

Bush Administration Has Not Set Priorities

Even excluding the recent Iraq supplemental bill, total federal outlays have risen 24 percent in the past three years.[5] The administration argues that high spending has been driven by defense and national security needs. That was a good excuse for awhile, but Congress and the administration should now be moving ahead with reforms to cut domestic spending and find cost efficiencies in the huge Pentagon budget.

Big defense spending is Big Government just like other types of spending. Defense outlays have risen by about $150 billion in just three years, sucking resources out of the private sector economy and ultimately reducing U.S. living standards. I don’t know what the correct level of defense spending is, but the Pentagon does seem to be one of the most waste-prone agencies in the government. For example, the GAO says that the Pentagon has “serious financial management problems … that are pervasive, complex, long-standing, and deeply rooted in virtually all business operations throughout the department.”[6] The Pentagon loses track of assets, wastes billions of dollars on excess inventory, and makes billions of dollars in erroneous contractor payments.[7] We cannot afford that sort of waste with today’s huge deficit.

Defense is a high-priority, but the Bush administration has identified few, if any, low-priority programs that could be cut. While Ronald Reagan also presided over a large defense spending increase, he managed to partly offset it with a 13 percent cut in real discretionary nondefense spending in his first three years.[8] Whether you agreed or not with Reagan’s fiscal approach, he clearly had a more consistent position regarding the budget and the role of government.

Bush’s budget director, Joshua Bolten, has been arguing that non-entitlement, nondefense, non-homeland security spending has not been rising very much. Thus, the administration claims that it has restrained spending in less than one-fifth of the entire budget. Shouldn’t the administration be looking for savings in the other four-fifths of the budget? Aside from possible defense savings, reforms are needed in the Medicaid program, for example. Medicaid spending is out of control with outlay increases averaging more than 10 percent annually the past three years.[9] Entitlements are often said to be on autopilot, as if nobody controlled them. But, of course, Congress does control entitlement spending and can pass laws at any time to cut spending or reduce spending growth.

Are Future Deficits Caused by Revenue Shortfalls or Spending Increases?

Projections of large future budget deficits are based on rapidly rising spending, not a shortage of revenues. Assuming that the Bush tax cuts are made permanent and the alternative minimum tax is fixed, federal revenues as a percentage of GDP will steadily rise from 16.2 percent in FY2004 to about 18 percent by FY2013.[10] Since 1970, revenues as a percentage of GDP have averaged 18.2 percent.[11] Thus, the Bush tax cuts do not starve the government for funds, and revenues will slowly and steadily rise over time due to "real bracket creep" under the income tax.

Looking at the spending side of the budget, outlays have increased from 18.4 percent of GDP in FY2000 to 20.5 percent today. Recent spending increases are higher than usually recognized. That is because interest costs have fallen substantially since the late 1990s, which has partly offset increases in program spending. For example, total federal outlays rose $147 billion in FY2002, but outlays excluding interest, or actual spending on programs, rose $182 billion.

Looking far ahead to 2040, outlays will rise from 20.5 percent of GDP today to more than 28 percent, given the CBO's current entitlement projections and assuming that the rest of government stays at the same size relative to the economy.[12] That means that without spending reforms the government will claim at least a 37 percent greater share of the average American's income by 2040 than today.

Long-Term Solution: Cut Spending

Congress has some very tough fiscal decisions to make in the years ahead. It would have been much easier being a member of Congress in the 1990s when revenues were pouring into federal coffers than later in this decade when the entitlement spending explosion begins. The extraordinary budget pressures caused by the baby boomers retiring will hopefully cause Congress to reconsider whether the government really needs to do many of the things it has done in past decades. As David Walker, comptroller general, has testified to Congress: "Government cannot accept as 'givens' all of its existing major programs, policies, and operations. A fundamental review of what the federal government does, how its does it, and in some cases, who does the government's business will be required, particularly given the demographic tidal wave that is starting to show on our fiscal horizon."[13]

I'm glad to see that other groups are starting to focus on fundamental changes to the federal government. Last week, the Brookings Institution released a study that included various plans to balance the budget by 2014. The Institute's "Smaller Government" plan generally moves in the right direction, but the study argues that tax increases are needed to balance the budget. However, I think that Congress can and should balance the budget without tax increases. Using Brookings' methodology, my Smaller Government plan would balance the budget by reducing spending by $562 billion by 2014 (compared to Brookings' $400 billion), by cutting business subsidies, devolving programs to the states, and trimming entitlements.[14]

Cato Smaller Government Plan to Balance the Federal Budget
(All figures are for 2014 using Brookings Institution methodology)

Spending cuts proposed in the *Cato Handbook for Congress*	$488 billion
Entitlement spending cuts proposed by Brookings	$74 billion
Total proposed cuts	$562 billion
Cuts needed to balance the budget per Brookings	$534 billion

Such a program of substantial spending cuts would likely be opposed by current benefit recipients. But it should be noted that Americans will be substantially wealthier in the future than in the past, which will provide greater scope to make the needed cuts to entitlements and other programs. For example, real per-capita GDP is expected to grow at at least 1.7 percent during the next few decades, a rate that would double U.S. living standards in the next 40 years. As income levels rise, there should be less need for government transfers for retirement, health care, housing, education, and other programs.

Conclusion

In closing, let me challenge both parties to revisit some of their budget restraint efforts from the mid-1990s. The Republicans should live up to their pledge in the 1994 Contract with America to "restore fiscal responsibility to an out-of-control Congress, requiring them to live under the same budget constraints as families and businesses."[15] And I'd like to see all policymakers take to heart President Clinton's 1995 State of the Union message: "Let's change the government—let's make it smaller, less costly and smarter."[16]

Thank you for holding hearings on this important topic.

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[1] For example, a new projection by the Brookings Institution that includes the Medicare prescription drug bill, increases in discretionary spending by inflation and population, and the extension of the Bush tax cuts, shows the budget deficit rising to $687 billion by 2014. See Brookings Institution, "Restoring Fiscal Sanity: How to Balance the Budget," January 2004, p. 5.
[2] Congressional Budget Office, "The Budget and Economic Outlook: An Update," August 2003, p. 9.
[3] Real discretionary outlay increases for FY2001, FY2002, and FY2003 have been the largest since FY1965 except for FY1966 and FY1967. FY2004 is a CBO estimate. See CBO, August 2003.
[4] *Budget of the United States Government, Fiscal Year 1995,* "The Budget Message of the President" (Washington: Government Printing Office, February 1994), p. 4.
[5] CBO, August 2003. Spending increase from FY2001 to FY2004. FY2004 is an estimate.
[6] General Accounting Office memo in the "Financial Report of the U.S. Government 2001," U.S. Treasury Department, March 29, 2002, p. 26.
[7] GAO, "Major Management Challenges and Program Risks-DOD," GAO-01-244, January 2001. See also, GAO, "High-Risk Update," GAO-01-263, January 2001.
[8] Veronique de Rugy and Tad DeHaven, "On Spending, Bush is No Reagan," Cato Institute Tax & Budget Bulletin no. 16, August 2003.
[9] CBO, August 2003, p. 9. Measured from FY2001 to FY2004.

[10] CBO, August 2003. Using Table 1-6 estimates of the impact of AMT reform and making the Bush tax cuts permanent (but ignoring interactive effects), revenues in 2013 would be 18.2 percent of GDP. Brookings puts 2013 revenues at 17.6 percent of GDP under these policies. See Brookings, January 2004, p. 5.

[11] Measured FY1970 to FY2004.

[12] Chris Edwards and Tad DeHaven, "War Between the Generations," Cato Institute Policy Analysis, September 16, 2003. Updated based on CBO's long-range budget projections from December 2003.

[13] David Walker, "Federal Budget: Opportunities for Oversight and Improved Use of Taxpayer Funds," General Accounting Office, June 18, 2003, p. 4.

[14] For a detailed list of cuts, see *Cato Handbook for the 108 Congress* at www.cato.org/pubs/handbook/hb108/hb108-23.pdf. I inflated the *Handbook's* FY2002 cuts to 2014 using Brookings' methodology.

[15] www.house.gov/house/Contract/CONTRACT.html.

[16] William J. Clinton, "State of the Union," Washington D.C., January 24, 1995, www.thisnation.com/library/sotu/1995bc.html.