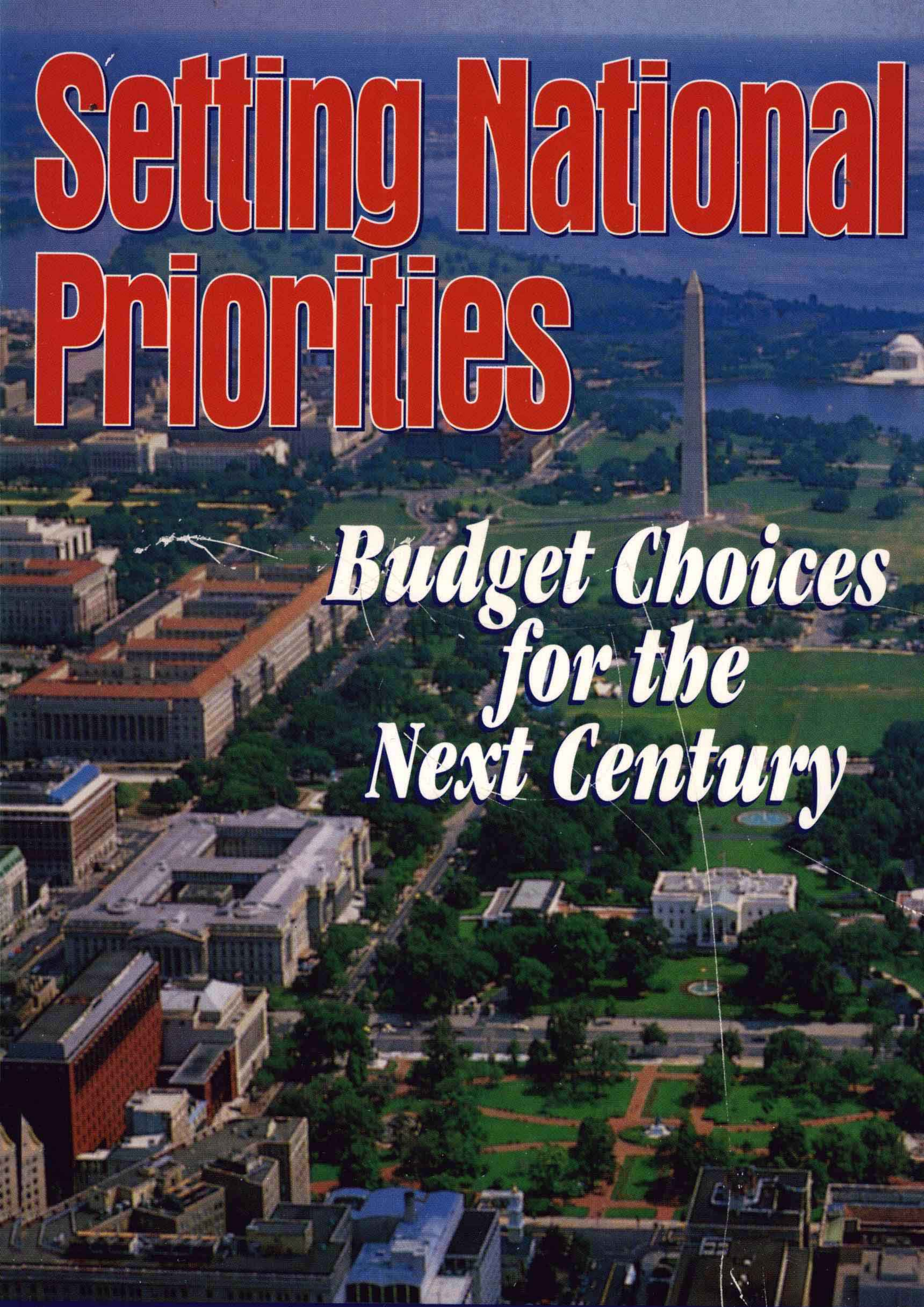
Setting National Priorities

Budget Choices for the Next Century



ROBERT D. REISCHAUER, Editor

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BUDGET CHOICES FOR THE NEXT CENTURY

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Foreword

NOW THAT THE November 1996 election results have reaffirmed the political realignment that occurred when the Republicans assumed the leadership of the House and Senate in 1995, President Clinton and the 105th Congress can turn their attention to the many important issues that crowd the policy agenda. These include fundamental questions about economic growth, the social safety net, the scope of the government's domestic activities, national security in the post–cold war era, the structure of the nation's tax system, and the sustainability of the entitlement programs created for retirees during the New Deal and Great Society eras. As policymakers address these issues they will be constrained by the daunting commitment they made in 1996 to balance the budget early in the twenty-first century.

The chapters in this volume provide concise, clear, and dispassionate discussions of the major issues facing the nation, forthright analyses of the complex and difficult trade-offs that policymakers will confront when trying to resolve them, and frank appraisals of the consequences of alternative policies. Two themes run through the book. First, policymakers should focus their attention on the problems that will significantly affect national life in the first half of the twenty-first century. And second, the last few years of the twentieth century offer a singular opportunity to deal with these long-run problems in a considered manner before they reach crisis proportions. The policy environment is comparatively tranquil: the economy is operating at close to its full capacity, the international environment is relatively benign, welfare rolls and crime rates are down, and the nation is in a favorable demographic period. In short, it is a good time to thoughtfully assess how the nation should meet its national security needs in the post–cold war world, how the major retirement programs should be restructured to withstand the pressures that the baby boom generation's retirement will impose, how the federal government should sort out the myriad domestic activities for which it has assumed responsibility, and how the government should raise the revenues that it needs.

This propitious environment for rational policymaking could come to an end quite suddenly if serious problems arise in the international sphere or the economy falls into recession. Moreover, the favorable demographic situation will end in a decade as the leading edge of the huge baby boom generation becomes eligible for social security benefits and then for medicare and supplementary security income benefits.

Pundits often assume that when one political party controls the White House and the other Congress, gridlock ensues and little constructive legislation is enacted. Instead, divided government should be considered as offering an opportunity to forge bipartisan solutions to the nation's most important problems; these solutions may prove more durable than those crafted by politicians of a single party.

The volume was edited by Nancy D. Davidson. Amanda K. Packel, Melanie L. Allen, Chris M. Furgiuele, Jasper J. Hoek, Christina Larson, Jeffrey J. McConnell, Joseph M. Milano, Susan L. Hardesty, James J. Prescott, and Sheryl K. Zohn provided research assistance for the various chapters in the volume. Kathleen Elliott Yinug provided administrative assistance. The manuscript was verified by Cynthia M. Iglesias and Gerard E. Trimarco. Carlotta Ribar provided proofreading services, and Robert Elwood prepared the index.

The views expressed in this volume are those of the authors and should not be ascribed to the trustees, officers, or other staff members of the Brookings Institution.

MICHAEL H. ARMACOST
President

November 1996
Washington, D.C.

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ROBERT D. REISCHAUER

The Budget: Crucible for the Policy Agenda

AS THE United States prepares for the twenty-first century, an unusual number of fundamental issues are crowding the agenda of the nation's policymakers. These include basic policy questions involving economics, entitlements, taxes, nondefense discretionary activities, and national security. President Clinton and the 105th Congress will have to decide which of these issues to address in the next two years and which to deal with later. As they grapple with these issues, policymakers will also be attempting to fulfill the bipartisan commitment made in 1995 to balance the budget early in the next century.

On the economic front, the nation's major problem is the slow growth of the economy's long-run capacity, which, because of disappointing productivity growth and smaller increases in the labor force, is projected to expand at a pace that is slow by historical standards. Possible responses include tax reform and tax rate cuts, reduced deficits, increased investment in public infrastructure and education, and further deregulation. The crucial social policy issues center on the need to restructure the New Deal and Great Society entitlement programs in ways that encourage more self-sufficiency, contain costs, and ensure sustainability in the long run. The tax question being debated is whether to replace the existing income tax with some form of consumption tax or to be content with incremental adjustments to the current tax system. Flat taxes, value-added taxes, consumed-income taxes, and national sales taxes have been advocated as alternatives to the income tax. In the domestic arena, the question being debated is what roles and responsibilities the federal government should perform. Should the broad array of activities that Wash-

The author thanks Thomas E. Mann for his significant contribution to the conception of this chapter.

ington entered into over the past half century be significantly scaled back, leaving more to individuals, states and localities, and the private sector? Finally, now that the cold war is over and the United States is left as the only power with a global reach, the basic national security questions facing policymakers are how to size our military forces and structure our relations with nations outside the U.S. alliance to meet the challenges posed by the new international environment.

Dealing with any one of these issues in a supportive environment would be difficult. All involve significant redistribution of resources, burdens, powers, or responsibilities. But grappling with several of them simultaneously in the face of inhospitable political and fiscal environments is truly daunting. Different political parties control Congress and the White House, congressional majorities are slim by historical standards, the political loyalties of the electorate are unstable, the public views government and politicians cynically, and fiscal resources are scarce for easing the transition from one policy regime to the next by compensating losers.

For over a decade, the formulation and discussion of almost all major policy initiatives have been shaped and constrained by the federal government's large budget deficits. This situation will persist even though the fiscal 1996 deficit in nominal terms was smaller than any since 1981 and, as a percentage of GDP, smaller than any since 1974. This is because, without further tax increases or spending cuts, the deficit is projected to begin rising again in 1997. By early in the next decade, deficits will return to troubling levels, and in the second and third decades of the next century, when the baby boom generation begins to draw on the government's retirement programs, deficits will reach unsustainable levels.

The bipartisan commitment to balance the budget by 2002 will also force President Clinton and the 105th Congress to pursue major policy issues in a budgetary context. While each issue has its own rationale, each also has important budgetary ramifications. For example, although the reassessment of the nation's security policy is being driven primarily by the changed nature of the post–cold war threats, some policymakers hope that a revised defense policy will contribute to the effort to balance the budget. Similarly, the impetus to cut tax rates and fundamentally reform the tax system arises from desires to spur economic growth, simplify the tax code, and reduce the size of government. Yet any reduction in revenues that results from tax cuts will make the job of balancing the budget all the more difficult because it will entail deeper spending cuts. However, if fundamental tax reform boosted economic growth, federal revenues would increase and the spending cuts needed to reach balance could be smaller.

For procedural reasons, any major policy change with spending or revenue ramifications will be constrained by limitations imposed by the budget process. Under current law, the net budgetary effects of all changes in tax and entitlement legislation enacted after 1993 cannot increase the deficit in any year. In addition to this pay-as-you-go limitation—often referred to as "PAYGO"—annual caps have been imposed on the amounts of budget authority and outlays available for appropriated discretionary programs.

In addition to these restrictive reasons why major policy changes must be handled through the budget process, there is an advantage to dealing with such initiatives through budget legislation. The congressional budget process provides special procedures under which policy initiatives with budgetary ramifications can be considered and acted upon in an expedited fashion. These rules, known as the reconciliation procedures, limit debate and the scope of amendments. They were used by President Reagan in 1981 to secure enactment of his spending reductions. The significant changes in tax and entitlement policies embodied in the 1990 and 1993 deficit reduction packages were also enacted in this manner, as were the procedural changes that established and extended the discretionary spending caps and the PAYGO discipline. The reconciliation procedures were used by the 104th Congress to pass tax reductions and revolutionary changes in medicare, medicaid, welfare, and other entitlement programs—the Balanced Budget Act of 1995—which President Clinton vetoed. The welfare reform bill ultimately enacted in August 1996 was considered under the expedited procedures of reconciliation.

Congressional Republicans and President Clinton have incorporated, explicitly or implicitly, most of their recent major policy initiatives into their respective plans to balance the budget by 2002. These budget proposals have included profound changes in many entitlement programs, major tax reductions, and significant future restraint on discretionary spending. Even though the two sides advanced broadly similar approaches, the volatile political environment of 1995–96 made compromise impossible. Nevertheless, the effort to forge agreement will be renewed in early 1997, when the debate over the fiscal 1998 budget gets under way. This debate will not only include substantive issues but will also have to address major procedural matters because the PAYGO restraints and discretionary spending caps are scheduled to expire after fiscal 1998.

The balance of this chapter sketches the budgetary context in which the major issues of the future will be addressed; it reviews the evolution of the current budget problem and recent efforts to resolve it. This review draws some lessons from past experiences and serves as a backdrop for the ensuing chapters' discussions of a number of the major policy issues that President Clinton and the 105th Congress will consider as the twentieth century draws to a close.

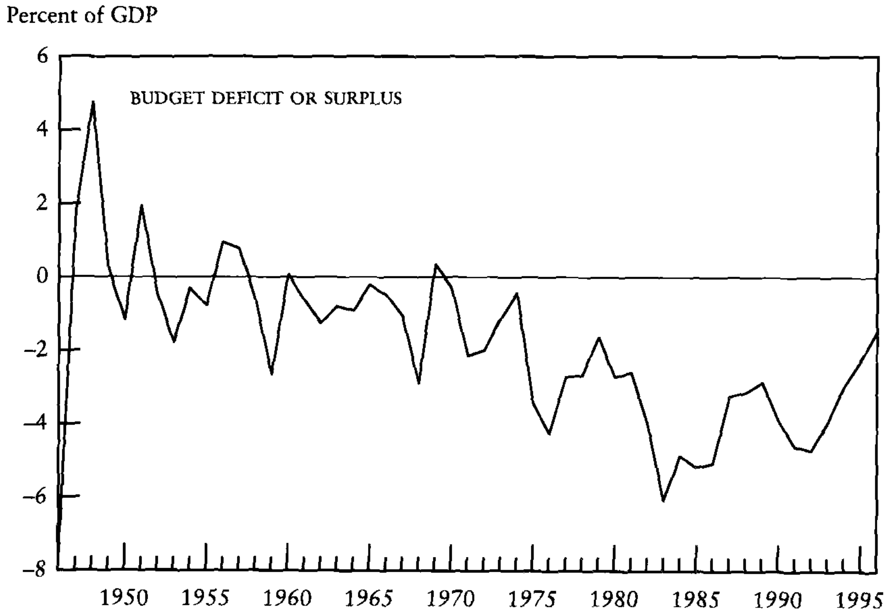
The Roots of the Deficit Problem

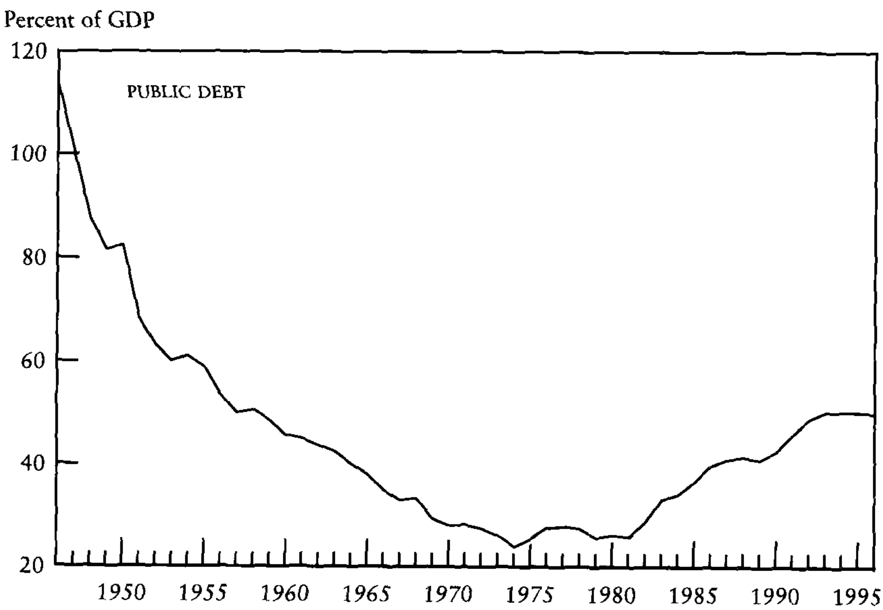
From the end of World War II through the mid-1970s, the budget deficit was not of major concern to policymakers. Although the surpluses that characterized the immediate postwar years occurred less and less frequently as the 1950s and 1960s unfolded, deficits tended to be quite modest until the mid-1970s (figure 1-1). Averaged over 1947–74, the federal government's red ink amounted to a bit less than 1 percent of GDP. Public debt had reached a peak of 114 percent of GDP in 1946 as a result of the war and depression era borrowing. During the next twenty-six years the economy grew strongly, causing debt as a percentage of GDP to decline fairly steadily even though deficits were adding to the stock of outstanding public debt in most years. By 1974 public debt had fallen to 24 percent of GDP.

The budget situation worsened significantly after the mid-1970s. In the last half of that decade, deficits averaged 2.9 percent of GDP; during the 1980s they averaged 4.0 percent; and during the first three years of the 1990s they averaged 4.4 percent. As a result of these large deficits, the public debt grew faster than the economy and the ratio of public debt to GDP more than doubled, reaching 50 percent in 1993.

The deterioration in the nation's fiscal situation was brought on by the interaction of several factors. Some are best characterized as policy mistakes, while others involved unanticipated and unpredictable changes in the fiscal environment over which policymakers exercised little or no direct control. The first and most significant of the latter was the unexpected economic slowdown that began in the mid-1970s. For reasons that economists still do not fully understand, the trend rate of economic growth slowed by about a percentage point

FIGURE 1-1. Budget Deficit or Surplus and Total Public Debt, Fiscal Years 1946–96





SOURCE: *Budget of the United States Government, Fiscal Year 1997, Historical Tables.*

after 1973. From the late 1940s through 1973, real per capita GDP grew at an average annual rate of 2.5 percent and real output per hour of labor grew at an average rate of 2.1 percent. From 1973 through 1995, real per capita GDP grew at only 1.5 percent a year and output per hour of labor grew at only 0.8 percent a year.[1] Because federal revenues grow as the economy expands, this slowdown had a significant impact on the budget situation.

The entitlement commitments the government made between 1962 and 1972 also contributed in an important way to the growing deficits of the past two decades. During this period, Congress and the president enacted laws establishing the medicare, medicaid, food stamp, guaranteed student loan, title XX social services, and supplemental security income programs. In addition, the social security program was modified to provide automatic annual increases in benefit levels keyed to changes in the consumer price index.

For several reasons, the entitlement commitments adopted during this decade, as well as those enacted earlier, turned out to be far more expensive than anticipated. First, the slowdown in the economy dampened income growth, increasing the numbers of individuals eligible for means-tested programs. Second, unexpected demographic developments—most notably, increased rates of divorce and out-of-wedlock births—boosted the number of people eligible for these programs. Between 1960 and 1980, the divorce rate more than doubled and the fraction of births to unwed mothers more than tripled.[2] These developments were reflected in the poverty rate, which, after declining fairly steadily from 22.4 percent of the population in 1959 to 11.1 percent in 1973, rose to an average of over 14 percent during 1980–95.[3]

A third reason why the new entitlement commitments turned out to be unexpectedly expensive was that health care costs, driven largely by the ever increasing capabilities of medicine, continued to grow at

1. The Department of Commerce revised, chain-weighted NIPA data using 1992 as the base year are available only back to 1959. The growth rates are based on the author's estimates of GDP for 1948–58.

2. Data from U.S. National Center for Health Statistics. The divorce rate rose from 2.2 per 1,000 population in 1960 to 5.3 per 1,000 in 1979. Since 1979, the divorce rate has dropped to around 4.4. The share of births to unwed mothers rose from about 5 percent in 1960 to 17.1 percent in 1979 and over 30 percent in 1992.

3. The first year for which there are official statistics is 1959. U.S. Bureau of the Census (1996).