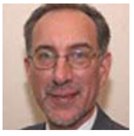
• *22* •

The Coming Budget Crisis and the Rising Threat of Large-Scale Federal Disinvestment



Robert Greenstein

If the recent tax cuts are continued and made permanent, they ultimately will take a large toll on the federal budget and affect an array of services important to both the middle class and the poor.

The purpose of the present chapter is to spell out the unprecedented challenges the federal budget faces and to call for a common-sense debate on federal budget priorities as they affect average Americans and those who are less fortunate.

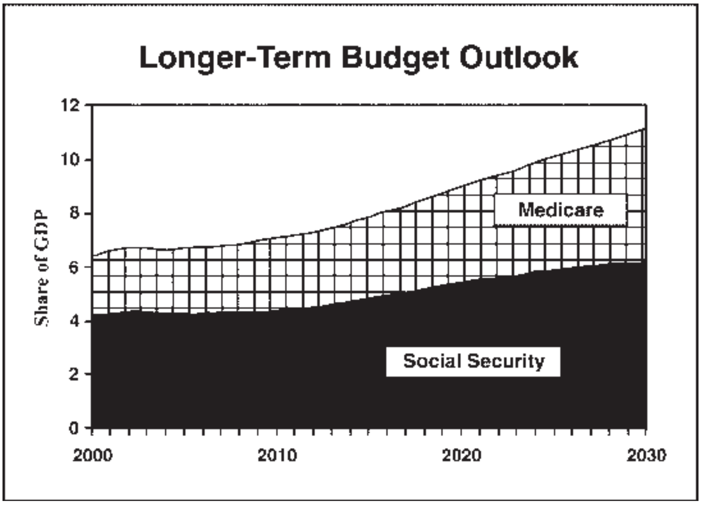
WHERE ARE WE HEADING?

Where is the federal budget headed? A starting point in answering this question is the well-known fact that when the baby-boom generation retires, costs will go up for Social Security and Medicare. Baby-boomers are people born between 1946 and 1964. They are numerous. When they retire, Social Security and Medicare will cost more. The cost of Medicaid long-term care also will rise.

From 2000 to 2030, Social Security and Medicare costs will increase by more than 5 percent of gross domestic product—that is, by more than 5 percent of the size of the U.S. economy (see fig. 22.1). This increase is larger than the U.S. defense budget.

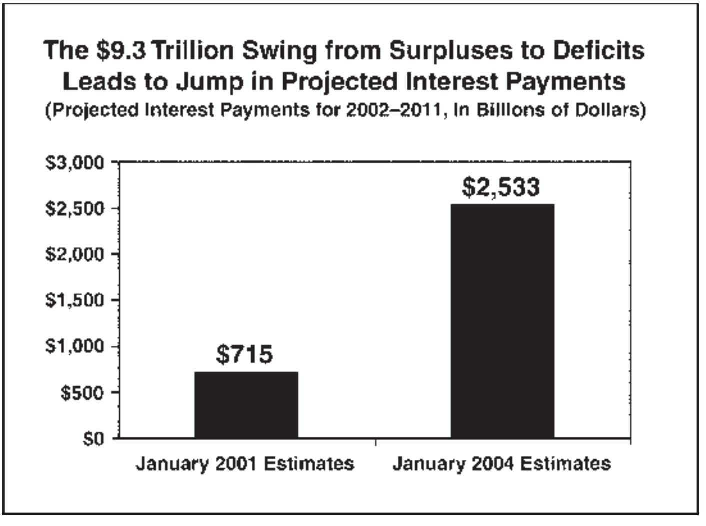
So the nation faces a challenge: How do we navigate our way through the period of the boomers' retirement, meeting our promises to the elderly, without severely squeezing the rest of the budget as the cost of the programs for the elderly rises?

At the start of 2001, it was projected that over the next ten years we would be spending about $700 billion in interest payments on the national debt. Estimates from early 2004 suggest we are more likely to spend about $2.5 trillion on interest



Source: Congressional Budget Office
Figure 22.1.

payments over the 2002–2011 period, or $1.8 trillion *more* than was projected three years earlier (see fig. 22.2). We are now on a course under which interest payments on the debt will rise to and then surpass $300 billion a year and will exceed $450 billion a year by 2014. Combined with the increases in Social Security and Medicare costs, this threatens to leave less room in the budget for everything else.



Source: Congressional Budget Office
Figure 22.2.

In short, there will be more elderly people, and while there will inevitably be some changes in Social Security and Medicare, costs for these programs are going to rise substantially. At the same time, the nation has a variety of serious unmet needs—44 million people without health insurance, environmental problems, educational inadequacies, and decaying infrastructure, among other issues. How are we going to address these unmet needs and still meet the needs of a growing elderly population in future decades?

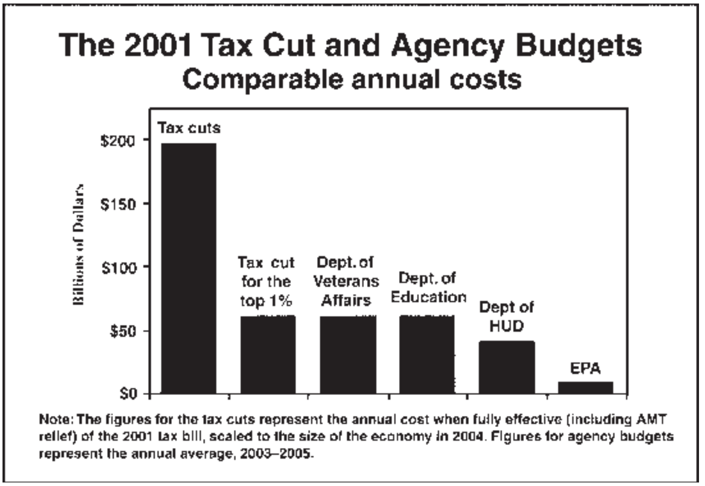
A logical answer would seem to include the basic point that, among other things, we are going to need to raise more revenue because we will have more expenditures with the aging of the population. Instead, fiscal policy is moving in the opposite direction.

THE 2001 TAX CUT

If you listen to popular descriptions of the 2001 tax cut, you often hear that tax cut described by its proponents as "moderate and prudent" in size, and you hear the figure that it cost $1.35 trillion over ten years. But the "official" cost estimate of the tax cut enacted in 2001 is $1.35 trillion only because of a series of slow phase-ins and artificial expiration dates that camouflage part of the law's ultimate cost.

What we want to look at is the cost of the 2001 tax cut *when it is fully in effect*. It has been proposed that the tax cut be made permanent. What would that cost?

As figure 22.3 indicates, when the 2001 tax cut is fully in effect, its annual cost will equal more than three times everything the federal government spends on education at



Source: Center on Budget and Policy Priorities
Figure 22.3.

Annual Cost of Tax Cut
Compared to Agency Budgets

When fully in effect, the annual cost of the tax cut will be:

- Five times as large as the budget of the Department of Housing and Urban Development
- Three times as large as the budget of the Department of Education
- More than three times the Department of Veterans Affairs and Department of Transportation budgets
- Twenty-four times larger than the EPA budget

Source: Center on Budget and Policy Priorities
Figure 22.4.

the elementary, secondary, and higher education levels combined, or five times everything the federal government spends on housing and urban development, or twenty-four times the entire Environment Protection Agency budget. If you look at the second bar in figure 22.3, you also see that when the tax cut is fully in effect the cost of just the portion of the tax cut going to the top 1 percent of the population will be as large as what the federal government spends on education at all levels.

So this is not a small tax cut; it is a very large one. Figures 22.4 and 22.5 can help provide some perspectives.

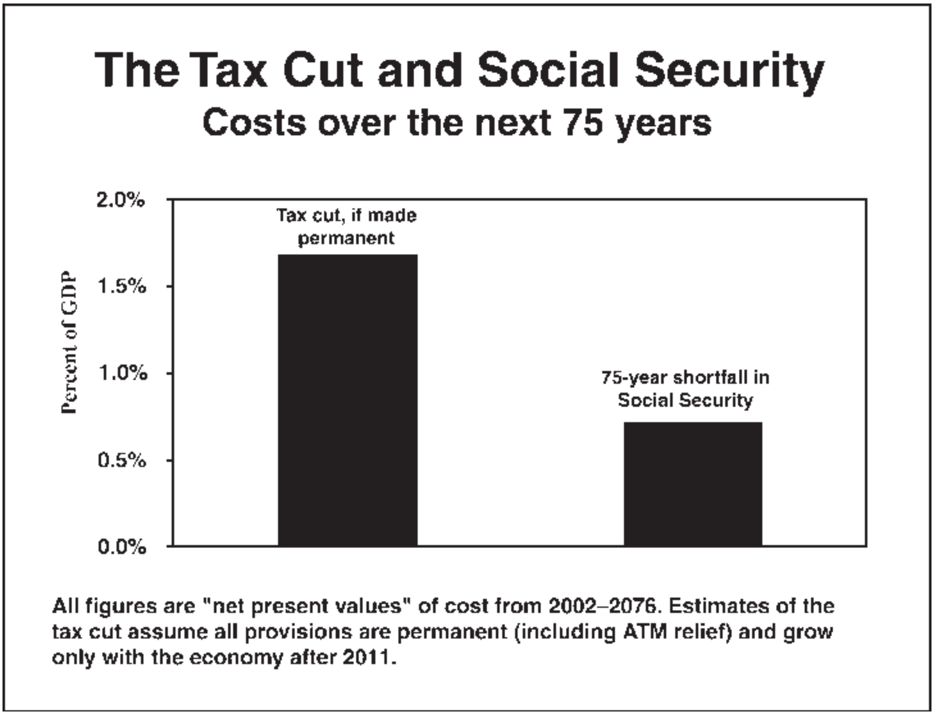
Here is another way to get one's mind around the size of the 2001 tax cut. Within the Washington Beltway, some of the same people who describe the 2001

Annual Cost of Tax Cuts for the
Top 1 Percent Compared to Agency Budgets

When fully in effect, the annual cost of the tax cut for the top 1 percent of filers will be:

- Twice the budget of the Department of Housing and Urban Development
- Larger than the department of Veterans Affairs and Department of Transportation budget
- As large as the Department of Education budget
- Nearly nine times as large as the EPA budget

Source: Center on Budget and Policy Priorities
Figure 22.5.



Source: Center on Budget and Policy Priorities
Figure 22.6.

tax cut as "moderate and prudent" tell us that we have a massive shortfall ahead of us in Social Security.

The Social Security shortfall is typically measured over a seventy-five-year period. By contrast, the cost of the tax cut is usually given over a ten-year period. So let us compare apples to apples. Take the cost of the tax cut and ask how its cost over seventy-five years, if it is made permanent, compares with the Social Security shortfall over the same seventy-five year period. The cost of the 2001 tax cut over the next seventy-five years is more than twice the seventy-five-year Social Security shortfall, as figure 22.6 illustrates.

POLICY RESPONSES TO A WORSENING FISCAL OUTLOOK

Faced with these developments, what might policymakers do? Consider a historical analogy. Twenty years apart, two conservative Republican present or former governors ran for president with the centerpiece of their platforms being a large tax cut: Ronald Reagan in 1980 and George W. Bush in 2000. Both won. Both pursued their tax cuts. Both delivered. Their tax cuts were both passed by the middle of their first year in office.

For other reasons, by their second year in office in both cases, the nation was in a recession, and a combination of factors, including the tax cuts, had led to a dramatically changed fiscal situation, with large deficits looming for years.

We sometimes forget that Bob Dole and Howard Baker, in their leadership roles in a Republican Senate, responded in 1982 by crafting the Tax Equity and Fiscal Responsibility Act of 1982, which Ronald Reagan signed and which had the effect of canceling out the equivalent of about 30 percent of the tax cut Reagan had secured the previous year.[1]

We sometimes also forget that, in Ronald Reagan's final seven years in office, he did not pursue large additional tax cuts that were not paid for. His big tax-reform initiative in the mid-1980s included large reductions in income tax rates, especially in the higher rates. But he proposed those rate reductions as part of a tax-overhaul proposal that closed enough tax breaks so that the Tax Reform Act of 1986 was revenue neutral. It did not shrink the federal government's revenue base.

Now fast-forward twenty years. In 2000, George W. Bush also campaigned on a big tax cut. He was elected and got his tax cut enacted. In fairly short order, for a variety of reasons, the fiscal picture worsened dramatically. Was his prescription like the one that Republican leaders pursued twenty years ago? It was not. In fact, it was the reverse. Essentially, it was to pass more tax cuts without paying for them.

New tax-cut legislation was signed into law in May 2003 with an official cost of $350 billion. Many newspapers have reported that the ultimate cost of the legislation is likely to be at least $660 billion. Figure 22.7 shows where that figure

Cost of Bill Through 2013 If Tax Cuts Are Extended

(In billions of dollars)

Dividend and capital gains [expires 2008]	$325
Top bracket rate reductions	74
Child tax credit [expires 2004]	90
10% bracket [expires 2004]	45
Tax breaks for married couples [expires 2004]	55
Expand Sec 179 business expensing [expires 2005]	35
Increase AMT exemption [expires 2004]	18
State fiscal relief	20
TOTAL	$662

Source: Center on Budget and Policy Priorities

Figure 22.7.

comes from. All of the provisions except one in the 2003 tax-cut law had artificial expiration dates (many being December 31, 2004). What appeared to be envisioned is that anyone who ran for election in 2004 saying that he or she did not want to extend these tax cuts beyond December 2004 would be met with attack ads labeling him or her as a tax increaser. If, as many expect, all of these tax cuts are extended, the cost of the new tax-cut law would turn out to be $660 billion over the ten-year period.

THE IMPLICATIONS OF THE TAX CUTS

What are these tax cuts likely to mean for the role of the federal government in American life? Three numbers help us answer this question.

The first number is 1950. Federal revenue in fiscal year 2004 will be at its lowest level, measured as a share of the economy, since 1950. Federal *income*-tax revenue will be at its lowest level as a share of the economy since 1943, as seen in figure 22.8. What did the federal government do and not do in 1950? There was no Medicare or Medicaid. There was not much federal aid to education and nothing like food stamps or Head Start. We had a very different federal government, particularly for people who are less fortunate. We did have Social Security and unemployment insurance. But many of the basic things the federal government does today were not done then. Another example is that the federal government did much less environmental protection then. This was before the Clean Water Act and the Clean Air Act.

Here is a second striking number. When the Bush administration began, extending all provisions of the tax code that were scheduled to expire and that would come up for renewal carried a cost of $22 billion in the tenth year. Today, following enactment of the 2001 and 2003 tax-cut laws, we have so many tax cuts with artificial expiration dates that the cost in the tenth year of extending all tax cuts that are officially scheduled to expire is $430 billion (see fig. 22.9).

Federal Revenues in 2004 As a Share of the Economy—A Historical Comparison

All Federal Revenues	**Lowest since 1950**
Federal Income Tax Revenues	**Lowest since 1942**

Source: Center on Budget and Policy Priorities
Figure 22.8.

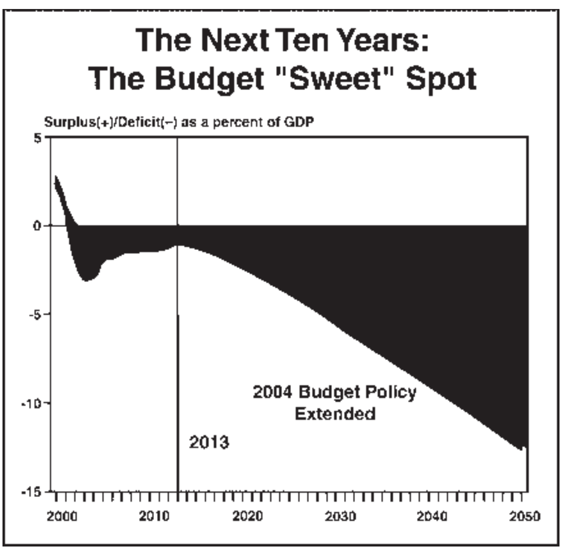
Cost in Tenth Year of Extending All Expiring Tax Provisions

Before President Bush
As of January 2001, the cost in 2011 of extending all expiring provisions was $22 billion
Today
The cost in 2014 of extending all expiring provisions is $430 billion

Source: Bill Gale and Peter Orszag, The Brookings Institution: "Sunsets in the Tax Code," May 26, 2003.
Figure 22.9.

The Medicare bill passed in 2003 costs at least $400 billion over its first decade and more than $1 trillion over the next decade. By 2014, simply extending all of the expiring tax cuts will cost $430 billion in a single year.

Figure 22.10 is a reproduction from a technical volume that was part of the Bush administration's fiscal year 2004 budget. (The title for fig. 22.10 differs from the more technical title that appeared in the budget, but the material in the graph is the same.) This graph was both revealing and disturbing. It shows that under "2004 Budget Policy Extended"—that is, under the policies proposed in President Bush's fiscal year 2004 budget, extended into the future—the expectation was for deficits every year for the next fifty years, with the deficits eventually exceeding 10 percent of gross domestic product.



Source: Federal Fiscal Year 2004 Budget
Figure 22.10.

The budget accompanied this graph with a discussion about how we need to get *spending* under control to avert serious long-term fiscal problems, as though losses of tax revenue had nothing to do with this problem.

Here we begin to see the connection between the tax cuts and a larger agenda. Grover Norquist, head of the Americans for Tax Reform and a leading conservative strategist, has articulated a goal of cutting the size of the domestic part of the federal government in half over a period of a few decades. As Norquist's vision may indicate, the tax cuts and the goal of shrinking the federal government are being pursued as complementary long-term strategies. Those pursuing these strategies are patient. They are willing to wait until 2010 to have the estate tax repealed. They are willing to take a long time to squeeze down the federal government, with the squeezing occurring gradually and incrementally but eventually reaching quite large proportions.

The mistake of Newt Gingrich in 1995—of overreaching and moving too fast—is not being repeated here. I believe there is a clear understanding on the part of proponents of this agenda that, if one were to publish in the budget today the kind of budget cuts that the recent federal tax cuts ultimately will entail, the tax cuts would have a considerably harder time being passed. So the deep budget cuts are *not* being published in the budget today alongside the tax cuts.

THE BLOCK GRANT STRATEGY

But such budget cuts are coming. Indeed, we can see some initial signs of them in the Bush administration's budget proposals. When one looks across the Bush budget, one of its noteworthy features is the degree to which it proposes converting various social programs into block grants. People often debate block grants by discussing how much flexibility states agencies have—and should have—in operating various federally funded programs. But I believe the principal reason for the inclusion of these block-grant proposals in the budget is a fiscal one.

Funding for block-grant programs tends to erode over time. For example, the welfare-reform block grant—which provides funds for basic cash assistance to poor families with children as well as for welfare-to-work programs and child care for working-poor families—is on track to decline 22 percent in purchasing power from 1998 (the block grant's first full year) to 2009. Similarly, funding for the State Children's Health Insurance Program, which insures low-income children, is nearly 20 percent lower in 2005 than when the block grant was established in 1997. And funding for the Social Services Block Grant, which funds an array of social services for low-income, vulnerable children, seniors, and people with disabilities, has lost 84 percent of its purchasing power since the block grant's inception in 1973.

The Bush administration plan would convert about two-thirds of the Medicaid program into a block grant. Today, the federal government pays 50 to 80 percent of a state's Medicaid costs, depending on the state. (The national average is 57 percent.)

If people lose their jobs and their employer-based health care coverage in an economic downturn and apply for Medicaid, and Medicaid costs consequently go up, the federal government pays its share. If an epidemic comes along and health care costs increase, the federal government pays its share. If there is a breakthrough in medical technology that saves lives, improves health, but costs a lot of money (like a new set of AIDS treatments that are extremely expensive), the federal government would pay its share for people who are eligible for Medicaid.

Under a block grant, however, all this ends. The federal government sets in advance a fixed dollar amount that each state gets in a given year. If health care costs are more than that, the states have to foot 100 percent of the difference. In return, states are freed from various federal rules and standards. But that primarily means states could cut the Medicaid program more heavily to deal with the loss of federal funding.

Moreover, Medicaid is now an entitlement. Any eligible family or individual who goes to the Medicaid office and applies must be given coverage. Under a block grant, a state can tell an eligible family, "We're sorry, but we have run out of money for the year. Get on the waiting list. Come back next year."

This is especially significant because, with the coming retirement of the baby-boom generation, there will be more low-income elderly people and individuals with disabilities. (The older the population, the larger the percentage of the population that consists of people with disabilities.) As a result, every budget projection shows large increases in Medicaid costs in future years and decades. It is unclear how states are going to meet these mounting costs unless they get more federal help in covering them.

In my view, the federal government needs to take on a larger share, not a smaller share, of the cost of insuring a group we call "the dual eligibles." These are low-income elderly people and persons with disabilities who are eligible for both Medicare and Medicaid. Instead, the proposed Medicaid block grant moves in the other direction. Over time, the federal government would likely bear less of the cost, and states would be faced with choices between covering escalating Medicaid costs (which many states likely would have difficulty affording) and cutting their Medicaid programs by scaling back health insurance for low-income people.

STATE BUDGET CRISES

Many states continue to face substantial budget deficits. Numerous states have responded by instituting deep budget cuts (for example in child care and aid to local governments and in the form of tuition increases). In some states, there have been sizable cuts in health care. Some states also have raised taxes.

Why are states facing such large budget problems? A standard conservative cable-TV sound bite is, "They've spent irresponsibly and gotten themselves into trouble." In fact, state spending grew slightly *more slowly* in the 1990s, on average, than in previous decades. The major reason for the current state budget crises is that state revenues have eroded significantly.

State revenues have declined in substantial part as a result of the economy and the bursting of the stock-market bubble. In addition, in the late 1990s a number of states made the same mistake the federal government has made in the last two years: they cut taxes too much. There also are serious structural problems in many state tax systems. Let me look briefly at these structural problems, particularly with an eye on corporate taxes.

Normally, when we hear about corporate tax avoidance, we think of it at the federal level. We hear stories about corporations relocating overseas or having a mailing address in the Grand Cayman Islands to escape federal taxation. We do not often recognize that the same thing goes on at the state level. For example, corporations can set up shells in Delaware. They effectively transfer their profits to the shells so that they don't show profits in the states where they are doing business. Delaware doesn't tax these transferred profits. As a result, corporations can avoid significant amounts of state corporate income taxes. Figure 22.11 shows that, fifteen years ago, corporations were paying 6 to 7 percent of their profits, in the aggregate, in state taxes. They are now paying about 5 percent.

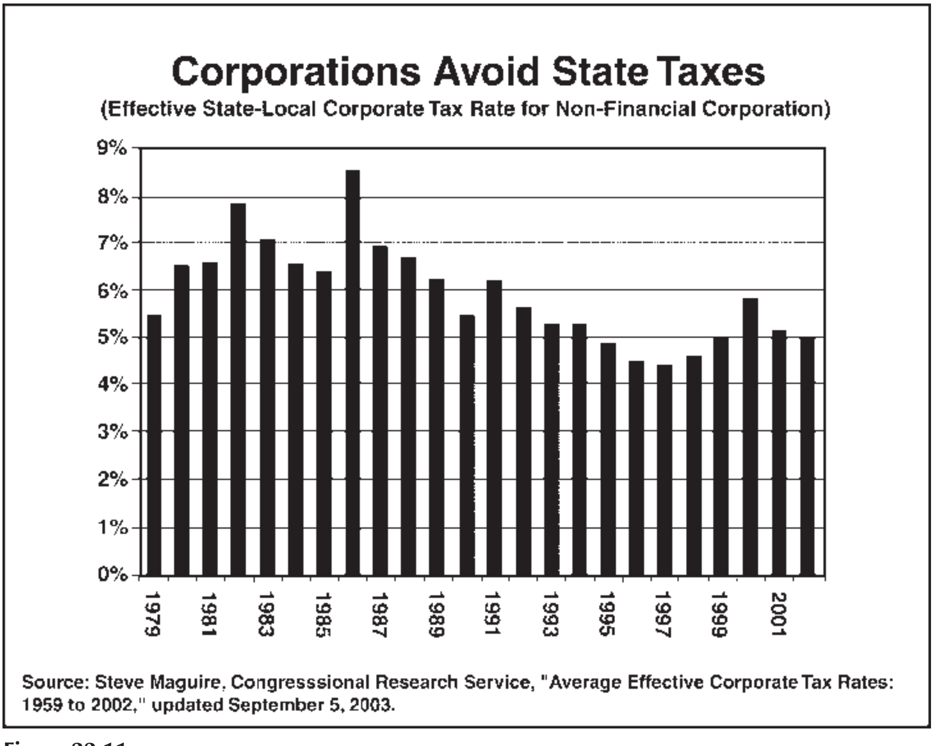


Figure 22.11.

Figure 22.12 is also of interest. It suggests that corporate tax avoidance has been growing more rapidly at the state level than at the federal level. This chart covers the economic boom years of 1995 to 2000. During this boom period, the amount of federal income taxes that corporations paid rose at an average rate of about 6 percent per year, reflecting the strong growth of corporate profits. But during this same period, the amount of *state* income taxes that corporations paid grew at an average rate of only 3 percent per year, or only half as much. The fact that state corporate tax revenues grew only half as much as federal corporate tax revenues during this period suggests that corporate tax avoidance may have been growing more rapidly at the state level than at the federal level.

Another problem is that state tax codes are regressive in many states. In recent decades, income growth has been greatest at the top of the income scale. If a state tax system is regressive and has a lower effective tax rate for high-income people than for others, the state does not capture in revenue a sufficient share of the growth in the economy when income growth is concentrated at the top of the scale.

In short, there are serious structural problems with state finances. In the past few years, we have witnessed cuts in basic services at the state level of a magnitude that few of us would previously have thought possible.

These developments in the states also are related to the change in policy direction by the federal government. The federal government, which can run deficits in downturns, should be doing much more now to ease the state budget crises. The federal government could have instituted a sizable countercyclical revenue-sharing

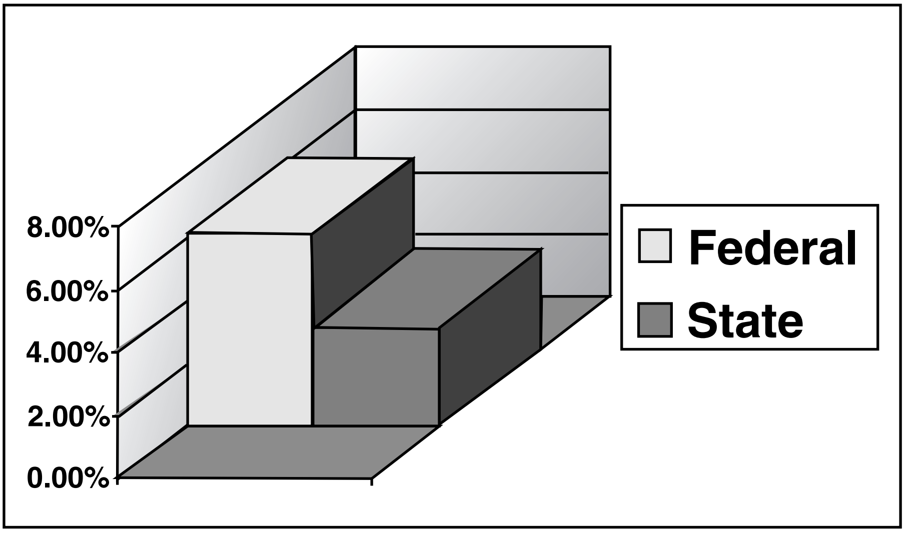


Figure 22.12.

program. It has not. It took eighteen months of effort just to secure $20 billion in fiscal relief to states in the tax-cut legislation enacted in May 2003, when what was needed was about double that amount. The long-term state budget outlook is even more disturbing. Two thirds of Medicaid expenditures today are for the elderly and disabled. That fraction will increase as the population ages and will cause severe fiscal distress for states, badly squeezing the funding available for education and other basic services that states deliver, including aid to local governments. A remedy is apparent and available—to have the federal government take on a larger role, in partnership with the states, and to bear a larger percentage of the health care costs of low-income seniors and people with disabilities. Whether this will actually occur is another story.

WHAT KIND OF SOCIETY?

As I noted earlier, federal revenue collections are now at their lowest level, as a share of gross domestic product, since 1950. Federal revenues will rise somewhat as the economy recovers but will remain low by historical standards. If the 2001 and 2003 tax cuts are extended and relief from the Alternative Minimum Tax is extended, as most observers expect, average federal revenues over the coming decade will be lower as a share of gross domestic product than average federal revenues were in the 1960s, 1970s, 1980s, or 1990s. Yet we are only a few years away from when the first boomers begin to collect Social Security and enroll in Medicare.

We must confront a fundamental question about what kind of society we want, and, in particular, what the role of the federal government should be in helping to bring that society about. We now are heading down a track where we may eventually be confronted with an unpalatable choice between running persistent deficits that eventually become so large they damage the economy and radically scaling back the domestic role of the federal government. If radical budgetary contraction occurs, it is likely to be not the "weak claims" that are hit hardest but the "weak clients," to use David Stockman's apt terminology.

There is, however, one bright note. There does not seem to be an overpowering national constituency to shrink the role of the federal government radically or to pass all of these tax cuts or make them all permanent. We sorely need public debate on these overarching fiscal policy issues—that is, on national budget priorities. If we simply allow the federal revenue base to continue shrinking, there eventually will be adverse effects on many public-policy issues that we care deeply about. We also will need to make changes in Social Security and Medicare so that the large growth in these programs in the decades ahead does not result in large, persistent deficits or leave insufficient room in the budget for other important priorities.

Now, I would caution that a plan that proposes to take *most or all* of the dollars slated to go for tax cuts and to use these funds for social-program improvements instead is not likely to succeed with the public. And it should not. That would likely still leave us with crippling long-term deficits. The recent tax cuts are sufficiently large, however, that it should be possible to design a broad program that scales them back substantially and uses a significant portion—but not most or all—of the saved revenues to address critical unmet priorities.

Restoration of fiscal responsibility is an essential ingredient of such a program. A healthy portion of the savings from more responsible fiscal policies will need to be used to restore the nation's long-term fiscal health so that we do not pass excessive burdens on to future generations.

In early 2001, the federal government said it would improve education, provide a drug benefit, improve government programs and services in other ways, and have plenty left over to fund the large tax cut and still pay down the debt. As Jeff Faux has articulated in chapter 20, Americans increasingly understand that there is *not* enough money to do all of these things. We have to make choices among them.

But organizations and individuals with views consistent with those expressed in this volume have not done a good enough job in making the choices and tradeoffs clear to the public. More needs to be done, for example, to educate the public about linkages between recent federal policies and the depth of the budget crises in the states. We could be providing more temporary fiscal relief to states, but the money is going instead to extremely large tax cuts for the nation's wealthiest individuals, despite the fact that large tax cuts for the well-to-do are likely to be less effective in stimulating the current weak economy than increased fiscal relief to the states would be.

When a library or a public-health facility is closing in a community due to state or local budget cuts, there ought to be discussion of whether the federal government could have eased such problems if it were pursuing different fiscal priorities and not conferring such large tax cuts on the very affluent. We need more efforts to "personalize" the impact on the daily lives of ordinary Americans of the type of policy choices discussed in this chapter and to bring to life the federal disinvestment that our citizens face if the nation does not change course.

NOTE

1. The revenue raised by the 1982 Act equaled about 30 percent of the revenue lost under the 1981 law, not counting the revenue lost as a result of provisions of the 1981 law that automatically adjusted (or "indexed") various provisions of the tax code for inflation. The indexing provisions are not counted here because prior to the enactment of the 1981 law, Congress made adjustments in the tax code every few years that had the rough effect of adjusting various parts of the code for inflation.

BIBLIOGRAPHY

Center on Budget and Policy Priorities, Center for Economic Development, and the Concord Coalition, "The Developing Crisis—Deficits Matter," and "Mid-Term and Long-Term Deficit Projections," Washington, D.C., September 29, 2003.

Peter A. Diamond and Peter R. Orszag, *Saving Social Security: A Balanced Approach*, The Brookings Institution, 2004.

Joel Friedman and Robert Greenstein, "The President's Proposal to Make Tax Cuts Permanent," Center on Budget and Policy Priorities, Washington, D.C., January 20, 2004.

William G. Gale and Samara R. Potter, "An Economic Evaluation of the Economic Growth and Tax Relief and Reconciliation Act of 2001," *National Tax Journal*, March 2002.

Robert Greenstein and Richard Kogan, "Analysis of the President's Budget," Center on Budget and Policy Priorities, Washington, D.C., February 5, 2004.

Robert Greenstein and Isaac Shapiro, "The New, Definitive CBO Data on Income and Tax Trends," Center on Budget and Policy Priorities, September 23, 2003.

John Holahan and Alan Weil, "Block Grants are the Wrong Prescription for Medicaid," The Urban Institute, May 27, 2003.

International Monetary Fund, "U.S. Fiscal Policies and Priorities for Long-Run Sustainability," January 7, 2004.

Iris Lav, "Federal Policies Contribute to the Severity of the State Fiscal Crisis," Center on Budget and Policy Priorities, Washington, D.C., December 3, 2003.

Cindy Mann, Melanie Nathanson, and Edwin Park, "Administration's Medicaid Proposal Would Shift Fiscal Risks to States," Center on Budget and Policy Priorities, April 22, 2003.

Peter Orszag, Richard Kogan, and Robert Greenstein, "The Administration's Tax Cuts and the Long-Term Budget Outlook," Center on Budget and Policy Priorities, March 19, 2003.

Alice M. Rivlin and Isabel Sawhill, *Restoring Fiscal Sanity: How to Balance the Budget*, The Brookings Institution, 2004.

Robert E. Rubin, Peter R. Orszag, and Allen Sinai, "Sustained Budget Deficits: Longer-Run U.S. Economic Performance and the Risk of Financial and Fiscal Disarray," presented at the AEA-NAEFA Joint Session, January 4, 2004. http://www.cbpp.org/1-13-04confpaper.pdf.