8. *Budget* **Reduction**

The most critical challenge facing the new Congress is to enact a credible budget plan that will eliminate federal deficit spending over the next five years. We strongly urge members of Congress to pass the balanced-budget constitutional amendment, but even if they do not, the federal budget can and should be balanced without a single penny of new taxes by the year 2000. Indeed, this chapter demonstrates how the budget can be balanced even if taxes are *reduced* by $400 billion over five years. The $400 billion tax reduction we propose is more than twice as large as the Republican tax proposal and four times as large as the president's. (Details of Cato's proposed tax reductions are outlined in a separate chapter.)

Over the next five years the federal government will spend $8.6 trillion. The Cato fiscal plan balances the budget with a generous tax cut by reducing outlays by $1.1 trillion. The significant features of the Cato budget plan are

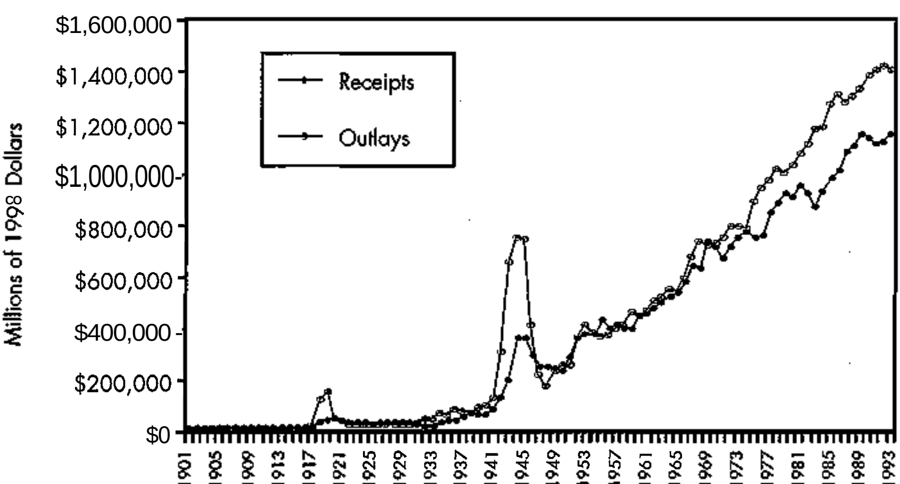
- **a 5 percent across-the-board rescission in all federal programs except Social Security for the second half of 1995 through the end of fiscal year 1996;**
- **the termination of more than 100 federal programs and agencies;**
- **a reduction in the defense budget to $204 billion by the year 2000 to reflect post-Cold War realities;**
- **the elimination of all bilateral and multilateral foreign aid spending;**
- **long-term cost reduction reforms in Social Security, such as significantly raising the retirement age, with the eventual goal of privatizing the program;**
- **a series of health care reforms, including cost sharing and medical savings accounts, to reduce the inflation in Medicare and Medicaid;**

- **a plan to end the federal government's failed role in welfare by turning all public assistance programs over to the states and private charities;**
- **the privatization of at least $100 billion worth of nonenvironmentally sensitive federal lands, oil reserves, and other federal assets, with the proceeds used to lower the national debt and interest payments.**

The Washington Spending Juggernaut

Government was never supposed to even approach the size that it is today. Most of the activities of government today—from dairy subsidies to urban transit grants to middle-income transfer payments—would have been inconceivable throughout most of American history. That point is underscored by Figure 8.1, which shows the expansion of the federal budget and taxes in the 20th century. Real federal outlays climbed from $8.3 billion in 1901 to $255 billion in 1950. Outlays will be $1,510 billion in 1995. Government spending is growing so much more rapidly than inflation that, if federal outlays had been restrained to the consumer price index over just the past 20 years, America would now have a $250 billion budget surplus, rather than a $200 billion deficit.

Figure 8.1
Real Federal Taxes and Spending, 1901–93



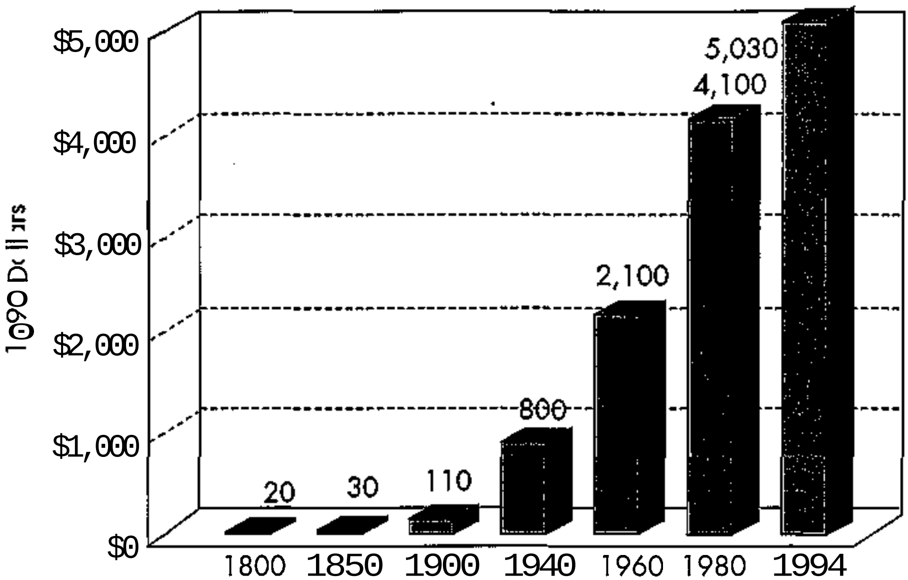
SOURCE: *Budget of the U.S. Government—Historical Tables,* FY 1995, Table 1.1, pp. 13–14; *Economic Report of the President,* February 1994, Table B-59, p. 335; and Bureau of Labor Statistics.

Of course, the nation is much larger today than in earlier periods, so one would expect government also to be bigger—though not proportionately so. Figure 8.2 shows the per capita real level of federal spending over time. Even when adjusting for the growth in population size (and inflation), government expenditures (in 1990 dollars) have mushroomed: the federal government spent $110 per person in 1900, $2,100 in 1960, and $5,030 in 1994.

Even as a share of total economic output government has reached an unprecedented size. Figure 8.3 shows that federal spending consumed less than 5 percent of total output in 1900 and 18 percent of total output in 1960; it now consumes about 23 percent of national output. With state and local spending added, government consumes roughly 35 percent of gross domestic product.

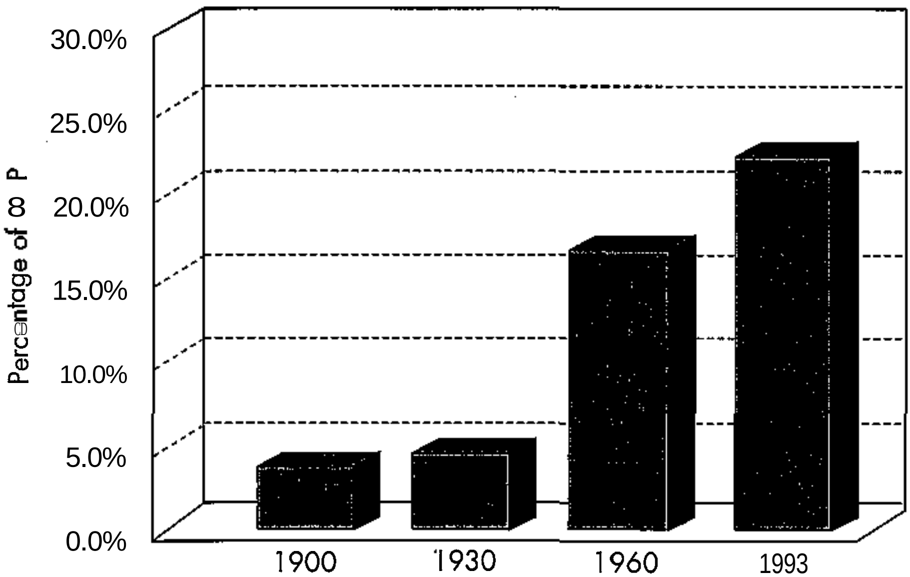
Contrary to the rhetoric from Washington about tight budget caps and fiscal restraint, federal spending has accelerated rapidly in the Bush-Clinton era. The federal government is one-third larger today in real terms than when Ronald Reagan left title White House.

Figure 8.2
Real per Capita Federal Outlays, 1800–1994



SOURCE Tax Foundation, *Facts and Figures on Government Finance,* various years; and *Budget of the United States, Historical Tables,* 1994.

Figure 8.3
Federal Outlays as a Share of GDP, 1900-93



SOURCE: Tax Foundation, *Facts and Figures on Government Finance*, various years; and *Budget of the United States, Historical Tables*, 1994.

Clearly, there is room for substantial budget reductions over the next five years without even touching the most politically sensitive programs.

The Clinton Budget: Myths and Reality

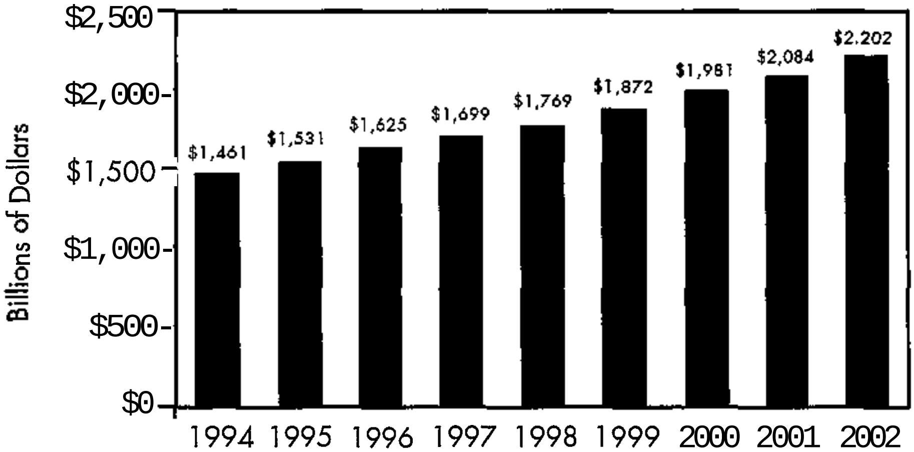
Almost everything that is written and said about the federal budget these days is false or misleading. Most notably, federal spending has not been restrained; the budget deficit is not on a downward path, and recent budget agreements have not worked. An accurate interpretation of recent budget developments leads to the following conclusions:

1. The long-term deficit outlook is very discouraging. The Congressional Budget Office forecasts a federal deficit of $284 billion in FY2000, $322 billion in FY2002, and $441 billion in FY2005. The cyclical fall in the deficit this year does not lessen the magnitude of the longer term emergency.
2. The 1990 and 1993 budget deals were failures. The deficit has been higher than the Congressional Budget Office forecasted when

Reagan left office for every single year from 1990 to 1995—and those forecasts assumed no new taxes. Almost all of the deficit reduction since 1992 is attributable to three factors: (a) the one-time sale of assets and properties acquired by the federal government during the savings-and-loan crisis of the late 1980s (that alone has accounted for about $75 billion in deficit reduction in recent years), (b) reductions in the military budget resulting from the end of the Cold War, and (c) the cyclical economic recovery.

3. Domestic spending has vastly expanded during the Bush-Clinton era. Real domestic spending has grown by some $200 billion, or nearly 30 percent, since Ronald Reagan left office. If Presidents Bush and Clinton had succeeded in simply holding domestic spending to the rate of inflation over the past seven years, the budget would be in surplus this year.
4. Unless there is a major correction, federal spending will continue to climb rapidly through the end of the century. The federal budget is expected to expand by $450 billion through 2000 and $670 billion through 2002, as shown in Figure 8.4. From 1996 through 2002, federal outlays will approach $13.5 trillion. That is a massive spending buildup at a time of supposed budget austerity.
5. Tax increases to balance the budget are counterproductive. Federal revenue growth over the past five years, even after two large tax increases in 1990 and again in 1993, has been no greater than was expected in 1989 without tax hikes. In fact, federal revenues have been climbing at a slower pace in the 1990s with two tax increases than in the 1980s following Reagan's income tax cut. Tax increases also tend to have no impact on the deficit because, as studies indicate, higher taxes encourage higher spending.
6. Economic growth is a necessary condition for deficit reduction. Pro-growth tax policies such as marginal rate reductions and substantial regulatory rollback measures, would contribute to deficit reduction. Conversely, anti-growth policies, such as higher marginal tax rates, inflationary monetary policy, and more stringent business and labor regulation, would slow growth and raise the deficit.
7. Both the administration and the Republicans in Congress are wrong to call for increased military spending. The Cold War really is over. We won. The Soviet Union is in dissolution. The United States now faces no significant military threat anywhere in the world. The $270 billion that the Pentagon will spend this year is

Figure 8.4
Federal Outlays, 1994 and Projections through 2002



SOURCE: Congressional Budget Office, *The Economic and Budget Outlook: Fiscal Year 1996-2000, A Preliminary Report,* January 5, 1995, Table 4.

more in real dollars than John F. Kennedy spent on the Defense Department at the height of the Cold War. It is five times more than is spent by any other nation. As an integral part of an overall deficit reduction strategy, defense spending should be reduced to roughly $204 billion by the year 2000.

8. Federal spending on the elderly is growing at a financially unsustainable pace. For obvious political reasons, Congress and the president would like to ignore the two largest entitlement programs in the federal budget: Social Security and Medicare. That makes long-term deficit reduction a virtual impossibility. Federal entitlement spending is doubling every eight years. That trend is unsustainable and, worse, it is expected to accelerate in the next century as a result of the aging of the baby boomers. Reforms must be set in motion today. The Kerrey Commission draft report made several sensible recommendations—such as raising the retirement age, indexing benefits, means testing for Medicare, and allowing workers to place some of their Social Security tax payments in individual retirement accounts.

9. A significant part of federal spending generates benefits for high-income people and businesses. Programs that benefit the wealthy and politically well connected corporations should be special targets for termination. At least $80 billion of spending could be eliminated annually through such an approach.
10. Hundreds of domestic programs are no longer necessary, and many never were. They should be abolished. Nearly $100 billion a year is spent on domestic programs that have been identified as candidates for termination by such independent agencies as the Congressional Budget Office, the General Accounting Office, the Grace Commission, and even President Clinton himself in his first two budgets. They survive, not because they serve any national interest, but because of political or parochial considerations.

The Moral Imperative for a Balanced Budget

Congress has not balanced the federal budget in any of the past 25 years. Why should lawmakers now be required to balance the federal budget and keep it in balance?

There are many flawed arguments for a balanced-budget amendment. For example, there is little evidence that deficits per se crowd out domestic investment or lead to higher interest rates. In the 1980s the deficit rose rapidly and nominal interest rates fell rapidly. In the past two years the deficit has fallen and interest rates have skyrocketed. The truth is that federal *spending* crowds out private investment, not federal *borrowing*.

Conservative and liberal arguments against the desirability of requiring a balanced budget are also unconvincing. One flawed argument against balancing the budget offered by many liberal economists is that a balanced-budget requirement would prevent Congress and the president from using fiscal policy as a tool for stabilizing the economy. The evidence over the past 40 years suggests that fiscal policy has been more destabilizing than stabilizing. Even under the Keynesian model, the idea is to run budget deficits during recessions and surpluses during recoveries. Over the past quarter century, Congress has run record deficits in good times and bad.

On the other side of the aisle, conservatives are misguided when they claim that a balanced budget would lead to higher taxes. The flaw in the thinking here is that it ignores the fact that the deficit *is* a tax. Deficits are simply deferred taxes. And it is very unlikely that voters will be willing to pay $200 billion more in taxes each year—or roughly $2,000 per household—to pay for the trillion-and-a-half-dollar federal budget. More likely, they will demand substantial reductions in federal spending. (The left, of course, fully understands that, which is why every spending constituency from the Children's Defense Fund, to the American Association of Retired People, to major defense contractors opposes the balanced-budget amendment.) And if the balanced-budget amendment leads to less spending, then the true tax burden on the American economy will decline, not rise.

There are two reasons why budget deficits should be eliminated and then permanently constrained via a constitutional restraint, one practical and one moral. The practical reason why budget deficits are harmful is that deficit finance is the ultimate form of hidden taxation. Federal borrowing injects a huge pro-spending bias into the budget process by allowing politicians to pass out a dollar of government spending to voters, while only imposing 80 cents of taxes on them. Because the deficit is largely an invisible tax, voters demand more government than they otherwise would. Eliminating federal borrowing means that Congress has to raise a full dollar of taxes today for every dollar of spending it undertakes. That will substantially increase voter hostility to government spending.

The moral argument for requiring a balanced budget is that federal borrowing is taxation without representation. Current deficit spending must be paid for eventually by future generations—that is, by those who have no say in the current political process. Federal deficits are a form of fiscal child abuse. In sum, the budget should be balanced as a matter of policy and as a matter of constitutional requirement, because running deficits is the ultimate form of tax unfairness.

The Path to a Balanced Budget

The tough question remains: How do we achieve a balanced budget by 2000 if taxes aren't going to be raised? A measure of the magnitude of the task is shown in Table 8.1, which shows the January 1995 Congressional Budget Office estimate of the FY95 budget and the forecast of the budget through FY2000. Total outlays in 2000 must be reduced by $284 billion to balance the budget by the end of that year, and by an additional $90 billion assuming tax cuts.

The table also makes clear where the budget cutting must be done; three programs—defense, Social Security, and medical care—account for almost two-thirds of total outlays. A "politics as usual" approach clearly won't do the job. Table 8.2 shows the Cato budget alternative. Rather than federal spending climbing from $1.5 trillion to $2 trillion over the

Table 8.1
The Federal Budget Outlook (billions of dollars)

	Fiscal Year					
	95	96	97	98	99	2000
Outlays						
Programs						
Defense	270	270	278	285	295	304
Social Security	334	352	371	390	411	433
Medical	266	296	328	361	398	435
International	21	22	22	22	23	24
Other	498	507	511	516	536	562
Total	1389	1447	1510	1574	1663	1758
Deposit insurance	-16	-9	-5	-5	-3	-3
Offsetting receipts	-77	-73	-76	-79	-82	-84
Net interest	235	260	270	279	294	310
Total outlays	1531	1625	1699	1769	1872	1981
Revenues	1355	1418	1475	1546	1618	1697
Deficit	176	207	224	222	253	284

SOURCE Congressional Budget Office, *The Economic and Budget Outlook*, January 1995.

Table 8.2
The Cato Budget Alternative (billions of dollars)

	Fiscal Year					
	95	96	97	98	99	2000
Outlays						
Programs						
Defense	265	256	240	225	215	204
Social Security	334	350	367	382	398	409
Medical	262	280	302	325	349	372
International	20	18	16	13	11	9
Other	489	472	472	472	472	472
Total	1370	1376	1397	1417	1445	1466
Deposit insurance	-16	-9	-5	-5	-3	-3
Offsetting receipts	-77	-73	-76	-79	-82	-84
Net interest	234	250	245	239	237	226
Total outlays	1511	1544	1562	1571	1595	1605
Revenues	1340	1353	1400	1466	1533	1607
Deficit	171	191	162	105	62	-2

SOURCE: Congressional Budget Office, *The Economic and Budget Outlook*, January 1995.

next five years, spending would grow from $1.5 trillion to $1.6 trillion. Table 8.3 specifies where the budget savings to achieve a balanced budget would come from. Finally, Table 8.4 shows that the budget blueprint presented in this chapter contains enough savings to balance the budget by 2000 even with a $400 billion five-year tax cut.

A Sequester and Freeze

Domestic expenditures have been growing by 6 percent above inflation since 1989. That contrasts with the practices of businesses and households that have been substantially tightening their belts in response to the stagnant economy. The federal government should not be immune from the downsizing that has taken place in the private sector.

The centerpiece of any credible plan to reduce the deficit is to *pull forward* the hard choices. The more common practice of extending budget caps continually into the future, the Bush-Clinton approach for the past six years, defers tough decisions that never seem to be made. Congress must showcase its commitment to long-term fiscal restraint by cutting

Table 8.3
Cato's Proposed Budget Savings (billions of dollars)

	Fiscal Year					
	95	96	97	98	99	2000
Defense	5	14	38	60	80	100
Social Security	0	2	4	8	13	24
Medical	4	16	26	36	49	63
International	1	4	6	9	12	15
Other domestic	9	35	39	44	64	90
Net interest	1	10	25	40	57	84
Total	20	81	138	197	275	376

Assumptions for savings:

Defense spending: 4 percent sequester for second half of 1995; an additional 3 percent sequester for 1996; then reduced to $204 billion by 2000, 2.25 percent of GDP.

Social Security: Retirement age raised and benefit formula indexed.

Medical: 4 percent sequester for second half of 1995 then cost control measures outlined in this chapter reduce inflation rate from 10 to 7.5 percent.

Other domestic: 5 percent sequester for second half of FY95; an additional 3 percent sequester in FY96; then spending freeze at 1996 level through 2000. Spending cuts to comply with cap as detailed in text.

International affairs: Elimination of all foreign aid programs; an overall 65 percent reduction in international affairs appropriations.

Net Interest: Interest rate savings from deficit reduction assuming a 6 percent interest rate on federal treasury notes and from sale of $100 billion of federal assets.

Table 8.4
Path to Balanced Budget under Ccrto Plan with $400 Billion Tax Cut (billions of dollars)

	Fiscal Year					
	95	96	97	98	99	2000
Baseline deficit	176	207	224	222	253	284
Budget savings	20	81	138	197	275	376
Tax cut	-15	-65	-75	-80	-85	-90
New deficit	171	191	161	105	63	-2

spending immediately—that is, cuts from the already approved 1995 budget. That can be done by taking the following steps:

1. Congress should approve a 5 percent across-the-board spending sequester starting in the second half of FY95 through the end of FY96. (That would cut 1995 spending for the entire year by 2.0 percent and 1996 spending by an additional 3 percent for a total budget reduction of 5.0 percent.) The sequester should cover *all* programs in the domestic and defense budgets, except Social Security. The benefit levels of other formula-payment programs would have to be reduced by 5 percent. (Sen. Phil Gramm and Rep. Dick Armey have put forward a blueprint for imposing a sequester on entitlement programs.) For discretionary programs, the sequester would be carried out in much the same manner as the 1986 Gramm-Rudman sequester. That would *permanently* lower the baseline spending levels for every program other than Social Security. The savings would multiply in every future year, thus setting a solid foundation for balancing the budget by 2000. A principal virtue of the sequester option is that it would signal to the public, the White House, and financial markets that the new Congress is serious about reducing deficit spending over the next several years.

   The sequester would save $20 billion in 1995 and roughly $65 billion in 1996.
2. A freeze on all domestic outlays other than Social Security should be established at the FY96 spending level over the period FY97 through FY2000.
3. Congress should retain the discretion to allocate funds among programs tinder the cap. For the overall ceiling to be enforced, any excess spending in one year would require a reduction of equal

magnitude the next year. That would require programs to compete with each other for funding. Congress would be forced to curtail the growth of medical care and other formula-payment programs because, if those programs were allowed to grow unimpeded, they would crowd out other domestic spending. During the Gramm-Rudman era of 1986-89, when a similar cap on expenditures existed, funding for formula-payment programs increased at only 1 percent above inflation.

National Defense

America can maintain an effective peacetime defense capability—the largest military budget in the world and by far the most modern and sophisticated arsenal—at a price tag far below current levels.

The Republican contract calls for "restoration of essential parts of our national security funding to strengthen our national defense." Congress is right to be concerned about the national security risks associated with President Clinton's adventurous deployment of America's military around the globe. In just the past year, the White House has sent U.S. troops to Haiti, Somalia, and the Persian Gulf. That is in addition to the 100,000 American troops still in Europe and the 30,000 U.S. soldiers in Korea.

Many military experts inside and outside the Pentagon are correctly arguing that our military is spread too thin with current spending levels. That *is* a threat to American national security. The problem is not that the Pentagon budget is too small, it is that a reduction in missions is necessary and desirable.

There are several reasons why Congress should reassess its misguided call for increased military spending. First, the United States faces no substantial military dangers anywhere in the world. The Evil Empire is no more. Second, although defense cutbacks have been made in recent years, President Clinton's $260 billion military budget for 1996 would still constitute the highest level of real peacetime spending ever. Third, Congress should recognize that a leaner Pentagon budget *and* a stronger national defense are not incompatible goals. What is needed at the Defense Department is not more spending, but smarter spending.

A number of responsible defense analysts have concluded that America can maintain an effective peacetime defense capability at a price tag of around $204 billion by 2000, down from the current level of $270 billion. (Indeed, in Chapter 9 Cato's defense analyst makes the case for an even smaller military budget than this.) In many areas, very large savings are achievable. Here are some recommendations:

- **Substantially reduce troops in Europe. There is no compelling rationale for still having 100,000 U.S. troops on the Continent. At the very least, half of those troops should be sent home at a savings of nearly $50 billion.**
- **Implement off-the-shelf procurement and other purchasing reforms long ago adopted in private industry to save an estimated $5 to $10 billion.**
- **End purchases of new B-2 bombers, Seawolf submarines, the D-5 missile, and the C-17 transport plane and slow the acquisition of other new weapons systems to save $20 billion.**
- **Cut the more than $5 billion of "nondefense" pork spending in the Pentagon budget identified by the nonpartisan General Accounting Office. The high-priority "national defense" spending stuffed inside the defense budget includes $3 million for urban youth programs, $9 million for the World Cup Soccer tournament, $57 million for AIDS research, and $10 million for U.S.-Japanese management training.**

To be sure, some areas of the defense budget should be increased. Those include the strategic defense initiative for defense of the United States against ballistic missiles and the military's reserve and National Guard forces to provide force augmentation in an environment of active-force reductions. The United States should also fully maintain an active research and development program.

Critics will argue mat these funding levels are inadequate to support America's current military role around the world. The truth is that the proposed budget is consistent with the new geopolitical realities of a post-Cold War world. It would still give America by far the largest military budget in the world. The proposed force structure would be adequate to maintain a survivable strategic nuclear force, sufficient active forces to meet the types of minor threats that might arise with short warning, and a sufficient mobilization base to respond to a major threat that could develop only over a period of years.

The proposed force would not be enough to maintain a global military presence *and* deploy a force the size of the one used in Operation Desert Storm, but mere are strong reasons to question whether those capabilities are now worth the large cost. On completion of the proposed phasedown, a force as large as that in Desert Storm could be deployed only with substantial augmentation from reserve and National Guard forces. On net, we regard this limitation as desirable; the willingness to call up reserve and National Guard forces is an important test of whether some foreign development is a substantial threat to our vital national interests. In other words, we would have to retreat from our role as the world's policeman.

In sum, the proposed budget and force structure is designed as an insurance policy for a nation without any major potential adversary and should be modified later only if a major potential threat comes from any source.

Social Security

With a budget of more than $300 billion, Social Security has now passed defense to become the largest single program in the federal budget. Over time, Social Security has been interpreted as a political contract between the working-age population and people who are now retired. That reduces the possibility of large savings in Social Security outlays in the near term, but it should not cause us to defer dealing with the long-term problems of the system—because those problems are massive.

The new Congress should consider three reforms to put Social Security on a sustainable basis. First, the increase in the retirement age that is already scheduled should be accelerated. Beginning in 1995 the retirement age (and early retirement age) should be raised by three months per year for the next 20 years. That would mean that the age at which one would receive full retirement benefits would be 66 in 1998, 67 in 2002, 68 in 2006, until the retirement age reached 70 in 2014. Incrementally increasing the age for receiving full benefits would be a substantial step toward cushioning the impact of the demographic time bomb that will explode in the next 20 years when the baby-boom generation begins to retire. Without a change in retirement age, the ratio of workers to retirees is expected to fall to less than 2 to 1 by the year 2030. Such a dependence ratio would place considerable strain on the economy and a larger burden on today's children—the next generation of workers.

The second recommended change to Social Security is to index the growth of future benefits (technically called the bend points and the earnings history) to the consumer price index rather than to wages. The benefit formula determines the starting cash benefit level of each Social Security recipient. It is based on the earnings history of each worker. As real wages rise over the life of the worker, so does the starting benefit level. If the formula were indexed to inflation, future retirees would still receive increasing real benefits over time, but the rate of increase would be slower than currently projected. Real benefits under the formula would double rather man triple over the next 70 years. That change would gradually transform the floor for Social Security benefits from one on relative benefits to one on real benefits, protecting the poor but increasing the incentive of others to save so as to have higher retirement incomes. Together, those two reforms would yield only minor savings of from $20 billion to $25 billion by the year 2000. But the resulting savings would be more than $500 billion by the year 2030.

Finally, Congress should immediately take steps to allow workers under the age of 50 to "opt out" of Social Security, by allowing the workers to take a share of their payroll tax each month and place the funds in an individual retirement account. The chapter on Social Security explains how such a program would work.

Medical Care

President Clinton's national health plan has been soundly rejected by the voters and by Congress. Many in Congress would now prefer the issue of health care to go away entirely. It won't.

There is still a crisis, but it is a crisis, not in health care delivery, but in the runaway inflation of the two major government programs of Medicare and Medicaid. Since 1988 Medicaid has been growing at a 15 percent annual rate. Recent slowdowns in overall health care inflation have helped reduce cost hikes somewhat, but the CBO still predicts an enormous 11 percent growth rate in federal health spending over the foreseeable future.

Medicare and Medicaid will consume $400 billion by 1999. The principal explanation of the runaway inflation in health costs for many years is that government has stimulated the demand for and restricted the supply of medical care. Total expenditures for medical care have increased from about 5 percent to 14 percent of GDP over the past 30 years. It is fairly certain that any health plan designed to expand health care demand through expanded insurance coverage for the 35 million uninsured would place upward pressures on medical inflation.

The crux of the medical care cost crisis is contained in one statistic: the share of health care costs paid directly by the patient has declined from about 50 percent to about 20 percent since 1960. Given the dominance of third-party payments, neither patients nor physicians have an adequate incentive to control the costs of medical care. The demand for medical care will continue to increase in response to an increase in real incomes and the relative size of the elderly population.

The primary focus of policymakers should be on reducing the growth of demand attributable to tax-subsidized private and public health insurance. A substantial part of the benefits of tax subsidization of health insurance accrues to higher income people. Higher income people are more likely to be privately insured, and the value of the tax deduction increases with the marginal tax rate. Similarly, people who have higher incomes are likely to live longer, and the value of Medicare increases with their marginal tax rate. Clearly, the amount of tax-subsidized health insurance could be substantially reduced without much change in the insurance available to the poor.

A reduction in tax-subsidized medical prepayment plans is necessary to reduce the growth of demand for medical care. That subsidy should be reduced primarily for higher income people to ensure that they bear part of the burden of balancing the budget. Tax-subsidized medical plans should be restricted to Medisave or to plans with a high income-tested deductible. One or more of the following measures should be considered as a way of achieving those objectives.

- Maintain the tax deduction only for medical savings account plans. A Medisave plan, in effect, is a medical IRA. Every person would be allowed a tax deduction up to some limit per year for funds set aside in a medical IRA. Individuals would be allowed to draw from those funds to purchase medical insurance or pay for out-of-pocket medical expenses. After some amount is accrued in a medical IRA (say $20,000), the excess may be spent for any purpose. A full deduction for that type of insurance should also be extended to purchasers of individual plans.

- Limit or eliminate the tax deduction. A limit could be set at some rate, such as $150 a month, that would be sufficient only for a high income-tested deductible. In any case, reduce the payroll tax by a corresponding amount; elimination of the tax deduction, for example, would permit a 2.2 percentage point reduction in the payroll tax for all workers with no net effect on federal revenues.

- Establish an income-tested deductible for the sum of payments under Part A and Part B of Medicare. That deductible could, for example, first be set at 1.5 percent of adjusted gross income (AGI) and then increased 1.5 percentage points each year for four years. Thus, beginning in the fifth year, the deductible would be 7.5 percent of AGI, the same rate that is now in the individual income tax code. Payments above the deductible, in most cases, would be fixed payments to the patient per illness or accident.

o Establish a similar plan with a high income-tested deductible for all Americans. That comprehensive catastrophic health insurance plan would replace the current tax deduction for private insurance and the outlays for both Medicare and Medicaid. The plan should probably be augmented to pay for several free visits to physicians each year by pregnant women and infants.

All of those measures would reduce the growth of the demand for medical care, the relative inflation of the price of medical services, and total private and public expenditures for medical care. The measures are listed in the order of increasing budget savings. The CBO projects that federal health care costs will climb by nearly 10 percent per year through 2000. The Cato reform measures are designed to reduce that inflation rate to at most 7.5 percent, thus generating savings of nearly $70 billion by the turn of the century.

We/fore

Thirty years ago, when President Lyndon Johnson launched the War on Poverty, he declared that "the days of the dole are numbered." We are now on day 10,000, with little end in sight. Over that period, some $4.5 trillion has been spent on this war—more in current dollars than the cost of fighting World War II.

The federal government, along with the states and cities, spends an estimated $250 bilh'on per year on anti-poverty programs. That is almost three times the amount that would be needed to lift every poor family to above the poverty level. Still, the poverty rate in the United States remains extremely high. As welfare expert Charles Murray of the American Enterprise Institute emphasizes, "The tragedy of the welfare state is not how much it costs, but how little it has bought." The system does not work well for either the poor or the taxpayer.

The goods news is that there is now nearly universal agreement mat the welfare system is broken. As President Clinton has put it, '"We must revolutionize our welfare system. It doesn't work. It defies our values as a nation." There is bipartisan support for "ending welfare as we know it." The only debate is about what should replace welfare.

The most promising approach to welfare is to turn the major programs over to the states entirely. That would have several positive effects. First, it would allow states full flexibility in serving as innovators and laboratories for devising welfare programs that provide a basic safety net without rewarding destructive behavior. State governments have already begun to experiment with promising reforms in welfare. The most ambitious of those experiments, designed to get people off welfare and into jobs, have been undertaken in Wisconsin under Gov. Tommy Thompson and in Michigan under Gov. John Engler. Devolution of welfare to the states would help quickly sort out approaches that work from those that do not.

Second, interstate competition would force states to control bureaucratic costs, hold down benefit levels, and impose meaningful restrictions on eligibility—all things Washington has failed to do.

Third, states are more likely to see the role of government as one of augmenting successful private charitable support systems, rather than supplanting them.

If welfare is not fully devolved to the states, a second-best option is to consolidate Aid to Families with Dependent Children, food stamps, public housing assistance, the earned income tax credit (EITC), child nutrition programs, SSI, and more than 50 other welfare programs in a single public welfare program with a work requirement. That single cash payment program would require all able-bodied recipients who cannot find private-sector jobs to perform a public service job in exchange for a welfare check. That program would reduce welfare fraud by weeding out those who are collecting welfare but working in the private sector already. It would also instill in young women the idea that welfare is not a substitute for work. Welfare would be seen as a temporary hand up, not a permanent handout. A conservative estimate is that those reforms would save $20 billion a year.

Terminate Unnecessary Federal Programs

Once a cap on federal expenditures is established, the president and Congress will need to set priorities for discretionary domestic spending. That will be a novel experience for federal lawmakers. Since 1980 only a handful of programs of the thousands in the budget have been closed down, despite a growing bipartisan consensus that tens of billions of dollars in savings could be generated by such measures. Even President Clinton now agrees that major program cancellations and restructuring are in order. The appendix to this chapter contains a list of more than 100 program terminations suggested by the staff of the Cato Institute. The list is meant to be illustrative and is by no means comprehensive.

It is essential that the new Congress demonstrates its commitment to deficit reduction and smaller government by eliminating programs, projects, and regulations. The experience of the 1980s proves that if programs are cut back but not eliminated, their budgets can easily be restored very rapidly under a new administration. Some strategies for identifying candidates for closure follow.

1. Repeal all of the $30 billion of new spending in the fraudulent crime bill passed by Congress in 1994. The repeal should not just be restricted to the pork spending, such as midnight basketball and dance classes; it should include funding for prisons and police as well. Those are state and local functions.
2. Accept the list of program terminations in the past two Clinton budgets. That would add to nearly $10 billion in savings per year.
3. Identify and cancel the $75 billion for business subsidies in the budget and eliminate them in combination with a capital gains tax cut. Clearly, a capital gains tax reduction would do far more for creating new businesses in America than 100 Small Business Administrations.
4. Family tax cuts should be combined with cutbacks in programs and regulations designed to "help" families, such as day care subsidies, head start, sex education funding, school lunch programs, and the "family leave" bill. Big government is anti-family.
5. Abolish cabinet agencies. Ideal candidates for closure include any or all of the following: the Department of Agriculture, the Department of Education, the Department of Energy, the Department of Commerce, the Department of Labor, and the Department of Housing and Urban Development. Those departments contain few programs whose costs do not exceed their benefits. The few necessary activities of tfiose departments should be transferred to other departments.

End Foreign Aid

The federal government spends $22 billion a year on international affairs. Some of those funds go to carrying out the legitimate foreign affairs activities of the State Department. But roughly $12 billion is spent each year on bilateral and multilateral aid to other nations. Those programs include U.S. contributions to the United Nations, the World Bank, and the International Monetary Fund. After tens of billions of dollars of U.S. taxpayer funding of those programs, there is not a scintilla of evidence that they have had any positive effect on economic development. Indeed, Cato scholars Doug Bandow and Ian Vásquez argue persuasively in their book *Perpetuating Poverty* that America's foreign aid programs do real harm to developing countries.

All U.S. bilateral and multilateral foreign aid should be terminated immediately. U.S. economic development assistance to developing countries should be based on a simple principle: trade, not aid.

Privatize Federal Assets

Government owns about one-third of all the land in the United States—and in most years it adds to its holdings by purchasing properties. Only a tiny fraction of those land holdings are of environmental or historical significance. The market value of oil lands alone is estimated to be roughly $450 billion. Government also owns tens of billions of dollars worth of other assets, including mineral stockpiles, buildings, and other physical capital. Many of those assets are not put to productive use and thus yield little or no return to taxpayers. The federal government should embark on an ambitious agenda of privatization. We recommend. $20 billion of asset sales per year for the next 10 years with the proceeds dedicated to reducing the interest on the national debt.

The Cato Budget: Shrinking the Burden of Government

As shown in Figure 8.3, over the 20th century the price we pay for government has climbed steadily. The federal government has grown from roughly 5 percent to 23 percent of national output. It is our contention that the rising burden of government has led to the slowdown in the rise of Americans' living standards and an erosion of basic liberties.

The Cato budget would dramatically reverse that trend. Table 8.5 shows that government spending as a share of national output would shrink to 17.6 percent by 2000 if all of the Cato budget recommendations were adopted. Federal revenues would be slightly higher. In future years federal spending would be reduced to roughly 16 percent of GDP when all the budget recommendations were fully implemented. We are also confident that the success of such a program would lead to further significant cuts in federal taxes and spending.

Conclusion

The conventional wisdom in Washington is that it is impossible to cut taxes and balance the budget. This chapter shows that the conventional wisdom is wrong. Both can—and should—be done.

Table 8.5
The Burden of Taxes and Spending under Cato Budget Alternative (percentage of GDP)

	Fiscal Year						
	94	95	96	97	98	99	2000
Outlays	22.0	21.2	20.7	19.9	19.0	18.4	17.6
Defense	4.3	3.7	3.5	3.2	2.9	2.5	2.2
Domestic	14.6	14.2	13.8	13.6	13.2	13.2	12.9
Net interest	3.1	3.3	3.4	3.1	2.9	2.7	2.5
Revenues	19.0	18.8	18.2	17.9	17.8	17.7	17.6
Deficit	3.0	2.4	2.5	2.0	1.2	0.7	0.0

Are the program reforms as outlined here politically achievable? They are if the commitment of the new GOP majority in Congress to restraining the size and scope of government matches the rhetoric.

To be sure, making the tough cuts will not be much fun for our federal politicians, but if the Republicans will not make the cuts, they too are part of the problem and should be replaced

Appendix to Chapter 8: Cato Institute List of Recommended Federal Program Terminations, January 1995

Dollar amounts in this appendix are in millions.

U.S. Department of Agriculture	
All Agriculture Crop and Dairy Subsidies	$10,000
Rural Electrification Administration	$1,000
All USDA Land Acquisition Programs	$100
Agricultural Stabilization and Conservation Service	$700
Soil Conservation Service	$600
Children's Nutrition Subsidies for Nonpoor	$1,000
Food Stamps	$25,500
Farmers Home Administration	$3,000
Economic Research Service	$60
Wool and Mohair Subsidies	$200
Foreign Agricultural Trade Service	$100
Nutrition Research and Education Service	$20
Extension Service	$400
National Agricultural Statistics Service	$80
Federal Crop Insurance Corporation	$300
Public Law 480	$1,200
Agriculture Research Service	$700
Cooperative State Research Service	$500
Agricultural Marketing Service	$500
Commodity Credit Corporation Export Loans	$400
Total Department of Agriculture	$46,360
Department of Commerce	
Minority Business Development Agency	$40
Economic Development Assistance	$300
United States Travel and Tourism Administration	$20
Export Administration	$40
International Trade Administration	$200
National Institute of Standards and Technology	* $200
Advanced Technology Program	$400
Total Department of Commerce	$1,200
Department of Defense	
D-5 Missile Program	$700
C-17 Cargo Plane	$2,000

Nondefense Spending in Military Budget	$5,500
V-22 Osprey	$500
Seawolf Submarine	$60
M-1 Tank Upgrade	$400
Tri-Service Standoff Attack Missile	$600
Uniformed Services University Health Sciences	$80
ARPA Technology Reinvestment Project	$600
Office of Economic Adjustment	$60
Defense Reinvestment and Conversion	$3,000
SEMATECH	$80
Corps of Engineers Civil Construction Projects	$1,500
Total Department of Defense	$15,060
Department of Education	
Elementary and Secondary Education Grants	$6,500
Impact Aid	$900
Office of Vocational Education	$1,500
Bilingual Education	$300
Head Start	$3,300
College Work Study Program	$600
College Housing and Academic Facility Loans	$60
Goals 2000	$100
Star Schools	$20
School Improvement Program	$1,600
Office of Special Education	$3,400
Educational Research	$300
Even Start	$100
Total Department of Education	$18,680
Department of Energy	
Nuclear Fusion	$300
Energy Conservation Programs	$600
Power Marketing Administration Subsidies	$300
General Science and Research Activities	$1,600
Nuclear Fission	$300
Fossil Energy Research and Development	$400
Naval Petroleum and Oil Shale Reserves	$200
Strategic Petroleum Reserve	$200
Energy Information Administration	$80
Clean Coal Technology	$300

Solar and Renewable Energy Programs	$300
Economic Regulatory Administration	$20
Magnetic Fusion	$300
Energy Supply, Research and Development	$3,000
Total Department of Energy	$7,900
Department of Health and Human Services	
Title X Family Planning Grants	$200
Child Care Assistance to States	$800
Refugee Assistance Programs	$300
Social Services Block Grants	$2,500
Low-Income Home Energy Assistance	$2,000
NIH Overhead Cost Reimbursements	$100
SSI Benefits to Substance Abusers and Noncitizens	$200
Child Welfare Services	$300
Community Health Centers	$500
Family Support and Resource Centers	$60
Community Service Block Grants	$500
Health Professions Curriculum Assistance	$200
Maternal and Child Health Block Grant	$600
Healthy Start	$100
Children and Family Services	$4,000
Substance Abuse Block Grant	$1,400
State Welfare Administrative Costs	$1,500
AFDC Day Care	$900
Total Department of Health and Human Services	$16,160
Department of Housing and Urban Development	
Community Development Grants	$4,000
Public Housing	$4,000
Federal Housing Administration	$500
Low-Income Housing Assistance (Sec. 8)	$9,000
Homeownership Assistance	$40
Rental Housing Assistance	$700
HOPE Grants	$60
Public and Indian Housing	$200
HOME Investment Partnership Program	$800
Fair Housing Activities	$20
Total Department of Housing and Urban Development	$19,320
Department of the Interior	
Bureau of Reclamation Water Projects	$300

National Biological Survey	$60
Bureau of Mines	$100
Helium Fund and Reserves	$20
Land Acquisition Programs	$200
Sport Fish Restoration Fund	$200
Migratory Bird Conservation	$40
Total Department of the Interior	$920
Department of Justice	
All Spending in the 1994 Crime Bill	$5,000
Antitrust Division	$60
Anti-Drug Program	$600
Total Department of Justice	$5,660
Department of Labor	
Job Training Partnership Act	$1,000
Job Corps	$1,000
Trade Adjustment Assistance	$200
Community Service Employment for Older Americans	$300
Employment Standards Administration	$200
Native American Job Training	$60
Migrant and Seasonal Worker Training	$80
Summer Youth Employment Services	$800
Dislocated Worker Assistance	$1,000
Job Training Grants to States	$1,500.
Total Department of Labor	$6,140
Department of State	
Foreign Aid to Egypt	$1,000
Foreign Aid to Israel	$2,000
United Nations Organizations	$600
United Nations Peacekeeping	$400
Inter-American Organizations	$100
NATO	$40
Migration and Refugee Assistance	$600
Total Department of State	$4,740
Department of Transportation	
Federal Transit Administration	$4,500
Airport Subsidies	$2,000
Amtrak Subsidies	$700

Highway Demonstration Projects	$300
Interstate Commerce Commission	$40
Maritime Administration	$700
Federal Railroad Administration Local Freight Assistance	$40
Payments to Air Carriers	$40
Cargo Preference Programs	$400
Total Department of Transportation	$8,720
Department of Veterans Affairs	
V.A. Benefits for Non-Service-Related Illnesses	$200
V.A. hospital construction	$600
Total Department of Veterans Affairs	$800
Other Agencies	
International Monetary Fund	$300
Small Business Administration	$400
National Endowment for the Humanities	$200
National Endowment for the Arts	$200
National Endowment for Democracy	$40
Corporation for Public Broadcasting	$300
Export-Import Bank	$500
Appalachian Regional Commission	$100
NASA Space Station	$2,000
Inter-America Foundation	$20
EPA Wastewater Treatment Subsidies	$2,400
Consumer Product Safety Commission	$40
Economic Support Fund	$2,500
Superfund	$1,500
Equal Employment Opportunity Commission	$200
Corporation for National and Community Service	$100
Overseas Private Investment Corporation	$20
ACTION	$200
African Development Foundation	$20
Peace Corps	$200
Institute of American Indian Culture and Arts Development	$20
Office of Technology Assessment	$20
Davis-Bacon Act	$1,000
Service Contract Act	$500
World Bank	$900
Agency for International Development	$500

Legal Services Corporation	$400
National Flood Insurance	$100
Federal Trade Commission	$60
Neighborhood Reinvestment Corporation	$40
Pennsylvania Avenue Development Corporation	$200
Total Cato Budget Savings	$166,640

—Prepared by William A. Niskanen and Stephen Moore