



Cato Handbook for Policymakers

CATO
INSTITUTE

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4. Cutting Federal Spending

Congress should

- cut federal spending from 21 percent to 16 percent of gross domestic product over 10 years, as detailed in this chapter;
- terminate, privatize, or transfer to state governments more than 100 programs and agencies, including those involved in agriculture, education, housing, and transportation;
- reform Social Security by cutting the growth in government benefits and adding a system of private accounts;
- cut Medicare spending growth and move toward a health care system based on individual savings and choice;
- convert Medicaid into a block grant and freeze federal spending; and
- impose a statutory cap on the annual growth in total federal outlays.

The federal government is spending too much, running large deficits, and heading toward a financial crisis. Total federal outlays increased 68 percent during the eight years of the Bush administration—fiscal years 2001 to 2009—with large increases in defense, education, health care, and other areas. Those increases have come just as the baby boomers begin to retire and the costs of federal entitlement programs are beginning to balloon. Spending on the three main entitlement programs—Social Security, Medicare, and Medicaid—is expected to roughly double from \$1.27 trillion in FY08 to \$2.42 trillion by FY18.

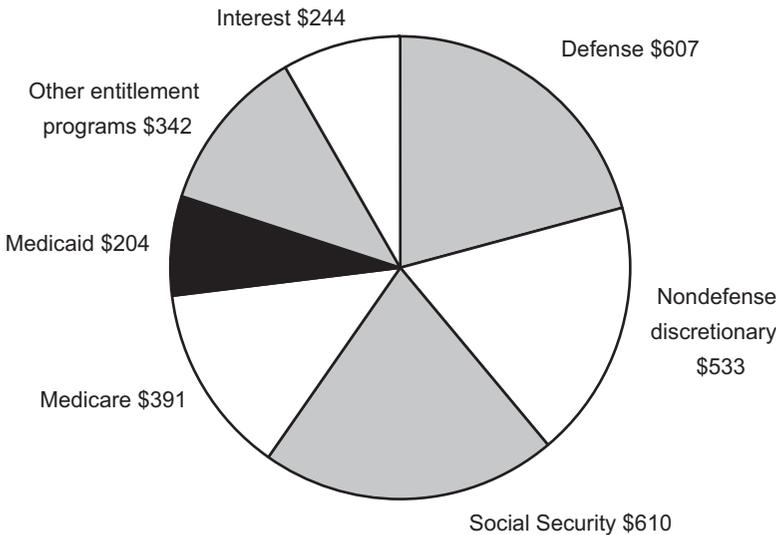
Where will the money come from? If government spending is not cut, average working families will face huge tax increases that dwarf anything seen in decades. Tax increases would damage the economy and be strongly resisted by the public. As a consequence, policymakers need to begin identifying programs in the federal budget that can be cut, terminated, transferred to the states, or privatized.

This chapter provides policymakers and the public with an outline of federal budget reforms. It proposes eliminating more than 100 agencies and programs to reduce federal spending from about 21 percent to 16 percent of the nation’s economy. Cutting the \$3.1 trillion budget would avert the looming federal financial crisis, while giving Americans a stronger economy and greater individual freedom. The budget data in this chapter were compiled before the hundreds of billions of dollars of financial system bailouts announced in Fall 2008, and thus the need for large cuts to federal programs has become even more acute.

Where Does Taxpayer Money Go?

Figure 4.1 shows what the federal government spent the taxpayers’ money on in FY08. The “entitlement” programs, including Social Security, Medicare, and Medicaid, accounted for 53 percent of total spending. These programs are on autopilot, and they will grow each year unless Congress passes laws to limit benefits or to reduce the number of beneficiaries.

Figure 4.1
Federal Outlays in Fiscal Year 2008
(Billions of Dollars)



SOURCE: *Budget of the U.S. Government, FY2009*. Medicare is net of offsetting receipts.

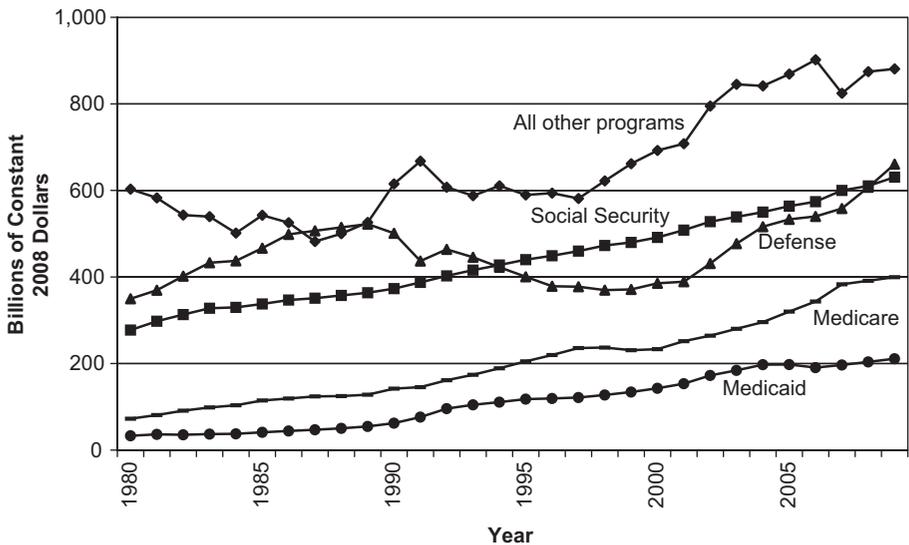
“Discretionary” programs accounted for 39 percent of federal spending. Congress appropriates funds for these programs annually. Discretionary programs cover a huge range of federal activities, including defense, education, energy, environment, foreign aid, housing, labor, science, space, and transportation. Interest represented the remaining 8 percent of the budget.

Figure 4.2 shows changes over time in real, or constant-dollar, spending in major budget categories. Real defense spending fell during the 1990s, but has been rising rapidly since 2001. Defense spending is expected to top Social Security spending in FY09 for the first time since the early 1990s. The category “all other programs” includes nondefense discretionary spending and smaller entitlement programs. This category of spending fell slightly during the 1980s, soared during the early 1990s, was flat during the mid-1990s, and started rising again in the late 1990s.

What’s Wrong with Federal Spending?

The federal government will spend more than \$3.1 trillion in FY09. After taking out the government’s core functions of national defense and

Figure 4.2
Federal Outlays by Program



SOURCE: Author calculations based on *Budget of the U.S. Government, FY2009*. FY2008 and FY2009 are estimates. Figure excludes net interest outlays.

justice, it will still spend about \$2.4 trillion. That amounts to roughly \$21,000 for every household in the United States. Clearly, the federal government has amassed to itself a huge range of spending programs beyond its basic responsibilities.

Indeed, the government is so large that the activities of hundreds of federal agencies are beyond the knowledge and understanding of most citizens. The government has also become too large for our representatives in Congress to adequately oversee and control, as scandal after scandal attests to. Congress has shown itself to be incapable of running a \$3 trillion organization with an adequate degree of competence.

Americans would receive more benefit from the federal government if its size and scope were greatly reduced, and they received a limited range of much better quality services. Reforms should begin to shed the noncore functions of the federal government so that members of Congress and the president can focus on delivering high-quality basic services, such as national security.

Table 4.1 at the end of this chapter targets more than 100 programs and agencies for elimination. These programs have one or more of the following failings:

- They are wasteful, which means duplicative, obsolete, mismanaged, ineffective, or subject to high levels of fraud and abuse.
- They benefit special interests at the expense of average citizens and taxpayers.
- They damage society by distorting the economy, by harming the environment, or by creating negative social effects.
- They are activities that should be left to state and local governments.
- They are activities that should be left to private businesses, individuals, and charities.
- They violate the Constitution as serious overreaches of federal power.

Programs with these failings are discussed throughout this *Handbook*, but this chapter tallies the overall savings from an ambitious overhaul of the budget based on these reform criteria.

How to Cut Federal Spending to 16 Percent of GDP

The programs in Table 4.1 should be terminated, privatized, or devolved to state and local governments. Those reforms would save about \$440 billion annually in 2008, which equates to savings of about \$580 billion annually in 2018 under baseline projections. The proposed

cuts are from nearly every federal department, including defense, education, energy, housing, and transportation. This plan includes only a portion of the reforms recommended in other *Handbook* chapters for defense, Social Security, Medicare, and Medicaid.

The reasons for particular cuts are discussed in *Downsizing the Federal Government*. To an economist, some reforms are no-brainers—farm subsidies should be terminated immediately, for example. Other reforms, such as privatizing Amtrak, would require detailed analysis to determine the best way to proceed. Over the long term, as federal involvement in the targeted activities ended, it would be up to state governments, businesses, consumers, and private charities to determine whether those activities were worth sustaining without federal help. Could an entrepreneur make Amtrak succeed in the marketplace? Let's privatize it and find out.

The key to averting a federal fiscal crisis in the years ahead is to cut the three main “entitlement” programs—Social Security, Medicare, and Medicaid. The following are four straightforward reforms that would create annual savings of about \$350 billion by 2018 (the first three estimates are based on data in the Congressional Budget Office’s “Budget Options”):

- Reduce the growth in Social Security by indexing initial benefits to changes in prices instead of wages to save about \$47 billion annually by 2018;
- Increase premiums for Medicare Part B to cover 50 percent of program costs (up from 25 percent today) to save about \$68 billion annually by 2018;
- Increase and conform the deductibles and cost sharing for Medicare Part A, Medicare Part B, and Medigap plans to save about \$10 billion annually by 2018; and
- Turn Medicaid into a block grant and freeze federal spending to save about \$227 billion annually by 2018. Currently, Medicaid funding is split between the federal and state governments in a structure that encourages overspending. This option would turn Medicaid into a block grant and freeze the federal contribution, thus forcing state governments to pursue cost-cutting reforms.

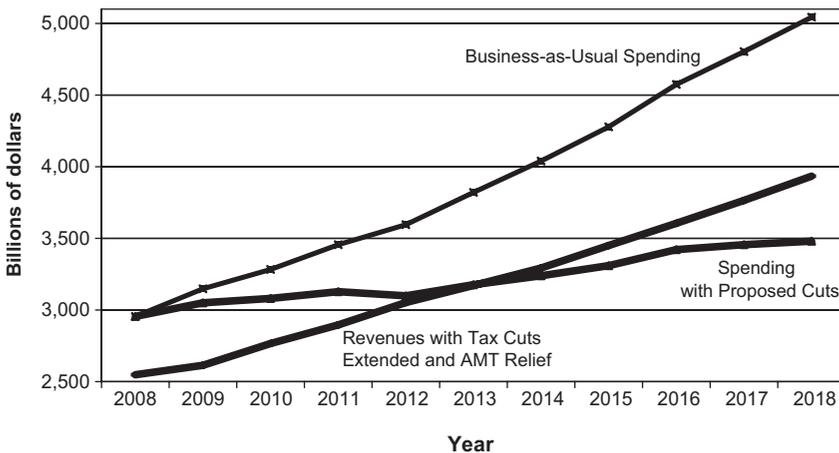
Further reforms to these entitlement programs are discussed in Chapters 12, 13, and 17. But the reforms listed above, combined with the proposed spending cuts in Table 4.1, would balance the federal budget and generate growing surpluses, even with all current tax cuts extended. The plan would reduce the size of the federal government from about 21 percent of gross domestic product today to less than 16 percent by 2018.

Figure 4.3 shows a 10-year projection of federal spending under a business-as-usual scenario and under the reform plan proposed here. Figure 4.4 shows the same projections measured as a share of GDP. The reform plan includes the entitlement cuts proposed here and assumes that the discretionary cuts from Table 4.1 would be phased in over 10 years.

Figures 4.3 and 4.4 also show a projection of federal revenues, based on the Congressional Budget Office forecast of September 2008. The projection assumes that all the tax cuts scheduled to expire by the end of 2010—including individual income tax cuts, business tax breaks, and the estate tax—are made permanent and that the alternative minimum tax is indexed for inflation.

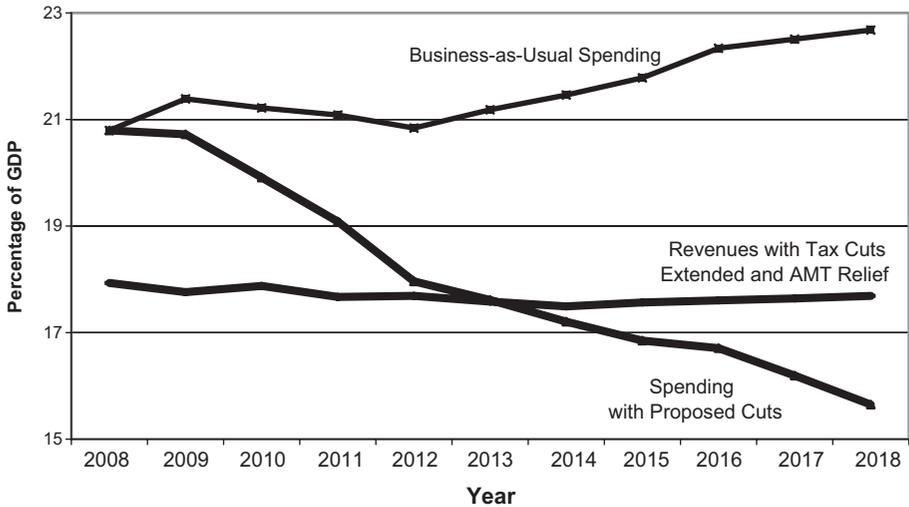
If the reform plan were enacted, the budget would be balanced by 2013, and there would be growing surpluses after that. By 2018, federal spending would be about 30 percent less than it would be under a business-as-usual scenario. The business-as-usual scenario starts with the Congressional Budget Office’s baseline projection from September 2008, but assumes that discretionary spending grows as fast as GDP, that troops in Iraq and Afghanistan are drawn down under CBO’s optimistic scenario, and that Medicare physician payments are not cut after 2010 as they are under the baseline.

Figure 4.3
Projected Federal Revenues and Spending



SOURCE: Author’s estimates based on Congressional Budget Office projections of September 2008. Note: Data are for fiscal years. The “Business as Usual” scenario is the Congressional Budget Office baseline but with discretionary spending growing with GDP. Both spending scenarios include CBO’s optimistic option for Iraq troop cuts.

Figure 4.4
Projected Federal Revenues and Spending, Percentage of GDP



SOURCE: Author's estimates based on Congressional Budget Office projections of September 2008. Note: Data are for fiscal years. The "Business as Usual" scenario is the Congressional Budget Office baseline but with discretionary spending growing with GDP. Both spending scenarios include CBO's optimistic option for Iraq troop cuts.

With the current tax cuts extended and alternative minimum tax relief in place, federal revenues are expected to increase from \$2.5 trillion in 2008 to \$3.9 trillion in 2018. Under the reform plan, spending would be limited to just \$3.5 trillion in 2018 and thus large surpluses would be created. Under the business-as-usual scenario, spending would soar to \$5.0 trillion in 2018 and annual deficits of more than \$1 trillion would be created.

Measured as a share of GDP, revenues with tax relief in place are projected to decline slightly from 17.9 percent in 2008 to 17.7 percent by 2018. Under the reform plan, spending would fall from 20.8 percent of GDP in 2008 to 15.6 percent by 2018.

The budget savings generated under the spending reform plan could be used to reduce the federal debt, to repeal the alternative minimum tax, or to pursue supply-side tax cuts, as discussed in Chapters 41 and 42. Also, the savings could be used to fund the transition to a Social Security system based on personal accounts, as discussed in Chapter 17.

The cuts included in this plan are not all the budget reforms that should be pursued. Government procurement policies should be reformed to end

frequent cost overruns, and additional grant-in-aid programs for the states should be cut. More importantly, further reforms should be made to Social Security, Medicare, and Medicaid. Nonetheless, the cuts listed here provide policymakers with a menu of high-priority reforms. If enacted, they would avert a financial crisis and shrink government in a responsible way, while increasing economic freedom and growth.

How to Reform Budget Rules

This chapter has proposed a range of detailed reductions to the federal budget, but most current members of Congress would find it difficult to make many of these cuts. Their basic instinct is to spend, and that instinct is reinforced by the Capitol Hill culture, by interest groups, and by voices in the media. Thus, part of the reform agenda must be to change federal budget rules to create greater top-down discipline in members of Congress. With tighter budget rules, members would be required to make the needed spending tradeoffs that are often avoided under current rules.

Federal reformers can look to the states for ideas on reforming the budget process, as state policymakers are bound by tighter rules than is Congress. All states except Vermont have statutory or constitutional requirements to balance their budgets. In addition, more than 20 states have some form of overall limitation on taxes or spending. For example, Colorado's constitution limits annual state revenue growth to the sum of population growth plus inflation.

Congress has occasionally bound itself to limits on the overall budget, such as under the 1985 Gramm-Rudman-Hollings Act. That act established a series of declining deficit targets, which, if not met, resulted in an automatic cut, or sequester, to a range of programs. Congress replaced GRH in 1990 with the Budget Enforcement Act. The BEA imposed annual dollar caps on discretionary spending and "pay-as-you-go" rules on entitlement programs, which required that the costs of program expansion be offset elsewhere in the budget.

Bolder efforts to control spending and deficits have been debated in Congress. A balanced-budget amendment (BBA) to the Constitution was introduced as far back as 1936. In 1982, the Senate passed a BBA by a vote of 69–31. In addition to requiring budget balance, the amendment would have limited the annual growth in federal revenues to the growth in national income. Unfortunately, the BBA failed to gain the needed two-thirds approval in the House. At the time, a parallel effort resulted in resolutions being passed in 31 states calling for a constitutional convention

to approve a BBA, but that effort came up three states short of the required number. In 1995, Congress again voted on a BBA, and it again narrowly failed. The BBA passed the House by a 300–132 margin, but it fell one vote short of passage in the Senate.

How to Cap Federal Spending

Given the difficulty of amending the Constitution, statutory changes to budget rules can provide a way forward to control spending. In particular, a cap should be placed on the overall annual growth in federal outlays. While the Budget Enforcement Act imposed multiyear caps on discretionary spending, entitlement spending was not capped. Yet it is mainly entitlement spending that is pushing the government toward a financial crisis, and thus entitlements should be included under a federal budget cap.

A simple way to structure a cap is to limit annual spending growth to the growth in an economic indicator, such as gross domestic product. Another possible cap is the sum of population growth plus inflation. In that case, if population grew at 1 percent and inflation was 3 percent, then federal spending could grow by no more than 4 percent. Whichever indicator is used should be smoothed by averaging it over about five years. The principle underlying such a cap is that the government should live within constraints, just as average families do, and it should not consume an increasing share of the nation's economy.

Under a statutory cap, the Office of Management and Budget would provide regular updates on whether spending would likely breach the legal limit, thus allowing Congress time to take corrective actions. If a fiscal year ended and OMB determined that outlays were above the cap, the president would be required to cut spending across the board by the amount needed to meet the cap. Gramm-Rudman-Hollings and the Budget Enforcement Act included such sequester mechanisms that covered various portions of the defense, nondefense, and entitlement budgets. But a better approach would be to cap all spending and subject all departments to a sequester should Congress fail to restrain spending sufficiently.

No statutory cap would ensure that Congress started making large cuts to the budget, such as those proposed in this chapter. But a cap would help lock in whatever spending cuts were achieved because an annual spending cap would prevent excessive growth based on the spending level of the prior year. And a budget growth cap would provide protection for taxpayers against a nightmare scenario of rapid spending increases should the costs of entitlement programs continue to explode.

It is true that Congress could rewrite a statutory spending cap if it didn't want to comply with it at some point in the future. However, with a cap in place, citizens and watchdog groups would have a high-profile symbol of fiscal restraint to rally around and defend. Over time, public awareness and budgetary tradition would aid in the enforcement of a cap.

To sum up, the proposals in this chapter would not only balance the budget but would help defuse the entitlement cost time bomb that threatens to explode on young taxpayers. Making the budget cuts outlined here will be a political challenge, but many cuts that now seem radical to some policymakers will become a policy imperative as entitlement costs rise in coming years.

Besides, policymakers should not view budget cutting as if it were taking bad-tasting medicine. Well-crafted cuts would be positive from many perspectives. They would enlarge personal freedom and responsibility, they would allow the economy to expand more rapidly, and they would leave a positive fiscal legacy to the next generation.

Table 4.1
Proposed Federal Budget Terminations
(FY08 outlays in millions of dollars)

Department of Agriculture	
Economic Research Service	\$77
Agricultural Statistics Service	\$162
Agricultural Research Service	\$1,234
CSREES	\$1,193
Agricultural Marketing Service	\$636
Risk Management Agency	\$4,455
Farm Service Agency	\$14,223
Rural Development	\$145
Rural Housing Service	\$2,326
Rural Business Cooperative Service	\$166
Rural Utilities Service	\$1,023
Foreign Agricultural Service	\$1,192
Food Stamp Program	\$38,780
School Lunch and related programs	\$14,452
WIC nutrition program	\$5,974
Forest Service: state and private	\$487
Forest Service: land acquisition	\$96
Total proposed cuts	\$86,621

Department of Commerce	
Economic Development Administration	\$352
International Trade Administration	\$369
Minority Business Development Agency	\$23
Pacific salmon state grants	\$74
Fisheries loans and marketing	\$7
Technology Administration	\$1
Advanced Technology Program	\$198
Manufacturing Extension Partnership	<u>\$91</u>
Total proposed cuts	\$1,115
Department of Defense	
A portion of the cuts proposed in Chapter 19	\$50,000
Department of Education	
Elimination of entire department	\$68,046
Department of Energy	
General science research	\$3,887
Energy supply research	\$894
Fossil energy research	\$646
Nuclear energy research	\$695
Electricity research	\$157
Energy Efficiency and Renewable Energy	\$1,549
Strategic Petroleum Reserve	\$182
Energy Information Administration	\$67
Power Marketing Administrations	<u>\$474</u>
Total proposed cuts	\$8,551
Department of Health and Human Services	
Medicare: increase premiums and deductibles; for other reforms, see Chapter 12	
Medicaid: convert to block grant and freeze federal spending; for other reforms, see Chapter 13	
National Institutes of Health: applied R & D	\$12,669
Substance Abuse and Mental Health	\$3,263
Temporary Assistance for Needy Families	\$17,030
State Payments for Family Support	\$4,277
Low-Income Home Energy Assistance	\$2,522
Promoting Safe and Stable Families	\$448

(continued)

Table 4.1
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Child Care Entitlement grants	\$2,978
Child Care and Development grants	\$2,001
Social Services grants	\$1,936
Foster Care and Adoption grants	\$6,670
Head Start	\$687
Community Services grants	\$654
Health professions subsidy	\$319
Administration on Aging	<u>\$1,389</u>
Total proposed cuts	\$56,843
Department of Homeland Security	
State and local programs	\$1,651
Assistance to Firefighters grants	\$662
Coast Guard: Boat Safety grants	<u>\$131</u>
Total proposed cuts	\$2,444
Department of Housing and Urban Development	
Elimination of entire department	\$52,269
Department of the Interior: Bureau of Reclamation	\$1,493
State and Tribal Wildlife grants	\$107
Land Acquisition programs	\$40
Sport Fish Restoration Fund	\$478
Bureau of Indian Affairs	\$2,464
Office of Insular Affairs	\$374
Indian Gaming Commission	<u>\$16</u>
Total proposed cuts	\$57,241
Department of Justice	
Antitrust Division	\$146
State and local assistance	\$1,262
Weed and Seed Program	\$52
Community Oriented Policing Services	\$480
Juvenile Justice programs	<u>\$322</u>
Total proposed cuts	\$2,262
Department of Labor	
Employment and Training services	\$3,504
Community Service for Seniors	\$517
Trade Adjustment Assistance	\$834

Job Corps	\$1,490
Bureau of International Labor Affairs	<u>\$81</u>
Total proposed cuts	\$6,426

Social Security

Cutting of growth in initial benefits by changing from wage indexing to price indexing; for other reforms, see Chapter 17

Department of State

Education and Cultural Exchanges	\$474
International Organizations, including the United Nations	\$1,578
Organisation for Economic Co-operation and Development	\$85
International Narcotics Control	\$708
Andean Counterdrug Initiative	<u>\$312</u>
Total proposed cuts	\$3,157

Department of Transportation

Essential Air Service	\$62
FAA: air traffic control	\$2,440
FAA: grants to airports	\$2,970
FAA: facilities and equipment	\$2,704
Federal Highway Administration	\$37,630
Federal Transit Administration	\$6,261
Maritime Administration	\$591
Amtrak	<u>\$1,397</u>
Total proposed cuts	\$54,055

Other Agencies and Activities

Agency for International Development	\$3,874
Appalachian, Delta, and Denali Commissions	\$99
Army Corps of Engineers	\$7,211
Cargo Preference Program	\$435
Corporation for National and Community Service	\$915
Corporation for Public Broadcasting	\$448
Davis Bacon Act	\$1,000
District of Columbia fiscal assistance	\$97
EPA: state grants	\$3,080
Equal Employment Opportunity Commission	\$330
Federal Trade Commission: antitrust	\$101
International assistance: economic	\$3,573

(continued)

Table 4.1
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International assistance: multilateral	\$2,093
International Trade Commission	\$68
Legal Services Corporation	\$350
Millennium Challenge Corporation	\$265
NASA	\$17,318
National Endowment for the Arts	\$132
National Endowment for the Humanities	\$146
National Labor Relations Board	\$249
National Mediation Board	\$12
Neighborhood Reinvestment Corp.	\$287
Peace Corps	\$333
Presidio Trust	\$3
Public Accounting Oversight Board	\$139
Service Contract Act	\$800
Small Business Administration	\$530
Trade and Development Agency	\$55
U.S. Postal Service subsidies	\$935
Total proposed cuts	\$44,878
Grand total annual spending cuts	\$441,639

SOURCE: Author, based on data in the *Budget of the U.S. Government, FY2009*.

NOTE: CSREES = Comparative State Research, Education, and Extension Service; EPA = Environmental Protection Agency; FAA = Federal Aviation Administration; NASA = National Aeronautics and Space Administration; R & D = research and development; WIC = Women, Infants, and Children.

Suggested Readings

Cato Institute. Downsizing the Federal Government website. www.downsizinggovernment.org.

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Slivinski, Stephen. *Buck Wild: How the Republicans Broke the Bank and Became the Party of Big Government*. Nashville, TN: Nelson Current, 2006.

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