A Plan to Cut Spending
and Balance the Federal Budget

by Chris Edwards,
Director of Tax Policy Studies,
Cato Institute

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Introduction

Federal spending is soaring, and government debt is piling up at more than a trillion dollars a year. Official projections show rivers of red ink for years to come unless policymakers enact major budget reforms. Unless spending is cut, the United States is headed down the road to economic ruin.

The results of the 2010 elections made clear that Americans want an end to the spending spree in Washington. People fear that today's spendthrift policies may lead to major tax increases and a lower standard of living for themselves and the next generation. The public has given Congress marching orders to start cutting spending and to rein in debt.

Policymakers should implement an emergency plan of cuts to defense, domestic, and entitlement programs. This essay proposes spending cuts of $1 trillion annually by 2020, which would balance the budget without resorting to damaging tax increases. Federal spending would be reduced to 18.5 percent of gross domestic product by 2020 under the plan, which compares to President Obama's projected spending that year of 23.5 percent of GDP.

Short of a full *balanced budget plan*, policymakers could put in place a *debt stabilization plan*. Such a plan would cut spending to 21.5 percent of GDP by 2020, which would trim annual deficits to 3 percent of GDP. With deficits at that level, federal debt would be at least stabilized as a share of the economy, and we would avoid a Greek-style debt crisis. To stabilize the debt, policymakers would need to enact somewhat less than half of the spending cuts discussed here for the balanced budget plan.

Whether policymakers try to stabilize the debt or fully balance the budget, each of the spending cuts proposed here would make sense whether or not the government was running deficits. That's because cutting federal spending would expand individual freedom and spur economic growth as resources were moved from lower-return government uses to higher-return activities in the private sector.

In recent decades, the federal government has expanded into hundreds of areas that should be left to state and local governments, businesses, charities, and individuals. That expansion is sucking the life out of the private economy and creating a top-down bureaucratic society that is alien to American traditions. Cutting federal spending would enhance civil liberties by dispersing power from Washington.

The need to cut spending and debt is urgent. Numerous think tanks and committees have recently proposed plans to tackle today's huge deficits, including President Obama's National Commission on Fiscal Responsibility and Reform.[1] The various plans are not in agreement about the role of taxes in reducing deficits, but there is broad support among budget experts for substantial spending cuts, particularly cuts to entitlement programs.

The plan presented here does not include tax increases. Official budget projections show that federal debt is exploding because spending is at abnormally high levels. With the 2001 and 2003 tax cuts in place, and with continued relief from the alternative minimum tax, federal revenues are expected to rise to 18.5 percent of GDP by 2020, which is a little higher than average over recent decades.[2] By contrast, it is federal spending—currently at 25 percent of GDP—that is far above normal levels. During the last two years of the Clinton administration a decade ago, federal spending was just 18 percent of GDP.

Some analysts claim that cutting government spending would hurt the economy, but that idea is based on faulty Keynesian theories. In fact, federal spending cuts would shift resources from often mismanaged and damaging government programs to the more productive private sector, thus increasing overall GDP. Consider Canada's experience. In the mid-1990s, the country faced a debt crisis caused by runaway government spending—similar to our current situation. The Canadian government changed course and slashed spending 10 percent in just two years and then held it roughly flat for another three years.[3] The Canadian economy did not sink into recession, but was instead launched on a 15-year economic boom.

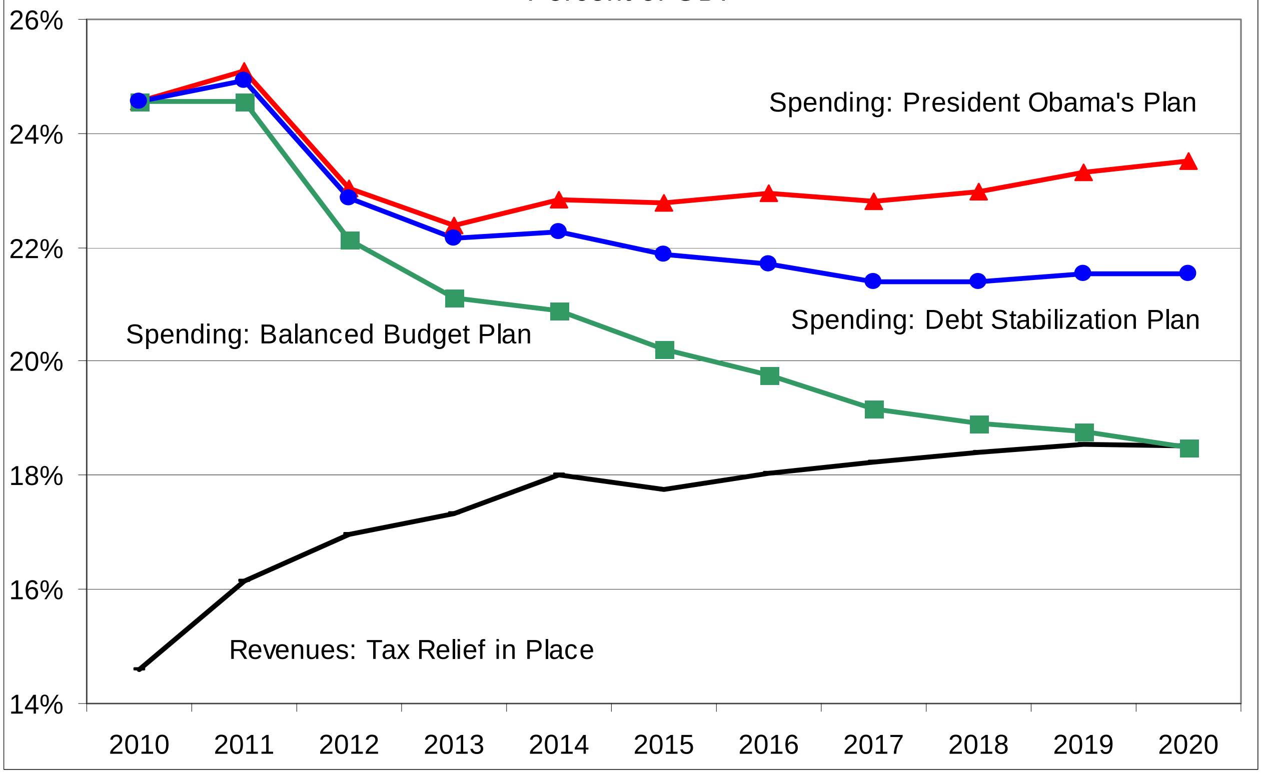
Policymakers shouldn't think of spending cuts as a necessary evil needed to reduce debt. Rather, the government's fiscal mess is an opportunity to make reforms that would spur growth and expand individual freedom. Whether Congress pursues limited spending cuts to stabilize the debt or strives to fully balance the budget, the plan below includes a useful menu of reform options. Most of these reforms are described in greater detail at www.downsizinggovernment.org.

Reducing Spending over 10 Years

This section illustrates how a reduction in spending could eliminate the federal budget deficit over the next 10 years. It shows projections of revenues and spending as a share of GDP based on the Obama administration's most recent budget figures.[4] The projections for revenue are based on the administration's "current policy baseline," which assumes that the 2001 and 2003 income tax cuts, and relief from the alternative minimum tax, are extended. I adjust current policy revenues downward slightly to assume that the tax increases in the 2010 health care law are repealed.

The bottom line in Figure 1 shows that federal revenues with tax relief in place are expected to rise to 18.5 percent of GDP by 2020 as the economy recovers and resumes normal growth.[5] The top line on the chart shows President Obama's proposed spending in his fiscal 2011 budget.[6] As a share of GDP, spending will dip the next few years as funding from the 2009 "stimulus" bill peters out, but then it is expected to rise again toward the end of decade. That high spending path would lead to higher taxes, higher debt, or both.

Figure 1. Projected Federal Revenues and Spending
Percent of GDP



The middle two lines of the chart show spending under the balanced budget plan and the debt stabilization plan. Under the balanced budget plan, spending cuts totaling $1.056 trillion annually by 2020 would be phased in over 10 years.[7] Those cuts would generate substantial interest savings by 2020, and total federal spending would fall to 18.5 percent of GDP—the same level as federal revenues that year. With those cuts, federal public debt would fall from a peak of 71 percent of GDP in 2014 to 61 percent by 2020.

What is the minimum amount that policymakers need to cut spending in order to get federal debt under control? The debt stabilization plan would phase in cuts of $470 billion annually by 2020, which would reduce spending that year to 21.5 percent of GDP, and annual deficits to 3.0 percent of GDP. Those cuts are 45 percent of the size of the cuts under the balanced budget plan. Phasing in cuts of this magnitude would stabilize federal debt at about 76 percent of GDP.

Spending Cut Details

Table 1 lists the proposed cuts for the balanced budget plan. By 2020, those include $474 billion in annual cuts to Medicare, Medicaid, and Social Security, $150 billion in annual cuts to military spending, and $432 billion in annual cuts to other programs. Including interest savings, total spending in 2020 would be about $1.2 trillion lower than projected under the president's budget that year of $5.6 trillion.[8] The spending cuts needed just to stabilize the debt would be 45 percent of the cuts listed here.

As a technical note, most of the figures in Table 1 are outlays for fiscal 2011 from President Obama's most recent budget.[9] The budget shows domestic discretionary spending essentially flat between now and 2020, so I've assumed that the 2011 values of cuts in the table would be the same magnitude in 2020. However, the value of cuts marked with an asterisk would grow over time, and the table shows the estimated values in 2020.

The reforms listed in the table are deeper than the "duplication" and "waste" items often mentioned by federal policymakers, such as earmarks. The reality is that the nation faces a fiscal emergency, and we need to cut hundreds of billions of dollars of "meat" from federal departments, not just the obvious "fat." If the activities to be cut are useful to society, then state governments or private groups should fund them, and those entities would probably be more efficient at doing so.

The particular spending cuts listed in the table are illustrative of how to begin getting the federal budget under control. Further government reforms are needed in addition to these cuts, particularly major structural changes to Medicare. But the important thing is to start cutting right away because the longer reforms are delayed, the deeper the pile of debt the next generation will have to dig out from.

Table 1 includes cuts to individual and business subsidies, cuts to state and local aid, cuts to military expenses, cuts to the growth in entitlement programs, and privatization of federal activities. The sections following the table discuss these types of cuts, and further analysis of the cuts is available at www.downsizinggovernment.org.

Table 1. Proposed Federal Budget Cuts

Agency and Activity	Annual Savings $ billion
Department of Agriculture	
End farm subsidies	28.7
Cut food subsidies by 25 percent	25.6
End rural subsidies	2.6
Total cuts	56.9
Department of Commerce	
End business subsidies	1.8
End economic development subsidies	0.5
Total cuts	2.4
Department of Defense	
Enact Preble/Friedman reforms*	150.0
Department of Education	
End K-12 education subsidies	60.0
End student aid and all other programs	34.0
Total cuts (terminate the department)	94.0
Department of Energy	
End subsidies for renewables	9.5
End subsidies for vehicle technologies	2.9
End the technology loan program	2.3
End electricity research subsidies	2.2
End fossil energy research	1.5
Privatize the power marketing administrations	1.1
End nuclear energy subsidies	0.9
Total cuts	20.3

Department of Health and Human Services	
Block grant Medicaid and freeze spending*	190.0
Repeal 2010 health care law*	87.0
Increase Medicare premiums*	57.0
Cut state and local grants by 50%	40.1
Cut Medicare payment error rate by 50%	24.4
Increase Medicare deductibles*	13.0
Tort reform	10.0
Total cuts	421.5
Department of Housing and Urban Development	
End rental assistance	28.9
End community development subsidies	15.8
End public housing subsidies	9.3
End housing finance and all other programs	(0.9)
Total cuts (terminate the department)	53.1
Department of Justice	
End state and local grants	4.9
Department of Labor	
End employment and training services	4.1
End Job Corps	1.8
End Community Service for Seniors	0.8
Total cuts	6.7
Social Security	
Price index initial benefits (CBO option)	60.0
Raise the normal retirement age (CBO option)	33.0
Total cuts	93.0
Department of Transportation	
End urban transit grants (federal fund savings)	5.2
Privatize air traffic control (federal fund savings)	3.8
Privatize Amtrak and end rail subsidies	3.1
Total cuts	12.1
Department of the Treasury	
Cut earned income tax credit by 50%	24.0
End refundable part of child tax credit	22.5
Total cuts	46.5
Other Savings	
Reform federal worker retirement	18.0
Freeze federal salaries for three years	15.1
Cut the federal civilian workforce 10%	13.2
Cut foreign aid by 50%	12.2
Cut NASA spending by 50%	9.0
Privatize the Corps of Engineers (Civil Works)	6.9
Repeal Davis-Bacon labor rules	6.0
End EPA state and local grants	5.5
End foreign military financing	5.4
End the Small Business Administration	1.4
End the Corp. for Nat. and Community Service	1.0
End subsidies to the Corp. for Public Broadcasting	0.5
End the Neighborhood Reinvestment Corp.	0.3
Total cuts	94.4
Grand total annual spending cuts	$1,055.6

Note: Most data items are outlays for fiscal 2011, but items with * refer to the value of savings in 2020.

Subsidies to Individuals and Businesses

The federal government operates more than 2,000 separate subsidy programs, a doubling of subsidy programs from about 1,000 in the mid-1980s.[10] The *scope* of federal activities has greatly expanded in recent decades, along with the *size* of the federal budget. The federal government subsidizes farm businesses, retirees, school lunches, rural utilities, the energy industry, rental housing, public broadcasting, job training, foreign aid activities, foreign purchases of weapons, urban transit services, and many other types of activities and people.

Each subsidy program costs money, generates a bureaucracy, spawns lobby groups, and encourages more people to demand freebies from the government. Individuals, businesses, and nonprofit groups that become hooked on federal subsidies essentially become tools of the state. They lose their independence, they have less incentive to innovate, and they shy away from criticizing the government.

Table 1 includes cuts to subsidies in agriculture, commerce, energy, housing, foreign aid, and other areas.[11] The table also includes the three reductions to federal employee costs that were part of the Obama Fiscal Commission draft proposal.[12] These cuts wouldn't eliminate all of the unjustified subsidies in the federal budget, but they would be a good start. Government subsidies are like addictive drugs, undermining America's traditions of individual reliance, voluntary charity, and entrepreneurialism.

Aid to State and Local Governments

Under the Constitution, the federal government was assigned specific limited powers, and most government functions were left to the states. To ensure that people understood the limits on federal power, the Framers added the Constitution's Tenth Amendment: "The powers not delegated to the United States by the Constitution, nor prohibited by it to the States, are reserved to the States respectively, or to the people." The amendment embodies federalism, the idea that federal and state governments have separate areas of activity and that federal responsibilities are supposed to be "few and defined," as James Madison noted.

Unfortunately, policymakers and the courts have mainly discarded federalism in recent decades. Congress has undertaken many activities that were traditionally reserved to state and local governments through the mechanism of "grants-in-aid." Grant programs are subsidies that are combined with federal regulatory controls to micromanage state and local activities. In fiscal 2011, federal aid to the states will total $646 billion, which will be distributed through more than 800 separate programs.[13]

The theory behind grants-in-aid is that the federal government can operate programs in the national interest to efficiently solve local problems. However, the federal aid system does not work that way in practice. Most federal politicians are consumed by the competitive scramble to maximize subsidies for their states, regardless of efficiency, fairness, or any appreciation of overall budget limitations.

Furthermore, federal aid stimulates overspending by state governments and creates a web of complex federal regulations that destroy state innovation. At all levels of the aid system, the focus is on regulatory compliance and spending, not on delivering quality public services. The aid system destroys government accountability because each level of government can blame the other levels when programs fail. It is a "triumph of expenditure without responsibility."

The federal aid system is a roundabout funding system for state and local activities. It serves no important economic purpose. By federalizing state and local activities, we are asking Congress to do the impossible—to efficiently plan for the competing needs of a diverse country of more than 300 million people.

The grants-in-aid system should be dramatically cut. Policymakers need to revive federalism and begin to terminate grant programs. Table 1 includes cuts to grants in the areas of agriculture, education, health care, justice, and transportation. The justice grants, for example, are for funding such items as bulletproof vests for local police.[14] There is no reason why such an activity shouldn't be funded at the city or county level.

Military Expenses

Cato Institute defense experts Christopher Preble and Benjamin Friedman have proposed a lengthy list of cuts to U.S. military spending totaling $1.2 trillion over 10 years.[15] By 2020, their proposal would reduce spending by about $150 billion annually, based on a strategy of restraint and reduced intervention abroad.

In proposing their plan, Preble and Friedman argue that the United States would be better off taking a wait-and-see approach to distant threats, while letting friendly nations bear more of the costs of their own defense. They note that U.S. policymakers have supported many extraneous missions for the military aside from the basic requirement to defend the nation. There is no doubt that America's military budget has become very bloated. Even aside from the wars in Iraq and Afghanistan, Department of Defense spending roughly doubled between 2001 and 2011.[16]

Medicare, Medicaid, and Social Security

The projected growth in Medicare, Medicaid, and Social Security is the main cause of America's looming fiscal crisis. Budget experts and policymakers across the political spectrum understand the need to restructure these programs. The reforms listed in Table 1 include repealing the 2010 health care law and some initial efforts to control health care and Social Security costs.

For Social Security, the growth in initial benefits would be indexed to prices rather than wages, which would slow benefit growth over time. The proposal would save about $60 billion annually by 2020 and growing amounts after that, according to the Congressional Budget Office.[17] The plan also includes a CBO option to modestly raise the program's normal retirement age over time.[18]

Medicaid should be converted from an open-ended matching grant program to a block grant, which would provide a fixed amount of funds to each state but allow state policymakers more program flexibility. That was the successful approach used for welfare reform in 1996. Converting Medicaid to a block grant would reduce federal costs, while encouraging innovation and cost reductions by the states. Setting the

Medicaid block grant at the 2011 level of Medicaid spending would save about $190 billion annually by 2020.

The plan includes some modest Medicare changes based on CBO figures, including increasing deductibles for services and increasing premiums for Part B to cover 40 percent of the program's costs.[19] The plan would repeal the 2010 health care law, including the higher revenues and spending, and it assumes that the Medicare improper payment rate, which is at least 10 percent, would be cut in half.

However, much larger reforms to the program are needed. Cato scholars have proposed moving to a system based on individual vouchers, personal savings, and consumer choice for elderly health care.[20] Rep. Paul Ryan (R-WI) has similarly proposed a plan to convert Medicare and Medicaid into consumer-driven health systems.[21] Such reforms would create strong incentives for providers and patients to improve system quality and efficiency.

Privatization

In recent decades, governments around the world have sold off state-owned assets to private investors.[22] Airports, railroads, electric utilities, post offices, and other assets have been privatized. Privatization generally leads to reduced costs, higher-quality services, and increased innovation in formerly moribund government industries.

There are many federal assets that should be privatized. Table 1 includes the privatization of Amtrak, the air traffic control system, and the Army Corps of Engineers. Such reforms would reduce federal budget deficits and help spur economic growth.

Consider the nation's air traffic control system, which is run by the Federal Aviation Administration.[23] The FAA has struggled to expand capacity and upgrade its technology, and its modernization efforts have often fallen behind schedule and gone over budget. Major improvements are needed to the air traffic control system, but there are fears that the FAA is not capable of meeting the rising air travel demand.

The good news is that a number of countries have reformed their air traffic control systems and provide good models for U.S. reforms. Canada privatized its air traffic control system in 1996, setting up a private, nonprofit corporation, Nav Canada. The company is self-supporting from charges on aviation users. The Canadian system has received high marks for sound finances, solid management, and investment in new technologies.[24] Aside from those advantages, a privatized system in the United States would save about $4 billion in annual general fund taxpayer costs.

Conclusions

Official projections show that without reforms federal spending will soar to more than 40 percent of GDP by 2050, and even higher after that. State and local government spending would come on top of that, with the result that governments would consume more than half of the entire U.S. economy.

However, it seems inconceivable that voters and taxpayers would let the government grow to anywhere near that large. Indeed, the results of the 2010 elections indicate that there is already widespread disapproval of big government. It is also unlikely that the government would be able to raise taxes much above current levels to support higher spending because of our increasingly globalized economy.[25]

The upshot is that we will have to make major spending cuts sooner or later, and it would be better to make them sooner, before we accumulate even more debt. Policymakers can start with the menu of cuts presented here, and then they should pursue other reforms such as restructuring Medicare. Leaders of other industrial nations have pursued vigorous cost-cutting when their nations' debt started getting out of control, and there is no reason why our political leaders shouldn't do the same.

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[1] See www.fiscalcommission.gov.

[2] See the "current policy baseline" in *Budget of the U.S. Government, Fiscal Year 2011, Mid-Session Review* (Washington: Government Printing Office, July 23, 2010). I've reduced current policy revenues by assuming that the tax increases in the 2010 health care law are repealed.

[3] See www.cato-at-liberty.org/cutting-government-the-canadian-way.

[4] *Budget of the U.S. Government, Fiscal Year 2011, Mid-Session Review* (Washington: Government Printing Office, July 23, 2010).
[5] This is the administration's "current policy baseline" for revenues, adjusted for the repeal of the 2010 health care law. See *Budget of the U.S. Government, Fiscal Year 2011, Mid-Session Review* (Washington: Government Printing Office, July 23, 2010), Table S-3.
[6] *Budget of the U.S. Government, Fiscal Year 2011, Mid-Session Review* (Washington: Government Printing Office, July 23, 2010).
[7] In particular, I assume that discretionary spending cuts are phased-in over 10 years, one-tenth each year. The proposed changes to Medicaid, Medicare, and Social Security would begin right away, but the savings would increase over time.
[8] Note that my estimated interest cost savings are conservative compared to other recent deficit-reduction plans.
[9] In particular, see *Budget of the U.S. Government, Fiscal Year 2011, Analytical Perspectives* (Washington: Government Printing Office, July 23, 2010), Table 33-1.
[10] See www.cato-at-liberty.org/federal-subsidy-programs-top-2000. And see www.cfda.org.
[11] The foreign aid cut would halve the budget category "International Assistance Programs."
[12] The Obama commission draft report included a three-year freeze on salaries, a reduction in the federal workforce by 10 percent, and reforms of worker retirement. The dollar value in the table for the former two cuts is for 2015, and the latter cut is for 2020.
[13] *Budget of the U.S. Government, Fiscal Year 2011, Analytical Perspectives* (Washington: Government Printing Office, 2010), p. 254; and see Chris Edwards, "Federal Aid to the States," Cato Institute Policy Analysis no. 593, May 22, 2007. Note that these 800 aid programs are a component of the 2,000 total subsidy programs mentioned earlier.
[14] See www.ojp.usdoj.gov/bvpbasi.
[15] See www.downsizinggovernment.org/defense.
[16] Aside from the costs of the Iraq and Afghanistan wars, Department of Defense spending will be about $560 billion in fiscal 2011, up from $290 billion in fiscal 2001.
[17] Congressional Budget Office, "Budget Options: Volume 2," August 2009, p. 143.
[18] Congressional Budget Office, "Budget Options: Volume 2," August 2009, p. 145.
[19] The savings for these options are based on estimates in Congressional Budget Office, "Budget Options: Volume 1," December 2008. See options 83 and 87.
[20] See www.downsizinggovernment.org/hhs.
[21] Rep. Paul Ryan (R-WI), House Committee on the Budget, "A Roadmap for America's Future, Version 2.0," January 2010.
[22] For further discussion, see www.downsizinggovernment.org/privatization.
[23] See www.downsizinggovernment.org/transportation/airports-atc.
[24] See Glen McDougall and Alasdair S. Roberts, "Commercializing Air Traffic Control: Have the Reforms Worked?" Suffolk University Law School, February 17, 2009; and Joel Bagnole, "How Canada Gets Jets Across the Sea," *Wall Street Journal,* May 9, 2002, p. A12.
[25] This theme is explored in Chris Edwards and Daniel Mitchell, *Global Tax Revolution* (Washington: Cato Institute, 2008).