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INITIALS: RUL DATE: 07/03/14

TO: **Hillary Rodham Clinton**
RE: **Medicare/Medicaid and the budget**
DT: **12/14/94**
cc: **Melanne**

In this morning's budget discussion, Alice will lay out where we fall short in achieving the current goals of a tax cut (approximately $50 billion), a worker retraining initiative (approximately $25 billion), and avoiding a deficit problem. Apparently, we face a significant shortfall (particularly when you consider some of our possible assumed savings are unlikely to be politically viable), which will require painful decisions -- decisions that may bring back into play some significant cuts in Medicare and, possibly, Medicaid.

I believe one of the desires of this (and/or previous) meetings has been to come to closure on exactly what is the size/scope of the tax cut, so that the President can talk about it with some specificity on Thursday. The one point I think is important to emphasize is that publicizing a specific number may well signficantly constrain our budget options and may push us to look at significant cuts in the health entitlements for financing. **My primary point here is to suggest that, if finalizing a tax cut policy has the potential to drive other budget numbers, you may consider asking what implications any such decision has on health care savings proposals. For example, does this by definition tie our hands into any specific funding need from the health programs beyond the extenders and, if so, what are the specific implifications in terms of dollars necessary and impact on health policy politics (whether for our budget or in future negotiations on the Hill).**

It is now clear that, as far as Leon and OMB are concerned, both sets of Medicare extenders [$19 billion over 5 years and $125 over 10 years] that we have been talking about as possible health reform financing sources are already being assumed in the budget baseline. In other words, these Medicare savings are being used as funding sources for the non-health care spenders or to help reduce the deficit problem.

Because of the budget pressures, it does not come as a surprise that these extenders are apparently being assumed for non-health purposes in the budget baseline (although some of our supporters, including Senator Kennedy -- who just met with the President today, will be upset). What would create disproportionately greater problems is a move for significantly greater cuts from Medicare and possibly Medicaid to address real or perceived shortfalls.

Apparently Alice will be presenting a whole range of Medicare and Medicaid savings that may amount to over 85 billion dollars more OVER 5 years. I believe she is preparing this information because (1) she thinks we should be placing these on the table now so that we can define ourselves in terms of being willing to step up to the plate and show our desire to both reduce the deficit and have small investments in health reform; (2) she believes Leon and Bob are open to additional Medicare (particularly provider) cuts; (3) she has heard Laura talk about the possible need for an entitlement summit and possible implications of a small Medicare entitlement cap; and (4) she thinks we need money or at least more options on the table to make the numbers eventually work out.

The fears I have about Alice's presentation can be narrowed to one word: **LEAKS. If there is any public perception that we are talking about major Medicare/Medicaid cuts (particularly if they are not signficantly redirected for reform), we will hear a major outcry from our traditional base of consumer advocates and the elderly, the hospitals, and many other providers.** I would like to suggest that you emphasize this point.

You may also want to ask her when we will have the new Medicare/Medicaid baseline numbers incorporated into the baseline (which apparently will lower the deficit -- perhaps by tens of billions of dollars -- and thus hopefully reduce pressure on us to cut programs for deficit reduction). [She is pushing HHS for these numbers now, but their absence means that we will have to recalibrate our deficit numbers and proposed savings numbers in a very short period of time].

Lastly, it is possible that the subject of a Medicaid block grant or other Medicaid savings proposals may come up. There may be some political and policy appeal to these proposals. Because of the states strong desire for flexibility and the Governors ongoing discussions with the Republicans (and the President), the President may understandably be somewhat intrigued. As you know, however, there are tremendous implications with proposals such as these and I would only ask that we have an informed discussion on the matter preceeded by a DPC/NEC Map Group meeting to help us prepare.

In case the Medicaid blockgrant issue is raised, I am attaching some background information and some pros & cons on it for your use. (I do this although I understand from Melanne's intelligence that most of the budget participants -- other than Gene and perhaps the President -- are not seriously focusing on this proposal at this point).

I am sure I am giving you too much, but I thought this information might be helpful for both the morning budget meeting (if you go) and your afternoon meeting with Bob, Alice and Laura.

MEDICAID PROGRAM AND POSSIBLE BLOCK GRANT

Background on Medicaid

The Medicaid program provides acute health care and long term care services to low-income families, the disabled, and the elderly. The program is jointly funded by the federal government and the states, with the federal "match" varying from 50% to 78% depending on average income in a state.

Any low-income family receiving AFDC, or elderly or disabled person receiving SSI, is automatically eligible for Medicaid. Certain categorical groups not eligible for cash assistance -- including low-income pregnant women and children -- may also eligible for Medicaid, with income thresholds generally varying from state to state.

Certain services and eligibility levels are specified in federal law, while others are funded on a matched basis by the federal government at the option of states.

Where Medicaid Dollars Go

- Medicaid is a program that serves five groups of people:
  - Low income mothers
  - Children
  - Non-elderly disabled people get health insurance and long-term care.
  - Poor elderly people get Medigap-like insurance to supplement Medicare.
  - Disabled elderly get long-term care.

- A disproportionate share of Medicaid funds are spent on elderly and disabled people:
  - Low income kids and adults account for 73.1% of Medicaid enrollees, but consume only 32.8% of total Medicaid spending.
  - Nonelderly disabled people comprise only 15.5% of Medicaid enrollees, but account for 38.7% of spending.
  - Elderly people make up only 11.5% of Medicaid enrollees, but account for 28.4% of spending.

- The Medicaid program is projected to grow at about 10.5% annually through the end of the decade (this may change slightly with new baseline). About two-fifths of the growth is projected growth in enrollment.
  - The disabled population on Medicaid is projected to grow by 8.2% per year.
  - The welfare population is projected to grow by less than 2% per year.
  - Enrollment in Medicaid of non-welfare children under poverty is projected to grow at 4% per year.

- The increase in per capita spending for Medicaid beneficiaries is projected to be about 6.5% annually; about the same as the projected per capita increase for private health insurance.

A Medicaid Block Grant

The Republicans, as part of their budget proposal, are likely to propose significant cuts in the Medicaid program. To be better able to influence the debate on this issue, it has been argued that the administration needs to propose some cuts in Medicaid as part of its budget. One option that has been put forward is for the administration to propose a Medicaid block grant.

Under a Medicaid block grant, the program could remain an entitlement, but it would be an entitlement to states rather than to individuals. The block grant would grow each year at a defined rate; to produce federal savings, the rate of growth would have to be lower than current federal projections. States would likely have broad flexibility to determine what kinds of services to provide and who receives them.

Arguments For a Block Grant Proposal

- Would permit the Administration to propose significant reductions in federal Medicaid spending (by capping growth in total spending) without identifying specific cuts that would provoke significant opposition.

- Proposing some reductions in Medicaid demonstrates the administration's commitment to re-evaluating existing government programs and allows the administration to oppose more significant cuts without being perceived as defending the status quo.

- Would provide states with relief from unfunded mandates.

- Would give states greater flexibility to respond to local circumstances.

- States willing to increase spending would have broad flexibility under a block grant approach to pursue strategies to reform their health care systems.

- A block grant proposal may be popular with governors.

<u>Arguments Against a Block Grant Proposal</u>

- Significant reductions in Medicaid would very likely lead to reductions in coverage or services.

  Medicaid is growing faster than private health spending because of enrollment growth -- not program inefficiency. (The per capita growth in Medicaid is about the same the per capita growth in private health insurance). There is no reason to expect that the Medicaid program can contain costs more successfully than the private sector. As a result, capping the program to achieve significant savings (e.g., Medicaid population plus general CPI) would inevitably lead to reductions in coverage or services.

- Proposing a cap on Medicaid (with or without a block grant) would provoke vocal criticism from many groups that are part of the Democratic base. And, despite the welfare image of the program, 67% of all Medicaid spending is for the elderly, blind, and disabled. A block grant proposal could engender significant opposition from these groups.

- Some states may atempt to control costs through further cuts in provider payments, which could reduce access or shift costs to the private sector.

- The administration has criticized the Republicans for failure to be specific in many of their budget and tax proposals. We may be subject to the same charge if we go with something that looks like a cap.

- The process of determining how much each state gets, how much the block grant increases over time, whether DSH continues, and what strings may be attached will be controversial and will pit some states against others.

- Block grants eliminate the federal floor for Medicaid eligibility and services and encourage states to reduce their programs to avoid becoming magnets for the poor and sick.

ISSUES RELATING TO THE BUDGET

This memo covers the following areas: turning Medicaid into a block grant; the middle-class tax cut; investments; and thinking strategically about budget cuts. I have limited knowledge of what's under consideration now and thus can't comment on other issues.

I. Medicaid Block Grant

An option has been developed to turn Medicaid into a block grant and cap it so it grows at 7% to 8% per year (rather than at the higher rates at which it is currently projected to grow). This is a very unwise idea for both substantive and political reasons.

Substantive Problems

- Absent strong action to reduce the rate of growth in costs throughout the U. S. health care system, this proposal would compel states to make large cuts in Medicaid eligibility and/or services. *The strong likelihood is that the number of uninsured would rise significantly as a result.*

- The proposal's proponents apparently argue that the rate of growth in Medicaid costs — projected at about 12% — is too high, and states should be able to bring it down to 7% or 8%. This argument misses several points. First, the 12 percent rate of growth in Medicaid costs is due not only to the rise in health care costs throughout the U. S. health care system but also to growth in the Medicaid beneficiary population. The number of beneficiaries is growing at a rate of about four percent per year, for three reasons: 1) federal requirements that states cover more poor children each year; 2) the steady growth in the number of disabled people; and 3) the steady increase in the number of low-income people who apply for Medicaid when they lose employer-based coverage. Many states are already moving aggressively to control the costs of health services reimbursed under Medicaid by shifting to managed care. To slow overall growth further so it is 7% or 8%, the first step that many states would likely take — if freed from federal Medical requirements — would be to reduce, or slow the increase in, the number of beneficiaries. That would most certainly mean more uninsured people — and in particular, more uninsured children.

Of particular concern is the fact that the most important advance in health care coverage for children over the past decade — the federally mandated extension of Medicaid to cover virtually all low-income pregnant women and young children and (by 2002) virtually all poor children through age 18 — would be in serious jeopardy. The federal requirement would disappear under the proposed block grant, and this would be a likely place for states to cut back.

- Also in jeopardy would be the federal requirement that states provide Early Periodic Screening, Diagnosis, and Treatment (EPSDT) exams for children in Medicaid and provide Medicaid coverage for medical problems uncovered by the EPSDT exams. This requirement, also, would be dropped under a block grant.

- Another group likely to be adversely affected would be elderly poor people who are not on SSI. Federal law requires that Medicaid help pay the ever-mounting Medicare premiums, deductibles, and co-payments that these low-income elderly face. Under the proposed block grant, many states could be expected to pare back or drop this coverage.

- Yet another problem is that Medicaid coverage would have to be cut back sharply during recessions. Under the current entitlement structure, increased federal Medicaid matching funds automatically become available when state Medicaid caseloads and costs rise during recessions. Under a block grant, a state's federal Medicaid funding for a year would be fixed; no additional funds would be provided if a recession hit. If the economy turned down, many states would be forced to put new Medicaid applicants (such as poor children in newly unemployed families) on waiting lists for Medicaid.

- Also, if a formula were developed to allocate block grant funds among states, still another problem could arise. Some states would be big "losers," while other would be "winners."

Political Problems

- This proposal would be seen as an Administration flip-flop. One year, the President proposes universal coverage. The next year, he proposes changes that would swell the ranks of the uninsured.

- As a result, this would likely be seen as crass political repositioning on the part of the President. That would intensify the already too-widespread view that he lacks core beliefs and is essentially a pol who doesn't stand for basic principles.

- It would anger the groups that supported the White House on health care reform. It would antagonize governors as well. It's hard to figure out who would like the proposal.

II. Middle-Class Tax Cut

I understand the political need to propose a middle-class tax cut. The question is how to design it and how to pay for it. Here are some thoughts.

- Keep the tax cut as modest as possible consistent with achieving its political goals. The Administration's tax cut will be a starting point, from which the size of the tax cut will grow on Capitol Hill. And with the balanced budget constitutional amendment likely to pass — and Social Security and defense off-limits — a large tax cut will make the reductions in other parts of the budget even more excruciating as we approach 2002. (2002 is the year the budget has to be balanced under the proposed constitutional amendment.)

- Draw a firm line so high-income people don't get the tax cut. I gather the White House plans to do this.

- Provide the tax cut in the form of a tax credit rather than in the form of an increase in the personal exemption or an expansion of eligibility for Individual Retirement Accounts (IRAs). A tax credit provides the same amount of tax relief to a family at $20,000 as to a family at $75,000. By contrast, an increase in the personal exemption is worth nearly twice as much to upper-middle income families in the 28% tax bracket as to lower-middle and middle-income families in the 15% bracket. Expanding IRAs is the least desirable of these approaches. IRA tax breaks are already available to families with incomes up to $50,000 (about 70% of families). A proposal to expand the IRA tax break would principally benefit those at higher income levels. Moreover, average middle-income families can't afford to put much into IRA accounts, while more affluent families can. The data showing that the expanded IRA tax bracket would be of little value to typical middle-income families are strong. (There may also be other middle-class tax cut options under consideration. I'm not aware of the specific tax cut proposals being considered.)

For both political and policy reasons, the Administration shouldn't propose a tax cut that benefits upper-middle income families more than families right in the middle of the income spectrum or hard-working families in the lower-middle class.

- If the tax cut is provided in the form of a tax credit, the credit should be at least partially "refundable." A refundable tax credit is one, like the earned income credit, that provides a payment to families that qualify for it but have incomes too low to owe income tax. A *non*-refundable credit does not provide a payment to those owing no tax. A substantial fraction of families with children owe no income tax and would not benefit from a middle-class tax cut provided as a non-refundable credit. (They also would not benefit from an increase in the personal exemption or expanded IRAs.) On the other hand, may of these families are benefitting from the expansion of the earned income credit.

  Making a tax credit fully refundable probably increases its cost too much, but there are lower-cost options that involve partial refundability. The children's tax credit in the Contract with America is refundable to a very limited degree. If it proposes a tax credit, the White House might consider including at least as much refundability as the Contract 's tax proposal does.

Paying for the Tax Cut

Under current law, a tax cut must be paid for through offsetting cuts in entitlements or increases in taxes. I understand that one option now under consideration calls for changing the budget laws so that the savings from lowering the cap on discretionary (i.e., non-entitlement) programs can be used to pay for tax cuts.

I believe this would be a dangerous route to follow. Once the Administration proposes changing the budget law to allow cuts in discretionary programs to be used to pay for tax cuts, the Republicans will seize upon it. They are likely to cut discretionary programs substantially deeper than the Administration proposes to do — and to use the additional savings to help fund larger tax cuts. This is a pattern that could be repeated in subsequent years.

Since the current budget structure was enacted in 1990, the requirement that a tax cut be paid for by an entitlement cut or a tax increase has worked extremely well in restraining tax-cutting. To abandon this procedure just when the Republicans are searching for ways to finance their rather massive tax cuts would, in my view, be folly. To balance the budget in seven years without touching defense or Social Security or raising taxes — as the Republicans propose to do — will require devastating reductions over the next seven years in the discretionary side of the budget. These reductions will dwarf the largest cuts Ronald Reagan ever proposed. Allowing discretionary cuts to pay for tax cuts will likely lead to still-larger tax cuts and still-deeper discretionary cuts in the years ahead and make this problem more severe.

It is understandable that the White House would feel a strong temptation to follow this route. It makes it easier to pay for a larger middle-class tax cut. But the long-term consequences for children's programs and other discretionary programs are serious.

III. Investments

The Republican Congress is likely to reject many of the Clinton investments. I would recommend having a shorter list of investments than in last year's budget, choosing the investments carefully, and picking several of the investments proposed in the budget to fight for visibly.

Among the investments I would keep in the President's budget are Head Start and WIC. I understand that the "passback" to HHS and USDA shortly before Thanksgiving included an increase of $400 million for Head Start and $350 million for WIC. I think those are very reasonable numbers. I hope they have not been reduced since late November.

I don't know enough about what the budget contains for other investments or children's programs to offer comments on them.

IV. Larger Strategy Questions

One final concern. I hope the White House is considering which elements of the Contract it most wants to beat and what allies it needs to do so. The question then arises of whether any of the cuts proposed in the budget would undermine such alliances. In other words, are there any budget cuts under consideration that would jeopardize larger, more important Administration goals and priorities? I don't know whether the White House is pursuing these questions in fashioning its budget cuts.

December 13, 1994

CUT-AND-INVEST TO COMPETE AND WIN

A Budget Strategy for American Growth

I. Introduction

This year's debate over the federal budget could provide President Clinton and Congress with a second chance to enact an authentic economic-growth program that can help restore America's competitiveness in the world economy.

To do so, the President and Congress will have to take new and decisive account of the central economic development of our time, the development of mature, global markets in both capital and commerce. To enable American workers and companies to better compete in the churning environment of global markets, production and investment, the federal government should become both more active *and* more self-disciplined. Americans must invest aggressively through the government in the national resources that genuinely make an economy more productive. But as taxpayers and consumers, Americans also must insist that government end the special spending programs, tax breaks and trade and regulatory protections that subsidize politically powerful industries and insulate them from the powerful market forces of the global economy.

The first step requires re-evaluating our current economic paradigms. Even in this period of tumultuous economic change, most liberals and conservatives have maintained faith in some version of conventional tax-and-spend macroeconomics. Many liberals, especially traditional Keynesians, focus on increasing spending and, when necessary, taxes too; many conservatives, especially supply-siders, concentrate on cutting taxes and, when possible, spending as well. But these gross approaches almost always miss the critical economic target: higher growth. The Keynesians' conviction that deficit spending will spur domestic production and drive broad-based growth is hopelessly outdated in a world where every store stocks imported goods and governments no longer control capital flows. The alternative from the right, hands-off government, is equally obsolete at a time when American workers compete with low-wage foreign labor and U.S. companies face foreign producers generously supported by their governments.

For both fiscal policy in particular and economic policy in general, tax-and-spend economics has to give way to a new growth strategy of *cut-and-invest*. The new approach recognizes that different kinds of spending and taxes have different implications, positive and negative, for growth, because global competition puts as high a premium on the *quality* of public spending and taxes as on their *quantity*.

We have to ensure that our workers and firms have the means to be more productive and resourceful in competitive world markets. As President Clinton pledged, the government should expand public investment that supports productivity and innovation throughout the economy, and which therefore directly affects our competitiveness with other economies. The basic building blocks include workers' education and skills, basic research for new technologies and the primary transportation networks that link firms, workers and customers into markets.

Greater *private* investment also is needed to upgrade the training, technologies and infrastructure systems *specific to each industry*. Government can best help here by actively promoting greater capital formation. Except during recessions, federal expenditures should always grow more slowly than the private economy -- the main achievement of President Clinton's 1993 budget battle. In addition, Washington has to maintain anti-inflationary monetary policy and should encourage greater private savings with more consumption-based taxes.

An authentic growth and competitiveness strategy has to maintain a clear and convincing distinction between genuine public investments and other federal spending that, worthy or not, may have to be restrained. Public investment *is* different. Its only purpose is to expand the private economy's capacity to create wealth. It is called for only in the specific areas where markets invariably fail to generate suitable private investment -- principally, once again, education and worker training, basic research and economic infrastructure. As a general rule, new federal borrowing should be limited to these genuine investments, which over time should pay for themselves by increasing growth and expanding the tax base. Other purposes also may be compelling, from health care to law enforcement, and we should meet those needs by paying for them as they occur.

This distinction between investments and other spending provides three principles for economically-sound budgeting:

* Divide the budget into two separate accounts: one for public economic investments; the second for everything else from entitlement transfers and defense to interest payments and government operations;

* Require an annual balanced budget for all *net non-investment* spending, except during recessions;

* Ensure that annual federal spending grows no faster than the private economy, except during recessions.

Until the current deficit declines to the range of the *net* investment budget, we will have to fund new public investment by cutting other federal spending. These cuts can and should start with the scores of public spending and tax subsidies that insulate particular industries from healthy market pressures to upgrade. By eliminating these wasteful programs that impair our growth, we will be able to fund investments that spur growth.

If a national economy were self-sufficient, the various spending and tax subsidies for particular sectors would be relatively benign. But in a world of global production, capital and commerce, these subsidies eventually erode the competitive position of both the industries receiving them *and* those that don't. The capacity of a firm, an industry and a nation to improve its productivity and to innovate efficiently is the most critical factor in determining its global competitiveness, against both lower-wage rivals and other advanced economies. Spending and tax subsidies, along with trade protections and certain forms of economic regulation, all shield domestic industries from the global market competition that drives their foreign rivals to upgrade their products and production. Subsidies and protections, therefore, ultimately leave their beneficiaries *less* able to succeed. As for other unsubsidized domestic sectors, these policies place them at a competitive disadvantage relative to subsidized industries, because the subsidies lower their costs of capital and labor. And in a global economy, firms forced to operate at a disadvantage at home will often move some operations and jobs abroad, where labor or materials are cheaper or subsidies are available.

Far from contracting the economy, selective spending restraint and tax reforms can contribute to growth *if* they target those programs that weaken the economic forces driving national competitiveness. Most of these subsidies and protections stem not from economic logic but from political influence. From farm supports and tax breaks for oil and gas firms, to textile quotas and telecommunications regulation, these special industry entitlements force taxpayers, consumers and businesses to transfer more resources to influential sectors than markets would otherwise require. This subsidy regime is also profoundly regressive, since the ultimate beneficiaries of these spending and tax transfers are the shareholders in the subsidized industries.

Some subsidies and regulations, however, serve compelling social purposes; and growth policy does *not* dictate, as many conservatives suggest, that government should stop supporting childhood immunization, end tax incentives for middle-class home ownership or suspend health and safety regulation. Becoming more competitive requires phasing-out provisions that artificially raise returns for industries with political clout, but for no overriding social end.

A serious effort to promote higher growth and American competitiveness will require the President and a majority in Congress to take on the Washington establishment. The commitment to do so is the political heart of a new economic reform agenda. Yet despite the potential effectiveness of a cut-and-invest program, the tax-and-spend paradigm maintains its firm hold on Washington -- as demonstrated recently by a failed effort to cut projected spending by $90 billion over five years, led by Reps. Tim Penny and John Kasich. Liberal opponents objected to virtually any spending restraint, while conservatives insisted that all savings go only for deficit reduction. The cut-and-invest alternative eluded both sides of the debate: cut unproductive spending and use part of the savings for the President's investment agenda, part for the deficit, and part for social reforms from health care and welfare to tax relief for families with children.

In the end, we can finance the public investments that the national economy needs in only three ways: higher deficits, higher taxes, or spending and tax subsidy cuts. Higher deficits won't work because they would force up interest rates and so force *down* growth and investment. Higher taxes would dampen investment and trigger a political revolt if they fell on the middle class. By cutting special-interest spending and tax subsidies, we get the resources to improve the infrastructure, train workers, expand research, *and* strengthen competition throughout the economy.

The cut-and-invest strategy represents a new, progressive approach for economic policy in a global economy. It seeks to remove the dead hand of obsolete subsidies from workers and companies striving to succeed. It aims to halt legally-mandated transfers from average people to the shareholders of influential industries. It offers an economically-sound alternative to the balanced budget amendment. And it would promote a growing economy, which ultimately is the best support and protection the government can provide to any industry.

This strategy begins with a rigorous accounting of all industry-specific spending and tax subsidies. This report identifies as candidates for this accounting about $114 billion in spending over five years and some $111 billion in tax provisions. Every one of these provisions has been long protected by skillful lobbying and local pressure. To break this gridlock, Congress should establish a Commission on National Competitiveness and Industry Subsidies modeled on the Base Closing Commission. The Commission would evaluate these spending and tax provisions and recommend a package of reforms that the President could submit to Congress. Congress should have to vote the package up-or-down without amendment.

This strategy plainly can provide means for financing a serious program of progressive economic and social reforms. This report proposes roughly $100 billion in additional public investment over five years, leaving sufficient resources to also advance reforms in welfare and law enforcement, provide a measure of middle-class tax relief *and* make more progress on the deficit. This approach also will permit us to dedicate additional budget savings from entitlement reforms, such as those proposed by the Progressive Policy Institute last year in *Mandate for Change*, to health-care reform.[1]

II. The United States in the Global Economy: The Crisis of Slow Growth

The serious problems with U.S. competitiveness are evident in the economy's long-term substandard performance. Through the 1970s and 1980s, the key measures of the economy's capacity to create new wealth -- average annual rates of growth in net investment, productivity and income gains, and total output -- all deteriorated by one-third to one-half, compared with the 1950s and 1960s (see Table 1).

Table 1. Performance of the U.S. Economy, Basic Measures
Average Annual Rates of Growth

Years	GNP	Productivity	Net Investment	Median Income
1950s	3.5%	2.9%	NA	3.4%
1960s	4.1%	3.0%	7.0%	3.6%
1970s	2.8%	1.5%	5.8%	1.1%
1980s	2.5%	1.2%	2.3%	0.9%

Sources: GNP: *Economic Report of the President*, Jan. 1993, Table B-2. Productivity: Department of Labor data for 1949-58; *Economic Report*, Table B-44 for later years. Net investment: *National Income & Product Accounts*, Table 5-3, and *Economic Report*, Table B-15. Median Income: U.S. Department of Commerce, Census Bureau data.

This weak economic performance has virtually halted progress in living standards for most Americans. In the 1950s and 1960s, vigorous growth supported genuine upward mobility. A 20- or 30-year-old who began working in 1950 found a generation later, in 1970, that his income had doubled, even after taking account of inflation and the costs of raising a child. Compare that with the income gains of the average 20- or 30-year-old who started working in 1970. A generation later in 1990, his inflation-adjusted income was barely more than when he started, after deducting the cost of a child. Twenty years of slow growth has produced an economy that offers most Americans little more than the equivalent of running in place (see Table 2).

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[1] These reforms involve a new approach to means-testing and an increase in the retirement age for Social Security and other federal pensions. We propose limiting entitlement spending and related tax benefits for high-income groups that now receive a larger share of the total benefits than their share of the population: Social Security and other federal pensions for people with incomes over $100,000; retirement-related tax benefits for those with incomes over $75,000; health-related tax benefits for those with incomes over $100,000; and Medicare recipients with incomes over $200,000. These reforms would raise $10 billion to $15 billion a year. We also urge Congress to examine raising the Social Security retirement age to 67 by the year 2008, instead of 2027 as under current law. This would raise $60 billion over two decades. See Robert Shapiro, "Enterprise Economics and the Federal Budget," *Mandate for Change*, pp. 21-51, Will Marshall and Martin Schram, eds., Berkley Books, 1992.

Table 2. Americans' Real Income Gains by Age

	Age 20-29		*Age 30-39*		*Age 40-49*	
	Annual	Decade	Annual	Decade	Annual	Decade
1950s	6.4%	85.7%	3.9%	46.0%	3.5%	40.7%
1960s	5.2%	65.3%	3.7%	43.1%	3.5%	40.4%
1970s	3.6%	42.7%	2.1%	22.9%	1.7%	18.8%
1980s	3.8%	45.6%	2.7%	30.4%	2.4%	27.3%

Source: Author's calculations from Census Bureau Data.

Slow growth did not affect all Americans equally. The 15 percent of workers with professional or managerial jobs saw their inflation-adjusted incomes continue to rise at the healthy rates of 4 to 6 percent a year that nearly everyone achieved in the previous generation. And the incomes of the richest 1 to 2 percent, those with large holdings in stocks, bonds and real estate, grew by more than 75 percent after inflation in the 1980s.[2] With overall, average real income growth of only about 1 percent a year over the 20 years, the strong performance by those at or near the top leaves only meager income gains for most other Americans.

America is not alone in this predicament; most other advanced economies grew little or no faster in the 1970s and 1980s. The International Monetary Fund reports that from 1975 to 1992, real output expanded even more slowly in Germany, France and Britain than in America, and the Canadian and Italian economies performed only marginally better. Among the major advanced economies, only Japan managed to sustain robust growth, averaging about 4 percent a year since 1975 -- until 1992.[3]

Moreover, much of America's growth in the 1970s and 1980s came from an influx of new labor, mainly women and immigrants, while investment and productivity lagged. As a result, by some measures most other advanced economies out-performed the U.S. In 1990, Germany and Japan both produced more wealth per person than we did, and France was close behind. In productivity (GDP per worker), Japan, Germany, France and Italy all led the United States. And our savings rate and trade balance have long been the worst of the advanced nations (see Table 3).

[2] Several factors account for these disproportionate gains by wealthy people. For example, as any economy matures the share of its national income earned by capital increases. The most crucial factors, however, were federal tax and regulatory policies that artificially raised the post-tax rate of return on capital -- tax benefits for real-estate partnerships, lower tax rate on high incomes, high real interest rates, and feverish merger-and-acquisition activity that drove up equity prices.

[3] International Monetary Fund, *World Economic Outlook*, October 1993, Table A1.

Table 3. Economic Performance, U.S. versus Other Advanced Economies

	Wealth/Person, (Per-capita GDP)	Productivity, 1990 (Per-worker GDP)	Natl. Savings Rate, 1990	Trade Balance 1990, % of GDP
U.S.	$21,449	$43,211	2.2%	-1.5%
Japan	$23,822	$46,098	20.5%	0.7%
Germany	$23,536	$49,891	12.7%	5.5%
France	$21,105	$49,764	8.5%	0.0%
Italy	$18,921	$45,940	7.4%	0.0%

Source: *OECD in Figures*, Supplement to *OECD Observer*, No. 176, June/July 1992. GNP: pp. 24-25; productivity: pp. 8-9, 24-25; savings: pp. 24-25; trade: pp. 60-61.

The problem of slow growth does not afflict every nation. Since 1973 scores of developing and newly industrializing countries have maintained high growth. Overall, non-advanced economies have expanded nearly twice as fast as G-7 nations, averaging 4.2 percent a year for 20 years. Asia's non-advanced economies have expanded nearly *three* times faster than the G-7 -- 50 percent faster than even Japan.

Table 4. Global Real Growth Rates

	Total Growth 1975-1992	**Average Annual Growth 1975-1992**
World	74.7%	3.2%
Advanced economies	58.0%	2.6%
U.S.	53.9%	2.4%
Japan	108.8%	4.0%
Germany	48.5%	2.2%
France	50.1%	2.3%
Italy	55.8%	2.5%
U.K.	38.1%	1.8%
Canada	64.2%	2.8%
Other advanced*	47.9%	2.2%
Non-advanced economies	127.7%	4.7%
Non-advanced Asian	217.9%	6.6%

* Australia, Austria, Belgium, Denmark, Finland, Greece, Iceland, Ireland, Luxembourg, Netherlands, New Zealand, Norway, Portugal, Spain, Sweden, Switzerland.

Source: Calculations by M. Jeff Hamond from *World Economic Outlook*, International Monetary Fund, October 1993, Tables A1, A2.

By 1990, for the first time in history, the world's developing and newly industrializing economies produced more total output than the three largest advanced economies combined -- the U.S., Japan, and Germany.

Global markets and the terms of competition

These developments point to a clear and certain conclusion: America's economic performance is inextricably tied to the global economy. *The most fundamental issues for U.S. economic policy in the 1990s and beyond arise from the costs and opportunities produced by global capital, commerce, and markets.*

In certain respects, the global economy is as old as international trade. Over the last 20 years, however, vast advances in the speed, efficiency and reach of international communications and transportation infrastructure systems have opened up most national economies to countless foreign economic forces and actors. These developments have reorganized national and international markets and changed the basic terms of economic competition.

The heart of the U.S. competitiveness problem lies in our responses to these changes. A generation ago, most large U.S. firms could compete using American capital, labor, materials and other resources to produce standard goods and services at the lowest cost for our national market. In this competition, foreign firms, foreign capital, foreign resources and foreign markets all played relatively minor roles. Today, America's large firms, like their counterparts around the world, must compete with rivals drawing on different and sometimes superior resources, including labor, technology and infrastructure. In this competition, we must use materials, production facilities and other resources located thousands of miles from our own market. Capital, too, is drawn from and shared by the entire world. Perhaps most important, the new global markets for goods and services are vastly different from the roughly uniform domestic markets of the 1950s and 1960s. They are an assemblage of market segments that provide new sources for every factor of production, and demand goods and services reflecting the various needs and desires of different countries and cultures, classes and communities around the world.

In this new competitive framework, successful firms have to efficiently organize productive factors from around the world -- research and development, materials and labor, product and process design, financing, marketing, packaging, distribution and more -- and produce the goods and services demanded by various market segments. The basic terms of competition created by global commerce and markets now require that firms and workers not simply produce standard goods and services efficiently -- the hallmark of America's (and Japan's) economic success in the 1950s and 1960s -- but also *innovate* efficiently in virtually every aspect of economic production.

From this perspective, the United States is no longer one economy, but *four*. We are first an *advanced economy* that uses sophisticated technologies and skills to produce complex products such as software and many machine tools. Here, we compete with the world's other advanced economies for sales in most world markets, including our own. But America is also an *industrial economy* producing basic, standard products such as slab steel, automobiles, and many microchips. Here, we compete with newly industrialized countries such as Korea and Taiwan, as well as with other advanced economies, for markets everywhere. In addition, America is a *commodity economy* producing basic staples such as food, textiles and petroleum in competition with developing nations and many others for sales everywhere. Finally, the United States includes vast sectors that make up a *non-traded services economy* in areas such as restaurants and health, where our firms compete with each other for the domestic market.

The inescapable conclusion is that Americans must now compete throughout the entire world, and not only with the handful of other large advanced economies but also with dozens of fast-growing developing and newly-industrialized economies. In part, these economies owe their stupendous growth and productivity gains to their roles as suppliers of inexpensive raw materials and labor for large corporations based in advanced countries. But they are developing as well as growing, becoming not only crucial markets but also important competitors to satisfy many of these markets.

Government's role in enhancing the economy's competitiveness

As the world's largest and most diversified economy, the United States has a great portfolio of national resources and investments encompassing every sphere of competition -- vast natural resources for commodity production, extensive social and economic organization for basic industrial production, and far-reaching human and intellectual capital for advanced production. An economic program for global competition should promote our competitive advantages not only with other advanced economies that have comparable cost structures, but also with the recently industrialized and developing nations producing standard industrial and commodity products with labor far cheaper than ours.

Two elements are essential for this task: 1) high levels of public and private investment, and 2) vigorous competitive pressures that can drive innovation and productivity gains by U.S. firms and workers that at least match those achieved by foreign competitors.

First, we must be prepared to match the basic resources employed by competing economies -- in the skills of our workers, the technologies of production, and the infrastructure systems that link our businesses to the sources of every factor they need to produce and deliver their products. This means greatly expanding both our *public and private* commitments, often through new government/private sector partnerships, to state-of-the-art education and training, advanced research and development, and world-class communications and transportation networks. On a per-worker basis, our stores of human, technological and physical capital must match or exceed other economies', especially the other advanced countries producing comparable goods and services. If American workers are the best trained, American technologies are the most advanced, and America's infrastructure is the most highly developed, the U.S. economy can be the world's most efficient.

The second crucial element is competition itself. We have to expose our firms and workers to more competitive pressures to make the most of our public and private investments in human, technological, and physical capital. The reason lies in human nature. Most people and firms will change only when they must to survive, compete and win. This capacity for change, shaped by knowledge of markets and the myriad aspects of economic production, is a powerful facility for efficient economic innovation -- the key factor in competitiveness created by economic globalization.

Government's responsibility for promoting economic innovation begins with phasing out current legal barriers to competition. Today, there are four principal ways in which the government insulates selected industries from healthy competitive pressures. In each case, these actions reduce the incentives to innovate by artificially supporting a particular industry's rate of return:

* Special spending subsidies, such as those for farm businesses and inland-waterway operators;
* Special tax subsidies, such as those for energy producers and housing construction;
* Special trade protection, such as those for textile makers and machine-tool manufacturers;
* Special regulatory protection, such as those for certain kinds of telecommunications companies and financial institutions.

In a global economy, these domestic subsidies and protection cost America jobs and growth -- as comparable measures in other countries weaken their economies. Provisions such as farm-price supports and textile quotas not only create barriers against normal competitive pressures to innovate for *foreign competition*, they also place industries such as automobile production or business services, that don't received favored treatment, at a disadvantage in the *domestic competition* for resources. As a result, these programs raise the operating costs for those doing business without special subsidies or protection. And this increases their incentives to press for their own benefits or take advantage of globalization and move some operations to countries where costs are lower or special subsidies are available.

American competitiveness does not dictate the elimination of every instance of spending, tax treatment, regulation or even trade protection targeted to a specific industry. Health-care spending for poor people, tax incentives for middle-class home ownership, many forms of health and safety regulation all promote social goals as important as marginal economic efficiency and innovation. In other instances, provisions that resemble anti-competitive subsidies or regulation are actually designed to offset genuine market failures, such as federal spending to protect bank depositors, tax incentives for basic research and much environmental regulation. But when there is no overriding social purpose or market failure, the dynamics of global competition create a substantial burden of proof for any instance of special spending or tax treatment, trade and regulatory protection.

III. Cutting Public Subsidies for Private Interests: Free Market Competition and National Competitiveness

For a decade, the debate in Washington over spending and tax policy has been largely disengaged from the genuine economics of growth. Political argument focuses easily and naturally on distributional questions -- who will pay more taxes and who will pay less, who might gain new benefits and who will have to shoulder the burden of fiscal restraint.[4] These terms of debate have to change if we are to have a budget program and an economic policy that actively promote U.S. competitiveness.

Consider the impact of a government subsidy for agriculture, an example which could apply to most instances of spending and tax subsidy. In the largely closed economies of the 1950s, when U.S. growth and employment were relatively unaffected by foreign competition and foreign markets, domestic farm supports produced net benefits. They directly helped some farmers. And if the subsidy enabled them to increase their productivity, such as a tax incentive for farm equipment, the higher taxes or upward pressures on prices paid by everyone else could be offset by lower prices from the productivity gains and by higher national wealth. And greater national wealth would increase investment throughout the economy.

The result is different in a more open economy. If a direct subsidy to farmers raises prices for domestically produced food, it also will increase the competitiveness of *foreign* agricultural goods, which in turn reduces the market share of domestic farmers, hampering their productivity gains. If the supports are financed by higher taxes, they reduce investment resources, also dampening productivity and growth.

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[4] Some old-fashioned liberals still believe in higher spending and higher deficits to boost growth, and many classical conservatives still see a golden age on the other side of a balanced budget -- as if America's open economy, interacting constantly with foreign financial and commercial markets, would still respond as it did when it was an economy to itself. And a handful of supply-side true-believers still insist that American competitiveness and growth would revive regardless of deficit policy, if only we would cut tax rates for wealthy people.

Subsidizing one sector while others are open to global competition makes matters worse. If only farming is subsidized, the policy artificially raises the rate of return for domestic farm businesses and so draws capital and other resources away from other industries. Since firms in other industries are open to foreign competition, the drain of resources to agriculture reduces their competitiveness and so hampers economic growth. When this happens, everybody bears a cost. Furthermore, with globalization U.S. firms in unsubsidized industries often shift resources to markets in other countries where subsidies or lower prices for land, labor and construction promise higher returns. One result is now painfully clear: In a global economy, subsidies for domestic industries reduce domestic job and business creation.

Nevertheless, as both Ronald Reagan and Bill Clinton discovered in their first budget battles, special interests usually can block serious action in Congress to phase-out their existing subsidies. Congress and the President have to find new ways to unravel this web of political influence.

As suggested earlier, Congress and the President should create a Commission on National Competitiveness and Industry Subsidies modeled on the Base Closing Commission. The Commission would recommend an annual package of reforms, from phase-outs to user ~~fees, to the P~~resident, who would submit the package to Congress. Congress would have to vote the package up-or-down without amendment.

The decline of liberal economic policy

The dynamics of globalization directly challenge the logic of traditional liberal macroeconomic policy. According to an orthodox Keynesian strategy, higher deficits, not discriminating spending cuts, will boost growth by stimulating demand, which in turn will spur productivity-enhancing investments to meet the new demand. The problem with this approach is that global trade and capital limit how much stimulus the economy receives from a higher deficit. In a global economy, foreign imports satisfy a good share of any new demand spurred by more deficit spending. Thus, as trade has increased while our competitiveness has stalled, a rising share of new U.S. deficit stimulus has ended up stimulating *foreign* production, jobs, and investment.

Global capital markets also limit the capacity of higher government spending to boost growth. When lenders can easily move their funds anywhere in the world, as they can today, and when they fear that higher deficits can also mean higher inflation -- as they often do unless the economy is in recession -- they respond to higher public spending either by demanding higher interest rates or by moving funds abroad. In either case, much of the original stimulus is neutralized.[5]

[5] Global capital markets also limit the stimulative effect of cutting short-term interest rates. Lenders have learned that when government cuts short-term rates in an expanding economy, inflation often accelerates; when this occurs, they are quick to shift their funds to other currencies with lower

Spending subsidies[8]

Virtually every part of the budget contains special-interest spending subsidies. Significant shares go to natural-resource companies, from timber and agriculture to energy and mining, and transportation firms. The list below is not exhaustive, and the proposed Commission on National Competitiveness and Industry Subsidies may find sound economic or social grounds for preserving some of these provisions. A fair selection of programs that should be evaluated by the proposed Commission, totalling roughly $114 billion in projected spending over five years, would include:

Energy-Industry Subsidies	5-Year Savings
• *Rural Electrification Administration (REA):* Created to electrify rural America, today it subsidizes private utilities in selected areas with low-cost loans. Reduce the subsidy by charging near-market rates on loans.[a]	$ 0.7 b.
• *Tennessee Valley Authority (TVA):* Much like the REA, TVA subsidizes electricity consumption and certain recreational activities in the Tennessee Valley. Reduce these subsidies.[a]	$ 0.6 b.
• *Clean Coal Technology Program:* End this program, which subsidizes practical research for one segment of the coal industry, which could finance it on its own.[a]	$ 0.3 b.
• *Energy Supply, Research and Development grants:* Cut funding for these grants, which since the late-1970s have subsidized research with little industry participation and often little commercial value.[b]	$ 6.9 b.

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inflationary expectations, forcing up long-term rates in the country that lowered its short-term rates.

[8] Five-year savings estimates for the proposed spending cuts and tax reforms are based on the following sources, identified by alphabet letter:

a: Congressional Budget Office, *Reducing the Deficit: Spending and Revenue Options*, Feb. 1993.
b: Heritage Foundation, "Real Deficit Reduction Demands Real Spending Cuts," *Backgrounder* No. 918, August 28, 1992.
c: Friends of the Earth, "The Green Solution to Red Ink," March 23, 1993.
d: *Budget of the United States Government*, Fiscal Year 1994.
e: Senator Hank Brown (R-Colo.)
f: Bill Clinton, *A Vision of Change for America*. This source provides estimates for *four years*.
g: National Performance Review, *From Red Tape to Results: Creating A Government that Works Better and Costs Less*, September 7, 1993. Estimates cover *six-years*, with the first year assumed to cover enactment of the reform.
h: Penny/Kasich Bipartisan Task Force, "A Common Cents Plan," October 27, 1993.
j: Joint Tax Committee, "Estimates of Federal Tax Expenditures for Fiscal Years 1994-1998," April 1993.

- *Fusion research grants:* Reduce these grants and require more private-industry support for research projects.[c] — $ 1.0 b.

- *Uranium enrichment services:* Recover the government's cost of enriching uranium for nuclear power firms.[c] — $ 1.6 b.

- *Strategic Petroleum Reserve:* Suspend new purchases.[a] — $ 1.1 b.

- *Naval Petroleum and Oil Shale Reserve:* Suspend new purchases.[d] — $ 1.8 b.

- *Advanced light-water reactor:* End federal subsidy for utilities' reactor-design costs and regulatory aid.[c] — $ 0.3 b.

- *Sales of federal hydroelectric power to private utilities in certain regions:* Raise rates to cover the government's cost of providing the power.[e] — $ 2.0 b.

- *Nuclear waste disposal fees:* Index for inflation government fees to dispose of utilities' nuclear wastes.[a] — $ 0.3 b.

Other Natural-Resource Industry Subsidies

- *1872 Mining Act subsidies:* Set a 12.5% royalty to mine on public lands and extend hardrock mining holding fees.[c] — $ 1.2 b.

- *Timber sales from national forests:* Raise price of timber from public lands to cover costs to prepare the timber.[a] — $ 0.2 b.

Agribusiness Subsidies[7]

- *Agricultural target price programs:* Lower price-subsidy supports for basic commodities by 3% a year.[a] — $11.2 b.

- *Agricultural subsidies to wealthy farmers:* Eliminate subsidy payments for individuals with taxable incomes of more than $120,000 and firms with incomes of more than $5 million.[c] — $ 1.0 b.

- *Export-enhancement agricultural subsidies:* End U.S. taxpayer subsidies for food purchased by foreign consumers.[a] — $ 3.2 b.

- *Grazing fees:* Raise fees for grazing on public lands so time commercial users pay market-based rates . — $ 0.2 b

[7]As much as possible, U.S. farm subsidies should be phased-out as other major world producers do the same.

* *Dairy-support program's milk marketing orders.* End government-set minimum pricing for fluid milk, which raises consumer prices and increases costs of price support program for milk products.[a] $ 1.1 b.

* *Irrigation programs:* Water subsidies created for family farms now subsidize many suburbs and agribusinesses. Impose a surcharge on water sales from Bureau of Reclamation projects and charge market rates for water used to irrigate surplus crops.[c] $ 4.3 b.

* *Meat and poultry inspection fees:* Require slaughterhouses and processing plants to pay for government inspections.[f] $ 0.5 b.

Transportation-Industry Subsidies

* *Airport grants-in-aid:* End direct taxpayer subsidies for projects to upgrade or expand airline terminals, which in a deregulated environment should be privately financed.[a] $ 6.7 b.

* *Federal Aviation Administration:* Charge airlines and private plane owners user fees to cover the marginal cost of FAA air-traffic control services on their behalf.[a] $ 6.8 b.

* *Highway demonstration projects:* Rescind funding for projects not eligible under state transportation plans or highway grant programs.[g] $ 7.9 b.

* *Inland-waterway programs:* Charge firms using inland waterways user fees to cover federal costs to maintain, operate and upgrade these routes.[a] $ 2.2 b.

* *Harbor maintenance programs:* Strictly enforce current fee collection for harbor maintenance charges.[c] $ 0.2 b.

* *Mass-transit operating subsidies:* Mass-transit construction is public investment, but operating subsidies are not and should be phased out.[a] $ 4.0 b.

* *Maritime Administration operating subsidies:* Phase out subsidies that protect U.S. shippers from competition.[b] $ 1.3 b.

* *Amtrak operating subsidies:* Reduce current subsidies by 50% so the system becomes more self-supporting.[b] $ 1.3 b.

* *Essential Air Service* program: Reduce subsidy to airlines to serve 125 small cities.[g] $ 0.7 b.

Aeroapace and High-Tech Industry Subsidies

* *National aerospace plane:* End this program, which is not supported by the Pentagon as a defense project.[a]	$ 0.7 b.
* *Sematech:* Phase-out research funding for consortium of semiconductor firms after 1997, as urged by the Defense Advanced Research Projects Agency.[a]	$ 0.1 b.
* *NASA advanced solid rocket motor:* End this program, which has virtually no support in scientific community.[a]	$ 1.7 b.
* *NASA space station:* Cancel the program, which has dubious prospects.[a]	$10.4 b.

Miscellaneous Industry Subsidies

* *Federal procurement:* Allow federal agencies to buy goods and services directly from private firms at market prices, as urged by the National Performance Review.[g]	$16.8 b.
* *Overhead payments for federally-supported university research:* Cap payment rate for overhead costs at 50%.[h]	$1.0 b.
* *Davis-Bacon Act:* This 1931 law requires all federal construction projects pay union wages, raising the cost of federal contracts by 30 percent. Limit this subsidy to projects of $100,000 or more.[h]	$ 0.2 b.
* *Market-promotion program:* End this program, which subsidizes foreign advertising costs of U.S. businesses.[a]	$ 0.9 b.
* *Superfund:* Require polluting firms pay more of the cost of cleaning-up their toxic wastes.[a]	$ 1.1 b.
* *Grants for constructing wastewater-treatment plants:* Phase-out grants in favor of a revolving fund.[a]	$ 6.3 b.
* *FDIC examinations of state-chartered banks:* Charge for this service.[a]	$ 1.4 b.
* *Public housing:* End operating subsidies for vacant public housing and substitute vouchers for new construction.[h]	$ 0.9 b.
* *Commodities Futures Trading Commission:* Impose a fee on futures-exchange transactions to cover costs of overseeing the exchanges.[h]	$ 0.3 b.

* *Federal Communications Commission:* Raise fees for private media using FCC services to cover costs.[a] — $ 0.4 b.

* *Securities and Exchange Commission:* Raise current charges to cover SEC's costs of registering and monitoring securities transactions.[h] — $ 0.2 b.

* *Travel and Tourism Administration* and *International Trade Administration:* Charge firms for using tourism export promotion services.[a] — $ 0.8 b.

* *Export-Import Bank programs:* Reduce loan subsidies to foreign purchasers of U.S. products by one-third, increase fees based on credit-risk, and direct loans to credit-worthy firms in growing countries.[a] — $ 0.9 b.

Total savings from spending reforms: $114.2 b.

Tax subsidies

Special-interest subsidies are as prevalent in the tax code as in spending programs. Major beneficiaries include natural resource and construction industry firms. Once again, the list is neither exhaustive nor definitive. Nevertheless, the proposed Commission on National Competitiveness and Industry Subsidies could begin by evaluating the following provisions, totalling $110 billion over five years.

Natural-Resource Industry Tax Subsidies	5-year savings
* *Special tax credit for producers of fuel from non-conventional sources*: Phase-out taxpayer subsidy for one particular source of energy.[j]	$ 5.7 b.
* *Expensing of oil, gas, and mineral firms' intangible drilling, exploration and development costs:* Phase-out extractive industry's special right to fully deduct certain capital costs instead of depreciating them.[a]	$ 5.9 b.
* *Percentage depletion cost-recovery for oil, gas and non-fuel mineral firms:* Repeal the extractive industry's special right to deduct a percentage of their gross income.[a]	$ 4.1 b.
* *Special tax credit for timber companies' reforestation costs:* Phase out subsidy for timber industry expenditures to prepare sites, seeds and seedlings, labor and tools, and depreciation.[f]	$ 0.2 b.

* *Timber-industry exception from uniform capitalization rules:* Reduce by half benefits from timber firms' special right to expense all indirect costs of production.[j]	$ 1.2 b.

Construction-Industry Tax Subsidies

* *Private-purpose revenue bonds:* End ability of state and local governments to raise funds loaned to private developers by issuing bonds exempt from federal tax.[a]	$ 5.3 b.
* *Mortgage-interest deduction:* Lower ceiling from $1 million to $300,000, to end the taxpayer subsidy of very high-priced housing for the top 4 percent of homeowners.[a]	$12.5 b.
* *Exclusion of capital gains on home sales:* Cap this exclusion at $125,000.[a]	$ 2.3 b.
* *Deductibility of interest paid on consumer loans secured by home equity:* Phase-out this special provision.[j]	$12.8 b.[5]
* *Tax credit for rehabilitating older buildings.* Reduce credit for historic structures to 15% and repeal the special tax benefit for older, non-historic structures.[a]	$ 0.4 b.
* *Tax depreciation on rental housing.* Treat depreciation of rental housing on same basis as other structures.[j]	$ 8.1 b.

Agribusiness Tax Subsidies

* *Exclusion of cost-sharing payments:* Phase-out farms' ability to exclude state or federal support payments from income if they are used for conservation.[j]	$ 0.1 b.
* *Exclusion of "cancellation of indebtedness" income:* Reduce ability of farm firms to exclude income from debt repayments.[j]	$ 0.5 b.
* *Cash accounting:* Phase-out farm firms' special right to defer tax on income from crops to be delivered the following year.[j]	$ 1.2 b.
* *Dairy and breeding cattle exclusion:* End special tax exclusion for costs of raising dairy and breeding cattle.[j]	$ 0.6 b.

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[5] The savings estimate is based on an assumption that 7.5% of current home-mortgage interest deductions represent home-equity loan interest, and that the current provision would be phased out gradually over four years.

Financial-Industry Tax Subsidies

• *Exemption of credit union income:* Tax credit unions' income on same basis as mutual savings banks and thrifts.[a]	$ 1.7 b.
• *Exemption of certain income for small property and casualty insurance companies.* Tax all property and casualty insurers on the same basis.[j]	$ 0.2 b.
• *Taxable income adjustment for small life insurance firms:* End ability of small life insurers to be taxed on investment income rather than adjusted gross income.[j]	$ 0.6 b.
• *Special deduction for certain health insurers:* End special deduction of one-fourth of annual claims and expenses for health insurers who accept all applicants, when health care reforms universalize this requirement.[j]	$ 0.8 b.

Miscellaneous Industry Tax Subsidies

• *U.S. territorial possessions tax credit:* Repeal tax credit exempting from tax any income earned by U.S. firms on operations in Puerto Rico and other U.S. possessions.[j]	$21.5 b.
• *Expensing of advertising costs:* End firms' right to fully deduct advertising costs by amortizing 20% as a capital cost to build brand recognition.[a]	$17.5 b.
• *Foreign sales corporations:* End ability of firms to exclude 15% of income on exports sold through special foreign subsidiaries set up as paper corporations.[j]	$ 7.9 b.
Total savings from tax reforms:	***$111.1 b.***

Subsidies and the distribution of benefits

Industry-specific tax and spending subsidies can affect the distribution of incomes and wealth throughout the country, as well as national competitiveness. When government acts to raise the rate of return for an industry and its firms, the first beneficiaries are the shareholders. And if the act is financed by higher taxes generally or by a higher deficit that pushes up interest rates and so slows the economy, the bottom line is a regressive transfer from middle-class people to those with high incomes. To be sure, far greater regressive effects can flow from spending and tax policies that are *not* industry-specific. For example, the top 4 percent of Americans, reporting taxable incomes of at least $100,000, receive nearly 6 percent of the $362 billion in federal retirement benefits paid out in 1993, including Social

Security, civilian and military retirement.[9] The top 4 percent also claim nearly 17 percent of more than $90 billion a year in retirement-related tax benefits, and 8 percent of some $40 billion a year in health care-related tax benefits.[10]

Other tax provisions also mainly benefit high-income people. For example, wealthy families claim the lion's share of the value of the current tax exemption for capital gains at death. Limiting this exemption to the first $75,000 in gains, plus $125,000 from the sale of a home and half of the remaining assets' value, would protect all but the top 2 percent, and raise nearly $32 billion over five years for public investment, deficit reduction or tax relief for families with children.[11]

Industry subsidies through trade protection

Current trade protections, much like spending and tax subsidies, undermine an industry's incentives to become more productive and resourceful. In this area, the Clinton Administration has achieved particular progress. Congressional approval of the North American Free Trade Agreement (NAFTA) and the conclusion of the Uruguay Round of the General Agreement on Tariffs and Trade are historic steps that should strengthen the competitive pressures on American producers while expanding their potential foreign markets.

The direct costs of trade protection usually come in the form of higher prices for American consumers and businesses, as compared to the higher taxes that finance most spending and tax subsidies. Nevertheless, industries typically gain trade protection in the same way as others win special spending and tax subsidies -- through well-organized campaigns of political influence that are difficult for unorganized consumers and businesses to counter.[12]

In a global economy, industries that win trade protection rarely achieve world-competitive status as a result. With weaker incentives to improve their productivity and innovate, protected industries often cannot maintain their domestic employment. According to a new analysis by Gary Hufbauer and Kimberly Elliott of the Institute

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[9] Robert J. Shapiro, "Enterprise Economics and the Federal Budget" in *Mandate for Change*, *op. cit.*, Table 5, p. 40; *Budget of the United States Government*, Fiscal Year 1994, pp. 25-30.

[10] *Ibid.*, Tables 5 and 6, pp. 40, 41; Joint Tax Committee, "Estimates of Federal Tax Expenditures for Fiscal Years 1994-1998," April 1993.

[11] Congressional Budget Office, *Reducing the Deficit: Spending and Revenue Options*, Report to the Senate and House Committees on the Budget, February 1993, pp. 375-377.

[12] One political difference is that most spending and tax subsidies are achieved through lobbying by corporate representatives, while many trade protections are concentrated in the minority of union-organized industries and have been won by coalitions of industry and union representatives.

for International Economics, U.S. trade protections today cover 21 industries with annual sales of $1 billion or more.[13] Yet from 1985 to 1990, as U.S. exports expanded sharply, employment still *declined* in 15 of these sectors and remained constant in three others. And while these job losses would have been greater without protection, the artificial demand created for these industries' products came from other, unprotected, sectors which otherwise would have created more jobs.

Most of these protections were established long before economic globalization changed the terms of competition and have persisted for decades or even centuries, long past any notion of providing temporary relief to adapt to foreign competition. Current maritime protection can be traced back to 1789. Of 20 other instances of significant formal protection today, two were established in 1922 -- glassware and organic chemicals -- and 11 more date from the early 1980s, including ball bearings, ceramic articles and tiles, costume jewelry, frozen concentrated orange juice, luggage, women's and all rubber footwear, women's handbags, polyethylene resins, and sugar. In 1951 and 1953, three agricultural commodities joined the list of protected sectors -- dairy products, peanuts, and canned tuna -- and in 1957 apparel and textiles, the largest protected sectors, attained their trade subsidies. Finally, in 1987, machine tools and softwood lumber won protection.

Hufbauer and Elliott estimate that the various arrangements transfer $32 billion a year from U.S. consumers and businesses to the protected sectors, or the equivalent of a 34.5 percent surtax over world-market prices for the products of the 21 effected industries. Hufbauer and Elliott also estimate that these protections maintained roughly 190,000 jobs. Accounting for the benefits of these jobs, the net direct cost of the protections comes to $9.1 billion a year. A similar analysis by the International Trade Commission, which also included many smaller protected sectors, estimated the net costs of U.S. trade protections at some $19 billion a year.[14]

The economic costs of protection are likely greater, since the trade protections impair the competitiveness of unprotected sectors by drawing away resources. Moreover, ending protection would ultimately benefit some protected sectors. For example, after protective quotas for U.S. steel makers ended, some firms shifted to specialty products that slab-steel makers in low-wage countries could not produce.

Abolishing all industry trade protections unilaterally is neither politically feasible nor even economically prudent. President Clinton should continue to press

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[13] Gary C. Hufbauer, Kimberly A. Elliott, Yoko Sazanami, Shujiro Urata and Hirahi Kawai, "Comparing the Costs of Protection in the United States and Japan." Institute for International Economics, forthcoming.

[14] U.S. International Trade Commission, "The Economic Effects of Significant U.S. Import Restraints," November 1993.

for multilateral liberalization and, where appropriate, bilateral progress on the model of NAFTA. In particular, future bilateral liberalization should focus first on fast-growing countries in Latin America and Asia that hold the greatest potential as expanding markets for American goods and services.

Industry subsidies through economic regulation

Finally, certain categories of economic regulation covering particular industries operate as anti-competitive subsidies. In contrast to *social* regulations that protect the health and safety of workers and consumers, many forms of *economic* regulation insulate a particular industry from potential domestic and foreign competitors. This economic regulation takes many forms: price controls on some trucking, railroad, and ocean shipping; limits on the products offered by security and commercial banking firms; geographical restrictions on utilities; Intelstat's monopoly on international satellite communications; certain restrictions on local and long-distance telephone companies' activities; and more.

Some instances of economic regulation arose from special pleading. But others grew out of well-founded concerns about promoting efficiency and protecting consumers in the presence of a monopoly such as local telephone service, or of virtually unlimited risks such as a financial panic. Economic regulation is still necessary where natural monopolies persist. But the universe of these cases is shrinking as advanced technologies invent new ways of providing old monopoly goods and services -- how long will it be, for example, before the spread of wireless-telephone technology breaks the monopoly bottleneck of local telephone exchanges?

Where some form of genuine market failure doesn't exist, however, the typical result of most economic regulation is higher prices with little or no national or social benefit. As with the other forms of anti-competitive subsidy, such economic regulation leaves the entire economy less productive and less efficient by legally enabling a favored sector to claim earnings that otherwise would go to more competitive domestic industries and firms.

Estimates of the costs of economic regulation to U.S. growth and productivity depend on econometric models of problematic reliability, but the price tag is probably tens of billions of dollars a year. Moreover, global commerce and markets increase the cost. Restrictions on the availability of certain products or controls on prices deny U.S. consumers and firms opportunities to purchase new goods and services, or standard ones at lower prices, from an entire world of innovative producers.

Over time, these regulatory barriers cannot stop innovative companies from developing alternative goods and services that can take the place of those protected by regulation. In effect, global markets and competition compel resourceful firms to claim part of a regulated market by redefining it. The regulatory walls insulating traditional financial institutions did not protect them from the competition of numerous new financial instruments -- revolving credit accounts, annuity funds, money market accounts, international investment funds, and many more -- created by resourceful retailers, insurers and real estate firms as well as by innovative securities and banking companies. And since the Carter Administration, the United States has increasingly recognized this reality and has significantly reduced economic regulation for various industries, principally transportation, communications, energy and finance. By one estimate, the share of U.S. GDP produced by fully-regulated industries declined from 17 percent in 1977 to 6.6 percent in 1988.[18]

A new growth and competitiveness program should include aggressive steps to further cut economic regulation, along with industry-specific trade protections and spending and tax subsidies. These reforms should provide the time and means for industries to adjust to more open competition. The effort could concentrate first on the telecommunications and financial sectors, two of the global economy's most dynamic industries, where current regulation raises domestic prices and stifles the innovation demanded by aggressive new rivals at home and abroad.

IV. Public and Private Investment: The Division of Labor Between Government and Business

Stronger domestic competition, by itself, will not solve America's economic problems. America also must invest more of its national resources, public and private, in the building blocks of productivity and growth -- educating and training workers, developing new technologies, and upgrading our economic infrastructure.

The general proposition that the United States needs to invest more national income in the factors of growth and productivity is non-controversial. But how should we go about it? Traditional conservatives insist that private markets alone can produce efficient investment decisions, and therefore the only sound pro-investment policy is deficit reduction and additional tax incentives for private investment. In a global economy, this conservative view is as outdated as some liberals' insistence that higher government spending and deficits are a prerequisite to growth.

The decline of conservative economic policy

The dynamics of global commerce and capital have fundamentally compromised the logic of the conservatives' case against public economic investment. Long before globalization, Adam Smith pointed out that markets alone normally will not generate

[18] Clifford Winston, "Economic Deregulation: Days of Reckoning for Microeconomists," *Journal of Economic Literature*, Volume XXXI, September 1993, pp. 1263-89.

CUT-AND-INVEST TO COMPETE AND WIN

A Budget Strategy for American Growth

I. Introduction

This year's debate over the federal budget could provide President Clinton and Congress with a second chance to enact an authentic economic-growth program that can help restore America's competitiveness in the world economy.

To do so, the President and Congress will have to take new and decisive account of the central economic development of our time, the development of mature, global markets in both capital and commerce. To enable American workers and companies to better compete in the churning environment of global markets, production and investment, the federal government should become both more active *and* more self-disciplined. Americans must invest aggressively through the government in the national resources that genuinely make an economy more productive. But as taxpayers and consumers, Americans also must insist that government end the special spending programs, tax breaks and trade and regulatory protections that subsidize politically powerful industries and insulate them from the powerful market forces of the global economy.

The first step requires re-evaluating our current economic paradigms. Even in this period of tumultuous economic change, most liberals and conservatives have maintained faith in some version of conventional tax-and-spend macroeconomics. Many liberals, especially traditional Keynesians, focus on increasing spending and, when necessary, taxes too; many conservatives, especially supply-siders, concentrate on cutting taxes and, when possible, spending as well. But these gross approaches almost always miss the critical economic target: higher growth. The Keynesians' conviction that deficit spending will spur domestic production and drive broad-based growth is hopelessly outdated in a world where every store stocks imported goods and governments no longer control capital flows. The alternative from the right, hands-off government, is equally obsolete at a time when American workers compete with low-wage foreign labor and U.S. companies face foreign producers generously supported by their governments.

For both fiscal policy in particular and economic policy in general, tax-and-spend economics has to give way to a new growth strategy of *cut-and-invest*. The new the education required for a society to make best use of its resources or the roads needed to enable its markets to work efficiently. In a global economy, these classical efficiency considerations become more significant, because each country's firms compete with others that may use better-trained labor, more advanced technologies and better-developed infrastructure systems.

Furthermore, the domestic tax incentives favored by conservatives are no longer a reliable way of increasing investment. International credit markets provide large firms everywhere with access to the entire world's capital, from which they borrow freely at home and abroad -- and the foreign capital providing much of the pool for U.S. investment today is largely unaffected by tax incentives for U.S. savings and investment. That is one important reason why four cuts in the U.S. capital-gains tax rate between 1977 and 1985 did not increase the growth rate of U.S. net investment. Instead, lower capital-gains taxes mainly shifted savings and investment from instruments denied the tax break, such as money-market accounts, to those granted it, such as stocks. As a result, the change *reduced* efficiency of U.S. capital markets, which is why Ronald Reagan's Treasury Department in 1984 recommended ending any capital-gains tax preferences.

Nor can the United States spur national investment by cutting marginal income tax rates for wealthy people, as supply-siders promised. Comparing U.S. economic performance in the business cycle of 1976-1979, before the tax cuts, and the business cycle of 1983-1989, after the cuts -- or throughout the 1970s and 1980s -- demonstrates that by every relevant measure, the economy performed no better *after* the supply-side reforms than before. (See Table 5.)

Table 5. U.S. Economic Performance Before and After Supply-Side Policy Changes

Average Annual Rate of Growth	**Pre Supply-Side**		**Post Supply-Side**	
	1970s	**1976-79**	**1980s**	**1983-89**
Real Gross Domestic Product	2.8%	4.2%	2.6%	3.7%
Civilian Jobs	2.7%	3.7%	1.9%	2.6%
Real Personal Income	3.0%	4.0%	3.1%	3.5%
	Pre Supply-Side		**Post Supply-Side**	
Share of National Income	**1970s**	**1976-79**	**1980s**	**1983-89**
Real Capital Spending	3.9%	2.6%	2.7%	2.3%
Personal Savings	6.7%	6.0%	4.1%	3.4%
Trade Balance	-0.1%	-0.4%	-3.0%	-4.0%

Source: Author's calculations from data reported in *Economic Report of the President*, February 1991, Tables B-2, B-26, B-29, B-33, B-58, B-101.

Conservatives are right that capital still counts. *But in the age of global capital markets, differences in the cost of capital among advanced economies don't reflect differences in tax policy.* Rather, they mainly reflect each nation's rate of expected inflation and the close relationships in some countries between banks and businesses.

The economic approach of traditional conservatives is flawed, but their general attitude towards public spending merits respect. For both political and economic reasons, government always should bear a substantial burden of proof when it claims the right to spend taxpayers' money for a general economic good. To begin, political debate about economic policy, often couched in an opaque language of experts, can easily camouflage a special-interest agenda; and promised results, such as higher productivity or a lower trade imbalance, are usually too diffuse for most taxpayers to evaluate.[16]

An economic presumption also lies against a government's claims to improve the economy by investing taxpayers' money for them. Without government, markets produce and distribute hundreds of thousands of resources through billions of transactions carried out by tens of millions of people acting in their own self-interest. A few hundred elected officials and bureaucrats sitting in Congress and executive branch buildings cannot begin to know or digest the information generally required to produce better results.

Recognizing genuine public economic investment

How do we recognize genuine public investment, especially when nearly every sort of spending is routinely described as an essential national investment, from immunization and law enforcement to health-care reform and defense? All such spending may be sound policy, but public economic investment has a specific character that can be described precisely. To meet the burdens of proof, public investment must have a compelling economic purpose, and private markets must be unable to fulfill this purpose without government support.

First, an investment should hold clear potential for producing future benefits; and as an economic investment in particular, these future benefits should be manifest through an increase in the private economy's wealth-creating capacity.

National economic investment is not the same as what accountants call capital improvements and which would include, for example, new defense installations or public buildings. Rather, it must have genuine potential to expand the private

[16] By contrast, when the government proposes to spend national resources for social purposes such as feeding poor children or providing health care for the elderly, most taxpayers can decide for themselves whether it seems just and reasonable.

economy and *not merely to shift resources from one place or sector to another.*

If public economic investment is intended to expand the country's productive capacity, why doesn't private investment through the private markets take care of it? The principal reason is that genuine public investments have a generic or systemic quality: They are intended to strengthen not a particular firm but large portions of the economy. Private incentives for such broad investments will always be weak, because a private investor cannot profit from the economy as a whole.

Second, public investment should occur only in particular pockets of the economy where the private capital markets fail to produce a level of investment that would make the most of the economy's potential.

The economy contains three significant pockets of "market failure," in the areas of human, technological and physical capital that are critical in global competition.

The first sphere for greater public economic investment is human capital. Many private firms are reluctant to train their employees, because a well-trained worker can easily move to a new job where the new employer will capture the benefit from his *competitor's* previous training investment. In an advanced economy such as the United States, dependent on sophisticated skills, this species of "market failure" has produced chronic under-investment in skill training and chronic business complaints about an under-skilled work force.

Average working Americans in factories and offices bear the main cost of this under-investment. Up to 70 percent of all private U.S. training dollars are spent on the top 10 percent of employees, principally professionals and managers. The on-going training they receive is an important reason why their incomes have continued to rise at healthy rates, and why income inequality is increasing. Widening gaps in income in the 1980s, as recent research has demonstrated, did not come from the contraction in manufacturing industries and expansions in domestic services, but rather from rising demand and wages for those with advanced skills *across industries*, and lower demand and wages for those without them *throughout the economy*.[17] In a global economy where standard products are less important, and innovation and flexibility are more valued, policies targeted to particular sectors do not reduce inequality. And only workers who can upgrade their skills on a regular basis will be able to significantly increase their productivity and incomes.

The second sphere for greater public investment is basic research and

[17] Kevin Murphy, Chin Hui Juhn and Brooks Pierce, "Wage Inequality and the Rise in Returns to Skill," *Journal of Political Economy*, June 1993, pp. 410-442; Kevin Murphy and Lawrence F. Katz, "Changes in Relative Wages, 1963-1987: Supply and Demand Factors," *Quarterly Journal of Economics*, February 1992, pp. 35-78.

development, the heart of an advanced economy's technological capital. It is clear why private investment generally generates less basic R&D than the economy could use profitably. Normal market incentives for developing new technologies, especially generic breakthroughs, are weak because most basic innovations generate downstream benefits which the original developer cannot claim. The more generic the area of research, the greater the market failure. Just as important, basic R&D is inherently risky, entailing costs that are hard to predict and potential benefits that are virtually impossible to value. The normal result is under-investment in R&D unless supports are provided by government, consortia or some other large entity.

The state of American basic research, especially relative to other advanced economies, is a critical factor in U.S. global competitiveness because it is the essence of innovation. A strong commitment to basic research, moreover, is as vital to America's traditional manufacturing and commodity sectors as to our advanced industries, because innovation, especially in production processes, is an advanced economy's natural area of comparative advantage when competing against low-wage foreign producers of standard products. Biogenetics has helped keep U.S. agriculture competitive with Asia and Latin America, and high technologies have revived parts of the U.S. apparel industry as well.

Public investment's proper role in R&D lies at the frontier promoting generic breakthroughs, such as superconducting materials or opto-electronics, where progress can produce benefits across industries and throughout the economy. As a research project becomes more specific to a particular industry, normal market incentives for private investment increase -- along with the temptation for an industry to use influence to gain government subsidies for the project.

The third sphere for increased public investment is physical capital: chiefly the transportation systems that form the core of our economic infrastructure. As with much investment in training and basic research, infrastructure investments typically produce income that a private investor cannot claim easily. In addition, the costs of building these systems are high and the risks often are large, for it is difficult to predict how much business will develop along a highway or around a harbor until it is in place. The results are government-owned and operated road systems, and government-subsidized air and rail networks.

As economy-wide investments, public infrastructure provides benefits across industries. By binding together our domestic suppliers, producers, distributors and customers into an American market, these investments can produce a comparative advantage for U.S. basic manufacturing and commodity industries competing with low-wage foreign producers for the American market. While more public resources are certainly needed to repair highways, most of the new infrastructure commitment should not recall traditional public works programs. The focus of the new infrastructure investment should be the *next* generation of transportation systems, including high-speed rail, "smart" highway systems, automated traffic management and the like. Additional government spending can be targeted to research and development and purchase of rights-of-way; while regulatory and legal reforms, especially to reduce liability exposure, can promote new public-private partnerships based on substantial private investment in the new transportation systems.

In other areas of economic infrastructure, notably telecommunications, fast-evolving market and technological conditions are *reducing* the need for direct public investment, apart from supporting basic research. For many years, public investment in telecommunications systems was sustained indirectly through cross-subsidies and controlled prices for the old AT&T monopoly. Rapid technological progress and the emergence of market competition, first in long-distance and more recently in local telephone exchange networks, have "resolved" much of the old monopoly market failure, creating vast new economic opportunities for a variety of industries to invest in telecommunications infrastructure. Through the 1990s, government's chief focus should be continuing to deregulate the telecommunications industry, while guaranteeing all consumers and businesses access to the new networks at competitive market prices.

Choosing viable public investments

The question remains, how can the government identify the *specific* public investments that make economic sense? No one can guarantee that every investment, public *or* private, will pay off. More money for outdated educational strategies or boondoggle highways will leave the country and the economy *less* productive. How can government recognize the infrastructure projects, training programs and research ventures that could generate higher returns than the average private investment -- which would be the economy's alternative use of the funds?

Government officials will not always choose correctly, any more than do private investors. But government also should not permit expanded public investment to become an entitlement for everyone who wants training dollars, research support or a new road.[18] Public-investment decisions have to be carefully insulated from the normal exercise of political influence by industries, municipalities and large firms. Otherwise, public investment will become another form of special-interest subsidy.

[18] Many widely-cited studies of U.S. infrastructure or training "needs" are wish lists without reference to priorities, budget constraints or technological alternatives. For example, most official "needs studies" for wastewater-treatment plant construction do not consider conservation measures that would reduce the volume of water needing treatment. Studies calling tens of thousands of older bridges "structurally deficient" assume that all bridges must meet the highest current engineering standards for those carrying substantial heavy-truck traffic -- although thousands on the list do not and never will. And requests for highway funds almost never consider the impact of reforms such as congestion pricing on traffic loads.

The President and Congress have to reinvent the way they select public-investment projects before spending more for them. First, all public investment should be targeted to elements common to all economic enterprise, not to those specific to one industry or firm. In order to qualify, the training should be *general*, the research should be *basic* and the infrastructure should be *primary*. Second, federal funding in these areas should be steady and reliable, so as to discourage frantic competition for support and subsequent project bottlenecks. Third, the government can encourage sound investment analysis by applying strict planning and review requirements to all state and local infrastructure or training programs seeking federal support.

Fourth and most important, public-investment decisions should incorporate a crucial element of private-market discipline: *those who receive support for a project should bear part of the project's cost.* If public-investment dollars are "free" to those receiving them, demand will be both limitless and indiscriminate.

States and localities receiving federal infrastructure funding should *always* provide substantial matching contributions. Federal funding also should be available for the *capital* costs of building a highway, subway, harbor or basic airport facility, but not for their *operating* costs or the facilities for private vendors such as airlines. If the initial decision to build is sound economically, those using it will be willing to pay fees to maintain it. And in many instances, as noted earlier, government actions to reduce liability and other associated economic risks can attract substantial private investment in infrastructure construction.

Federal funding for basic non-military research also should be directed to projects with substantial private support. In most cases, government can address the market failure in basic research through the partial tax credit for private R&D spending provided today. Direct government support will always be appropriate to advance the frontiers of science, and substantial funding increases through the 1990s and beyond are needed to restore American leadership in basic scientific research. But direct federal funding for large, esoteric construction projects should be accompanied by major private-industry investment -- a safeguard which might have headed-off the budget-busting superconducting supercollider.

In the area of education and training investment, federal college-tuition support can be tied to the student's commitment to pay back the country, on the model of President Clinton's National Service program. Federal support for training should concentrate on apprenticeship programs, jointly-operated and financed by local school districts or governments and local businesses prepared to match federal contributions. Alternatively, a tax credit for businesses willing to invest in training their workers will always be a sounder investment than a government-run training program.

An investment budget for national competitiveness

A growth and competitiveness policy based in part on expanded public economic investment should appreciate that there are many sound *non-economic* reasons for spending public money -- to keep the country safe from enemies, for example, and help those who cannot help themselves. It also should recognize the differences. As a budgetary matter, the principal distinction should lie in how government finances these different activities. Non-investment spending should be paid for with tax revenues on an annual basis *as it occurs*. Genuine public economic investment *may* be expanded through deficit-financing because over time it pays for itself by enhancing the economy's productivity and thereby expanding the tax base.

As the Progressive Policy Institute has maintained since 1990 -- and as President Clinton concurred in his 1992 presidential campaign -- the federal budget should be divided into one account for public economic investments, and another for all other, consumption-related spending. By law, total federal spending (except interest payments on the national debt) should be permitted to expand no faster than the private economy; and an annual balanced budget should be required covering all non-investment spending. Put another way, the annual federal deficit, by law, should be no greater than annual net investment spending.[19] These restraints on the growth of federal spending and the size of the annual deficit can help ensure that American businesses have the capital to invest in the specific skills, technologies, and physical equipment that can make their particular enterprises more productive and efficient.

The budget reforms enacted in 1993 succeeded in slowing the growth of federal spending and the size of the federal deficit. By current projections, spending will rise by about 20 percent over the next five years, as compared to expected economic growth of 28 percent over the same period. President Clinton and the Congress prudently provided a substantial gap between expected spending and expected

[19] The critical distinction is between public investments intended to promote common prosperity, often by providing a specific benefit such as education, and other public spending designed to provide specific benefits, often in ways that generate some common gain. The government should be able to borrow to finance the first while the bill for the second should be due on delivery. Classifying certain programs will be controversial. Military purchases, for example, are often considered capital investments because they *look* like other durable goods -- but from an economic perspective, purchasing and maintaining most weapons systems and defense installations are forms of national consumption. The basic distinction also provides a sound basis for resolving the debate over the budget treatment of payroll-tax revenues. Current Social Security benefits would fall within the consumption account, balanced by equivalent payroll tax revenues. *Surplus* payroll-tax revenues, however, should be applied to the capital account as an investment in the economic growth required to finance future benefits. This arrangement would end any financing of non-Social Security government operations by Social Security taxes. Surplus payroll-tax receipts, like other government trust fund revenues, could either reduce the borrowing requirements for public investment or finance additional public investment.

economic growth. Unanticipated expenditures will arise regularly, perhaps for defense or foreign assistance, and some existing programs will grow faster than expected, especially Medicare and Medicaid. Looking ahead, we also should assume that national health-care reform will cost more than is acknowledged.

Yet, the 1993 budget program did *not* include a significant, new national commitment to public investment. Federal support for infrastructure increased by only $2.6 billion in fiscal year 1994. Education spending rose by just $3 billion for the fiscal year, the National Service program was decidedly underfunded, and apprenticeship and other training initiatives still await enactment. Finally, support for civilian research was expanded by barely $1 billion.

A serious program for economic public investment should include a total, five-year increase in public spending in these areas of at least 25 percent. By this standard, federal public investment spending would rise from $121 billion this year to about $150 billion in 1998. This will require additional federal spending, relative to current spending, of $17 billion to $30 billion a year in these areas over the five-year period. (See Table 6.)

Table 6. Public Investment: A Budget for National Competitiveness

($ billions)

Current Investments	**1994**	**1995**	**1996**	**1997**	**1998**
Education/Training	$47.7	$47.7	$47.7	$47.7	$47.7
Civilian R&D	$29.0	$29.0	$29.0	$29.0	$29.0
Infrastructure	$47.0	$47.0	$47.0	$47.0	$47.0
Total	$120.7	$120.7	$120.7	$120.7	$120.7
New Investments					
Education/Training	3.0	5.0	6.0	8.0	10.0
Civilian R&D	1.0	4.0	5.0	5.5	6.0
Infrastructure	2.6	8.0	10.0	12.0	13.0
New Budget	$120.7	$137.7	$141.7	$146.2	$149.7
Percent Increase	5.8%	14.1%	17.4%	21.1%	24.6%

Sources: *Budget of the United States Government*, Fiscal Year 1974, p. 72; Congressional Budget Office, "Updating Trends in Public Infrastructure Spending," August 1993; Office of Management and Budget, "Results of the President's Investment Agenda for Fiscal Year 1994," August 1993.

This commitment to public investment could be financed by the savings from reforming special-interest subsidies. The investment agenda would require some $100 billion in additional resources over the next five years, or barely 40 percent of the potential savings identified earlier from reforming industry-specific spending and tax subsidies.

V. Cut-and-Invest, or More Tax-and-Spend?

President Clinton, the Congress and the country face a clear choice: the tax-and-spend economics of the Washington establishment, or a cut-and-invest strategy for global competitiveness.

The first choice commits the United States to its current course of short-changing genuine public investment, preserving special-interest tax and spending subsidies, and insulating U.S. industries and workers from the global economy's incentives to be more productive, innovative, and efficient. This path of economic retreat and national resignation would ensure an economic future much like the recent past and present. American firms and workers will fall further behind in the contest for world markets, and another generation will live with slow growth and stagnant living standards.

Instead, the United States should face the world as it is. The global economy offers great challenges and opportunities to any nation willing to invest in the common resources that can make it richer, and ready to throw off the false security of special subsidies and protections for exclusive interests. America has the resources to make these investments *without* raising income taxes, cutting vital social programs or retreating from world leadership.

America will determine its own future. Never before have we failed ourselves when the choice was so clear.

* * *

About the Author

Robert J. Shapiro is a founder and the Vice President of the Progressive Policy Institute, where he directs economic studies. Dr. Shapiro also served as a principal economic advisor to Bill Clinton in the 1992 presidential campaign.

Before joining PPI, Dr. Shapiro was Deputy Issues Director and chief economic adviser in the 1988 Dukakis-Bentsen campaign. Previously, he was Associate Editor of *U.S. News & World Report*, Legislative Director and economic adviser to Senator Daniel Patrick Moynihan, and Senator Moynihan's principal aide to the Senate Finance Committee and the Senate Budget Committee.

Dr. Shapiro is also a Contributing Editor of *The New Republic*. He has been a Fellow of Harvard University, the National Bureau of Economic Research, and the Alexis de Tocqueville Institute. He holds a doctorate from Harvard University, as well as degrees from the London School of Economics and Political Science and the University of Chicago. He is widely published on economics and policy in both scholarly and popular journals.

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Chart 9. REDUCTION IN FY 1994 APPROPRIATIONS BILLS

APPROPRIATION SUBCOMMITTEE	ACCOUNTS REDUCED	SAVINGS BELOW FY 1993 (BUDGET AUTHORITY IN BILLIONS)
Commerce/Justice/State	65	-1.4
Defense	46	-22.8
Energy and Water	12	-1.9
Foreign Operations	25	-1.9
Interior	32	-0.3
Labor/HHS/Education	18	-0.5
Legislative Branch	23	-0.02
Military Construction	5	-1.1
Rural Development	29	-2.1
Transportation	22	-0.6
Treasury/Postal	27	-0.1
VA/HUD	38	-4.9
TOTAL:	342	-37.6

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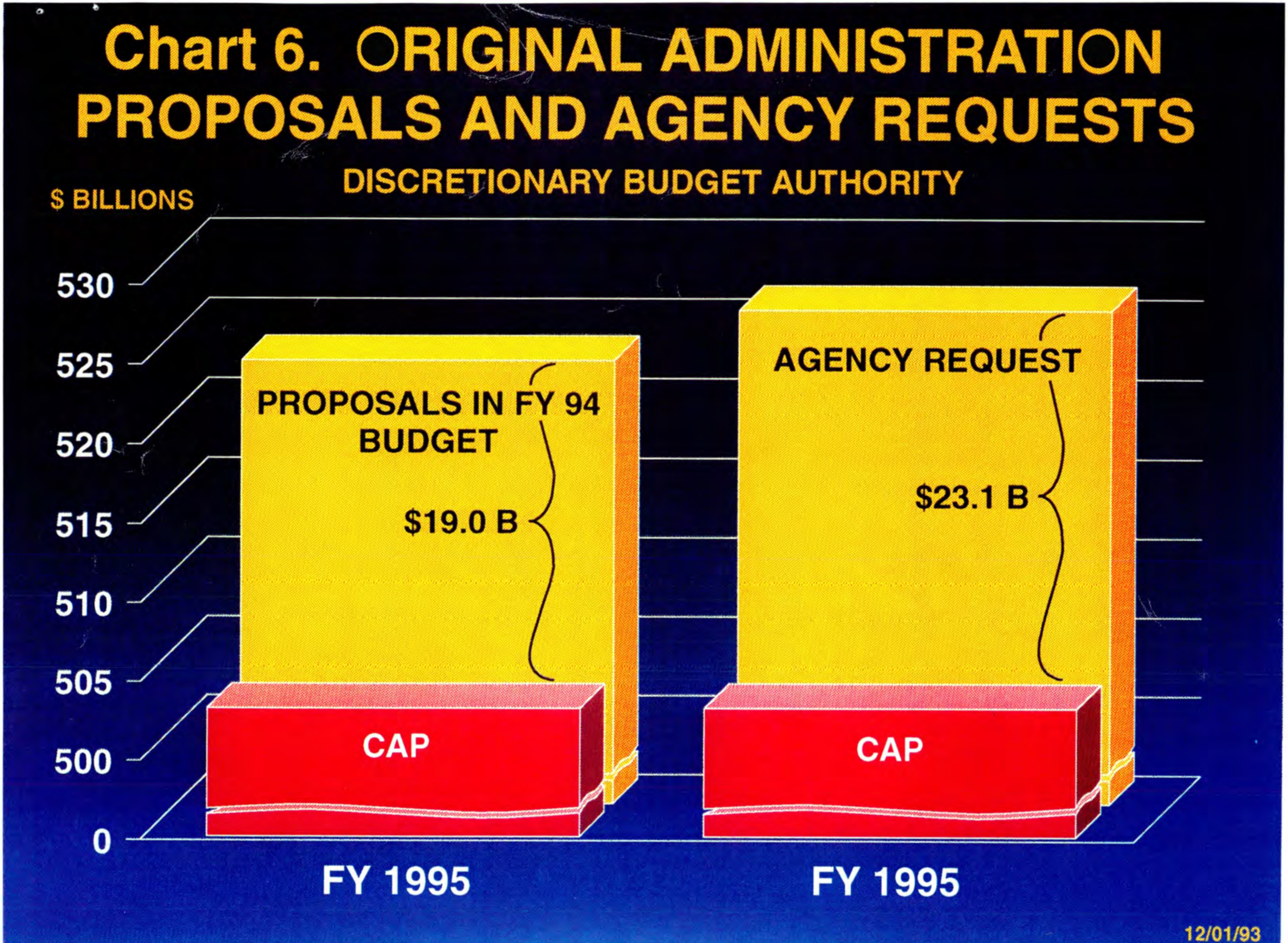
Chart 6. ORIGINAL ADMINISTRATION PROPOSALS AND AGENCY REQUESTS
DISCRETIONARY BUDGET AUTHORITY
$ BILLIONS
530
525
520
515
510
505
500
0
PROPOSALS IN FY 94 BUDGET
$19.0 B
CAP
FY 1995
AGENCY REQUEST
$23.1 B
CAP
FY 1995
12/01/93

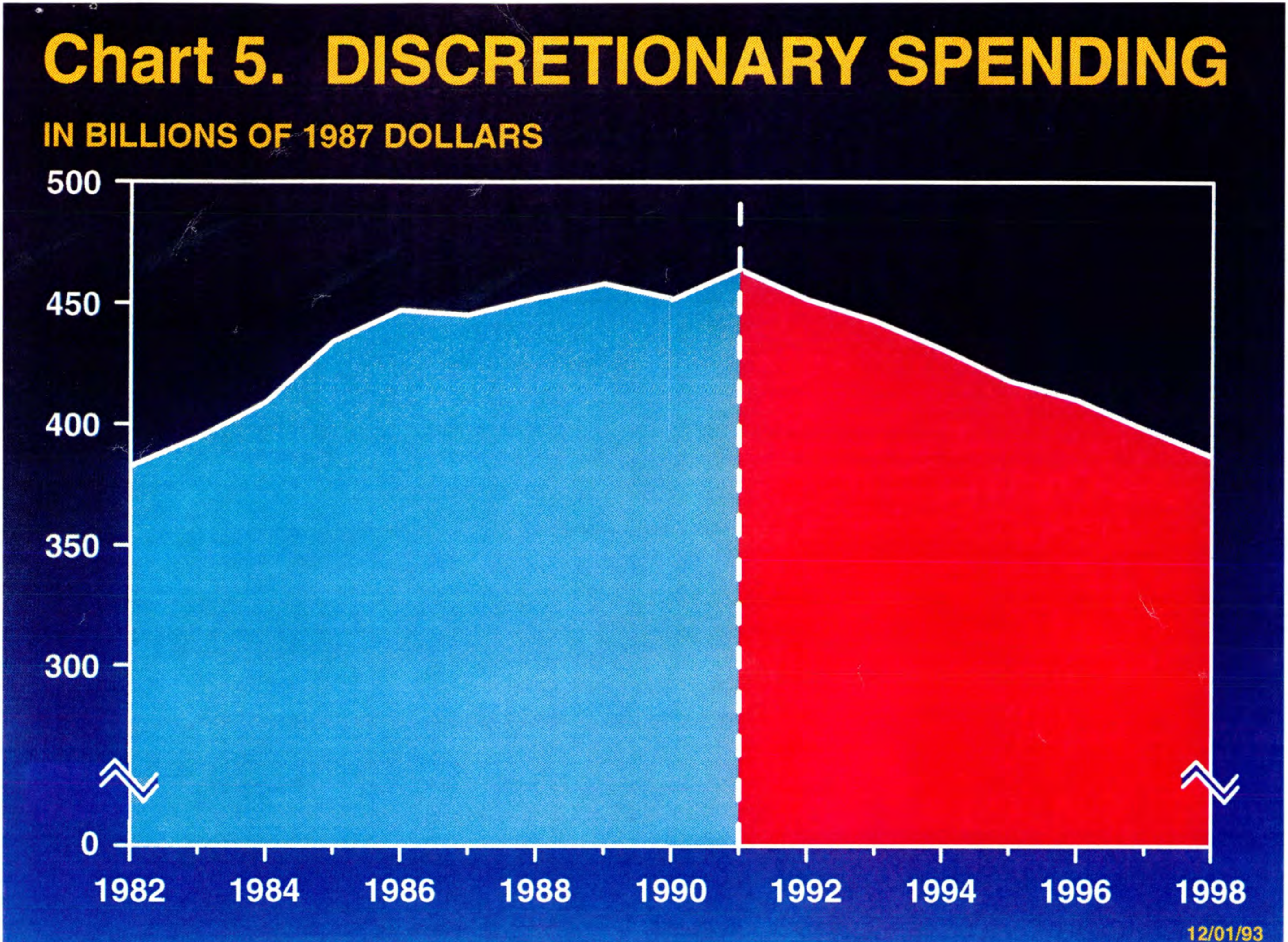
Chart 5. DISCRETIONARY SPENDING
IN BILLIONS OF 1987 DOLLARS
500
450
400
350
300
0
1982
1984
1986
1988
1990
1992
1994
1996
1998
12/01/93

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I. Overview

In coming months, the new Republican Congress will consider a fiscal agenda that would cause a virtual revolution in American government. The most momentous changes since the creation of the New Deal 60 years ago may be in the offing. Like the New Deal, these changes could establish a framework within which the federal government operates for decades thereafter.

This new framework would likely lead to both the dismantling of much of the federal social safety net and the redistribution of income from low- and middle-income households to upper-income Americans. The way in which these changes would be accomplished, however, may not be obvious at first glance. The new fiscal agenda is made up of a number of intertwined proposals and strategies, some of the long-term consequences of which may not be immediately apparent.

At the core of the new fiscal agenda is the establishment of a constitutional requirement for a balanced federal budget each year, starting in fiscal year 2002. The agenda also includes efforts to protect defense and Social Security from budget reductions, cut taxes heavily, and make it difficult to raise taxes in the future.

Balancing the budget without raising taxes, touching Social Security, or reducing the overall level of defense spending — and while cutting taxes as well — is a formidable undertaking. It would necessitate dismantling substantial parts of the federal government over the coming decade.

- More than $1.3 trillion in non-defense, non-Social Security program cuts would be required over the next seven years to balance the budget and pay for the tax cuts contained in the "Contract with America," the campaign document that nearly all House Republican members signed last fall and that incoming Speaker Newt Gingrich has vowed to try to move through Congress quickly.

- All federal expenditures other than Social Security and defense (and the required interest on the national debt) would have to be cut nearly 30 percent compared with spending projected under current law for fiscal year 2002. In years after 2002, the reductions would grow still deeper.

If this fiscal framework is put into place by mid-1995, it is likely to lead to five noteworthy outcomes:

- Programs that are politically weak could be cut especially severely during the coming decade. Much of the federal safety net for the poor could consequently be removed.

- The middle class, despite receiving an initial tax cut, could ultimately lose more in government benefits and services than it gained in tax reductions.

- Elderly and disabled Medicare beneficiaries would likely face particularly large reductions in Medicare benefits.

- State and local governments would bear a disproportionate share of the budget cutting, which could lead to further reductions in safety net programs and to increased state and local taxes on low- and middle-income households.

- High-income households that would benefit from generous tax subsidies for investors, along with corporations, would be the only clear beneficiaries of the new agenda.

Speaker Gingrich on the Budget

"The budget is the transformation document for this system. When you change the budget, you change government. Until you change the budget, you've just talked about changing government."

"You will see changes in the next six months that will be stunning, because the legislative branch starting with the House has an enormous ability to change things, and it will happen."

Newt Gingrich
December 7, 1994

Safety Net Programs

The first indication that the safety net is in jeopardy is found in the Contract with America. The Contract calls for balancing the budget, protecting defense spending, and cutting taxes.[1] Extremely large budget cuts in domestic programs would be needed as a result. But the Contract's authors shied away from endorsing specific budget cuts before the election in most areas except one — programs targeted on the poor. Virtually all of the budget savings proposed in the Contract consist of reductions in basic food, cash, housing, medical, child care and other benefits for poor families and individuals.

The cuts in low-income programs identified in the Contract also stand out for another reason. They are unprecedented in their severity. For example, if the Contract's AFDC changes were fully in effect today, five million fewer children — over half of the children now on AFDC — would be receiving this cash assistance.[2] Overall, the benefit cuts in means-tested entitlement programs the Contract calls for are almost three times as large as the benefit cuts in such programs that were enacted in 1981 and 1982 under President Ronald Reagan.

For example, the Contract calls for ending all federal food assistance programs as separate programs — including food stamps, WIC, and the school lunch program — and merging them into a block grant to states. The block grant would be funded at levels significantly below what these programs would cost under current law and be structured so food assistance would likely be reduced about $18 billion over four years. Other low-income programs — including Supplemental Security Income (SSI) benefits for the elderly and disabled poor, AFDC, low-income housing, the child support enforcement program, child care support for working poor families not on welfare, and the employment and training program for AFDC recipients — would be placed under a separate cap that would require program cuts of $26 billion over four years. Furthermore, the major safety net programs would lose entitlement status; the funds available would no longer adjust automatically to reflect changes in the number of

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[1] The less-detailed Senate Republican campaign document — *Seven More in '94: An Agenda for the Republican Majority in the 104th Congress* — also calls for balancing the budget, increasing defense spending, shielding Social Security and defense from budget cuts, lowering taxes, and providing generous tax breaks for wealthy investors. The Republican campaign document was not signed or endorsed by most Republican Senate candidates and it does not carry as much weight in the Senate as the Contract carries in the House.

[2] The Center's estimate of the number of children who would be affected by the Contract's welfare proposals is based on the version of the Contract unveiled this fall. On January 5, 1995, when the House leadership formally introduced the Contract's welfare reform bill, some provisions of the bill were modified. The Center has not completed analysis of the January 5, 1995 version of the bill, but it does not appear that the estimate of the number of children affected will change substantially.

households in need. In addition, the Contract also calls for making most *legal* immigrants ineligible for 60 different health, education, job training, nutrition, housing, cash assistance, and social service programs.

Despite the depth of these reductions, the Contract's cuts in poverty programs would constitute only about 10 percent of the total spending cuts needed to balance the budget by fiscal year 2002 without touching Social Security or defense and while cutting taxes. These cuts thus would only be the "tip of the iceberg." Since programs for the poor are likely to remain more susceptible to cuts in the years ahead than most other programs, prospects for a significant federal safety net surviving a decade from now will be bleak if the budget agenda outlined here is adopted.

The Middle Class

A second likely outcome would be that the middle class, despite receiving an initial tax cut, would ultimately lose more in benefits and services than it gained in tax reductions. To some extent, such a result is an inevitable outcome of most plans to eliminate the deficit. Large-scale deficit reduction essentially means that the middle class must undergo some sacrifice now to secure the long-term economic benefits that smaller deficits should bring. The degree of middle-class sacrifice required, however, is increased under the emerging Republican plan because budget cuts are needed not only to balance the budget but also to finance an array of generous tax cuts primarily benefiting upper-income Americans and large corporations.

The tax cuts in the Contract are presented as losing slightly more than $190 billion in revenue over the first five years. That cost explodes, however, to approximately $470 billion in subsequent five-year periods.[3] (The Treasury Department estimated in December that the Contract's tax cuts will lose $515 billion in fiscal years 2001 through 2005, the second five years they are in effect. Subsequent changes made by House Republican leaders in one of the tax provisions moderate its cost somewhat, but the five-year loss in 2001 through 2005 appears to remain very high, at about $470 billion.)

That the tax cuts lose about two and one half times as much in the second five years they are in effect as in the first five years does *not* mean tax relief for the middle class will increase over time. The cost of the major provision in the Contract that benefits middle class households, a tax credit for children, remains relatively constant over time. The children's tax credit costs approximately $107 billion over the first five-

[3] Under federal budget laws, the first five years' losses from a tax cut must be offset either by entitlement cuts or tax increases. This rule has led some Members of Congress — and especially the authors of the Contract — to design tax breaks so their full revenue-losing effects are delayed until after the five-year point passes.

years and modestly more than that in subsequent five-year periods. By contrast, the tax cuts in the Contract that principally benefit high-income households and corporations are designed so their costs remain small — a little more than $40 billion — during the first five years after enactment but then rise to approximately $265 billion in subsequent five-year periods.[4]

Consequently, once these tax cuts take full effect, only a minority of the tax benefits will go to middle-class families. The Treasury Department has found that more than half of the benefits from the Contract's tax cuts will go to the top ten percent of U. S. families, those with incomes over $100,000 a year. About one-third of the benefits will go to the top two percent of families, those with incomes exceeding $200,000.

Meanwhile, a significant proportion of the budget cuts needed to compensate for the revenue loss are likely to fall on the middle class. To reach and stay at budget balance while these revenue losses continue to mount will require steadily larger reductions in discretionary programs important to the middle class, such as funding for education and transportation.

In addition, the large entitlement programs that will have to be reduced are mainly programs that principally benefit the middle class. Even if many of the poverty programs were abolished, the savings would fall short of what was needed to balance the budget and pay for the tax cuts. Significant reductions in middle-class benefits such as Medicare and student loans would be inescapable, with such reductions growing as the revenue losses increased.

Prospects for Medicare

Prospects for Medicare and its beneficiaries would be particularly troublesome. Medicare already faces serious financial difficulty. Medicare Part A, the component of Medicare that provides hospital insurance and is financed from the Medicare trust fund, is projected to become insolvent in 2001. To avoid insolvency without jeopardizing the health care coverage of the elderly and disabled or instituting large increases in Medicare payroll taxes, major restructuring of the U. S. health care system is needed to slow escalating health care costs. In the wake of the collapse of efforts to enact comprehensive health care reform in 1993, however, this seems unlikely.

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[4] This includes the cost of three provisions benefiting upper-income individuals or corporations: the new type of Individual Retirement Account, the capital gains tax reduction, and the more generous depreciation allowances. Certain other provisions, such as the increased estate and gift tax exclusion, also primarily benefit upper-income households.

Instead, the emerging Republican fiscal agenda could intensify pressure on Medicare in two ways. First, the Contract calls for repealing a provision of the 1993 budget law that raises the proportion of Social Security benefits counted as taxable income for the one-eighth of Social Security beneficiaries with the highest incomes. Since the revenue raised by that provision is deposited in the Medicare trust fund, its repeal would deepen Medicare's financial hole. Second, balancing the budget while exempting Social Security and defense and cutting taxes heavily is bound to place greater pressure on Medicare since it is the largest federal program remaining on the chopping block.

Some increases in out-of-pocket payments made by Medicare beneficiaries are likely to be passed this year. The full dimensions of what could turn into a major assault on Medicare are not likely to become visible, however, until later in the 1990s. At that point, the combination of a need for massive further budget-cutting to balance the budget and the looming insolvency of the Medicare trust fund could lead to efforts to cut back Medicare radically or alter it so it bears little resemblance to the current Medicare program. In fact, Speaker Newt Gingrich called publicly in early January for eventually scrapping Medicare and replacing it with "another system." Gingrich did not provide details of what an alternative to Medicare might look like beyond noting it could save "a heck of a lot of money."[5]

State and Local Governments

Another outcome is that state and local governments would be hit hard. This is true regardless of whether legislation or even a constitutional amendment bars "unfunded mandates." Grants to state and local governments constitute about one-third of what remains in the federal budget when Social Security, defense, and interest payments on the debt are excluded. Some of the rest of what remains in the budget consists of essential federal functions such as protecting the borders, maintaining embassies overseas, fighting forest fires, constructing and operating federal prisons, operating the Internal Revenue Service and Social Security offices, and providing benefits to veterans; these programs are not likely to be cut by large percentages. As a result, grants to state and local governments stand to bear a disproportionate share of the budget-cutting.

One other factor would heighten the adverse fiscal impact on states. Most states incorporate the federal definitions of adjusted gross income and corporate net income into their tax codes. Hence, the proposed tax cuts benefiting upper-income individuals and corporations would result in tax cuts — and revenue losses — in many states. State revenues would decline at the same time that federal grants to states were being cut

[5] "Gingrich Urges Replacing Medicare, But Gives No Specifics or Timetable," *Wall Street Journal*, January 6, 1995.

sharply. The resulting impact on states would, in turn, likely lead to further reductions both in assistance to low-income households and in aid to local governments, as well as to some state and local tax increases.

Virtually all states have regressive tax systems. Lowering taxes at the federal level and raising them at state and local levels would tend to transfer income from the poor and the middle class to the wealthy.

Upward Redistribution of Income

Along with corporations that would benefit from the new business tax write-offs, upper-income households would be the only clear winners under the new agenda. Not only would they receive the lion's share of the tax cuts, but they would secure a much smaller percentage of their income from government benefits than average families at middle- and lower-income levels do. Upper-income families would likely be affected the least by the required budget cuts.

These developments come at a time when Census data show the gap between rich and poor, as well as the gap between the wealthy and the middle class, is greater than at any time since the end of World War II. The proposals in the Contract, as well as the provisions in the less-detailed Senate Republican campaign document, would widen these disparities further.

II. The Emerging Republican Budget Plan

The emerging plan includes several important changes in the nation's fiscal structure and procedures.

- *A constitutional balanced budget amendment.* The House is expected to consider the amendment on January 19, while the Senate will take it up shortly after that, probably later in January. At the current time, approval in both the House and Senate by the requisite two-thirds majority appears likely. If the amendment passes in Congress and three-quarters of the state legislatures approve it within seven years, it will become part of the U.S. Constitution. Neither the President nor governors can veto the amendment. Congress and state legislatures are the actors here.

- *Tighter discretionary spending caps.* The current stringent caps on non-entitlement (or "discretionary") spending, which run through fiscal year 1998, would be extended and lowered. Procedures designed to ensure that defense spending is not reduced below planned levels — and that all additional reductions needed to meet the caps thus come from non-defense spending — are also anticipated.

- *A supermajority requirement for tax increases.* At the urging of Speaker Newt Gingrich, the House of Representatives adopted a new House rule in early January. The rule requires any measure coming to the House floor that contains an increase in income tax rates to secure the votes of three-fifths of the full House membership to pass. This rule will make it more difficult to raise taxes and help to ensure that deep cuts in domestic programs will be made to offset the tax cuts as well as to meet balanced budget requirements.

The Contract with America also calls for writing into the forthcoming balanced budget amendment a constitutional requirement that any tax-raising measure (including measures ending special-interest tax breaks) must secure the votes of three-fifths of the membership of both houses to pass. It is less clear whether there is sufficient support in either the House or the Senate to make such a requirement part of the U.S. Constitution.

These steps, coupled with the Republican leadership's move to exempt Social Security from reductions, would have profound effects. The budget would have to be balanced in seven years and remain balanced thereafter while taxes were cut substantially and defense and Social Security were protected. A recent report by the Senate Budget Committee Republican staff notes that "nearly 50 percent of spending programs have been removed from Republican deficit reduction — Social Security, defense, and net interest."

This fiscal agenda could be implemented despite the countervailing power of the President. The President has no ability to veto either a constitutional balanced budget amendment or the change in House rules requiring a three-fifths vote to raise income tax rates. To be sure, the "budget reconciliation" bill that is expected to include the tax cuts, various budget cuts, and possibly the extension and lowering of the caps on non-entitlement spending would come to the President for his signature. But this legislation also is likely to include a provision raising the debt ceiling under which the federal government borrows funds; if the debt ceiling is not raised by this summer, the federal government will go into default. The probable inclusion of all of these elements in the reconciliation bill would appear to be a shrewd strategy. If President Clinton vetoes the bill, Republicans can be expected to charge him with blocking a middle-class tax cut, frustrating deficit reduction, and risking a default on the part of the U.S. government.

How Much Would Have to Be Cut?

Based on the latest Congressional Budget Office projections, balancing the budget by fiscal year 2002 *without cutting taxes* would require expenditure cuts of $1 trillion over the next seven years. This is in addition to savings on interest payments on the debt that would result.[6]

By fiscal year 2002, the cuts would reach $260 billion a year. This equals 22 percent of all expenditures on areas other than Social Security, defense, and interest

[6] These figures assume the deficit would be steadily ratcheted down each year between now and fiscal year 2002. For years after fiscal year 1998, these figures also measure reductions in non-entitlement spending from the statutory spending cap for 1998, adjusted for inflation in years after 1998.

payments on the debt. The cuts made under President Ronald Reagan were small compared to this.

When tax cuts are added to the mix, the level of budget reductions needed climbs to still higher levels.

- Offsetting the cost of the tax cuts proposed in the Contract with America would raise the amount of budget cuts needed to balance the budget over the next seven years to more than $1.3 trillion.

- Over the next 10 years — the period from fiscal year 1996 through fiscal year 2005 — a total of $2.5 trillion in cuts would be needed. The level of required cuts mushrooms after the turn of the century. The deficit widens at that time, primarily as a result of the mounting costs of health care programs. In addition, the revenue loss from the Contract's tax cuts rises sharply after the year 2000.

- The level of annual budget cuts needed would rise to about $340 billion by fiscal year 2002.

- All federal expenditures other than Social Security and defense (and the required interest on the national debt) would have to be cut nearly 30 percent compared to spending projected under current law for fiscal year 2002. In years after 2002, the reductions would grow still deeper.

III. The New Tax Cuts

Among the tax cuts proposed in the Contract, the middle-class tax cut has received the most attention. Yet it accounts for only a minority of the revenue loss that occurs when the tax cuts take full effect. Over the long-term, the Contract's tax reductions for wealthy individuals and corporations are substantially larger than its middle-class tax cut. These tax reductions include deep cuts in taxes on capital gains income, new Individual Retirement Account tax breaks for higher-income taxpayers who lost them in the Tax Reform Act of 1986, and new depreciation provisions that will sharply reduce corporate taxes.[7]

Capital Gains Taxes

Investors who buy assets such as stocks or bonds and later sell these assets pay taxes on their profit — technically called their capital gain. The profit is measured as the amount by which their sale price exceeds their purchase price. The Contract proposes changing this measurement by adjusting the purchase price to reflect inflation between the time of purchase and the time of sale. In most cases, that would substantially reduce the amount of profit subject to taxation. The Contract also would make half of the remaining profit tax-free. The combined effect of these two changes in capital gains taxation would be to exempt most capital gains profits from taxation.

While profits from stocks, bonds, real estate speculation, and the like — which accrue primarily to those at high income levels — would be largely exempt from taxation as a result of this provision, no changes would be made in the tax treatment of interest income from the savings accounts of ordinary middle-class Americans. No

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[7] For additional information on the revenue provisions on the Contract, see the Center's report *The Contract with America Proposal: Assessing the Long-Term Impact*.

adjustment for inflation or exclusion from taxation would be provided for interest earned by savings accounts.

In addition, wealthy investors would be able to borrow large sums to purchase stocks or bonds, deduct all of the interest payments on these loans when figuring their taxes, and then sell the asset and pay tax on only half the profit remaining after the purchase price is adjusted for inflation. In many cases, the deductions taken on the interest payments would exceed the capital gain profit subject to taxation, making it appear as though the wealthy investor had lost money. These losses could then be used to offset other taxable income the investor had and thereby lower the investor's taxes. In other words, the capital gains proposals in the Contract would lead to the creation of lucrative tax shelters for wealthy investors and skew investments toward investment opportunities that yield capital gains, rather than investments yielding interest, dividends, or business income.

This potential problem has been highlighted by Herbert Stein, Senior Fellow at the American Enterprise Institute and chair of the Council of Economic Advisors under President Nixon, who has written that capital gains tax cuts are likely to result in inefficiencies and tax-avoidance schemes:

> Unless cutting the capital gains tax increases the rate of saving, it will only divert investments to projects that can be structured to yield capital gains away from projects that cannot. I see no reason to want such a diversion. On the question whether cutting the capital gains tax would increase saving you can get as many different answers as you can find econometricians. My own view is that the effect would be extremely small, and not worth betting on.... I think the only economic consequence we can confidently expect from reducing the capital gains tax is increased activity by lawyers and accountants in converting other income into capital gains.[8]

In the past, Republican supply-side tax-cutters generally have called *either* for indexing capital gains *or* for excluding 30 percent to 50 percent of capital gains profits from taxation. The Contract calls for instituting both measures, each of which constitutes a massive tax cut for wealthy investors by itself.

Past analyses by the Joint Committee on Taxation have indicated that under proposals for more modest capital gains tax cuts, approximately 50 percent of the tax benefits would go to the wealthiest one percent of American taxpayers, those with incomes exceeding $200,000 a year. About 70 percent of the benefits from the capital

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[8] *Summary of the Statement of Herbert Stein*, Senior Fellow, American Enterprise Institute, to the House Ways and Means Committee, December 17, 1991.

gains tax cuts appear to go to those with incomes exceeding $100,000, who constitute about the top five percent of taxpayers. An analysis of a much more modest proposal that excluded from income a portion of capital gains income (but did not allow indexing) found that those in the top one percent of taxpayers who would benefit from the tax break would receive tax cuts averaging more than $8,500 per year.[9]

Individual Retirement Accounts

In addition to the capital gains tax cuts, the Contract would create a new, more generous type of Individual Retirement Account tax break that would be available to taxpayers at all income levels, including upper-income taxpayers who enjoy private pension coverage. IRA tax breaks currently are available to single individuals with incomes below $35,000 and married couples with incomes below $50,000 if they are not covered by a private pension plan. About 70 percent of U. S. households are eligible for these tax benefits. The Contract would extend IRA tax breaks to other households — those that are above these income levels and that benefit from other tax-favored pension or retirement plans.

Wealthy households are more likely to have the funds to deposit in an IRA than middle-class households. In addition, IRA tax breaks are worth the most to those in the top income tax brackets, because their income is taxed at higher marginal rates. An estimated 95 percent of the tax benefits from proposals such as this would accrue to the wealthiest fifth of U.S. households.

Taxation of Social Security Benefits

The Contract also would repeal the provision enacted in 1993 that raised the proportion of Social Security benefits treated as taxable income for the one-eighth of beneficiaries with the highest incomes. Repealing this provision would provide another tax cut tilted toward those at higher income levels. As described earlier, it also would weaken the financing of the Medicare program.

Business Depreciation

Finally, but hardly least important, the Contract calls for substantial changes in the tax rules that businesses use to claim deductions for the depreciation of equipment, machinery, and buildings. These proposed changes would constitute a large corporate

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[9] The Joint Committee on Taxation and the Treasury Department use somewhat different methodologies for defining income and for grouping taxpayers into income classes. The Joint Committee considers each tax return separately, while Treasury combines tax returns of some related persons. Thus, Joint Committee data show five percent of tax filers have income exceeding $100,000 and one percent have income exceeding $200,000, while Treasury data show 10 percent of families have income exceeding $100,000 and two percent have income exceeding $200,000.

tax break. Currently, if a corporation buys a building for $100 million, it can take depreciation deductions on its tax returns that total no more than $100 million over a number of years. Under the Contract, the amount taken in depreciation deductions would *exceed* the amount the corporation paid for the building and do so by a large amount. For example, for a building purchased for $100 million, the total amount of depreciation a corporation could deduct from its taxes over time would increase under this proposal from $100 million to approximately $180 million.[10] This proposal would have the effect of sharply reducing — or even eliminating — taxable income for a number of corporations.

Under the Contract with America, this tax break would be structured in an especially dubious way. It would *raise*, rather than lower, revenue during its first five years. But in the following five years, it would lose approximately $135 billion.[11]

Passage of the Contract's tax proposals would make something of a mockery of the widely heralded Tax Reform Act of 1986. That Act sharply lowered income tax *rates* on wealthy individuals and corporations in return for scaling back the tax breaks provided for such things as capital gains, IRAs, and depreciation. Under the Contract, the tax rates faced by those in the top brackets would remain far below the rates such taxpayers encountered prior to the 1986 Act. But capital gains, IRAs, and depreciation tax breaks would not only be restored but would be made more generous than they were before 1986. The result would be windfalls for wealthy investors and large corporations. This would likely occur while much of the safety net was being taken down and cuts were made in many benefits and services for the middle class in order to meet the balanced budget requirement and pay for these tax cuts.

Some of the data cited here showing that the tax cuts would heavily benefit high-income Americans come from past Congressional Budget Office and Joint Tax Committee analyses of the effects of various tax proposals on income groups. It is unclear whether such analyses will be available in the future. The Republican Congressional leadership plans to name a new CBO director and has appointed a new director of the Joint Tax Committee. There is concern that under the new regime, these

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[10] The exact amount that could be taken in depreciation deductions would depend in part on the inflation rate. The $180 million figure noted here assumes a modest inflation rate of three percent and the 39-year depreciable life of a building used for business purposes. If inflation were higher, the deductions would be still greater.

[11] The Treasury Department has estimated that the depreciation provision included in the Contract last fall would lose more than $180 billion in revenue in the second five years the provision was in effect. On January 5, 1995, when the House leadership formally introduced the Contract, it somewhat scaled back the depreciation provision. A cost estimate on the revised provision is not yet available. Based on its design, the revised provision is likely to lose approximately $135 billion in the second five years.

institutions may cease producing analyses showing the impacts on income groups of various tax measures under consideration.

The Fiscal Impact of the Tax Cuts

The tax cuts aimed at wealthy individuals and corporations will have major fiscal impacts. They are structured so their full revenue impacts do not appear until after the end of the five-year period that is used to measure the budgetary effect of proposed changes in taxes and entitlements.

The House Republican Conference has estimated that the tax cuts in the Contract will lose about $190 billion in revenue over the first five years. A Treasury Department analysis issued in December 1994 confirms this estimate for the initial five years. But the Treasury analysis shows that in the second five years the tax cuts would be in effect, the revenue losses resulting from these provisions would explode to $515 billion. Past Joint Tax Committee and Congressional Research Service analyses of similar tax proposals indicate long-term revenue losses similar to those forecast by the Treasury. (See box on page 18.) The Republican leadership scaled back the depreciation tax break somewhat when introducing the Contract in early January, but the revenue losses from the Contract tax provisions remain very large — approximately $470 billion — in the second five years they would be in effect.

The ballooning of the revenue losses after the initial five-year period is not accidental. Federal budget debates on proposed tax cuts focus in part on whether the tax reductions would be "paid for" in their first five years through offsetting spending cuts or tax increases. This has led some Members of Congress from both parties to design provisions in recent years whose true fiscal impacts do not emerge until after the five-year point passes. The tax cuts recently proposed by President Clinton also grow after the initial five-year period ends.[12] Never before, however, have a set of tax provisions advanced by leaders of either party contained so many devices to postpone and camouflage so much of the full cost of the provisions as the tax proposals in the Contract.

Interestingly, devices of this nature are *not* employed for the Contract's middle-class tax cut; its costs do not swell after the five-year period ends. The cost of the tax credit for children, which benefits middle-class households, will remain relatively constant over time — it would cost $107 billion during the first five years and $137 billion over the second five-year period. By contrast, the proposed upper-income and corporate tax cuts — the capital gains, IRA, and depreciation provisions — are designed so their costs remain relatively small (a little more than $40 billion) during the

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[12] The Clinton tax cuts would lose $60 billion in the first five years and $114 billion in the second five years.

Revenue Losses from Proposed Tax Cuts Grow Over Time

The Contract with America calls for federal tax changes that would reduce federal revenues by a little over $190 billion over the next five years. The revenue proposals include a new tax credit for children, a new type of Individual Retirement Account, reductions in the rate of taxation of capital gains income for individuals and corporations, a reduction in taxes for businesses that invest in buildings, machinery, and equipment, and a reduction in the extent to which Social Security income is taxable for higher-income taxpayers.

The revenue loss from these tax proposals would rise dramatically after five years. The IRA, capital gains, business depreciation, and Social Security provisions in the Contract are designed so they lose smaller amounts or even raise revenue over the next five years — but then lose much larger amounts of revenue after the five-year budget period ends. In subsequent five-year periods, the federal revenue loss would reach approximately $470 billion.

- The IRA proposal is said by the House Republican Conference to raise $5 billion over the next five years. Short-term revenue gains would come from incentives for holders of current-law IRAs to pay taxes on those holdings now, rather than at retirement, and roll over the funds to the new, more generous and more flexible, IRAs. After the rollover window expires, however, the revenue losses mount. In the second five years, this proposal would lose more than $16 billion, according to the Treasury Department. Past analyses of similar proposals indicate their losses would continue to mount even after the second five-year period and could eventually be as high as $10 billion per year. The IRA proposal in the Clinton tax package uses a similar device to keep its costs low in the first five years.

- The Contract puts the cost of its capital gains proposal at $56 billion over its first five years. The proposal includes both an adjustment of the gain for inflation and an exclusion from taxation of half of the remaining gain. In the years immediately after implementation, revenues are assumed to be boosted by an increase in asset sales as investors rush to take advantage of the new provisions. Over time, however, asset sales level off and the cost of inflation indexing increases. The Joint Committee on Taxation has estimated that the cost of such a provision in the second five-year period after enactment would exceed $160 billion; the Treasury Department places the cost in the second five years at $113 billion.

- The Contract lists the depreciation proposal as raising $20 billion over the first five years. The proposal is turned into a revenue gainer for this initial five-year period by decreasing, in the first few years, depreciation allowances for equipment that turns over frequently, such as computers and vehicles. But depreciation for longer-lived assets is made much more generous, and the long-term costs of this proposal are very large. The Treasury estimated that the depreciation provision contained in the original Contract would lose more than $180 billion in the second five years. This provision was scaled back in early January by the Contract's authors. While a new cost estimate is not yet available, the revised provision still loses large sums — probably about $135 billion — in the second five years.

- The provision lowering the proportion of Social Security benefits subject to taxation for higher-income beneficiaries is phased in so that its full revenue-losing effects are delayed. The Treasury analysis shows its losses would rise from $15 billion in the first five years to $33.5 billion in the second five years.

first five years after enactment and rise to approximately $265 billion in subsequent five-year periods.

The mounting revenue losses from these tax cuts have profound ramifications. The tax cuts in the Contract raise the total cuts needed to balance the budget by fiscal year 2002 and keep it balanced after that to more than $1.3 trillion over the next seven years — and to $2.5 trillion over the next 10 years. By fiscal year 2002, nearly 30 percent of federal expenditures in areas other than Social Security and defense would have to be eliminated to offset the tax cuts and meet the balanced budget requirements.

IV. Impacts on Poor Households, the Middle Class, and State and Local Governments

To grasp the type and impact of the budget cuts likely to occur, it is useful to understand the dimensions of the reductions needed to achieve a balanced budget. Expenditures for programs other than Social Security and defense would have to be reduced 29 percent by fiscal year 2002 to balance the budget and pay for the Contract tax cuts.[13] This, of course, does not mean that each area of non-defense, non-Social Security spending would be reduced 29 percent. Some areas would inevitably be cut less and others reduced more deeply.

It is particularly unlikely that entitlements would cut this sharply. Doing so would entail cutting entitlement programs other than Social Security a cumulative total of nearly $1 trillion over the next seven years and nearly $250 billion in 2002 alone.

It is unthinkable that Congress and the White House would find close to $1 trillion in non-Social Security entitlement reductions they could pass. In the absence of system-wide health care reform that now appears moribund, there are limits to the amounts by which payments made to doctors and hospitals participating in the Medicare and Medicaid programs can be reduced without inducing substantial cost-shifting to the private sector. To achieve nearly $1 trillion in entitlement savings would likely entail drastic reductions in Medicare coverage — either through withdrawing coverage for numerous services, greatly increasing the portion of costs paid by the

[13] This assumes that defense spending is set at levels proposed by President Clinton in December 1994. Some Republican leaders have called for a higher level of defense spending. If defense spending is raised significantly above the new Clinton levels, which themselves constituted an increase over earlier defense spending levels proposed by the Administration, non-defense, non-Social Security spending would need to be reduced more than 29 percent to balance the budget by fiscal year 2002 while paying for the Contract tax cuts.

Measuring Discretionary Program Cuts

This report compares the program cuts required to offset tax cuts and balance the budget to projections of non-Social Security, non-defense spending under current law for fiscal year 2002. A document recently prepared by the Republican staff of the Senate Budget Committee also includes tables showing the amount of budget-cutting needed to balance the budget by 2002 without touching Social Security or defense or raising taxes. Its conclusions on the amount of the cuts needed to balance the budget are generally similar to the numbers used in this Center analysis. But the Republican Budget Committee staff calculated the size of the cuts needed in non-entitlement programs in fiscal years 1999 through 2002 in a somewhat different way than we did.

Both we and the Republican staff projected spending under current law for fiscal years 1999 through 2002 based on the amount of non-entitlement spending allowed in fiscal year 1998, the last year for which non-entitlement spending is currently capped. In projecting spending under current law for fiscal years 1999 through 2002, the Republican staff did *not* adjust the amount of spending allowed in fiscal year 1998 for inflation in the years from 1999 to 2002. We did make such an inflation adjustment; CBO also has traditionally included such an adjustment in developing its budget estimates and deficit projections.

The approach used in the Senate Republican document reflects the view that when funding for a program rises to keep pace with inflation, this should be regarded as a spending increase. Under this perspective, freezing spending with no adjustment for inflation does not constitute a cut.

There are flaws with this argument, however. The cost of delivering goods and services rises with inflation. If a particular non-entitlement program provides funding to states to deliver a service, for example, the salaries and fringe benefits the state pays the employees who provide the service — along with the goods the state must purchase to carry out the program — will increase as prices rise. Accordingly, if program funding is frozen, the state generally must reduce the level of services provided. This is why the Congressional Budget Office and the Office of Management and Budget have customarily measured increases and cuts in non-entitlement spending by comparing proposed levels for future years to the current year's level, as adjusted for inflation.

In addition, many of those who argue for ignoring the effects of inflation take a different tack when speaking of the defense budget. Some of the same Members of Congress who argue that a freeze is not a cut when domestic programs are concerned speak of the large defense cuts that have occurred over the past decade. Yet actual defense spending in fiscal year 1994 was $277 billion, slightly above the fiscal year 1986 figure.

Statements that the defense budget has been pared back are correct. For example, there are eight fewer divisions and 15.5 fewer fighter wings than at the peak levels in the 1980s. The same point, however, holds true for domestic programs. Services must be cut when funding levels are frozen year after year. The Republican staff document understates the magnitude of the cuts that will be needed in non-entitlement programs if the budget is to be balanced in 2002, because the document ignores the reductions that will have to be instituted if this part of the budget is frozen from fiscal year 1998 to fiscal year 2002.

beneficiaries, or both — along with elimination of Medicaid coverage for various services and possibly for some categories of beneficiaries, major reductions in programs like student loans, veterans' benefits, military and civil service retirement, and farm price supports, and deep cuts in safety net programs providing basic benefits for the poor.

If entitlement programs are cut less than 29 percent, the non-entitlement programs must be cut more deeply. Suppose total spending for non-entitlement programs other than Social Security were cut 20 percent by fiscal year 2002; this would entail unprecedented reductions of about $170 billion a year by 2002. If that were done, non-entitlement programs other than defense would have to cut more than 45 percent by 2002 to balance the budget and pay for the Contract's tax cuts. Nearly half of the non-entitlement side of the government, other than defense, would disappear.

Impact for Poor Families and Individuals

The implications of this budget strategy for poor families are profound. Programs targeted on low-income families are likely to suffer larger percentage reductions than those that principally benefit the broad middle class. To achieve budget balance while paying for tax cuts and shielding defense and Social Security, benefit for low-income families and individuals would likely be cut heavily.

Developments to date point strongly in this direction. Of the more than $1.3 trillion in spending reductions needed to balance the budget by fiscal year 2002 and pay for the tax cuts they propose, the authors of the Contract found it prudent to identify only about $59 billion in specific reductions (measured over four years) before the elections.[14] Nearly all of the cuts they identified would come in means-tested benefits for low-income families. In addition, in early January, in discussing which programs under his jurisdiction to reduce to help pay for tax cuts, House Ways and Means Committee chairman Bill Archer identified only one type of program — welfare programs.

The cuts in low-income programs contained in the Contract are unprecedented in their depth. Overall, the benefit cuts the Contract calls for in means-tested entitlement programs are about three times as large in real terms as the benefit cuts in

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[14] The authors of the Contract (the House Republican Conference) estimated that the provisions in the Contract's Personal Responsibility Act would save $40 billion over fiscal years 1995 through 1999 (although the provisions do not take effect until 1996). The Center on Budget and Policy Priorities finds that the effect of the PRA would be a net reduction of about $59 billion over the four-year period from 1996 to 1999, with the cuts escalating over time. For additional information, see the Center's report *The Personal Responsibility Act: An Analysis.* The Center's analysis of the Personal Responsibility Act is based on the version of the bill unveiled in September 1994. Estimates based on the January 1995 version of the bill may differ slightly.

such programs that were enacted in 1981 and 1982 under President Ronald Reagan.[15] For example, if the AFDC changes were fully in effect today, five million children — over half of the children now on AFDC — would lose all their cash assistance. (See box on page 25.)

The Contract also calls for ending all federal food assistance programs as separate programs — including food stamps, the school lunch program, and WIC — and merging them into a block grant. The block grant would be funded at levels several billion dollars a year below what these programs would cost under current law. The block grant is constructed in such a manner that food stamp assistance would likely be reduced about $4 billion a year. Furthermore, programs like food stamps and school lunches would lose their entitlement status.

Loss of entitlement status would be particularly problematic when recessions hit and the number of poor families needing food stamps and the number of poor children needing free school lunches increased. From June 1990 to June 1992, when the civilian unemployment rate rose from 5.1 percent to 7.7 percent, food stamp participation climbed by more than five million people. The average number of low-income children receiving free school lunches rose by more than one million during this time. Under the contract, increased additional federal resources to meet mounting needs during recessions would no longer be forthcoming. States would have to cut benefits across the board, eliminate benefits for various categories of poor households, or put needy applicants on waiting lists, unless states were willing to cut other programs or raise taxes in a recession.

Another provision in the Contract would place a cap on total annual expenditures for an array of low-income programs, including Supplemental Security Income (SSI) benefits for the elderly and disabled poor, AFDC, low-income housing, the child support enforcement program, and child care support for working poor families not on welfare. The cap would require that these programs be cut by about $26 billion over four years. Here, too, entitlement status would be ended for all programs that currently are entitlements. This would mean that additional federal AFDC funds would no longer become available automatically if a recession temporarily increased the numbers applying for assistance. Nor would additional SSI resources automatically become available if the number of elderly poor applying for benefits rose as the number of elderly people climbed.

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[15] The spending on the proposed new work program for AFDC recipients is not considered in this calculation. This spending is for administrative and child care costs for those in the new mandatory work slots, while this calculation attempts to measure changes in benefits to low-income people that affect their standard of living. If the spending on the work program was included, then the cuts identified in the Contract would still be twice the size of the cuts in the early 1980s.

PRA Would Begin to Dismantle Key Features of the Safety Net and Deny AFDC to Five Million Children

A proposal affecting low-income programs, the Personal Responsibility Act (PRA), is part of the "Contract with America" unveiled in September 1994. A slightly revised version of the PRA was introduced in the House in early January 1995. The PRA differs in important ways from recent welfare reform plans. Key elements of the bill include the following:

- The PRA proposes deep cuts in a broad range of programs for low-income households and eliminates the entitlement status of most major low-income benefit programs, including the Supplemental Security Income program for the elderly and disabled poor and the food stamp program. The effect would be a net reduction in low-income programs of about $59 billion over the four-year period from 1996 to 1999, with the cuts escalating over time.

- The bill would deny Aid to Families with Dependent Children and housing benefits to many poor children born to young unmarried mothers for their entire childhood, diverting these funds to support programs such as orphanages for poor children. In addition, the "child portion" of AFDC benefits would be denied for children whose paternity has not been established even if their mothers were fully cooperating with state efforts to track down the absent fathers and establish paternity. Some 29 percent of the children currently receiving benefits — 2.8 million children — do not have paternity established. These provisions would apply to all new applicants for AFDC (as distinguished from those now on the rolls). Eventually, the provisions would apply to the full AFDC caseload.

- The bill would establish extremely stringent time limits and work requirements. States would be required to terminate both cash assistance and work opportunities for families who had received AFDC for a total of five years; regardless of their circumstances, these families could never receive assistance again. States would have the option of ending welfare assistance for families after they receive aid for a total of two years. The PRA would *not* provide work opportunities for parents who reach these time limits and are unable to find jobs even if the parents fully complied with work requirements while on assistance and made faithful efforts to find employment. During the period in which they would receive aid, a large fraction of recipients would be required to work their AFDC benefits off at "wages" that would equal $2.42 an hour for a family of three in the typical state.

- In combination, PRA provisions that would bar certain categories of children from receiving AFDC benefits and the PRA's mandatory time limit would ultimately deny assistance to *a majority* of the children who would be eligible for AFDC under current law. If the provisions were fully in effect today, more than five million children would be denied AFDC. At least 2.5 million fewer families would receive AFDC benefits.

In recent weeks, some Republican Members of Congress and some Republican governors have spoken of creating an alternative proposal under which current welfare programs are replaced with a welfare block grant at significantly reduced funding levels. It is unclear whether some of the requirements in the PRA would be part of the block grant. Also unclear is the amount that funding would be cut. It should be noted that whatever the size of the initial cut, a welfare block grant would likely be cut further in subsequent years as Congress struggled to meet the austere caps on non-entitlement spending that the Republican budget strategy will require. Moreover, because of the block grant structure, additional federal funds for assistance to poor families would no longer become available automatically when a state's economy entered a recession and the number of poor families needing aid increased.

Still another provision of the Contract would make most *legal* immigrants ineligible for 60 different health, education, job training, housing, cash aid, and social service programs. Legal immigrant children could not be screened for lead poisoning and would be barred from immunization programs. Pregnant women who are legal immigrants would be barred from WIC. Legal immigrants who became disabled on the job in the United States would be shut out of SSI.

As noted, these low-income benefit cuts would be much larger than those in low-income entitlements secured by President Reagan in his first two years in office, when nearly all of the cuts in low-income benefits during his term were passed. Yet even if all of the low-income cuts listed in the Contract were enacted, only about 10 percent of the cuts needed to balance the budget and pay for the tax cuts would have been secured. Severe as the Contract's proposed cuts in benefits for the poor are, they would be but the tip of the iceberg, just the first installment of much deeper cuts in programs serving low-income households that would almost certainly follow.

There also is another lesson in the low-income cuts included in the Contract. The fact that the specific cuts House Republicans felt comfortable endorsing before the election consisted overwhelmingly of reductions in benefits for the poor speaks volumes about the political weakness of programs for the less fortunate in the current political atmosphere.

In short, the chances are high that the budget and tax changes likely to be put in place in the first half of 1995 would lead to the weakening of much of the federal safety net in the decade ahead.

Impact on the Middle Class

Evisceration of the safety net would not, by itself, provide the level of cuts needed to balance the budget and pay for the tax cuts. A need for hundreds of billions of dollars in additional savings would remain. *Non*-means-tested entitlements also would have to be reduced to meet the requirements of the entitlement cap, and appropriations for many discretionary programs primarily serving the middle class would have to be sliced to comply with the discretionary caps.

The losses in benefits and services borne by middle-class households would likely outweigh by a significant margin the tax cuts these households receive. The principal middle-class tax cut in the Contract — a $500 tax credit per child — accounts for less than 30 percent of the revenue loss generated by the Contract's tax provisions when their full revenue impacts are felt (that is, after the five-year mark passes). To reach budget balance and offset these tax cuts will entail steadily increasing reductions in discretionary programs important to the middle class. In addition, the large entitlement programs that ultimately will have to be reduced principally benefit the

What About Social Security?

Republican leaders have said Social Security is now off-limits to budget cutting. That does not mean, however, that Social Security will remain off-limits permanently.

Speaker Newt Gingrich has said that Congress should look at Social Security at some future point, perhaps five to seven years from now. Changes in Social Security at some point are inevitable because the program is out of long-term actuarial balance. To keep Social Security on a sound footing for the future, actuarial balance must be restored. Moreover, reductions in Social Security costs would count toward meeting the balanced budget requirement.

There is a difference, however, between adjusting Social Security benefit levels and taxes to achieve the long-term actuarial balance needed to accommodate the retirement of the baby-boom generation and cutting Social Security to meet a balanced budget stricture. A requirement to keep the budget balanced every year after 2002 as the population ages — while cutting taxes sharply and maintaining or raising defense spending levels — is likely to lead over time to pressures for greater long-term reductions in Social Security than would otherwise be the case. In that situation, benefits could be reduced significantly more than needed to place the program in long-term actuarial balance.

middle class. From increases in out-of-pocket costs for Medicare services to reductions in student aid for middle-class college students to hikes in school lunch prices, middle-class households would be likely to have their incomes reduced or their expenses raised in various ways.

This is particularly true for those relying on Medicare. Some Medicare reductions requiring beneficiaries to pay more out of pocket are likely in 1995. Much deeper Medicare reductions are likely in the late 1990s.

As noted earlier, the Medicare hospital insurance trust fund is projected to become insolvent in 2001. The proposed repeal of the provision of the 1993 budget law that raised the portion of Social Security benefits counted as taxable income for higher-income beneficiaries would exacerbate this problem, because the taxes on that income currently are deposited in the Medicare trust fund. Congress may be unwilling to approve any increase in the Medicare payroll tax to help close part of the financing gap, and comprehensive health care reform, which could ease pressure on Medicare by slowing the rate of growth in health care costs in both the public and private sectors, seems unlikely. Finally, the need to avoid shifting tens of billions of dollars in costs now paid by Medicare to private employers, as could occur if payments to Medicare providers were cut deeply, limits the savings that can be achieved from lowering Medicare fees to physicians and hospitals.

The likely result is a full-scale Medicare financing crisis in the late 1990s at the same time that massive additional savings are needed to comply with the balanced budget requirement by 2002. Major retrenchment in Medicare that alters the nature of the program and shifts large costs back to elderly and disabled individuals (and to relatives on whom they may be forced to rely) may become a strong possibility in such an atmosphere. If that occurs, the health care expenditures borne by many middle-class households would likely rise substantially.

Middle-class households also can be expected to face sizeable increases in state and local taxes to help fill the hole created by large-scale retrenchment in federal aid to state and local governments (see below). Virtually every state has a regressive tax system, under which poor and middle-class households pay a larger share of their incomes in taxes than higher-income households do. The process of shifting the responsibility for collecting taxes and providing benefits and services from the federal to state and local levels would tend to redistribute disposable income from low- and moderate-income families to those at higher income levels.

Effects on State and Local Governments

The arithmetic of achieving a balanced budget without cutting Social Security or defense or raising revenues — and while cutting taxes — virtually assures that states and localities will absorb large hits. Grants to state and local governments make up one-third of what remains in the federal budget when Social Security, defense, and interest payments on the debt are excluded.

If overall expenditures other than those for Social Security and defense must be cut sufficiently both to balance the budget and pay for the Contract's tax cuts, nearly 30 percent of non-Social Security, non-defense costs must be eliminated by fiscal year 2002. Grants to state and local governments, however, almost certainly will be cut by a larger percentage than this. Much of the budget that remains on the table after Social Security and defense are removed consist of federal programs that either cannot or will not be cut very much, which would make the cuts in other areas — such as grants to state and local governments — still deeper.

For example, funds for federal functions such as protecting the borders, maintaining embassies overseas, fighting forest fires, constructing and operating federal prisons, operating the Internal Revenue Service and Social Security offices, and making pension and disability payments to veterans are unlikely to suffer more than modest cuts. These and other tasks tend to be viewed as essential federal functions. To the extent that large portions of the budget are reduced significantly less than 30 percent, grants to states and localities will be cut by a substantially larger proportion.

This problem will be aggravated because most of the tax cuts called for in the Contract would generate revenue losses for many states as well. Most states conform the definitions of individual adjusted gross income and corporate net income used in their income tax codes to the federal definitions of such income. Several of the major tax cuts proposed by the Republican leadership — such as the cuts in capital gains tax, the expansion of Individual Retirement Accounts, and the much more generous depreciation schedules — would be incorporated into many state tax codes if these measures were enacted at the federal level. The result would be narrower state tax bases and some loss of state revenue. The revenue loss would occur at the same time that the federal government was sharply scaling back grants to states and localities, placing state and local governments in a double bind.

An Unfunded Mandate Ban Does Not Address These Problems

Some state and local officials believe passage of legislation or a constitutional amendment barring new unfunded mandates would address these problems. Such a belief is mistaken. Unfunded mandate protection would affect only those situations where the federal government *requires* other levels of government to perform certain tasks without paying the cost of those tasks. Unfunded mandate provisions do not prevent highly disproportionate cuts in aid to states and local governments that result from large parts of the federal budget being placed off-limits while the budget is being balanced and taxes are cut. Nor would an unfunded mandate measure forestall federal decisions to shed functions that some level of government must perform, thereby leaving other levels of government little choice but to pick up the pieces without any federal funds to undertake the work.

An unfunded mandate ban would not, for example, protect against increases in Medicare cost-sharing requirements that drive up state Medicaid costs under "medically needy" programs. It would not protect against cuts in child care programs that increase the load on public schools that operate pre-school programs with state or local funds. Neither would unfunded mandate protection replace lost federal funding for primarily state-local functions, such as mass transit, education, or economic development.

Local governments could be hit particularly hard. In addition to large cuts in federal aid, they would likely be saddled with deep reductions in state aid as states passed on part of the pain caused by the withdrawal of billions of dollars in federal grants. The consequent reduction in both federal and state support for cities would occur at the same time the safety net was being substantially weakened, a mix that could spell trouble for some cities.

CENTER ON BUDGET AND POLICY PRIORITIES

BACKGROUND ON THE CENTER

The Center on Budget and Policy Priorities, located in Washington, D.C., is a leader in analyzing a broad range of budget and policy issues, with an emphasis on those affecting low- and moderate-income Americans. The Center has attained a national reputation for blending rigorous research with the ability to present work in a timely and non-technical manner. The Center is a principal source of information and analysis for policymakers, program managers, the media, nonprofit organizations, and researchers at the federal, state, and local levels. In 1988, *Washington Monthly* magazine called the Center one of the five best among 2,000 nonprofit organizations working on public policy issues in Washington.

Research is the foundation of all Center activities. Using data from the most reliable sources, the Center analyzes such matters as federal and state budget and tax policies, poverty and income trends, wage and unemployment issues, and welfare, job training, and housing issues. The Center's work on federal budget and policy issues dates back to its inception in 1981. In the late 1980s, the Center began to expand its work on state issues, and in 1992, the Center established the State Fiscal Project, which studies state budget matters and related policy issues in depth.

The Center on Budget and Policy Priorities is an independent, nonprofit, tax-exempt organization supported primarily by major foundation grants. With approximately 40 employees, it has an annual budget of more than $3 million.

Members of the Center's board of directors include John R. Kramer, Dean of Tulane Law School; Henry J. Aaron, Director of the Economic Studies Program, Brookings Institution; Richard C. Atkinson, Chancellor, University of California, San Diego; Angela Glover Blackwell, President, Urban Strategies Council, Oakland, California; Rebecca M. Blank, Associate Professor of Economics, Northwestern University; David de Ferranti, Director, Population Health and Nutrition Department, the World Bank; Marian Wright Edelman, President, Children's Defense Fund; Arthur S. Flemming, former Secretary, U.S. Department of Health, Education, and Welfare; James O. Gibson, Senior Associate, Urban Institute; Thomas L. McNaugher, Senior Fellow, Foreign Policy Studies, Brookings Institution; Eleanor Holmes Norton, Congresswoman, District of Columbia; Marion Pines, Senior Fellow, Johns Hopkins University Institute for Policy Studies; Susan Sechler, Vice President, the Aspen Institute; Juan Sepulveda, Jr., Research Associate, Southwest Voter Research Institute; William Julius Wilson, Professor of Sociology and Public Policy, University of Chicago; William S. Woodside, Chairman, Sky Chefs, Inc.

CENTER ON BUDGET AND POLICY PRIORITIES

WHAT OTHERS SAY ABOUT THE CENTER

"...I leave the Board convinced more than ever that the work of the Center is vital to the future of our nation. The Center's impact on the course of public policy has been more significant than that of any other organization with which I have been affiliated."

Robert Reischauer, in resigning from the Center's board to become Director of the Congressional Budget Office

"I'd be grateful for your work if it were merely quick, but it's also sound. You are often critical of what comes out of the agencies...but your shots are never cheap. There can't be a lot of financial reward for what you are doing...all the more reason to tell you how much I use, appreciate, and indeed, admire the Center's work."

Jack Rosenthal, *The New York Times*; statement made when he was Editorial Page Editor

"[The Center's] influence derives from the invariable accuracy of the Center's work...[it is] assembled with great speed and made available to legislators, reporters and public organizations while policy action is in progress, focusing on angles of issues that may not be readily apparent from raw reports... In short, the Center has credibility."

Washington Post profile on the Center

"[The Center] has made itself a key player in the ever-important debate over the federal budget. What makes the Center unusual, cast against its liberal type, are its business-page approach to poverty and the brief it carries for fiscal discipline....The Center has found a powerful niche by purveying timely analyses of complex and often confounding fiscal issues."

National Journal profile on the Center

"Their numbers, which are trusted across the ideological spectrum, often speak for themselves."

"The Best and Worst of Public Interest Groups"
The Washington Monthly, March 1988, naming the Center one of the five best public interest groups in Washington

"What makes them unique is the consistent high quality of their research and analysis. When you get material from them, you know it's accurate."

Michael Weinstein
Editorial Board, *New York Times*

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CENTER ON BUDGET AND POLICY PRIORITIES

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FOOD BLOCK GRANT PROPOSAL CIRCULATED BY REPUBLICAN GOVERNORS WOULD HAVE SEVERE, UNINTENDED RESULTS, ANALYSIS FINDS

A block grant proposal presented to Congressional Republican leaders last week by a group of Republican governors would cause substantial reductions in food assistance for poor families and elderly people, according to an analysis of the proposal by the Center on Budget and Policy Priorities. Also affected would be the school lunch program which includes benefits to middle-income children.

If the proposal had been in effect since 1989, the large majority of states would have received at least 20 percent less in federal food assistance in 1994, the report found. If the proposal is put into place today, states would have nearly $8 billion less in food assistance over the next four years, even if no recession occurs.

Under the proposal, all federal food assistance programs would end in their current form and be converted to a block grant. Funding for the block grant would be set at the amount expended for these programs in fiscal year 1994, adjusted only for inflation. Each state's share of the block grant would be permanently set at its percentage share of federal food assistance funds in 1994.

Proposal Unresponsive to Recessions

The Center's analysis shows that block grant funding levels would fail to respond to such factors as increases in poverty during recessions and rising school enrollments. As a result, it would cause major reductions in food assistance. Had an identical proposal been passed five years ago and been based on federal funding levels in fiscal 1989, a year before the recession of the early 1990s began, every state in the nation but one would have received less to meet the needs of its residents than was actually provided last year. Some 35 states would have lost more than 20 percent of the federal food assistance funds they received last year.

California would have lost nearly half — 48 percent — of the federal food assistance funds it received last year, nearly $2 billion. Florida would have lost 49 percent of the funds it received. Other states that would have lost 30 percent or more of the funds they received to provide food aid to the poor include Alaska, Arizona, Connecticut, Delaware, the District of Columbia, Georgia, Hawaii, Indiana, Maine, Maryland, Nevada, New Hampshire, New Jersey, New Mexico, New York, North Carolina, Rhode Island, Texas, Vermont, and Virginia. (State-by-state data are included in the full report.)

— more —

Nearly $8 Billion Cut Over Next Four Years, Even if no Recession

Even if no recession were to occur for years into the future — an unlikely scenario — federal funding for food assistance would be reduced in coming years below the amounts that would be provided under current law, according to the Center's analysis. If no recession were to occur between now and 1999 and the economy were to perform in accordance with the Congressional Budget Office's assumptions, states would lose $7.8 billion over the first few years of the block grant. The reductions in funding, as compared to funding levels under current law, would grow larger each year, the Center said.

The Center's analysis found that while the overall level of federal block grant funding would be adjusted for inflation, it would fail to reflect several other key factors such as increases or decreases in poverty and unemployment and school enrollment. The Department of Education, for example, estimates that the number of elementary and secondary school children will rise eight percent over the next five years; this will result in more children eating school lunches. Under current law, federal school lunch funding would rise to met this additional increase and later decline if school enrollment subsequently decreased. Because the school lunch and other food aid programs would be merged into a block grant that did not respond to such changes in need, however, the governors' proposal would force states to choose between such actions as raising the amounts middle-class parents must pay for their children's lunches and cutting food assistance to poor children and elderly and disabled people (the vast majority of food aid recipients) even more than would otherwise be the case under the proposal.

"I doubt the governors who designed the proposal fully understood its ramifications," the Center's director Robert Greenstein noted. "It would harm state treasuries along with poor families, children and elderly people."

"The next time a recession hits and millions of Americans lose their jobs, many of the newly unemployed will seek food assistance to get them through a rough period," Greenstein noted. "States would be forced to choose between meeting the increased need entirely with state funds — and probably raising state taxes in the middle of a recession to do it — or leaving the need unmet and witnessing steep rises in hunger, hardship, and destitution."

The Center on Budget and Policy Priorities conducts research and analysis on a range of government policies and programs, with an emphasis on those affecting low- and moderate-income people. It is supported primarily by foundation grants.

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CENTER ON BUDGET
AND POLICY PRIORITIES

January 12, 1995

HOW WOULD A FOOD ASSISTANCE BLOCK GRANT ADJUSTED FOR INFLATION AFFECT STATES?

By Robert Greenstein and David Super

A group of Republican governors have proposed replacing the current federal nutrition assistance programs with a block grant to states. Under their proposal, the overall size of the block grant each year would equal the amount expended in these programs in FY 1994, adjusted for inflation. In addition, each state's share of the total federal appropriation would equal its share of federal food assistance spending in fiscal year 1994.

Some governors may believe that annually adjusting the block grant funding level for inflation would protect states from cuts in nutrition funding that would have resulted under earlier food block grant proposals. In fact, the Republican governors' new proposal itself would result in substantial and rapidly rising cuts in federal funding to states for food assistance.

- If no recession occurs between now and 1999, states would lose $7.8 billion over the first four years of the proposed block grant, compared with the amounts states would be provided under current law. These cuts would grow larger over the years; by fiscal year 1999, the cut would equal $3.3 billion per year.

- If a recession occurs, the cut would be far more severe. During recessions, existing food assistance programs such as food stamps and free school meals expand automatically to meet rising need as poverty and unemployment increase. Federal funding under the proposed block grant would not expand during economic downturns and would fall far behind need — and far behind what the existing programs would have provided. This is particularly true because the base year that would be used to calculate the amount provided for block grants — presumably 1994 — was a recovery year, when economic conditions were far more favorable than during recession years.

  During past recessions, federal spending on food assistance programs has risen sharply. When ensuing economic recoveries subsequently reduced unemployment and poverty rates, federal spending has receded. At present, the entitlement funding of the food stamp and child nutrition

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programs ensures that the federal government bears the added burden during economic downturns. Under the proposed block grant, states would have to meet the increased need during recessions entirely with state funds.

An analysis of how states would have fared last year if an identical block grant proposal had been enacted five years earlier illustrates this point. Had a block grant been passed that set the block grant at the overall level of federal expenditures in fiscal year 1989, adjusted for inflation — and fixed each state's share of the block grant at its share of the FY 1989 expenditures — more than $10 billion in fiscal year 1994 food assistance support — 29 percent of the total food assistance nationally — would have been lost. (See Table 1.) The onset of recession in the intervening years accounts for a substantial share of this loss in funds; under the block grant proposal, no additional funds would be provided when unemployment and poverty rose during economic downturns.

If such a block grant had been passed in 1989, every state in the nation but one would have received less in food assistance funding in 1994 than was actually provided. All but four states would have lost more than 10 percent of the funding provided in the state in FY 1994. Some 35 states would have lost more than 20 percent of the funds received under the current programs. California and Florida each would have lost about half of their food assistance funds, with California losing 48 percent of the food assistance funding it received in fiscal year 1994 and Florida losing 49 percent.

Even if no recession were to take place for years to come, states would still lose funding throughout the rest of the 1990s under this proposal. A block grant that adjusts only for inflation is likely to leave states with inadequate resources to meet food assistance needs for several reasons:

- The block grant would not take into account increased need for school lunches and breakfasts as school enrollments rise. The U.S. Department of Education projects that the number of children in grades K through 12 will rise more than eight percent over the next five years. This is one of a number of reasons that, even without a recession, the proposed block grant would represent a cut in projected federal grant levels to states.

- Similarly, the proposed formula does not account for projected increases in the number of low-income children who will be enrolled in child care institutions and qualify for meals under the child care food program. As states move more poor mothers from welfare to work, the number of low-income children in child care will rise. Federal funding under the child care food program expands automatically to meet increases in need; a block grant would not do so and would leave states further short of funds.

- Rolling the WIC program into a block grant that expands only at the rate of inflation also would effectively end prospects for achieving the national, bipartisan goal of achieving full funding for WIC so all eligible mothers and children can be served. The WIC program has been found to reduce infant mortality, low birthweight, and child anemia — and state and federal Medicaid costs.

- Finally, as described in another recent Center analysis, Congress could reduce the amount appropriated for the block grant below the amounts specified in the legislation that establishes the block grant. With deep cuts in total federal spending required if the federal budget is to be balanced by fiscal year 2002, the block grant could still undergo substantial additional cuts.

Problems with Distributing Funds Among States

One other problem looms. Freezing each state's percentage share of block grant funds at its share of total nutrition spending in fiscal year 1994 would expose some states to particularly sharp funding shortages. Under the existing programs, states whose economies are performing poorly automatically receive additional federal food stamp and school lunch dollars to meet the needs of the newly unemployed. In the same way, any state with increased school or child care enrollment automatically receives increased federal child nutrition funding. This means that states whose economies fare more poorly than the average state economy, whose population growth is above average, or whose school and child care enrollment is rising at an above average rate, could receive too small a share of the funds available nationally. Suppose, as the Republican governors' proposal suggests, each state's share of the block grant is set at its share of total federal food assistance expenditures in fiscal year 1994. As the years pass and 1994 recedes farther in the past, the inequities among states will grow larger. These inequities will become particularly acute during recessions when some states suffer sharp increases in unemployment while others do not.

The problems that this distribution formula would cause can be seen by looking at the distribution of federal food assistance funds to states in fiscal year 1989 and fiscal year 1994. Suppose the percentage share of funds each state received in fiscal year 1994 were held to the same level as in fiscal year 1989. What would have happened? Even if the block grant proposal were redesigned *so the total amount of funds distributed nationally in 1994 equaled the amount actually distributed last year,* most states would have lost or gained more than five percent. Delaware, for example, would have gotten 15 percent less in federal funds than it actually received; Florida would have lost 28 percent of its funds; California would have lost 27 percent. Meanwhile, Wisconsin would have obtained 19 percent more than it received under current law, while Michigan received 18 percent more. (See Table 2.) As noted above, these problems deepen when one takes into account that under the proposal, the amount of food assistance foods distributed nationally — and thus to each state — would be less than would be the case under current law.

Finally, states vary in the degree to which their eligible populations can be served with the federal WIC funds they receive. As a result, a portion of each year's WIC appropriation now is allocated to help expand WIC participation in states that historically have received lower-than-average WIC funding. A block grant that froze each state's share of total nutrition funding at 1994 levels would lock in current inequities in the distribution of WIC funds.

TABLE 1: The Effect the Republican Governors' Food Block Grant Proposal Would Have Had in 1994 if it Had Been Adopted in 1989

(in millions of dollars)

	Federal Nutrition Funds in FY 1989	Federal Nutrition Funds in FY 1994	Share of Nutrition Funds in FY 1989	Federal Nutrition Funds in FY 1994 if GOP Gov. Prop. Adopted in 1989	Gain (Loss) if FY 1994 Funds Set at FY 1989 Levels Plus Inflation and State % Shares Set at 1989 Shares	
					($ millions)	(percent)
Alabama	$471.1	$708.3	2.30%	$575.9	(132.4)	-18.7%
Alaska	48.7	92.5	0.24%	59.5	(32.9)	-35.6%
Arizona	328.4	653.9	1.61%	401.5	(252.4)	-38.6%
Arkansas	241.0	366.7	1.18%	294.6	(72.1)	-19.7%
California	1,713.2	4,035.4	8.38%	2,094.2	(1,941.2)	-48.1%
Colorado	234.4	362.5	1.15%	286.5	(76.0)	-21.0%
Connecticut	138.2	272.6	0.68%	168.9	(103.7)	-38.0%
Delaware	40.8	82.6	0.20%	49.8	(32.8)	-39.7%
Dist. of Col.	67.2	130.6	0.33%	82.1	(48.5)	-37.1%
Florida	817.2	1,962.6	4.00%	999.0	(963.6)	-49.1%
Georgia	586.9	1,106.3	2.87%	717.4	(388.9)	-35.2%
Hawaii	114.9	213.9	0.56%	140.5	(73.4)	-34.3%
Idaho	74.9	113.0	0.37%	91.6	(21.5)	-19.0%
Illinois	1,086.6	1,545.4	5.31%	1,328.3	(217.2)	-14.1%
Indiana	339.1	627.4	1.66%	414.5	(212.9)	-33.9%
Iowa	189.6	257.8	0.93%	231.8	(26.1)	-10.1%
Kansas	167.3	276.9	0.82%	204.5	(72.4)	-26.2%
Kentucky	470.9	639.3	2.30%	575.6	(63.7)	-10.0%
Louisiana	750.7	994.8	3.67%	917.7	(77.1)	-7.7%
Maine	86.6	163.4	0.42%	105.9	(57.5)	35.2%
Maryland	298.0	525.5	1.46%	364.2	(161.3)	-30.7%
Massachusetts	319.2	545.1	1.56%	390.2	(154.8)	-28.4%
Michigan	835.1	1,224.4	4.08%	1,020.9	(203.5)	-16.6%
Minnesota	278.3	458.0	1.36%	340.3	(117.7)	-25.7%
Mississippi	504.1	611.8	2.46%	616.2	4.4	0.7%
Missouri	421.0	716.8	2.06%	514.6	(202.1)	-28.2%
Montana	71.3	103.4	0.35%	87.1	(16.3)	-15.7%
Nebraska	108.7	168.3	0.53%	132.9	(35.4)	-21.0%
Nevada	56.1	135.1	0.27%	68.6	(66.5)	-49.2%
New Hampshire	34.9	65.5	0.17%	42.7	(22.9)	-34.9%
New Jersey	422.3	755.9	2.06%	516.2	(239.6)	-31.7%
New Mexico	188.0	333.5	0.92%	229.8	(103.7)	-31.1%
New York	1,658.8	2,896.0	8.11%	2,027.7	(868.3)	-30.0%
North Carolina	471.3	824.3	2.30%	576.1	(248.1)	-30.1%
North Dakota	54.2	77.2	0.26%	66.2	(11.0)	-14.3%
Ohio	1,074.2	1,497.3	5.25%	1,313.2	(184.1)	-12.3%
Oklahoma	308.6	507.1	1.51%	377.2	(129.9)	-25.6%
Oregon	235.1	374.4	1.15%	287.4	(87.0)	-23.2%
Pennsylvania	895.4	1,468.2	4.38%	1,094.6	(373.6)	-25.4%
Rhode Island	60.7	113.1	0.30%	74.1	(39.0)	-34.5%
South Carolina	323.4	514.3	1.58%	395.4	(119.0)	-23.1%
South Dakota	72.9	92.1	0.36%	89.1	(3.1)	-3.3%
Tennessee	508.1	857.7	2.48%	621.1	(236.6)	-27.6%
Texas	1,840.2	3,458.5	9.00%	2,249.5	(1,209.1)	-35.0%
Utah	131.6	203.2	0.64%	160.8	(42.3)	-20.8%
Vermont	38.2	72.7	0.19%	46.7	(26.1)	-35.9%
Virginia	378.9	696.9	1.85%	463.1	(233.8)	-33.5%
Washington	329.0	615.2	1.61%	402.2	(213.0)	-34.6%
West Virginia	243.7	354.7	1.19%	297.9	(56.8)	-16.0%
Wisconsin	289.7	419.0	1.42%	354.1	(65.0)	-15.5%
Wyoming	36.8	53.9	0.18%	45.0	(9.0)	-16.6%
TOTAL	20,455.1	35,345.3	100.00%	25,004.7	(10,340.6)	-29.3%

TABLE 2: How the Distribution of Federal Food Assistance Funding Would Have Been Affected in 1994 if Each State's Funding Had Been Set Equal to its Percentage Share in 1989*
(in millions of dollars)

	Federal Nutrition Funds in FY 1989	Federal Nutrition Funds in FY 1994	Share of Nutrition Funds in FY 1989	Federal Nutrition Funds in FY 1994 if Share Frozen at FY 1989 Level	Gain (Loss) if FY 1994 Funds Distributed According to States' FY 1989 Shares	
					($ millions)	(percent)
Alabama	$471.1	$708.3	2.30%	$814.1	105.7	14.9%
Alaska	48.7	92.5	0.24%	84.2	(8.3)	-9.0%
Arizona	328.4	653.9	1.61%	567.5	(86.3)	-13.2%
Arkansas	241.0	366.7	1.18%	416.4	49.7	13.5%
California	1,713.2	4,035.4	8.38%	2,960.3	(1,075.1)	-26.6%
Colorado	234.4	362.5	1.15%	405.0	42.5	11.7%
Connecticut	138.2	272.6	0.68%	238.8	(33.9)	-12.4%
Delaware	40.8	82.6	0.20%	70.4	(12.2)	-14.7%
Dist. of Col.	67.2	130.6	0.33%	116.0	(14.5)	-11.1%
Florida	817.2	1,962.6	4.00%	1,412.1	(550.5)	-28.0%
Georgia	586.9	1,106.3	2.87%	1,014.1	(92.2)	-8.3%
Hawaii	114.9	213.9	0.56%	198.5	(15.3)	-7.2%
Idaho	74.9	113.0	0.37%	129.5	16.4	14.5%
Illinois	1,086.6	1,545.4	5.31%	1,877.6	332.1	21.5%
Indiana	339.1	627.4	1.66%	585.9	(41.5)	-6.6%
Iowa	189.6	257.8	0.93%	327.6	69.8	27.1%
Kansas	167.3	276.9	0.82%	289.0	12.1	4.4%
Kentucky	470.9	639.3	2.30%	813.6	174.3	27.3%
Louisiana	750.7	994.8	3.67%	1,297.2	302.4	30.4%
Maine	86.6	163.4	0.42%	149.7	(13.7)	-8.4%
Maryland	298.0	525.5	1.46%	514.8	(10.7)	-2.0%
Massachusetts	319.2	545.1	1.56%	551.6	6.6	1.2%
Michigan	835.1	1,224.4	4.08%	1,443.1	218.7	17.9%
Minnesota	278.3	458.0	1.36%	481.0	23.0	5.0%
Mississippi	504.1	611.8	2.46%	871.1	259.3	42.4%
Missouri	421.0	716.8	2.06%	727.5	10.7	1.5%
Montana	71.3	103.4	0.35%	123.1	19.7	19.1%
Nebraska	108.7	168.3	0.53%	187.9	19.6	11.6%
Nevada	56.1	135.1	0.27%	96.9	(38.1)	-28.2%
New Hampshire	34.9	65.5	0.17%	60.3	(5.2)	-8.0%
New Jersey	422.3	755.9	2.06%	729.7	(26.1)	-3.5%
New Mexico	188.0	333.5	0.92%	324.8	(8.7)	-2.6%
New York	1,658.8	2,896.0	8.11%	2,866.3	(29.8)	-1.0%
North Carolina	471.3	824.3	2.30%	814.4	(9.9)	-1.2%
North Dakota	54.2	77.2	0.26%	93.6	16.4	21.2%
Ohio	1,074.2	1,497.3	5.25%	1,856.2	358.9	24.0%
Oklahoma	308.6	507.1	1.51%	533.2	26.1	5.1%
Oregon	235.1	374.4	1.15%	406.2	31.8	8.5%
Pennsylvania	895.4	1,468.2	4.38%	1,547.3	79.1	5.4%
Rhode Island	60.7	113.1	0.30%	104.8	(8.3)	-7.4%
South Carolina	323.4	514.3	1.58%	558.8	44.5	8.7%
South Dakota	72.9	92.1	0.36%	125.9	33.8	36.6%
Tennessee	508.1	857.7	2.48%	877.9	20.2	2.4%
Texas	1,840.2	3,458.5	9.00%	3,179.7	(278.8)	-8.1%
Utah	131.6	203.2	0.64%	227.3	24.2	11.9%
Vermont	38.2	72.7	0.19%	65.9	(6.8)	-9.3%
Virginia	378.9	696.9	1.85%	654.7	(42.2)	-6.1%
Washington	329.0	615.2	1.61%	568.5	(46.7)	-7.6%
West Virginia	243.7	354.7	1.19%	421.0	66.3	18.7%
Wisconsin	289.7	419.0	1.42%	500.5	81.5	19.4%
Wyoming	36.8	53.9	0.18%	63.6	9.6	17.9%
TOTAL	20,455.1	35,345.3	100%	35,345.3	0.0	0.0%

*Assumes no cut in total funding from the amount actually expended in fiscal year 1994.

Note from Center on Budget and Policy Priorities: This is a copy of the plan proposed by some Republican Governors.

Republican Governors' Association
Welfare Reform Session

I. Objective

To have a thorough discussion on the broad outline of welfare reform among the GOP Governors and House and Senate Republican leaders.

II. Issues for Discussion

A. Block Grants -- GOP Governors support Block Grants in 3 major areas of welfare and social spending: AFDC/Cash Assistance, Food, and Child Care. GOP Governors are interested in exploring Block Grants in 5 additional areas: Child Welfare, Social Services, Employment and Training, Health, and Housing.

- The programs for inclusion in the above 3 Block Grants are:

  Food -- Food Stamps, Nutrition Assistance for Puerto Rico, Special Milk Program, Child Nutrition, Child Nutrition Commodities, Food Donations, Women, Infants, Children Program (WIC), Emergency Food Assistance Program, Congregate Meals, and Meals on Wheels.

  -- Each State will receive that portion of the Block Grant that equals the portion of the total Federal spending received by each State in FY 1994. This amount would be adjusted each year for inflation.

  AFDC/Cash -- Aid to Families with Dependent Children (single parent and two parent families), Emergency Assistance, AFDC Administration, and Job Opportunities and Basic Skills (JOBS) program.

  -- Each State would receive the amount equal to the average of spending in FY 1990 - 1994.

  Child Care -- Title I (Education for the Disadvantaged), Migrant Education, Native Hawaiian Family Education Centers, Child and Adult Food Program, Child Care and Development Block Grant, Child Development Associate Credential Scholarship, State Dependent Care Planning and Development Grants, Temporary Child Care for Children with Disabilities, At-Risk Child Care, Transitional Child Care, Head Start, and Even Start.

  -- Each State will receive that portion of the Block Grant that equals the portion of the total Federal spending received by each State in FY 1994.

B. Funding -- Funding is a State entitlement. See above for distribution.

C. Administration -- Maximum flexibility for States to design and administer programs would be given in the Block Grants. Reporting requirements and Federal regulations would be minimized. Programs would be audited and States would repay any misspent funds.

More specifically:

- States will develop plans, detailing how they will use the funds to meet the broad goals of each Block Grant. A copy of the plan will be sent to the Secretary, and each State will also submit an annual report, with information on the number of people served, services provided, and funds expended.

- Audits will determine whether funds have been misspent, and States will repay such amounts.

- The Secretary's ability to require additional reporting from States and impose restrictions on States will be limited.

- States may transfer up to 50 percent from one Block Grant to another.

- States may carryover funds from one fiscal year to the next.

III. Outstanding Issues

A. Medicaid -- Current eligibility tied to AFDC receipt; AFDC maintenance of effort, in Medicaid statute, needs to be eliminated. Other Medicaid/AFDC linkages need exploration.

B. Legal Aliens -- Allow States the option to provide assistance to this population. Adjust base amount for each State to reflect the legal alien population they would no longer have to serve.

C. Waivers -- States would be released from current waiver and cost-neutrality agreements.

D. Automation -- Funding for information systems needs discussion.

TITLE V - CONSOLIDATING FOOD ASSISTANCE PROGRAMS

SECTION I. FOOD ASSISTANCE BLOCK GRANT PROGRAM.

(a) PURPOSE.

(1) The purpose of this act is to consolidate Federal food assistance into a single block grant to provide greater flexibility to States to meet the food needs of the State, as far as practicable under the conditions in that State.

(b) AUTHORITY TO MAKE BLOCK GRANTS.

(1) The Secretary of Agriculture shall make grants in accordance with this section to States to provide food and nutrition assistance to individuals and families.

(c) DISTRIBUTION OF FUNDS.

(1) The funds appropriated to carry out this section shall be allotted among the States as follows: A State shall receive that portion of the block grant that equals the portion of the total amount that State received for FY 1994 under the following programs: (see attached)

(2) The amount received for FYs 97 - 2000 shall not be less than the amount received for FY 1996. This amount shall be an entitlement for States.

(3).The amount allotted under paragraph (1) shall be adjusted each fiscal year by the Secretary to reflect the percentage change in the food at home component of the Consumer Price Index For All Urban Consumers for the 1 year period ending May 31 of such preceding fiscal year.

(c) METHOD OF PAYMENT.

(1) The Secretary may make payments to a State in installments, in advance or by way of reimbursement, with necessary adjustments on account of overpayments or underpayments, as the Secretary may determine.

(d) SPENDING OF FUNDS BY STATE.

(1) Payments to a State from the allotment under section I for any

fiscal year may be obligated by the State in that fiscal year or in the succeeding fiscal year. Twenty percent of the payments to a State from the allotment under Section I for any fiscal year may be transferred to other block grant programs.

(e) ELIGIBILITY TO RECEIVE GRANTS.

(1) To be eligible to receive a grant in the amount allotted to a State for a fiscal year, such State shall submit to the Secretary a State plan containing assurances that -

(A) such grant will be expended by the State to provide food and nutrition assistance to resident individuals in the State, and
(B) such grant will be used for administrative costs incurred to provide assistance under this section.

(2) Prior to expenditure by a State of payments made to it under this section for any fiscal year, the State shall report on the intended use of the payments the State is to receive including information on the types of activities to be supported and the categories or characteristics of persons to be served. The report shall be transmitted to the Secretary and made public within the State in such manner as to facilitate comment by any person (including any Federal or other public agency) during development of the report and after its completion. The report shall be revised throughout the year as may be necessary to reflect substantial changes in the activities assisted under this section, and any revision shall be subject to the requirements of the previous sentence. The Secretary shall not impose additional reporting requirements on States.

(f) ANNUAL REPORTS AND AUDITS.

(1) Annual Report: Not later than December 31, 1996, and annually thereafter, a State that receives a grant under section I shall prepare and submit to the Secretary a report

(A) Specifying the uses for which the State expended funds specified under Section I and the amount of funds expended for such uses; and

(B) Containing available data on the manner in which the food and nutrition needs of families in the State are being fulfilled, including information concerning the number of individuals and families being assisted with funds provided under Section I during the period for which such report is required to be submitted.

(2) Audits:

(A) Requirement. A State shall, after the close of each program period covered by a report submitted under section I audit its expenditures during such program period from amounts received under this section.

(B) Independent Auditor. Audits under this section shall be conducted by an entity that is independent of any agency administering activities that receive assistance under this section and be in accordance with generally accepted auditing principles.

(C) Submission. Not later than 30 days after the completion of an audit under this section, the State shall submit a copy of the audit to the legislature of the State and to the Secretary.

(D) Repayment. Each State shall repay to the United States any amounts determined through an audit under this section not to have been expended in accordance with this section, or the Secretary may offset such amounts against any other amounts to which the State is or may be entitled under this section.

SECTION II. DEFINITIONS.

(a) Secretary.

(1) Secretary refers to the Secretary of Agriculture.

DRAFT

Overview of Federal Food and Nutrition Programs
for Low-Income Persons
November, 1994

Program	FY 1995 Spending (millions)
Food Stamps	$24,750
Nutrition Assistance for Puerto Rico	1,143
Special Milk	15
Child Nutrition	7,371
Child Nutrition Commodities	400
Food Donations	268
Women, Infants and Children Program	3,237
CSFP	107
Emergency Food Assistance Program	123
HHS: Congregate Meals	366
HHS: Meals on Wheels	96
Food Program Administration	131
Total	$37,967

Source. Congressional Budget Office.

nutblfood

Attachment