

BUDGET SCENARIOS

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BUDGET SCENARIOS

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ARGUMENTS FOR BUDGET SCENARIO 1

IT IS DESIRABLE

- SCENARIO 1 GENERATES SUBSTANTIALLY MORE DEFICIT REDUCTION THAN SCENARIO 3 — \$196 BILLION OVER THE PERIOD 1996-2000 VERSUS \$70 BILLION.
- EVEN UNDER THE AGGRESSIVE COST CONTAINMENT ASSUMED IN SCENARIO 1, HEALTH CARE SPENDING WOULD STILL RISE TO 17% OF GDP BY THE YEAR 2000. THE LOOSER BUDGET IN SCENARIO 3 WOULD ALLOW SPENDING TO RISE TO 18.7% OF GDP.

THERE IS LITTLE REASON TO BELIEVE HEALTH OUTCOMES WILL BE ANY BETTER AT 18.7% OF GDP THAN AT 17%, YET THE ADDITIONAL SPENDING WOULD LEAVE MUCH LESS FOR OTHER INVESTMENTS.

- A TIGHT BUDGET WILL BRING DISCIPLINE TO A SYSTEM THAT HAS BEEN OPERATING FOR MANY YEARS WITHOUT RESTRAINT.

IT IS DOABLE

- TIGHT BUDGET CONSTRAINTS MUST BE VIEWED IN THE CONTEXT OF INVESTMENTS BEING MADE IN THE FIRST YEAR OF THE NEW SYSTEM. NEW RESOURCES WILL BE ADDED TO COMPENSATE PROVIDERS FOR NEW SERVICES DELIVERED TO THE CURRENTLY UNINSURED.

GIVEN THE RELATIVELY FIXED SUPPLY OF SOME HEALTH CARE RESOURCES IN THE SHORT TERM, THIS MAY PROVIDE A CUSHION FOR MEETING STRINGENT BUDGET CONSTRAINTS, BOTH UNDER MEDICARE AND IN THE PRIVATE SECTOR.

- OTHER INDUSTRIALIZED COUNTRIES, SUCH AS GERMANY AND JAPAN, HAVE RESTRAINED GROWTH IN HEALTH CARE COSTS TO APPROXIMATELY GDP OVER THE LAST DECADE. FOR SHORTER PERIODS, GROWTH IN GERMANY, FOR EXAMPLE, HAS REMAINED BELOW GDP.

- THERE IS BROAD AGREEMENT THAT PRIVATE SECTOR SAVINGS FROM ELIMINATING THE SMALL GROUP MARKET AND ADMINISTRATIVE SIMPLIFICATION COULD MEET SCENARIO 1 BUDGET CONSTRAINTS DURING THE FIRST YEAR OF IMPLEMENTATION.

MID-RANGE ESTIMATES OF SAVINGS FROM CONSUMERS SWITCHING TO LOWER COST PLANS GENERATE SUFFICIENT ADDITIONAL SPENDING REDUCTIONS TO MEET THE BUDGET IN THE SECOND YEAR OF THE NEW SYSTEM.

ONLY IN THE THIRD YEAR AND BEYOND ARE BEHAVIOR CHANGES BY PROVIDERS NECESSARY TO MEET THE SCENARIO 1 BUDGET. THE EXTENT AND NATURE OF THESE CHANGES ARE ADMITTEDLY SUBJECT TO MORE UNCERTAINTY THAN OTHER SOURCES OF SAVINGS.

- THERE IS SUBSTANTIAL WASTE IN THE SYSTEM. WE SPEND MORE THAN OTHER INDUSTRIALIZED COUNTRIES DO BY A LARGE MARGIN. MANY STUDIES OF HEALTH CARE PROVIDED IN THE UNITED STATES HAVE SHOWN THAT COMMON AND EXPENSIVE MEDICAL THERAPIES ARE FREQUENTLY USED WHEN UNNECESSARY AND EVEN INAPPROPRIATE.

IT IS POLITICALLY ACCEPTABLE AND CREDIBLE

- WHILE SOME HEALTH CARE ECONOMISTS MAY VIEW SCENARIO 1 AS OVERLY CONSTRAINED, THE PUBLIC IS LIKELY TO VIEW AGGRESSIVE RESTRAINT OF HEALTH INSURANCE PREMIUMS AND PROVIDER PRICES AS DESIRABLE.
- GIVEN THE INEVITABLE PRESSURE FROM STAKEHOLDERS TO ALLOW A LOOSER BUDGET, WE SHOULD BEGIN FROM A POSITION OF AGGRESSIVE COST CONTAINMENT.

ARGUMENTS FOR BUDGET SCENARIO 3

IT IS DESIRABLE

- SCENARIO 3 INCREASES THE LIKELIHOOD THAT COMPETITION WILL DRIVE THE SYSTEM NOT REGULATION.
- SCENARIO 1 MAY DESTROY INCENTIVES FOR MARKET ENTRY, ESPECIALLY NEW COMMUNITY BASED PLANS, REDUCING CHOICE.
- SCENARIO 3 PROVIDES AN INCENTIVE FOR AGGRESSIVE BIDDING BY PROVIDING A CUSHION FOR UNCERTAINTY.

IT IS DOABLE

- SCENARIO 3 REDUCES THE RISK OF NEGATIVE HEALTH EFFECTS AS THE MEANS OF ADJUSTING TO BUDGETS. EVEN ASSUMING WASTE IN THE SYSTEM, THERE IS A LARGER CHANCE UNDER SCENARIO 1 THAT IN SUCH A SHORT TIME FRAME THE REDUCTIONS MAY EFFECT REAL AND NECESSARY CARE, AND ENCOURAGE SHORT TERM MAXIMIZATION AT THE EXPENSE OF LONG TERM MAXIMIZATION.
- SCENARIO 3 REDUCES THE LIKELIHOOD THAT THE REDUCTIONS WILL BE ACHIEVED THROUGH RATIONING.
- THE MEDICARE REDUCTIONS UNDER SCENARIO 3 ARE ACHIEVABLE. UNDER SCENARIO 1, THE REDUCTIONS THREATEN ACCESS AND QUALITY OF CARE.

ARGUMENTS FOR BUDGET SCENARIO 3

IT IS POLITICALLY ACCEPTABLE AND CREDIBLE.

- NO BILL ON THE HILL IS AS LOW AS SCENARIO 1, AND A FINANCING SCHEME BASED ON AN UNREALISTICALLY LOW LEVEL OF BUDGET GROWTH MAY THREATEN THE CREDIBILITY OF THE ENTIRE PLAN
- TALK OF LARGE MEDICARE CUTS MAY SCARE SENIORS.
- HAS A BETTER CHANCE OF ACHIEVING SOME PROVIDER SUPPORT.
- SCENARIO 3 WILL STILL BE VIEWED AS AN AGGRESSIVE PLAN WITH CONSIDERABLE DEFICIT REDUCTION.
- SCENARIO 1 IS VERY SUBJECT TO THE CHARGES OF EXCESSIVE GOVERNMENT INTERVENTION, REGULATION, AND RATIONING.

ALTERNATIVE

- THE CONCERNS ABOUT BUDGET SCENARIO I COULD BE SUBSTANTIALLY REDUCED, WHILE RETAINING THE PREPONDERANCE OF DEFICIT REDUCTION AND HEALTH CARE/GDP RATIO ADVANTAGES THROUGH MORE GRADUAL PHASING OF THE BASIC HEALTH CARE PLAN, LONG TERM CARE AND DRUG BENEFITS, AND/OR REDUCING THE SIZE OF THESE PROGRAMS.

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**BUDGET ENFORCEMENT IN THE FIRST YEAR
EXAMPLE**

- ◆ NATIONAL HEALTH BOARD ESTABLISHES A NATIONAL PREMIUM TARGET BASED ON PROJECTED COST OF THE GUARANTEED BENEFITS WITH A REDUCTION IN CURRENTLY UNCOMPENSATED CARE.

NATIONAL PREMIUM TARGET: \$1,900

- ◆ NATIONAL HEALTH BOARD ADJUSTS THE NATIONAL TARGET FOR REGIONAL VARIATIONS IN HEALTH SPENDING AND RATE OF UNINSURANCE/UNDER-INSURANCE.

SAMPLE ALLIANCE TARGET: \$2,000

- ◆ HEALTH PLANS SUBMIT BIDS TO THE ALLIANCE (WITH OR WITHOUT KNOWLEDGE OF THE TARGET). ALLIANCE NEGOTIATES WITH HEALTH PLANS AND SUBMITS FINAL BIDS TO THE NATIONAL HEALTH BOARD FOR REVIEW.

HEALTH PLAN 1 FINAL BID: \$1,800
HEALTH PLAN 2 FINAL BID: \$2,200

- ◆ USING PROJECTED ENROLLMENT AND BIDS, THE NATIONAL HEALTH BOARD CALCULATES THE WEIGHTED AVERAGE PREMIUM.

HEALTH PLAN 1 ENROLLMENT: 40%
HEALTH PLAN 2 ENROLLMENT: 60%
EXPECTED WEIGHTED AVERAGE: \$2,040 (\$40 OVER BUDGET)

- ◆ IF THE EXPECTED WEIGHTED AVERAGE PREMIUM EXCEEDS THE ALLIANCE'S TARGET, EACH PLAN WHOSE PREMIUM INCREASE EXCEEDS THE ALLIANCE'S ALLOWABLE PREMIUM INCREASE IS ASSESSED FOR THE DIFFERENCE BETWEEN ITS INCREASE AND THE ALLOWABLE INCREASE. IN EFFECT, THE ALLIANCE'S ALLOWABLE PREMIUM INCREASE BECOMES A CAP.

THE PLAN ALSO ASSESSES ITS PROVIDERS AN EQUAL AMOUNT.

HEALTH PLAN 1 HAS NO ASSESSMENT (IT'S PREMIUM INCREASE IS LESS THAN 5%)
HEALTH PLAN 2 IS ASSESSED: 1.9%
HEALTH PLAN 2 NET PREMIUM: \$2,310 (5% INCREASE)

[NOTE: ALTERNATIVE ASSESSMENT MECHANISMS ARE POSSIBLE, AND ARE BEING REVIEWED.]

- ◆ IF ACTUAL ENROLLMENT DURING THE OPEN ENROLLMENT PERIOD PRODUCES A WEIGHTED AVERAGE PREMIUM IN EXCESS OF THE ALLIANCE'S TARGET, THEN THE ALLIANCE'S ALLOWABLE PREMIUM INCREASE FOR THE SUBSEQUENT TWO YEARS IS REDUCED TO RECOUP THE OVERAGE.

HEALTH PLAN 1 1998 ENROLLMENT: 40%
HEALTH PLAN 2 1998 ENROLLMENT: 60%
ACTUAL AVERAGE PREMIUM: \$2,135
AMOUNT OF OVERAGE: \$35

**BUDGET ENFORCEMENT AFTER THE FIRST YEAR
EXAMPLE (1998)**

- ◆ NATIONAL HEALTH BOARD PROVIDES EACH ALLIANCE WITH ITS ALLOWABLE PREMIUM INCREASE AND ITS NEW PREMIUM TARGET.

| | |
|----------------------|-----------------------|
| 1997 PREMIUM TARGET: | \$2,000 |
| 1998 PREMIUM TARGET: | \$2,100 (5% INCREASE) |

- ◆ ALLIANCES ACCEPT PREMIUM BIDS FROM HEALTH PLANS.
- ◆ EACH ALLIANCE NEGOTIATES WITH HEALTH PLANS — KNOWING WHETHER OR NOT IT IS IN LINE WITH BUDGET — AND SUBMITS FINAL BIDS TO THE NATIONAL HEALTH BOARD FOR REVIEW.

| | |
|--------------------------|-----------------------|
| HEALTH PLAN 1 FINAL BID: | \$1,872 (4% INCREASE) |
| HEALTH PLAN 2 FINAL BID: | \$2,354 (7% INCREASE) |

- ◆ NATIONAL HEALTH BOARD CALCULATES THE EXPECTED WEIGHTED AVERAGE PREMIUM FOR THE ALLIANCE BASED ON THE PREVIOUS YEAR'S ENROLLMENT AND THE NEW PREMIUMS.

| | |
|--------------------------------|----------------------------|
| HEALTH PLAN 1 1997 ENROLLMENT: | 50% |
| HEALTH PLAN 2 1997 ENROLLMENT: | 50% |
| EXPECTED WEIGHTED AVERAGE: | \$2,113 (\$13 OVER BUDGET) |

- ◆ IF THE EXPECTED WEIGHTED AVERAGE PREMIUM IS LESS THAN THE ALLIANCE'S TARGET, THEN NO ENFORCEMENT ACTION IS TAKEN PRIOR TO ENROLLMENT.
- ◆ OTHERWISE, THE ALLIANCE IS NOTIFIED THAT IT IS OUT OF LINE WITH THE BUDGET TARGET AND IS GIVEN AN OPPORTUNITY TO RE-NEGOTIATE PREMIUMS WITH PLANS.

IF THE WEIGHTED AVERAGE OF THE FINAL BIDS STILL EXCEEDS THE ALLIANCE'S TARGET, THEN EACH PLAN ABOVE THE TARGET IS ASSESSED THE DIFFERENCE BETWEEN ITS BID AND THE ALLIANCE'S TARGET. IN EFFECT, THE ALLIANCE'S TARGET BECOMES A CAP.

THE PLAN ALSO ASSESSES ITS PROVIDERS AN EQUAL AMOUNT.

| | |
|---------------------------------|--|
| HEALTH PLAN 1 HAS NO ASSESSMENT | (BID IS BELOW THE ALLIANCE'S TARGET) |
| HEALTH PLAN 2 ASSESSMENT: | 9.1% (DIFFERENCE BETWEEN BID & TARGET) |
| HEALTH PLAN 2 NET PREMIUM: | \$2,000 (AFTER ASSESSMENT) |
| NEW AVERAGE PREMIUM: | \$1,920 |

[NOTE: ALTERNATIVE ASSESSMENT MECHANISMS ARE POSSIBLE, AND ARE BEING REVIEWED.]

- ◆ IF ACTUAL ENROLLMENT DURING THE OPEN ENROLLMENT PERIOD PRODUCES A WEIGHTED AVERAGE PREMIUM IN EXCESS OF THE ALLIANCE'S TARGET, THEN THE ALLOWABLE PREMIUM INCREASE FOR THE SUBSEQUENT TWO YEARS IS REDUCED TO RECOUP THE OVERAGE.

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to Nancy
Su'sester

December 7, 1994

**THE NEW FISCAL AGENDA:
WHAT WILL IT MEAN AND HOW WILL IT BE ACCOMPLISHED?**

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 operated for decades thereafter.

This new framework would begin to change radically the purpose of government in this country — through dismantling much of the federal social safety net and redistributing substantial amounts of income from low- and middle-income households to upper-income Americans. But the way in which this would be accomplished is far from obvious or straightforward. The new fiscal agenda is made up of a number of intertwined proposals and strategies, the long-term consequences of which may not be immediately apparent. Unless the new proposals are subjected to careful analysis and widespread discussion, the public is unlikely to understand the way in which the agenda will affect them, their families, and the communities in which they live.

At the core of the new fiscal strategy is the establishment of a constitutional requirement for a balanced federal budget each year, starting in fiscal year 2002, accompanied by a series of statutory and procedural changes that “wall off” 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 or touching Social Security or defense — 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.
- All federal expenditures other than Social Security and defense (and the required interest on the national debt) would have to be *cut by more than one dollar out of every four* compared to spending projected under current law for fiscal year 2002.

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

- Programs that are weak politically would stand to be cut especially severely during the coming decade. Much of the federal safety net for the poor could consequently come to an end.
- ✓ The middle class, despite receiving an initial tax cut, could ultimately lose more in government benefits than it gained in tax reductions.
- ✓ State and local governments will bear a disproportionate share of the budget cutting, which likely will lead to further reductions in the safety net and increased state and local taxes on low- and middle-income households.
- High-income households, who will benefit from generous tax subsidies for investors, are the only clear beneficiaries of the new agenda.

Safety Net Programs

The first indication that the safety net is in jeopardy is found in the *Contract with America*, a platform that was signed this fall by most House Republican Members and that incoming Speaker Newt Gingrich has vowed to try to push through the House of Representatives by mid-April. The Contract calls for balancing the budget, protecting defense spending, and cutting taxes. (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.) Massive budget cuts in domestic programs would be needed as a result.

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 AFDC changes were fully in effect today, more than five million *fewer* children — over half of the children now on AFDC — would be receiving this cash assistance. Overall, the benefit cuts in means-tested entitlement programs the Contract calls for are almost



The William Paterson College of New Jersey
Memorandum

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three times as large as the benefit cuts in such programs that were enacted in 1981 and 1982 under President Ronald Reagan.

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 several billion dollars below what these programs would cost under current law and would be structured so that food stamp assistance would likely to be reduced about \$4 billion a year. 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, and child care support for working poor families not on welfare — would be placed under a separate cap that would require program cuts of \$26 billion over four years. The entitlement status of these programs also would be ended. In addition, the Contract calls for making most *legal* immigrants ineligible for 60 different health, education, job training, nutrition, housing, cash assistance, and social service programs.

Despite the severity of these reductions, the Contract's deep cuts in poverty programs would constitute 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 would only be the "tip of the iceberg." This suggests that prospects for a significant federal safety net surviving a decade from now will be bleak if the Republican strategy is adopted, since programs for the poor are likely to remain more susceptible to cuts in the years ahead than most other programs.

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 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 in order to secure the long-term economic benefits that smaller deficits are thought to bring. The degree of middle-class sacrifice required, however, would be increased under the emerging Republican plan because budget cuts would be needed not only to balance the budget but also to finance an array of extremely generous tax cuts primarily benefiting upper-income Americans and large corporations.

The tax cuts in the Contract are presented as losing \$192 billion in revenue over the first five years, but that cost explodes to over \$400 billion in subsequent five-year

periods.¹ That does not mean, however, that tax relief for the middle class will increase over time. The cost of the major provision that will benefit middle class households, a tax credit for children, will remain relatively constant over time — costing approximately \$107 billion over the first five-years and over subsequent five year periods as well. But those tax cuts contained in the Contract that principally benefit high-income households and corporations are designed so their costs remain small — approximately \$31 billion — during the first five years after enactment, and then rise to more than \$260 billion in subsequent five-year periods.² Thus, less than one-third of the expected revenue losses from the proposed tax cuts after the initial five years will be targeted on middle-class families.

Moreover, a significant proportion of the budget cuts that will be necessary 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 entail steadily increasing 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 primarily programs that principally benefit the middle class. 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, student loans, school lunches, and the like would be inescapable, with such reductions growing as the revenue losses increased.

State and Local Governments

A third likely outcome is that state and local governments would be hit hard. This is true regardless of whether legislation — or even a constitutional amendment — passes that 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. In addition, some other parts of what remains in the budget constitute essential federal functions such as protecting the borders, maintaining embassies overseas, fighting forest fires, constructing and

¹ 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 that 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.

² 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. Other provisions, such as the increased estate and gift tax exclusion also would primarily benefit upper-income households.

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 much. As a result, grants to state and local governments will have 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 definition of adjusted gross income and corporate net income into their tax codes. Hence, the proposed tax cuts benefitting 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 deeply. 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. The Urban Institute found evidence of such a chain of events after the Reagan tax and budget cuts of the early 1980s.

Upward Redistribution of Income

Upper-income households would be the only large winners under the new agenda. While these households would receive the lion's share of the tax cuts, they 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 be affected the least by the required budget cuts.

These developments would 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, are greater than at any time since the end of World War II. The proposals in the Contract, as well as the similar provisions in the less-detailed Senate Republican campaign document, would widen these disparities further.

II. The Emerging Republican Budget Plan

The emerging plan includes four key changes in the nation's fiscal structure and procedures. Once in place, these changes would set federal budget policy on a fixed path. The four changes are:

- *A constitutional balanced budget amendment.* The House is expected to consider the amendment on January 19, while the Senate will take it up sometime after that (probably in February). 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, 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.

- *An entitlement cap.* A new budget device whose importance cannot be overstated — an “entitlement cap” — would be established, probably in a “budget reconciliation” bill that Congress would pass in the first half of 1995. A binding cap would be placed on the total amount the federal government can spend each fiscal year on entitlements other than Social Security. The cap would be set at levels that are well below what entitlements would cost under current law. With each passing year, the amount that the cap falls below what entitlements would otherwise cost would grow. If Congress and the President failed to cut entitlements enough to fit within the cap for a given year, all entitlements except Social Security would be cut across-the-board by the amount needed to comply with the cap.
- *Tighter discretionary spending caps.* The establishment of an entitlement cap would be accompanied by a measure extending the current stringent caps on non-entitlement (or “discretionary”) spending through fiscal year 2002 and lowering these caps sharply. As part of this measure, defense spending would be “walled off” so *all* of the steep cuts needed to meet the tightened discretionary caps would come from non-defense programs. Defense spending also is highly likely to be increased over time, making the required cuts in domestic discretionary programs still greater.
- *A supermajority requirement for tax increases.* Of importance as well is a new House rule that soon-to-be Speaker Newt Gingrich will establish (on a party-line vote) when Congress convenes in January. The rule will stipulate that any measure coming to the House floor which contains an increase in tax rates (and possibly increases in certain other tax measures) must secure the votes of three-fifths of the full House membership to pass. This rule is likely to drive Congress to cut domestic programs even more deeply in coming years in order to offset those new tax cuts that Congress wishes to provide.

The Contract with America even 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 the votes are there in either the House or the Senate to make such a requirement part of the U.S. Constitution.

The two spending caps just described — the entitlement cap and the discretionary spending cap — are integral to the new fiscal structure the Republican leadership would erect. These caps would be set at levels so stringent that, by themselves, they reduce the deficit to zero by fiscal year 2002. Since Social Security would not be affected by the entitlement cap and defense spending would be walled off, the two caps would require spending on areas other than Social Security and defense to be cut sufficiently to reach budget balance.³ A recent report prepared 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.”

In any year in which a spending cap would otherwise be breached, across-the-board cuts would automatically occur. The two caps, especially if backed by a constitutional amendment requiring budget balance by 2002, would lock in the new fiscal requirements and lead to the dismantling of substantial parts of the federal government — most likely including large elements of the safety net — in the years ahead.

There are a number of probable scenarios under which this radical, sweeping agenda could be accomplished despite the countervailing power of a presidential veto. For example, the legislation that is likely to include the provisions establishing entitlement caps and tightening the discretionary caps — the budget reconciliation bill — also would contain the tax cuts the Republican leadership is proposing and some cuts in entitlement programs to help pay for the tax cuts. In addition, the bill is likely to include another important element — a provision raising the debt ceiling under which the federal government may borrow funds. If the debt ceiling is not raised by this summer, the federal government will go into default.

The likely inclusion of these elements in one bill appears to be a shrewd strategy. If President Clinton vetoes the bill, Republicans would charge him with blocking a middle-class tax cut, frustrating deficit reduction, and risking a default on the part of the U.S. Government.

³ Under such an arrangement, if Social Security and defense were cut or taxes were raised, those actions would have no effect on meeting the caps.

How Much Would Have to Be Cut?

Based on the latest Congressional Budget Office projections, balancing the budget by fiscal year 2002 without raising taxes would require expenditure cuts of about \$1 trillion over the next seven years. This excludes savings in interest payments on the debt. It entails \$1 trillion in program cuts.⁴

By fiscal year 2002, the cuts would exceed \$260 billion a year. This equals between 20 percent and 25 percent of all expenditures on areas other than Social Security, defense, and interest payments on the debt. The cuts made under President Ronald Reagan were tiny compared to this.

Moreover, these figures significantly understate the degree of cutting that would be required. Cuts in programs would need to be large enough not only to balance the budget, but also to offset the costs of the tax cuts. Balancing the budget and offsetting the cost of the tax cuts proposed in the Contract with America would raise the amount of budget cuts needed over the next seven years to about \$1.3 trillion. It would increase the level of budget cuts needed on an annual basis to well above \$260 billion a year by fiscal year 2002 and still more in years after that.

III. The New Tax Cuts

The tax cuts being proposed by the Republican leadership — especially those included in the Contract with America — are of particular note. While the middle-class tax cut in the Contract has received the most attention, it accounts for only a minority share of the revenue loss that would occur beyond the first five-year period. Over the long-term, the tax reductions proposed for wealthy individuals and corporations are substantially larger than the middle-class tax cut. They include deep cuts in taxes on capital gains income, 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 the taxable income of corporations.⁵

⁴ These figures assume a plan to ratchet down the deficit each year between now and fiscal year 2002.

⁵ 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*.

Capital Gains Taxes

The Contract's proposals regarding capital gains taxes are especially striking. Currently, investors who buy assets such as stocks or bonds and later sell these assets pay taxes on their profit — that is, on the amount by which their sale price exceeds their purchase price. The Contract, however, proposes adjusting the purchase price to reflect inflation between the time of purchase and the time of sale, which would substantially reduce the taxable profit in most cases. The Contract would make half of the remaining profit tax-free as well. The result would be the elimination of taxes on most capital gains profits.

While profits from stocks, bonds, real estate speculation, and the like — which accrue overwhelmingly to those at high income levels — would be largely exempt from taxation, no changes would be made in the treatment of interest income from the savings accounts that ordinary middle-class Americans hold. For interest earnings, no adjustment for inflation or exclusion from taxation would be provided.

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. This would create lucrative tax shelters for wealthy investors and skew investments toward investment opportunities that yield capital gains.

For example, Herbert Stein, Senior Fellow at the American Enterprise Institute and chair of the Council of Economic Advisors under President Nixon, has written that capital gains tax cuts are not likely to promote savings but will 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.⁶

⁶ *Summary of the Statement of Herbert Stein, Senior Fellow, American Enterprise Institute, to the House Ways and Means Committee, December 17, 1991.*

In the past, Republican supply-side tax-cutters have tended to call *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, more than 50 percent of the tax benefits would go to the wealthiest one percent of Americans, those with incomes exceeding \$200,000 a year. About 70 percent of the benefits from the capital gains tax cuts appear to go to those with incomes exceeding \$100,000, who constitute about the top five percent of households. An analysis of a more modest proposal which excluded from income a portion of capital gains income (but which did not allow indexing) found that individuals in the top one percent of the population who benefit from these tax breaks would receive tax cuts averaging more than \$8,500 per year.

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 are currently available to single individuals with incomes below \$35,000 and married couples with incomes below \$50,000 who are not covered by a private pension plan. The Contract would extend tax breaks to households above these income levels who already 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. Thus 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 lose revenue and provide another tax cut tilted toward those at higher income levels. It also would weaken the Medicare program. The 1993 budget law stipulates that the revenue raised by this provision be deposited in the Medicare hospital insurance trust fund, an important step since the trust fund is in deep financial trouble and faces insolvency in 2001. Repealing this provision would make Medicare's financial hole deeper.

Business Depreciation

Finally, but hardly least important, the Contract calls for sweeping 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 massive corporate tax break. Currently, if a corporation buys a building for \$1 million, it can take depreciation deductions on its tax returns that total \$1 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 \$1 million, the total amount of depreciation a corporation could deduct from its taxes over time would increase from \$1 million to approximately \$4.2 million.⁷ This proposal would have the effect of sharply reducing or eliminating taxable income for a significant number of firms.

Passage of these provisions 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, IRA, and depreciation tax breaks would not only be restored, but they would be made more generous than they were before 1986. The result would be massive windfalls for wealthy investors and large corporations. This would occur while benefits for millions of poor children were being withdrawn and much of the safety net likely was being taken down to meet the balanced budget requirement and pay for these tax cuts.

The data cited above showing that the tax cuts would heavily benefit high-income Americans come from CBO and Joint Tax Committee analyses conducted in recent years. This type of analysis may not, however, be available in the future. For more than a decade, the highly respected non-partisan Congressional Budget Office and the equally well-respected and non-partisan Joint Committee on Taxation have provided analyses of the effects of various tax proposals on different income groups. The Republican Congressional leadership plans to name a new CBO director and a new director of the Joint Tax Committee. It is widely feared that under the new regime, these institutions will cease producing analyses showing the impacts on different income groups of various tax measures under consideration. Without such distribution tables, information that has helped illuminate policy debates on these issues in the past

⁷ The exact amount that could be taken in depreciation deductions would depend in part on the inflation rate. The \$4.2 million figure noted here assumes a modest inflation rate of three percent. If inflation were higher, the deductions would be still greater.

— and also has helped to prevent passage of certain tax policies skewed to the wealthy
— will be gone.

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 next five years. Past Joint Tax Committee and Congressional Research Service estimates of tax provisions similar to those in the Contract indicate that the cost of these provisions would *exceed \$400 billion* over subsequent five-year periods. (See box on page 13.)

The ballooning of the revenue losses after the five-year mark is not accidental. As noted, federal budget rules require tax cuts to be “paid for” through offsetting entitlement cuts or tax increases for their first five years. 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. 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 tax cuts they were proposing.

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 devices are used only for tax cuts heavily benefitting upper-income households and corporations. The cost of the tax credit for children that benefits middle class households will remain relatively constant over time — costing approximately \$107 billion over the first five years and over subsequent five-year periods. But the capital gains, IRA, and depreciation provisions described above that principally benefit high-income households and corporations are designed so their costs remain relatively small — approximately \$31 billion — during the first five years after enactment but rise to more than \$260 billion in subsequent five-year periods.

The mounting revenue losses from these tax cuts would have profound ramifications. As noted, the tax cuts in the Contract would raise the total cuts needed to balance the budget by fiscal year 2002 — as the proposed constitutional amendment would require — to about \$1.3 trillion over the next seven years. By fiscal year 2002, more than one-quarter of federal expenditures in areas other than Social Security and defense would have to be eliminated. In years after that, as the revenue losses

Revenue Loss From Proposed Tax Cuts Grows over Time

The Contract with America calls for federal tax changes that the House Budget Committee minority staff estimate would reduce federal revenues by about \$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 is likely to exceed \$400 billion.

- The IRA proposal is said to raise \$5 billion over the next five years. Short-term revenue gains 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. Past analyses of similar proposals show they eventually lose as much as \$50 billion over subsequent five-year periods.
- The Contract puts the cost of the 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 the remaining gain. In the years immediately after implementation, revenues are assumed to be boosted by an increase in asset sales 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 Contract lists the depreciation proposal as raising \$20 billion over the first five years. This costly 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 turn 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 large. Past analyses of similar proposals suggest the revenue loss in subsequent five-year periods could reach \$58 billion.

Just these three proposals in the Contract, which are said to have a net cost of \$31 billion in their first five years, could have a combined cost in subsequent five-year periods of more than \$260 billion. As a result, even if the cost of all other tax provisions in the Contract remained constant at \$159 billion, the cost in subsequent five-year periods would exceed \$400 billion.

continued to mount and Social Security costs continued climbing with the aging of the population, still more of the government would have to be dismantled.

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

To grasp the type and impact of the budget cuts that are likely to occur, it is useful to understand the stringency of the entitlement cap and the discretionary spending caps needed to achieve a balanced budget. A plausible design of entitlement and discretionary caps designed to reach a balanced budget by fiscal year 2002 — while cutting taxes — could require non-Social Security entitlement spending to be cut by 20 percent and non-defense discretionary spending to be cut by 40 percent to 50 percent.

An entitlement cap is likely to be constructed in a more severe fashion than most Republican entitlement cap proposals that have been offered in the past. For example, overall non-Social Security entitlement spending could be capped permanently at the cost of entitlements in fiscal year 1995 with adjustments in the spending cap allowed only for inflation and changes in entitlement program caseloads. No adjustments would be allowed for rising health care costs, a significant omission since Medicare and Medicaid are projected to make up 65 percent of non-Social Security entitlement spending by 2002. An analysis based on Congressional Budget Office data shows that under this type of entitlement cap more than \$600 billion in entitlement cuts would be required between now and fiscal year 2002. By fiscal year 2002, entitlements other than Social Security would have to be sliced about one-fifth to meet the requirements of the entitlement cap; entitlement spending in fiscal year 2002 would have to be about \$165 billion less than projected under current law.

It is difficult to imagine where Congress would find \$600 billion in entitlement reductions. As noted above, Medicare and Medicaid are projected to constitute about 65 percent of all non-Social Security entitlement spending by fiscal year 2002; there are limits to how severely they can be cut. Congressional Budget Office director Robert Reischauer told the bipartisan Entitlement Commission last summer that if deep cuts are made in Medicare and Medicaid but are not accompanied by major health care reforms in the private sector, substantial cost-shifting to the private sector will result, with employers affected significantly. (Other costs would be shifted to state and local government.) In the aftermath of this year's health care debates, major reform of private sector health care appears largely moribund. Instituting deep Medicare and Medicaid cuts in the absence of system-wide health care reform would likely cause premiums charged to other purchasers of health insurance — principally employers — to mount more rapidly. That, in turn, would likely induce more employers to drop coverage for their employees or drive employers to push down wages to make up for their escalating health care costs. The depth of the cuts that can be made in Medicare

and Medicaid is also limited by a second factor — the strength of doctors, hospitals, and organizations representing the elderly.

This does not mean, however, that an entitlement cap of this nature would be rejected as being too severe. An entitlement cap such as this would still leave the government far short of budget balance if Social Security and defense were taken off the table and taxes could not be raised as part of the budget-balancing effort.

Even if an entitlement cap were this stringent, expenditures for non-defense discretionary programs would have to be cut nearly 30 percent below fiscal year 1994 levels, after adjusting for inflation, by 2002 to achieve a balanced budget that year. And that is if no tax cuts are instituted. When the tax cuts envisioned in the Contract are factored in, expenditures for non-defense discretionary programs would have to be cut 40 percent to 50 percent in real terms by fiscal year 2002 to produce a balanced budget, in conjunction with the stringent entitlement cap described here. (Alternatively, entitlements could be cut more severely and domestic discretionary programs reduced less than 40 percent to 50 percent, but that would likely necessitate even larger Medicare cuts.) These figures indicate why large parts of the government would have to be dismantled.

Impact on Poor Families and Individuals

The implications of this budget strategy for poor families are profound. By fiscal year 2002, Medicare alone will constitute more than 40 percent of all non-Social Security entitlement spending. While the Republican budget framework ultimately would lead to major Medicare cuts, there are — as just noted — limits to the depth that such reductions could reach. In fact, Rep. Bill Archer, who will be the new chairman of the House Ways and Means Committee, recently expressed a desire to make Medicare as well as Social Security off-limits to cuts this year.

Certain other entitlements not targeted on the poor are unlikely to be cut much either. Benefits for disabled veterans are one such example.

This leads to an inescapable conclusion — to meet the stringent entitlement caps likely to be imposed, benefits for low-income families and individuals are likely to be slashed severely.

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.⁸ Nearly all of the cuts they identified would come in means-tested benefits for low-income families.

The cuts in low-income programs identified in the Contract are unprecedented in their severity. Overall, the benefit cuts the Contract calls for in means-tested entitlement programs are three times as large as the benefit cuts in such programs that were enacted in 1981 and 1982 under President Ronald Reagan.⁹ For example, if the AFDC changes were fully in effect today, more than five million fewer children — over half of the children now on AFDC — would not be receiving this cash assistance. (See box on p. 17.)

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. For example, from June 1990 to June 1992, civilian unemployment rose from 5.1 percent to 7.7 percent. During this time, food stamp participation rose from 20.3 million to 25.7 million people. The average number of children receiving free school lunches rose from 9.9 million in fiscal year 1990 school year to 11.1 million in fiscal year 1992. Under the Contract plan, increased additional federal resources to meet the mounting needs would no longer be forthcoming. States would have to cut benefits across-the-board, eliminate benefits for categories of poor households, or put needy applicants on waiting lists unless they were willing to cut other programs or raise state taxes in a recession.

⁸ 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*.

⁹ 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 new proposal affecting low-income programs, the Personal Responsibility Act (PRA), is part of the "Contract with America" unveiled in September 1994 by Republican members of the House of Representatives and congressional candidates. 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 — 29 percent of all children currently receiving AFDC — even if their mothers were fully cooperating with state efforts to track down absent fathers and establish paternity.
- 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 *substantial 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.

Still 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 more than \$26 billion over four years. Here, also, entitlement status would be ended for all programs that are now 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.

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 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 for the poor that would 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 weakness of programs for the less fortunate in the current political atmosphere.

In short, the chances are high that the new budget structures and tax cuts that seem likely to be put in place in the first half of 1995 would lead to the dismantling of much of the safety net in the decade ahead.

Impact on the Middle Class

Eviscerating the safety net would not, by itself, provide the level of cuts needed to balance the budget and pay for the tax cuts. Hundreds of billions of dollars in additional cuts would still be needed. *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. To be sure, various special interest expenditures can and should be targeted, although the extent to which such expenditures can actually be reduced (due to the power of the interests that protect them) remains to be seen. But the arithmetic dictates that programs providing benefits and services for the middle class be cut substantially as well.

A scaling back of various programs benefitting the middle class is, of course, a likely result of any effort to eliminate most or all of the deficit. To reach budget balance will entail steadily increasing reductions in discretionary programs important to the middle class, such as funding for education and transportation. In addition, the large entitlement programs that ultimately will have to be reduced are primarily programs that principally benefit the middle class. 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. While reductions in middle-class benefits such as Medicare might not be as deep as 20 percent (because of concern for cost-shifting, as noted above), substantial cuts would be inescapable.

The budget reductions affecting the middle class will be larger than otherwise would be the case, due to the need to pay for the upper-income and corporate tax cuts. In the absence of tax cuts, it is likely that low-income programs would be cut to the maximum extent politically possible and then budget cuts affecting the middle class would make up much of the remainder of the cuts necessary to achieve budget balance. Few additional low-income cuts would be available to pay for tax cuts on top of budget balancing, so additional cuts in middle-income programs in a sense will have to pay for the tax provisions that primarily benefit upper-income households and corporations.

The losses in benefits and services borne by middle-class households are likely to outweigh by a significant margin the tax cuts these households would receive. As noted above, the middle-class tax cut in the Contract accounts for less than one-third of the revenue loss generated by the Contract's tax reductions when their full revenue losses are felt. From reductions in student aid for middle-class college students to hikes in school lunch prices to sizeable increases in the out-of-pocket health care costs that elderly Medicare beneficiaries are required to pay, middle-class households would be likely to have their incomes reduced or their expenses raised in various ways.

Middle-class households also would likely 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 tax burdens 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, between one-quarter and one-third 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. Significant parts of the budget that would remain "on the table" after Social Security and defense were removed consist of 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. As discussed, Medicare is likely to be reduced less than its proportionate share. To the extent that large portions of the budget other than Social Security and defense spending are reduced significantly less than one dollar in four, the likelihood increases that 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 definition 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 either legislation or a constitutional amendment barring 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 measures 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 which operate pre-school programs with state or local funds. Nor 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 severely weakened, a mix that could spell deep trouble for some cities.

V. Can This Really Occur?

Some who read this paper may think such radical changes will never occur. But if the Republican budget strategy is passed essentially intact in the next few months, such changes will be difficult to avoid.

If the balanced budget amendment is enshrined in the Constitution and the entitlement cap and stricter discretionary caps are enacted, along with large tax cuts, the die will essentially have been cast. Most developments described here are logical outgrowths of such events.

This raises the question of whether the balanced budget amendment, the two caps, and the tax cuts can pass? At the present time, all of them seem *likely* to pass,

with the details of the tax cuts to be worked out. Indeed, the balanced budget amendment and the two caps share a common characteristic that facilitates their passage — they come without specifics, so their consequences are largely hidden from view at the time they are voted on. Most of the blanks would get filled in later, *after* the amendment is in the Constitution and the caps are in law. Similarly, the full extent of the revenue losses caused by the tax cuts will not become apparent until five years down the road. And if the Congressional Budget Office and Joint Tax Committee cease conducting analyses of the impacts of policy changes on different groups, as is likely under the new Republican leadership, the extent to which these proposals would transfer income up the income scale — from low- and moderate-income families to the well-to-do — will be obscured as well.

The changes described here would represent the most radical changes in federal policy and in the role of the federal government in more than half a century. They warrant careful, thoughtful debate and thorough examination of their implications. Policymakers, journalists, foundations, non-profit organizations, and ordinary citizens ought to endeavor to ensure that a full debate takes place.