Center on Budget and Policy Priorities

820 First Street NE, Suite 510
Washington, DC 20002

Tel: 202-408-1080
Fax: 202-408-1056

center@cbpp.org
www.cbpp.org

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CORKER-MCCASKILL SPENDING CAP DOESN'T ACCOUNT FOR BASIC CHANGES IN SOCIETY AND GOVERNMENT

Would Force Draconian Cuts in Social Security and Medicare; Make It Harder for Nation to Recover From Recessions

by Paul N. Van de Water

The proposal from Senators Bob Corker (R-TN) and Claire McCaskill (D-MO) to limit total federal spending to 20.6 percent of gross domestic product (GDP), the average from 1970 to 2008, would force draconian cuts in Social Security, Medicare, and many other programs while making it harder for the nation to recover from recession.

That's because the proposal, which would take effect in 2013 and phase in over 10 years, does not account for fundamental changes in society and government: the aging of the population, substantial increases in health care costs, and new federal responsibilities in areas such as homeland security, veterans' health care, and prescription drug coverage for seniors. These factors make the spending levels of an earlier era inapplicable for today's discussions about how to reduce looming budget deficits and put the budget on a sustainable path in the coming years.

Limiting spending to an historical average of some kind has been a longstanding goal of very conservative organizations such as the Heritage Foundation.[1] The reality is, however, that policymakers will find it virtually impossible to maintain federal spending at its average level for decades back to 1970 without making draconian cuts in Social Security, Medicare, and an array of other vital federal activities. That average reflects a federal government with far less responsibility than today, and a country with a much smaller percentage of elderly people and considerably lower health care costs. In particular:

- The aging of the population — the percentage of Americans aged 65 and older will grow by more than half over the next 25 years — and increases in per-person costs throughout the health care system (in both the public and private sectors) will raise the cost of meeting longstanding federal commitments to seniors and people with disabilities. Together, these factors will drive up spending for the three largest domestic programs — Medicare, Medicaid, and Social Security. Limiting total federal spending to 20.6 percent of GDP would have enormous implications for those programs as well as the rest of government.

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[1] Brian M. Riedl, *The Three Biggest Myths About Tax Cuts and the Budget Deficit,* Heritage Foundation, June 21, 2010, Backgrounder No. 2423.

- Federal responsibilities have grown since 2000, with developments at home and abroad pushing spending above the average for earlier decades. These responsibilities include homeland security in the aftermath of the September 11, 2001 attacks; aid to veterans of the Iraq and Afghanistan wars, many of whom — especially those disabled in the wars — will need health care and income support for decades to come; the Medicare prescription drug benefit, which Congress added in 2003; and health reform, which extends health coverage to tens of millions of Americans who would otherwise be uninsured and will increase federal spending, even though it will reduce the deficit.

- Spending for interest on federal debt also will be substantially higher in coming decades than it was during the past 40 years. Today — largely due to the wars in Iraq and Afghanistan, the large Bush-era tax cuts, and the severe recession — debt held by the public is almost twice as large (as a percentage of GDP) as in 2001, with a commensurate increase in interest costs once interest rates return to typical levels.

Aiming to stabilize the budget at the recent historical spending average of 20.6 percent of GDP might be appropriate for the years ahead *if* the age distribution of the population remained the same as in recent decades; if health care costs grew no faster than the economy; if Medicare had no drug benefit; if we were willing to leave more than 30 million Americans without health coverage; if there were no terrorist threats and hence no need for homeland security spending; if no wounded veterans of Iraq and Afghanistan needed medical care and income support; and if decisions and events over the last decade had not nearly doubled the national debt as a share of GDP. But that's not the world in which we live, and it's not the target at which we should aim.

Author and commentator Matt Miller has noted that federal spending under President Reagan averaged 22 percent of GDP — at a time when no baby boomers were retired and health care costs were more than *one-third lower* as a share of the economy than they are today. "As a matter of math," Miller notes, "if you run the government at a smaller level than did Ronald Reagan while accommodating this massive increase in the number of seniors on our health and pension programs, you have to decimate the rest of the budget."[2]

Indeed, when an expert committee on the deficit convened by the National Academy of Sciences and National Academy of Public Administration issued a major report early last year, it outlined four possible paths to stabilize the debt. As committee co-chair and former Congressional Budget Office director Rudolph Penner explained, the panel designed paths at two "extremes" — one that achieved nearly all its deficit reduction by cutting programs and another that got nearly all its deficit reduction by raising taxes — and two intermediate paths that blended program and tax changes. The extreme low-spending path — the path that got nearly all of its deficit reduction by cutting programs, while doing very little on the revenue side of the budget despite the presence of over $1 trillion a year in special interest tax breaks and other tax expenditures — included very deep cuts in Social Security, Medicare, and Medicaid, and reductions of about 20 percent in *all* other spending, including defense, veterans programs, and the like. Under this extreme path, federal spending would be *slightly higher than the Corker-McCaskill level* — about 21 percent of GDP.

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[2] Matt Miller, "A spending goal too small for aging America," *Washington Post*, January 28, 2010.

As the National Academy of Sciences study suggests, a proposal to limit total federal spending to 20.6 percent of GDP essentially establishes as a policy of the United States that programs on the "spending" side of the budget — no matter how effective and meritorious — must be accorded lower priority and made subject to the budget knife while the $1 trillion a year in tax expenditures are given much greater protection. Last summer, conservative economist Martin Feldstein, chair of President Reagan's Council of Economic Advisers, wrote that tax expenditures are the single best place in the budget to cut wasteful or unnecessary spending.[3] The Corker-McCaskill proposal ignores his advice. Indeed, under the Corker-McCaskill bill, it would become difficult or impossible to finance a badly needed program expenditure by closing an egregious special-interest tax loophole. Moreover, creating a new tax loophole without an offsetting revenue increase would automatically necessitate new cuts in program spending, because the loss in revenue resulting from the loophole would increase deficits and debt and hence interest payments on the debt, which would count against the 20.6 percent of GDP limit and thereby force additional program cuts.

Finally, imposing an arbitrary limit on federal spending would risk tipping faltering economies into recession, make recessions deeper, and make recovery from a recession more difficult. Spending for some important federal programs — including unemployment insurance, food stamps and Medicaid — increases automatically during a recession, when the need for assistance grows. Since GDP also shrinks during a recession and remains below its trend level during the early stages of recovery, federal spending increases significantly as a share of GDP during periods of economic weakness. This automatic response softens the recession's blow not only for the programs' beneficiaries but also for the economy as a whole by maintaining total purchasing power. Attempting to limit federal spending to a fixed share of GDP would "impinge on the stabilizers on the spending side of the budget," as CBO Director Douglas Elmendorf testified last week. Taking away these stabilizers, Elmendorf warned, "risks making the economy less stable [and] risks exacerbating the swings in the business cycle."[4]

To be sure, Congress could waive the law to allow for spending to exceed the limit during an emergency. But the waiver would require a two-thirds vote in both the House and Senate, an extremely high hurdle that could be difficult or impossible to overcome even in a very severe economic downturn (as shown by the recent difficulty of securing even a three-fifths vote in the Senate to extend unemployment insurance benefits at a time when unemployment stood at close to 10 percent). Furthermore, even if Congress eventually waived the limit, the economy would almost certainly weaken substantially *before* several calendar quarters of data became available to document that the economy was in a recession, and then weaken further before Congress suspended the expenditure limit.

Meeting Longstanding Federal Commitments Will Cost More

One reason why the historical average level of spending is not an appropriate benchmark is that economic and demographic developments will increase the cost of meeting longstanding federal commitments. The Center on Budget and Policy Priorities projects that, without policy changes,

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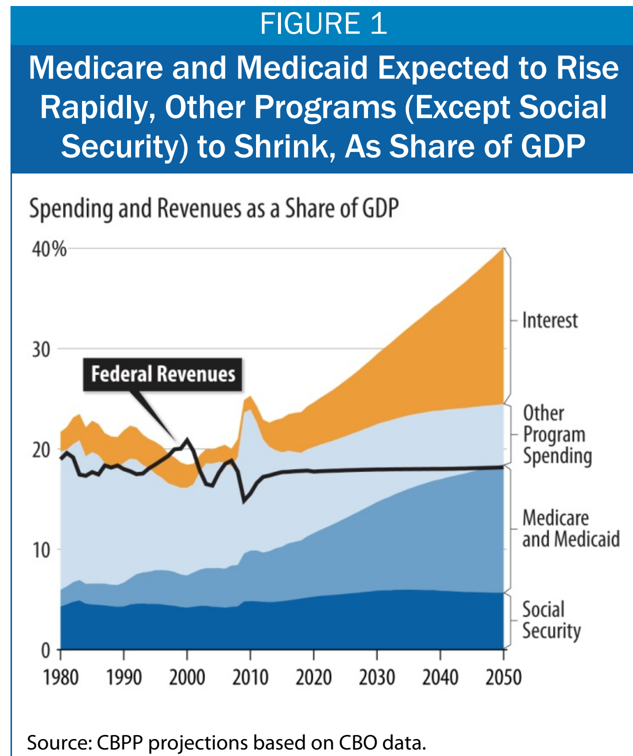
[3] Martin Feldstein, "The 'Tax Expenditure' Solution for Our National Debt," *Wall Street Journal*, July 20, 2010.

[4] Douglas W. Elmendorf, Director, Congressional Budget Office, Transcript of Testimony before the Senate Budget Committee, January 27, 2011, Federal News Service.

program expenditures (that is, spending for everything other than interest payments on the national debt) will reach 24.5 percent of GDP by 2050.[5] Revenues, in contrast, are projected to be only 18.2 percent of GDP in 2050 under current policies — a level that is near the 40-year historical average but would have been insufficient to cover expenditures in all but two of those 40 years. Under this scenario, rising interest costs will cause deficits and debt to explode. (See Figure 1.)

FIGURE 1

Medicare and Medicaid Expected to Rise Rapidly, Other Programs (Except Social Security) to Shrink, As Share of GDP



Source: CBPP projections based on CBO data.

The two main sources of rising federal expenditures relative to GDP over the long run are rising per-person costs throughout the U.S. health care system (both public and private) and the aging of the population. Together, these factors will drive up spending for the three largest domestic spending programs: Medicare, Medicaid, and Social Security. Spending for all other federal programs is projected to shrink as a share of the economy in coming decades.

The U.S. population is growing older, which will add to the number of people eligible for Medicare, Medicaid, and Social Security over the next 25 years. As the members of the post-war Baby Boom (those born between 1946 and 1964) reach retirement, the fraction of the U.S. population ages 65 and over will grow by more than half — from 13 percent in 2010 to 20 percent by 2035 — and then level off at about that share.[6]

Rising health care costs account for the rest of the projected long-run growth. For decades, costs per person throughout the U. S. health care system — both in the public and private sectors — have been growing about 2 percentage points faster per year than GDP per person. Although the Affordable Care Act should slow this growth somewhat, health care costs will almost certainly continue to grow faster than GDP as medical breakthroughs continue to improve health and prolong lives but add to health care costs.

While Social Security will largely stop growing as a share of GDP after 2035, when the demographic shift is mostly complete, Medicare and Medicaid will continue rising because health care costs are projected to continue growing faster than GDP as medical advances continue.

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[5] Kathy Ruffing, Kris Cox, and James Horney, *The Right Target: Stabilize the Federal Debt*, Center on Budget and Policy Priorities, January 12, 2010, http://www.cbpp.org/files/01-12-10bud.pdf. The projections do not include the effects of the Affordable Care Act.

[6] Board of Trustees of the Federal Old-Age and Survivors Insurance and Federal Disability Insurance Trust Funds, *2010 Annual Report*, Table V.A2, page 87.

The Federal Government Has Taken On More Responsibilities

Another reason that the historical average level of federal spending is not an appropriate benchmark is that the federal government's responsibilities have grown significantly in recent years. Since 2000, developments at home and abroad have pushed federal spending significantly above its average in earlier decades. Here are some examples:

- *Homeland Security*. Following the attacks of September 11, 2001, federal spending for homeland security increased significantly. Total homeland security budget authority has grown from $21 billion (0.2 percent of GDP) in fiscal year 2001 to $71 billion (0.5 percent of GDP) in 2010.[7]

- *Veterans of Iraq and Afghanistan*. The wars in Iraq and Afghanistan have increased the numbers of wounded veterans needing health care and income support. Budget authority for veterans' benefits and services has grown from $45 billion (0.5 percent of GDP) in 2000 to $125 billion (0.9 percent of GDP) in 2010.[8]

- *Medicare Prescription Drug Benefit*. The Medicare Prescription Drug, Improvement, and Modernization Act of 2003 added a prescription drug benefit to the Medicare program. The drug benefit adds about 0.3 percent of GDP to federal spending in 2010 and more in later years.[9]

- *Education*. With the No Child Left Behind Act of 2001, the College Cost Reduction and Access Act of 2007, and other legislation over the past decade, the federal government has taken a greater role in educating the future workforce to compete in the global economy. The federal government is providing more resources for public schools, tied to standards designed to improve educational quality and outcomes. Budget authority for elementary, secondary, and higher education programs has increased from $29 billion (0.3 percent of GDP) in 2000 to $60 billion (0.4 percent of GDP) in 2010.[10]

- *Health Reform*. The Affordable Care Act of 2010 extends health coverage to tens of millions of Americans who would otherwise be uninsured. CBO estimates that the new law will increase federal spending by about 0.4 percent of GDP after it is fully phased in.[11] CBO also estimates that it will *reduce* the deficit by $230 billion over the 2012-2021 period and by one-half of one percent of GDP, or roughly $1.3 trillion, in its second decade. Under a rule that seeks to hold spending to its historical average, however, the fact that the law reduces the deficit would be ignored, and the survival of the legislation would be threatened to a considerably greater degree.

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[7] Congressional Budget Office, *Federal Funding for Homeland Security*, April 30, 2004; *Budget of the United States Government, Fiscal Year 2011, Analytical Perspectives*, "Homeland Security Funding Analysis," Chapter 23.

[8] *Budget of the United States Government, Fiscal Year 2011, Historical Tables*, Table 5.1.

[9] CBO estimate of net spending for Part D of Medicare less CBPP estimate of reduction in Medicaid spending.

[10] *Ibid.*

[11] Douglas W. Elmendorf, Director, Congressional Budget Office, Letter to the Honorable Nancy Pelosi, March 20, 2010.

Federal Government Will Owe More Interest

In addition, spending for interest on the federal government's debt will be substantially higher in coming decades than it was during the past 40 years. Over the 1970-2008 period, interest costs averaged just 2.3 percent of GDP, and debt held by the public averaged 36 percent of GDP. But by the end of 2010 — largely as a result of the wars in Iraq and Afghanistan, the large Bush-era tax cuts, and the recent severe recession — debt held by the public reached 62 percent of GDP.

Under the deficit reduction plan proposed by Erskine Bowles and former Senator Alan Simpson, co-chairs of the National Commission on Fiscal Responsibility and Reform, the debt would peak at slightly over 70 percent of GDP — a level twice as large relative to the economy as the average level that prevailed in 1970 through 2009. Interest costs would be commensurately higher. In 2020, once interest rates rise from today's record-low levels, estimated interest costs would amount to 3.2 percent of GDP — *about a percentage point higher* than the 1970-2008 average.[12]

In short, the rising costs of Social Security and health care, new governmental responsibilities, and a larger debt-service burden all point to one clear conclusion: historical spending levels are not a realistic or appropriate goal for the future.

Reductions in Spending Alone Cannot Solve the Long-Term Problem

Although Medicare, Medicaid, and Social Security account for all of the projected increase in program spending relative to the size of the economy through 2050, cuts in these programs alone cannot realistically be expected to solve the long-term budget problem.[13] The growth of Medicare and Medicaid costs cannot be held below the growth of private-sector medical costs for very long without endangering access to medical care for low- and moderate-income beneficiaries or shifting costs to private payers. Advances in medical technology will also make it difficult — and probably undesirable — to keep both private and public spending on health care from growing faster than the economy. As economic growth raises national income, Americans will likely want to devote a larger share of that income to medical advances that hold promise of improving health and prolonging life, but also entail added cost.

Similarly, there are limits to how much Social Security can be cut without undermining its crucial role in reducing poverty and replacing income lost when a wage earner retires, dies, or becomes disabled. Social Security benefits are quite modest, averaging only $1,175 a month (or $14,105 a year) for a retired worker. Social Security checks now replace about 37 percent of an average worker's pre-retirement earnings — one of the lowest percentages of any western industrialized country — and that figure will gradually fall to about 32 percent over the next two decades, largely because of the scheduled increase in the full retirement age to 67.[14]

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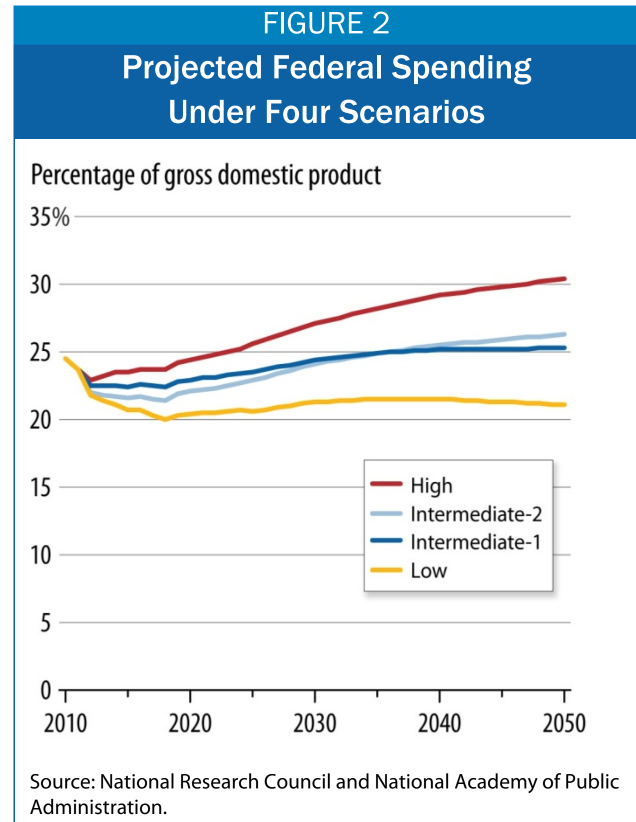
[12] Erskine Bowles and Alan Simpson, *The Moment of Truth*, Draft Report of the National Commission on Fiscal Responsibility and Reform, December 2010, page 57.

[13] Ruffing, Cox, and Horney, *The Right Target.*

[14] Kathy A. Ruffing and Paul N. Van de Water, *Social Security Benefits Are Modest*, Center on Budget and Policy Priorities, January 11, 2011. These replacement rates are net of premiums for Part B of Medicare, which are deducted from most Social Security checks, and of average Medicare Part D premiums, which most beneficiaries pay separately.

Prospects for deep reductions in other spending in coming years are also limited. Spending for programs besides the "big three" is already projected to *decline* as a percentage of GDP under current policies. Although cuts can doubtless be made in some programs, there will also be pressures to increase spending in areas of emerging national need, such as infrastructure investment, environmental protection, and medical and scientific research. "The rest of the outlay side of the budget is too small," writes Martin Feldstein, chair of President Reagan's Council of Economic Advisers, "to provide much scope for reducing annual budget deficits."[15]

In 2010, the Committee on the Fiscal Future of the United States, a joint effort of the National Academy of Sciences and the National Academy of Public Administration, developed four budget paths or scenarios to illustrate the range of available policy choices for federal spending and revenues.[16] One was a low-spending path that eschewed revenue increases and accomplished nearly all of its deficit reduction by cutting programs. At the other end of the spectrum was a path that accomplished most of its deficit reduction by raising taxes. Between these two paths, the committee outlined two intermediate scenarios. (See Figure 2.) Committee co-chair and former CBO director Rudolph Penner has described both the low-spending and high-spending paths as "extreme," explaining that "At one extreme, the committee asked what spending cuts would be necessary to stabilize the debt-GDP target at 60 percent if the total tax burden was maintained at its historical level between 18 and 19 percent of GDP."[17]



Source: National Research Council and National Academy of Public Administration.

Under the committee's extreme low path that secured almost all of its deficit reduction through budget cuts, federal spending would be about *21 percent of GDP*. The 21-percent-of-GDP path included the following measures.

- *Large cuts in Social Security benefits*. The full retirement age would be increased to 67 by 2017 and further increased by one month every two years thereafter; for new retirees, benefits would also be reduced below the levels scheduled under current law for all but the poorest 30 percent of earners; and benefits would grow more slowly after initial receipt. By 2050, the benefit of a newly retired worker with average earnings would be 27 percent lower than the benefit scheduled under current law.[18]

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[15] Feldstein, *op. cit.*

[16] National Research Council and National Academy of Public Administration, *Choosing the Nation's Fiscal Future,* Washington: National Academies Press, 2010.

[17] Rudolph G. Penner, Statement before the Senate Budget Committee, February 11, 2010.

[18] *Choosing the Nation's Fiscal Future*, Appendix C.

- *Unspecified policies to hold the growth of Medicare and Medicaid costs per beneficiary to the same rate as the growth of GDP per capita, even as general health care costs continue to rise more rapidly.* Compared to current law, expenditures for Medicare and Medicaid would be cut 20 percent by 2025 and over 40 percent by 2050. The committee observed, "This steep, sustained slowdown of spending growth is possible only under a regime of tough cost controls in at least the near and medium term. Many analysts would consider this trajectory to be politically unrealistic. It also may be regarded as implausible to the extent that competing policy objectives of expanding access to care and improving quality are taken seriously."[19] The only way of achieving this outcome would likely be to replace Medicare's guaranteed benefit with a voucher for the purchase of private insurance and Medicaid with a block grant to states; the value of the voucher and block grant would grow much less rapidly than the actual cost of health care, thus subjecting Medicare and Medicaid beneficiaries to cuts in health care services that would grow larger each year.

- *Cutting all other programs (other than Social Security, Medicare, and Medicaid) by about 20 percent overall.* If some large parts of the budget — like defense and veterans' programs — were cut substantially less than 20 percent, or if new programs were needed, other parts of the budget would have to be cut much more severely.

In the committee's three other illustrative paths, spending and revenues would exceed their averages over the decades since 1970. In the path that accomplished most of its deficit reduction through revenue increases, total spending (including interest) would reach 26 percent of GDP by 2025 (and 30 percent of GDP by 2050). In the two intermediate paths spending would total 23 percent of GDP in 2025 (and 25 or 26 percent of GDP in 2050). The committee noted that even the intermediate paths required instituting major budget cuts to hold spending well below the levels that would be reached under a continuation of current policies.

On November 17, 2010, a commission of the Bipartisan Policy Center that was co-chaired by former Clinton Office of Management and Budget Director Alice Rivlin and former Republican Senate Budget Committee Chairman Pete Domenici released its own deficit reduction plan.[20] The Rivlin-Domenici commission proposal accepts the reality that the world and federal responsibilities have changed and that it will not be possible to meet national needs in coming decades and hold spending to the level deemed appropriate in the past. It proposes major program changes to reduce spending well below what it will be if policies remain unchanged, but it accepts that total federal spending will have to be significantly above 20.6 percent of GDP in the decades ahead. *Under the Rivlin-Domenici plan, total spending will equal approximately 23 percent of GDP in 2020 and rise to somewhat higher levels in later years.*[21]

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[19] *Ibid.*, p. 79.

[20] Debt Reduction Task Force, *Restoring America's Future,* Bipartisan Policy Center, November 17, 2010.

[21] James Horney, Paul N. Van de Water, and Robert Greenstein, *Rivlin-Domenici Deficit Reduction Plan Is Superior to Bowles-Simpson in Most Areas, But Health Proposal Is Very Troubling*, Center on Budget and Policy Priorities, November 30, 2010.

Arbitrary Budgetary Targets Are Misguided

The bottom line is that arbitrary numerical targets for federal spending and revenues are misguided. Although history provides useful information and guidance, it should not be a straitjacket. What will be appropriate in 2020, 2030, or 2050 is not the same as in 1970 or 1980. Budgetary policies, like other policies, must respond to changing circumstances. "As our cause is new," wrote Abraham Lincoln, "so we must think anew, and act anew."[22]

Determining the appropriate levels of federal spending and revenues requires making a thoughtful assessment of national needs and weighing the benefits of federal spending programs and tax expenditures against each other and against the costs of the taxes to pay for them. Limiting spending and revenues to their historical average or another inflexible target would prevent these trade-offs from being made. For example, it would make it impossible to create a highly beneficial spending program that would be fully paid for by closing an egregious tax loophole. In our view, the aging of the population, the continued importance of Social Security and Medicare, the growth in federal responsibilities in recent years in areas such as homeland security, and rising health care costs justify higher levels of federal spending and revenues over the next 40 years than over the past four decades.

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[22] Abraham Lincoln, Message to Congress, December 1, 1862.