THE BUDGET

INTRODUCTION

America’s ability to meet the needs of its citizens and create a better quality of life for them depends on a strong economy. Federal and state budgets both reflect the economic health of the country and make significant contributions to ensuring that the economy is growing and creating new jobs and opportunity for all Americans.

In the 60 years since the end of World War II the economy has grown at an average annual rate of 3.5 percent and per capita real incomes have increased more than 2.2 percent per year. However, there have been nine economic recessions during this period, when the economy contracted, jobs were lost, and incomes declined. The most recent recession occurred in 2001, and the recovery that began in 2002 is now in its fourth year. This recovery has been relatively sluggish, with lagging job growth, despite real growth in gross domestic product that has been close to average. One surprise is evidence of a surge in wage-and-salary income in the first half of 2006. Pay grew at an annual pace of around 7 percent after adjusting for inflation. This could put upward pressure on the inflation rate.

When the economy experiences a recession government budgets can be adversely affected for several years. This has been the experience since 2001, with the federal budget plunging into deficit after several years of surpluses and state and local budgets also suffering. These federal deficits, arising from a combination of the weak economy and policies designed by Congress and the president to cut taxes and increase spending, have provided some stimulus to economic growth. Monetary policy was eased considerably to aid the economic recovery. Beginning in mid-2004, the Federal Reserve tightened monetary policy with 17 consecutive interest rate increases in two years meant to cool the economy and bring down inflation. Short-term interest rates have held steady since mid-2006.

However after several years of economic recovery, the budget remains seriously out of balance. While budget deficits can help support a weak economy in the short run, large and persistent deficits can adversely affect long-term economic growth. Projections suggest that over the next decade the federal budget deficits could remain large, both in dollars and relative to the size of the economy, depending on congressional policies. This could have a significant impact on funding for government programs that serve the most vulnerable populations in the country. Just as important such long-term deficits could put pressure on interest rates to rise to levels higher than might otherwise be expected, dampening investment and future economic growth. The budget outlook beyond the next ten years suggests that policymakers need to consider the impact of their decisions on future generations of Americans as well. Many analysts have pointed out that the aging of America will put additional pressures on the federal budget due to the rising costs of health care and retirement programs. There is also concern about the
increase in interest costs on a large federal debt if balance is not returned to the federal budget.

Economic disparities remain substantial despite the strong growth of the late 1990s. Since the late 1970s the concentration of wealth has increased steadily, with the gap between rich and poor widening substantially. Poverty rates have increased for four consecutive years despite the recovery. The 2004 national poverty rate of 12.7 percent is unacceptably high. While the poverty rate for people age 65 and over declined slightly, to 9.8 percent, poverty rates rose again for those under 18 (to 17.8 percent) and for those between 18 and 64 (to 11.3 percent). Real income levels have declined too. The average income of people age 65 and older in 2004 was more than 2 percent lower than in 1998. The widening income gap, rising poverty rates, and the adverse budget outlook have troubling implications for the adoption of desirable economic, social and budget policies.

Regional economic disparities also persist and have an effect on the ability of state and local governments to provide public services. States obviously vary widely in their ability to generate revenues and thus their provision of public services. But even larger and richer states are subject to economic fluctuations. In light of states’ general inability to run deficits, these changes can lead to boom-and-bust cycles that amplify the fluctuations in the national economy.
THE BUDGET

AARP PRINCIPLES

Budget policy should promote economic growth and stability.
Fairness across generations should be an important goal in formulating budget policy.
The federal government should strive for balance in the unified budget over economic cycles, while maintaining flexibility and protecting vulnerable populations.
Federal and state budget policymakers should be mindful of how their decisions impact other levels of government.
The Federal Budget and National Saving

After falling into deficit during the recession in 2001, the budget outlook has not improved, despite the recovery. This suggests the development of a structural deficit that will persist even as the economy grows, unless policies change.

The current deficit is putting pressure on social programs, especially those that assist low-income groups. In addition deficits have resulted in the need to borrow substantial amounts from foreign lenders. This has put upward pressure on domestic interest rates and created a large trade deficit. The so-called twin deficits—budget and foreign trade—have led to concerns about the impact on the economy of a long-term debt buildup. In fiscal year (FY) 2006 federal government finances improved slightly for the second consecutive year. As a result the deficit fell to $248 billion (Figure 1-1). Although the FY 2006 deficit represents a high level in dollar terms, at 1.9 percent it is a smaller percentage of gross domestic product (GDP) than the deficits of the mid-1980s and early 1990s. This contrasts with the brief four-year period from 1998 to 2002, when there was a unified budget surplus.

![Figure 1-1](image.png)

**Figure 1-1**

**Annual Unified Federal Budget Surplus or Deficit, 1980–2006**

$billions

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Current federal budget projections show deficits continuing for at least the next six years. The January 2006 budget projections, using the budget period from FY 2006 through FY 2016, predict a $1.7 trillion unified deficit, even with Social Security surpluses of $2.8 trillion. In other words the portion of the budget outside Social Security is projected to run a deficit totaling $3.9 trillion in the next ten years.

The deficit in FY 2004 reached $412 billion, the largest deficit on record in dollar terms. However, the deficit in FY 2005 declined to $318 billion, largely due to an unexpected and temporary increase in personal and corporate tax revenues.

Because of changing fiscal policies, past baselines for projecting budget surpluses or deficits have not held up. These estimates do not take into account any of the new spending that will likely occur to meet increased defense and homeland security needs. In the baseline developed by the Congressional Budget Office (CBO), for example, budget authority for discretionary spending programs is projected by inflating from the level appropriated for the current year, as specified by the Deficit Control Act. Thus the official baseline assumes that discretionary budget authority will rise at an annual rate of 2.7 percent from FY 2006 to FY 2016. The CBO has estimated the budget impact of other assumptions about future discretionary spending. For example the assumption that appropriations will rise by 4.8 percent a year—the average annual rate of GDP growth after 2005—boosts projections of discretionary spending, i.e., increases the deficit by $1.6 trillion over the 2007–2016 period. Another source of uncertainty is future policy regarding extension of tax cuts now set to expire in 2010.

The tax cuts of recent years have reduced federal revenues to their lowest level in more than 40 years. Many analysts have questioned whether this level can be sustained while the government continues to fund existing federal services. The enormous future deficits will have severe impacts on all federal programs, especially those related to the retirement of the baby boomers.

Recent developments have not altered the long-term budget outlook to any significant extent. The unanticipated increase in federal revenues in 2005 is considered temporary by most budget analysts, and revenues are expected to return to the path of earlier projections within several years. Similarly the costs associated with disaster relief and reconstruction in the Gulf Coast area should have a major impact on the budget for one or two years, but will not change longer-term projections.

Although current CBO budget projections show a substantial decline in the deficit beginning in 2011, the baseline does not include policies that Congress will be under great pressure to adopt in the next five years. The most important of these are the extension of the 2001 and 2003 tax cuts, which are set to expire in 2010, and proposals to lessen the impact of the alternative minimum tax. Extending all of these tax cuts and other proposals without offsets would result in a significantly larger deficit beginning in 2011.
The government’s fiscal outlook is potentially worse beyond the next ten years. Next year the oldest baby boomers will turn 62, making them eligible for Social Security’s early retirement benefits (past history suggests more than half will begin taking Social Security benefits at age 62); in 2011 these boomers will be eligible for Medicare. If the 2001 and 2003 tax cuts are extended beyond 2010 (the year in which they are currently scheduled to expire) the lower revenues combined with the increased spending on entitlement programs will contribute to an increase in structural deficits. These will seriously limit the investments in human and physical capital needed to maintain economic growth and global competitiveness.

Options that policymakers have for dealing with deficits—raising taxes or constraining spending—are likely to have very different impacts on economic growth and the economy’s capacity to maintain the government’s largest entitlement programs (i.e., Social Security, Medicare and Medicaid) and other government programs and activities. The CBO predicts that by 2046, outlays for those programs, if left unchanged, will rise and may equal the share of GDP now absorbed by all federal revenues. However, revenues could remain below the levels of the last three decades if the tax cuts are extended. Budget choices will have to factor in concerns about generational equity to treat elderly and working generations fairly.

Because of the deterioration in the budget outlook, the publicly held debt (the cumulative amount of all government borrowing from the public) will continue increasing.

The level of gross federal debt was $7.9 trillion at the end of FY 2005. Gross debt is the sum of the debt held by the public ($4.6 trillion in FY 2005) and the debt in intragovernmental holdings ($3.3 trillion), such as the Social Security and Medicare trust funds. Annual deficits or surpluses represent the yearly change in the amount of government borrowing, while the debt represents the total amount of net deficits accumulated over time, including interest costs. Each year’s unified budget deficit adds to the amount of publicly held debt, while a surplus reduces it. The debt, in turn, affects the budget by requiring annual outlays to pay interest to public holders of federal securities. Net interest paid on outstanding federal debt constitutes a significant portion of the federal government’s annual budget outlays ($277 billion in net interest costs for FY 2009, rising to $302 billion by FY 2014).

Federal borrowing also puts upward pressure on interest rates. Despite improvements in the budget during the 1990s, the ratio of gross federal debt to GDP continues to be high by historical peacetime standards. This ratio has varied widely over the years, from a high of 124.4 percent in postwar 1946 to a low of 32.6 percent in 1981. In 2005 the ratio inched back up, to approximately 64.3 percent of GDP (Figure 1-2). The CBO estimates that debt held by the public in 2015 will be $5.9 trillion, with gross federal debt at $12.6 trillion. Over the ten-year period, the CBO estimates, it will cost more than $2.8 trillion in net interest to service this debt.
The situation created by the war and occupation in Iraq, the ongoing operations in Afghanistan, and the disaster relief and reconstruction presents Congress and the president with a number of difficult decisions.

Large federal deficits and the growing national debt are of serious concern to the extent they adversely impact the ability of the general fund to meet its future obligations to the Social Security and Medicare trust funds. Large federal deficits also create undue pressure to cut federal social programs that serve the poor, the disabled and the elderly. Continued large-scale deficit spending is untenable, and reducing the federal deficit to a manageable level, while ensuring an adequate revenue stream to support vulnerable Americans, is a priority.

**FEDERAL POLICY**

**FEDERAL BUDGET**

**The Federal Budget and National Saving**

Given the deterioration in the budget outlook and the need to fund national spending priorities, Congress must ensure an adequate revenue base. This could include reconsideration of any tax changes yet to take effect.

With the reemergence of sizable and ongoing budget deficits, proposals that would increase these deficits or spend future projected surpluses, whether through direct spending or tax cuts, should be considered cautiously.

Budget policy should be designed to restore balance in the unified budget. Social Security surpluses should be dedicated to maintaining Social Security’s defined benefits and not to individual accounts.
Changes to Social Security should not be made for the purpose of reducing the deficit in the non-Social Security budget.

Deficit-reduction efforts should avoid cuts in programs that serve people of modest means.

Federal budget policy must consider the fiscal impact of federally mandated initiatives on state and local budgets.

**FEDERAL BUDGET**

**Background**

**Social Security**

The federal budget and Social Security are closely linked, even though they are in many ways separate and distinct. The federal budget is a device for determining the level and allocation of government income among programs during a prescribed period—usually one to ten years—while Social Security, with its long-term benefit commitments, requires a much longer perspective (75 years).

Because Social Security has its own dedicated funding source and will be building a sizable reserve, legislation adopted in 1990 separated it from the rest of the budget by taking Social Security revenues, spending on benefits and the trust fund surpluses “off budget.” (The program’s administrative costs are “on budget.”) This required that the calculation of the federal deficit or surplus be adjusted in both the president’s and Congress’s budget. Despite the 1990 change the administration and Congress have continued to present a “unified” budget, resulting in a misrepresentation of the balance in the non–Social Security portion of the budget (Figure 1-3).

For many years there have been accusations that the Social Security trust funds have been “raided.” In fact no one has done that. Current law requires that Social Security funds be dedicated exclusively to the program’s obligations and that any surplus funds be loaned to the US Treasury. The Social Security trust funds in turn are credited with special-issue Treasury bonds guaranteed by the government. The government has never defaulted on its obligations to Social Security or to any other purchaser of government bonds. In times of deficit the Treasury borrows funds from Social Security to meet government obligations. In times of surplus the Treasury uses Social Security funds to reduce publicly held debt. If the Treasury did not borrow funds from Social Security, it would have to borrow from the public. The solvency or the size of the trust fund is the same regardless of whether Social Security funds are used for debt reduction or other purposes.
Social Security is not in crisis now, nor is it projected to be in the near future, and it can pay full benefits until 2041. Beginning in 2017 expenditures from the Old Age, Survivors and Disability Insurance (OASDI) trust funds are expected to exceed tax revenues, and interest earnings will have to be used to pay the difference. The first year OASDI expenditures are projected to exceed tax-plus-interest income is 2027. In 2041 trust fund assets will be depleted, but incoming revenue can finance about 70 percent of promised benefits for decades thereafter. The Congressional Budget Office, using different assumptions and methodology, found that Social Security will have sufficient funds to continue paying benefits on time through 2052.

All Treasury securities, including those owned by Social Security, are redeemed with general revenue. The stronger the economy, the easier it is for the Treasury to redeem outstanding bonds. For this reason, if the non–Social Security portion of the budget (the on-budget part) is in surplus, it is easier to repay the funds borrowed from the Social Security trust fund.

Reducing federal debt could make the nation better off. When the government owes less, and is borrowing less or repaying past debt, its borrowing costs decrease and money that is currently spent on interest payments can be used for other purposes. In addition lower deficits take pressure off the financial markets, enabling interest rates to be lower than they would be otherwise. This encourages investment by businesses and individuals in new capital that helps the economy grow.
FEDERAL POLICY

Social Security

The Social Security trust funds represent a compact among generations and should continue to be spent only for purposes that reflect the spirit of this understanding.

Any Social Security reserves should continue to be dedicated only to maintaining Social Security’s defined benefits and not to individual accounts.

The uniqueness of Social Security requires that it be kept separate from the rest of the budget. This will maintain the public’s confidence in Social Security and better protect its reserves.

The costs of various proposed changes to Social Security could affect the non–Social Security budget. Therefore, they must be recognized and accounted for in a clear and transparent fashion.

STATE AND LOCAL BUDGETS

Background

Block Grants and Unfunded Mandates

The federal government provides states with block grants in several discretionary spending areas, and states frequently pass block grants to local governments, either with or without additional state funds. Block grants have a long tradition in intergovernmental relations but have become more common in recent years as a way around the criticism that the federal government had given states too many unfunded mandates (i.e., programs the states were required to adopt and implement but without receiving adequate resources to accomplish successfully).

In the past several years states have experienced negative fiscal effects from federal actions in two ways. First, because many state income tax codes are linked to the federal code (via adjusted gross income, federal taxable income or federal income tax), states lose revenue when the federal government cuts taxes, as it has done several times, unless states unlink their tax systems. Second, the federal government has established several programs for the states to operate, with the understanding that federal funding would be provided. Yet sufficient funding has not materialized for Temporary Assistance for Needy Families (TANF, the successor to welfare, or Aid to Families with Dependent Children); the No Child Left Behind Act (education reform); the Homeland Security Act (antiterrorism efforts, in which states and localities are the nation’s first line of defense); and the Help America Vote Act (election reform, aimed at replacing obsolete voting equipment and making polling places more accessible for people with disabilities).
Block Grants and Unfunded Mandates

Block-grant programs should be implemented and operated by the level of government most appropriate to deliver the covered services.

States should at a minimum maintain their current funding commitments and accommodate changes in demographics and inflation when creating and amending funding formulas to meet the needs of benefit recipients.

A governing body or public entity should monitor the implementation, effectiveness and ongoing activities of block-grant programs.

Discretionary decisions about the use of block-grant allocations should be made in the open and with input from affected stakeholders. Adequate advance notice, open hearings at the local level, and accurate, timely information are essential to the process.

In allocating block grants to local governments, states should ensure that the allocations reflect localities’ needs and ability to raise revenues, as well as accommodating variations in the cost of service delivery.

When a higher level of government determines that a lower level should take on the performance of a necessary function, adequate resources must be made available to accomplish the task.

State and Local Budget Policy and Economic Growth

Although the federal government dominates the economic policy agenda, the budgets and economic policies of state and local governments play an increasingly important role in the nation’s and citizens’ well-being. State and local economic and budget policies often fill gaps in national policy, providing such services as health care for the uninsured and affordable housing. Indeed, states and localities are often responsible for some of the most urgent and critical needs of vulnerable populations. They are also first responders in the event of natural disasters or acts of terrorism. Hurricanes Katrina and Rita have placed enormous strains on the governments of the affected states, including those receiving the storms’ evacuees, which will continue to be felt for the foreseeable future.

Federal economic policies affect state economies and budgets by influencing overall economic growth, credit markets, defense procurement, international trade, and research and development. Federal actions—from agricultural subsidies and environmental cleanups to the location of defense facilities and elimination of programs—all influence state economies. States, and
sometimes local governments, are the ultimate inheritors of the consequences of scores of ongoing changes in federal policies.

State fiscal health is closely tied to national economic performance. In particular, recessions reduce state and local government revenues while increasing necessary expenditures for vulnerable populations and the unemployed. Unlike the federal government, states often must make sharp spending cuts during recessions because, except for Vermont, they are precluded by legislation, their constitution or regulation from running deficits. Conversely, during economic expansions state revenues tend to grow faster than state spending, creating surpluses that lead to higher spending and/or tax reductions.

Unlike the federal government, however, states maintain capital budgets for large projects that can serve as a buffer from the business cycle. States can also borrow to fill budget gaps, but must be mindful of creditworthiness and repayment costs.

During recessions, rainy-day funds that were accumulated during good economic times can cushion against drops in spending on needed programs. But these funds need to be replenished when normal times resume. Some states do not maintain rainy-day funds, and not all of those that do have replenished them since the end of the most recent recession. Because of states’ need to balance budgets on an annual basis, the conventional wisdom has been that rainy-day fund balances should total about 5 percent of annual general fund expenditures. For states with very stable year-to-year budgets, that percentage may be too high; whereas states with considerable budget volatility should probably aim for rainy-day balances greater than 5 percent.

When state budgets experience difficulties, as they have recently, vital programs are underfunded, including in such areas as education, health care for the uninsured, and housing assistance. In order to preserve essential services in a downturn, states need to find new sources of revenue just when everyone’s budgets are stretched thin. Some revenue-increasing measures that are temporary or inherently unstable or declining (such as taxes on tobacco, alcohol and gambling) become tied to vital programs, placing them in jeopardy. An issue of growing importance to states is the loss of sales tax revenue due to expanding Internet commerce (see Chapter 2, Taxation).

In efforts to attract businesses and wealthier residents, states use economic development strategies to reduce reliance on income and business taxes, focusing instead on sales and excise taxes—particularly where such taxes can be “exported” to nonresidents via tourism. Yet surveys reveal that taxes are just one of many factors that influence the location decisions of businesses and families. Equally or more important are educational and workforce quality, amenities and climate.
State and Local Budget Policy and Economic Growth

States should provide localities with the funding they need to meet their obligations. Passing responsibilities down to lower levels of government should be undertaken primarily to place services closer to the people being served and to maximize administrative efficiencies, not as a way to reduce costs.

Building rainy-day funds should be part of a balanced approach to maintaining essential services in a recession. The use of rainy-day funds should be restricted to times when revenues, adjusted for inflation, actually decline.

When economic conditions permit, states should accumulate budget reserves of at least 5 percent of total general fund expenditures in separate rainy-day funds, protected against raids for nonessential purposes, to help maintain services during recessions.

States should not tie essential spending programs to unstable revenue sources.

States and localities should carefully evaluate the incentives they offer to attract or retain business, since such subsidies must be offset by greater tax burdens on consumers and other taxpayers and may have negative environmental consequences.

States and localities should promote low-income housing by issuing tax-exempt bonds, maintaining reasonable development and impact fees, and encouraging public-private partnerships.

Proposals to spend current and projected budget surpluses or refund them to citizens in the form of tax cuts should be considered cautiously, since state budget projections can change radically within a short time.

In all phases of the economic cycle, state governments should endeavor to protect programs for low- and moderate-income populations.

BUDGET PROCESS AND REFORMS

Background

Until 2002 there were two enforcement mechanisms in place to limit the ability of both Congress and the president to increase budget deficits or decrease budget surpluses: caps on discretionary appropriations and the pay-as-you-go (PAYGO) rules, which required that spending increases or tax cuts be offset by specific changes in entitlement spending or taxes. These rules to enforce fiscal discipline were adopted in 1990 and modified in 1993 and 1997. While the caps and rules were effective when the president and
Congress agreed on the overall budgetary framework, they caused evasion of and frustration with the process when no overall agreement could be reached.

The discretionary appropriations caps, for example, were set as rigid targets that frequently proved to be unrealistically low in light of subsequent congressional or presidential action. Consequently lawmakers struggled to find ways of spending more while technically staying within the caps. At other times efforts to keep spending below the caps resulted in reduced funding for programs critical to vulnerable groups, especially people with low incomes.

The current outlook for large and continuing budget deficits may again generate some support for a constitutional amendment to balance the federal budget. While supporters claim that a balanced budget amendment would mirror balanced budget requirements in many states, the structure of state requirements frequently differs from proposals that Congress has considered. In particular, “budget balance” in the states frequently relates only to their general fund (about 50 percent to 60 percent of the total budget in most states) and not to the total budget, including capital spending. So “balance” in state budgets does not automatically mean that current revenues equal current spending.

A constitutional amendment is not necessary to balance the federal budget. To be enforceable a constitutional amendment would shift the power to tax and spend from elected officials to an unelected judiciary. Such a change would weaken the accountability of Congress and the president for fiscal decisions and could lead to a constitutional conflict between the courts on one side and Congress and the president on the other. As a practical matter a strict constitutional requirement for a balanced budget would limit the government’s ability to respond to changes in the economy and to national emergencies.

Congress has considered less far-reaching proposals to reform the budget process in recent years, but without success. Some proposals would modify the rules that expired in 2002 by tightening the definition of “emergency” discretionary spending to close a loophole in the caps on appropriations. Other proposed changes would alter the PAYGO rules to allow non–Social Security budget surpluses to be spent on tax cuts without offsets. One proposal that was defeated by the House of Representatives would have made these changes and required that the congressional budget resolution be signed into law by the president.

In 2004 a proposal was made to reinstate the PAYGO rules but apply them only to increases in mandatory spending, not reductions in revenues. This proposal was not successful.

Other reform proposals have included moving to a two-year budget cycle, in which a budget is adopted one year and Congress is responsible for oversight in the second year; establishing a capital budget that distinguishes between consumption and investment spending; and changing the accounting rules
from the current cash-based system to an accrual-based system, which businesses use. However, none of these reforms has had much backing in Congress, and interest in them is likely to remain limited.

In 1996 the line-item veto was approved, allowing the president to cancel appropriations, direct or entitlement spending, and limited tax benefits. While the president had to notify Congress of his actions, the items struck from newly enacted laws were permanently cancelled unless Congress voted to disapprove the measure within a limited period of time. Because disapproval legislation could be vetoed, stopping a presidential cancellation in reality required a two-thirds majority vote. In 1998 the Supreme Court ruled the law unconstitutional.

During 2006 Congress considered but did not pass an enhanced rescission power. While called a line-item veto, the power did not permit the president to cancel spending or tax items without congressional approval. The proposed legislation would have allowed the president to develop packages of appropriations, entitlements or tax provisions that he wished to strike from newly enacted laws and then send the package back to Congress under an expedited consideration procedure. Only if Congress approved would the items have been deleted.

While supporters of the line-item veto claim that it would reduce the number of special-interest provisions and help contain the deficit, other budget experts note that such vetoes are rarely used and result in little actual reduction. Opponents submit that too much power might be given to the executive branch and that spending items and tax breaks are not equally protected.

One Senate proposal in 2006 included other budget process reforms such as declining deficit caps, based on a percentage of gross domestic product to bring the budget into balance by 2012, and new discretionary caps, both enforced with across-the-board reductions if the caps are breached.

Nearly all states have statutory or constitutional provisions requiring a balanced budget, and thus any decision affecting revenues or expenditures requires a value judgment on the merit of the expenditure and necessity of the revenue. State revenues and expenditure levels vary not only by action of the legislature but also because of growth or decline in the economy, changes in price and wage levels, federal legislation, disasters, and myriad other foreseeable and unforeseeable factors.

In recent years taxing and spending questions increasingly have been put before the public on ballots, with the result that the electorate votes directly on highly complex but often simplistically formulated fiscal matters. This is part of a general trend that is especially pronounced in western states but is spreading, toward governing via initiatives and referenda rather than legislatively.

Beginning in 2005, Taxpayer Bill of Rights (TABOR) initiatives began to appear in about half the states. TABOR would place rigid constitutional
limits on state (and sometimes local) government revenues and expenditures based on a formula of inflation plus population growth. This formula does not allow for the fact that the fastest-growing demographic groups—the elderly, the disabled, and the prison population—are the most expensive to serve; nor does it take account of states’ need to accommodate natural disasters, acts of terrorism, or sudden increases in costs imposed by the federal government.

TABOR has been tried only in Colorado, where it caused serious economic disruptions and was rolled back by voters for a five-year period in November 2005.

Such initiatives are backed by extremely conservative out-of-state groups portraying the effort as part of a citizens’ grassroots movement. Supporters are dedicated to shrinking government and privatizing most of its primary functions, and although proponents have failed to get TABOR on the ballot in all but a handful of states, it will be an issue for the states for the indefinite future, and ultimately perhaps for the federal government.

The push for such initiatives poses a threat to representative democracy. State budgets should be negotiated documents that reflect the values of the state in the light of projected revenues and expenditures. Such negotiation must be done by legislators annually; in fact, that is the very essence of the task for which they are elected. That task is undermined if it is constrained by constitutional mandates specifying the maximum or minimum amount of revenues or expenditures, either in general or from particular sources or for particular purposes.

FEDERAL POLICY

AARP opposes a balanced budget amendment to the US Constitution because it would endanger the nation’s economic health by limiting the government’s ability to address economic and political changes and invest in our nation’s future.

AARP opposes the legislative line-item veto and enhanced rescission proposals because they would give the president the authority to make arbitrary cuts to important programs and tilt the balance of power in favor of the executive branch.

If discretionary spending caps are reimposed, they should be set at a realistic level to avoid placing unnecessary burdens on programs serving low-income people and the administrative funding of Social Security.

Congress should consider modifying existing rules in order to enhance the budget process by requiring that tax cuts or increases in mandatory spending be offset by tax increases or reductions in mandatory spending. Any reform of the process should take into account the potential impacts on Social Security, Medicare, and programs serving people with modest means.
Given the large and continuing budget deficits, Congress should approve effective and balanced rules for fiscal discipline. Both mandatory spending and revenues should be subject to pay-as-you-go rules.

**STATE POLICY**

**BUDGET PROCESS AND REFORMS**

States should reject any balanced budget amendment that Congress refers to them for ratification.

States should avoid establishing supermajority voting requirements for budgetary matters; approvals by simple majority are more in keeping with the democratic process.

State constitutions (as applied to state finances) and state constitutions and statutes (as applied to local governments) should ensure flexibility in revenue and expenditure decisions, so that governments can adequately fund needed programs and services. Taxpayer Bill of Rights initiatives are the worst example of proposals that would virtually eliminate such flexibility.

If states and localities have tax and expenditure limits, whether statutory or constitutional, they should contain a sunset provision, perhaps of a ten-year duration; a single base year from which all future annual increases are calculated; annual increases based on population growth or a similar measure of service load, inflation and a reflection of changes in economic activity; a requirement that excess revenue be used first to bring the rainy-day fund to adequate levels of general fund expenditures; and a procedure for refunding surplus revenue, as nearly as possible, to those who paid it.

Except for general obligation bond issues, states should not refer tax and spending matters to the electorate for decision.

**ENTITLEMENT SPENDING AND REFORM**

**Background**

There are more than 350 entitlement programs that make payments to recipients—usually individuals but sometimes businesses, not-for-profit institutions, or state and local governments—who are eligible and apply for funds (Figure 1-4). Entitlements are not synonymous with public assistance or welfare. Rather “entitlement” refers to the fact that recipients are eligible for benefits, as established in law, by virtue of meeting specific criteria and that Congress is not required to appropriate funds annually for the benefits to be paid. Entitlement and other mandatory spending, as defined by the Congressional Budget Office, totaled about $1.4 trillion in fiscal year (FY) 2006, or more than 53 percent of all federal spending. In FY 2005 such spending was 10.7 percent of gross domestic product (GDP)—a figure that is comparable with levels reached in the early 1980s.
Figure 1-4
Where the Federal Dollar Goes
(FY 2006 Total: $2,654 billion*)

Entitlements  Nonentitlements  Net interest

Social Security ($544b) 19.5%
Medicare ($374b) 13.4%
Medicaid ($181b) 6.5%
Other welfare programs ($168b) 6%
Other domestic spending *** ($496b) 17.7%
Unemployment and other ($285b) 10.2%
Net interest** ($184b) 8.1%
Defense ($520b) 18.6%

* Includes $141 billion in offsetting revenues from Medicare premiums, deposit insurance and other sources not shown in the chart.
** Includes federal interest payment to the public, offset by interest income received by the government on loans and cash balances.
*** Includes all nonentitlement spending, but excludes defense spending.


Figure 1-5

Entitlement spending programs, especially Social Security and Medicare, are commonly labeled the chief cause of the nation’s continuing budget challenges, and many have projected an economic catastrophe in the future due to the retirement of baby boomers and increased longevity. However, changing demographics are not the primary cause of our fiscal dilemmas; it is the health care system, which delivers too little care and costs too much.

Most entitlements have not grown over time as a share of the overall economy. Retirement and safety-net entitlement spending are lower as a percentage of GDP than they were two decades ago. The only growth in entitlements relative to the economy has occurred in the health area—Medicare and Medicaid—which have doubled in size relative to GDP since the early 1980s (Figure 1-5). But the growth in health entitlements is merely a symptom of the inability to contain costs within our total health care system. For virtually any historical period selected, Medicare spending has actually grown more slowly than private health spending (Figure 1-6).

Some people also regard as entitlements the provisions in the tax code, known as tax expenditures, that confer benefits on certain taxpayers. The three largest of these, totaling $278 billion in FY 2005, are benefits for employer pension plans, the deductibility of home mortgage interest, and the exclusion of employer contributions for medical insurance. Many analyses fail to consider the impact of these expenditures on the federal deficit (see Chapter 2, Taxation, for further discussion of tax expenditures). The vast majority of benefits from entitlements go to people with moderate and lower incomes, in contrast to benefits from tax expenditures, which go mostly to the better-off. For example, about 70 percent of Social Security and Medicare benefits are received by households having total annual incomes (including transfer payments) of less than $30,000.

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**Figure 1-6**

**Average Annual Growth in Medicare Spending and Private Health Insurance Premiums, 1970–2004**

<table>
<thead>
<tr>
<th>Year</th>
<th>Medicare spending</th>
<th>Private health insurance premiums</th>
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<tbody>
<tr>
<td>1970–1974</td>
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<td>1995–1999</td>
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<td>2000–2004</td>
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</tbody>
</table>

Despite widespread perceptions that Social Security and Medicare are politically untouchable, they and other entitlement programs have seen significant cuts in the last 25 years. Legislation has been enacted to raise gradually the full retirement age for Social Security (OASDI) from 65 to 67 over 22 years, tax a portion of Social Security benefits for higher-income beneficiaries, and reduce Medicare spending growth in a number of areas (although some of these reductions were restored).

Entitlement cuts have been proposed as the primary way to reduce the federal deficit and maintain fiscal discipline. These proposals may be resurrected due to large projected deficits. Any proposal to cap entitlement spending could mean a direct attack on Medicare, Medicaid and other programs, because the growth of health care costs has exceeded growth in GDP.

In 2006 interest in an entitlement reform commission increased because of a proposal made by the president. In addition several congressional proposals were drafted with a wide range of suggested structures. Some would have limited the scope of the commission to consideration of the three non-tax major entitlements—Social Security, Medicare, and Medicaid—while other proposals would have expanded the focus to the entire range of entitlements and taxes. The model for military base closings and other expedited procedures have also been incorporated in some proposals.

Although the aging of the baby boomers and the increased longevity of Americans generally present real financial and social challenges, they can be countered with policies to control health care costs, ensure the solvency of Social Security, increase retirement savings, make it possible for people to work longer, restore and strengthen the depleted federal revenue base, and vigorously promote economic growth.

**FEDERAL POLICY**

**ENTITLEMENT SPENDING AND REFORM**

Legislative proposals to curb overall entitlement spending should recognize that continuing increases in overall health care spending are largely responsible for the growth in entitlements. To maintain significant long-term fiscal discipline, health care costs must be contained through broader reform rather than to meet arbitrary budget goals.

AARP opposes commissions that are unbalanced in their membership or are too narrowly focused. AARP supports an entitlement commission whose membership is not only balanced, but whose deliberations are fair and transparent, with adequate time given for all sides to study and present their positions on both tax expenditures as well as entitlements.

Legislation that caps or makes across-the-board cuts in entitlement spending fails to address issues, such as escalating health spending, that face individual programs. Arbitrary limits also may have unintended and undesirable
consequences, such as reductions in critical programs for low-income individuals.

Reductions in entitlement spending should take into account the sacrifices various groups have made already. The creation or expansion of tax expenditures, and the limitation or elimination of entitlements, warrant at least the same scrutiny as direct spending reductions.