MANUFACTURERS ALLIANCE Executive Letter

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The Federal Budget Deficit

In Comments to Bipartisan Commission on Entitlement and Tax Reform, Manufacturers Alliance Challenges Commission To Recommend Passage Next Year of Spending Cuts of $500 Billion Over Five-Year Period; Alliance Also Points Out That Major Restructuring of Federal Entitlements Will be Required in Next Two Decades

On July 30, 1994, the Manufacturers Alliance presented its views, copy attached, to the Bipartisan Commission on Entitlement and Tax Reform. The Commission was established last year at the demand of legislators who believed that the Omnibus Budget Reconciliation Act passed in August 1993 should have contained more spending cuts. The executive order creating the Commission charges it with recommending potential long-term budget savings involving revisions to mandatory programs and alternative tax reform proposals. The Commission is to report its findings to the National Economic Council and the congressional leadership by December 15, 1994.

The Manufacturers Alliance believes that a significant reduction in the federal budget deficit is the single most important policy the Administration and the Congress can undertake to encourage investment and economic growth. We are skeptical, however, that the Commission will be able to achieve any substantive progress toward this goal. Almost one-third of the Commission has endorsed the Clinton approach to health care reform, an approach that would expand further the role of the federal government. The Commission's mandate is weak and there is no assurance that either the Congress or the Administration will act on its recommendations.

The rising deficits of the past 30 years have been caused by the growth in federal entitlement programs, not by a reduction in tax revenues. The Alliance encourages the Commission to deliver a clear bipartisan commitment to achieve $500 billion in additional deficit reduction over five years. This deficit reduction should consist solely of spending cuts. Any savings achieved by eliminating tax expenditures should be devoted to lowering basic tax rates.

In our comments, we also point out that the current structure of federal entitlement programs is likely to collapse over the next 20 years. These programs, and the budget deficits caused by them, are placing a growing burden on the younger generation. The generation of baby boomers, born in the period 1945 to about 1952, will pay a net tax rate (taxes paid less Social Security benefits) of about 33 percent of their lifetime income. For those born in 1993 the net lifetime tax rate will escalate to 82 percent of income. This intergenerational inequity will worsen as Congress requires a combination of higher taxes and lower benefits to solve the program's long-term fiscal imbalance. A similar fiscal imbalance exists in the federal government's retirement program.

Problems in managing Medicare and Medicaid have contributed to the perception that the United States faces a health care crisis. These and other federal health programs account for roughly one-half of all health care expenditures. Because federal payments are poorly linked to benefits received, a huge inflationary pressure exists. Neither health reform nor deficit reduction is possible without dramatic changes in these programs.

The Alliance recommends specific reforms to deal with these problems. First, total federal spending should be limited to a constant percent of gross

domestic product. Second, the government should replace the numerous programs dealing with health, housing, nutrition, and other social problems with a relatively simple supplemental income program based on the recipient's willingness to work and to avoid socially destructive behavior. Third, procedural changes in the Congress and the Administration are needed to make government more responsive to the general interest of its citizens and to reduce the power of factional interests.

I hope you find this statement helpful as you express your own views on these public policy issues. If you have any questions or comments, please call me at 703/841-9000 or Joe Kennedy of the Alliance staff who prepared this report.

Ken McKenzie
President

Comments of
Kenneth McLennan, President
Manufacturers Alliance for Productivity and Innovation, Inc.
to the
Bipartisan Commission on Entitlement and Tax Reform
on
Recommendations on Statutory Entitlements and Other Mandatory Programs and Tax Reform Proposals

July 28, 1994

Introduction

The Manufacturers Alliance for Productivity and Innovation is a policy research organization whose approximately 500 member companies include leaders in almost every manufacturing industry. For more than 60 years, the Alliance has served as a spokesman for policies which promote technological advancement and economic growth.

The Alliance firmly believes that a significant reduction in the federal budget deficit is the single most important policy the Administration and the Congress can undertake to encourage investment and economic growth.[1] Over the last 30 years, total revenues have held remarkably steady at approximately 19 percent of gross domestic product (GDP), notwithstanding major changes in the tax laws. This percentage fell slightly over the past few years as a result of the recent recession, but the on-going economic recovery and last year's tax increases are restoring the long-run average. The budget deficits of the past 15 years have not been caused by declining tax revenues.

In contrast, federal spending as a percent of GDP has risen steadily over the last 30 years. Although this growth was reversed slightly during the last half of the 1980s, federal spending is expected to climb steadily over the next decade, averaging 21.6 percent of GDP. Only twice in the last 30 years have total ***revenues*** risen above 20 percent of GDP.

The bulk of the growth in spending has occurred in the government's entitlement programs. Discretionary programs have actually decreased as a percent of GDP over the last decade due entirely to a decrease in defense outlays from 6.5 percent to 4.6 percent of GDP. Meanwhile, the proportion of national income devoted to entitlement programs, particularly Social Security, Medicare, Medicaid, and federal retirement, has risen in an almost unbroken string since the 1960s. Before the Great Society initiatives of the Johnson Administration, mandatory spending averaged roughly 5.7 percent of GDP. It has now reached over 12 percent and is expected to exceed 14 percent by 2004.[2] In order to balance the budget, growth in spending must not only be stopped, it should be reversed.

Outlook for the Commission's Success

The executive order creating the Commission charged it with recommending potential long-term budget savings involving revisions to mandatory programs and alternative tax reform proposals. In spite of this mandate, there are reasons to doubt whether the Commission is capable of any significant progress toward this goal. Failure to solve the budget problem has not been due to a lack of knowledge or ideas. Nor do we believe that there is an absence of public support for what needs to be done. The core of the problem has been the federal government's unwillingness to make the tough decisions that political leadership requires. We question whether the Commission will be able to effect changes of this magnitude.

The 1993 Omnibus Budget Reconciliation Act (OBRA '93) was another missed opportunity to address the problem of increased spending. As estimated by the Congressional Budget Office (CBO), that act fell well short of its goal of $500 billion in deficit reduction over five years. More importantly, over 60 percent of the deficit reduction was achieved through higher taxes. p The Commission appears to have been created partly to mollify those who were disturbed by this missed opportunity. Like the Future of Entitlements Conference held to justify Representative Marjorie Margolies-Mezvinsky's (D-PA) critical support for OBRA '93, the Commission's likely impact on future policy appears weak.

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[1]For recent analyses of the federal budget deficit see the following publications by the Manufacturers Alliance: *The Omnibus Budget Reconciliation Act of 1993: Will It Reduce the Deficit?*, PR-125, August 1993; *Is the Budget Deficit Still a Problem?*, PR-129, April 1994.

[2]Congressional Budget Office, *The Economic and Budget Outlook: Fiscal Years 1995-1999*, January 1994, pp. 29 and 89-97.

Second, over one-third of the Commission's members have endorsed President Clinton's approach to health care reform. While reform of the government's health programs should be a vital component of any deficit reduction effort, successful reform in no way implies an increase in the type of government commitments that have caused rising deficits in the first place. Because the original Clinton proposal contained significant increases in government programs and entitlement spending, if enacted the Clinton proposal would lead to sizable increases in future budget deficits.

Third, we are concerned that any recommendations the Commission makes will not be considered seriously by the leadership in both houses of Congress. Unlike the recommendations of the Base Closure Commission, there is no procedure for forcing Congress to consider any recommendations. Unlike the time when the National Commission on Social Security Reform of 1983 was established, the public and the Congress do not appear to believe, as does the Alliance, that the government is on the verge of insolvency in any of its major programs. As a result, the recommendations of this Commission are likely to face a fate similar to those by the Joint Committee on the Organization of Congress and the National Performance Review proposed last year. These groups have seen the product of their efforts subverted by congressional committees of jurisdiction that do not share their perception of the need for reform.

What Is Needed To Achieve Long-Term Budget Reduction?

Given this background, we feel that the Commission's most important accomplishment would be to commit its members and, indirectly, the Administration to another round of deficit reduction during the 1995 budget cycle. We recommend a goal of $500 billion in additional deficit reduction over five years, all of it in the form of spending cuts. While there may be a need to evaluate tax expenditures, we firmly believe that there should be an early understanding that any changes to the tax laws would be revenue neutral. In other words, any elimination of a tax break would be accompanied by a reduction in basic tax rates. By publicly advocating an effort to reduce the deficit by $500 billion over five years, the Commission could help create public pressure, similar to that generated by the efforts of Paul Tsongas and Ross Perot during the last presidential campaign, to generate the necessary political will.

We believe that there is a real danger associated with focusing too much on the exact nature of spending cuts contained in the Commission's recommendations. Given the Commission's makeup, consensus may prove elusive and represent a movement to the lowest common denominator rather than a bold vision for the future. At this juncture, the exact nature of the spending cuts is far less important than their magnitude.

By now, most policymakers are familiar with proposals to cut spending. They appear regularly in government publications by the CBO and the General Accounting Office (GAO) and in policy studies by groups such as the Concord Coalition and the Citizens Against Government Waste. Many of these proposals have been recommended by successive Administrations, both Republican and Democrat, but never acted on by Congress. The merits of these proposals have been debated throughout the past decade. Rather than engage in public discourse, Congress needs to act on these proposals. Only in this way can the American people judge whether their legislators are accurately representing their views on federal budget policy.

Failure of Government Programs

The Alliance would like to take this opportunity to discuss a more serious, longer term problem associated with entitlement programs. We believe that within the next two decades the federal government faces the collapse of its most important expenditure programs. How the Congress responds to this problem will have an important effect on the stability of the nation's economy and the well-being of its population.

Almost all of our most important social programs were originally designed to address problems that existed three to five decades ago. Since that time the country has experienced significant economic and demographic changes, but the basic design of the social programs has remained the same. These programs create incentives for individuals to act in ways that are not socially productive and, in many cases, are socially harmful. The adverse cumulative effect of these programs has been to impose a large and growing cost on the American economy. The financing for many of these programs has been achieved by borrowing from the future, either directly by spending more each year than the government takes in, or indirectly by promising large future benefits without putting aside the resources to pay for them. As a result, the majority of these programs treat younger generations far less generously than they treat the middle-aged or elderly. As the younger generation increasingly comes to represent the majority of the electorate, political support for these programs is likely to erode.

Another problem is that the programs have become too complex. Over the past two decades, the complexity and pace of change of American society have increased dramatically. Management of a complex, rapidly changing system such as the various

sectors of the U.S. economy, presents a totally new challenge for government. Government programs which are themselves complex, top-driven, and which apply uniform rules to different situations, are unlikely to succeed. As a result, in program after program we find trust funds running out faster than expected, fraud and overhead costs rising rapidly, and the quality of services falling. Even though the government accounts for over one-fifth of all spending in the richest economy on earth, its ability to accomplish its tasks is dissipated by duplicative programs, conflicting objectives, competing agencies, and mind-numbing regulation.

Social Security

In 1983, Congress waited until the Social Security Trust Fund faced imminent insolvency before passing significant reforms of the Social Security system. These changes included a massive increase in the payroll tax to its current level of 12.4 percent of wages. At the time they were passed, these reforms were expected to fund the system through the year 2049. This estimate has been revised downward in six of the last seven years. The Trust Fund is currently scheduled to become insolvent in 2029. If the history of projections continues at the current rate, actual insolvency could occur before 2010. Social Security's Disability Insurance Trust Fund will become insolvent by the end of next year. Transferring funds from the Old-Age and Survivors Insurance (OASI) Trust Fund, as recommended by the Administration, will delay insolvency but will not solve the underlying problem and will weaken the OASI Trust Fund.

Past Social Security reforms have relied heavily on tax increases in an attempt to restore fiscal soundness to the system. This has increased intergenerational inequity. For example, according to 1993 figures by the Social Security Administration, a newborn male is expected to receive only 87 percent of the actuarial value of his contributions to Social Security under present law. A female can expect to receive a 100 percent return. These figures do not take into account the latest downward revision in the Trustees' estimates and therefore are too optimistic. Most of the proposed reforms to Social Security include delaying the retirement age and increasing the payroll contributions. These reforms would further lessen the payoff to younger generations. Given such facts, their political support of the continued existence of the program may be questionable.

At a time when increased national savings and investment are essential to global competitiveness, better jobs, and increased income, the government should reexamine the wisdom of continuing a payroll tax that significantly reduces the younger generation's ability to save and diminishes the lifetime wealth of even the poorest worker.

Medicare and Medicaid

The government's two principal health programs, Medicare and Medicaid, have been growing at unsustainable rates and have contributed to the perception that this country faces a health care crisis. Although the rapid rate of federal expenditures in these programs is alarming, even more disconcerting is the fact that the money does not appear to have been spent well.

Federal expenditures now account for roughly half of all demand in the U.S. health care market. The government's inability to link firmly this spending and value received has resulted in an inflationary surge as both patients and suppliers respond to what seems to them a free resource.

The current exclusion from taxable income of employer-paid health care premiums also has contributed to an expansion of the demand for health care services by making individual workers less aware of the true cost of their choices and by strongly reducing any incentive to make tradeoffs based on cost. Ironically, this Exemption began as a historical byproduct of wage controls imposed during World War II and was first implemented by regulation under emergency powers.

These government policies have contributed to a general inflation in the cost of health care services which, in turn, has led to higher program prices and inefficiency. This vicious circle of rising inflation and rising program costs is unlikely to end until the government is willing to make individuals bear a higher proportion of the cost of the choices they make. The Alliance opposes the Clinton Administration's approach to health care reform because it fails to move in this direction, relying instead on price controls and complex government regulation to restrain costs.

We believe that it would be unwise for the Commission to preempt the current debate on health care reform. However, two points need to be made. The first is that any positive effect the Commission has on spending reductions elsewhere in the budget can quickly be undone by the passage of poorly structured health reform in which government once again promises its citizens more social benefits than they are willing to finance. The second is that since the Commission's mandate runs until the end of the year, the Commission should reserve time to examine possible further reforms to Medicare and Medicaid after Congress has completed action on health reform legislation.

Federal Retirement Benefits

If the government were required to abide by the same financial requirements it imposes on private employers which maintain defined benefit plans, the government's pension plans would be underfunded by roughly $1 trillion. The existence of such a large

unfunded liability raises at least two questions. The first is the fairness of imposing standards on the private sector that the federal government is unwilling to adopt in its own operations. The existence of a double standard is always troubling.

Second, the refusal to fund these liabilities as they accrue may cause younger workers to question whether the government will be willing to raise the large amount of revenues needed to pay them when they become due. Workers may decide that the government is more likely to cut their pension benefits than it is to raise taxes. If this happens, younger workers may press for changes in the operation of federal pension benefits in order to spread the expected benefit reductions among a larger number of workers.

Federal government pensions are far more generous than those available in major corporations in the private sector. Yet many federal government employees are not exposed to the competitive pressures and constant demand for improved performance faced by workers in the private sector. If the federal government is to make a credible demand for public sacrifice to reduce the deficit, it must begin by imposing a sacrifice on itself. This can be done by reducing future pension benefits by modifying the cost of living adjustments in benefits. This would be an equitable way of reducing the unfunded liabilities which now exists in the federal employees pension plan. In the future, benefit increases could be limited to perhaps 60 percent of the rate of increase in inflation.

Intergenerational Equity

While it is easy to overstate the potential of intergenerational conflict, the Alliance is concerned that current programs and the "reforms" most often discussed impose an inequitable burden on younger workers. Policies which make it more difficult for younger people to pursue education and training or to find jobs can have serious lifelong effects. Because in the long-run the U.S. standard of living depends on a productive U.S. working population, any decision to sacrifice the long-term welfare of younger workers in order to maintain temporarily current benefit levels on the nonworking population will erode the government's ability to address future problems.

The magnitude of the intergenerational transfer of income is described in the Administration's 1995 budget. For the baby boomer born in 1950 the average lifetime net tax rate (taxes paid less transfers received from Social Security benefits) was 33.2 percent of income. If current Social Security benefit levels are maintained and if lifetime tax rates for living citizens remain the same, those born in 1993 would have to pay 82 percent of their lifetime salaries in taxes in order to pay for the commitments government has already made.[3] This imbalance is clearly unsustainable, and dramatically higher taxation is not the answer.[4] Instead, the federal government ***will be forced to*** revoke benefit commitments. Because of the size of the necessary benefit reductions, the sooner the government makes these spending cuts and the broader the reductions are spread among programs and beneficiaries, the less disruptive and fairer the result will be.

We would also like to draw attention to some of the ways that government policies impose a heavy burden on people who are starting a career and beginning to save for the future. Efforts to reduce the federal work force through relatively generous buyouts confer large benefits on older and middle-aged workers. These buyouts often go to the most productive federal employees. As a result, the government is less well situated than if personnel reductions had been accomplished on the basis of merit, as they are in the private sector. These buyouts may in some instances also increase the unfunded pension liabilities which must be paid for by future taxpayers. Because buyouts often are accompanied by hiring freezes, younger workers find fewer employment opportunities available to them. Finally, even in cases where reductions in force are used to reduce personnel, such reductions are usually made by seniority rather than ability. All of these policies work to the disadvantage of younger workers and reduce the quality of the public work force.

Efforts to reduce mandatory spending also tend to discriminate against younger workers. The "grandfathering" of premium increases or benefit reductions so that they only apply to those who retire after a certain age increases the burden borne by the young. To the maximum extent possible, benefit reductions should be spread broadly among beneficiaries. The government should, of course, take care to ensure that those with incomes below or near the poverty line do not suffer from benefits reductions.

The Need for a New Approach

We believe the above analysis shows that dramatic changes must be made to the structure of current government programs. Unless reform addresses

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[3] *Budget of the United States Government for Fiscal Year 1995, Analytical Perspectives*, p. 25.

[4] For a detailed analysis of the sources of the future insolvency of the Social Security trust funds and the intergenerational implications, see C. Eugene Steurle and Jon M. Bakua, *Retooling Social Security for the 21st Century*, The Urban Institute Press, Washington, DC, 1994.

the perverse incentives created by current programs, it is unlikely to solve the mismatch between the demand for benefits and the willingness to pay for them. However, we also believe the public's attachment to current programs and their distrust of Congress will make it difficult to enact these reforms without a clear vision of what would replace them. The remarks that follow summarize one such approach.

The above reference to public distrust is not meant to indicate that the public is unwilling to make sacrifices. We believe that the American public recognizes the danger large deficits pose to our future and is willing to make the necessary sacrifices, provided it is convinced that the sacrifices will actually solve the problem. In this respect, public opinion is far ahead of the congressional leadership and many of the public interest groups that claim to represent it.

Public support for major spending reductions, however, is conditioned on results. For this reason tax increases are unlikely to generate much support since most individuals believe that the additional revenues will be spent rather than used to reduce the deficit. The next budget reduction plan must be comprehensive, with reductions in all major non-defense federal programs. Defense should be excluded since expenditures for national security have already been cut substantially.

Deficit reduction must follow broad principles that define what government should and should not do in a market economy. Every time a program is singled out for protection due to the political influence of one or two members of Congress, it contributes to the perception that policy is based, not on notions of fairness or merit, but on political patronage. This perception encourages factional interests to continue fighting for their own narrow interests, even at the expense of broad deficit reduction. Finally, any deficit reduction exercise must commit to eliminating the deficit over the next five years. The public's willingness to accept sacrifices will be substantially reduced if it believes that deficits will continue to pose a problem to the national economy. The believability of a commitment to achieve balanced budgets diminishes rapidly as the time frame exceeds five years.

In order to be successful, future government programs must be simpler and less ambitious. We believe that, if properly structured, simpler programs could do a better job of addressing the most serious issues on which a consensus already exists for government involvement. By demonstrating an ability to accomplish clearly defined goals, more modest programs also would renew the public's confidence in government. The public will be more supportive of government programs that they believe add value and are administered with competence.

The central component of government's social programs should be a revised income supplement program clearly linked to the recipient's willingness to work and to avoid socially unacceptable behavior. This program should take the form of a contract between the recipient and the government. While there is likely to be a great deal of debate on the terms of the contract, these terms should be limited, simple to understand, uniform for all recipients, and enjoy broad public support. The federal government will not have the financial resources needed to make such a program work unless it substantially restructures existing mandatory programs. If, however, such an income support policy could guarantee a safety net to all working Americans, the need for the vast array of separate nutrition, housing, and health programs would diminish substantially.

The Alliance also believes there should be a cap on the maximum amount of government outlays. This cap should be a percentage of the GDP with the percentage varying with the business cycle. Since revenues have consistently averaged between 18.5 percent and 19 percent of GDP, the spending cap should be set within this range. Adoption of such an approach should link firmly government spending to the nation's ability to pay for it. This would force the Administration and the Congress to make explicit choices among spending programs. Just as important, it would give the government a stronger incentive to raise the required revenue in ways that minimize the negative effect on economic growth. Provided the Congress is forced to keep spending under this cap during periods of strong economic growth, higher spending could take place to moderate the effects of a recession or emergencies such as floods, epidemics, etc.

Better government also requires procedural changes in the Congress. The congressional leadership does not reflect consistently the will and aspirations of the American people. The rigidity and influence of power centers encourages factionalism and impedes the passage of broad reform. In some cases, such as the ability of individual Senators to put holds on important nominations and legislation and the need to steer complex pieces of legislation through a number of committees, power needs to be centralized in specific committees. In other cases, such as the election of party leaders and chairmen and the ability to amend bills, power should be decentralized in order to give all members of Congress a greater ability to force debate and votes on legislation that has significant support.

Conclusion

The Manufacturers Alliance is skeptical about the Commission's ability to accomplish much in the way of reform. This skepticism stems both from the Commission's roots in the failure to reduce federal expenditures in last year's budget process and the fact that many of its members are on record as favoring a large expansion in the benefits the government provides to citizens. Given the amount of attention deficit reduction has received over the last 15 years, the value of additional analysis and debate is small. The most important contribution the Commission can make over the short term is ***not*** to develop yet another set of recommendations but to produce a clear bipartisan commitment for another round of deficit reduction next year, at least as large as the package enacted in August 1993. This time, however, net deficit reduction should be accomplished solely through spending cuts.

The Congress inevitably will be forced to enact comprehensive structural changes in the main entitlement programs within the next two decades. The extent of the disruption caused by these reductions in the growth of entitlements will be affected strongly by their timing and the length of deliberation that proceeds them. If credible program changes were to be enacted before the turn of the century, the negative impact of these changes would be minimized. Over the longer term, the most important contribution this Commission can make would be to call attention to the need for these changes and to address the structural problems within the Congress and the executive branch which impede their consideration.