# BUDGET POLICY, DEFICITS, AND DEFENSE: A FISCAL FRAMEWORK FOR DEFENSE PLANNING

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## FOREWORD

The transformation of the U.S. military is entering a critical stage. The Department of Defense is initiating the most far-reaching changes in its worldwide bases and deployments since the 1950s. Parallel efforts to consolidate domestic bases and defense facilities are likely as well, now that the 2005 Base Realignment and Closure Commission has begun its work. And the Quadrennial Defense Review currently underway could have a profound impact on the size and shape of future forces.

As defense planners grapple with the pace and direction of military transformation, the budgetary context of strategic decisionmaking is becoming much less favorable. In this monograph, Dennis S. Ippolito focuses on the spending policy, deficit and debt, and retirement and healthcare entitlement dynamics that will make it difficult, if not impossible, to fund current defense plans. Transformational strategies, he concludes, must be adjusted to accomodate lower and more volatile future spending levels. The most important adjustment is to shift spending priorities to readiness and traditional modernization needs that are more urgent in terms of capabilities than transformational technologies, as well as more predictable and controllable in terms of costs.

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DENNIS S. IPPOLITO is the Eugene McElvaney Professor of Political Science and Chairman of the Department of Political Science at Southern Methodist University (SMU). Prior to joining the faculty at SMU in 1982, he taught at the University of Virginia and at Emory University. Professor Ippolito's recent books on the federal budget include *Why Budgets Matter: Budget Policy and American Politics; Budget Policy and the Future of Defense*; and *Uncertain Legacies: Federal Budget Policy from Roosevelt through Reagan*. He presented annual lectures at the U.S. Army War College from 1990-2003.

## SUMMARY

Since the war on terrorism began in earnest after September 11, 2001, defense budgets have risen sharply. It would be reassuring to believe that the resources to fight this war will continue to be made available, regardless of its cost or duration, and that Congress and the President will at the same time maintain the broader military capabilities needed to protect the nation's security interests. Fiscal realities, however, have often compromised military capabilities in the past and may do so again in the future. The short-term threat to defense is tied to deficit control. Reducing the very large deficits projected for the next several years will require cutbacks in discretionary spending. As a result, defense will be competing with domestic programs for a shrinking share of the budget, and the politics of this competition could prove highly unfavorable for defense.

Over the longer term, the budget policy outlook is clearly negative. Like other advanced democracies, the United States must find a way to reform its social welfare system in response to an aging population. Unless retirement and healthcare entitlements for the elderly are retrenched significantly, these programs will generate enormous spending pressures, making it more and more difficult to support defense as well as other national needs. And since the defense commitments of the United States are unique, the fiscal challenge associated with welfare state modernization is especially pressing.

The purpose of this monograph, then, is to present a fiscal policy framework that is likely to shape current and future defense funding levels. This framework is not immutable, but it does mean that defense planners need to take into account the ways in which domestic policy commitments, budget policy trends, and budgetary politics affect defense. In particular, current defense plans contain optimistic, and arguably unrealistic, assumptions about long-term funding for the core defense budget. Recent Future Years Defense Programs have projected real (inflation-adjusted) spending levels well above Cold War peaks and assumed that these levels, unlike the Cold War peaks, can be sustained indefinitely. However, with

unusually severe budgetary constraints in place for the foreseeable future, defense spending levels will likely be lower and more volatile than current planning envisions. The challenge for strategic planners, then, is to impose clear priorities on a defense budget that cannot accommodate all they deem desirable. These priorities must also be prudent, which in a wartime context means protecting funding for the urgent and the necessary—readiness and traditional modernization—against the highly uncertain potential benefits of transformational modernization.

# BUDGET POLICY, DEFICITS, AND DEFENSE: A FISCAL FRAMEWORK FOR DEFENSE PLANNING

> As the duties of superintending the national defense and of securing the public peace against foreign or domestic violence involve a provision for casualties and dangers to which no possible limits can be assigned, the power of making that provision ought to know no other bounds than the exigencies of the nation and the resources of the community.
>
> Alexander Hamilton, *Federalist* No. 31

## INTRODUCTION

Annual congressional debates about the President's defense program focus primarily on immediate military requirements, and this focus necessarily tightens during wartime and other emergencies. Many decisions about weapons systems, force levels and compensation, and other defense programs, however, have long-term implications with respect to the level of budgetary resources needed to support the nation's military. The Department of Defense's (DoD) Future Years Defense Program (FYDP) offers important guidance about these long-term effects by providing 5-6 year cost estimates for future defense programs and priorities.

Recent FYDPs have indicated that the core defense budget will require continued real increases over the next several years. Under the FY 2005 FYDP, for example, defense spending authority (excluding the supplemental appropriations that have been used to fund military operations in Iraq and Afghanistan) is projected to increase from $402 billion in 2005 to $455 in 2009.[1] According to the Congressional Budget Office (CBO), extended costs would be still higher, with constant-dollar spending averaging $485 billion from 2010-22.[2]

Defense spending levels would have to be substantially higher to accommodate what the CBO terms "cost risk"—future military commitments equivalent to the Afghanistan, Iraq, and global war on terror engagements along with less optimistic (and more historically-based) cost assumptions about weapons programs. Total cost risk for

2005-09 added to core defense budget estimates raises average annual spending to nearly $500 billion in constant dollars; the projection for 2010-22 is more than $550 billion.[3] Both the level and the duration of these defense spending commitments would be unprecedented historically and politically problematical.

Moreover, fiscal realities will make it much more difficult to protect defense against competing political needs. Budget deficits over the past 3 years (FY 2002-04) have totaled nearly $950 billion; projected deficits for FY 2005-09 are approximately $1.4 trillion.[4] Any serious effort to reduce these deficits requires tight control over discretionary spending, forcing defense to compete with domestic programs for a shrinking share of the budget. The long-term budget outlook is even more unfavorable, since entitlement financing pressures will further reduce discretionary spending margins and exacerbate the defense-domestic program competition.

The strategic and policy challenges facing defense planners today cannot be divorced from fiscal considerations. It might be helpful, then, to complement their strategic and policy debates with some basic facts about the budget policy framework that determines, over time, the budgetary resources available for defense. In particular, long-term trends in budget policy have enormous implications for current and future defense budgets. This monograph will focus on several of these trends—namely, the changing level and composition of spending policy; the deficit and debt dynamic in recent fiscal policy; and the long-term fiscal impact of retirement and healthcare entitlement programs.

## SPENDING POLICY: FROM DEFENSE TO SOCIAL WELFARE

The spending side of the budget defines the size, roles, and priorities of the federal government, and the history of modern spending policy reveals important changes in the federal policy agenda. The New Deal and Cold War took the federal budget to an entirely new level in terms of relative size and set in motion what has become an ongoing competition between defense and domestic needs. During the 1920s, for example, federal spending accounted for only about 3 percent of gross domestic product (GDP).[5] With the New Deal, however, the size of government roughly tripled—

to approximately 10 percent of GDP by the late 1930s. World War II then generated the highest level of spending in U.S. history, with outlay-GDP levels above 40 percent from 1943-45. Although postwar spending plummeted from this peak, the renewed defense requirements created by the Cold War and the expanded domestic role established by the New Deal brought spending to the 20 percent (+/-) of GDP range where it has remained for more than 50 years (see Table 1). This relatively stable level of total spending, however, masks a major shift in composition from defense to domestic programs over the past 4 decades.

| Fiscal Years | Average Annual Level |
|---|---|
| 1950-1959 | 17.6% |
| 1960-1969 | 18.6 |
| 1970-1979 | 20.0 |
| 1980-1989 | 22.1 |
| 1990-1999 | 20.7 |
| 2000-2009 (est.)* | 19.4 |

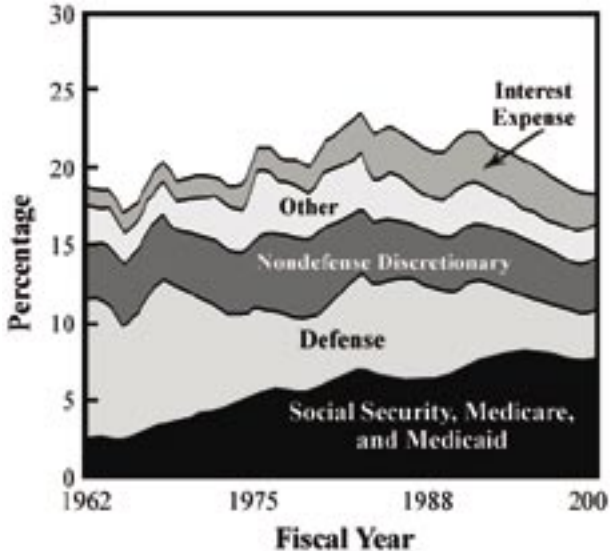
*FY 2000-03 are actual; 2004-09 are estimates.

Source: *Historical Tables, Budget of the United States Government, Fiscal Year 2005,* Washington, DC: U.S. Government Printing Office, 2004, pp. 23-24.

**Table 1. Federal Outlays as a Percentage of GDP, Fiscal Years 1950-2009**.

During the Korean War, defense spending climbed to almost 70 percent of total outlays and 14 percent of GDP. Postwar defense levels remained high, with peacetime defense budgets during the Eisenhower administration averaging more than 10 percent of GDP. When John F. Kennedy took office in 1961, defense was still more than half the total budget. Since the early 1960s, however, the defense budget share and GDP share have fallen dramatically, while domestic spending has moved steadily upward (see Figure 1). The upward shift in entitlement programs has been especially steep. Social Security, Medicare, and Medicaid are the largest and fastest-growing of these entitlements, with their combined outlays having

risen to more than 8 percent of GDP currently, and even higher levels are projected for future years. Taking all entitlement programs together, outlay-GDP levels have risen by 6 percentage points since the early 1960s. The corresponding decline in defense-GDP levels has been approximately the same.



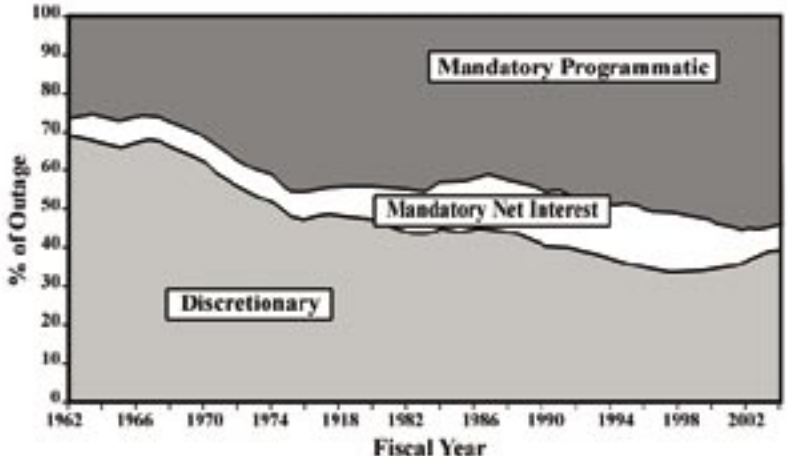

Source: *Long-Range Fiscal Policy Brief: A 125-Year Picture of the Federal Government's Share of the Economy, 1950-2075*, Washington, DC: U.S. Congressional Budget Office, 2002, p. 2.

**Figure 1. Federal Outlays, FY 1962-2001 (as a percentage of GDP)**.

The welfare shift, then, describes the changed composition of spending policy. The greatly increased weight of social welfare entitlements is a clear indication of the federal government's long-term policy and political priorities. In addition, budgets dominated by entitlements are less flexible and controllable in the short term. The control points of the budget process are not well-suited for dealing with the "automatic" spending that funds entitlement programs, and the widespread political support for retirement and healthcare entitlements makes it even more difficult to control spending. As a result, the welfare shift has changed the way policymakers adjust budgets to fund defense buildups and wars.

**Appropriations and Controllability.**

The budget process distinguishes between two broad categories of spending—discretionary spending and mandatory, or direct, spending—with the balance between them having changed significantly over time. Several decades ago, discretionary spending (primarily defense) accounted for two-thirds of total outlays (see Figure 2). By the late 1990s, this share had been cut almost in half. The mandatory portion of the budget, which includes entitlement programs and net interest outlays, has averaged well above 60 percent since the early 1990s, with a ratio of programmatic outlays to net interest outlays of approximately 4:1.[6]




Source: *Historical Tables, Budget of the United States Government, Fiscal Year 2005*, Washington, DC: U.S. Government Printing Office, 2004, p. 127.

**Figure 2. Discretionary vs. Mandatory Spending as a Percentage of Total Outlays, Fiscal Years 1962-2004**.

The change in discretionary vs. mandatory spending budget shares narrows the reach of the appropriations process in Congress, which is an effective control point only for discretionary programs. There are 13 regular appropriations bills that must be enacted each year (see Table 2), with two of these—Military Construction and DoD—

Agriculture, Rural Development, Food and Drug Administration, and Related Agencies Appropriations Bill [$16.8]
- Department of Agriculture
- Department of Health and Human Services

Departments of Commerce, Justice, and State, the Judiciary, and Related Agencies Appropriations Bill [$37.6]
- Department of Commerce
- Department of Justice
- Department of State
- The Judiciary
- Small Business Administration

Department of Defense Appropriations Act [$366.4]

District of Columbia Appropriations Bill [$0.5]

Energy and Water Development Appropriations Act [$27.3]
- Department of Energy
- Corps of Engineers
- Department of the Interior, Bureau of Reclamation

Foreign Operations, Export Financing, and Related Programs Appropriations Bill [$17.5]
- Department of Defense
- Department of State
- Agency for International Development
- Department of Agriculture

Department of Homeland Security Appropriations Act [$29.2]

Department of the Interior and Related Agencies Appropriations Act [$19.5]
- Department of the Interior, excluding of Bureau of Reclamation
- Department of Agriculture
- Department of Energy
- Department of Education
- Department of Health and Human Services

Departments of Labor, Health and Human Services, and Education and Related Agencies Appropriations Bill [$139.0]
- Department of Labor
- Department of Health and Human Services
- Department of Education

Legislative Branch Appropriations Act [$3.5]

Military Construction Appropriations Act [$9.3]

Departments of Transportation and Treasury, and Independent Agencies Appropriations Bill [$28.4]
- All departments, agencies, and corporations

Departments of Veterans Affairs, Housing and Urban Development, and Independent Agencies [$90.8]

Source: Appropriations bill listing is from *Budget of the United States Government, Fiscal Year 2005: Appendix*, Washington, DC: U.S. Government Printing Office, 2004, pp. 3-4. FY 2004 enacted budget authority figures are from *Congressional Quarterly Weekly Report*, Vol. 62, June 5, 2004, p. 1324.

**Table 2. Appropriations Bills for FY 2005, Principal Departments and Agencies,* and Enacted Budget Authority for FY 2004 (in billions of dollars)**

* A document called the Budget *Appendix* provides the President's proposals for various appropriations bills. The *Appendix* "includes the language proposed for enactment by Congress on each item that requires congressional action in an appropriations bill. It also contains the language proposed for the general provisions of appropriations acts that apply to entire agencies or groups of agencies."

providing the bulk of defense spending authority. For defense, as well as the domestic and international programs funded through annual appropriations, Congress and the President must agree on all future spending. And for defense, most programs are also covered by annual authorizations; Congress and the President must act to authorize future spending and then to appropriate funds for programs and activities that have been authorized. For discretionary spending, and especially for its defense component, comprehensive control over spending is exercised through the appropriations process.

For mandatory spending, the situation is quite different. Spending for mandatory programs, i.e., entitlements, is determined by the eligibility criteria and benefit levels set forth in entitlement authorizations and other authorizations of direct spending. With mandatory spending, some programs such as Social Security are funded by permanent, indefinite appropriations and bypass the annual appropriations process entirely. Others are funded through annual appropriations, but the amounts to be spent are controlled by authorization statutes. Unless these statutes are changed, appropriations must be provided to fund all of the benefits to which recipients are entitled by law. (Net interest outlays are principally determined by the size of the publicly-held debt, its composition in terms of maturities, and interest rates.[7])

It is more difficult to exercise spending control over mandatory programs than over discretionary programs for several reasons. First, the institutional leverage over mandatory programs is weaker. Majorities in the House and Senate must agree on funding levels for discretionary programs, and the President must agree as well. With mandatory programs, majorities must be put together to change existing law (and previous commitments), or spending will continue at predetermined levels. Deadlock on discretionary spending means

no funding for disputed programs, whereas deadlock over an entitlement policy change means funding will continue indefinitely.

A second distinction affecting controllability involves determinants of spending growth. Mandatory programs are directly affected by economic and demographic factors that can make spending growth volatile. Social Security, for example, serves a beneficiary population that is going to continue to grow rapidly for the foreseeable future. Moreover, the retirement benefits this beneficiary population receives are indexed by law to inflation rates through annual cost-of-living-adjustments (COLAs). Many entitlements have similar provisions to protect the real value of transfer payments and of in-kind benefits such as medical care. Medicare reimbursement rates are adjusted automatically for changes in healthcare costs, and federal payments to the states for Medicaid services are governed by a statutory formula under which the federal government's costs rise when the states increase benefits in response to healthcare cost inflation. In addition, spending for these and other healthcare programs escalates as beneficiaries utilize more, and more costly, procedures on a per capita basis.

With discretionary programs, policymakers have considerably greater leverage over spending growth. The President and Congress, for example, have kept civilian agency employment in the executive branch at approximately the same level for the past 3 decades.[8] They have also shifted the balance between defense and domestic programs several times. During the 1970s, constant dollar spending for defense was cut by almost 30 percent, while real discretionary outlays for domestic programs were increased by more than 75 percent. President Ronald W. Reagan's defense buildup during the 1980s then boosted defense spending by nearly 50 percent in constant dollars, with discretionary domestic outlays dropping by approximately 15 percent. During the 1990s, constant dollar spending for all discretionary programs fell by 10 percent, but defense absorbed a much larger cut, making it possible for Congress and the Clinton administration to boost domestic spending. These shifts demonstrate how policymakers can use the fixed schedule of policy decisions each year to effect significant changes in the level and composition of discretionary spending.

**Statutory Budget Controls.**

During the 1990s, multiyear budget controls were used to reduce deficits. These controls, which are now being proposed for the same purpose, reinforce the controllability differences between discretionary and mandatory spending. The statutory controls applied to discretionary programs are caps, or limits, on spending that Congress and the President cannot exceed. For mandatory programs, the control is termed PAYGO (or pay-as-you-go), which governs legislative actions that increase entitlement benefits but does not set actual spending levels.

These controls were first used in the 1990 Omnibus Budget Reconciliation Act (OBRA 1990). Title XIII of this measure established discretionary spending limits for fiscal years 1991-95 and provided for across-the-board spending cuts (known as sequestration) if regular and supplemental appropriations bills for any of these fiscal years exceeded the spending cap.[9] The PAYGO control, by comparison, covered any new legislation that increased entitlement benefits compared to existing law or decreased revenues compared to existing law. For each year covered by OBRA 1990, combined revenue and entitlement legislative changes had to be deficit-neutral; if not, sequestration was to be applied to entitlement programs.

The enforcement of discretionary spending caps is relatively straightforward. The House and Senate Appropriations Committees receive an allocation of discretionary spending, which they then distribute among their appropriations subcommittees. The appropriations bills reported out by these subcommittees and then by the full committees cannot exceed these allocations; and total allocations, in turn, must be within the allowable cap. So unless Congress deliberately waives or circumvents the statutory limits on discretionary spending, appropriated amounts and actual spending will be within predetermined totals. With entitlement programs, the correspondence between budgeted amounts and actual spending can vary a great deal, since the PAYGO restriction only constrains policy changes that raise entitlement spending above baseline levels. When spending exceeds baseline levels because economic conditions or other nonlegislative factors automatically raise benefits, PAYGO controls do not apply.

The discretionary caps and PAYGO controls established in 1990 were extended for 5 years in 1993 and again in 1997. Between 1991 and 1998, total discretionary spending increased by less than $20 billion, to just over $550 billion. Over this same period, with PAYGO controls in place, spending for mandatory programs grew from $635 billion to over $900 billion. While PAYGO had restrained entitlement policy changes, mandatory spending nevertheless had risen by more than 40 percent as a result of growing numbers of beneficiaries and higher benefits mandated by existing law.

The composition of spending policy today makes it difficult for policymakers to control spending growth. The budget process does not require Congress and the President to make decisions each year on mandatory spending, and the factors that drive mandatory spending growth are not incorporated easily into multiyear budget controls. Budgets dominated by mandatory programs are less flexible, less predictable, and less controllable with respect to legislative procedures and processes, and the politics of entitlement programs adds an additional complication. Major retirement and healthcare entitlements have enormous constituencies, and there is a strong moral as well as legal claim on the benefits these programs provide. These political realities have made budgets even less flexible when tradeoffs from domestic programs to defense are required. Thus, one important implication of the welfare shift is the obstacle it presents to adjusting spending policy even during wartime.

**Wartime Finance and Peace Dividends.**

During World War II and the Korean War, defense needs accounted for most of the growth in federal spending. In both cases, domestic spending, for social welfare entitlements as well as for discretionary programs, was tightly controlled (see Table 3). Afterward, defense budgets were scaled back, and domestic programs were expanded. This relationship between wartime finance and postwar peace dividends was the standard approach to budget policy, a "guns vs. butter" tradeoff that was feasible given the prevailing political consensus and low levels of mandatory spending during the 1940s and 1950s.

**World War II**

| | National Defense | | | Payments for Individuals | | |
|---|---|---|---|---|---|---|
| Fiscal Year | Constant (FY 2000) Dollars | Percentage of GDP | Percentage of Total Outlays | Constant (FY 2000) Dollars | Percentage of GDP | Percentage of Total Outlays |
| 1940 | $19.9 | 1.7% | 17.5% | $17.8 | 1.7% | 17.5% |
| 1941 | 64.7 | 5.6 | 47.1 | 18.0 | 1.5 | 12.7 |
| 1942 | 216.3 | 17.8 | 73.0 | 16.7 | 1.2 | 5.0 |
| 1943 | 526.0 | 37.0 | 84.9 | 14.1 | 0.9 | 2.1 |
| 1944 | 684.0 | 37.8 | 86.7 | 13.8 | 0.8 | 1.9 |
| 1945 | 774.6 | 37.5 | 89.5 | 16.8 | 1.0 | 2.4 |
| 1946 | 405.7 | 19.2 | 77.3 | 40.9 | 2.5 | 10.3 |
| 1947 | 112.6 | 5.5 | 37.1 | 60.6 | 3.9 | 26.2 |
| 1948 | 86.5 | 3.5 | 30.6 | 55.4 | 3.5 | 30.4 |

**Korean War**

| | National Defense | | | Payments for Individuals | | |
|---|---|---|---|---|---|---|
| Fiscal Year | Constant (FY 2000) Dollars | Percentage of GDP | Percentage of Total Outlays | Constant (FY 2000) Dollars | Percentage of GDP | Percentage of Total Outlays |
| 1950 | $129.6 | 5.0% | 32.2% | $82.5 | 5.0% | 32.1% |
| 1951 | 211.7 | 7.4 | 51.8 | 58.8 | 3.2 | 22.6 |
| 1952 | 396.6 | 13.2 | 68.1 | 59.8 | 3.1 | 16.0 |
| 1953 | 416.1 | 14.2 | 69.4 | 59.4 | 2.9 | 14.4 |
| 1954 | 381.9 | 13.1 | 69.5 | 67.5 | 3.3 | 17.8 |
| 1955 | 320.1 | 10.8 | 62.4 | 76.5 | 3.6 | 20.9 |

Source: *Historical Tables, Budget of the United States Government, Fiscal Year 2005*, Washington, DC: U.S. Government Printing Office, 2004, pp. 110-111.

**Table 3. Wartime Finance, National Defense vs. Payments for Individuals, World War II and the Korean War (in billions of dollars).**

The Vietnam War marked a turning point in wartime finance. Even during its early stage, domestic program spending, particularly for entitlements, rose at a rate nearly equal to defense. When real defense spending began to fall after 1969, domestic programs went

up at a much faster rate (see Table 4). In FY 1965, when the war began, constant dollar spending for defense was nearly double social welfare spending. In FY 1973, when it ended, the latter was almost 30 percent higher than defense.

| | National Defense | | | Payments for Individuals | | |
|---|---|---|---|---|---|---|
| Fiscal Year | Constant (FY 2000) Dollars | Percentage of GDP | Percentage of Total Outlays | Constant (FY 2000) Dollars | Percentage of GDP | Percentage of Total Outlays |
| 1965 | $291.8 | 7.4% | 42.8% | $149.9 | 4.8% | 28.0% |
| 1966 | 322.8 | 7.7 | 43.2 | 164.9 | 4.9 | 27.6 |
| 1967 | 383.3 | 8.8 | 45.4 | 187.2 | 5.3 | 27.4 |
| 1968 | 420.1 | 9.4 | 46.0 | 209.5 | 5.7 | 28.0 |
| 1969 | 400.1 | 8.7 | 44.9 | 230.6 | 6.0 | 31.2 |
| 1970 | 375.1 | 8.1 | 41.8 | 249.1 | 6.4 | 33.1 |
| 1971 | 340.8 | 7.3 | 37.5 | 296.3 | 7.5 | 38.3 |
| 1972 | 310.4 | 6.7 | 34.3 | 329.6 | 7.9 | 40.3 |
| 1973 | 278.6 | 5.8 | 31.2 | 357.3 | 8.0 | 42.6 |

Source: *Historical Tables, Budget of the United States Government, Fiscal Year 2005*, Washington, DC: U.S. Government Printing Office, 2004, pp. 112-113.

**Table 4. Wartime Finance, National Defense vs. Payments for Individuals,Vietnam War (in billions of dollars)**.

| | National Defense | | Discretionary Domestic and Mandatory Programmatic | |
|---|---|---|---|---|
| Fiscal Year | Constant (FY 2000) Dollars | Percentage of GDP | Constant (FY 2000) Dollars | Percentage of GDP |
| 1974 | $272.1 | 5.6% | $580.7 | 12.4% |
| 1975 | 266.1 | 5.6 | 672.5 | 14.6 |
| 1976 | 253.4 | 5.2 | 722.8 | 15.1 |
| 1977 | 251.3 | 4.9 | 738.2 | 14.6 |
| 1978 | 251.5 | 4.7 | 783.4 | 14.7 |
| 1979 | 258.4 | 4.7 | 783.2 | 14.1 |
| 1980 | 268.3 | 4.9 | 825.1 | 15.0 |

Source: *Historical Tables, Budget of the United States Government, Fiscal Year 2005*, Washington, DC: U.S. Government Printing Office, 2004, pp. 126, 128.

**Table 5. The Post-Vietnam Peace Dividend, National Defense vs. Domestic Spending, Fiscal Years 1974-80 (in billions of dollars)**.

Nevertheless, Congress aggressively pushed postwar peace dividends, forcing further tradeoffs from defense to domestic programs. By FY 1980, defense had dropped to less than one-quarter of total spending, the defense-GDP level was under 5 percent, and constant-dollar defense outlays were well below pre-Vietnam levels (see Table 5). Entitlement spending and discretionary domestic outlays, by comparison, climbed sharply during the 1970s, funded both by cuts in defense and by much higher levels of total spending.

The Vietnam wartime finance model was mirrored to a considerable extent during the Reagan defense buildup and has been followed even more faithfully during the current war on terrorism. During the 1980s, for example, defense budgets more than doubled; in constant dollars, defense outlays went up by almost 50 percent (see Table 6). President Reagan managed to offset a portion of the defense buildup by forcing reductions in discretionary domestic programs, but efforts to retrench entitlements were largely unsuccessful. As a result, overall domestic spending increased by more than $100 billion in constant dollars between 1980 and 1989, and domestic spending-GDP levels remained relatively high.

| | **National Defense** | | **Discretionary Domestic and Mandatory Programmatic** | |
|---|---|---|---|---|
| Fiscal Year | Constant (FY 2000) Dollars | Percentage of GDP | Constant (FY 2000) Dollars | Percentage of GDP |
| 1980 | $268.3 | 4.9% | $825.1 | 15.0% |
| 1981 | 283.0 | 5.2 | 848.3 | 15.3 |
| 1982 | 308.0 | 5.8 | 833.3 | 15.1 |
| 1983 | 330.6 | 6.1 | 863.0 | 15.4 |
| 1984 | 334.9 | 5.9 | 828.9 | 13.7 |
| 1985 | 357.0 | 6.1 | 879.8 | 14.0 |
| 1986 | 381.4 | 6.2 | 880.2 | 13.5 |
| 1987 | 387.9 | 6.1 | 872.5 | 13.1 |
| 1988 | 393.9 | 5.8 | 897.2 | 12.9 |
| 1989 | 399.6 | 5.6 | 926.2 | 12.9 |

Source: *Historical Tables, Budget of the United States Government, Fiscal Year 2005*, Washington, DC: U.S. Government Printing Office, 2004, pp. 126, 128.

**Table 6. The Reagan Defense Buildup, National Defense vs. Domestic Spending, Fiscal Years 1980-89 (in billions of dollars)**.

With the war on terrorism, tradeoffs from domestic programs to defense have been virtually nonexistent. The defense-GDP level has risen from 3.0 percent to nearly 4 percent since 2000, and constant-dollar defense outlays have risen by about $120 billion for the FY 2000-04 period (see Table 7). The corresponding real growth in discretionary domestic programs has been about one-half of the defense increase, but social welfare spending has risen by over $225 billion. Total domestic spending, as a result, has climbed to over 15 percent of GDP, the highest level in more than 2 decades.

| | **National Defense** | | **Discretionary Domestic and Mandatory Programmatic** | |
|---|---|---|---|---|
| Fiscal Year | Constant (FY 2000) Dollars | Percentage of GDP | Constant (FY 2000) Dollars | Percentage of GDP |
| 2000 | $295.0 | 3.0% | $1,292.2 | 13.3% |
| 2001 | 298.1 | 3.0 | 1,345.4 | 13.7 |
| 2002 | 331.2 | 3.4 | 1,456.3 | 14.6 |
| 2003 | 374.5 | 3.7 | 1,535.1 | 15.0 |
| 2004 | 401.9 | 3.9 | 1,601.5 | 15.0 |

Source: *Historical Tables, Budget of the United States Government, Fiscal Year 2006*, Washington, DC: U.S. Government Printing Office, 2004, pp. 126, 128.

**Table 7. The War on Terrorism, National Defense vs. Domestic Spending, Fiscal Years 2000-04 (in billions of dollars)**.

Spending policy today is very different than it was during the early stages of the Cold War. The budget is now dominated by mandatory spending programs, and their domination is likely to become even more pronounced in the years ahead. As a result, budgets are becoming less controllable and less flexible, the margins to support discretionary spending are becoming narrower, and the political disadvantages attached to defense are becoming more threatening.

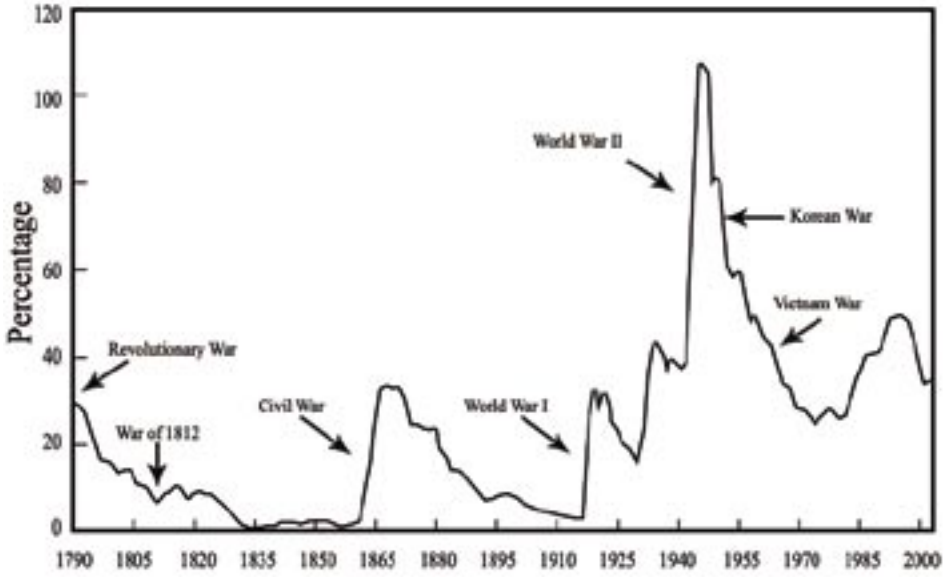
## DEFICITS AND DEBT: CAUSES AND CONSEQUENCES

The programmatic base for modern spending policy was created during the 1930s and 1940s, as the federal government assumed greater domestic and national security responsibilities, and the domestic part of that base has made it more difficult to keep budgets limited and balanced. From 1789-1930, peacetime budgets were usually balanced. Since 1930, deficits have been the norm; over the past 75 years, budgets have been balanced only a dozen times. As a result, the size of the federal debt and its financing costs have grown substantially over time. Net interest outlays over the next 5 years are expected to nearly double—from approximately $160 billion in 2004 to about $300 billion in 2009. Concerns about the costs and economic effects of rising debt levels create strong pressures to reduce deficits, but the politics of spending policy makes it virtually impossible to apportion the costs of deficit reduction uniformly across defense and domestic programs. Instead, deficit reduction is usually aimed at defense and, on the revenue side of the budget, individual income taxes.

### Background: Wartime Deficits.

For much of our early history, deficit and debt problems were chiefly tied to war. Starting with the Revolutionary War, heavy borrowing has been needed to finance most of the nation's wars (see Figure 3). The national debt after the Revolutionary War was $40 million, and, in 1789, the newly-established federal government also assumed responsibility for the wartime debts incurred by the states.[10] The federal debt in 1790 has been calculated at approximately 30 percent of GDP; slightly higher debt levels were in place after the Civil War and World War I.

The costs of financing these wartime debts were substantial. Interest payments after the Civil War, for example, were more than double the size of the entire federal budget before the war.[11] In addition, the prevailing theory of public finance during this period dictated that wartime debts should be "extinguished"; postwar budgets were kept in surplus so that maturing debt could be retired. By the mid-1830s, almost the entire federal debt had been




Source: *The Long-Term Budget Outlook*, Washington, DC: U.S. Congressional Budget Office, 2003, p. 16.

**Figure 3. Federal Debt as a Percentage of GDP, 1790-2002.**

eliminated—the officially reported principal had fallen to less than $40,000—and an optimistic Congress authorized a program for apportioning future surpluses among the states.[12]

Ironically, the period during which the government was free of debt did not ensure economic prosperity and thus proved to be extremely brief. The "Panic of 1837" and ensuing economic collapse wiped out the hoped for surpluses, the Mexican War and periodic financial crises created new debt, and the nation entered the Civil War with a public debt of $65 million. Five years later, the debt was $2.7 billion, and, once again, debt reduction preoccupied Congress. A quarter-century of uninterrupted surpluses cut the Civil War debt by nearly two-thirds, and debt levels continued to fall until World War I. Despite the heavy individual income and corporation income taxes levied during that war, deficits in 1918 and 1919 totaled more than $22 billion. Total wartime borrowing brought the debt-GDP ratio to 40 percent, about the same relative level as the Civil War.

During the 1920s, wartime revenue levels were reduced, but spending was tightly controlled, and annual surpluses averaged more than $750 million.[13] When the Great Depression began, the World War I debt had been cut by about one-third. The budget moved into deficit in 1931, and additional deficits over the course of the decade raised the publicly-held debt to over $40 billion—almost 45 percent of GDP—in 1940. World War II added $200 billion in new borrowing, and the publicly-held debt level in 1946 was by far the highest in history—just under 110 percent of GDP.

Over the next 3 decades, the debt-GDP ratio fell steadily, despite the Korean and Vietnam wars and the permanent defense budgetary commitments arising from the Cold War. Between 1950 and 1969, budgets were in deficit for 15 years. Average net deficits for this period averaged less than 1 percent of GDP (see Table 8). In the Korean War case, tax increases financed much of the defense buildup; the peak wartime deficit, in 1953, was only 1.7 percent of GDP. During Vietnam, the Johnson administration delayed a tax increase until 1968, and the deficit that year was 2.9 percent of GDP. A 1-year tax surcharge was then enacted that boosted revenues and brought the budget into surplus in FY 1969. At the midpoint of the Vietnam War, publicly-held debt was still under 30 percent of GDP.

**Annual Average Deficits***

| Fiscal Years | Current Dollars | Constant Dollars (FY 2000) | Percentage of GDP |
|---|---|---|---|
| 1950-59 (7) | $1.8 | $10.8 | 0.4% |
| 1960-69 (8) | 5.7 | 28.7 | 0.8 |
| 1970-79 (10) | 35.1 | 99.0 | 2.1 |

*For each decade, these figures are average net deficits (i.e., deficits minus surpluses). The numbers in parentheses for each fiscal period are the annual deficits in each period.

Source: *Historical Tables, Budget of the United States Government, Fiscal Year 2005*, Washington, DC: U.S. Government Printing Office, 2004, p. 25.

**Table 8. Budget Deficits, 1950-79 (in billions of dollars)**.

**Structural Deficits.**

During the 1970s, a different type of deficit began to emerge—"structural" deficits caused by revenue and spending laws rather than wars or economic cycles.[14] Defense budgets were cut sharply between 1970 and 1979, in terms of real spending levels, GDP shares, and budget shares. Total spending during the late 1970s, however, averaged almost 21 percent of GDP, the highest level since World War II.[15] Congress was unwilling to raise taxes to cover the rapidly increasing domestic spending that was taking over the budget, and the average annual deficit for the 1970s was 2.1 percent of GDP, more than five times higher than the average level only 2 decades earlier. The public debt-GDP ratio, which had been declining steadily for nearly 3 decades, stopped falling in the mid-1970s. For FY 1975-79, the public debt-GDP ratio averaged approximately 27 percent, about the same level as 1970-74.

During the 1980s, deficits exploded. The Reagan administration's tax cuts and defense buildup obviously contributed to this phenomenon, but the fiscal picture was much more complex. Average revenue levels during Reagan's tenure were, in fact, slightly above those of the preceding 3 decades (see Table 9). Moreover, the defense-GDP level under Reagan was well below the levels of the 1950s and 1960s and on a par with the average for the 1970s. The average deficits for the 1980s, however, were almost four percent of GDP because of the extremely high spending growth for social welfare programs.

**Annual Average Percentage of GDP**

| Fiscal Years | Revenues | Defense |
|---|---|---|
| 1950-59 | 17.2% | 10.4% |
| 1960-69 | 17.9 | 8.7 |
| 1970-79 | 17.9 | 5.8 |
| 1980-89 | 18.3 | 5.8 |

Source: *Historical Tables, Budget of the United States Government, Fiscal Year 2005*, Washington, DC: U.S. Government Printing Office, 2004, pp. 23-24, 111-115.

**Table 9. Revenue and Defense Levels, 1950-89 (as a percentage of GDP)**.

Emergency deficits caused by wartime spending are essentially self-correcting. The same is true for cyclical deficits resulting from economic downturns. Once the economy recovers, revenues rebound and spending for income assistance programs falls back to normal levels. With structural deficits, however, current policy must be changed in order to close the gap between revenue and spending. During the Reagan presidency, there were irreconcilable differences between the administration and Congress over spending and tax policy. Both sides wanted to reduce deficits, but there was a basic disagreement over the level of spending at which the budget should be balanced. Reagan was committed to returning domestic spending-GDP ratios for discretionary and social welfare programs to pre-Great Society levels, but Congress refused to allow retrenchments of this magnitude. Reagan, in turn, was unwilling to close the deficit gap by raising individual income tax levels. Although Reagan did sign tax increases in 1982 and 1983 affecting corporate income taxes and payroll taxes, his economic program was focused on lowering, not raising, marginal tax rates on individuals. In sum, the budget policy impasse of the Reagan years was rooted in Congress' unwillingness to cut the largest component of federal spending—major retirement and healthcare entitlements—and Reagan's refusal to increase the largest revenue source—individual income taxes.

**From GRH to OBRA.**

Since Reagan and Congress could not agree on policy, balanced-budget advocates decided to experiment with "automatic" deficit reduction. The Balanced Budget and Emergency Deficit Control Act of 1985 (popularly known as Gramm-Rudman-Hollings [GRH] for its Senate sponsors) mandated that the budget be balanced over a 6-year period. The mechanism for accomplishing this was a series of declining deficit ceilings; for each fiscal year, Congress and the President were required to enact spending and tax laws that complied with a specific deficit ceiling.[16] If they failed to do so, GRH provided for automatic spending cuts, or sequesters, to reduce the deficit. These cuts were to be apportioned between defense and discretionary nondefense programs on a roughly equal basis. Major entitlements were exempted from sequestration totally (Social Security) or

partially (Medicare and Medicaid); tax policy was entirely outside the purview of GRH.

The supporters of GRH hoped that the threat of across-the-board cuts in essential programs would encourage policymakers to negotiate a more balanced and comprehensive deficit-reduction program. These hopes never were tested under Reagan, because GRH enforcement was blocked by the Supreme Court. Congress was forced to redraft GRH in 1987, and the 6-year timetable for balancing the budget was extended to 1993.[17] The revised deficit ceilings for the last 2 years of Reagan's presidency were sufficiently high to negate serious compliance problems. Under Reagan's successor, however, the collision between deficit reduction and painful policy adjustments finally occurred.

President George H. Bush had pledged to protect the Reagan tax program and to continue Reagan's defense modernization program. (His famous "no new taxes" pledge was one of the rhetorical high points of his acceptance speech to the Republican national convention in 1988.) Bush also was strongly committed to deficit reduction, but he soon found it impossible to reconcile these different objectives. In 1989, Bush had professed optimism about working with the Democratic-controlled Congress on a bipartisan deficit-reduction program. After months of negotiation, however, very little was accomplished. Bush and congressional leaders had agreed on a $28 billion deficit-reduction goal. Actual deficit savings from FY 1990 appropriations, sequestration, and budget reconciliation yielded about $15 billion, primarily through defense cuts and minor revenue increases.

The Bush administration's second year was tumultuous. In January 1990, the FY 1991 budget was submitted to Congress, and the President stated that the $64 billion GRH deficit ceiling for 1991 and the zero-deficit requirement for 1993 would be achieved without major policy adjustments, including tax increases.[18] Over the next few months, however, the economic outlook deteriorated unexpectedly, and deficit projections steadily worsened. The March FY 1991 deficit projection was $130 billion, and, by June, the projection had risen to $230 billion.[19] Under these circumstances, GRH compliance was simply not feasible. Neither defense nor nondefense programs could absorb the huge sequestration reductions needed to comply with

the deficit ceilings for 1991-1993.[20] On May 6, 1990, the President called on congressional leaders to negotiate a bipartisan deficit-reduction alternative to GRH. Seven weeks later, the formal talks began, and a comprehensive 5-year plan was presented to Congress in September.

This initial proposal was fairly balanced in terms of competing priorities. The administration accepted a variety of tax increases, but these did not affect marginal tax rates on individuals. The Democratic leadership agreed to retrenchments in healthcare entitlements as an offset to expanded discretionary domestic programs. The President's defense program was reduced, but Democrats agreed to prohibit additional transfers from defense to domestic programs for at least 3 years. These compromises proved unacceptable, however, to conservative Republicans and liberal Democrats in the House, who teamed together to defeat the budget agreement when it was presented to Congress.

With Iraq having invaded Kuwait in August, President Bush was faced with a serious foreign policy crisis, and he allowed congressional Democrats to take the lead on a new budget package. They did so, but the revised budget plan and reconciliation bill that the House and Senate then approved were very different from the original agreement. Of the estimated $480 billion in 5-year deficit reduction, nearly one-third was accounted for by revenue increases, including higher marginal rates and higher Medicare taxes, along with reduced exemptions and deductions aimed at high-income taxpayers. Spending cuts in discretionary programs were targeted entirely on defense, while major entitlement benefits were preserved largely intact. The administration's budget enforcement initiatives—discretionary spending caps, PAYGO restrictions on revenue and entitlement policy changes, and separate sequestration enforcement for violations of the spending caps and PAYGO limits—were included in Title XIII of the Omnibus Budget Enforcement Act of 1990 (OBRA 1990), but congressional Democrats had won key policy victories on tax policy and defense.

The political price that George Bush paid for abandoning his "no new taxes" pledge was magnified by the apparent lack of progress on deficit control. When Reagan left office, the deficit was just over $150 billion. Three years later, after enactment of the largest deficit-

reduction bill of the modern era, the deficit was more than $290 billion. The doubling of the deficit was largely attributable to a very weak economy that had sharply lowered revenue levels, but this explanation was not terribly helpful to Bush. Nor was it possible to convince the electorate that deficits would have been even worse without the 1990 budget act. Bush had, in effect, sacrificed the Republican party's long-standing advantage on defense and taxes for a goal that seemed more distant in 1992 than it had when he took office. If his foreign policy leadership had been stunningly successful, his budget and economic policy leadership had been the exact opposite.

**Erasing the Deficit.**

Two major deficit-reduction programs were enacted during the Clinton presidency. The Omnibus Budget Reconciliation Act of 1993 (OBRA 1993) was a $500 billion package of tax increases and spending cuts that was expected to reduce deficits by roughly one-third from FY 1994-98.[21] The 1997 Balanced Budget Act and Taxpayer Relief Act were companion reconciliation bills designed to complete the deficit-reduction effort and to yield a balanced budget by 2002. Even as the latter were proceeding through Congress, however, the budget outlook was improving much more rapidly and dramatically than had been anticipated. After OBRA 1993 was passed, the FY 1998 budget deficit had been projected at $200 billion.[22] Instead, there was a $70 billion surplus in 1998, and 2 years later the surplus had climbed above $235 billion.

OBRA 1993 was an enormously controversial measure that barely passed the House and Senate.[23] Republicans in both chambers unanimously voted against it, and there were significant Democratic defections as well. Republican opposition and Democratic unease were particularly targeted on the tax increases contained in OBRA 1993—$240 billion over 5 years, with most of the additional revenues drawn from upper-income taxpayers.[24] Indeed, the single largest deficit-reduction provision in OBRA 1993 was the $115 billion increase in revenues from raising the top marginal rate on individual income from 31 percent to 39.6 percent.

By contrast, OBRA 1993 made only minor changes in spending policy. The discretionary spending caps due to expire in 1995 were extended through 1998, with estimated deficit savings of approximately $70 billion.[25] Retirement and healthcare benefits were protected, with entitlement savings limited to reduced Medicare reimbursements for healthcare providers. Since the Clinton administration and the Democratic majorities in the House and Senate were intent on raising discretionary domestic spending, the prospects for defense under OBRA 1993 were dismal.

These prospects improved only marginally when Republicans gained control of Congress in the 1994 midterm elections, because their priorities were deficit reduction and tax cuts. In 1995, congressional Republicans first attempted to pass a constitutional balanced-budget amendment. When this failed, Republicans pressed for policy changes that would actually balance the budget. The House and Senate passed a reconciliation bill that contained massive spending cuts in social welfare programs, along with cuts in individual and corporation taxes. President Clinton successfully vetoed the reconciliation bill, and he vetoed as well a number of domestic appropriations bills that Republicans had cut.

The battle between Clinton and congressional Republicans over appropriations resulted in government shutdowns at the end of 1995, the public response to which produced a full-scale Republican retreat. In 1996, the Republican leadership gave the Clinton administration most of what it had requested for domestic spending. The 1997 budget agreement that followed was decidedly modest, with Clinton and congressional Republicans agreeing to $200 billion in deficit reduction over 5 years. The savings included an extension of discretionary spending caps through 2002 and additional reductions in Medicare reimbursement rates. Republicans did manage to enact several tax cuts, including child tax credits and lower capital gains tax rates, but the OBRA 1993 tax increases on upper-income taxpayers remained largely intact.

Republicans were also able to slow the transfer of defense cuts to domestic programs, but the burden of deficit reduction during the 1990s still fell heavily on defense—and on upper-income taxpayers. The fiscal turnaround between 1990 and 2000 was enormous—$457 billion or 6.3 percent of GDP (See Table 10). More than one-third

of the GDP change was absorbed by defense. Another third was accounted for by the sharp increase in individual income tax levels. The revenue-GDP level in 2000 was 20.8 percent, the highest level since World War II. The individual income-GDP ratio of 10.3 percent was the highest ever recorded. The defense-GDP ratio in 2000 was distinctive as well—the lowest since 1940.

| **FY 1990 =** | **- $221** | **FY 2000 =** | **+$236** |
|---|---|---|---|
| Revenues = | 18.0% GDP | Revenues = | 20.8% GDP |
| Outlays = | 21.8% | Outlays = | 18.4% |
| Deficit = | -3.9% | Surplus = | +2.4% |

| | **FY 1990** | **FY 2000** | **Change** |
|---|---|---|---|
| REVENUES | 18.0% GDP | 20.8% GDP | 2.8% GDP |
| Individual | 8.1 | 10.3 | (+2.2) |
| Corporation | 1.6 | 2.1 | (+0.5) |
| Payroll | 6.6 | 6.7 | (+0.1) |
| Other | 1.6 | 1.6 | (+0.0) |
| OUTLAYS | 21.8% | 18.4% | -3.4% |
| Disc. Defense | 5.2 | 3.0 | (-2.2) |
| Disc. Non-Defense | 3.5 | 3.3 | (-0.2) |
| Mandatory Programmatic | 9.9 | 10.6 | (+0.7) |
| Deposit Insurance | 1.0 | 0.0 | (-1.0) |
| Net Interest | 3.2 | 2.3 | (-0.9) |
| | 22.8 | 19.1 | -3.6 |
| Offsetting Receipts | -1.0 | -0.8 | +0.2 |
| | 21.8 | 18.4 | -3.4 |

Source: *The Budget and Economic Outlook, Fiscal Years 2004-2013*, Washington, DC: U.S. Congressional Budget Office, 2003, pp. 148-157.

**Table 10. Components of Deficit Reduction, Fiscal Years 1990-2000 (in billions of dollars and percentage of GDP)**.

**The Politics of Surpluses.**

Once surpluses became available, the Clinton administration and Congress agreed to boost spending, while clashing repeatedly

over tax cuts. Spending increases, however, were primarily directed toward domestic programs. Beginning in 1998, the administration and Congress repeatedly maneuvered around the discretionary spending caps and PAYGO entitlement limits.[26] By 2001, discretionary outlays were more than $80 billion higher than the statutory cap and $100 billion above FY 1997 levels. Approximately two-thirds of these discretionary spending increases were for domestic programs. Entitlement programs were also expanded, with Medicare reimbursement rates raised by more than $50 billion in 1999 and 2000, and additional spending was provided for children's and military retirees' healthcare and for veterans' benefits.

The low priority assigned defense was striking, given the strong evidence that defense had been seriously underfunded during the 1990s. With the end of the Cold War, the first Bush administration had proposed a defense planning strategy focusing on regional wars. Its "Base Force" program, with approximately 1.63 million active-duty personnel and $1.4 trillion in defense outlays from 1994-1998, had a primary capability of fighting two major regional wars simultaneously. When the Clinton administration took office in 1993, it adopted the two regional war strategy but proceeded to cut force levels and funding to support that strategy.[27] By the end of the decade, many defense experts were convinced that these cumulative cuts had compromised essential capabilities. In its analysis of the FY 2000 defense budget, the CBO concluded that appropriations were more than $50 billion below what was needed to "keep defense forces in a 'steady state'."[28] The shortfall in procurement was particularly glaring—an estimated $90 billion in required funding compared to actual appropriations of $53 billion.

Surplus budgeting was more favorable to defense than deficit reduction had been, but defense was still at a disadvantage when competing with domestic programs. In 1995, congressional Republicans had shut down the government in a failed attempt to curb domestic spending. Three years later, they joined Clinton in expanding domestic spending commitments. The disappearance of deficits and the electoral imperative of maintaining control of Congress had defused the traditional Republican aversion to domestic spending. Surplus budgeting did reinforce the Republican commitment to large tax cuts, but they were unable to enact either

across-the-board reductions for individuals or targeted cuts. The former were stymied by Clinton's insistence that the large Social Security trust fund surpluses be used to reduce publicly-held debt until a Social Security reform package was enacted.[29] With no reform remotely possible, this "Save Social Security First" strategy meant that only a small portion of current and projected surpluses could be used to finance tax cuts, and Clinton then vetoed smaller, targeted tax reductions on policy grounds.

Despite the scandal and distraction of Clinton's impeachment in 1998, his budget program fared remarkably well. By the end of his second term, revenue levels were extremely high, domestic spending was growing rapidly, and surplus projections were becoming more and more favorable. This new era of surplus budgeting was not expected to last indefinitely. Within 2 or 3 decades, analysts warned, demographic trends would begin to "overwhelm the surplus and drive us back to escalating deficits and debt," unless retirement and healthcare entitlements were retrenched.[30] This long-term budget challenge was therefore an integral part of the emerging debate over the size and shape of the federal budget—how to allocate surpluses among debt reduction, tax cuts, and spending increases without exacerbating future entitlement financing problems.

**The Deficit Problem Returns.**

The 2000 presidential election was, in large part, a contest about the future size of government. The contest of the 1990s had been whether to balance the budget at high or low revenue levels, and Clinton, along with congressional Democrats, had prevailed. The Democratic agenda after Clinton depended on maintaining these high revenue levels in order to expand discretionary domestic programs in the short term and to preserve Social Security and Medicare commitments over the long term. Al Gore's fiscal program highlighted debt reduction and domestic program initiatives to use up projected surpluses. George W. Bush, however, called for massive, permanent tax cuts to lower revenue levels and reduce the margins available for new domestic spending. The Gore-Bush differences over tax cuts were directly related to social welfare policy. Gore wanted to maintain existing retirement and healthcare policies, while Bush

favored Social Security and Medicare reforms that would reduce future spending and keep tax levels relatively low.

Bush's victory and continued, albeit temporary, Republican control of Congress in early 2001 settled the tax issue.[31] The Economic Growth and Tax Relief Reconciliation Act of 2001 was the biggest tax cut in 2 decades, with a 10-year revenue cost of $1.35 trillion. The bulk of tax relief was directed toward individual taxpayers—marginal income tax rate cuts accounted for about two-thirds of the overall revenue reduction.[32] As the tax bill was moving through Congress, the economy was weakening and surplus projections falling, but the administration never wavered from its tax-cut commitment. And in 2002 and 2003, with deficits firmly in place, the Bush administration sponsored additional, if more limited, tax cuts.

On the spending side, the FY 2002 budget called for reining in the "recent explosive growth in discretionary spending."[33] The administration proposed an increase of approximately $40 billion in discretionary outlays for FY 2002, roughly divided between defense and nondefense programs, but annual increases for 2003-2006 were reduced to about $20 billion. The FY 2002 budget's defense numbers were "placeholders," with the administration promising revised, and presumably larger, numbers once its strategy review had been completed. Nevertheless, the initial Bush budget program assumed that discretionary spending-GDP levels could be cut below 6 percent. It seemed highly unlikely that Congress would support such a sharp reduction and even less likely that defense budgets could be insulated from disproportionate cuts in the event that Congress did so. Moreover, the defense planning taking place early in 2001 suggested that the strategy, force levels, and funding program inherited from the Clinton administration would be extended without major changes. Indeed, there were indications that the two regional war capability would be scaled back a bit in order to control force levels and spending.[34]

In any case, discretionary spending has been on an entirely different trajectory since September 11, 2001. Defense outlays have increased by more than 50 percent in 3 years, while nondefense discretionary spending has risen by 30 percent. In addition, a weak economy and additional tax cuts in 2002 and 2003 have greatly reduced revenue levels. This combination of higher spending and lower revenues has

pushed the budget back into deficit, and the budget outlook shows no quick or easy return to surpluses. The magnitude of the fiscal policy gap is presented in Table 11. In January 2001, the 10-year baseline projection for spending was $22.3 trillion. The January 2004 estimate for spending over the FY 2002-11 period is nearly $26 trillion, with about half of this increase in discretionary spending. Revenues have fallen by approximately $4.8 trillion due to tax cuts, as well as less favorable economic assumptions and technical estimates regarding taxable income, bringing the total surplus-deficit change to $8.5 trillion.

| | Baseline Projections | | |
|---|---|---|---|
| | **January 2001** | **January 2004** | **Change** |
| Revenues | $27,887 | $23,114 | -$4,773 |
| Spending | 22,276 | 25,991 | +3,715 |
| Discretionary | 7,759 | 9,458 | +1,699 |
| Mandatory | 13,897 | 14,174 | +277 |
| Net Interest | 620 | 2,359 | +1,739 |
| Surplus (+)/Deficit (-) | +5,610 | - 2,877 | 8,487 |

Source: The January 2001 projections are from *The Budget and Economic Outlook: Fiscal Years 2002-2011*, Washington, DC: U.S. Congressional Budget Office, p. 4. The January 2004 data are from *The Budget and Economic Outlook: Fiscal Years 2005-2014*, Washington, DC: U.S. Congressional Budget Office, 2004, p. 3.

**Table 11. Components of Baseline Surplus-Deficit Change, Fiscal Years 2002-11 (in billions of dollars)**.

The deficit projections now in place, like the earlier surplus projections, are subject to some uncertainty. Revenues are extremely difficult to estimate accurately, given the extreme sensitivity of tax levels to economic changes. From 1981-2001, for example, the average difference between 5th-year revenue projections and actual revenues for those years was more than 2 percent of GDP, even with adjustments for legislative changes.[35] It is entirely possible, then, that revenues will increase more rapidly than expected if economic

growth exceeds forecasts over the next few years, bringing about a corresponding reduction in deficits. There is uncertainty as well with estimates for some large spending programs, such as Medicare and Medicaid, that are affected by highly unpredictable cost factors. Spending for these and other volatile programs could be lower than expected, which would reduce deficits as well.

There is little prospect, however, that deficits can be eliminated or even brought down to acceptable levels without significant policy changes—tax increases and spending cuts. This is especially true for so-called on-budget deficits, which include all federal spending and revenues except the Social Security trust funds.[36] The Social Security trust funds are currently running large surpluses—an estimated $1.7 trillion through 2011—while on-budget deficits total more than $4 trillion over this same period. Since the Social Security surpluses are expected to disappear in about 15 years, the on-budget deficit problem needs to be addressed before it becomes more unmanageable.[37]

The on-budget deficit gap, however, cannot be significantly reduced without extremely large increases in individual income tax revenues or extremely large cuts in discretionary programs. Excluding Social Security revenues and spending from budget totals means that individual income taxes account for 60 percent of current revenues and discretionary spending for nearly half of total outlays. It is simply not feasible to erase on-budget deficits without the high individual income tax-GDP levels and low discretionary spending-GDP levels of the late 1990s. And to the extent that individual income tax increases are postponed or proscribed, the weight of deficit reduction will fall even more heavily on discretionary programs.

The resurgence of large deficits, then, has direct implications for defense. Policymakers have agreed that deficits must be reduced significantly over the next several years in order to restrain upward pressures on interest rates and to accelerate economic growth. The Bush administration, for example, hopes to cut deficits in half by 2009.

The usual concerns about deficits, however, are being reinforced by uncertainties about foreign-held debt. During the 1970s and 1980s, about 15 percent of publicly-held debt was owned by foreign central banks and foreign investors.[38] These levels began to rise sharply during the late 1990s, and the current percentage is nearly

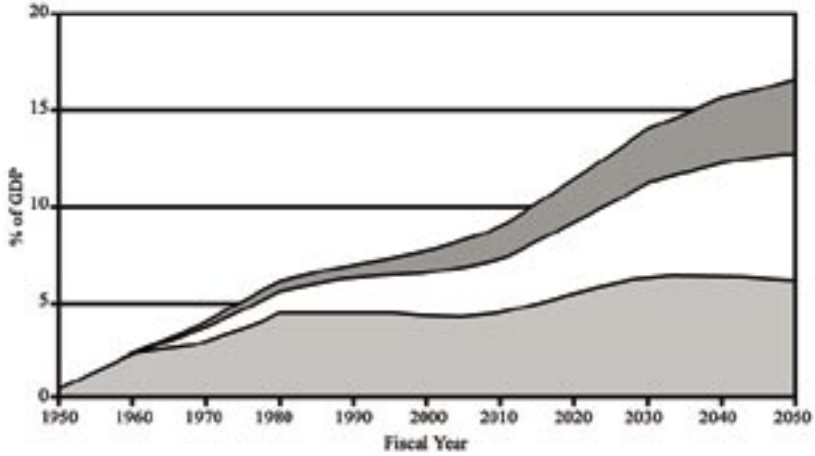
40 percent. If interest rates must be raised in order to continue to attract foreign investment, the impact on debt service costs would be severe. A percentage point increase in interest rates, for example, would raise baseline interest costs by about $600 billion from 2005-14.[39] Higher interest costs, in turn, would reduce the margins available for discretionary spending.

The connection between deficits and defense is straightforward. The politics of deficit reduction means that most entitlement programs (particularly Social Security and Medicare) are exempt from deficit-reduction efforts; the spending savings needed to reduce deficits are invariably concentrated on discretionary programs, and defense is by far the largest and most visible of these programs. Moreover, unless deficits are cut, interest costs will begin to crowd out new spending for discretionary programs, with a potentially disproportionate impact on defense. Simply put, if short-term budgets were balanced or in surplus, it is conceivable that defense budgets could be raised to planned levels over the next several years. However, with the very different fiscal outlook the nation now faces, the prospects for defense are very different.

## THE LONG-TERM OUTLOOK

Finally, these fiscal problems are exacerbated by demographic trends that threaten to transform budget policy. As the baby-boom generation reaches retirement age, spending for Social Security, Medicare, and Medicaid will increase very rapidly. These programs now account for about 8.5 percent of GDP, but their combined spending-GDP level could double by 2050 under current policy projections (see Figure 4). Since **all** federal spending has averaged about 20 percent of GDP over the past 4 decades—and revenues have averaged slightly more than 18 percent—the projected growth of retirement and healthcare programs poses serious problems in terms of fiscal sustainability.

In terms of revenue levels, for example, the GDP peaks of World War II and the late 1990s were just above 20 percent. Even these levels, however, could not accommodate the projected growth in entitlement commitments for the elderly along with the defense and domestic obligations the federal government has in place. Moreover,




*Source: Long-Range Fiscal Policy Brief: A 125-Year Picture of the Federal Government's Share of the Economy, 1950-2075*, Washington, DC: U.S. Congressional Budget Office, 2002, p. 3.

**Figure 4. Spending for Social Security, Medicare, and Medicaid, 1950-2050 (as a percentage of GDP)**.

unless deficits are controlled over the short term, interest obligations will generate even higher spending levels. The consensus among budget policy experts is that revenues cannot be raised to the 25-30 percent of GDP that might be necessary to finance federal spending if entitlement growth is left unchecked.[40] The political checks on such unprecedented tax levels are obviously one consideration. Negative economic effects are another important concern, since high tax levels could reduce economic growth and make it even more difficult to stabilize government finances.

These political and economic policy considerations have added weight in light of changing dependency ratios. The entitlement financing challenge is not simply a matter of more retirees, but rather an increase in the size of the retiree population relative to the working-age population. The dependency ratio is used to measure the fiscal impact of population aging by comparing the number of potential workers (usually the population aged 16-64) to the number of retirees (the population aged 65 and older). Large numbers of workers per retiree—about 5 to 1 in the United States in 1960, about

4 to 1 today—provides an ample economic and tax base support for the elderly.[41] The dependency ratio in the United States, however, is expected to change dramatically after 2010—a worker-to-beneficiary ratio of 2.5 to 1 in 2030 and perhaps 2 to 1 by 2060. Under these circumstances, the tax burdens needed to support retirees under current policy would likely be unacceptably high.

The spending-control solution to retirement and healthcare entitlement financing—forcing all discretionary spending as well as all other entitlements into a narrower and narrower GDP margin—is equally unrealistic, particularly since the relative size of these programs has already fallen sharply over time. The first stage of the welfare shift, for example, has cut the GDP share of discretionary spending nearly in half, but even larger cuts would be needed over the next 50 years to offset the growth in existing entitlement commitments. As the U.S. General Accounting Office summarized the problem, "Absent changes in the structure of Social Security and Medicare [and Medicaid], some time during the 2040s the federal government would do nothing but mail checks to the elderly and their healthcare providers."[42]

If structural entitlement policy reforms are indeed inevitable, the Social Security program is the easiest to deal with in terms of costs and policy options. Under current benefit formulas and retirement ages—normal retirement under Social Security will be increased, in phases, to 66 by 2009 and to 67 by 2027—the Social Security-GDP level would increase by about 2 percentage points over the next 50 years.[43] Virtually all of this growth could be erased by straightforward policy changes—higher retirement ages, reduced COLAs, and less generous benefit formulas.

The Medicare and Medicaid programs are, in fiscal terms, potentially much larger and, in policy terms, more intractable. The key issue for these programs is "excess cost growth"—the extent to which the costs per Medicare and Medicaid beneficiary exceed per capita GDP growth.[44] Over the past several decades, excess cost growth in both programs has been quite high—about 3 percent annually for Medicare and about 2.7 percent for Medicaid.[45]

Projected future spending for Medicare and Medicaid depends heavily on whether excess cost growth can be contained. No excess growth through 2050, for example, keeps the increase in Medicare

and Medicaid outlays on a par with Social Security—from 4.1 percent today to 6.4 percent in 2050.[46] A 1.0 percent excess growth rate (the figure used by the Medicare program's trustees in their financial forecasts) yields an 11.5 percent of GDP estimate for 2050. A continuation of past healthcare cost trends, however, dwarfs this latter estimate. The combined Medicare and Medicaid outlay-GDP level in 2050, assuming 2.5 percent excess cost growth annually, is 21.3 percent.

The necessity for cost controls is obvious, but definitive policy solutions are elusive. Increasing the eligibility age for Medicare to 70, for example, would have only a modest impact on costs. Reducing the government's share of healthcare expenses could yield appreciable savings, but the added costs to beneficiaries or healthcare providers might restrict access to care. Controlling the cost per beneficiary, which is the real policy challenge, ultimately depends on largely untested strategies for making healthcare more efficient—improved care management and disease management, increased competition through private health plans in the Medicare system, and expanded use of lower-cost medical services.

## CONCLUSION

The fiscal obstacles confronting defense planners are formidable. Over the short term, politically potent demands for deficit reduction, permanent tax cuts, and domestic program expansions will make it difficult to maintain core defense budget needs at adequate levels. Over the long term, the spending margins available to support defense and other national commitments will be defined by the extent and timing of retirement and healthcare entitlement reforms.

The Bush administration's FY 2006 budget, for example, calls for reducing the deficit to approximately 1.3 percent of GDP by 2010. Under this deficit-reduction program, discretionary spending-GDP levels would fall sharply over the next several years.[47] More important, the administration is proposing cutbacks in constant-dollar outlays for defense and nondefense programs. The proposed cuts in nondefense programs are larger than the defense reductions—from a total of $413 billion in FY 2005 to $364 billion in FY 2010 (measured in FY 2000 dollars).[48] But the latter are appreciable. With supplementals

excluded, constant-dollar outlays for defense would decline from over $400 billion in 2005 to less than $380 billion in 2010.[49] The core defense budget, then, would have negative real growth over the next several years when measured in actual spending.

Given this funding trajectory, the demands on the U.S. military are even more daunting—fighting a highly unpredictable global war on terrorism while implementing a largely undefined transformation in organization, equipment, and doctrine. Current defense budget projections ignore future costs of the former and understate the potential costs of the latter. But quite apart from these shortcomings, defense plans that assume steady increases in real spending levels are fiscally unrealistic and politically naïve. Instead, difficult choices are inescapable with regard to the major components of the defense budget—readiness, force levels, and procurement to support traditional and transformational modernization. The debate over Army end-strength illustrates the dilemma. Army Chief of Staff Peter Schoomaker recently stated that the temporary increase of 30,000 Army troops might have to be raised to 50,000 and made permanent.[50] If this proves correct, offsetting procurement cutbacks will be needed to hold defense budgets within politically realistic limits.

The procurement issue, moreover, will almost certainly intensify over time. There have already been stretch outs, reductions, and terminations in numerous procurement programs. The Army's next-generation *Comanche* helicopter program has been cancelled, and the development phase for its Future Combat System program has been extended. The Navy's DD(X) destroyer procurement schedule has been delayed by 1 year and its attack submarine program schedule by 2 years. The Air Force's investment plans are being buffeted by rapidly increasing costs for its new fighter attack aircraft and related programs, making it difficult to maintain procurement schedules and procurement quantities. Even taking these into account, the investment programs that remain in place will require significant increases in aggregate real spending over the next several years. Finally, it is reasonable to assume that cost overruns will affect many of the new technologies and exotic weapons systems currently under development, complicating still further the investment projections now in place.

Since the defense budgets likely to be in place over the next several years cannot accommodate higher force levels, improved readiness, traditional modernization, and transformational modernization, there must inevitably be painful tradeoffs. The key tradeoff, moreover, will likely involve the scale and pace of modernization initiatives, particularly for the transformational technologies, against the readiness requirements for attracting and retaining a highly-skilled military. Slowing the former to ensure adequate funding for the level and quality of forces is a prudent choice in terms of the tangible military capabilities currently needed to meet existing threats. It is also more predictable, more controllable, and more reversible in terms of costs. Given the fiscal outlook that defense planners face, these advantages are compelling.[51]

## ENDNOTES

1. *The Long-Term Implications of Current Defense Plans: Summary Update for Fiscal Year 2005*, Washington, DC: U.S. Congressional Budget Office, September 2004, p. 2.

2. *Ibid*.

3. *Ibid*., p. 3.

4. These are baseline deficit estimates. See *The Budget and Economic Outlook: Fiscal Years 2006-2015*, Washington, DC: U.S. Congressional Budget Office, 2005, p. xiv.

5. This spending-GDP relationship is the conventional benchmark for measuring the size of government. It is particularly useful for analyzing changes in the size of a nation's government over time (i.e., historically) and for comparing the size of governments in different countries (i.e., cross-nationally).

6. The actual costs of entitlement programs consist of program outlays minus certain offsetting receipts—"payments from the public or intragovernmental transactions that the federal government records as negative spending. . . ." The largest of these are premiums paid by Medicare beneficiaries for supplementary medical insurance (covering physician and outpatient services) and the payments by federal agencies into their employees' retirements plans (military and civilian). *The Budget and Economic Outlook: Fiscal Years 2005-2014*, Washington, DC: U.S. Congressional Budget Office, 2004, pp. 63-65.

7. The gross interest costs of the federal debt include payments to holders of "publicly-held debt" and to federal trust funds (such as the Social Security and civil service retirement trust funds) that hold government securities. Interest costs for the latter are treated as intragovernmental transactions and have no budgetary impact. Net interest outlays, which are a component of mandatory spending, essentially represent the costs of the debt held by nonfederal investors—i.e., publicly-held debt. *Ibid.*, pp. 65, 68-69.

8. Executive branch civilian employment (excluding the Postal Service) was over two million from 1966-95. The level has fallen since that time, to an average of 1.84 million. *Historical Tables, Budget of the United States Government, Fiscal Year 2005*, Washington, DC: U.S. Government Printing Office, 2004, pp. 295-296.

9. For fiscal years 1991-93, separate caps were set for defense, domestic, and international programs. Congress could appropriate up to the cap for each category, but could not appropriate less for one category, such as defense, and transfer that savings to another category.

10. The demise of the Articles of Confederation government during the 1780s was, in part, caused by its inability to manage the Revolutionary War debt. The framers of the Constitution remedied the fiscal defects of the Confederation by giving the national government broader powers to tax, spend, and borrow. Alexander Hamilton, the first Secretary of the Treasury, then designed the financial strategy for managing borrowing and debt. His "Report Relative to a Provision for the Support of Public Credit" is a landmark in the history of public finance.

11. From 1850-60, total federal spending averaged less than $65 million annually. In 1870, interest costs were nearly $130 million, while total spending was over $300 million. See Dennis S. Ippolito, *Why Budgets Matter: Budget Policy and American Politics*, University Park: Pennsylvania State University Press, 2003, pp. 61, 80.

12. *Ibid.*, p. 55.

13. Over this period, spending averaged approximately $3.5 billion annually. The large surpluses devoted to debt retirement acted as a brake on new spending and also required Congress to maintain income and corporation taxes at levels that would have been unimaginable prior to the war.

14. A structural deficit measurement removes the influence of cyclical factors. It is an estimate of the deficit "that would occur under current law if the economy operated at potential GDP." (Eliminating structural deficits therefore requires changes in current law—cutting spending, increasing revenues, or both.) *The Budget and Economic Outlook: Fiscal Years 2005-2014*, p. 159.

15. Peak spending during the Korean War was 20.4 percent of GDP in FY 1953. The Vietnam peak was 20.5 percent in 1968.

16. Deficit ceilings under GRH were: FY 1986 = $172 (billion); FY 1987 = $144; FY 1988 = $108; FY 1989 = $72; FY 1990 = $36; FY 1991 = $0.

17. The revised ceilings were: FY 1988 = $144 (billion); FY 1989 = $136; FY 1990 = $100; FY 1991 = $64; FY 1992 = $32; 1993 = $0.

18. *Budget of the United States Government, Fiscal Year 1991*, Washington, DC: U.S. Government Printing Office, 1990, p. 3.

19. *An Analysis of the President's Budgetary Proposals for Fiscal Year 1991*, Washington, DC: U.S. Congressional Budget Office, 1990, p. 42; *The Economic and Budget Outlook: An Update*, Washington, DC: U.S. Congressional Budget Office, July 1990, p. xiii.

20. *The Economic and Budget Outlook: An Update*, July 1990, p. xiii.

21. *The Economic and Budget Outlook: An Update*, Washington, DC: U.S. Congressional Budget Office, September 1993, p. 36.

22. *Ibid*.

23. The margin in the House was 218-216. The Senate vote was 51-50, with Vice President Al Gore casting the tie-breaking vote.

24. Approximately 70 percent of the revenue increase was directed toward upper-income taxpayers in the form of higher marginal rates, higher Medicare payroll taxes, and higher Social Security benefits taxes. Ippolito, p. 264.

25. *Ibid*.

26. On these various maneuvers, see *Ibid*., pp. 285-286.

27. The administration's 1993 defense plan reduced active-duty personnel by more than 200,000 and cut 1994-98 recommended outlays by $130 billion under the Bush program.

28. *Budgeting for Defense: Maintaining Today's Forces*, Washington, DC: U.S. Congressional Budget Office, September 2000, p. xi.

29. On the competing reform proposals, see Ippolito, pp. 286-287.

30. *Long-Term Budget Issues: Moving from Balancing the Budget to Balancing Fiscal Risk*, Washington, DC: U.S. General Accounting Office, 2001, p. 1.

31. In May 2001, Vermont Senator James M. Jeffords switched his party designation from Republican to Independent. The 50-50 party division in the Senate, which had given Republicans control with Vice President Dick Cheney's tie-breaking vote, changed to 50D-49R-1I, allowing the Democrats to organize the chamber.

32. Ippolito, p. 298.

33. *Budget of the United States Government, Fiscal Year 2002*, Washington, DC: U.S. Government Printing Office, 2001, p. 7.

34. See Michael E. O'Hanlon, *Defense Policy Choices for the Bush Administration*, 2d ed., Washington, DC: Brookings Institution, 2002, pp. 11-14.

35. *The Budget and Economic Outlook: Fiscal Years 2003-2012*, Washington, DC: U.S. Congressional Budget Office, 2002, p. 92.

36. The Old-Age and Survivors Insurance Trust Fund and the Disability Insurance Trust Fund, as well as transactions of the Postal Service, are by law treated as off-budget—they are not included in budget resolution totals or deficit calculations under the Deficit Control Act.

37. The current estimate is that Social Security tax revenues will not be sufficient to cover benefits and other costs beginning in 2018. Reserves and interest on trust fund reserves, however, would cover shortfalls for another 25 years. Peter A. Diamond and Peter R. Orszag, *Saving Social Security*, Washington, DC: Brookings Institution, 2004, pp. 52-53.

38. *Analytical Perspectives, Budget of the United States Government, Fiscal Year 2005*, Washington, DC: U.S. Government Printing Office, 2004, p. 235.

39. *The Budget and Economic Outlook: Fiscal Years 2005-2014*, pp. 104-105.

40. Spending estimates of this type are of course speculative. For an analysis of various "spending paths," see *The Long-Term Budget Outlook*, Washington, DC: U.S. Congressional Budget Office, 2003, pp. 6-12.

41. Ippolito, pp. 308-309.

42. *Long-Term Budget Issues*, p. 10.

43. *The Long-Term Budget Outlook*, p. 23.

44. *Ibid.*, pp. 4-5.

45. *Ibid.*

46. *Ibid*., p. 28.

47. *Historical Tables, Budget of the United States Government, Fiscal Year 2006*, Washington, DC: U.S. Government Printing Office, 2005, p. 128.

48. *Ibid*., p. 126.

49. *Ibid*.

50. James Kitfield, "Changing and Fighting, Simultaneously," *National Journal*, October 30, 2004, p. 3301.

51. For a comprehensive and exceptionally detailed analysis of the modernization debate and these tradeoffs, see Stephen Biddle, *Military Power*, Princeton: Princeton University Press, 2004. With respect to budget priorities, Biddle concludes that:

> One should be wary . . . of proposals to protect modernization at the expense of readiness. . . . The issue is the relative pace of modernization, and the analysis above suggests that trading slower modernization for lesser cutbacks in training, schools, and quality-of-life accounts (i.e., those parts of the budget that help create and retain skilled personnel capable of implementing demanding modern-system force employment) would be a better choice than the reverse. At the margin, a less-skilled military is more dangerous than less-advanced technology (p. 203).