Reducing the Federal Deficit: A bandwagon worth jumping on

Last week I provided broad parameters for reducing the federal budget deficit. Since then President Obama’s Debt Commission co-chairs have made some [preliminary suggestions](http://msnbcmedia.msn.com/i/MSNBC/Sections/NEWS/A_Politics/___Politics_Today_Stories_Teases/CoChair_Draft.pdf) for reducing the deficit. It’s actually a pretty good read. They suggest major and [minor cuts](http://politics.blogs.foxnews.com/2010/11/11/money-matters-debt-commission-budget-cuts-you-havent-heard) in spending [alike](http://politics.blogs.foxnews.com/2010/11/15/more-money-matters-debt-commission-budget-cuts-you-haven-t-heard). Since then it seems that everyone has been making suggestions for reducing the deficit. The New York Times even has a [game](http://www.nytimes.com/interactive/2010/11/13/weekinreview/deficits-graphic.html) you can play to reduce the deficit on your own. They make it look easy – which it is in theory, just not in political reality. Today Alice Rivlin and Pete Domenici made r[ecommendations](http://www.reuters.com/article/idUSTRE6AG31U20101117).

For each of the major reform categories below, I will list A, B, and C options to choose from. The A option is the answer that it is best for the long term health of the US economy. It usually requires the largest reform. The B option provides the best option given the existing political framework. The C option is better than doing nothing, but requires a real lack of thought and courage. I won’t bother with D or F options. You need at least a C to graduate. After all, “C’s are degrees”.

**Step 1: Reform Discretionary Spending**

**Keys to Success:** Match up actual spending with what the public believes is the actual role of the federal government. We need to ask ourselves what it is that we want the federal government to do. If you don’t know where you are going, you’ll never know when you get there.

**Option A**: The federal government can define and enforce property rights. This would require them to fund national defense (military, intelligence, homeland security, diplomats, and border security). It would also require them to fund a federal court system, a patent office, and coin and print money. All other government functions would be reserved to states via the 10th Amendment.

**Option B:** The federal government can do Option A plus fund interstate transportation, fight communicable diseases, protect the environment, and reduce the impact of poverty. In this way they can try to overcome “market failures” at the national level. You would need to fund the CDC and the EPA but the social safety net could be provided through vouchers, i.e. food stamps, housing vouchers, medical vouchers, and education vouchers. Imagine how much we could improve inner city schools by abolishing the US Department of Education and giving the same amount of money to poor kids via school vouchers that could be used at public or private schools (like the Pell Grant). In any case this would dramatically reduce the federal work force.

Other obvious deletions (though not a comprehensive list) include NPR, the US Post Office, Amtrak, Fannie Mae, Freddie Mac, General Motors, and any other “businesses” the federal government has gotten into. The federal government also needs to stop paying people not to work, so farm subsidies are out.

**Option C:** The federal government can do whatever it is doing today, but just do less of it. Roll back each department’s spending back to its 2007 level and allow it to grow only at a rate equal to the CPI minus 1%. Sure you’ll still have a lot of wasteful spending, but it will be less than you have now.

**Step 2: Reform Entitlements**

**Keys to Success:** Everyone is responsible for creating promises for which we can’t pay. Everyone should help pay for the solution. Making entitlements fully funded to prevent unfunded liability permanently solves the entitlement problem.

**Option A:** Fully fund Social Security, Medicare, Medicaid, Welfare, and Unemployment Insurance. This is done by creating an account for each taxpayer. The money they pay in during their working years is the money they can withdraw when they become old or unemployed. The unemployment, Medicaid, and welfare account can be drawn to a negative balance for people under 45 years of age. It forces people to save, but also to recognize that spending has an opportunity cost. If you want to take your Medicare money out for drugs, it won’t be there for hospital stays. Any money left in your account upon your death can be bequeathed tax free. This fund would work best as one large fund without breaking it down by specific category. For instance, if your pressing need is health care now, you can use your unemployment insurance money. In this way every worker will have a safety net.

For current Social Security and Medicare recipients, their payments should be made through general tax revenue and benefits should be means tested. General tax revenues will also be used for the truly indigent – those who can’t work.

**Option B:** Increase the retirement age for Social Security and Medicare to reflect average life expectancy minus five years. When Social Security started, benefits kicked in at 65 but life expectancy was also 65. Means test Social Security and Medicare benefits. This way a graying America can afford to provide benefits to those who are most in need of help. Apply the Social Security tax to all earned income.

Reform medical malpractice laws and make it more difficult to collect disability payments. Require work, training, or education to collect from the social safety net (welfare or Medicaid). Restrict unemployment insurance to 26 weeks at a time.

**Option C:** Increase the retirement age to 70 for Social Security and Medicare. Apply the payroll tax to all earned income and increase benefits by the CPI minus 1% annually.

**Step 3: Reform the Tax Code**

**Keys to Success:** Lower the marginal tax rates (particularly on capital) and increase average tax rates by broadening the tax base. Such pro growth tax reforms will help the economy grow out of debt.

**Option A:** Repeal the 16th Amendment (thereby eliminating the income, corporate, capital gains and payroll taxes), end the estate tax, and add a national sales tax of 20% which exempts food and housing (thereby ensuring progressivity in the tax code). No entity will have tax exempt status. Any remaining needed tax revenue will be generated by a carbon tax.

**Option B**: Eliminate all deductions and exemptions in the income tax code and reduce marginal tax rates to three brackets of 10%, 17.5% and 25%. Reduce the corporate income tax and capital gains tax rates to 10%. End the payroll tax and any remaining needed tax revenue will be generated by a carbon tax.

**Option C:** End the home mortgage and employer health insurance tax deductions and change the tax brackets to 15%, 20% and 25%. Tax corporate income and capital gains at 20%. Apply the payroll tax to all earned income.

**Step 4: Make Binding Constraints**

**Keys to Success:** The Debt to GDP ratio will fall over time. Constitutionally binding constraints are necessary.

**Option A:** Budget for a surplus. Canada ran more than a decade of straight budget surpluses and we can too. Outlaw deficits as long as unemployment is below 10%. Deficits must be under 5% of GDP if unemployment is over 10%.

**Option B:** Eliminate the structural deficit. The budget must, at a minimum, be balanced over the business cycle. Budget surpluses are required when the unemployment rate falls below 6.5% and budget deficits cannot exceed 3% of GDP when unemployment is under 10%. Budget deficits cannot exceed 6% if unemployment is over 10%.

**Option C:** Run budget deficits that are smaller than economic growth rates over the business cycle. You never have to balance a budget, but the increase in the national debt must grow more slowly than the economy so that the debt/GDP ratio falls. Budget deficits cannot average more than 3% for any 10 year period of time.

**Summary Comments:** It’s easier to point out what the federal government should fund than it is to point out what they should cut. This is because they have so many pointless, duplicate, and harmful programs.

The most important steps are steps 3 and 4. It is imperative that constitutionally binding constraints be placed on politicians so they can avoid being lured by the call of Sirens to smash our economy onto the rocks of debt. A pro-growth tax policy will go a long way to helping our economy grow its way out of debt. There’s no substitute for economic growth.

We can’t live in fairyland. We should only make promises when we meet those promises with money. Our government should only take on roles that are needed and can be afforded. Climbing out of debt will be a communal effort and everyone needs to help pull. Together our economy can regain its strength based on sound long term fiscal policy.