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BUDGETARY STRATEGIES FOR FISCAL YEARS 1979-1983

A Report to the Senate and House Committees on the Budget —Part I

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CONGRESS OF THE UNITED STATES

CONGRESSIONAL BUDGET OFFICE

BUDGETARY STRATEGIES

FOR FISCAL YEARS 1979-1983

A Report to the Senate and House Committees on the Budget

The Congress of the United States
Congressional Budget Office

CBO STUDIES SUPPLEMENTING THIS REPORT

The Congressional Budget Office is currently preparing a series of Budget Issue Papers for fiscal year 1979. The series will include studies in the following subject areas:

- Agriculture
- The Budget
- Defense Funding and Expenditures
- The Economy
- Employment and Training
- Energy
- The Environment
- Federal Aid to Education
- Federal Aid to State and Local Governments
- Federal Government Management Programs
- Federal Loan Guarantees
- Health
- Housing
- Income Assistance
- International Economic Relations
- Military Manpower
- Tax Revenues and Expenditures
- Transportation
- Urban and Regional Development
- Veterans' Affairs

PREFACE

The Congressional Budget Office is required by Section 202(f) of The Congressional Budget Act of 1974 (Public Law 93-344) to submit an annual report to the Senate and House Committees on the Budget. This year the report is in two portions: Budgetary Strategies for Fiscal Years 1979-1983 and The Economic Outlook.

Budgetary Strategies for Fiscal Years 1979-1983--Part I--examines the budget as a means for accomplishing long-term objectives. It presents four hypotehtical five-year budgets to illustrate the broad range of choices facing the Congress. As part of this discussion, some of the competing economic and programmatic goals that the Congress is bound to encounter are also outlined.

The options discussed in this report are treated in greater detail in a series of Budget Issue Papers and Background Papers that have been prepared to assist the Congress in its budget-making function. Also to assist the Congress in its deliberations, CBO has released An Analysis of the President's Budgetary Proposals for Fiscal Year 1979.

In keeping with the mandate of the Congressional Budget Office to provide objective, nonpartisan analysis of issues before the Congress, neither portion of this report contains any recommendations. The illustrative budgets presented in Part I do not represent policies advocated by the Congressional Budget Office. They have been chosen simply to indicate the range of possibilities.

All divisions of the Congressional Budget Office contributed to the drafting of this report. Johanna Zacharias and Robert L. Faherty edited the manuscript, and Tricia Knapick coordinated its preparation for publication. Special recognition goes to Janet Fain, Shirley Hornbuckle, Mary L. Judge, and Patricia J. Minton for their skill in typing the many drafts.

Alice M. Rivlin
Director

February 1978

NOTES ABOUT THE DATA

Except where otherwise noted, dates are expressed in fiscal years and dollar amounts are expressed in current dollars.

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SUMMARY

As the Congress moves toward decisions on the budget for fiscal year 1979, it needs to look ahead--to consider the revenues likely to be available to the federal government over the next several years, and to weigh the competing claims on those revenues for funding new federal programs or expanding old ones. And in looking ahead, the Congress must also balance conflicting objectives: moving toward full employment, reducing inflation, eliminating the federal deficit, and keeping the federal share of the economy in the desired relation to the rest of the economy.

None of these aims can be achieved quickly. Decisions on the fiscal year 1979 budget should be regarded only as crucial first steps in a budgetary strategy for the next several years.

CONTINUATION OF CURRENT POLICY

If the Congress were to continue current tax and expenditure policies into the future, federal revenues would grow considerably faster than federal expenditures, primarily because revenues from the progressive income tax rise rapidly when incomes are growing and inflation is high. Hence, if current policies were continued, the federal budget would exert a fiscal drag on the economy, which would slow economic growth; eventually, progress in cutting unemployment would come to a halt and even go into reverse. To avoid recession, therefore, the Congress must be prepared over the next several years either to increase federal outlays above the levels implied by continuation of current programs, to cut taxes, or to do both. The magnitude of the expenditure increase or tax cut needed depends on three factors:

- o How the Congress balances the desire to increase economic growth against the risk of escalating inflation and continuing budget deficits,

- o What type of tax cuts or expenditure increases are contemplated, and

o What is the strength of the nonfederal sectors of the economy--consumer spending, business investment, net exports, and state and local spending.

Even if the nonfederal sectors perform slightly above their historical norms over the next several years, maintaining a healthy economy will require substantial tax cuts or spending increases. In deciding between the two courses, the Congress must weigh competing claims for increased spending against the desire to cut down the relative size of the federal sector by holding down spending and cutting taxes.

CLAIMS FOR MORE SPENDING AND POSSIBLE CUTS

Welfare Reform. Improving the nation's welfare system is a matter of high priority in both the Legislative and Executive Branches. The Administration's recent proposal--calling for a combination of jobs, cash assistance, and tax credits--would raise welfare spending above current policy levels by more than $18 billion by fiscal year 1983. More modest incremental changes would cost less, but they would be less effective in reducing poverty.

Defense Spending. Major programs to improve the capabilities of U.S. strategic and general purpose forces are now underway or contemplated. The Administration, along with other NATO governments, has agreed to raise defense spending over the next five years by 3 percent a year in real terms, which could result in increases of $22 billion over current policy levels by 1983.

Health Care. A comprehensive national health insurance system, which might cost as much as $150 billion, would probably have to be implemented in steps. If some form of catastrophic health insurance plus a shift to a uniform, federally funded medicaid program were to constitute the first stages of a health insurance plan, then federal health expenditures could rise by some $27 billion over current policy levels by fiscal year 1983.

Urban Programs. Proposals to assist hard-pressed urban governments and to revitalize decaying cities come with varying price tags. The Administration has indicated it will submit an urban program to the Congress later this year. Urban initiatives, if enacted, might cost in the neighborhood of $12 billion above current policy levels by 1983.

Other Spending Growth. As the above examples indicate, new spending initiatives could easily add $100 billion to federal outlays. Increased spending in existing programs could add as much or more. Indeed, if the Congress allows small but repeated increases in a large number of programs, it could substantially cut into funds available to cover tax cuts or spending intiatives.

Reducing Federal Spending. Cutting spending below current policy levels is clearly more difficult than raising it. Some opportunities may arise to cut old programs as new ones are added--for example, to eliminate the state share of general revenue sharing if a welfare reform is enacted. Refusals to grant discretionary increases for inflation would hold grant programs below current policy levels by about $8 billion in fiscal year 1983.

Additional reductions might be achieved by changes in Defense Department manpower policies. Programs designed to diminish the fraction of the armed forces engaged in training, to encourage reenlistment, to make military pay fully taxable, and to reform the department's civilian pay practices could save $2.5 billion a year by fiscal year 1983. (Reform of the military retirement system would not bring about major savings during the next five years, but farther in the future, the effects of reform could be quite significant, cutting outlays by as much as $2 billion per year.)

TAX REDUCTIONS AND REFORM

Support for major tax reductions grows largely out of two perceptions: that a general reduction in the size of the federal government is desirable, and that there is a need to offset the recently enacted social security tax increases and the effects of inflation on the income tax. By fiscal year 1983, the social security tax increase just passed will yield on the order of $27 billion extra in federal revenues. These increased revenues are likely to have a depressing effect on the economy that will have to be offset by lowering other taxes. If the Congress votes major new tax increases as part of a comprehensive energy program, the need for tax cuts could be further intensified.

Thus, the situation the Congress faces is one of having to choose among competing goals. Faster economic growth entails a greater risk of inflation. Speedier reductions in unemployment mean larger federal deficits. More program initiatives would mean smaller tax cuts. Tight restraints on the size of the federal sector of the economy pose difficult choices among new spending programs.

RESOURCES FOR PROGRAMS AND TAX CUTS

Unless tax laws are changed or nonfederal demand is much stronger than it has been in recent years, the increases in federal expenditures needed to achieve even quite modest rates of economic growth would probably be large enough to accommodate most of the major new spending programs proposed for the next few years. Indeed, if the Congress chooses to seek fairly rapid economic growth, but not to cut tax rates, even the adoption of all of these spending programs would fail to offset the fiscal drag; in that case still larger increases in federal spending would be necessary.

But to hold tax laws constant and offset the fiscal drag entirely through increased federal spending would result in a federal sector that is much larger relative to GNP in the future than it is today. If federal expenditures are to be held at or below their current 21.4 percent share of potential GNP, a large portion of the needed economic stimulus will have to come from tax reductions rather than spending increases.

FOUR ALTERNATIVE BUDGETARY APPROACHES

To illustrate these points, CBO has prepared four hypothetical five-year budgets. (Tables depicting these four budgets appear at the end of this summary. The budges are analyzed in greater detail in Chapter III.) The first and second cut the federal share of GNP but vary the the targets for economic growth, unemployment, and inflation. The third follows a strategy designed to achieve high rates of growth to bring about a continuation of the economic growth assumed in the Second Concurrent Resolution on the Budget for Fiscal Year 1978. And the fourth increases growth and reduces unemployment rapidly through relatively unrestricted increases in federal spending.

Budget I--Smaller Federal Sector with Lower Economic Growth

Budget I is designed to shrink the federal sector from its current 21.4 percent of potential GNP to 19.5 percent by fiscal year 1983 and to bring the budget into balance by that year. It also aims to reduce inflation to about 5 percent by the end of the five-year period. These goals can be achieved, but only if one is willing to settle for a low rate of economic growth (about 4 percent a year) and very slow declines in unemployment. With such a budgetary policy, the unemployment rate would probably still be about 5.6 percent even in fiscal year 1983. Such a budget policy could be achieved by holding total federal spending to approximately the current policy level. If any additional spending were undertaken--for example, real growth in defense spending at 3 percent and a modest, incremental welfare reform--spending for other programs would have to be cut by comparable amounts below the current policy level. With this restrained level of spending, tax cuts amounting to $98 billion by fiscal year 1983 would be needed to keep the economy growing at the desired rate.

Budget II--Smaller Federal Sector with Moderate Economic Growth

Restraining the growth of federal spending does not necessarily have to result in slow economic growth. Budget II would keep federal spending at the same levels as those in Budget I, but would allow larger tax cuts and hence a more rapid growth of GNP. The higher economic growth rate (about 4.4 percent a year) would allow unemployment to decline faster (to about 5.0 percent by fiscal year 1983) but at the cost of somewhat more rapid inflation than under Budget I. The larger tax cuts would mean deficits slightly larger than under Budget I, especially in the early years.

Budget III--Slightly Smaller Federal Sector with Vigorous Economic Growth

If the goals of a small federal sector and a low rate of inflation are relaxed somewhat, even more rapid economic growth is possible and room is available in the budget for some major spending initiatives. Budget III would hold the share of GNP accounted for by federal spending slightly below its present level, but it would provide enough stimulus to allow vigorous economic growth and a decline of unemployment to about 4.5 percent by fiscal year 1983. Inflation could be expected to moderate slightly and then rise again to approximately its present level by the end of the five years. Under Budget III, spending would rise by some $44 billion above current policy levels by fiscal year 1983. This $44 billion would be available for new spending initiatives. Major tax cuts, reaching $99

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billion by fiscal year 1983, would be necessary to maintain the desired levels of economic growth, and a balanced budget would not be reached until after 1983.

Budget IV--Larger Federal Sector with Rapid Economic Growth

Policies implied in Budget IV would allow many major new program initiatives to be undertaken and the reduction of the rate of unemployment to 4.2 percent by fiscal year 1983. Even with the greatly increased federal spending represented here, significant tax cuts would be required to achieve enough economic growth to reduce unemployment. The penalties for this reduced unemployment are higher federal deficits, an increased rate of inflation, and an a larger federal share of the economy.

THE PROBLEMS OF ACHIEVING MULTIYEAR GOALS

Few of the goals sought by the budgets outlined above can be achieved quickly. Reductions in unemployment or inflation rates can come about only gradually. Similarly, program goals may take years to accomplish: social programs must be phased in gradually to avoid disruption, research must be completed before new weapon systems can be deployed, designing complex programs may take years of technical and political preparation. For all these reasons, the Congress has to act today to effect results in the future. Conversely, actions taken now to achieve immediate ends may have budgetary or functional implications for the future that will constrain the choices available to future Congresses. Caution is needed to insure that the future consequences of present decisions are consistent with the long-term national goals.

Both these tasks--changing national policy and keeping current decisions consistent with future goals--could be made considerably easier if the Congress had a way to reconcile systematically future goals and current decisions. Such a method could be provided by a shift to a multiyear framework for budgetary decisions, with the Congress adopting targets for five years in advance. Such targets would not be binding and could be reviewed each year, but the process of setting the targets would compel the Congress to consider the future effects of present actions and hence give it more ability to influence the size and composition of federal spending and revenues by choice rather than by accident.

SUMMARY TABLE 1. BUDGET I--SMALLER FEDERAL SECTOR WITH LOWER ECONOMIC GROWTH a/

	1979	1980	1981	1982	1983
Real GNP Growth Rate (percent)	4.3	4.0	4.0	4.0	4.0
Unemployment Rate (percent)	6.3	6.1	6.0	5.8	5.6
Inflation Rate (percent)	5.9	5.7	5.3	5.2	5.1
Current Policy Outlays	492	528	563	602	647
Changes from Current Policy					
3 percent real growth in defense spending	2	6	10	16	22
Incremental welfare reform b/	4	5	5	6	6
Subtotal	498	539	578	624	675
Spending Cuts Below Current Policy to Reach 19.5 Percent	6	14	20	23	25
TOTAL OUTLAYS	492	525	558	601	650
Current Policy Revenues	460	523	595	672	749
Tax Cuts Required Below Current Policy	35	50	76	93	98
TOTAL REVENUES	425	473	519	579	651
DEFICIT (-) OR SURPLUS	-67	-51	-38	-21	+2

a/ Details may not add to totals because of rounding.

b/ Some increased federal spending is offset by decreased state and local spending.

SUMMARY TABLE 2: BUDGET--SMALLER FEDERAL SECTOR WITH MODERATE ECONOMIC GROWTH

	1979	1980	1981	1982	1983
Real GNP Growth Rate (percent)	4.4	4.4	4.4	4.4	4.4
Unemployment Rate (percent)	6.3	6.0	5.6	5.3	5.0
Inflation Rate (percent)	6.0	5.8	5.4	5.4	5.4
Current Policy Outlays	492	528	563	604	650
Changes from Current Policy					
3 percent real growth in defense spending	2	6	10	16	22
Incremental welfare reform b/	4	5	5	6	6
Subtotal	498	539	578	626	678
Spending Cuts Below Current Policy to Reach 19.5 Percent	6	14	20	25	28
TOTAL OUTLAYS	492	525	558	601	650
Current Policy Revenues	460	526	601	684	767
Tax Cuts Required Below Current Policy	44	64	89	109	122
TOTAL REVENUES	416	462	512	575	645
DEFICIT (-) OR SURPLUS	-76	-63	-46	-26	-5

a/ Details may not add to totals because of rounding.

b/ Some increased federal spending is offset by decreased state and local spending.

SUMMARY TABLE 3. BUDGET III--SLIGHTLY SMALLER FEDERAL SECTOR WITH VIGOROUS ECONOMIC GROWTH

	1979	1980	1981	1982	1983
Real GNP Growth Rate (percent)	4.6	4.8	4.8	4.8	4.0
Unemployment Rate (percent)	6.3	5.8	5.3	4.8	4.5
Inflation Rate (percent)	6.0	5.8	5.5	5.6	5.8
Current Policy Outlays	494	528	563	603	651
Changes from Current Policy					
Five-year projection of defense spending	0	1	0	1	1
Major welfare reform b/	5	9	12	17	18
Urban policy initiative	0	6	8	10	12
Other changes	7	4	9	6	13
TOTAL OUTLAYS	506	548	592	637	695
Current Policy Revenues	460	528	606	692	777
Available for Tax Cuts Below Current Policy	27	45	70	92	99
TOTAL REVENUES	433	483	536	600	678
DEFICIT (-) OR SURPLUS	-73	-65	-56	-37	-17

a/ Detail may not add to totals because of rounding.

b/ Some increased federal spending is offset by decreased state and local spending.

SUMMARY TABLE 4. BUDGET IV—LARGER FEDERAL SECTOR WITH RAPID ECONOMIC GROWTH a/

	1979	1980	1981	1982	1983
Real GNP Growth Rate (percent)	4.6	4.8	4.9	5.0	5.0
Unemployment Rate (percent)	6.3	5.8	5.3	4.8	4.2
Inflation Rate (percent)	6.0	5.9	5.5	5.7	6.0
Current Policy Outlays	494	528	564	606	657
Changes from Current Policy					
Five-year projection of defense spending	0	1	0	1	1
Catastrophic health insurance plus federalized medicaid b/	0	0	20	24	27
Major welfare reform b/	5	9	12	17	18
Urban policy initiative	0	6	8	10	12
Other changes	7	15	25	41	67
TOTAL OUTLAYS	506	559	629	699	782
Current Policy Revenues	460	528	617	694	788
Available for Tax Cuts Below Current Policy	27	27	27	27	27
TOTAL REVENUES	433	501	590	667	761
DEFICIT (-) OR SURPLUS	-73	-58	-39	-32	-21

a/ Details may not add to totals because of rounding.

b/ Some increased federal spending is offset by decreased state and local spending.

CHAPTER I. FISCAL NEEDS AND CONGRESSIONAL GOALS

As the Congress faces the task of formulating the federal budget for fiscal year 1979, the Congressional Budget Office submits this report to provide a framework for considering the major challenges and opportunities that lie ahead. The discussion is not limited to the budget for fiscal year 1979, however, because few of the goals the Congress may wish to pursue through its budgetary policies can be achieved in a single year.

Reaching certain goals will require the adoption of a series of consistent budgets. Lowering the rates of inflation and unemployment, changing the size or composition of federal spending or the structure of federal taxes, or eliminating the federal deficit can be accomplished only in steps. Decisions on the fiscal year 1979 budget should, therefore, be regarded as part of a general budgetary strategy for the next several years.

WHERE DO CURRENT POLICIES HAVE US HEADED?

A discussion of alternative long-range budgetary policies can begin with the question: What would happen to the federal budget if current policies were simply continued into the future? The answer, of course, depends on what happens to the economy. If the economy continues to recover at approximately the rates assumed in the conference report on the Second Concurrent Resolution on the Budget for Fiscal Year 1978--at least until the unemployment rate reaches 4.5 percent--and inflation declines slowly (see Table 1), estimated receipts would increase from about $460 billion in fiscal year 1979 to about $777 billion in fiscal year 1983--that is, from 19 to 23 percent of the potential Gross National Product (GNP). 1/ Outlays would rise from about $494 billion in fiscal year 1979 to about $651 billion in fiscal year 1983, declining from 21 to 19 percent of potential

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1/ This projection includes the effects of the social security tax legislation passed after the Second Concurrent Resolution on the Budget for Fiscal Year 1978.

TABLE 1. AGGREGATE ECONOMIC ASSUMPTIONS: BY FISCAL YEARS AND CALENDAR YEARS

Selected Economic Variables	1977	1978	1979	1980	1981	1982	1983
Gross National Product (GNP)							
Current dollar GNP (billions of dollars)							
Fiscal year	1,841	2,057	2,274	2,519	2,783	3,079	3,386
Calendar year	1,890	2,107	2,334	2,582	2,854	3,156	3,465
Real GNP (billions of 1972 dollars)							
Fiscal year	1,319	1,387	1,451	1,520	1,593	1,670	1,736
Calendar year	1,338	1,403	1,468	1,538	1,612	1,688	1,751
Growth rate of real GNP (percent)							
Fiscal year	4.9	5.2	4.6	4.8	4.8	4.8	4.0
Calendar year	4.9	4.8	4.7	4.8	4.8	4.7	3.7
Unemployment Rate (percent)							
Fiscal year	7.3	6.7	6.3	5.8	5.3	4.8	4.5
Calendar year	7.0	6.5	6.2	5.7	5.2	4.7	4.5
Consumer Price Index (percent change)							
Fiscal year	6.1	6.0	6.0	5.8	5.5	5.6	5.8
Calendar year	6.5	5.6	6.0	5.7	5.5	5.7	5.9

GNP. The disproportionate rise in receipts as compared with outlays is due largely to already scheduled increases in social security taxes and to the rapid rate at which the progressivity of the individual income tax raises receipts as GNP grows. 2/

OFFSETTING THE FISCAL DRAG

Not only does the economy affect the budget, the budget also affects the economy. Consequently, these projected current-policy revenues and expenditures are not consistent with the objectives for economic growth set in the Second Concurrent Resolution on the Budget for Fiscal Year 1978. If present policies were actually followed without change for the next five years, the federal budget would exert a restrictive influence on the economy. This is because, with incomes rising and inflation high, the government's receipts grow much faster than do the outlays that are put back into the economy in the form of wages, purchases, and benefit payments. Thus, if the level of unemployment is to be lowered significantly during the next five years, the government will have to counteract this restrictive effect (sometimes called "the fiscal drag") by cutting taxes or raising spending relative to the levels under current policy. Table 2 shows the range of expenditure increases or tax cuts that would produce a continuation of the growth objectives set in the Second Concurrent Resolution on the Budget for Fiscal Year 1978. (The current policy outlay projections are divided into the major components of the budget in Table 3.)

The total dollar amount of fiscal action required to meet the output and unemployment goals ("Fiscal Drag Offset" in Table 2) could vary, depending on which items in the budget were altered to meet the needs of fiscal policy. Generally speaking, purchases of goods and services have more impact per budget dollar on output and employment than do broadly based tax cuts or increases in income support programs. That is because purchases of goods and services directly generate economic activity. Among the spending programs, public employment tends to have more

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2/ More details are given here in Table 2 and in Five-Year Budget Projections: Fiscal Years 1979-1983, CBO Report (December 1977).

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TABLE 2. FIVE-YEAR BUDGET PROJECTIONS, INCLUDING EFFECTS OF CONFERENCE AGREEMENT ON SOCIAL SECURITY: BY FISCAL YEARS, IN BILLIONS OF DOLLARS a/

	1978 Second Concurrent Resolution	Projections				
		1979	1980	1981	1982	1983
Current Policy Receipts	397.00	460	528	606	692	777
Current Policy Outlays	458.25	494	528	563	603	651
Current Policy Margin b/	-61.25	-34	--	43	88	126
Fiscal Drag Offset b/	c/	34 to 41	55 to 67	82 to 99	107 to 128	120 to 145
Deficit (-) or Surplus b/	-61.25	-68 to -75	-55 to -67	-39 to -56	-19 to -40	+ 6 to -19

a/ Details may not add to totals because of rounding.

b/ The current policy margin is the difference between current policy receipts and current policy outlays that would develop if the economic assumptions (targets) of Table 1 were realized. The fiscal drag offset indicates a rough estimate of the amount by which expenditures would have to be increased (low end of range) or taxes cut (high end of range) to keep the economy on the growth path set out in Table 1 if the nonfederal demand were "moderate." As long as the current policy margin is less than the fiscal drag offset, the budget remains in deficit.

c/ It is assumed that the spending ceiling and revenue floor in the second concurrent resolution are consistent with the fiscal stimulus needed for the economy to grow at the rate of 4.8 percent in fiscal year 1978. If more or less fiscal stimulus is required, corresponding adjustments would have to be made in the estimates of the fiscal drag offset for fiscal years 1979-1983.

impact on jobs than do other instruments of fiscal policy. Specially designed tax changes, however, such as the investment tax credit, can have powerful effects on output and jobs after a lag of one or two years.

To illustrate this phenomenon, Table 2 sets out ranges for the fiscal drag offsets and the resulting surpluses or deficits. The lower ends of the ranges are derived under the assumption that only increased expenditures will be utilized to offset the fiscal drag, while the higher ends of the ranges follow from the assumption that only tax cuts will be used for this purpose. It is assumed that spending increases will be spread across programs to retain the current balance among types of expenditures. It is also assumed that tax cuts will occur so that all current types of taxes will be lowered by the same percentage.

As Table 2 shows, a strategy to reach economic targets that relies solely on reducing receipts would require tax cuts that would cause revenues in fiscal year 1983 to reach an amount $145 billion lower than would be attained under current policy. In contrast, a plan depending only on increased outlays would require $120 billion more in expenditures than is projected under current policy. Thus, the deficits would be slightly lower if the fiscal drag were offset through expenditures. These two illustrative strategies would also affect the size of the federal share of the economy--with the tax cut option causing the federal share of potential GNP to fall to 19.3 percent by fiscal year 1983 and the expenditure option causing this figure to rise to 23.1 percent.

The extent to which the Congress elects to offset the fiscal drag, either by increasing spending or cutting taxes, depends on the relative importance it accords to two objectives: maintenance of rapid economic growth and avoidance of inflation. The larger the increase in spending or the cut in taxes, the better the chances that growth will be rapid and that unemployment will decline--but the greater the risk of accelerating inflation.

The estimated sizes of the tax cuts or expenditure increases needed to keep the economy growing at the desired rate also depend partly on forces that are beyond the Congress' control: that is, the strength of the nonfederal sector of the economy. The vitality of private consumption, business investment, state and local government spending, and net exports cannot be predicted accurately. Some assumptions must be made; those made in this report are that the nonfederal sectors will perform

TABLE 3. MAJOR COMPONENTS OF BUDGET OUTLAY AND REVENUE PROJECTIONS, BY FISCAL YEARS

Major Component	1977 Estimate	1978 Second Concurrent Resolution	Current Policy Projections 1979	1980	1981	1982	1983
OUTLAYS							
In Billions of Dollars							
National Defense	97	110	119	128	139	150	161
Contributory Benefit Payments for Individuals	136	148	160	175	192	210	234
Other Benefit Payments for Individuals	46	49	53	57	60	64	68
Grants to State and Local Governments	47	57	57	58	58	60	63
Net Interest	30	33	37	39	41	42	42
Other Federal Operations	47	62	68	72	73	77	82
TOTAL OUTLAYS	402	458	494	528	563	603	651
As a Percent of Total Outlays							
National Defense	24	24	24	24	25	25	25
Contributory Benefit Payments for Individuals	34	32	33	33	34	35	36
Other Benefit Payments for Individuals	11	11	11	11	11	11	10
Grants to State and Local Governments	12	12	12	11	10	10	10
Net Interest	7	7	7	7	7	7	6
Other Federal Operations	12	13	14	13	13	13	13
TOTAL OUTLAYS	100	100	100	100	100	100	100
As a Percent of Potential GNP							
TOTAL OUTLAYS	22	21	21	20	20	20	19

(continued)

TABLE 3. (CONTINUED)

Major Component	1977 Estimate	1978 Second Concurrent Resolution	Current Policy Projections 1979	1980	1981	1982	1983
		REVENUES					
	In Billions of Dollars						
Individual Income Taxes	157	175	213	150	290	338	389
Corporate Income Tax	55	59	67	76	86	95	106
Social Insurance Taxes and Contributions	109	124	140	158	184	209	230
Other Taxes and Receipts	36	39	40	44	46	50	52
TOTAL REVENUES	357	397 a/	460	528	606	692	777
	As a Percent of Total Revenues						
Individual Income Taxes	44	44	46	48	48	49	50
Corporate Income Tax	15	15	15	14	14	14	13
Social Insurance Taxes and Contributions	31	31	30	30	30	30	30
Other Taxes and Receipts	10	10	9	8	8	7	7
TOTAL REVENUES	100	100	100	100	100	100	100
	As a Percent of Potential GNP						
TOTAL REVENUES	19	19	19	20	21	22	23

NOTE: Details may not add to totals because of rounding.

a/ The Second Concurrent Resolution on the Budget for Fiscal Year 1978 assumed energy legislation would add $1.1 billion in receipts in fiscal year 1978.

slightly above historical norms. But the Congress must stand ready to alter its budgetary policy if these assumptions prove too optimistic or too pessimistic, or if other, unpredicted events occur.

Unless nonfederal demand is unprecedentedly strong during the next five years, major new spending programs or tax reductions will be necessary to maintain economic growth at a rate high enough to provide jobs for a growing labor force. This is a safe assertion to make, despite so many uncertainties. What combination of increased expenditures or lowered taxes the Congress chooses will depend not only on how the Members weigh economic growth against the risk of inflation, but also on how they balance desires for new programs, or expansions of current programs, against the wish to limit the role of government. Considerable pressures work in both directions.

This chapter reviews some of the major claims for additional spending and summarizes briefly some of the arguments for and against taking on such expenditures. 1/ In each case, cost is an important negative argument; a major function of any budget, and of this document analyzing multiyear budgeting, is to show the trade-offs between the costs of any program and those of other programs or tax cuts. In addition to proposals that would involve increased expenditures, therefore, this report also reviews some possible ways of reducing the budget over the next several years.

MAJOR PROGRAMMATIC CLAIMS

Welfare Reform

Reform of the nation's welfare system has been a long-standing concern in the Congress. Recently, the Carter Administration submitted a proposal for comprehensive reform--the Program for Better Jobs and Income. The Administration's plan calls for replacing several state and federal assistance programs with a uniform cash assistance program, an expanded earned income tax credit, and an expanded public service employment program for families with children. The third of these proposals would provide up to 1.4 million jobs in fiscal year 1981. In addition, efforts to get welfare recipients into private jobs would be meshed with the public jobs program. If this proposal were adopted in 1978, it could raise federal welfare costs above those incurred under current policy by more than $18 billion by fiscal year 1983.

The case for comprehensive welfare reform rests on a perception of faults in the present set of welfare programs. Critics argue that the existing programs exclude many poor people,

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1/ A series of published or forthcoming CBO Budget Issue Papers and Background Papers examine major issues and costs in detail. See the note on page ii.

particularly those in intact families headed by low-income wage-earners, and that this situation has created inequities among families with similar needs. The current programs, their detractors maintain, encourage potential earners to stay out of the job market and offer incentives for families to break up in order to qualify for assistance.

In addition, proponents of comprehensive reform argue that the in-kind programs, such as food stamps, that make up part of the current welfare system force recipients to spend in a certain way rather than allowing them to meet their own greatest needs through straight cash assistance. And finally, advocates of comprehensive reform argue that the current system of several separate programs is administratively inefficient and incomprehensible to welfare workers and recipients alike.

Arguments on the other side--against comprehensive reform--begin with its high cost. Going further, most critics of this approach contend that it would expand the welfare rolls, in particular, with able-bodied males who, some feel, should not receive public assistance. In addition, there are claims that substituting cash for in-kind assistance would lead to irresponsible spending of assistance payments on the part of recipients.

A more specific argument against the President's proposed reform is that the joint public/private jobs portion of the proposal is untested and thus potentially cumbersome to administer. Proponents of this view fear that this proposal, if implemented, might collapse, thus discrediting the whole program of jobs and cash assistance. It is also alleged that the program's combination of jobs and cash assistance is so complicated that it would be difficult to administer.

These arguments against comprehensive welfare reform have led to proposals for much more modest and less costly changes in individual welfare programs. One example of such an "incremental" approach is the change in eligibility for food stamps passed by the Congress last year. Other examples include such proposals as the Public Assistance Amendments of 1977 (H.R. 7200), which would lower the burden of welfare costs on states and localities by altering one or more existing welfare programs.

Cost estimates both for the President's comprehensive reform proposal and for a bundle of incremental reforms appear in Table 4. Although the table shows only cost-adding reforms, the reader should note that there are other proposals that would cut federal welfare costs.

TABLE 4. NET COST CHANGES RESULTING FROM WELFARE REFORM PROPOSALS: BY FISCAL YEARS, IN BILLIONS OF DOLLARS

	1979	1980	1981	1982	1983
The Administration's Welfare Reform Proposal (H.R. 9030)					
Federal	5.4	9.4	11.7	17.4	18.4
State and local	0	0	0	-3.4	-3.6
TOTAL	5.4	9.4	11.7	14.0	14.8
Incremental Option a/					
Federal	4.3	4.7	5.1	5.6	6.1
State and local	-3.0	-3.3	-3.5	-3.9	-4.2
TOTAL	1.3	1.4	1.6	1.7	1.9

a/ The combination of federalized Aid to Families with Dependent Children (AFDC) and food stamp bonus value equal to 75 percent of poverty-line income. See Welfare Reform: Issues, Objectives, and Approaches, CBO Background Paper (July 1977), pages 59-65.

Defense Spending

In recent years, the Soviet nuclear force's improved capabilities and growth have raised fears that the Soviets might be able by sometime in the latter half of the 1980s to launch an attack that would destroy most of the U.S. Minuteman missile force. Moreover, the aging of the Polaris and Poseidon missile-launching submarines and the possibility that the B-52 bombers might be unable to penetrate improving Soviet air defenses have aroused concern.

This year, the Congress will face funding requests for several programs that address these threats. If the Congress votes funds for full-scale development in fiscal year 1979, the MX missile, a more accurate and powerful intercontinental ballistic missile (ICBM) that would move at random in underground trenches 10 to 12 miles long or among several protective shelters above ground, could be available for deployment in the mid-1980s. The Trident II missile, a submarine-launched ballistic missile that could be carried in the large missile tubes of the Trident submarines now under construction, could be available shortly after the MX missile. The Trident II offers an additional option to improve the accuracy and increase the destructive power of the U.S. strategic nuclear forces. In the wake of the decision to cancel the B-1 bomber, programs are underway to equip B-52s with cruise missiles and possibly to adapt a wide-bodied commercial transport aircraft to the role of a launcher for the cruise missile.

Neither the MX nor the Trident II is proposed for full-scale development in the Administration's budget request for fiscal year 1979. The B-52 cruise missile program is proceeding, but the specialized carrier is still in the early stages of design. Decisions to speed up or slow down these programs will rest on several considerations: whether the United States should increase its capability against Soviet silos in response to growing Soviet capability against U.S. missile silos; whether the United States wishes to pose a threat to Soviet land-based missiles as great as the MX and Trident II can offer; and whether it will be necessary in the 1980s to retain a strategic nuclear force of three independent components--based on land, in submarines, and carried in aircraft.

Of even greater importance to the budget over the next five years are decisions on the role of U.S. general purpose forces in the defense of NATO Europe. In considering forces for the defense of NATO's Central Front--roughly the eastern border of West Germany--one must keep in mind that the United States is only part of an alliance, contributing about one-quarter of the troops and tactical air forces that would be deployed along the Central Front at the beginning of a war. Therefore, the size, location, and capability of allied forces are important considerations in determining appropriate changes in the U.S. posture. In general, British, Belgian, and Dutch forces deployed along the northern part of the Central Front are less well equipped than the U.S. and West German forces in the south. An important choice for the United States is whether to offset this imbalance in strength between north and south, and if so, how.

In May 1977, the Administration--along with other NATO governments--agreed to raise defense spending by 3 percent per year in real terms. As can be seen in Table 5, 3 percent real growth in total defense spending could result in increases of about $22 billion above current policy by 1983.

TABLE 5. COSTS OF ALTERNATIVE DEFENSE PROGRAMS: BY FISCAL YEARS, OUTLAYS IN BILLIONS OF DOLLARS

	1979	1980	1981	1982	1983
3 Percent Real Growth of DoD Military Spending	121	134	149	166	183
Fiscal Year 1979 Submission, Five-Year Projection	118	129	139	151	162
Current Policy	119	128	139	150	161

The Administration's budget request contains a proposal to begin to preposition equipment and supplies for three U.S. Army divisions in the north of Germany and to continue procurement--at somewhat lower rates than planned earlier--of tanks, tactical aircraft, and other materiel apparently intended to improve U.S. capability in a NATO war. As Table 5 shows, this plan would not result in substantial growth of the budget above the levels under current policy.

Health Care

Pressure to establish some sort of national health insurance system continues, but there is not yet agreement on the desired system's nature and magnitude. Debate now centers on such basic questions as what share of national resources should be devoted to health-care services, how great an effect increased national spending would have on health status, and how a major health-care initiative might affect health-care costs. Even among those who favor some form of national health insurance, disagreement exists on such issues as the scope of the benefits, the sources of financing, and the type of administration.

A comprehensive, federally funded system that encompassed most hospital, physician, and nursing services, and some dental and mental health care might add as much as $150 billion to the federal budget. Imposing patient cost sharing requirements or strict controls on the use of services would reduce the federal cost somewhat. Even so, the magnitude of such a program would exceed that contemplated in any other area of federal spending.

Proponents of this sort of system argue that much of the federal cost would represent a shift in current health-care spending from private to public responsibility rather than an increase in the portion of national income allocated to health. Indeed, they contend that the rapid rise in private and public health-care costs might best be curbed by channeling most health-care spending through the federal government. On the opposite side, opponents maintain that a wholly tax-financed system would encourage excessive demand and that administrative mechanisms would be ineffective in containing costs. Still other critics argue that so large a shift from private to public spending would be inimical to the U.S. economy and to society as a whole.

While questions about the degree of federal involvement either in financing or in administering health care remain unresolved, the various streams of opinion converge on the need to phase in changes. A federally funded, comprehensive system would have to be implemented in stages. Accommodating the costs in the budget, giving the health-care system time to adjust to changed patterns of demand, and establishing the necessary administrative structure all must be done in steps. Proposals that envision a more modest federal role in financing or that just fill gaps in existing insurance coverage, of course, are incremental by nature.

Few disagree with the notion that all people should have adequate financial access to the health care they need, or that they should be protected from the disastrous effects that high medical expenses can have. Two incremental changes designed to address these goals are the provision of catastrophic health insurance and what is termed the "federalization" of medicaid, the federal/state health program for the poor. There are several ways to accomplish either change. For example, insurance could be provided against catastrophic medical expenses defined either as high dollar expenses or as expenses that are high relative to income. Alternatively, protection could be offered to people with diseases known to demand prolonged and costly medical treatment, such as chronic kidney failure. A premium and tax-financed catastrophic plan protecting against high dollar expenses (such as expenses of hospital care after 60 days and other medical expenses in excess of $2,500) would cost the federal government an estimated $13 billion in 1983 (see Table 6).

To federalize medicaid by establishing uniform eligibility requirements to cover all the poor and by setting national minimum benefit levels would add $13.6 billion in federal outlays in 1983. (This estimate assumes the continuation of state funding responsibility.)

TABLE 6. FEDERAL COSTS OF INCREMENTAL HEALTH INSURANCE PROPOSALS: BY FISCAL YEARS, OUTLAYS IN BILLIONS OF DOLLARS

	1979 a/	1980 a/	1981	1982	1983
Catastrophic Health Insurance	0	0	9.1	11.5	13.1
Federalized Medicaid (Federal/State Financed) b/	0	0	10.5	12.0	13.6
TOTAL	0	0	19.6	23.5	26.7

a/ The first year of operation is assumed to be 1981.

b/ This level of expenditures is based on the assumption that the catastrophic health insurance proposal is implemented along with the federalization of medicaid. The expenditure stream for 1981 through 1983 for federalized medicaid alone is $12.6, $14.4, $16.3 billion.

Urban Programs

Numerous proposals to extend aid of various kinds to U.S. cities have been made in the Congress. Plans range from major attempts to rebuild decaying city centers to modest ones aimed at improving schools in areas with high concentrations of disadvantaged children. The Administration has indicated that it is reviewing new proposals as well as existing federal programs that affect cities in preparation for the development of a comprehensive urban policy. A Presidential statement is expected in March of this year; details of proposed programmatic and budget changes are not available at this time.

As the shape of the urban initiative emerges, a number of issues are bound to surface. Should funds be targeted on older, declining cities at the risk of ignoring small-scale but serious problems in newer, growing cities? Should the major focus of federal efforts be on providing opportunities for the poorest people, stimulating private sector investment in central city areas, or assisting local governments to provide needed services? And which governmental tools are likely to be most effective--loans, grants, or tax incentives?

Even when the specifics of the President's proposal become available, estimating its cost may be difficult. 2/ Many variables must be taken into account. Cost estimates will have to incorporate savings that might be induced in other programs. They must allow for the increased tax receipts that would result from a successful revitalization of cities. Also, the President's proposed urban policy may rely upon other programs that are already existing or proposed. The public service jobs program in the inner city, for instance, may overlap with the jobs portion of the Administration's comprehensive welfare reform proposal. Where such overlap occurs, the costs should not be counted twice.

2/ The cost estimates used in Table 14 are based on a hypothetical program that starts at zero in fiscal year 1979 and grows to $12 billion in fiscal year 1983. Such an estimate could cover any number of possible, fairly expensive programs.

OTHER PROGRAM INITIATIVES

Almost every Member of the Congress can point to ongoing programs that he feels deserve more funding. In the context of a half-trillion dollar budget, most of these proposed increases seem quite modest. But a series of small increases, when combined, can total to a significant rise in expenditures. For example, if budget outlays were to continue growing by an average of 10 percent per year (as they have for the last ten years), by fiscal year 1983 total outlays would be $733 billion, $82 billion above the estimated current policy level.

More generally, if the various contributory benefit payments to individuals rose at a rate 2 percent per year faster than assumed under current policy, keeping pace with the growth of wages rather than just rising with prices, outlays in fiscal year 1983 would rise by about $20 billion. A similar increase of 2 percent per year above current policy would raise grants to state and local governments by about $5 billion. If the Congress allowed small increases in many programs, it could lose the chance to achieve its economic goals while initiating major programs or tax cuts. Multiyear budgeting could help focus attention on this danger.

POSSIBLE TOTAL INCREASES

The foregoing brief list of possible new initiatives is clearly incomplete. Nothing has been said about energy, for example, or about transportation, space exploration, or agriculture. But the few items discussed do illustrate the point that proposals now under serious discussion could easily add $100 billion to federal spending by fiscal year 1983, even without comprehensive national health insurance.

To summarize, the figure of $100 billion breaks down roughly as follows:

Welfare reform	$18 billion
Defense spending (3 percent real growth per year)	$22 billion
Catastrophic health insurance and federalized medicaid	$27 billion
New urban policies	$12 billion
Other increases	$21 billion

POSSIBLE CUTS

Cutting federal spending is clearly more difficult than increasing it. That is why most proposals attempt to hold the line on increases by constraining federal spending to the current policy level. Because the Gross National Product is projected to grow at a faster pace than are current policy expenditures, such a strategy, while not effecting cuts in individual programs, will reduce the federal share of the economy.

Nonetheless, opportunities to cut do exist. For example, the Second Concurrent Resolution on the Budget for Fiscal Year 1978, which the Congress passed in September 1977, contemplates one major cut: the Hospital Cost Containment Act of 1977 (S. 1391) as ordered reported by the Senate Human Resources Committee. Although the act has not been passed, if it is passed and is implemented in fiscal year 1979, the federal savings could reach an estimated $10.6 billion in fiscal year 1983 (Table 7). 3/

TABLE 7. ESTIMATED SAVINGS TO MEDICARE AND MEDICAID FROM HOSPITAL COST CONTAINMENT: OUTLAYS IN BILLIONS OF DOLLARS

	1979	1980	1981	1982	1983
Savings in Medicare	2.6	4.0	5.9	8.3	9.6
Savings in Medicaid	0.2	0.4	0.6	0.9	1.0
TOTAL	2.8	4.4	6.5	9.2	10.6

3/ The estimated hospital cost containment savings set out in Table 7 were assumed in the Second Concurrent Resolution on the Budget for Fiscal Year 1978. Therefore, these savings

Many observers cite the act as not only a way to cut outlays for health, but also as a way to encourage more efficient use of resources in hospitals, where, critics argue, lack of appropriate incentives (partly attributable to federal programs) has promoted the growth of duplicative and unnecessarily complex facilities.

The opportunity to achieve cuts in current programs might arise as new ones are added. Thus, for example, some observers might feel that the enactment of an incremental welfare reform option that would federalize the state cost of Aid to Families with Dependent Children (AFDC) would allow the Congress to eliminate the state share of the general revenue sharing program. Similarly, an increase in federal funding for elementary and secondary education might permit a phasing out of all or part of the School Assistance in Federally Affected Areas program (called "impact aid").

Expenditures could also be held down by refusing to grant discretionary increases for inflation. In fiscal year 1983, for example, $7.7 billion could be saved by holding most state and local grant programs to current funding levels without allowances for inflation. A series of these cutbacks could have a significant effect on the share of the budget going to different types of activities. The series of changes illustrated in Table 8 would have the effect of lowering by two percentage points the portion of the budget designated to aid state and local governments in fiscal year 1983.

Changes in Defense Department manpower policies could affect additional reductions. Programs designed to diminish the fraction of the armed forces engaged in training, to encourage reenlistment, to make military pay fully taxable, and to reform the department's civilian pay practices could save $2.5 billion a year by 1983. Reform of the military retirement system would not bring about major savings during the next five years; but farther in the future, the effects of reform could be quite significant, cutting outlays by as much as $2 billion per year.

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included in the current policy projection (base) used in this report and set out in Five Year Budget Projections: Fiscal Years 1979-1983: Technical Background, CBO Report Supplement (January 1978), page 76.

TABLE 8. POSSIBLE REDUCTIONS IN OUTLAYS FROM CURRENT POLICY FOR SELECTED STATE AND LOCAL GRANT PROGRAMS: BY FISCAL YEARS, IN BILLIONS OF DOLLARS

	1979	1980	1981	1982	1983
Eliminate State Share of General Revenue Sharing and Hold at Current Law Levels	—	—	2.6	3.1	3.7
Limit LEAA's Responsibility to Research a/	0.1	0.5	0.7	0.7	0.8
Eliminate "Impact Aid" (Education)	0.9	0.9	1.1	1.1	1.1
Hold Other Grant Programs at Current Levels (No Increases for Inflation)	0.6	1.9	3.5	5.3	7.7
TOTAL	1.6	3.3	7.9	10.2	13.3

a/ Law Enforcement Assistance Administration.

Finally, the Congress can reduce the federal budget by cutting certain programs down or out entirely. The former possibility is inherent in the zero-base budgeting techniques being promoted throughout the Executive Branch. The so-called "Sunset Laws" proposed in the Congress are intended to facilitate intensive review of programs that could result in either trimming or complete cutting.

TAX REDUCTIONS AND REFORM

Support for offsetting the fiscal drag (discussed in Chapter I) by means of major tax reductions grows largely out of two perceptions: that a general reduction in the size of the federal government is desirable, and that there is a specific need to offset the recently enacted social security tax increases and the effects of inflation on the income tax. By fiscal year 1983, the social security tax increase just passed will yield on the order of $27 billion extra in federal revenues. These increased revenues are likely to have a depressing effect on the economy that probably will have to be offset by lowering other taxes. If the Congress votes major new tax increases as part of a comprehensive energy program, the need for tax cuts could be further intensified.

The need for large tax cuts during the next five years will require the Congress to make a number of decisions concerning the existing tax structure and the distribution of the total tax burden. The Congress could, for example, seek to provide most of the needed tax relief through reductions in personal income tax rates. Alternatively, reductions could be achieved through lower corporate and business taxes or by some combination of personal and business tax cuts.

The President has proposed a net tax cut of some $25 billion for fiscal year 1979. The principal features of his plan are a new $240 personal tax credit, reductions in personal and corporate tax rates, and more generous provisions for investment tax credits. Table 9 shows the effects of the President's proposal on federal revenues for the next five years. During the next five years, the President's proposal (as compared to current policy) would reduce somewhat the portion of total federal revenues coming from personal income taxes and from corporate taxes. If the Congress chose to alter the distribution of the tax burden during this period, it could adopt tax reductions different from those proposed by the President. Larger rate reductions could be enacted, of course, if bigger tax cuts were desired.

The Congress will not only face choices about the distribution of tax cuts between individual and corporate taxpayers. It will also have to decide how cuts should be distributed among taxpayers with different incomes. The President's tax reduction and reform proposals would result in a net tax reduction for most individual taxpayers with incomes below $100,000, but the overwhelming bulk of the reductions (94 percent) would be concentrated on persons with incomes below $30,000. Of the net reduction, three-fourths would go to taxpayers with incomes between $10,000 and $30,000--a group that makes up 43 percent of all taxpayers and pays 55 percent of current taxes.

TABLE 9. SUMMARY OF REVENUE EFFECTS OF PROPOSED INCOME TAX REDUCTIONS, TAX REFORMS, AND TELEPHONE EXCISE AND UNEMPLOYMENT INSURANCE TAX REDUCTIONS: BY FISCAL YEARS, IN BILLIONS OF DOLLARS a/

	1979	1980	1981	1982	1983
Individual Income Tax					
Tax reductions	-22.5	-25.7	-29.2	-33.4	-38.5
Tax reforms	4.2	7.4	8.9	10.6	12.3
Net change	-18.3	-18.2	-20.3	-22.8	-26.2
Corporation Income Tax					
Tax reductions	-6.3	-9.4	-11.1	-11.8	-12.8
Tax reforms	1.1	3.0	4.3	5.0	5.2
Net change	-5.1	-6.4	-6.8	-6.8	-7.6
Telephone Excise and Unemployment Insurance Tax reductions	-1.6	-2.0	-1.6	-1.2	-1.1
Total	-25.0	-26.6	-28.6	-30.8	-34.9

SOURCE: U.S. Department of the Treasury.

NOTE: Details may not add to totals because of rounding.

a/ This table does not include the effects of the President's energy tax proposals or his proposals for waterway user taxes, airport and airway user taxes, or other smaller tax items. The totals are therefore different from those in receipts tables appearing in the The Budget of the United States Government, Fiscal Year 1979 and elsewhere.

In addition to proposals for general tax reductions, the Congress will be considering the President's tax reform proposals as well as other proposals for more specialized tax reform and relief. The President's program calls for the repeal of deductions of state sales and gasoline taxes, modifications of the medical and casualty expense deductions, and a number of limitations on tax shelters and other individual tax preferences.

The President also proposes a three-year phaseout of both the Domestic International Sales Corporation (DISC) export subsidy and the tax deferral on income of foreign subsidiaries of U.S. corporations. The Congress is also likely to consider proposals for additional specialized tax relief in the form of college tuition tax credits, employment tax credits, and similar tax expenditures.

A full evaluation of proposals for new tax expenditures and changes in existing tax expenditures requires that they be considered in the context of related direct expenditure programs. College tuition tax credits, for example, should be evaluated in the context of existing and proposed programs for direct grants and loans to middle-income families with children in college. 4/ Similarly, the President's proposal for simplifying and tightening the deduction for medical expenses can be looked at as a way of recasting the function of the deduction. As it now stands, the deduction serves as a form of insurance for a fraction of medical expenses--most of them "normal"; revised, the deduction would become a system that covers mainly severe, unusual, or "catastrophic" health expenses. Viewed in this way, it can be evaluated by the same health-policy standards that are applied to nontax proposals for catastrophic health insurance. As another example, the present new jobs tax credit, which is scheduled to expire at the end of this year, can be compared in terms of its cost and effectiveness to public service jobs and manpower training programs, which also come up for reauthorization this year.

These special tax subsidies or tax expenditures are similar in most respects to direct expenditure programs. They subsidize or encourage specific private sector activities, as do many direct expenditure programs, and some of them grow as rapidly as some direct expenditure programs would. Any attempt to formulate multiyear budget plans must therefore take into account these tax expenditures and their future-year effects. Table 10 shows the effects of some possible changes in tax expenditures during the next five years.

4/ See Federal Aid to Postsecondary Students: Tax Allowances and Alternative Subsidies, CBO Background Paper (January 1978).

TABLE 10. EFFECTS OF SELECTED CHANGES IN TAX EXPENDITURES: CALENDAR YEARS 1979-1983, IN BILLIONS OF DOLLARS

	1979	1980	1981	1982	1983
Phase Out DISC Tax Benefits	0.7	1.2	1.5	1.6	1.8
Phase Out Deferral of Taxes on Foreign Subsidiaries' Incomes	0.1	0.3	0.8	0.8	0.9
Modify Health and Casualty Expense Deduction	1.9	2.1	2.4	2.6	2.9
Extend New Jobs Tax Credit	-2.5	-2.6	-2.6	-2.6	-2.7
Tax Unemployment Insurance Payments to Higher-Income Beneficiaries	0.2	0.2	0.2	0.2	0.2
Establish College Tuition Tax Credit	-2.4	-2.4	-2.4	-2.5	-2.5

RESOURCES FOR PROGRAMS AND TAX CUTS

Economists used to warn the Congress that adding substantial new federal programs to the current policy base would require increases in tax rates. But with inflation running at 5 percent to 6 percent, increases in effective tax rates are automatic. Unless tax laws are changed or nonfederal demand is much stronger than it has been in recent years, the increases in expenditures needed to achieve even quite modest rates of economic growth would probably be large enough to accommodate most of the major new spending programs proposed for the next few years. Indeed, if the Congress chooses to seek fairly rapid economic growth but not to cut tax rates, even the adoption of all of these spending programs would fail to offset the fiscal drag; still larger increases in federal spending would be necessary.

But to hold tax laws constant and offset the fiscal drag entirely through increased federal spending would result in a federal sector that is much larger relative to GNP in the future than it is today. If federal expenditures are to be held at or below their current 21 percent share of potential GNP, a large portion of the needed economic stimulus will have to be provided through tax reductions rather than spending increases.

CHAPTER III. FOUR POSSIBLE BUDGETARY APPROACHES

To illustrate the points outlined in Chapters I and II, CBO has prepared four hypothetical five-year budgets. The first and second cut the federal share of potential GNP to 19.5 percent but vary the targets for economic growth, unemployment, and inflation. The third follows a strategy designed to achieve higher rates of growth than is achieved by the first two budgets In order to continue the economic growth assumed in the Second Concurrent Resolution on the Budget for Fiscal Year 1978. And the fourth increases growth and reduces unemployment rapidly by means of very large unrestricted increases in federal spending.

Of course, these are but four of an infinite number of five-year budgets. The relationship between the rates of economic growth and the increase or decrease of the federal share of the economy should be seen as being characteristic of these examples only. Large tax cuts, for example, could make possible the combination of a much smaller federal share of the potential Gross National Product and the achievement of rapid economic growth.

BUDGET I--SMALLER FEDERAL SECTOR WITH LOWER ECONOMIC GROWTH

The budgetary policy depicted in Table 11 is designed to shrink the fraction of potential GNP accounted for by federal spending from its current level of 21.4 percent down to 19.5 percent by fiscal year 1983. At the same time, such a policy would promote a continuing, moderate rate of economic growth. (In this illustration and in all the illustrations presented here, it is assumed that the level of nonfederal demand is vigorous, but not unprecedentedly so.) According to the budget shown in Table 11, inflation could be expected to drop from an estimated 6.0 percent in fiscal year 1978 to 5.1 percent in fiscal year 1983. This could be accomplished, however, only by slowing the rate of real economic growth to about 4 percent a year. This growth rate would be sufficient to alleviate unemployment only modestly--from 6.4 percent at present to about 5.6 percent in fiscal year 1983.

TABLE 11. BUDGET I--LOWER GROWTH WITH EXPENDITURES FALLING TO 19.5 PERCENT OF POTENTIAL GNP BY 1983: BY FISCAL YEARS, IN BILLIONS OF DOLLARS a/

	1979	1980	1981	1982	1983
Real GNP Growth Rate (percent)	4.3	4.0	4.0	4.0	4.0
Unemployment Rate (percent)	6.3	6.1	6.0	5.8	5.6
Inflation Rate (percent)	5.9	5.7	5.3	5.2	5.1
Current Policy Outlays	492	528	563	602	647
Changes from Current Policy					
3 percent real growth in defense spending	2	6	10	16	22
Incremental welfare reform b/	4	5	5	6	6
Subtotal	498	539	578	624	675
Spending Cuts Below Current Policy to Reach 19.5 Percent	6	14	20	23	25
TOTAL OUTLAYS	492	525	558	601	650
Current Policy Revenues	460	523	595	672	749
Tax Cuts Required Below Current Policy	35	50	76	93	98
TOTAL REVENUES	425	473	519	579	651
DEFICIT (-) OR SURPLUS	-67	-51	-38	-21	+2

a/ Details may not add to totals because of rounding.

b/ Some increased federal spending is offset by decreased state and local spending.

Reducing federal spending to 19.5 percent of potential GNP by 1983 severely restricts the growth of federal spending. In fact, for the five years shown in Table 11, federal outlays must be slightly below outlays under current policy. The average growth rate in outlays would be only slightly more than 7 percent, compared to an average growth rate of 10 percent during the past 10 years. This means that, if any new federal spending is to be undertaken, offsetting cuts will have to be made in already existing programs. Given the past difficulty in achieving large cuts in expenditures below current policy, only a modest increase in federal spending, such as that associated with an incremental reform of the current welfare system, can be included in this budget. Note that reductions of as much as $25 billion by fiscal year 1983 must be made in other programs in order to make room for these increases in spending.

Because federal spending is so restricted in this budget, most of the fiscal drag offset needed to produce even the relatively slow economic growth shown in the table derives from tax cuts. These amount to $35 billion in fiscal year 1979. Further cuts below current policy amounting to $63 billion are required between 1979 and 1983. Despite these large tax cuts, however, the federal deficit moves steadily toward surplus. A $67 billion deficit in 1979 becomes a $2 billion surplus five years later.

BUDGET II--SMALLER FEDERAL SECTOR WITH MODERATE ECONOMIC GROWTH

Restricting the size of the federal sector does not necessarily result in slow economic growth. Table 12 shows a budgetary policy that holds federal spending to the same low levels as in Budget I but produces more rapid economic growth--and a more rapid reduction in unemployment--by including larger tax cuts. Such a budget might be expected to result in real economic growth of 4.4 percent per year and to reduce unemployment to 5.0 percent by fiscal year 1983 (compared with 5.6 percent resulting from Budget I). This more rapid growth, however, will allow a smaller reduction in the inflation rate than in the first budget; the inflation rate will fall to 5.4 percent by 1983 rather than the 5.1 percent rate achieved in Budget I.

Federal spending rises no faster in this budget than in the first, and similar reductions in existing programs will be required to finance increased defense spending or welfare reform. The tax cuts needed to reach a higher rate of economic

TABLE 12. BUDGET II--MODERATE GROWTH WITH EXPENDITURES FALLING TO 19.5 PERCENT OF POTENTIAL GNP BY 1983: BY FISCAL YEARS, IN BILLIONS OF DOLLARS a/

	1979	1980	1981	1982	1983
Real GNP Growth Rate (percent)	4.4	4.4	4.4	4.4	4.4
Unemployment Rate (percent)	6.3	6.0	5.6	5.3	5.0
Inflation Rate (percent)	6.0	5.8	5.4	5.4	5.4
Current Policy Outlays	492	528	563	604	650
Changes from Current Policy					
3 percent real growth in defense spending	2	6	10	16	22
Incremental welfare reform b/	4	5	5	6	6
Subtotal	498	539	578	626	678
Spending Cuts Below Current Policy to Reach 19.5 Percent	6	14	20	25	28
TOTAL OUTLAYS	492	525	558	601	650
Current Policy Revenues	460	526	601	684	767
Tax Cuts Required Below Current Policy	44	64	89	109	122
TOTAL REVENUES	416	462	512	575	645
DEFICIT (-) OR SURPLUS	-76	-63	-46	-26	-5

a/ Details may not add to totals because of rounding.

b/ Some increased federal spending is offset by decreased state and local spending.

growth are larger than those called for in the first budget. A $44 billion decrease is needed in fiscal year 1979; by fiscal year 1983, the reduction required is $122 billion. Because tax cuts are larger in this budget and federal spending roughly the same, the budget deficits associated with this policy are larger than those of the first example. The budget shows the same tendency to move toward balance, however, with he deficit declining from $76 billion in fiscal year 1979 to $5 billion in 1983.

BUDGET III--SLIGHTLY SMALLER FEDERAL SECTOR WITH VIGOROUS ECONOMIC GROWTH

The set of budgets illustrated in Table 13 would lower federal spending only to 20.5 percent of potential GNP by fiscal year 1983 and could produce a faster reduction in unemployment at the price of more inflation. In this example, larger spending increases and tax cuts result in real rates of economic growth of 4.8 percent a year through fiscal year 1982 and a slower rate of 4.0 percent in fiscal year 1983. The reason for this slowing in the rate of economic growth is that, by 1983, the unemployment rate would be down to 4.5 percent (a level sometimes termed "full employment"), and if such rapid economic growth were to continue, strong inflationary pressures would be generated. As it is, the rate of inflation declines slightly in fiscal year 1981 but would begin to rise in 1982 and 1983.

By allowing federal expenditures to constitute a slightly larger share of potential GNP than in the first two budgets, more room becomes available in this example for new spending initiatives. By 1983, federal outlays can be $44 billion higher than the levels under current policy. This amount is sufficient to allow defense spending to grow at the rates projected in the Five Year Defense Plan submitted with this year's budget request and to allow both the implementation of the Administration's welfare reform program and a hypotheticcal urban policy initative. Even if these new programs were implemented, some room would be left for increases in other programs.

Federal outlays are higher in this third example than in Budgets I or II. These increased expenditures provide stimulus for more rapid economic growth and the tax cuts needed to maintain this growth are roughly equal to those needed in Budget I and less than those in Budget II. By fiscal year 1983, a reduction of some $99 billion would be required in Budget III. The

TABLE 13. BUDGET III—VIGOROUS ECONOMIC GROWTH WITH EXPENDITURES FALLING TO 20.5 PERCENT OF POTENTIAL GNP BY 1983: BY FISCAL YEARS, IN BILLIONS OF DOLLARS a/

	1979	1980	1981	1982	1983
Real GNP Growth Rate (percent)	4.6	4.8	4.8	4.8	4.0
Unemployment Rate (percent)	6.3	5.8	5.3	4.8	4.5
Inflation Rate (percent)	6.0	5.8	5.5	5.6	5.8
Current Policy Outlays	494	528	563	603	651
Changes from Current Policy					
Five-year projection of defense spending	0	1	0	1	1
Major welfare reform b/	5	9	12	17	18
Urban policy initiative	0	6	8	10	12
Other changes	7	4	9	6	13
TOTAL OUTLAYS	506	548	592	637	695
Current Policy Revenues	460	528	606	692	777
Available for Tax Cuts Below Current Policy	27	45	70	92	99
TOTAL REVENUES	433	483	536	600	678
DEFICIT (-) OR SURPLUS	-73	-65	-56	-37	-17

a/ Detail may not add to totals because of rounding.

b/ Some increased federal spending is offset by decreased state and local spending.

budget deficits generated by these tax cuts and expenditure increases are somewhat higher--especially in the later years of the five-year period--than in the first two hypothetical budgets.

The tax cuts shown in Budget III can be characterized by their likely effect on individual income tax rates. If the $99 billion cut were divided between business and personal taxes in roughly the same proportion as cuts have been divided in the past, one might expect that $70 billion of the cut would be in personal income tax. Cuts of approximately this magnitude might be accomplished in several ways, for example:

- By subtracting 5 percent tax points from each rate so that the rates would range from 9 to 65 percent instead of the current 14 to 70 percent; or

- By setting each rate at 80 percent of its previous level so that new rates would run from 11 percent to 56 percent.

Obviously, such changes are large enough to be perceptible to most taxpayers.

BUDGET IV--LARGER FEDERAL SECTOR WITH RAPID ECONOMIC GROWTH

A budget designed to lower the rate of unemployment to 4 percent by calendar year 1983 and then to maintain that level is illustrated in Table 14. To reach this goal, very rapid economic growth is needed, and large amounts of federal stimulus are necessary to produce this rapid growth. The price for this rapid growth, however, is higher inflation. Although the inflation rate might be expected to decline somewhat in 1981 and 1982, by 1983 it would return to about 6 percent. Because inflation usually lags behind economic growth, the worst of the inflation effects of this set of budgets would not appear until 1985 when the rate would reach 7.5 percent.

In Budget IV, no constraint is placed on the size of federal spending. For illustrative purposes, CBO's examples include many of the major new spending programs that have been suggested, as well as sizable increases in other, existing programs. These increases will result in a federal sector that would account for a slightly larger share of potential GNP in fiscal year 1983 (23.1 percent) than it does today (21.4 percent). Despite these large increases in federal spending, a sizable permanent tax cut is still required initially to bring about economic growth.

TABLE 14. BUDGET IV—RAPID ECONOMIC GROWTH WITH EXPENDITURES RISING TO 23.1 PERCENT OF POTENTIAL GNP BY 1983: BY FISCAL YEARS, IN BILLIONS OF DOLLARS a/

	1979	1980	1981	1982	1983
Real GNP Growth Rate (percent)	4.6	4.8	4.9	5.0	5.0
Unemployment Rate (percent)	6.3	5.8	5.3	4.8	4.2
Inflation Rate (percent)	6.0	5.9	5.5	5.7	6.0
Current Policy Outlays	494	528	564	606	657
Changes from Current Policy					
Five-year projection of defense spending	0	1	0	1	1
Catastrophic health insurance plus federalized medicaid b/	0	0	20	24	27
Major welfare reform b/	5	9	12	17	18
Urban policy initiative	0	6	8	10	12
Other changes	7	15	25	41	67
TOTAL OUTLAYS	506	559	629	699	782
Current Policy Revenues	460	528	617	694	788
Available for Tax Cuts Below Current Policy	27	27	27	27	27
TOTAL REVENUES	433	501	590	667	761
DEFICIT (-) OR SURPLUS	-73	-58	-39	-32	-21

a/ Details may not add to totals because of rounding.

b/ Some increased federal spending is offset by decreased state and local spending.

CHAPTER IV. THE BENEFITS OF ADVANCE TARGETING

The hypothetical budgets outlined in Chapter III represent only a sampling of the options available to the Congress. While great uncertainty is attached to all the estimates upon which they are based, the examples do illustrate the range of choices. They also show how, in a five-year perspective, choices of one goal or policy constrain the possibilities of pursuing other goals. Comparison of the four budgets suggests the following general observations:

- o In order to get to an economic path with significant declines in unemployment, major tax cuts or increases in expenditures--or both--will be required;

- o Any economic path with significant economic growth will generate enough revenue to pay for most of the new program initiatives now under discussion, unless the Congress wishes to reduce the federal share of GNP;

- o If the Congress does wish to cut the share of GNP going to the federal government, then new initiatives will have to be limited or financed by cutbacks in current programs, and the fiscal drag offsets will have to be accomplished mostly through general tax cuts.

THE NEED TO LOOK AHEAD

CBO's hypothetical budgets point to a need for the Congress to look and plan ahead. To achieve economic and programmatic goals through the budget process, the Congress must realize that current decisions may limit the possibility of realizing goals that can only be attained over a period of years. It also has to determine how much modification in present policy would be needed in order to achieve these goals.

So long as Congressional budgeting retains its current single-year perspective, changing national policy and keeping present decisions consistent with future goals will be difficult. Three factors account for this difficulty. First, changing the budget dramatically in a single year is neither possible nor desirable. Second, decisions that have small effects in the short run often have major effects in later years. And third, because of the first two factors, and because the budget and the economy interact, the achievement of most Congressional goals requires a sequence of actions over several budgets.

Under the current budget process, each Congress significantly limits the options of future Congresses. A series of laws has created a situation in which about half of each year's budget authority (49 percent of the budget authority in a fiscal year 1979 current policy budget) is required to meet expenses for programs mandated by law. One of the reasons is that budget authority is usually granted through a permanent appropriation to cover costs such as those associated with social security payments, interest on the public debt, or the expenses of other entitlement programs.

Each Congress further binds future Congresses by enacting budget authority that will be expended two or more fiscal years into the future. If the second session of the 95th Congress were to enact a current policy budget for fiscal year 1979, 24 percent of that budget's authority (or 48 percent of the nonmandated budget authority) will be outlayed in fiscal year 1980 and beyond. This is because, when Congress chooses to fund a new aircraft carrier or housing program, for example, the entire cost is covered by the budget authority enacted at that time, even though actually expending the funds will take several years.

While the present Congress has the constitutional authority to undo most of the decisions made by past Congresses, it rarely does so; stability is an important responsibility of government. Past commitments must be honored if future commitments are to be believed. The states and localities need time to plan their budgets. Within the federal government itself, frequent changes would probably lead to inefficient administration of programs.

While stability means that budgets should remain similar from year to year, it does not preclude modest year-to-year changes that will have an enormous impact several years after they are made. There is nothing new about this observation; the Congress has always passed laws with small first-year and large out-year effects. But the Congress has never had a comprehensive and organized procedure for making this year's budgetary decisions in the light of their likely impact on the next and subsequent years.

The ability of policy to accelerate or decelerate economic growth in any one year is limited. But several years of concerted budgetary policies can bring about major changes. Thus, the economies associated with the hypothetical budgets of this report vary from each other only slightly in fiscal years 1979 and 1980, but they differ markedly by 1983. Similarly, program goals may take years to accomplish. Social programs must be phased in gradually to avoid disruption. Research and development must be completed before new weapon systems can be deployed. The design and implementation of complex programs may take years of technical and political preparation. For all these reasons, the Congress must take actions today that are designed to bring about desired results in the future.

Conversely, the Congress must also take into account now the fact that actions taken to meet immediate ends may have significant budgetary or functional implications for the future that will prevent the achievement of other Congressional goals. Precisely because program design and implementation have become increasingly complex, the major initiatives now being debated in the Congress--tax reform, welfare reform, national health insurance, energy legislation, and the proper defense effort--all call for a phasing in of benefits and resulting expenditures. Most of the major options set out in this report result in much higher real costs in 1983--after full implementation--than will initially appear in the budget. If these programs are enacted without foresight to determine their effects on other goals, the Congress might lose opportunities to enact still other programs, to meet its targets for the economy, to move toward a predetermined federal-sector share of the economy, or to balance the budget.

The development and implementation of budget strategies are impossible so long as the Congress maintains its one-year time frame for budgeting. What is needed is a method that would allow the Congress to reconcile systematically its future goals with its present decisions. This need seems particularly acute in the case of tax proposals; their out-year effects tend to differ from their first-year impact to a greater degree than is the case with most spending proposals. Yet, unlike the latter, they are not subject to the discipline of the annual appropriations process. In addition, with some exceptions in recent years, they do not have expiration dates that might force an examination as to whether the particular provision should be continued, amended, or ended altogether.

The Congressional Budget Office believes that such a method could be provided by shifting to a multiyear framework for budgetary decisions, with the Congress setting budget targets for up to five years in advance. 1/ Such targets would not be binding and should be reviewed each year. Thus, the Congress could both pursue long-term strategies to achieve goals and, at the same time, modify the targets in any year to reflect a changing economy or a shifting Congressional will.

A procedure for advance targeting could be included in the current budget process without new legislation. One possibility would be for the House and Senate Budget Committees to include such targets as part of their first concurrent resolutions on the budget. Such targets could either be included in the reports of the Budget Committee that accompany the resolutions, or they could be part of the resolution and thus be voted on by each House.

The targets could be used in a manner analogous to that employed with the present targets of the first concurrent resolution. That is, CBO could keep score to determine how Congressional activity is modifying the initial targets. As revenue and expenditure measures come to the floor of each House, Members could be reminded of the five-year costs and of how adoption of such measures would affect Congress' ability to achieve its other goals.

The Congressional Budget Act of 1974 gave the Congress a method for voting on the budget as a whole, for making conscious decisions about the proper size of the federal sector of the economy and the proper fiscal policy to be exercised through the budget. Such decisions, of course, applied only to the upcoming fiscal year. Advance targeting would extend that process so that the Congress could develop a budgetary strategy to achieve long-term goals consistent with current program and revenue decisions. As such, decisions on specific program and tax changes could be related to each other and to their effects on long-term goals. This, in turn, would give the Congress the opportunity to influence the size and composition of federal spending and revenues by choice rather than by accident.

1/ See Advance Budgeting: A Report to the Congress, CBO Report (February 24, 1977).

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