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An Analysis of the President's Budgetary Proposals for Fiscal Year 1986

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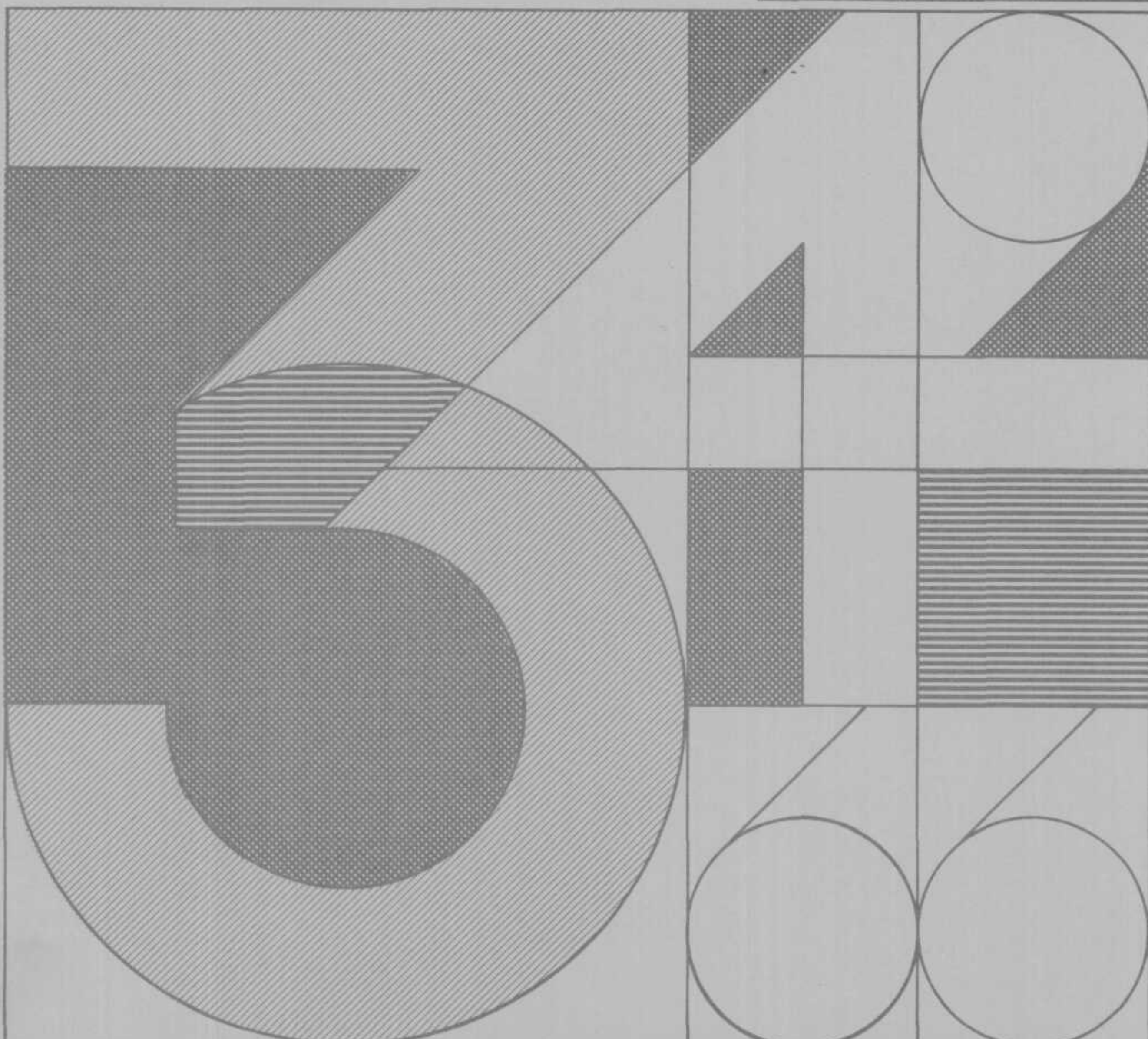
Prepared at the Request of the
Senate Committee on Appropriations



AN ANALYSIS OF THE PRESIDENT'S BUDGETARY PROPOSALS FOR FISCAL YEAR 1986

The Congress of the United States
Congressional Budget Office

Unless otherwise noted, all years referred to in this report are fiscal years.

Details in the text, tables, and figures of this report may not add to the totals because of rounding.

PREFACE

This analysis of the President's budget for fiscal year 1986 was prepared at the request of the Senate Committee on Appropriations. The report discusses the President's policy proposals in terms of changes from the Congressional Budget Office (CBO) baseline budget projections for 1986-1990. It provides estimates of the budgetary impact of the Administration's proposals using CBO's economic assumptions and technical estimating methods.

This report was prepared by the staff of the Budget Analysis, Fiscal Analysis, and Tax Analysis Divisions under the supervision of James L. Blum, William J. Beeman, and Rosemary D. Marcuss, respectively. Paul Van de Water was responsible for the Summary; Frederick C. Ribe for Chapter I; Rosemary D. Marcuss for Chapter II; Michael A. Miller for Chapter III; Charles E. Seagrave for Chapter IV; Robert A. Sunshine for Chapter V; Kathy A. Ruffing for Chapter VI; and Richard P. Emery for Chapter VII. Principal contributors are listed in Appendix C.

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Rudolph G. Penner
Director

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SUMMARY

The Administration's budget proposal for fiscal year 1986 would reduce projected deficits solely by cutting government spending. The Congressional Budget Office (CBO) estimates that these spending reductions would total $364 billion over the next five years. Defense spending would be increased relative to CBO's baseline projections by $43 billion, but nondefense spending would be cut by $406 billion. The Administration proposes only minor changes in revenues.

According to CBO's revised baseline projections, the federal budget deficit would rise from $215 billion in 1985 to $220 billion in 1986 and $302 billion by 1990 if current spending and taxing policies were continued. Under the same economic and technical estimating assumptions, the Administration's proposals would stabilize the deficit at just under $190 billion in the 1986-1990 period. If interest rates decline as the Administration assumes, the deficit under Presidential policies would drop to $122 billion by 1990.

THE BUDGET UNDER CURRENT POLICIES

CBO's baseline budget projections assume, for the most part, no changes in current laws governing taxes or entitlement spending. For nondefense spending that is discretionary and subject to annual appropriations, the baseline projections generally assume that the 1985 appropriation levels will be increased to keep pace with inflation. For defense spending, an extrapolation of the 1985 Congressional budget resolution is used as the best approximation of current policy. Thus, the baseline projections are not forecasts of future federal budgets, since those budgets will doubtless include numerous policy changes. The projections are, however, a benchmark against which proposed policy changes may be measured.

Summary Table 1 shows the latest CBO baseline budget projections. The outlay and deficit projections are slight upward revisions of those published earlier this month and reflect additional information about spending patterns gleaned from the President's budget. Most of the changes in the projections are for public enterprise funds--such as the Agricultural Credit Insurance Fund, Rural Housing Insurance Fund, Postal Service Fund, Low-Rent Public Housing Loan Fund, and Loan Guaranty Revolving Fund--where the Executive Branch has considerable freedom of action in administering the programs.

In relation to gross national product, baseline deficits are roughly stable--at about 5.4 percent of GNP. In dollar terms, however, the baseline deficit rises from $220 billion in 1986 to $302 billion by 1990. With deficits of this magnitude, federal debt held by the public would more than double over the next six years. At the end of 1984, debt held by the public equaled $1.3 trillion, or 37 percent of GNP. By the end of 1990, it would reach $2.8 trillion, or 50 percent of GNP--far above its average of 28 percent of GNP during the 1970s.

SUMMARY TABLE 1. CBO BASELINE BUDGET PROJECTIONS (By fiscal year) a/

	1985	1986	1987	1988	1989	1990
		In Billions of Dollars				
Revenues	735	788	855	934	1,005	1,088
Outlays b/	950	1,008	1,095	1,191	1,284	1,390
Deficit b/	215	220	240	257	280	302
Debt Held by the Public	1,526	1,745	1,984	2,240	2,519	2,820
		As a Percent of GNP				
Revenues	19.1	19.0	19.1	19.3	19.3	19.4
Outlays b/	24.6	24.2	24.4	24.7	24.7	24.8
Deficit b/	5.6	5.3	5.4	5.3	5.4	5.4
Debt Held by the Public	39.6	42.0	44.3	46.4	48.4	50.3

a. The baseline figures are revisions of those appearing in Congressional Budget Office, The Economic and Budget Outlook: Fiscal Years 1986-1990 (February 1985).

b. Includes programs that are off-budget under current law.

For comparability with Administration estimates, the baseline projections of outlays and the deficit include spending that is off-budget under current law. The Administration is proposing that programs currently excluded from the unified budget be included in the budget totals. Like the unified budget deficit, the outlays of these off-budget entities must be financed by borrowing from the public. The Congressional Budget Office has long supported a comprehensive federal budget because it portrays most accurately the economic importance of government activities and gives policymakers the greatest control over spending and tax policies.

THE ADMINISTRATION'S BUDGET PROGRAM

The Administration's 1986 budget continues the current trends toward higher defense and lower nondefense spending. The proposed reductions in nondefense outlays are similar in size to those requested by President Reagan in 1981, and are greater than those requested in any year since. Moreover, the reductions generally consist of specific proposals and do not include, as in past years, unspecified future reductions or management savings targets.

The major elements of the Administration's budget program are listed in Summary Table 2. Over the 1986-1990 period, revenues would be within $4 billion of the CBO baseline. The proposed outlay changes, however, would reduce spending by $364 billion. This reduction is the net effect of $43 billion in defense spending increases, $363 billion in cuts in nondefense spending programs, and a $43 billion reduction in net interest costs resulting from the other spending changes. The proposed reductions in nondefense programs consist of:

- **$144 billion in reductions in entitlement programs.** The largest reductions--$44 billion--would be targeted on Medicare and Medicaid. Farm price supports would be cut by $32 billion, general revenue sharing by $24 billion, and federal employee retirement by $12 billion. No reductions are proposed in Social Security, unemployment insurance, or veterans' benefits. Only small cuts would be made in means-tested, income-transfer programs.

- **$187 billion in lower nondefense discretionary spending.** Fifty percent of these cuts can be found in only six areas--$39 billion from eliminating most direct loans by the Farmers Home Administration, $19 billion from lower civilian agency pay, $14 billion from reduced housing subsidies, $9 billion from halving urban mass transit assistance, $8 billion from ceasing to add oil to the Strategic Petroleum Reserve, and $7 billion from eliminating

SUMMARY TABLE 2. THE ADMINISTRATION'S DEFICIT REDUCTION PROGRAM AS ESTIMATED BY CBO
(By fiscal year, in billions of dollars)

	1986	1987	1988	1989	1990	Cumulative Five-Year Total
CBO Baseline Deficit a/	220	240	257	280	302	1,299
Policy Changes						
Revenues b/	-1	1	c/	-2	-2	-4
Outlays						
National defense	2	6	11	12	10	43
Entitlements and other mandatory spending	-14	-23	-31	-36	-40	-144
Nondefense discretionary spending a/	-17	-32	-39	-46	-53	-187
Offsetting receipts	-4	-5	-6	-8	-9	-32
Net interest	c/	-3	-7	-13	-21	-43
Subtotal, outlays	-33	-56	-71	-91	-113	-364
Total Policy Changes	-33	-55	-71	-93	-116	-368
President's Budget as Estimated by CBO a/	186	185	186	187	187	930

a. Includes programs that are off-budget under current law.

b. Revenue increases are shown with minus signs because they reduce the deficit; revenue decreases, which are displayed with no sign, increase the deficit.

c. Less than $500 million.

Export-Import Bank direct lending. Another 20 percent of the savings would be achieved in student financial aid, training and employment assistance, highway grants, small business and rural electric loans, health research, and subsidies to Amtrak and the Postal Service.

- **$32 billion in increased offsetting receipts.** One-third of this increase would come from fees charged to users of government services such as inland waterways, deep-draft ports, customs inspections, nonemergency boating assistance, and meat inspection. Another third of the increased receipts comes from increasing the premiums charged to participants in Supplementary Medical Insurance (Part B of Medicare). Other proposals include increases in Postal Service payments for employee retirement and the sale of Small Business Administration loan assets and the Conrail system.

The Administration's proposed revenue and spending changes are described in detail and analyzed in Chapters II through VI of this report.

The Administration proposes particularly deep cuts in federal credit programs and in grants to state and local governments. Over the 1986-1990 period, subsidized lending by the Farmers Home Administration, Rural Electrification Administration, Export-Import Bank, Small Business Administration, and other agencies would be cut by $80 billion. The savings in credit subsidy costs would be $48 billion. The Administration contends that borrowers under these programs can find alternative sources of credit and that credit subsidies drive up the interest costs of nonsubsidized borrowers. Chapter VII reviews the credit budget in detail.

Grants to state and local governments would be cut by roughly $105 billion. Programs targeted for cuts are revenue sharing and other general purpose fiscal assistance, Medicaid and public assistance, highways and mass transit, education and social services, community development, and sewage treatment plant construction. The Administration argues that many of the programs provide only local benefits and should not be subsidized by the national taxpayer. It also points to the relatively favorable fiscal position of states and localities vis-a-vis the federal government. Under the Administration's proposals, federal grants would represent 1.9 percent of GNP in 1990, as compared with 2.7 percent of GNP in 1985, and 3.6 percent of GNP as recently as 1980.

Altogether, nondefense discretionary spending over the 1986-1990 period would be cut 19 percent from CBO baseline levels, while the entitlement reductions represent only 6 percent of that category. Excluding Social Security and Medicare benefits, however, entitlements would be cut by

12 percent. The proposed increase in defense spending and the cuts in nondefense spending would change the composition of federal spending as set out in Summary Table 3 and Summary Figure 1. Defense spending would grow from $253 billion in 1985 to $435 billion in 1990 and would reach 7.8 percent of GNP, about the same level as in 1965. Nondefense discretionary spending, which is already slightly below its 1965 level, would shrink from its current 4.6 percent of GNP to 2.9 percent of GNP in 1990. Social Security and Medicare benefits would remain a roughly constant share of GNP, but the projected decline in other entitlements and mandatory spending would be accelerated.

CBO's spending reduction estimates are substantially lower than those of the Administration--$33 billion instead of $51 billion in 1986 and $364 billion instead of $507 billion over the 1986-1990 period. Of the $143 billion cumulative difference, $113 billion is definitional and results from using alternative baseline concepts for national defense. As noted earlier, CBO uses the appropriation targets in the most recent Congressional budget resolution (extrapolated from 1988 to 1990) as its defense baseline; defense outlays are estimated consistently with the assumed budget authority using CBO technical estimating methods. In contrast, the Administration measures its defense policy changes from the outlays in the Administration's August 1984 mid-session budget review. The remaining discrepancy of $30 billion in cumulative savings represents different estimates of the budgetary effects of the Administration's proposal.

CBO BUDGET ESTIMATES

For purposes of comparability with the CBO baseline projections and with other deficit-reduction plans, the foregoing estimates of the Administration's budget use CBO baseline economic and technical estimating assumptions. Such projections provide a basis for evaluating the initial, static budgetary impact of the Administration's proposals, prior to considering any changes in the economy that might result from changes in the budget. Under these assumptions, the Administration's policies would hold the deficit virtually constant at about $186 billion each year during the 1986-1990 period. The Administration's own estimates of the deficit, however, are substantially lower, as shown in Summary Table 4.

Almost all of the differences in budget estimates between CBO and the Administration derive from their differing economic assumptions, which are described in detail in Chapter I. Most of the economic differences result, in turn, from differences in assumed interest rates, which become quite substantial in 1989 and 1990. CBO holds real interest rates constant

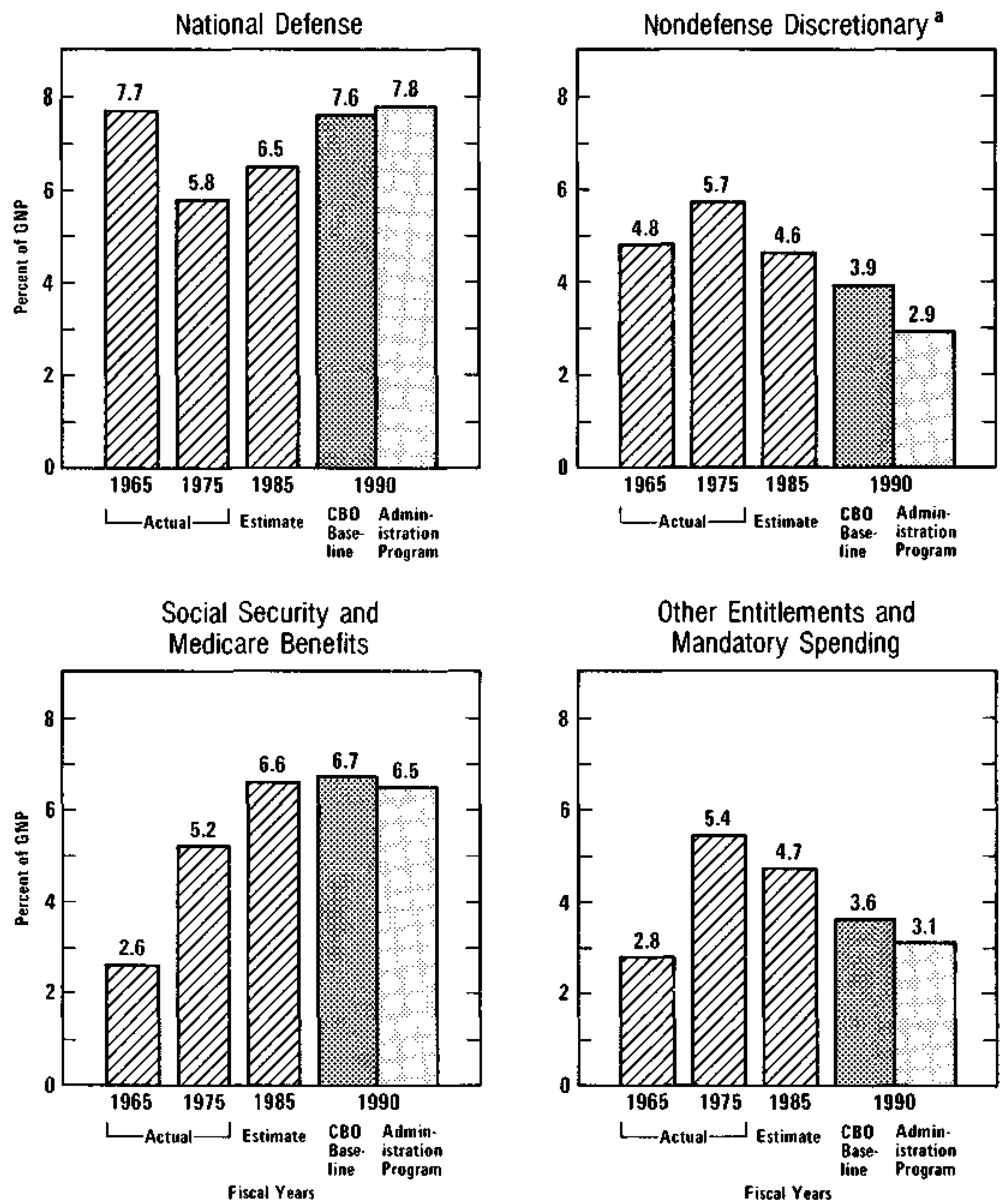
SUMMARY TABLE 3. CBO ESTIMATES OF THE ADMINISTRATION'S SPENDING PROGRAM BY MAJOR CATEGORY (By fiscal year)

	1985	1986	1987	1988	1989	1990
	In Billions of Dollars					
National Defense	253	284	319	358	396	435
Entitlements and Other Mandatory Spending						
Social Security and Medicare benefits	255	269	290	313	338	365
Other entitlements	182	162	166	167	169	173
Subtotal	437	431	456	481	507	538
Nondefense Discretionary a/	179	167	162	164	164	165
Net Interest	130	146	161	180	195	212
Offsetting Receipts	-48	-54	-59	-64	-68	-73
Total outlays a/	950	975	1,039	1,120	1,193	1,276
	As a Percent of GNP					
National Defense	6.6	6.8	7.1	7.4	7.6	7.8
Entitlements and Other Mandatory Spending						
Social Security and Medicare benefits	6.6	6.5	6.5	6.5	6.5	6.5
Other entitlements	4.7	3.9	3.7	3.5	3.2	3.1
Subtotal	11.3	10.4	10.2	10.0	9.7	9.6
Nondefense Discretionary a/	4.6	4.0	3.6	3.4	3.2	2.9
Net Interest	3.4	3.5	3.6	3.7	3.7	3.8
Offsetting Receipts	-1.2	-1.3	-1.3	-1.3	-1.3	-1.3
Total outlays a/	24.7	23.5	23.2	23.2	22.9	22.8

a. Includes programs that are off-budget under current law.

Summary Figure 1.

The Composition of Federal Spending



[a] Including programs that are off-budget under current law.

SOURCE: Congressional Budget Office.

SUMMARY TABLE 4. CBO AND ADMINISTRATION ESTIMATES OF THE ADMINISTRATION'S BUDGET PROGRAM (By fiscal year, in billions of dollars)

	1985	1986	1987	1988	1989	1990
Using CBO Technical and Economic Assumptions						
Revenues	735	789	855	934	1,007	1,090
Outlays	950	975	1,039	1,120	1,193	1,276
Deficit	215	186	185	186	187	187
Using CBO Technical Assumptions, Administration Interest Rates, and Other CBO Economic Assumptions						
Revenues	735	789	855	934	1,005	1,086
Outlays	950	972	1,034	1,102	1,152	1,208
Deficit	215	183	179	168	147	122
Using CBO Technical Assumptions and Administration Economic Assumptions						
Revenues	736	793	864	953	1,029	1,108
Outlays	950	972	1,033	1,100	1,148	1,202
Deficit	214	179	169	147	119	94
Using Administration Technical and Economic Assumptions						
Revenues	737	794	862	950	1,030	1,108
Outlays	959	974	1,027	1,095	1,137	1,190
Deficit	222	180	165	144	107	82

by convention after 1986; the three-month Treasury bill rate is a flat 8.2 percent from 1987 through 1990. In contrast, the Administration assumes that real interest rates decline steadily after 1987; the Treasury bill rate falls to 5.0 percent by 1990. The different patterns stem in part from the fact that CBO assumes current budgetary policy, while the Administration assumes deficit reductions of $368 billion from 1986 through 1990. The difference in interest rates also reflects the Administration's lower inflation assumptions in 1986 and later years. If the effect of Administration policies were estimated using Administration interest rates, the projected deficit in 1990 would be $65 billion lower than the estimate assuming CBO rates.

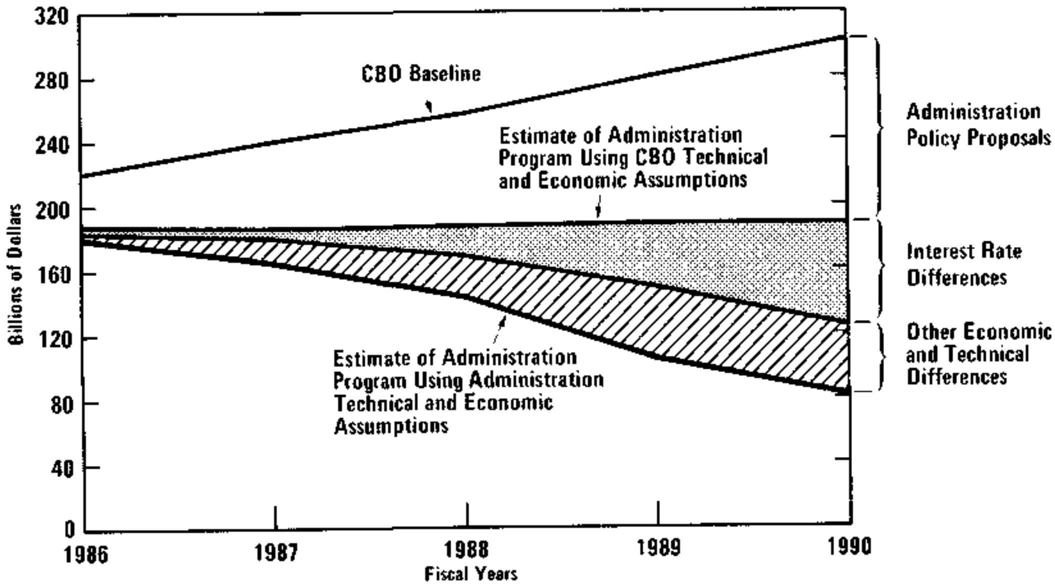
The remaining economic differences result from the Administration's assumption of more rapid growth in the gross national product throughout the 1985-1990 period. The Administration's projection of nominal GNP exceeds CBO's by $21 billion in 1985, $47 billion in 1986, and an average of $84 billion in the 1987-1990 period. These GNP differences affect revenues, debt service costs, and, to a minor extent, non-interest outlays by a total of $4 billion in 1986 and $28 billion in 1990.

In contrast to recent years, technical differences between CBO and Administration budget estimates are relatively small. CBO would shave the Administration's 1985 deficit estimate by $9 billion for technical reasons--primarily as a result of lower spending estimates for defense, foreign military sales, nuclear waste fees, Medicare, and Social Security. By 1989 and 1990, however, technical estimating differences cause CBO's deficit projections to exceed the Administration's by $11 billion. CBO's reestimates of the Administration's revenue and outlay figures are analyzed in Appendixes A and B.

Summary Figure 2 illustrates the effects of the Administration's proposals and of different economic and technical assumptions on the deficit projections. Under current budgetary policies, CBO projects that the deficit would rise from $220 billion in 1986 to $302 billion in 1990. Under the President's program, and using CBO technical and economic assumptions, the deficit would be stabilized at about $186 billion. Using Administration interest rates but other CBO assumptions, the deficit under Administration policies would decline from $183 billion in 1986 to $122 billion by 1990. Using Administration economic and technical assumptions, the decline in the deficit would be even greater--from $180 billion in 1986 to $82 billion in 1990.

Summary Figure 2.

Federal Deficit Projections



SOURCE: Congressional Budget Office.

CHAPTER I

THE ADMINISTRATION'S ECONOMIC ASSUMPTIONS

Economic projections play an important role in budget estimates. Assumptions as to the rate of economic growth affect forecasts of the tax base and of spending for certain entitlement programs. Interest-rate projections help determine the expected levels of outlays for interest on the debt and of tax revenues (since they affect individual and corporate incomes from financial assets). Inflation projections are important to the estimates of federal purchases and spending on indexed programs.

This chapter briefly compares the Administration's economic projections with those of the Congressional Budget Office (CBO). The CBO figures are used in the reestimates of the Administration's 1986 budget proposals that are presented in this volume, and also in CBO's current baseline budget projections.

THE SHORT-RUN OUTLOOK

CBO's short-run economic forecast for 1985 and 1986 is conditional on several specific assumptions regarding policy and external developments. It assumes that current federal spending and tax policies remain in effect. It also assumes that the growth of the M1 monetary aggregate will be held to 5.5 percent in 1985 (the midpoint of the tentative target range announced last July by the Federal Reserve) and to 5.0 percent in 1986. Other assumptions relate to the behavior of such factors as commodity prices and exchange rates. 1/

The Administration's forecast is based on different policy assumptions in that it assumes the implementation of proposed deficit reductions of $160

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1. For a detailed discussion of CBO's forecast, see Congressional Budget Office, The Economic and Budget Outlook: Fiscal Years 1986-1990 (February 1985).

billion over three years. This difference in assumptions makes a noticeable difference in the medium-term economic projections discussed elsewhere in this chapter. The reductions would occur too late, however--both in terms of when the legislation would be passed and when its economic effects would be felt--to affect the short-term economic outlook significantly.

Largely for this reason, the near-term economic forecasts by the Administration and by CBO are quite similar (see Table I-1). Both imply that the economic expansion should continue at a healthy rate at least through the end of 1986, without a major acceleration of inflation. The Administration projects growth in real GNP of about 4.0 percent during this period, while CBO's forecast is below 3.5 percent. Both forecasts have the unemployment rate declining to around 7.0 percent by 1986, while inflation remains in the 4.0 percent to 4.5 percent range. The two inflation and real-growth forecasts are close enough that the projections of nominal GNP in 1986, which include both real growth and inflation, are only 1 percent or about $45 billion apart (CBO's is the lower of the two).

Significant short-run differences begin to appear only in the two interest-rate forecasts. Both the Administration and the CBO expect short-term rates to remain between 8.0 percent and 8.5 percent during calendar year 1985. After that, however, the interest-rate paths in the two projections begin to diverge. Rates rise slightly in the CBO projection, but they start to decline in the Administration's projection. The different patterns stem in part from the fact that CBO assumes current budget policy while the Administration assumes deficit reductions of $33 billion in fiscal year 1986. The difference also reflects the Administration's lower forecasts of inflation in 1986 and later years.

MEDIUM-TERM PROJECTIONS

Neither CBO nor the Administration attempts to forecast economic activity beyond the end of 1986. Economic forecasting is highly uncertain even in the short term, and is especially difficult over extended periods such as those covered by longer-term budget projections. Various alternative procedures have been tried, including the use of goals or targets for the economy's performance instead of longer-term forecasts. Their results have consistently turned out to be too optimistic. Partly for this reason, both CBO and the Administration now generate their longer-term projections (shown in Table I-2) using simple rules of thumb based on historical experience.

TABLE I-1. COMPARISON OF ADMINISTRATION AND CBO SHORT-RUN ECONOMIC FORECASTS (By calendar year)

Economic Variable	Actual 1984	Forecast 1985	Forecast 1986
Fourth Quarter to Fourth Quarter (percent change)			
Real GNP	5.6	4.0	4.0
Administration		3.4	3.1
CBO			
Nominal GNP	9.3		
Administration		8.5	8.5
CBO		7.7	7.8
Consumer Price Index a/	3.5		
Administration		4.2	4.3
CBO		3.9	4.5
Calendar-Year Average (percent)			
3-Month Treasury Bill Rate	9.5		
Administration		8.1	7.9
CBO		8.3	8.7
Civilian Unemployment Rate	7.5		
Administration b/		7.0	6.9
CBO		7.1	6.9

SOURCE: Congressional Budget Office.

a. Urban wage and clerical workers.

b. The Administration's projection is for the total labor force including armed forces residing in the United States, while CBO's is for the civilian labor force excluding armed forces. In recent years, the former has tended to be 0.1 to 0.2 percentage points below the rate for the civilian labor force.

TABLE I-2. COMPARISON OF ADMINISTRATION AND CBO ECONOMIC ASSUMPTIONS, 1985-1990 (By calendar year)

	Actual 1984	1985	1986	1987	1988	1989	1990
Nominal GNP (in billions of dollars)	3661						
Administration		3948	4285	4642	5017	5399	5780
CBO		3927	4238	4567	4921	5301	5711
Real GNP (percent change, year over year)	6.8						
Administration		3.9	4.0	4.0	4.0	3.9	3.6
CBO		3.5	3.2	3.3	3.4	3.4	3.4
Consumer Price Index (percent change, year over year) a/	3.4						
Administration		4.1	4.3	4.2	3.9	3.6	3.3
CBO		3.8	4.5	4.2	4.2	4.2	4.2
91-Day Treasury Bill Rate (percent)	9.5						
Administration		8.1	7.9	7.2	5.9	5.1	5.0
CBO		8.3	8.7	8.2	8.2	8.2	8.2
Civilian Unemployment Rate (percent)	7.5						
Administration b/		7.0	6.9	6.6	6.3	6.1	5.8
CBO		7.1	6.9	6.7	6.6	6.4	6.2

SOURCE: Congressional Budget Office.

a. Urban wage and clerical workers.

b. The Administration's projection is for the total labor force including armed forces residing in the United States, while CBO's is for the civilian labor force excluding armed forces. In recent years, the former has tended to be 0.1 to 0.2 percentage points below the rate for the civilian labor force.

The CBO projections assume that labor productivity and real GNP grow over the entire period from the trough of the recent recession (in late 1982) through 1990 at the average rates achieved over comparable periods during past postwar recovery-expansions. Thus, real GNP growth is in the range of 3.3 percent to 3.4 percent during the later years of the projection period, a pattern consistent with the projection of a gradual decline in the unemployment rate to 6.2 percent in 1990 and with the projected inflation rate of 4.2 percent. Because CBO assumes no change in budget policy, real interest rates are kept constant by convention over the longer-term projection, a procedure that is reflected in the 8.2 percent Treasury bill rate.

The rules governing the Administration's longer-term projections are somewhat different: the assumed growth rate of real output exceeds the postwar average assumed by CBO but falls short of that achieved during the strongest postwar expansion in 1961 through 1969. As a result, longer-term real growth in the Administration's projection averages nearly 4.0 percent. The Administration assumes a larger decline in unemployment than does CBO (to 5.8 percent by 1990), a slowing in inflation to 3.3 percent, and gradually declining real and nominal interest rates--the Treasury bill rate falling to 5.0 percent by 1990.

USING THE ECONOMIC PROJECTIONS

Economic projections play an important role in estimating the budgetary impacts of changes in spending and tax provisions, as this discussion has already suggested. The projections provide a basis for evaluating the "static" or "direct" budgetary impacts of such changes--that is, the impacts measured before any consideration is given to changes in the economy that might be caused by the policy changes, and to the impacts such changes in the economy might in turn have on the budget.

Economists disagree sharply over how the economy might react to different deficit-reducing measures. Indeed, the ultimate effects will depend on the composition as well as the size of the policy changes. CBO's longer-term projections therefore make no attempt to analyze the economic impacts of budget policy changes. Instead, they provide the basis for consistent estimates of the static quantitative impacts of different proposals.

A variety of deficit-reducing proposals are expected to be put before the Congress during the next several months, including the Administration's proposals discussed in this volume. Since all of these proposals will have current budget policy as their starting point, CBO's economic projection, with its assumption of a continuation of current policy, provides a good basis for measuring and comparing the static impacts of all the proposals.

CHAPTER II

THE ADMINISTRATION'S REVENUE PROPOSALS

The Administration's fiscal year 1986 budget includes some revenue proposals that were contained in earlier budgets and some new proposals that would have relatively minor revenue effects. Together, the Administration's proposals would reduce revenues slightly in 1986, 1987, and 1988 and increase them slightly in 1989 and 1990 (see Table II-1).

The CBO estimates of revenues under the Administration's budget are lower than those of the Administration, by amounts growing from $2 billion in 1985 to $23 billion in 1989 and $18 billion in 1990. This is because CBO uses somewhat different assumptions in its estimates, which are described in detail in Appendix A. A breakdown of estimated receipts by major tax source is given in Table II-2.

The Administration describes its proposals as "primarily user fees and trust fund reforms." Proposed reductions in income taxes slightly outweigh proposed increases in payroll taxes, excise taxes, and fees in 1986-1988. By 1989, the tax increases dominate, adding $1 billion to receipts in that year and $0.5 billion in 1990.

Earlier budgets proposed a higher education tax incentive, a tuition tax credit, a revised dependent care credit, enterprise zones, and a three-year extension of the research and experimentation (R&E) credit, which is scheduled to expire at the end of this year. These proposals are repeated in the current budget. Proposed increases in taxes for the Hazardous Substance Response and Black Lung Disability trust funds and additional collections from increased IRS auditing partially offset the proposed tax reductions. (For a list of all proposals, see Table II-3.)

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TABLE II-1. PROJECTED REVENUES UNDER THE ADMINISTRATION'S 1986 BUDGET PROPOSALS (By fiscal year, in billions of dollars)

	1985	1986	1987	1988	1989	1990
CBO Baseline a/	735	788	855	934	1,005	1,088
Adjustments to CBO baseline to reflect Administration definition of current services a/	b/	1	1	1	1	2
Administration current services as estimated by CBO	735	789	856	935	1,006	1,089
Administration Proposals						
Legislative proposals c/	--	b/	-2	-3	-2	-2
Administrative actions	b/	b/	b/	2	3	3
Subtotal, revenue proposals	b/	b/	-1	-1	1	b/
President's Budget as Estimated by CBO	735	789	855	934	1,007	1,090

SOURCES: Budget of the United States Government for Fiscal Year 1986 and Congressional Budget Office.

a. The CBO baseline assumes the extension of the 1.3 percent contributions to the Civil Service Retirement program paid by newly hired federal workers and the extension of the Hazardous Substance Response Trust Fund (Superfund) taxes at current rates. The Administration current services estimates do not assume the extension of the Civil Service Retirement adjustment. They assume extension of Superfund taxes at higher than current rates.

b. Less than $500 million.

c. Includes net effects of proposed Superfund tax increases above current services levels.

TABLE II-2. ADMINISTRATION AND CBO ESTIMATES OF ADMINISTRATION'S BUDGET REVENUES, BY SOURCE (By fiscal year, in billions of dollars)

	1985	1986	1987	1988	1989	1990
Administration Estimates						
Individual Income Taxes a/	333	363	397	439	482	520
Corporate Income Taxes	66	74	87	99	107	113
Social Insurance Taxes and Contributions a/	265	285	305	341	370	401
Excise Taxes						
Windfall profit taxes	7	5	4	4	3	3
Other	30	30	31	30	30	31
Other	35	36	37	38	38	40
Total	737	794	862	950	1,030	1,108
Percent of Administration GNP	19.0	18.9	18.9	19.3	19.4	19.5
CBO Estimates						
Individual Income Taxes a/	333	361	392	431	470	513
Corporate Income Taxes	63	70	87	95	102	108
Social Insurance Taxes and Contributions a/	266	285	302	335	360	391
Excise Taxes						
Windfall profit taxes	7	5	4	4	4	3
Other	31	30	32	31	31	32
Other	36	37	38	39	40	43
Total	735	789	855	934	1,007	1,090
Percent of CBO GNP	19.1	19.0	19.1	19.3	19.3	19.4

SOURCES: Budget of the United States Government for Fiscal Year 1986 and Congressional Budget Office.

a. The Administration's own budget estimates include a reduction in individual income taxes and an increase in social insurance taxes to reflect the general revenue transfer to the Social Security trust funds for the (partial) taxation of Social Security benefits. Both the CBO and Administration estimates shown here exclude this transfer; that is, the revenues are included in individual income taxes.

TABLE II-3. ADMINISTRATION'S REVENUE PROPOSALS
(By fiscal year, in billions of dollars)

	1985	1986	1987	1988	1989	1990
			Legislative Proposals			
New, Revised or Extended Tax Incentives						
Education savings accounts	--	a/	-0.1	-0.3	-0.5	-0.7
Tuition tax credit	--	-0.4	-0.6	-0.9	-0.9	-0.9
Revision in dependent care credit	--	a/	-0.2	-0.2	-0.2	-0.1
Enterprise zones	--	-0.1	-0.5	-0.9	-1.1	-1.1
Extension of research and experimentation credit	--	-0.7	-1.3	-1.5	-1.0	-0.5
Subtotal, tax incentives	--	-1.2	-2.8	-3.8	-3.7	-3.3
User Fees and Other b/	--	0.1	0.1	0.1	0.1	0.1
Trust Fund Tax Increases						
Extension and increase in Hazardous Substance Response Trust Fund (Superfund) taxes c/	--	0.3	0.3	0.3	0.3	0.4
Increase in Black Lung Disability Trust Fund fees	--	0.2	0.2	0.2	0.2	0.3
Increase in D.C. government retirement contributions	--	a/	a/	a/	0.1	0.1

SOURCE: Budget of the United States Government for Fiscal Year 1986 and the Congressional Budget Office.

a. Less than $50 million.

b. IRS user charges, Iranian claim fees, and increases in migratory bird-hunting stamp fees and Department of Housing and Urban Development mobile home inspection fees.

c. Includes net effects of proposed increases above current services levels.

(Continued)

TABLE II-3. (Continued)

	1985	1986	1987	1988	1989	1990
Extension of unemployment insurance coverage to railroad employees	--	0.2	0.2	0.2	0.2	0.1
Subtotal, trust funds	--	0.7	0.7	0.8	0.8	0.8
Other						
Taxation of Railroad Retirement benefits as pensions	--	a/	0.1	0.1	0.1	0.1
Acceleration of deposits of Social Security taxes by state and local governments	--	0.4	a/	0.3	1.2	0.2
Subtotal, other	--	0.4	0.1	0.4	1.2	0.2
Subtotal, Legislative Proposals	--	a/	-1.9	-2.6	-1.6	-2.3
Administrative Actions						
Increase in IRS Examination Staff	--	--	0.5	1.5	2.6	2.8
Other d/	a/	a/	a/	a/	a/	a/
Subtotal, Administrative Actions	a/	a/	0.5	1.5	2.6	2.8
Total Legislative Proposals and Administrative Actions	a/	a/	-1.4	-1.1	1.0	0.5

d. Increases in fishermen's contingency fund fees and Department of Housing and Urban Development fees on interstate land sales.

Education Savings Accounts

For the third year, the Administration is proposing to exclude from taxation the interest earnings of savings accounts earmarked for higher education. Under this proposal, a separate account could be set up for each dependent child under 18 years of age, with contributions permitted up to $1,000 per child per year. The $1,000 contribution limit would decline for contributors with adjusted gross incomes (AGIs) above $40,000 and would reach zero for those with AGIs above $60,000. These thresholds would not be indexed for inflation. Interest earnings would become taxable to the contributor and a penalty would be assessed if the savings were not used for higher education expenses before the child reached 26 years of age. Certain unspecified exceptions would be allowed.

The revenue loss from these accounts would be small initially, but would grow rapidly for 10 years or more as amounts deposited grew. The Administration projects a revenue loss of about $30 million in 1986, increasing to about $700 million in 1990. By the mid-1990s revenue reductions from such accounts could equal $2 billion per year.

Several bills permitting education savings accounts (S. 1489, H.R. 919, H.R. 4147, and H.R. 4794) were introduced in the 98th Congress, although none was voted out of committee. These bills differed structurally from the Administration's proposal in that contributions would be deductible from the parents' AGI and the accumulated value of an account would be included in the child's AGI after college. Initial-year revenue losses are much higher when deposits are deductible, but the difference narrows over time because the entire account would ultimately be included in the AGI of the child.

Other Administration 1986 budget proposals would reduce federal outlays and loan guarantees for higher education. Total federal aid per student would be capped at $4,000 per year; students from families with AGIs above $25,000 would not qualify for grants, direct loans, or subsidized jobs; and students from families with incomes above $32,500 would not qualify for subsidized guaranteed loans. All children under the age of 22 would have their parents' AGI used in determining eligibility and benefit levels. Currently, some children are assessed on the basis of their own income. The subsidy in guaranteed student loans would also be decreased.

Some of the reduction in federal support for higher education via loans and grants could be offset over time through the tax preference for education savings accounts. This would be true mainly for families with AGIs above the proposed limits for grants and subsidized loans--$25,000 and $32,500--but below the proposed $60,000 maximum limit for the savings accounts. Even for these families, however, there would be several years of reduced federal government support because the grant and loan cutbacks would begin in 1986, while significant benefit from the savings accounts would require at least five years of cumulated contributions.

Tuition Tax Credits

The Administration is also proposing a nonrefundable tax credit for families sending their children to private elementary and secondary schools. This is the third year the credit has been proposed. It would be equal to a maximum of 50 percent of tuition costs. Following a two-year phase-in period, the credit would be capped at $300 per dependent and gradually reduced below this level for taxpayers with AGIs above $40,000. Taxpayers with AGIs of $60,000 or more would receive no credit. The revenue loss from the credit is estimated to start at $360 million in 1986 and level off around $900 million per year when fully phased in two years later. The revenue loss could be greater if the recently observed growth in private school enrollments continues.

Many bills providing for tuition tax credits were introduced in the 98th Congress. One, S. 528, was reported out of the Senate Committee on Finance but was not voted on by the Senate. This bill was similar to the Administration's proposal except that the credit would have been completely phased out at $50,000 of AGI instead of $60,000. An amendment authorizing similar tuition credits, offered to House Joint Resolution 290, was tabled by the Senate.

If enacted, the tuition credits would constitute a relatively large share of total general-purpose federal aid for elementary and secondary education. Currently, the major source of untargeted federal aid is the Chapter II block grant, with proposed budget authority of $500 million for 1986. Most of the remaining $6.1 billion in federal aid for elementary and secondary education is targeted on children or local districts with special needs, on districts adversely affected by federal installations, or on particular services such as science education.

Revision in the Dependent Care Credit

The Administration is proposing a restructuring of the child and dependent care credit that would focus the tax preference more on lower-income taxpayers. Under current law, the credit is available for up to 30 percent of qualifying expenses for taxpayers with AGIs below $10,000. It phases down to 20 percent for those with AGIs over $28,000. The Administration's proposal would raise the credit to 40 percent for those with AGIs under $11,000, and phase it down to zero for those with AGIs over $60,000. As a result, the credit would be raised for taxpayers with AGIs under $35,000 (about 70 percent of taxpayers claiming the credit in 1982) and lowered for the remaining taxpayers with higher AGIs. For example, for a family with $16,500 of AGI, the credit would be 36 percent of expenses under the proposal, instead of 26 percent under current law. The Administration estimates that this would reduce revenues by about $20 million in 1986, $200 million in 1987 and in 1988, and by diminishing amounts thereafter. This is the second year the proposal has been made.

Qualifying expenses are those that enable a person to be gainfully employed and that are spent for the care of children under 15 years of age or other people unable to care for themselves. Up to $2,400 in annual expenses may be claimed for one dependent; $4,800 for two or more. A family with $16,500 in AGI and one dependent could claim a maximum of $864 under the proposal, instead of $624 under current law. In contrast, a taxpayer with $60,000 or more in AGI and two dependents would receive nothing under the proposal, compared with a credit of $960 under current law. Thus, the restructuring of the credit would shift its benefits more to those less able to afford child care and more in need of assistance to make a job financially practical. Many single-parent families would benefit. One out of five families with dependent children is female-headed, and the median 1982 income of such families, as reported in a Bureau of the Census survey, was $9,000, compared with $27,000 for two-parent families with dependent children. 1/ Similar revisions in the credit were included in two bills introduced last year, H.R. 4500 and S. 888, neither of which was reported out of committee.

The federal government also finances child care through another provision of the tax code and several direct expenditure programs. Employers are allowed to provide child care for employees as a tax-free fringe benefit. Such care is not yet widespread nor is it targeted toward lower-paid employees. Most federal outlays for child care, however, go to those in financial need. Programs providing some child care support include Head Start (budgeted for $1 billion in 1986), Social Services Block Grants (budgeted for $2.7 billion, but not restricted to child care), the Child Care Food

1. U.S. Bureau of the Census, Current Population Reports, Series P-60, No. 142, Money Income of Households, Families, and Persons in the United States: 1982, p. 93.

program (budgeted for $0.3 billion), and the exclusion of $160 per month of child care expenses from the benefit calculation for Aid to Families with Dependent Children. As a whole, funding for these programs was reduced in 1982, but has grown slowly since then.

Enterprise Zones

The Administration is proposing enterprise zone legislation that would provide for the designation of up to 75 small, economically distressed geographic areas as enterprise zones, at a rate not to exceed 25 zones per year. Within these zones, federal tax and other incentives would be available in order to stimulate private-sector economic activity and employment. Employers operating within the zones would receive a wide range of tax preferences, including a tax credit based on the wages of economically disadvantaged employees. Employees of zone firms would be allowed a tax credit equal to 5 percent of the first $10,500 earned in the zone. The investment tax credit now in effect would be increased by 50 percent for equipment used within the zones; a 10 percent investment credit would be allowed for new construction and reconstruction of buildings within the zones; capital gains on zone business interests and property would be exempt from taxation; and small issue industrial development bonds could be used to finance investment in the zones after the 1986 sunset date for these bonds.

The proposal, made for the fourth year, is estimated by the Administration to reduce revenues by about $1.4 billion over the 1986-1988 period and by $3.7 billion through 1990. These losses are very difficult to estimate because they would depend on the size and characteristics of the zones as designated by the Secretary of the Department of Housing and Urban Development. The proposal gives the Secretary such wide latitude in his choice that specific cost estimates are impossible to make. The Treasury's estimates are based on assumptions that might or might not apply to enterprise zones. For example, if average employment in the zones was lower than the Treasury assumptions, revenue losses could be lower; conversely, if employment was higher or the average size of zones was larger, revenue losses could be greater.

At the same time, the Administration is proposing to cut the amount of direct assistance provided to distressed urban areas. The programs earmarked for cuts are different in their effects from the tax incentives that would be provided through enterprise zones. The Community Development Block Grant (CDBG) program provides community and economic development support to cities, counties, Indian tribes, and territories. This support takes many forms and is available for use in industrial, commercial, and residential areas. In an effort to funnel a larger share of total assistance to rural areas, the Administration proposes to change the statutory urban-rural distribution from a 70/30 percent split to a 60/40 percent split. It also proposes to reduce total budget authority for the overall CDBG program by 10 percent in 1986 (to $3.1 billion from a 1985 level of nearly $3.5 billion).

The Administration also proposes to terminate the Urban Development Action Grant program, which has budget authority of $440 million in 1985. A final element in the proposals for urban areas is the termination of all of the Department of Commerce's Economic Development Administration (EDA) activities. EDA provides public works grants to states, localities, and Indian tribes. Its budget authority has been reduced from $300 million in 1984 to about $50 million for 1985. No new budget authority is requested for 1986, with the exception of small amounts to cover expenses associated with the expenditure of obligations made in earlier years.

Extension of Research and Experimentation Credit

The Administration is proposing a three-year extension of the research and experimentation (R&E) tax credit. The credit, which is for 25 percent of the incremental research and experimentation expenditures by an ongoing business over an established base level, is scheduled to expire at the end of 1985. Extension would reduce income tax revenues by about $660 million in 1986 and about $5 billion over the 1986-1990 period. This is the second year the proposal has been made.

The budget does not present a rationale for extending the R&E credit, but testimony by a Treasury Department official in August 1984 presented the Administration's position at that time. The credit is favored in order to encourage technological innovation that is "necessary for the long-run vitality of the American economy." 2/ The Treasury does not currently support permanent extension of the credit, however, because not enough data are available to measure its effectiveness in promoting research activities. The Treasury would like to see the definition of qualifying expenditures tightened up so that only activities that result in a significant advancement of scientific knowledge or produce a significant technological improvement of a business component are eligible for the credit.

In addition to the credit, the tax code currently provides additional favorable treatment for R&E expenditures. R&E costs, such as wages and

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2. Statement of Ronald A. Pearlman, Acting Assistant Secretary (Tax Policy), Department of the Treasury, before the Subcommittee on Oversight of the Committee on Ways and Means (August 2, 1984).

supplies, can be expensed. Also, the current effective tax treatment of depreciable property used in R&E is similar to expensing. The federal government also provides significant support (about $40 billion in 1984) for research and development through direct expenditures.

The Senate included a permanent extension of the credit in its version of the Deficit Reduction Act of 1984, but the provision was dropped in conference. If no legislative action is taken this year, the credit will expire.

Internal Revenue Service User Fees

The Administration proposes a $100 fee for each IRS letter of determination requested by a pension fund or a tax-exempt organization. The letters, which provide approval of tax-exempt status, are now free. The $100 fee would also apply to private letter rulings, which are clarifications of the IRS position regarding unusual circumstances, such as changes in accounting periods or methods. The fees would generate about $40 million in receipts per year.

Increase in Superfund Taxes

The Administration proposes to increase the taxes used to finance the Hazardous Substance Response Trust Fund, or Superfund, which supports cleanup of hazardous waste sites. The specifications of the proposal have not yet been announced. The proposed increase is intended to cover outlays for cleanup proposed by the Administration for the 1986-1988 period.

Under current law, Superfund taxes would expire at the end of 1985. In its current services receipts projections, the Administration includes an extension of these taxes at rates sufficient to match projected trust fund budget authority for 1986-1990. The assumed tax rates would require the removal of the cap on trust fund revenues, originally imposed in 1980 to ensure the termination of taxes when cumulative collections reached $1.38 billion. The proposed extension and increase in taxes would raise unified budget receipts by a net amount of about $650 million in 1986, growing to $750 million in 1990, when measured relative to receipts generated under current law. When measured relative to the Administration's current services receipts estimates, the proposed tax increases would add about $315 million to net receipts in 1986, growing to about $360 million in 1990.

In 1984, the House passed H.R. 5640 which would have increased Superfund tax rates on an expanded set of feedstock chemicals but would not have imposed a tax on hazardous wastes, an option debated in the Congress. The bill addressed this issue by including two sets of tax rates on chemicals, the higher set to become effective on October 1, 1986, if a hazardous waste tax was not enacted before July 1, 1986. The bill was not acted on by the Senate. It would have increased net unified budget receipts by about $6 billion over the 1986-1990 period.

Increase Black Lung Disability Trust Fund Taxes

The Administration proposes to increase the tax on coal production from $1.00 to $1.50 per ton for underground mining and from $.50 to $.75 per ton for surface mining. This is a new proposal. The taxes were last adjusted by the Black Lung Revenue Act of 1981 (Public Law 97-119), which raised the taxes from $.50 to $1.00 per ton for underground mining and from $.25 to $.50 per ton for surface mining.

The proposed fee increases are considered necessary because Black Lung Disability receipts have not kept pace with expenditures, leading to a rapidly growing trust fund deficit. This proposal is designed to put the fund on a path that would freeze the cumulative deficit over the 1986-1990 period by raising receipts to cover expected outlays. It would raise net unified budget receipts by about $210 million in 1986 and $260 million in 1990.

Extension of Unemployment Insurance to Railroad Employees

The Administration proposes to extend federal and state unemployment insurance coverage to railroad employees beginning in October 1985. This is the last major sector to be covered. The Railroad Unemployment Insurance program has been in debt to the Railroad Retirement program for 19 of the last 24 years. The Railroad Retirement Solvency Act of 1983 (Public Law 98-76) mandated that there be no borrowing after September 1985, after which the program must repay its loans from the Railroad Retirement System. This proposal complies with Public Law 98-76. A similar proposal was included in last year's budget.

The Administration estimates that unemployment insurance receipts would increase by about $150 million each year. The CBO estimates are slightly higher than those of the Administration. These differences are explained by CBO's assumption of higher unemployment, which necessitates higher benefit payments.

Increase in D.C. Employer Contribution to Civil Service Retirement

The District of Columbia currently contributes 7 percent of employees' wages and salaries to the Civil Service Retirement system on behalf of its employees. Employees also contribute 7 percent of their wages and salaries. These amounts do not cover the full cost of D.C. employee benefits. The Administration proposes that the D.C. government increase its contribution by 2 percent a year until the employer contribution reaches 29 percent of payroll, the level (in addition to the 7 percent employee contribution) necessary to cover the full cost of these benefits.

The Administration estimates that this proposal will increase Civil Service Retirement system revenues by about $10 million in 1986, and close to $70 million in 1990.

Taxation of Railroad Industry Pensions

The Administration proposes to make tax treatment of a portion of Tier I Railroad Retirement benefits consistent with that of ordinary pensions. This is proposed as a technical correction to the Social Security Amendments of 1983 (Public Law 98-21), which taxed all of Tier I benefits like Social Security benefits. The Administration estimates that this would increase individual income tax revenues by about $30 million in 1986, growing to about $60 million in 1990.

Acceleration of Deposits of Social Security Taxes by State and Local Governments

The Administration proposes that state and local governments make deposits of Federal Insurance Contributions Act (FICA) taxes at the same frequency as private employers. This proposal would mean that state and large local governments would make deposits about every four days. Under current law, state and local governments are required to make their deposits only twice a month. Their deposit schedule was last changed by the Social Security Amendments of 1983, and this provision took effect in January 1984. The proposal would also make state and local governments subject to the same penalty rate on late deposits (the prime interest rate) charged private employers.

The Administration estimates that the speedup of deposits would increase Social Security revenues by about $2.0 billion over the 1986-1990 period.

ADMINISTRATIVE ACTIONS

Increase in Internal Revenue Service (IRS) Examination Staff

This proposal would increase the IRS examination staff by 2,500 examiners each year over the 1987 to 1989 period (for a total increase of 7,500 examiners). The added revenues attributable to this increase are estimated to be $0.5 billion, $1.5 billion, and $2.6 billion in 1987, 1988, and 1989, with concurrent costs of $100 million, $200 million, and $300 million.

The Administration's assumptions for 1990 are unclear. The estimated revenue gain of $2.8 billion in 1990 assumes continued employment of the 7,500 examiners. The Administration's 1990 outlay estimates, however, do not include any amount to cover the cost of continued employment during that year, about $300 million. If that cost was included, the 1990 deficit reduction attributable to this initiative would be about $2.5 billion instead of the $2.8 billion included in the Administration's budget.

Other

The Administration also proposes to increase Department of Housing and Urban Development fees on interstate land sales and fishermen's contingency fund fees. Together, these fees generate about $2 million in receipts per year.

CHAPTER III

THE ADMINISTRATION'S DEFENSE BUDGET

The Administration's fiscal year 1986 budget proposes substantial real growth in defense spending over the next five years. Appropriation requests for national defense programs rise from $323 billion in budget authority in 1986 to $488 billion in 1990, for a five-year total of about $2 trillion. Under CBO's assumptions about future inflation, the Administration's dollar requests represent an average annual real growth of 5.7 percent in defense appropriations. Under the Administration's slightly lower inflation assumptions, the real growth in budget authority is an average of 6.4 percent for the period.

The program increases in the President's budget are concentrated in research and development, which would grow by 18 percent in real terms from 1986 through 1990, based on CBO economic assumptions. All other major accounts would also grow in real terms over the five-year period, though most at slower annual rates than those achieved since 1980. Military end strengths would increase by 73,000, or 2.3 percent, with most of the increase in the reserve components. Funding for both operation and maintenance and procurement would grow about 4 percent in real terms. The portion of total defense budget authority for research, development, testing, and evaluation would increase from 10.8 percent in 1985 to 13.5 percent by 1990, while most other categories would retain their relative shares, except military personnel whose percentage would decline.

Defense outlays would grow by $32 billion from 1985 to 1986 under the Administration's request. The largest part of that growth--$18 billion--comes from past appropriations. Price growth would contribute $6 billion and real program growth would add nearly $9 billion. In 1990 outlays would be $182 billion higher than 1985, with real program growth accounting for the largest share of the increase--$92 billion; inflation would account for $61 billion and outlays from prior appropriations would add the remaining $30 billion.

DEFENSE BUDGET ESTIMATES

The CBO and the Administration estimates for the defense budget differ in two basic ways. First, CBO and the Administration use different concepts for defining the defense baseline. The CBO defense baseline is derived from the budget authority targets for 1986 and 1987 specified in the Congressional budget resolution for 1985 adopted last September. CBO extrapolated these targets for 1988-1990 with guidance from the two Budget Committees and applied its technical estimating methods to produce corresponding outlay projections. The Administration defense baseline, or current services projections, for 1986-1990 represent administration policy proposals as contained in the OMB Mid-Session Review of the 1985 budget made last August. The two different defense baselines are as follows:

(In billions of dollars)

	1986	1987	1988	1989	1990
CBO Baseline					
Budget Authority	325	360	398	439	485
Outlays	282	313	347	384	425
Administration Current Services					
Budget Authority	334	372	421	461	501
Outlays	295	330	368	404	442

The second major difference in defense budget estimates results from the use of different inflation assumptions and technical estimating methods. Different inflation assumptions produce different estimates of real growth in defense budget authority. Different technical estimating methods produce different estimates of outlays that will occur each fiscal year from given levels of budget authority provided in appropriation bills. The different real growth and outlay estimates for the Administration's 1986-1990 defense budget authority proposals are shown below. Further details on these differences are provided in Appendix B.

	1986	1987	1988	1989	1990
Real Growth in Budget Authority (percent change, year-to-year)					
CBO	5.5	7.4	7.9	3.9	3.9
Administration	6.0	7.9	8.7	4.8	4.7
Outlays Resulting from Administration Budget Authority Proposals ($billions)					
CBO	284	319	358	396	435
Administration	286	321	358	392	429

The Administration's budget proposes $323 billion in budget authority for the national defense function in 1986, an increase of $30 billion from the level provided for 1985. After adjusting for projected inflation, the increase in budget authority would represent real growth of 5.5 percent under CBO's assumptions and 6.0 percent under the Administration's (see box on facing page). The real growth in budget authority for 1986 would be about half as large as the increases provided in 1981 and 1982, and roughly equal to the average annual real increases since 1982.

Defense appropriations would continue to increase during each of the four succeeding years under the Administration's plan. Total budget authority would rise to $363 billion in 1987 and to $488 billion by 1990. The projected annual real growth in defense budget authority under CBO inflation assumptions would increase to about 7.4 percent in 1987 and 7.9 percent in 1988, before falling to about 3.9 percent annually in 1989 and 1990. CBO estimates that defense outlays also would grow substantially during the next five years under the Administration's proposals, rising from an estimated $253 billion in 1985 to $284 billion in 1986 and $435 billion in 1990.

As shown in Table III-1, the Administration's defense proposals are very close to the CBO baseline projection for 1986. The proposals exceed the CBO baseline projections over the five-year period, however, by about $28 billion in budget authority and $43 billion in outlays. Estimated outlays under the Administration's proposals exceed the CBO baseline by more than budget authority because of proposed changes in the composition of the defense budget. The Administration's budget allocates somewhat more funds to relatively fast-spending program areas than was assumed for the CBO baseline, which was based on 1985 appropriation action and last year's budget resolution targets for 1986-1987.

Table III-2 displays the composition of the Administration's defense budget, with outlays as estimated by CBO. Over the five-year period 1986-1990, procurement accounts for the largest portion of the national defense budget, amounting to $693 billion, or 34 percent of total budget authority. Procurement funds are spent out relatively slowly because of the long lead times involved in completing major weapons systems. Therefore, procurement outlays for the five-year period are $151 billion less than proposed budget authority. The next largest component is operation and maintenance, which receives $531 billion, or 26 percent of total defense budget authority. These are relatively fast-spending budget items so that outlays nearly match the budget authority during the next five years. Military personnel takes another $425 billion, or 21 percent. Again, these are fast-spending accounts so that outlays almost equal budget authority. Military research and development (R&D) programs add $253 billion over the 1986-1990 period; and military construction, family housing, and other national defense activities account for $85 billion. Five-year outlays for these budget accounts are somewhat lower--$224 billion for R&D programs and $54 billion for the other activities.

TABLE III-1. CBO ESTIMATE OF THE ADMINISTRATION'S NATIONAL DEFENSE PROPOSALS
(By fiscal year, in billions of dollars)

	1986	1987	1988	1989	1990	Cumulative Five-Year Change
Budget Authority						
CBO Baseline Projections a/	325	360	398	439	485	
Proposed Changes	-2	4	14	9	3	28
Administration's Budget as Estimated by CBO	323	363	412	449	488	
Outlays						
CBO Baseline Projections a/	282	313	347	384	425	
Proposed Changes	2	6	11	12	10	43
Administration's Budget as Estimated by CBO	284	319	358	396	435	

SOURCE: Congressional Budget Office.

a. Defense budget authority for 1986 and 1987 are the amounts specified in the most recent Congressional budget resolution. Defense budget authority for 1988-1990 is a CBO extrapolation of the budget resolution. CBO baseline outlay projections are based on CBO technical estimating methods.

b. CBO reestimates of the budget authority proposals in the President's budget are limited to the treatment of reappropriations or extension of expiring authority.

TABLE III-2. ADMINISTRATION'S DEFENSE BUDGET AS ESTIMATED BY CBO, BY COMPONENTS (By fiscal year, in billions of dollars)

Component	1985	1986	1987	1988	1989	1990	Total 1986-1990
			Budget Authority				
Military Personnel	68.9	73.4	79.6	85.5	90.7	95.4	424.6
Operation and Maintenance	78.2	82.5	95.1	108.9	117.7	127.1	531.2
Procurement	97.3	107.4	122.5	141.4	155.0	166.9	693.2
Research, Development, Test, and Evaluation	31.5	39.3	42.6	49.3	55.9	66.0	253.1
Other	9.3	11.8	14.4	16.8	19.5	22.3	84.7
Subtotal, DoD	285.1	314.4	354.1	401.8	438.8	477.7	1,986.8
Other National Defense	7.8	8.5	9.3	9.9	10.1	10.4	48.1
Total	293.0	322.9	363.4	411.7	448.9	488.1	2,034.9
			Outlays				
Military Personnel	67.9	72.6	78.7	84.5	89.8	94.5	420.1
Operation and Maintenance	73.1	80.0	89.4	102.4	112.4	121.7	505.9
Procurement	70.8	83.2	94.5	107.3	121.7	135.6	542.3
Research, Development, Test, and Evaluation	27.3	33.2	38.8	43.8	50.1	58.1	224.0
Other	5.9	7.1	9.0	10.7	12.5	14.5	53.8
Subtotal, DoD	245.1	276.2	310.4	348.7	386.5	424.5	1,746.2
Other National Defense	7.5	8.2	8.9	9.8	10.0	10.2	47.0
Total	252.6	284.4	319.2	358.5	396.5	434.7	1,793.2

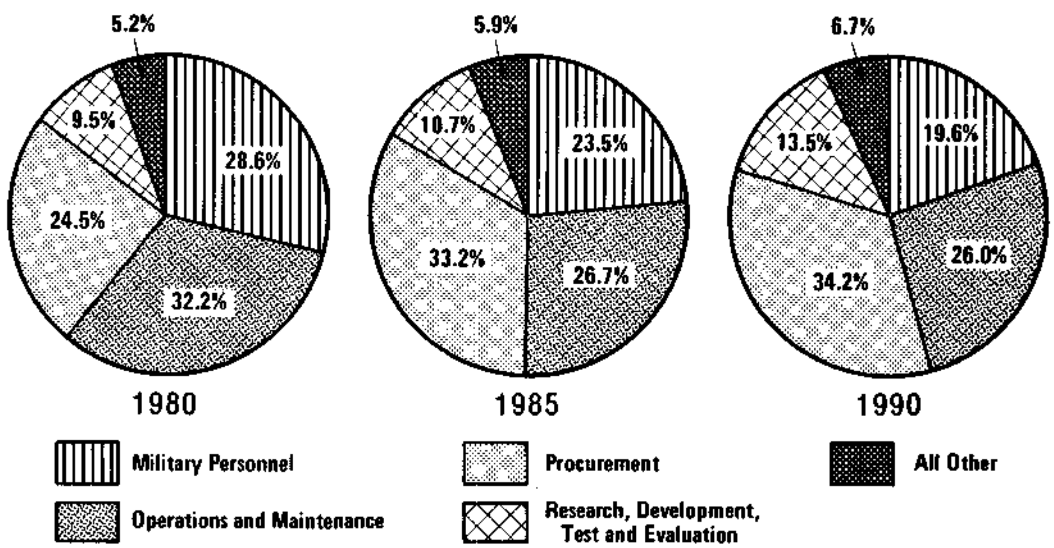
SOURCE: Congressional Budget Office.

Figure III-1 shows that from 1980 through 1985 an increasing share of defense budget authority went to investment, primarily procurement, with the shares of military personnel and operation and maintenance declining. From 1985 through 1990, this pattern continues, with research and development having a greater share of the investment portion and military personnel declining as a share of the operating accounts. These shifts in the relative composition of the defense budget affect slightly the overall rate of spending of budget authority during the next five years. The Administration's proposals call for a faster-spending mix of programs than the CBO baseline assumes.

Focusing more on 1986, Table III-3 compares the 1986 request with 1985 and with average annual rates for 1980-1985 in terms of real growth in dollars and percents, using CBO inflation assumptions. The largest real increase in 1986 over 1985 occurs in research, development, test, and evaluation (RDT&E) which grows by $6.1 billion, or 18 percent, which are both larger than 1980-1985 annual averages. The procurement account grows by 4.3 percent ($4.4 billion) over 1985 in real terms, much slower annual growth than has been the case since 1980. Operation and mainte-

Figure III-1.

Composition of Administration's Request for National Defense (Budget authority in percent of total request)



SOURCE: Congressional Budget Office.

TABLE III-3. REAL GROWTH IN DEFENSE BUDGET AUTHORITY BY APPROPRIATION CATEGORIES (By fiscal year)

Category	1986 Request (Billions of Dollars)	Average Annual Real Growth 1980-1985 a/ Billions of Dollars	Average Annual Real Growth 1980-1985 a/ Percents	Real Growth 1985 to 1986 a/ Billions of Dollars	Real Growth 1985 to 1986 a/ Percents
Department of Defense Military					
Military personnel	73.4	1.9	2.9	0.9	1.2
Operation & maintenance	82.5	4.5	6.9	3.0	3.8
Procurement	107.4	10.3	14.9	4.4	4.3
Research, development, test, and evaluation	39.3	2.9	12.3	6.1	18.3
Military construction	7.1	0.6	14.3	1.3	23.6
Family housing	3.3	0.2	8.3	0.3	9.9
Revolving funds & other	1.4	c/	3.0	0.6	66.2
Total, DoD b/	314.4	20.5	8.8	16.6	5.6
Other National Defense	8.5	0.8	13.8	0.3	2.5
Total b/	322.9	21.3	9.0	16.8	5.5

SOURCE: Compiled by Congressional Budget Office from data supplied by the Department of Defense.

a. Real growth computed using CBO's economic assumptions and the President's pay-raise assumptions.

b. Individual percentage calculations are not weighted and therefore are not additive.

c. Less than $50 million.

nance is 3.8 percent higher ($3 billion) than the real 1985 program, another decrease in the rate of real growth. Military personnel and "Other National Defense" similarly grow, but at lower rates. Military construction, family housing, and the revolving funds show large real increases from 1985 to 1986; these are larger than the 1980-1985 averages, but relatively small in dollar terms.

The next section of this chapter centers on the four largest appropriation categories of the defense budget: military personnel, operations and maintenance, procurement, and RDT&E.

MAJOR DEFENSE PROPOSALS

The defense budget serves the national security objectives of the United States by supporting a variety of land, air, and naval forces. Table III-4 shows that most major force categories would increase from 1985 to 1986 and that improvements have already occurred since 1980. The table might understate force improvements because, in addition to the greater quantities it displays, force levels have a higher quality now than in the past; for example, many Army units now are equipped with M-1 tanks instead of M-60 tanks.

The following section discusses the proposed funding for the defense force structure in terms of appropriation categories used by Congress. The appropriation categories of military personnel and operation and maintenance (O&M) fund the operations and readiness of currently deployed forces. Military personnel pays for those people on active and reserve duty and O&M finances a wide range of logistical and personnel support functions. The procurement accounts contribute to force operations and readiness with funding for spare parts.

The force growth in terms of weapons projected for 1986 results from past decisions to procure ships, aircraft, and vehicles. The improvements in quality of weapons result from past decisions to pursue technological initiatives with RDT&E funding. These two categories have grown signficantly in real terms since 1980. On average, procurement appropriations have grown 15 percent in real terms from 1980 to 1985 while research and development has risen by 12 percent. Operation and maintenance on the other hand has risen by a smaller amount--7 percent annually in real terms--and military personnel funding has risen by only 3 percent.

Military Personnel

For the military personnel appropriation in 1986, the Administration is requesting $4.5 billion more than in 1985, for a total of $73.4 billion. The request calls for increasing both active and reserve (including National

TABLE III-4. SUMMARY OF MAJOR U.S. FORCES AND MANPOWER FOR FISCAL YEARS 1980, 1985, and 1986

Forces	Actual 1980	Estimated 1985	Estimated 1986
Active Forces (in units)			
Strategic bomber aircraft	376	298	315
Strategic defense squadrons	7	5	4
Land-based intercontinental ballistic missiles	1,052	1,023	1,009
Sea-based intercontinental ballistic missiles	576	640	688
Army and Marine Corps divisions	19	20	21
Naval battle forces	473	528	537
Tactical air squadrons	164	166	169
Airlift and tactical support aircraft	567	583	609
Active Manpower (personnel in thousands)			
Active duty end strength	2,050	2,152	2,178
Civilian end strength	990	1,088	1,107
Reserve and Guard Forces (in units)			
Strategic defense squadrons	10	11	11
Army and Marine Corps divisions	9	10	11
Naval battle forces	6	14	18
Tactical air squadrons	56	60	60
Airlift and tactical support aircraft	410	336	336
Reserve Manpower (personnel in thousands)	851	1,077	1,124

SOURCE: Compiled by Congressional Budget Office from data supplied by the Department of Defense.

Guard) end strengths by 73,000 people by the end of 1986, representing a 2.3 percent increase, the same rate of increase as the 1980-1985 average. Also, the request would raise certain components of military pay and allowances.

Table III-5 shows the average percent growth in strength levels from 1980 through 1985 and from 1985 to 1986. Since 1980 active end strength has increased by an average of 20,000 people (or 1.0 percent) per year; the growth in 1986 would be slightly greater--26,000 people, or 1.2 percent. Of the four services, the Army has had the smallest amount of growth over the 1980-1985 period. The Army is modernizing and redefining its active force structure without requiring many additional people, but as discussed below, the Army's reserve components are growing, with much of the growth in

TABLE III-5. REQUESTED MILITARY STRENGTH LEVELS (By fiscal year, in thousands of people at year end)

				Percent Increase	
Service Branch	1980	1985	1986	1980-1985 Average	1985-1986
Army	777	781	781	a/	--
Navy	527	571	586	1.6	2.6
Marine Corps	188	198	200	1.1	0.6
Air Force	558	602	612	1.5	1.6
Subtotal	2,050	2,152	2,178	1.0	1.2
Reserves	851	1,077	1,124	4.8	4.4
Total	2,901	3,229	3,302	2.3	2.3

SOURCE: Compiled by Congressional Budget Office from data supplied by the Department of Defense.

a. Less than 0.5 percent.

full-time personnel. The largest active force growth occurs in the Navy, with the goal of manning a 600-ship force. The Marine Corps' increase is relatively small, and additional manpower has been targeted towards fleet Marine improvements. The Air Force accounts for the second largest active-duty increase, 1.5 percent per year over the 1980-1985 period and 1.6 percent from 1985 to 1986. Through 1985 extra manpower was targeted for 26 tactical fighter wings; in 1986 the additional people are intended to support strategic programs as well.

The 1986 request would raise end strengths in the reserve components by 47,000, or 4.4 percent over 1985; this is a slightly slower increase than has been averaged since 1980. Army Reserve and National Guard strengths would increase by a combined 27,000 (3.7 percent), continuing progress to fill 90 percent of planned unit strength. Of the 27,000 people, 14,000 would be full-time personnel. The Navy Reserve would grow by 13,000 people to support additional force structure. The Marine Corps Reserve would add 1,000 people to assume additional duties and missions. The Air Force Reserve and National Guard would increase by 6,000 as units are either expanded or formed.

CBO estimates the cost of the strength increases at $290 million for active-duty forces and $630 million for the reserves. Pay raises account for most of the remaining increase in the appropriation request. The proposed July 1985 pay raise of 3 percent would cost $1.8 billion in 1986, and the full-year effect of the January 1985 pay raise would cost about $550 million.

Other significant increases are $412 million for permanent change of station allowances, $130 million for variable housing allowances, $168 million for an increase in basic allowances for quarters rates, $86 million for subsistence-in-kind, $43 million for enlistment and reenlistment bonuses, and $167 million for a new educational assistance program.

Operation and Maintenance

The 1986 operation and maintenance budget includes an increase of $4.2 billion, or 4 percent in real terms, over 1985 budget authority. This represents the continuation of a trend of increases in the O&M accounts, though at a slower rate. Over the 1980-1985 period, O&M budgets have increased by almost 40 percent after adjusting for inflation, an average of almost 7 percent per year. Of the eight major programs, only one, reserve forces, would grow at a faster rate than it has from 1980 to 1985 (see Table III-6).

Reserve forces would have the largest source of growth in the 1986 O&M budget, an inflation-adjusted rate of 9 percent. These additional funds

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would allow reserve forces to operate the additional C-5, C-141, KC-10, and F/A-18 aircraft available to reserve forces. Intelligence and communication funds would increase by over 5 percent, with a portion going to modernize the Defense Communication System. Increases in flying hours and operating funds for new weapons for the Army and Marines account for much of the

TABLE III-6. ADMINISTRATION'S REQUEST FOR OPERATION AND MAINTENANCE (By fiscal year, in budget authority)

Program	1986 Request (Billions of Dollars)	Average Annual Real Growth 1980-1985 a/		Real Growth 1985 to 1986 a/	
		Billions of Dollars	Percents	Billions of Dollars	Percents
Strategic Forces	5.5	0.2	5	0.1	3
General Purpose Forces	24.7	1.6	9	0.9	4
Intelligence and Communications	7.6	0.6	11	0.4	6
Airlift and Sealift	2.0	0.2	14	0.1	5
Reserve Forces	6.1	0.3	5	0.5	9
Central Supply and Maintenance	21.4	0.7	4	0.4	2
Training, Medical, and Other	11.6	0.7	7	0.4	3
Administration	3.4	0.2	8	0.2	7
Support to Other Nations	0.2	b/	12	b/	--
Total	82.5	4.5	7	3.0	4

SOURCE: Congressional Budget Office based on Budget of the United States Government 1986 Appendix.

a. Real growth computed using CBO's economic assumptions and President's pay-raise assumptions.

b. Less than $50 million.

increase in the strategic forces, general purpose forces, and airlift and sealift categories.

Over the 1980-1985 period, the largest percentage increases in the O&M budget have been in the intelligence and communications, airlift and sealift, and support to other nations categories, each of which has grown by over 10 percent annually. In 1986 this rate would be slowed to no more than 6 percent per year for each category. Central supply and maintenance, which has had the lowest real growth in the preceding five-year period, would increase two percent in 1986. Operation and maintenance for strategic forces, which has increased by 5 percent per year since 1980, would grow by only 3 percent in 1986.

Procurement

The 1986 request for procurement represents a 4 percent real increase over the 1985 level (see Table III-7). This growth rate is down from an average of 15 percent annual real growth over the 1980-1985 period. This growth rate would be 3 percent, however, if $1.5 billion of 1985 procurement funds for 21 MX missiles were included in 1985. Similarly, real funds for ballistic missiles would be more than double the 1985 level. The average annual growth rate for the 1980-1985 period would be 15 percent rather than -2 percent, and the growth between 1985 and 1986 would be 33 percent. The programs primarily responsible for this growth include the MX, Trident II, and Tomahawk missiles.

The second largest real growth in procurement from 1985 to 1986 would be for purchases of communications and electronic equipment. Many individual programs would contribute to this real increase. The same is true in other missiles, torpedoes, and weapons. The remaining seven budget activities would experience real rates of growth lower than their preceding five-year averages. Five of these seven would experience real decline over the 1985 level.

About half of the 1986 request would pay for defense hardware like ships, missile, aircraft, tanks, and other weapons. The rest would fund support equipment, communications and electronic equipment modifications of existing equipment, spares, and ammunition. The next section of this report discusses the Administration's procurement plans in more detail and in terms of quantities of weapons. In general, a greater number of weapons are planned than have been funded for 1985. These purchases contribute to lower estimated unit costs through, for example, learning curve effects--the tendency for unit costs to fall as the cumulative number of units purchased gets larger.

TABLE III-7. REAL GROWTH IN PROCUREMENT BUDGET AUTHORITY, BY BUDGET ACTIVITIES (By fiscal year))

Activity	1986 Request (Billions of Dollars)	Average Annual Real Growth 1980-1985 a/ Billions of Dollars	Percents	Real Growth 1985 to 1986 a/ Billions of Dollars	Percents
Aircraft	24.7	2.9	18	-1.1	-4
Modifications	6.0	0.4	8	-0.5	-8
Spares and Repair Parts b/	8.8	1.1	22	-0.2	-2
Vehicles c/	7.6	1.0	21	-0.4	-5
Support and Other Equipment	20.8	2.1	16	1.0	5
Ballistic Missiles d/	3.8	e/	-2	2.5	199
Other Missiles, Torpedoes, and Weapons	10.9	1.0	17	1.9	21
Shipbuilding and Conversion	11.5	0.7	7	-0.7	-6
Communications and Electronic Equipment	8.6	0.7	14	1.6	23
Ammunition, Munitions and Related Equipment	4.7	0.5	18	0.2	5
Total	107.4	10.3	15	4.4	4

SOURCE: Compiled by Congressional Budget Office from data supplied by the Department of Defense.

a. Real growth computed using CBO's economic assumptions and the President's pay-raise assumptions.

b. Spares and repair parts for Navy weapon procurement, Navy "other" procurement, and Marine Corps procurement were not broken-out in the DoD justification materials until 1986.

c. Includes Army weapons and tracked combat vehicles and purchases of National Guard and Reserve equipment, but excludes all Navy vehicles which are included in Support and Other Equipment.

d. Fiscal year 1985 does not include $1.5 billion of prior-year funds for the purchase of 21 MX missiles; if these funds were included in the analysis, the five-year average for ballistic missiles would be 15 percent and the real growth between 1985 and 1986 would be 33 percent.

e. Less than $50 million.

Aircraft. The Administration wants $25 billion in 1986 for 919 new aircraft (see Table III-8). This includes almost $10 billion for Navy and Air Force fighters, including the large F-14s and F-15s and the smaller F-16s and F-18s. The Administration also plans to spend about $6 billion for 48 B-1 bombers to complete the Administration's plan to buy 100 B-1s. Nearly $3 billion is targeted for 16 C-5 cargo planes and 12 KC-10 advanced tanker cargo aircraft, which are used primarily for mid-air refueling of strategic and tactical aircraft. The Army would like $2 billion for helicopters, and the Navy hopes for $1 billion in 1986 for antisubmarine aircraft. The remainder would pay for a variety of other aircraft. The Administration proposes to buy 54 more aircraft in 1986 than in 1985. Only the Army would purchase fewer (40) aircraft--eight fewer UH-60 assault/support helicopters and 32 fewer other aircraft, such as trainers and transports. Requests for AV-8B close air support aircraft, EA-6B aircraft that help hide U.S. planes from the enemy radars by jamming them, and CH/MH-53 heavy transport helicopters, in addition to aircraft such as trainers and transports, account for the increase of 23 aircraft in the Navy and Marine Corps. The Air Force program shows increased requests for all major aircraft. The Air Force plan for 1986 projects buying 71 more aircraft than in 1985. This proposed increase is primarily in purchases of major combat aircraft such as F-15s, F-16s, and B-1s, and cargo aircraft like C-5s and KC-10s; the Air Force plan also shows an increase in the purchase of trainer and transport aircraft.

Missiles. Of the $4 billion the Administration requests for buying more ballistic missiles, $3 billion is allocated for 48 MX missiles. If this request and the 1985 request were approved, about 133 more missiles would have to be purchased to meet the President's goal of deploying 100 MXs. The request for all strategic and theater nuclear missiles, except for Pershing II missiles, for 1986 is 71 missiles higher than in 1985 (Pershing II missile quantities are classified in 1986). While the Navy plans to buy 69 more Tomahawk cruise missiles, the Air Force plans to buy 25 fewer ground-launched cruise missiles and 27 more MX missiles (see Table III-9).

Table III-10 shows that the number of tactical missiles would increase by 38,975 from 1985 to 1986. About 55 percent of the proposed increase is in relatively inexpensive rockets for the Army's surface-to-surface multiple launch rocket system.

In 1987 the Administration plans to request more air-to-air, air-to-surface, and surface-to-air missiles than in 1986, but it would buy fewer surface-to-surface missiles.

Armored Vehicles. Real funding of all vehicles would decline by $400 million in 1986. Procurement of armored combat vehicles, such as tanks, fighting vehicles, light armored personnel carriers, and ancillary armored recov-

TABLE III-8. AIRCRAFT ACQUISITION PLANS, BY TYPE AND SERVICE (By fiscal year, in units procured)

Aircraft Type	1984	1985	1986	1987
Army				
AH-64 helicopter	112	144	144	144
UH-60 helicopter	84	86	78	78
EH-60 helicopter	12	18	18	18
Other aircraft	6	32	--	--
Subtotal	214	280	240	240
Navy/Marine Corps				
F/A-18 aircraft	84	84	84	102
F-14 aircraft	24	24	18	18
AV-8B aircraft	27	32	46	47
A-6E aircraft	6	6	6	6
EA-6B aircraft	8	6	12	12
CH/MH-53E helicopter	11	10	14	14
SH-60B helicopter	21	24	18	18
Other aircraft	51	113	124	112
Subtotal	232	299	322	329
Air Force				
F-16 aircraft	144	150	180	180
F-15 aircraft	36	42	48	48
B-1B aircraft	10	34	48	--
KC-10 aircraft	8	8	12	8
C-5B aircraft	4	8	16	21
TR-1 aircraft	6	4	8	2
Other aircraft	34	40	45	128
Subtotal	242	286	357	387
Total	688	865	919	956

SOURCE: Compiled by Congressional Budget Office from data supplied by the Department of Defense.

ery vehicles, would increase, as shown in Table III-11. The Administration's program for armored combat vehicles emphasizes acquisition of two "families" of vehicles (see Table III-11):

- o Heavy combat vehicles for use by Army forces in Europe committed to NATO; and

TABLE III-9. STRATEGIC AND THEATER NUCLEAR MISSILE ACQUISITION PLANS, BY TYPE AND SERVICE (By fiscal year, in units procured)

	Funded		Requested	
Missile Type	1984	1985	1986	1987
Army				
Pershing II	72	70	a/	a/
Navy				
Trident I	52	--	--	--
Trident II	--	--	--	27
Tomahawk	124	180	249	330
Subtotal	176	180	249	357
Air Force				
MX	21	21	48	48
Air-launched cruise missile	240	b/	b/	b/
Ground-launched cruise missile	120	120	95	76
Subtotal	381	141	143	124
Total	629	391	392	481

SOURCE: Compiled by Congressional Budget Office from data supplied by the Department of Defense.

a. Quantity classified.

b. Program terminated in favor of a classified radar-evading version that is not included in this table.

o Light armored vehicles for both the Army and the Marine Corps to support the heavy combat vehicles committed to NATO and to strengthen the Rapid Deployment Force, primarily for potential operations in the Middle East.

The major 1986 change for heavy combat vehicles is an increase of 61 fighting vehicles over the 1985 funded level. For light armored vehicles, the

TABLE III-10. TACTICAL MISSILE ACQUISITION PLANS, BY TYPE AND SERVICE (By fiscal year, in units procured)

Missile Type	Funded 1984	Funded 1985	Requested 1986	Requested 1987
Air-to-Air Missiles				
Navy	1,310	2,936	3,525	3,703
Air Force	2,705	404	1,315	1,555
Subtotal	4,015	3,340	4,840	5,258
Air-to-Surface Missiles				
Army	4,651	5,342	6,576	6,576
Navy	785	1,851	3,903	4,780
Air Force	2,297	3,556	5,312	8,329
Subtotal	7,733	10,749	15,791	19,685
Surface-to-Air Missiles				
Army	1,645	2,800	4,324	8,925
Navy/Marine Corps	1,091	1,230	1,467	3,030
Air Force	60	156	--	--
Subtotal	2,796	4,186	5,791	11,955
Surface-to-Surface Missiles				
Army	54,000	62,472	92,100	89,000
Navy/Marine Corps	3,705	5,293	6,493	6,693
Subtotal	57,705	67,765	98,593	95,693
Total	72,249	86,040	125,015	132,591

SOURCE: Compiled by Congressional Budget Office from data supplied by the Department of Defense.

budget proposes large increases in quantities of M-113 armored personnel carriers, as well as increases in quantities of field artillery ammunition support vehicles and M-88A1 recovery vehicles, or tow trucks for wrecked tanks. There is a planned decrease in the request for M-577 light command post carriers. The Marine Corps does not plan to purchase any additional light armored vehicles in 1986.

TABLE III-11. ARMORED COMBAT VEHICLE ACQUISITION PLANS, BY TYPE AND SERVICE (By fiscal year, in units procured)

	Funded		Requested	
Vehicle Type	1984	1985	1986	1987
Heavy Combat Vehicles				
Army				
M-1 tanks	840	840	840	840
Fighting vehicles	600	655	716	870
Subtotal	1,440	1,495	1,556	1,710
Light Armored Vehicles				
Army				
M-113 armored personnel carriers	125	35	325	--
M-577 light command post carriers	250	167	115	--
Field artillery ammunition support vehicles	120	170	197	190
M-88A1 medium recovery vehicles	180	180	240	180
Subtotal	675	552	877	370
Marine Corps				
Light armored vehicles	236	292	--	--
Total	2,351	2,339	2,433	2,080

SOURCE: Compiled by Congressional Budget Office from data supplied by the Department of Defense.

Ships. Having won the funds for a 600-ship Navy, the Administration requests about $12 billion for ships in 1986, the bulk of which is for 28 new ships and conversions of older vessels. The request includes about $3 billion for three cruisers equipped with the Aegis antimissile control system. The Administration would also like $3 billion for four hunter-killer submarines of the Los Angeles class. Nearly $2 billion would be allocated for a new helicopter carrying ship, about the size of a WWII aircraft carrier. The remainder would pay for various other ships and would cover modernization of older ships, including the aircraft carrier Kitty Hawk and advance funding for the reactivation of the battleship Wisconsin which is planned for 1987. As Table III-12 shows, its plan calls for 131 ships to be constructed, converted, or modified from 1986 through 1990. The 1986 request for 28 ships re-

TABLE III-12. ADMINISTRATION'S NAVY SHIPBUILDING PROGRAM FOR 1986-1990 (By fiscal year, in units procured)

Ship Type	Funded 1985	Requested 1986	1987	1988	1989	1990	1986-1990 Total
Trident Submarines	1	1	1	1	1	1	5
Other Major Warships a/	9	7	11	12	10	10	50
Amphibious Ships	2	3	--	4	6	6	19
Mine Warfare and Patrol Ships b/	4	8	5	4	4	--	21
Auxiliaries	9	9	7	7	6	7	36
Total c/	25	28	24	28	27	24	131

SOURCE: Compiled by Congressional Budget Office from data supplied by the Department of Defense.

a. Includes service life extension program (SLEP) for one conventional carrier in 1985, 1987, and 1990, but no nuclear carriers.

b. Includes frigates.

c. Includes 27 planned reactivations, SLEPs, and conversions.

flects a net increase of three ships over those funded in 1985. In the major warships category, however, the Administration has requested one less destroyer and one less complete overhaul of an aircraft carrier in 1986 than in 1985. The 1986 request also reflects procurement of four more mine sweeper-hunter ships and one more amphibious assault ship than in 1985. Nevertheless the proposed budget for shipbuilding and conversion would decrease from $11.6 billion in 1985 to $11.5 billion in 1986 in nominal terms, which represents a real decline of $700 million.

Unit Costs. In recent years, much of the defense budget debate has centered on the unit costs of major weapons systems; in fact, legislation has been enacted that brings unit cost increases to the attention of the relevant committees. Too little budget justification material is available to evaluate fully the most recent changes in unit costs, but what is available suggests that, on balance, unit prices are slightly lower than the Administration estimated a year ago. Table III-13 provides cost-growth data for 74 major weapons systems by comparing unit costs for 1986 as initially projected by the Administration in February 1984 against estimates contained in the current budget. The table shows a net projected cost decrease of $795 million, or 1.4 percent, since last year (lower inflation estimates account for roughly $175 million of the decline). The table shows that, based on Department of Defense (DoD) estimates, the costs for 45 systems experiencing savings would be about $3.1 billion lower in 1986 than previously projected for the same year. The table also shows that 29 systems would experience cost increases totaling about $2.3 billion above the 1984 estimates.

Generally, unit costs vary inversely with quantities purchased for two reasons. First, fixed costs need to be distributed regardless of the ultimate quantity purchased--lower quantities increase fixed costs per unit. Second, production becomes more efficient as experience increases with quantities purchased--the learning curve effect (see Table III-14). In 14 cases, quantities have been revised upward and unit costs decline, as expected, and in another 20 cases, the opposite occurs. Quantity changes, however, might not be the only reason for the changes in projected unit costs for these 34 systems. Reduced or increased prices could result from any or all of the following: contract negotiations on prior-year purchases, engineering changes, schedule changes, contractor cost performance, support changes, or estimating changes. Indeed, for 40 other procurement items, changes in unit costs appear not to be related to changes in planned new quantities. With no change in planned quantity, 24 systems would experience unit price decreases and 10 systems would experience unit price increases. Five systems would experience unit price decreases with decreases in the planned quantity, and one system would experience a unit price increase with an increase in the planned quantity. The budget justification material already

TABLE III-13. ADMINISTRATION'S CHANGES IN COSTS OF MAJOR WEAPONS SYSTEMS BETWEEN FEBRUARY 1984 AND FEBRUARY 1985 ESTIMATED AND ON 1986 BUDGET EFFECT
(In millions of dollars, in budget authority and percents)

Weapons System	Procurement Unit Cost February 1984	Procurement Unit Cost February 1985	Percent Change a/	Cost Effect on 1986 Budget a/
	Programs with Decreases			
TR-1 aircraft	96.60	44.05	-54	-420
HH-60D helicopter	57.70	33.33	-42	-73
AGM-130 powered GBU-15 bomb	0.77	0.50	-35	-26
Chaparral missile	0.51	0.37	-28	-42
TOW missile, Marine Corps	0.01	0.01	-26	-16
EA-6B aircraft	52.23	38.96	-25	-159
MSH-1 mine sweeper hunter ship	58.58	46.13	-21	-50
UC-12B aircraft	2.79	2.24	-20	-7
37 Other Systems	--	--	--	-2,347
Subtotal, decreases for 45 systems	--	--	--	-3,140
	Programs with Increases			
AMRAAM missile, Air Force	0.78	4.40	466	326
MC-130H aircraft	35.23	83.90	138	49
IIR Maverick missile, Air Force	0.09	0.14	61	191
Phoenix missile	0.89	1.39	55	131
RAM missile	0.26	0.38	49	15
DIVAD gun	3.00	4.33	44	155
Sidearm missile	0.09	0.12	41	6
E-6A aircraft	141.40	197.50	40	112
21 Other Systems	--	--	--	1,360
Subtotal, increases for 29 systems	--	--	--	2,345
Total Effect of 74 Systems				-795

SOURCE: Compiled by Congressional Budget Office from data supplied by the Department of Defense.

a. Percent change and cost effect were calculated before rounding procurement unit costs.

TABLE III-14. PERCENT CHANGE BETWEEN FEBRUARY 1984 AND FEBRUARY 1985 IN QUANTITY AND PROCUREMENT UNIT COST OF SELECTED WEAPONS IN THE ADMINISTRATION'S 1986 ACQUISITION PLAN

Weapons System	Change in Quantity	Change in Procurement Unit Cost
Increasing Quantity and Decreasing Cost		
TR-1 Aircraft	700	-54
AGM-130 Powered GBU-15 Bomb	49	-35
TOW Missile, Marine Corps	19	-26
EA-6B Aircraft	100	-25
Harpoon Missile	10	-15
HARM Missile, Navy	16	-14
HARM Missile, Air Force	2	-10
M-1 Tank	17	-8
Tomahawk Missile	38	-7
C-20A Aircraft	167	-6
Sparrow Missile	11	-5
M88A1 Medium Recovery Vehicle	33	-4
Hawk Missile, Marine Corps	14	-3
TOW 2 Missile, Army	12	-1
Decreasing Quantity and Increasing Cost		
AMRAAM Missile, Air Force	-91	466
MC-130 Aircraft	-75	138
IIR Maverick Missile, Air Force	-56	61
Phoenix Missile	-53	55
RAM Missile	-13	49
DIVAD Gun	-19	44
E-6A Aircraft	-33	40
Standard Missile	-46	29
T-34C Aircraft	-67	18
F/A-18 Aircraft	-18	16
Patriot Missile	-28	14
Stinger Missile, Marine Corps	-61	12
IIR Maverick Missile, Navy	-3	10
F-15 Aircraft	-20	8
F-14 Aircraft	-25	6
Stinger Missile, Army	-47	5
GLCM Missile	-21	5
Bushmaster 25mm Gun	-24	4
MK-46 Torpedo	-67	2
Fighting Vehicle	-20	2

SOURCE: Compiled by Congressional Budget Office from data supplied by the Department of Defense.

provided by DoD does not provide an explanation for any of these unit price changes.

Research, Development, Test, and Evaluation

The 1986 RDT&E budget of $39 billion represents an increase in budget authority of $6.1 billion, or 18 percent (both in real terms), over 1985 levels (see Table III-15). This continues the trend set in the 1980-1985 period, at an increased rate. Over the previous five-year period, RDT&E budgets increased an average of 12 percent a year after adjusting for inflation.

TABLE III-15. REAL GROWTH IN BUDGET AUTHORITY FOR RESEARCH, DEVELOPMENT, TEST, AND EVALUATION, BY BUDGET ACTIVITIES

Program	1986 Request (Billions of Dollars)	Average Annual Real Growth 1980-1985 a/ Billions of Dollars	Percents	Real Growth 1985 to 1986 a/ Billions of Dollars	Percents
Technology Base	3.5	b/	1	0.2	7
Advanced Technology Development	5.5	0.4	28	2.5	87
Strategic Programs	8.6	1.2	24	-0.3	-3
Tactical Programs	12.4	0.5	6	2.4	24
Intelligence and Communications	5.0	0.5	22	0.9	21
Defense-wide Mission Support	4.3	0.2	8	0.4	9
Total	39.3	2.9	12	6.1	18

SOURCE: Compiled by Congressional Budget Office from data supplied by the Department of Defense.

a. Real growth computed using CBO's economic assumptions and the President's pay-raise assumptions.

b. Less than $50 million.

The largest increase in the 1986 budget is for advanced technology development, 87 percent after adjusting for inflation, which is significantly higher than the past five-year average of 28 percent. Advanced technology programs explore alternative designs before development of specific hardware/software systems. The request of about $4 billion for the strategic defense initiative accounts for $2.2 billion of the $2.5 billion real increase. The balance of the increase is scattered among many programs. Tactical programs would grow by nearly 24 percent in 1986, compared with an average annual growth rate of 6 percent over the 1980-1985 period. Many programs contribute to this growth, including all types of weapons from new designs through modifications of existing systems. The third largest increase, 21 percent in real terms, would occur in intelligence and communications programs, in which classified programs account for most of the increase. Defense-wide mission support programs would grow at a rate of 9 percent in 1986, a slightly higher rate than the past five-year average of 8 percent. On the other hand, technology base programs--those dealing with more theoretical research--would grow 7 percent in 1986, compared with the past five-year average of only 1 percent. Many programs would account for these planned increases.

Over the 1980-1985 period, the largest average real growth in the RDT&E budget--28 percent--appeared in the advanced technology development activity. Some of the programs contributing to this growth were the strategic defense initiative, very high-speed integrated circuits, and several other programs. Programs such as the B-1B aircraft, Trident II long-range ballistic missile, strategic communications, and classified programs contributed to the 24 percent average annual increase in strategic programs. Classified programs were the primary cause of the 22 percent average real growth in intelligence and communications activity. Defense-wide mission support grew by about 8 percent annually, primarily because of increases in such programs as satellite launch support.

Tactical programs, for example, missiles, radars, and advanced fighter aircraft, increased by an average of 6 percent over the 1980-1985 period. Programs such as ballistics technology, defense against chemical agents, and laser weapons would be the primary reasons for the 1 percent average real growth in the technology base activity.

Other Accounts

The military construction account funds programs directed at improving the quality of life on military installations and at supporting the introduction of new weapons systems. Quality of life programs are aimed at improving living and working conditions on military bases. Weapons-related projects in this budget category would support the ground-launched cruise missile, the multiple launch rocket system, the Trident II missile, and the B-1 bomber.

The Administration requests $3.3 billion for construction, operations, and leasing of housing for military families. The request calls for 9.8 percent real growth ($300 million) and includes initiatives to renovate and replace units that are energy inefficient.

The Department of Energy (DOE) conducts research and production programs for nuclear weapons and materials; DOE also has programs related to storing nuclear waste and to the design of reactors for nuclear-powered naval vessels. A real increase over 1985 of about $266 million, or 3.4 percent, would support increases in missile warhead production and production of special nuclear materials.

SOURCES OF OUTLAY GROWTH AND POTENTIAL REDUCTIONS

In the previous section, the defense budget was discussed in terms of budget authority, that is, the authority to spend approved by the Congress in appropriation bills. Budget authority levels can be raised or lowered more easily than cash outlays although it is outlays that are calculated in the budget deficit, not budget authority. Defense outlays would grow over the next five years even if budget authority were held absolutely constant over the entire period. The growth stems from the large funding increases for defense since 1980, and from the fact that a time lag exists between appropriations and corresponding expenditures. 1/ With constant budget authority, defense outlays would increase until they eventually equaled budget authority. Increasing the budget authority each year to cover the costs of expected inflation means that outlays will also grow because they vary in somewhat direct proportion to budget authority. Similarly, providing real growth in budget authority means still further growth in outlays.

The major sources of outlay growth in the Administration's defense budget from 1986 through 1990 are shown in Figure III-2. The largest component of the $32 billion growth in defense outlays proposed for 1986 is the result of past increases in budget authority. If defense budget authority were frozen in 1986 at the 1985 level, outlays would still grow by $18 billion

1. This time lag varies from one to eight years, depending on the program. An appropriation that would fully fund an aircraft carrier in one fiscal year, for example, would result in outlays for five or more years because of the time required for contracts to be negotiated fully, the work to be performed, and the expenditures (outlays) to be made.

as funds are paid out from prior-year appropriations. Another $5.9 billion of the increase can be attributed to keeping pace with inflation. The real growth component of the 1986 increase in defense outlays is $8.5 billion, or 26 percent of the total outlay increase. By 1988, the real growth component is substantially larger than the inflation component or the outlay catch-up for past budget authority increases, and by 1990 it represents 51 percent ($92 billion) of the $183 billion increase over the 1985 outlay level. Keeping pace with assumed inflation over the next five years will make up $61 billion (33 percent) of the 1990 outlay increase. The remaining $30 billion increase can be attributed to outlays catching up with the budget authority increases provided prior to 1986.

The future pattern of outlay growth in the Administration's budget proposals is similar to that of the last five years. Figure III-3 shows a similar pattern for the growth in defense outlays from 1981 through 1985. Of the $119 billion increase in defense outlays during this five-year period, $70 billion (59 percent) can be attributed to real growth in budget authority, $40 billion (34 percent) to keeping pace with inflation, and $9 billion (7 percent) to increases in budget authority in prior years. In both periods, it is the increases in budget authority to cover inflation and to provide real growth that eventually dominate outlay growth.

The sources of future growth in defense outlays will be directly related to alternative defense budgets that the Congress will consider. In recent years, the debate about appropriate levels of defense appropriations has been couched in terms of different real growth rates--for example, 3 percent, 5 percent, 7 percent, and the like. This year, the notion of a freeze in defense appropriations is also being considered. A freeze in defense spending authority can be applied in real terms, allowing increases for expected inflation, or in nominal terms with no increases for inflation. A nominal freeze in defense appropriations would mean a real decline in funding levels since the costs of inflation still would have to be met.

Table III-16 shows various levels of funding under different rates of defense growth, including a one-year freeze in 1986 in both real and nominal terms. The most stringent level of funding shown is a defense budget that only keeps pace with expected inflation during 1986-1990--a zero real growth budget. A zero real growth budget would save $81 billion in outlays by 1988 and $243 billion by 1990. In contrast, a nominal freeze in 1986 followed by baseline budget authority lagged one year for 1987-1990 would save slightly more through 1988, $85 billion, but less through 1990, $183 billion. 2/

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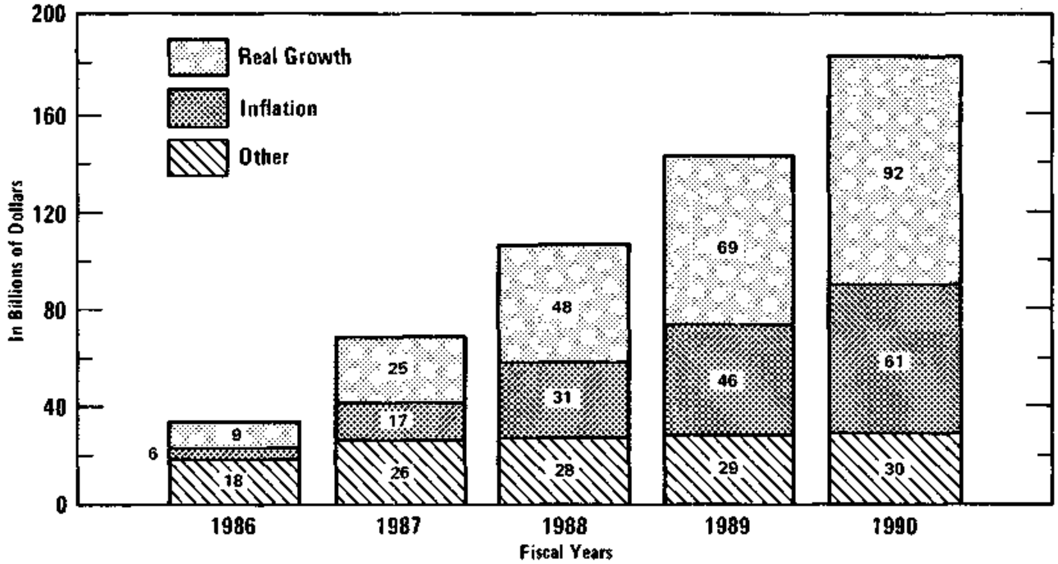
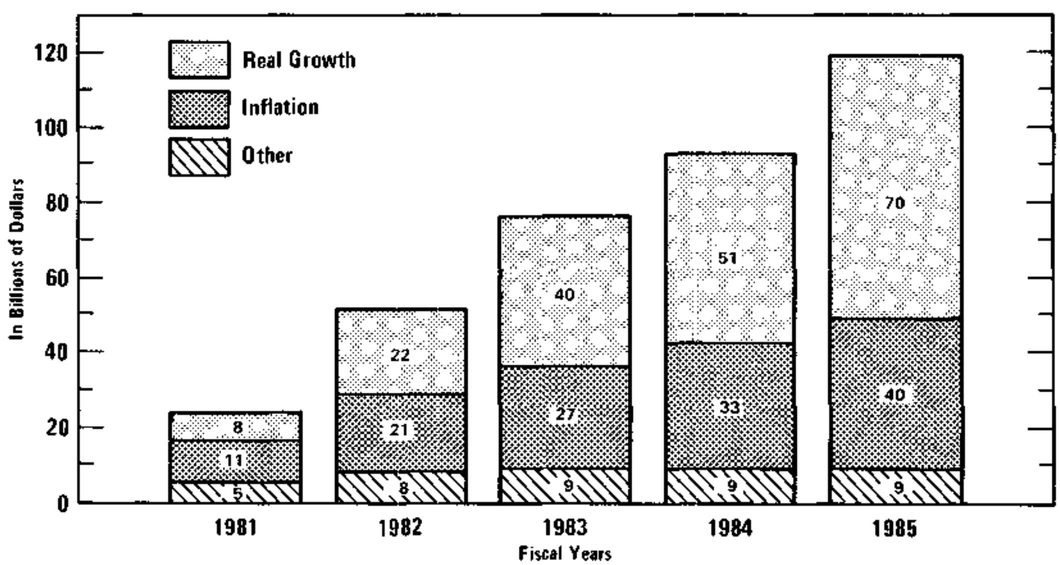
2. This alternative effectively slips the budget resolution one year in that 1986 budget authority equals the budget resolution amount for 1985; 1987 budget authority equals the baseline amount for 1986 and so on.

Figure III-2.
Sources of Growth in Defense Outlays, Fiscal Years 1986-1990



SOURCE: Congressional Budget Office.

Figure III-3.
Sources of Growth in Defense Outlays, Fiscal Years 1981-1985



SOURCE: Congressional Budget Office.

The second pair of alternatives shows the importance of the 1986 base in achieving savings. A zero real growth budget in 1986, followed by 3 percent real growth, would save $68 billion through 1988 and $179 billion through 1990. In contrast, 3 percent real growth in all years would save $50 billion and $141 billion through 1988 and 1990, respectively. The difference between providing 3 percent real growth in the 1986 base is $18 billion through 1988 and $38 billion through 1990.

The programmatic consequences of these alternatives are hard to predict for there are many options available. An alternative calling for lower real growth in budget authority might be implemented by trimming or postponing marginal programs and levels of effort from the Administration's request. Such possible program reductions are outlined in the CBO report, Reducing the Deficit: Spending and Revenue Options (February 1985). The options outlined in the CBO report are certainly not exhaustive. They are enough, however, to assemble packages that significantly reduce defense spending by slowing investment force growth or operating costs--or by some combination of these options. The choice affects the speed of modernization versus improvements in force and readiness. It also determines when the effects on deficits take place. Emphasis on slowing investment means smaller outlay reductions in the budget year. For example, providing no real growth in defense budget authority in 1986--which reduces 1986 budget authority by $17 billion--would reduce outlays from the Administration's request by $9 billion in 1986 if total budget authority were allocated according to CBO baseline assumptions. Alternatively, outlays would be cut by $5 billion if total budget authority were allocated with a faster spending mix of programs such as the Administration does with its increases in RDT&E.

The alternatives shown in Table III-16 incorporate two important sets of assumptions. First, CBO economic assumptions for defense purchases and the Administration's pay- raise proposals are used to determine budget authority. Second, when an option calls for real growth, CBO assumes that the real growth is used much more to buy hardware than to increase numbers of military and civilian employees. The second assumption means that, for a given amount of defense budget authority, associated outlays would be lower than if budget authority were allocated to faster-spending accounts as the Administration does when it allocates a sharply increasing share to RDT&E.

CBO estimates for price growth in defense purchases are related to CBO's overall economic forecast calling for generally higher inflation than the Administration. Consequently, CBO expects more price growth in defense purchases than the Administration does, as shown in box on page 52. (Outlay deflators measure current price change much as the GNP deflator

TABLE III-16. COMPARISON OF THE CBO REESTIMATE OF THE ADMINISTRATION'S 1986 DEFENSE BUDGET WITH ALTERNATIVE BUDGET ASSUMPTIONS (By fiscal year, in billions of dollars)

Spending Level	1986	1987	1988	1989	1990	Cumulative Five-Year Totals
Administration's Request						
Budget Authority	323	363	412	449	488	2,035
Outlays	284	319	358	396	435	1,793
Alternative Funding Levels						
3 Percent Real Growth in All Years, 1986-1990						
Budget Authority	315	341	368	398	429	1,851
Outlays	279	304	329	356	384	1,653
Zero Real Growth 1986-1990						
Budget Authority	306	321	337	354	370	1,688
Outlays	276	294	311	327	343	1,551
Real Freeze in 1986, 3 Percent Real Growth 1987-1990						
Budget Authority	306	331	358	386	417	1,798
Outlays	276	297	321	347	373	1,614
Nominal Freeze in 1986, Lagged Baseline Levels in 1987-1990						
Budget Authority	293	324	360	398	439	1,814
Outlays	270	290	317	349	385	1,609

(Continued)

TABLE III-16. (Continued)

Spending Level	1986	1987	1988	1989	1990	Cumulative Five-Year Totals
Administration's Request						
Budget Authority	323	363	412	449	488	2,035
Outlays	284	319	358	396	435	1,793
Savings Under Alternative Funding Levels						
3 Percent Real Growth in All Years, 1986-1990						
Budget Authority	8	23	43	51	59	183
Outlays	6	15	29	40	50	141
Zero Real Growth 1986-1990						
Budget Authority	17	42	75	95	118	347
Outlays	9	25	48	69	92	243
Real Freeze in 1986, 3 Percent Real Growth 1987-1990						
Budget Authority	17	33	54	62	71	237
Outlays	9	22	38	50	61	179
Nominal Freeze in 1986, Lagged Baseline Levels in 1987-1990						
Budget Authority	30	39	52	51	49	220
Outlays	15	29	42	48	50	183

SOURCE: Congressional Budget Office.

does and in contrast to budget authority deflators that are a weighted average of future inflation). 3/

Through 1985, most real increases in budget authority have been allocated to purchasing hardware--especially major weapons systems. CBO bases its projections of alternative funding levels on the assumption that such allocations will continue. The Administration's request would change the pattern by increasing RDT&E, a relatively fast-spending account, more than other areas. As a result, the differences between the alternatives in Table III-16 and the request reflect both a difference in budget authority and a difference in program mix. Greater outlay savings or lesser outlay savings are possible, depending on how one proposes to allocate a given amount of budget authority.

COMPARISON OF CBO AND ADMINISTRATION INFLATION ASSUMPTIONS FOR DEFENSE PURCHASES
(Percent change, purchase deflator for outlays)

	1985	1986	1987	1988	1989	1990
CBO	4.0	4.7	5.4	5.3	5.1	4.8
Administration	3.6	4.6	4.5	4.4	4.1	3.7

3. Pay raises pose a unique problem in that they are treated as administered price changes. Real growth in military personnel is determined by increases in strengths; in the short term, pay raises do not affect strength and quality appreciably and are a suitable proxy for price changes. In the long run, differences in pay between federal and private employees can make a difference in measuring real growth because quantity and quality have time to change.

CHAPTER IV

ENTITLEMENTS AND OTHER MANDATORY SPENDING

The Administration's fiscal year 1986 budget proposes reductions that would lower entitlement spending relative to CBO's baseline by $14 billion in 1986 and by $144 billion from 1986 to 1990. These program changes amount to 3 percent of baseline spending in 1986 and rise to almost 7 percent by 1990. Since half of entitlement spending, including that in Social Security, is excluded from the proposals, reductions in the remaining programs are relatively large, and one program--general revenue sharing--is proposed for elimination.

Entitlement programs provide benefits to persons, businesses, or units of government that meet eligibility requirements established in law. Social Security is the largest entitlement program, with outlays constituting about 20 percent of the entire federal budget. Other major entitlement programs include Railroad Retirement, civil service and military retirement and disability, Unemployment Insurance, Medicare and Medicaid, Aid to Families with Dependent Children (AFDC), Supplemental Security Income (SSI), Food Stamps, farm price supports, Guaranteed Student Loans (GSLs), and veterans' compensation, pensions, and readjustment benefits.

OVERVIEW OF ADMINISTRATION PROPOSALS

Directly setting levels of budgetary outlays in entitlement programs is virtually impossible. To reduce spending below baseline levels, laws must be changed to modify eligibility rules or benefit levels. A complete freeze on entitlement spending, for example, would require complicated programmatic changes to offset the often unpredictable growth in caseloads or benefit levels.

The Administration proposals fall into two categories: (1) freezing benefit levels in selected programs where benefit rates or other explicit program parameters are increased for inflation; or (2) more fundamental programmatic changes in areas not susceptible to freezes.

Freeze Variants

The 1986 budget proposes to: (1) eliminate the COLAs for one year in all federal employee retirement and disability programs, (2) eliminate the July 1986 inflation adjustment in reimbursement rates for child nutrition programs, (3) freeze the reimbursement rates to hospitals and physicians in the Medicare program, and (4) freeze the benefit levels in the Black Lung and Special Benefits for Disabled Coal Miners programs. Together these actions are estimated to save $30 billion from 1986 through 1990.

The Administration's request does not, however, propose eliminating the 1986 COLA in other indexed programs. Social Security and veterans' compensation beneficiaries would receive a full inflation adjustment on January 1, 1986, under the President's request. If, as some Congressional plans have suggested, these COLAs were also eliminated for one year, savings would increase by $36 billion from 1986 through 1990. Finally, the Administration's request would give full COLAs to recipients of SSI, veterans' pensions, and food stamps. If the 1986 inflation adjustment were eliminated in these means-tested programs, savings would increase by $6 billion in the period 1986-1990.

For several programs, reductions are proposed in addition to a one-year freeze. The Administration proposes a number of additional reductions in Medicare and in civil service and foreign service retirement and disability, many of which have been included in previous budgets but have not been enacted by the Congress. Together these additional proposals would save $15 billion from 1986 through 1990.

Programs Not Susceptible to a Freeze

The Administration's request also suggests large reductions in a number of other programs not susceptible to a freeze, including farm price supports, Guaranteed Student Loans, and other entitlement programs. Finally, general revenue sharing would be eliminated under the Administration's request. These additional proposals would save another $99 billion over the next five years.

As shown in Table IV-1, the distribution of reductions across entitlement programs is highly uneven. The Administration has proposed no reductions for Social Security, Unemployment Insurance, SSI, and veterans' compensation and pensions. Yet Social Security alone is responsible for almost 45 percent of total baseline spending for entitlements from 1986-1990, and when other programs exempted from reductions are considered, over half of all entitlement spending is held harmless.

While the Administration's request would reduce total entitlement spending by almost 6 percent, programs targeted for reductions would be reduced by 12 percent on average. A number of programs would be reduced even more. General revenue sharing would be eliminated. Farm price supports would be reduced by 50 percent. Guaranteed Student Loans and child nutrition would each be reduced by 20 percent or more as would

TABLE IV-1. CBO BASELINE AND CBO ESTIMATES OF THE ADMINISTRATION'S PROPOSED REDUCTIONS IN ENTITLEMENTS AND OTHER MANDATORY SPENDING (In billions of dollars)

Program	CBO Baseline 1986-1990	Administration Reductions 1986-1990	Percent Reduction
Social Security and Railroad Retirement	1,144	a/	b/
Federal Retirement and Disability	247	-12	5
Medicare and Medicaid	624	-44	7
Unemployment Insurance	88	a/	b/
AFDC, Food Stamps, SSI	170	-1	1
Veterans' Programs c/	85	-2	2
Farm Price Supports	64	-32	50
General Revenue Sharing	25	-24	96
Child Nutrition	23	-5	22
Guaranteed Student Loans	18	-5	30
Other	72	-21	29
Total	2,557	-144	6

a. Less than $500 million.

b. Less than 0.5 percent.

c. Includes veterans' compensation, pensions, readjustment benefits, and home loan guarantees.

certain other, smaller entitlement programs. On the other hand, the reductions proposed for the major means-tested programs are small relative to the reductions proposed in other entitlement programs and relative to reductions proposed in these programs in previous years.

The annual savings in proposed entitlement reductions are estimated by CBO to grow rapidly from $14 billion in 1986 to $40 billion in 1990 (see Table IV-2). The largest savings are proposed for the major health entitlements, Medicare and Medicaid, followed by farm price supports. Estimated savings from the four largest program categories--health, farm price supports, general revenue sharing, and federal retirement and disability--equal $112 billion over the five-year period and constitute over 75 percent of the total savings requested.

MAJOR PROGRAM PROPOSALS

Medicare and Medicaid

Medicare and Medicaid, the major entitlement programs providing federal funding for health services, are the fastest-growing programs in the nondefense budget (aside from interest costs). Medicare, which includes the Hospital Insurance (HI) and the Supplementary Medical Insurance (SMI) programs, covers hospital, physician, and other medical costs for people aged 65 and over and for most disabled people entitled to Social Security cash benefits. Medicaid, through federal and state financing, pays for health services for some low-income people. Medicare and Medicaid together provide benefits to about 50 million people, at an estimated federal cost of $93 billion in 1985.

The President's proposed cuts from the CBO baseline in Medicare and Medicaid total $4.4 billion in 1986 and $43.9 billion in 1986-1990. They account for 30 percent of proposed savings in entitlement programs.

Medicare. The Administration's 1986 budget proposals would curb the growth in the Medicare program both by limiting the growth in reimbursements to health care providers and by shifting costs to beneficiaries. The Administration's proposals--both regulatory and legislative--would save an estimated $24.1 billion in HI and $6.2 billion in SMI between 1986 and 1990. Savings of another $10.8 billion from increases in SMI premiums are also proposed. Further discussion of premiums can be found in Chapter VI. Even with these proposed reductions, Medicare spending is projected to rise by 51 percent between 1986 and 1990, and rise relative to GNP from 1.8 percent to 2.0 percent. The major components of the proposed Medicare cuts are shown in Table IV-3 and discussed below.

TABLE IV-2. CBO ESTIMATES OF THE ADMINISTRATION'S PROPOSED REDUCTIONS IN ENTITLEMENTS AND OTHER MANDATORY SPENDING
(By fiscal year, in billions of dollars)

	1986	1987	1988	1989	1990	Cumulative Five-Year Change
CBO Baseline Outlays	446	478	512	543	578	
Proposed Changes						
Medicare and Medicaid	-4	-7	-9	-11	-13	-44
Farm price supports	-1	-4	-8	-10	-10	-32
General revenue sharing	-3	-5	-5	-5	-5	-24
Federal retirement and disability	-1	-2	-3	-3	-4	-12
Housing loans and expenses a/	-1	-2	-2	-2	-2	-10
Guaranteed Student Loans	-1	-1	-1	-1	-2	-5
Child nutrition	-1	-1	-1	-1	-1	-5
Mortgage guaranty fees	-1	-1	-1	-1	-1	-4
AFDC, Food Stamps, and SSI	b/	b/	b/	b/	b/	-1
Other	-1	-1	-1	-2	-2	-7
Total	-14	-23	-31	-36	-40	-144
President's 1986 Budget as Estimated by CBO	431	456	481	507	538	

a. The President's budget proposes that the Department of Housing and Urban Development be forgiven the interest payments on certain Treasury borrowing made in 1985 and earlier years. The reduced interest payments shown above are offset elsewhere in the unified budget. This change is discussed in Chapter VI.

b. Less than $500 million.

TABLE IV-3. CBO ESTIMATES OF THE ADMINISTRATION'S PROPOSED REDUCTIONS IN MEDICARE (By fiscal year, in billions of dollars)

Proposal	1986	1987	1988	1989	1990	Cumulative Five-Year Change
CBO Baseline Outlays	77.5	86.3	96.5	107.9	120.7	
		Freeze Provider Payments				
Change Hospital DRG Rate: 1986 Freeze	-1.5	-2.1	-2.4	-2.6	-2.9	-11.5
1987-1990 Policy- - Market Basket Only		-0.1	-0.3	-0.5	-0.8	-1.7
Freeze Physician Fees	-0.5	-0.5	-0.5	-0.5	-0.5	-2.3
Freeze Other Payments- - Skilled Nursing Facilities, Labs, PPS-Exempt Hospitals, Direct Medical Education, Medical Supplies	-0.3	-0.5	-0.9	-1.3	-1.7	-4.8
Total Freeze Changes	-2.3	-3.2	-4.0	-4.9	-5.9	-20.3
		Mandate Program Changes				
Phase SMI Premium to 35 Percent, Offsets from Other Proposals a/	(-0.2)	(-0.7)	(-1.7)	(-3.2)	(-4.9)	(-10.8)
Reduce Indirect Medical Education Add-on to 5.79 Percent	-0.6	-0.8	-1.1	-1.2	-1.4	-5.1
Require Home Health Copayment, Increase SMI Deductible, Delay Eligibility One Month	-0.3	-0.5	-0.6	-0.7	-0.9	-3.0
Extend Medicare Second Payer to Over-Age 69, and Other	-0.2	-0.4	-0.4	-0.5	-0.5	-2.0
Total Program Changes	-1.1	-1.6	-2.1	-2.4	-2.7	-10.1
Total Changes	-3.4	-4.8	-6.1	-7.3	-8.6	-30.3
President's 1986 Budget as Estimated by CBO	74.0	81.4	90.3	100.5	112.0	

a. SMI premiums are included in the offsetting receipts category discussed in Chapter VI and are not counted in the totals for entitlements.

Under current law, hospitals are reimbursed by Medicare through a prospective payment system (PPS) under which rates are set in advance for each of 468 diagnostic categories, known as diagnosis related groups (DRGs). In the HI program, the Administration proposes to achieve major savings by freezing the DRG rates of reimbursement in 1986 for hospitals subject to PPS. In addition, the Administration's current services projections assume that in 1987 through 1990 the rate of increase in DRGs would be limited to the rate of increase in the cost of a market basket of goods and services typically purchased by hospitals. This policy differs from that enacted in the Deficit Reduction Act of 1984, which capped the growth in the DRG rates at market basket plus one-quarter (0.25 percentage point) for 1986 and left future increases to the discretion of the Secretary of Health and Human Services with the advice of a special commission. The CBO baseline assumes a rate of increase equal to the market basket plus one-quarter. The Administration's policy changes would lower DRG growth one-quarter of a percentage point each year from 1987 through 1990 relative to CBO baseline. Estimated savings from these initiatives would total $13.2 billion from 1986 through 1990 and would account for a 4 percent decrease in HI outlays.

The Administration is also proposing to freeze physician fees for one additional year, which would reduce SMI outlays. The Deficit Reduction Act of 1984 froze physician fees for 15 months beginning in July 1984, and this new legislative proposal would extend the freeze through fiscal year 1986, for a total of 27 months. The Administration's proposed freeze would save $2.3 billion over the 1986-1990 period, and total savings from the 27-month freeze would be $5.8 billion over the same period.

A freeze is also proposed on certain other payments: to skilled nursing facilities, to laboratories, to certain hospitals not included in the prospective payment system, and for direct medical education and medical supplies. All of the freeze proposals account for about two-thirds of the total $30.3 billion estimated to be saved in Medicare during 1986-1990.

In addition to freezing certain provider payments, the Administration is proposing a number of program changes. One of these changes--reducing reimbursement for indirect medical education by 50 percent (to 5.79 percent)--would also affect providers in teaching hospitals and save an estimated $5.1 billion during 1986-1990.

A number of the proposed changes would affect beneficiaries directly. Similar proposals have been suggested by the Administration in previous budgets. The SMI deductible would be indexed and increased each year. The deductible would increase from the current rate of $75 to $90 by 1990. A copayment equal to 1 percent of the hospital deductible (about $4.80 in

1986) would be established for each home health visit after 20 visits. Also, Medicare eligibility for the aged would be delayed one month, to the first day of the month following a person's sixty-fifth birthday. Together these proposals would save an estimated $3 billion during 1986-1990.

Finally, coverage of elderly people who work would be modified by making Medicare the secondary payer for workers over 69 who chose to be covered under employment-related insurance. This and several other proposals would save an estimated $2 billion during 1986-1990.

Medicaid. The President's budget proposes to change the nature of the Medicaid program from an open-ended entitlement to one that is capped. Estimated savings would total $13.6 billion between 1986 and 1990.

Specifically, the President's budget proposes to limit 1986 payments to the states for medical care services to a level $1.3 billion below current services. During 1986 only, a total of $0.3 billion would be returned to the states in the form of payments to states facing special problems. From 1987 through 1990, the limits on Medicaid payments would be adjusted for changes in the medical care component of the CPI. The Administration intends to offer additional legislative and regulatory changes to increase state flexibility in limiting eligibility, coverage, or reimbursements. Otherwise, states might find it impossible to meet federal requirements without substantial increases in their spending on Medicaid.

In addition to a cap on spending for medical services, the President proposes to limit the federal payment for administrative expenses in 1986 to the 1985 level. After 1986, the federal share for administrative expenses would be allowed to grow at a rate equivalent to the GNP deflator.

Farm Price Supports

Farm price- and income-support programs provide benefits to farmers by stabilizing and enhancing farm prices and incomes (see accompanying box). Outlays for price-support programs peaked at $18.9 billion in 1983, nearly six times their average in the 1970s. Outlays fell to $7.3 billion in fiscal year 1984 as a result of a sharp decline in crop production caused by the payment-in-kind (PIK) program and a severe drought. Outlays in 1985 are expected to rise to $14.2 billion as crop production rebounds and exports remain sluggish in the face of a strong dollar. In addition, advance deficiency payments on 1985 crops will help push outlays above last year's level. With a continuation of current policy, outlays are forecast to average $12.8 billion over the 1986-1990 period.

HOW FARM PRICE SUPPORTS WORK

Price-support expenditures are designed to stabilize crop prices and increase farm income. The commodities covered by these programs are wheat, corn and other feed grains, soybeans, rice, upland cotton, tobacco, peanuts, milk, and wool. The main price stabilization tools are nonrecourse loans and the farmer-owned grain reserve.

Nonrecourse loans are made to crop farmers at a specified loan rate, or price support, per unit of production. Farmers may store crops and use them as collateral for 9- to 12-month loans at the loan rate. If a farmer elects not to repay the loan plus interest, the government agrees to accept the commodity as full reimbursement. Thus, nonrecourse loans place a floor under market prices, provide a source of interim financing for farmers, and help farmers spread their sales throughout the marketing year.

A wheat or feed grain grower may place grain in the farmer-owned reserve when a nonrecourse loan becomes due. Under the reserve program, a farmer contracts with the government to store grain for a three-year period, while the farmer receives an extended nonrecourse loan. Grain in the reserve cannot be sold, except with a financial penalty, until the market price reaches a trigger release price, at which time storage payments cease and the farmer can repay his loan without financial penalty. Interest is charged only for the first year. Both nonrecourse loans and the farmer-owned reserve tend to withhold products from the market when prices are low.

Under certain conditions, farmers can also qualify for deficiency payments and reductions in planted acreage. Deficiency payments support the incomes of feed grain, wheat, rice, and cotton farmers when national average prices for a specified period fall below target prices. The maximum payment per unit of production is the difference between the target price and the nonrecourse loan rate.

Reductions in planted acreage from predetermined base levels may also be required of grain and cotton farmers to qualify them for the above program benefits. Further, these farmers may be offered land diversion payments in cash or in kind for additional acreage reduction. The total amount of deficiency and cash diversion payments that an individual can receive is $50,000 a year.

Milk prices are supported by government purchases of surplus manufactured dairy products. The support price for milk determines the government purchases of these products.

The President proposes to reduce spending from projected baseline levels for price supports by 50 percent over the five-year period. The proposed changes are estimated by CBO to save $1.4 billion in 1986 and $32.2 billion from 1986-1990. The major components of the proposal are:

- o Setting nonrecourse loan rates at 75 percent of the average of market prices during the past three years.

- o Phasing out deficiency payments by the 1991 crop. For the 1986 crop, target prices would be set at 100 percent of the average of market prices experienced during the preceding three years.

- o Reducing the $50,000 limitation on direct payments to individuals to $20,000 for the 1986 crop, $15,000 for the 1987 crop, and $10,000 for the 1988 and later crops.

- o Phasing out acreage control programs. During the first three years of the program a transitional acreage control program would be retained for wheat, corn and other feed grains, cotton, and rice.

- o Phasing out the dairy price-support purchase program and replacing it with a direct payment program in 1988.

The effects of these changes on the farm sector are difficult to forecast. In recent years, price-support programs and the high value of the dollar have caused U.S. crops to become less competitive in world markets. Reducing market prices through lower price supports should result in increased exports of our agricultural products. In addition, some analysts argue that current agricultural policies encourage excessive investment in agriculture. The proposed changes would cause investment and production decisions to be determined more by market forces than by federal agricultural policy. Consumers would benefit directly from lower prices for sugar and dairy products. Meat prices might also decline as grain prices drop.

Lower prices and reductions in income support, however, would have significant effects on farmers. These changes would aggravate current credit problems brought on by high interest rates and already relatively low commodity prices. Transitional costs could be high for people in certain sectors of the agricultural economy as the value of land and other assets adjust to the new lower commodity prices.

General Revenue Sharing

The general revenue sharing (GRS) program provides unrestricted grants totaling $4.6 billion annually to all local governments--counties, municipalities, townships, and Indian tribes. Revenue sharing funds are divided among local governments according to formulas based on population, income, and tax factors. The formulas are designed to target assistance toward governments with low per capita incomes or high tax efforts. The program generally has accounted for less than 2 percent of local government revenues, although for some rural and suburban governments the percentage has been higher. States participated in the program until 1981 when their shares were eliminated.

The President proposes eliminating the program in 1986, a year before the current authorization expires. Savings from this proposal would be $3.4 billion in 1986 and $23.7 billion over the 1986-1990 period. The estimated savings are from the CBO baseline, which assumes that the program is reauthorized in 1987 at levels that would keep pace with inflation. Previous Presidential budgets have not proposed eliminating general revenue sharing funds.

Federal Retirement and Disability

Federal retirement and disability programs provide benefits to all federal employees--both civilian and military--when they retire or become disabled. The President's 1986 budget proposes eliminating the scheduled 1986 COLAs in all federal retirement programs. Based on projections of consumer prices, CBO projects a 3.7 percent COLA under current law. Eliminating this COLA would reduce projected benefit payments beginning in January 1986, saving $1.2 billion in 1986 and $7.7 billion in 1986-1990.

Civil Service and Foreign Service Retirement and Disability. The President's budget proposes almost identical changes to the civil service and foreign service retirement and disability programs. Elimination of the 1986 COLA would save an estimated $0.7 billion in 1986 and $4.3 billion in 1986-1990. In addition, the President's budget suggests structural changes in these programs that would save another $4.8 billion over the five-year period ending in 1990. Most structural changes have been requested in previous budgets, but they have never been acted on by Congress.

Beginning in 1987, the COLA would be changed to equal the lower of the proposed General Schedule (GS) pay increase for civil servants or the change in the Consumer Price Index. The Administration's proposed GS pay increase of 3 percent each year in 1987 through 1990 is estimated to be lower than the CPI change, resulting in a lower COLA than under current law. Also, those whose benefits exceed $10,000 a year would receive only 55 percent of the COLA on benefit amounts in excess of $10,000.

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In addition to COLA changes, the budget proposes to reduce civil service benefits for those retiring before age 65 (before age 60 for foreign service retirees). This reduction would be phased in over 10 years and would not affect people currently 55 years or older. When fully implemented, those people retiring at age 55 with 30 years of service would receive 50 percent less in benefits than under current law. Other proposals in civil service and foreign service retirement include reducing survivor benefits, eliminating student benefits, phasing out the use of unused sick leave in calculating retirement benefits, and changing the annuity calculation from using the highest three years of pay to the highest five years of pay.

The magnitude of the proposed reductions is far larger than the five-year savings would indicate. Savings from the changes would grow considerably after the end of the projection period. The President's proposals this year to change federal retirement benefits, and to reduce federal civilian pay and federal employee health insurance benefits, would focus a significant portion of the proposed budget reductions on federal civilian employees.

Other Retirement and Disability Programs. The proposed freeze of the 1986 COLA would also lower benefits in the retirement programs of the military, Public Health Service Commissioned Officers, Coast Guard, and in federal employee workers' compensation. Savings are estimated to be $0.5 billion in 1986 and $3.5 billion in 1986-1990.

The Administration's treatment of military retirement is in sharp contrast to the proposed reductions in civil service retirement and disability. While COLAs are proposed for elimination in both programs, civil service is also targeted for additional major changes in the calculation of benefits for future retirees. No additional reductions are proposed for current or future military retirees.

Guaranteed Student Loans

The Guaranteed Student Loans (GSL) program provides guaranteed loans at below-market interest rates to eligible college students. The President has proposed comprehensive changes for students attending postsecondary institutions, covering both grants--such as Pell grants discussed in Chapter V--and guaranteed loans. The President's proposal for the GSL program would further target assistance toward the lowest-income students and would reduce subsidies and loan levels generally. All parties--students, lenders, and state guarantee agencies--would be affected, resulting in estimated savings of $0.5 billion in 1986 and $5.2 billion in 1986-1990. By 1990, projected program costs would be cut by 50 percent.

Some 35 percent fewer students would be eligible for guaranteed loans in 1986 under the proposed tightening of eligibility rules. Any student from a family with income greater than $32,500 would be ineligible for a subsidized loan. Financial need assessments would be required for all students. With few exceptions, no students under age 22 could be classified as financially independent from their parents, thus implying that parental income would be considered in determining eligibility. Finally, a "mega cap" of $4,000 a year would be imposed on all federal student aid. Interest rates paid by the student after leaving school would be set at the market rate rather than at the current 8 percent rate, but the government would continue to pay interest while students are in school.

Lenders who now receive a variable return of 350 basis points above a fluctuating 91-day Treasury bill rate would receive 150 basis points above the bill rate at the loan's initiation while the student is in school and 300 basis points above that rate when the student is repaying the loan. This would increase lenders' risk to rising interest rates. Lenders would also be required to disburse funds in multiple increments over the school year. In addition, state guarantee agencies would no longer receive an administrative allowance, would be required to share more of the cost of defaults, and would have to return all federal advance funds.

CBO estimates that the combined effect of these proposals would be to cut in half annual new loan volume, reducing it to an estimated $4.8 billion in 1987. The estimated number of GSL borrowers in 1987 would drop from 3.6 million to 2.3 million. Some 1.0 million students from families with incomes in excess of $30,000--almost 30 percent of current borrowers--would be eliminated from the program as would another 0.3 million borrowers with incomes below $30,000. The effect would be even larger than estimated here if private lenders dropped out of the program because of either a reduced demand for loans or reduced subsidies.

Child Nutrition

The child nutrition programs provide subsidized meals to children, with larger subsidies going to those in families with low or moderate incomes. The President's budget proposes to eliminate all subsidies to children from families with incomes above 185 percent of the poverty level. These subsidies currently account for 16 percent of total outlays. In addition, the July 1986 inflation adjustment in reimbursement rates for meals would be eliminated. Total savings from these changes are estimated to be $0.7 billion in 1986 and $5.2 billion from 1986-1990. CBO estimates that program spending would be cut by almost one-quarter as a result of these proposed changes. Eliminating subsidies to children from families with incomes above 185 percent of poverty would affect the school lunch, school breakfast, and child care programs and would save an estimated $1.0 billion in 1990. The Administration proposed a similar change in its 1982 budget, but since then has sought to limit growth primarily by consolidating certain child nutrition programs into a block grant to states.

This proposal would eliminate subsidies for approximately one-half of the children now in the school lunch program. As a result, some schools, though probably a small number, might discontinue the school lunch program, thereby further decreasing the number of subsidized meals.

Mortgage Guaranty Fees

The Federal Housing Administration (FHA) and the Veterans Administration (VA) insure home loans made to veterans and other qualified buyers by private lenders against the risk of default. The Government National Mortgage Association (GNMA), an agency of the Department of Housing and Urban Development, sells government securities that are backed by pools of the mortgages insured by FHA or VA. GNMA further guarantees the prompt payment of principal and interest to the purchasers of these securities.

A major strategy underlying many of the President's deficit reduction proposals is to shift more of the costs of providing federal services to the specific users of the services. As part of this approach, the 1986 budget proposes to increase the fees charged by these agencies to guaranty or insure home mortgages and mortgage-backed securities.

Federal Housing Administration. Under current law, the FHA charges a mortgage insurance premium set at a level sufficient to cover the risk incurred by the government on these loans. The current premium is 3.8 percent of the mortgage principal. The President's proposal would raise the premium to 5.0 percent, an increase of 1.2 percentage points. This small an increase is not expected to have a significant impact on either new loans insured or on default rates. The measure would, however, expand FHA collections by $0.3 billion in 1986 and $2.2 billion over the full five-year period.

Veterans' Home Loan Guaranty Program. The President is also proposing to increase the loan origination fee charged by the VA to guaranty veterans' home loans to 5 percent of the mortgage principal. The current VA fee is only 1 percent. Thus this proposal represents a major increase, the results of which are expected to have more of an effect on program activity than would be expected from the relatively small increase in the FHA premium. CBO anticipates that the VA measure would raise both the default rate and the default cost for loans in which the fee is financed as part of the mortgage principal. Further, the discounts paid by the agency to sell vendee loans incorporating the 5 percent fee would also be expected to rise. The net result of these effects could be program outlays in 1990 that are actually higher than 1990 baseline outlays. The $1.6 billion in added collections estimated to accrue from 1986 to 1989 would, thus, be more than offset by higher costs in 1990 and beyond.

Mortgage-Backed Securities. Higher fees are also proposed in the 1986 budget for the guaranties provided by the Government National Mortgage Association (GNMA) in connection with the sale of mortgage-backed securities. Beginning in 1986, the annual guaranty fee would be raised 9 basis points (0.09 percentage points) from 6 points to 15 points. This change would increase federal collections by an estimated $0.6 billion over the 1986-1990 period.

Major Means-Tested Transfer Programs

Means-tested transfer programs--Aid to Families with Dependent Children, Food Stamps, and Supplemental Security Income--provide the major governmental support to low-income families. The Administration's 1986 budget proposes no changes in SSI and only small reductions in AFDC and Food Stamps. The proposed reductions are smaller than in any of the President's previous budgets. CBO's estimated savings for the Administration's proposals are $0.1 billion in 1986 and $0.6 billion over the 1986-1990 period.

The proposed reductions are repeats of previous Administration requests. First, the Administration proposes to convert the financing of administrative costs in both AFDC and Food Stamps from an open-ended entitlement to a grant in the same manner as in the Medicaid program. Based on CBO's estimates, this proposal would account for over 60 percent of total AFDC and Food Stamp savings from 1986-1990. A similar proposal --combined welfare administration--was in the President's 1983 budget, but the grant would have been fixed rather than increased over time by the GNP deflator.

The concept of workfare--requiring employable AFDC and Food Stamp recipients to work off their welfare grants--is proposed again. States would be required to include only 25 percent of employable recipients in workfare or in similar work-related activities in 1986 and 75 percent in 1988 and later years. Administrative costs associated with workfare would be financed in full under current matching rates despite the limitation on administrative costs discussed above. CBO estimates small savings over the five-year period beginning in 1986, but evidence is not available to assess the cost-effectiveness of workfare with any reliability.

In other AFDC changes proposed by the Administration, an employable caretaker would no longer receive benefits after the youngest child turned 16 years of age, and an unmarried minor mother would have to live with her parents to receive benefits.

All Other Entitlements and Mandatory Spending

This residual category contains a diverse collection of smaller programs including the Forest Service, the Pension Benefit Guaranty Corporation, the Bonneville Power Administration, and Federal Employees Health Benefits. Cuts proposed in these programs would reduce federal expenditures by $1 billion in 1986 and $7 billion over the five-year period from 1986-1990.

The Administration is proposing to deduct certain operating costs from the timber and mineral receipts collected by the Forest and Minerals Management Services before calculating the share of those receipts to be returned to the states. This measure would save an estimated $1.7 billion over the next five years. An increase in the single-employer premium charged by the Pension Benefit Guaranty Corporation is proposed by the President for the third consecutive year. This year's proposed increase, from $2.60 to $7.50 per employee, is estimated to raise collections by $1.2 billion from 1986-1990. A new method of calculating the employers' contribution to Federal Employees Health Benefits, proposed for the second time by this Administration, would decrease outlays for this program by $0.3 billion between now and 1990.

The President's 1986 budget also proposes measures to ensure the recovery of the federal investment in the Bonneville Power Administration and other power-marketing administrations that sell the hydroelectric power generated at federal dams. This proposal, which would increase Bonneville's collections by $1.3 billion from 1986 to 1990, would impose a fixed schedule for repayment of principal and would increase the interest charged on outstanding balances to the current cost of Treasury borrowing. While the changes would increase the cost of electricity for Bonneville's customers, the higher rates would still be only about half the national average.

CHAPTER V

NONDEFENSE DISCRETIONARY SPENDING

A major share of the President's deficit reduction effort is concentrated in nondefense discretionary programs. More than half of the five-year savings relative to the CBO baseline fall in this category, even though only about 17 percent of projected federal outlays in 1986 through 1990 fall in this category under current policies.

WHAT IS NONDEFENSE DISCRETIONARY SPENDING?

Many nondefense programs are considered "discretionary" in that the law establishes no entitlement to benefits from them. The Congress controls spending for these programs through the appropriations process-- either by providing budget authority or by establishing loan limits, expenditure limits, or obligation ceilings.

The nondefense discretionary category encompasses a wide array of programs--including foreign aid, environmental regulation, housing assistance, education and community development grants, and law enforcement activities, among many others. Of the $163 billion in this category spent in 1984, slightly more than half went either to states and localities (about $48 billion) or for pay and benefits of the federal work force (about $36 billion). The remainder went directly to individuals, businesses, or foreign governments in the form of loans, grants, or purchases of goods and services.

While most of such spending appears in the unified budget, a portion is defined in law as "off-budget" and is not counted in the budget totals. The President is proposing to eliminate this distinction, and in order to provide useful comparisons, this chapter will not differentiate between on- and off-budget programs. a/

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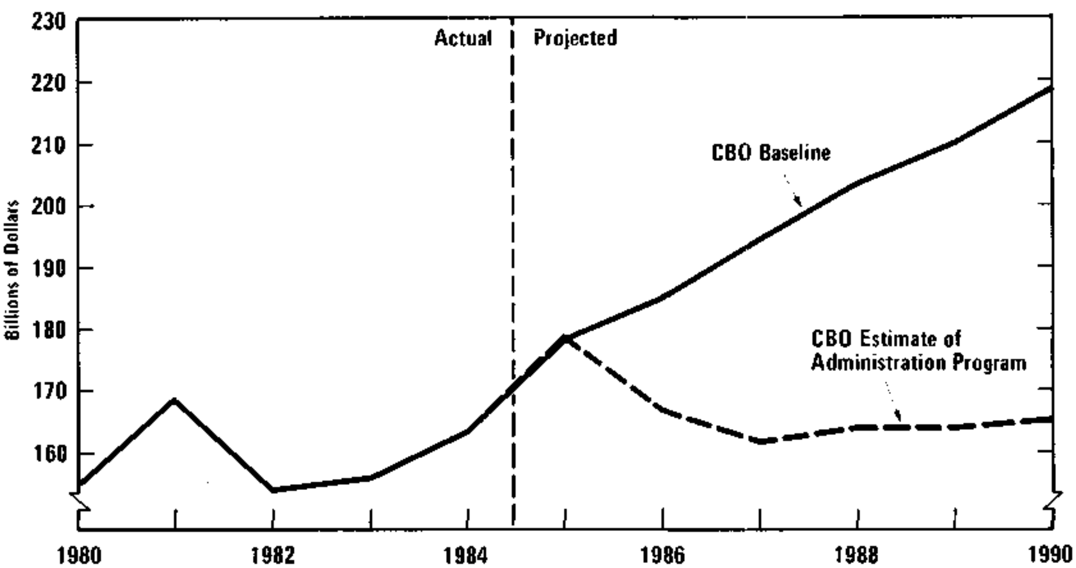
a. Virtually all off-budget spending falls in the nondefense discretionary category.

The President's proposals would reduce nondefense discretionary outlays from an estimated $179 billion in 1985 to $167 billion in 1986 and to $162 billion in 1987, a drop of 9.4 percent over the two years. The budget would maintain spending at close to that level for the rest of the decade, with outlays reaching $165 billion in 1990. This amount contrasts with CBO's baseline projections, which assume that spending under current policies would keep pace with inflation, growing by about 4 percent per year over the next five years to $218 billion in 1990. The difference between the Administration's outlays as reestimated by CBO and the CBO baseline is $17 billion in 1986, rising to $32 billion in 1987 and $53 billion in 1990 (see Figure V-1). Total spending reductions over the five-year period would be $187 billion, and spending in 1990 would be 24 percent below the baseline level. As a proportion of all budget outlays, nondefense discretionary

Figure V-1.
Nondefense Discretionary Spending, 1980-1990



SOURCE: Congressional Budget Office.

spending would fall from an estimated 19 percent in 1985 to 13 percent in 1990. 1/

Spending cuts are proposed for almost all types of nondefense discretionary spending, but the treatment of individual programs varies widely. A number of programs would be eliminated, many would have sharply reduced funding, but some would be maintained at current levels or even increased.

The Administration's spending priorities for discretionary programs are concentrated on basic operations of the federal government, foreign aid, space, and veterans' programs. Expenditures for space and science programs would be 19 percent above the baseline, and relatively small reductions would be made in veterans' programs, international affairs, justice, and general government. On the other hand, significant reductions are proposed for assistance to business and commerce, human resources programs, transportation, natural resources, and community development activities. Discretionary outlays in the agriculture and mortgage credit areas would be reduced by two-thirds or more over the 1986-1990 period relative to the CBO baseline, while spending for commerce, energy, community and regional development, training, employment, and social services would be reduced by 25 percent to 40 percent. Table V-1 summarizes the percentage changes proposed by the President for the various program areas, which are ranked by the percentage reduction in outlays over the 1986-1990 period.

MAJOR SPENDING REDUCTIONS

Over 70 percent of the proposed savings would be obtained in 15 major programs or program areas, while the remainder would be spread over hundreds of programs or accounts (see Table V-2). The largest dollar savings are proposed in farm and rural housing loans made by the Farmers Home Administration (FmHA), in federal employees' pay, and in housing programs of the Department of Housing and Urban Development (HUD); these four areas alone account for almost 40 percent of the recommended savings in this category.

Farm Loans

The Administration is proposing to eliminate most direct loan programs of the Agricultural Credit Insurance Fund and replace them with increased loan guarantee activity. It would eliminate direct ownership loans--used to improve or acquire farms, refinance debts, finance nonfarm enterprises, or

1. In 1980, outlays for this category totaled $155 billion, or 6.0 percent of GNP.

TABLE V-1. CBO ESTIMATE OF THE ADMINISTRATION'S PROPOSED INCREASE OR DECREASE IN OUTLAYS OF DISCRETIONARY PROGRAMS (By fiscal year, in percent differences from the CBO baseline)

Program Area	Percentage Increase or Decrease (-) for Program Area: 1986	1990	Total 1986-1990	Program with Largest Proposed Outlay Reduction
ALL DISCRETIONARY NONDEFENSE PROGRAMS	-9	-24	-19	
Agriculture	-71	-74	-70	FmHA Farm Loans
Mortgage Credit	-39	-84	-66	FmHA Housing Loans
Commerce	-2	-54	-39	Postal Subsidies
Energy	-15	-51	-38	Strategic Petroleum Reserve
Community and Regional Development	-7	-39	-27	SBA Disaster Loans
Training, Employment and Social Services	-11	-32	-25	Training and Employment Services
Education	-6	-23	-18	Postsecondary Student Aid
Transportation	-6	-23	-15	Mass Transit Grants
Income Security	-10	-20	-15	HUD Housing Subsidies
Natural Resources and Environment	-8	-20	-14	EPA Construction Grants
Health	-6	-18	-14	NIH Research
International Affairs	1	-13	-7	Export-Import Bank
Justice, General Government and Fiscal Assistance	-4	-6	-4	Legal Services Corporation
Veterans' Benefits and Services	-1	-5	-3	VA Medical Care
General Science, Space and Technology	2	7	4	NASA Space Shuttle

NOTE: This table reflects only the discretionary spending in each program area. The budgetary effects of the President's proposals on entitlement or mandatory programs and offsetting receipts are discussed in Chapters IV and VI, respectively.

TABLE V-2. CBO ESTIMATE OF THE ADMINISTRATION'S PROPOSED REDUCTIONS IN NONDEFENSE DISCRETIONARY SPENDING (By fiscal year, in billions of dollars)

	1986	1987	1988	1989	1990	Cumulative Five-Year Total
CBO Baseline Outlays	184.5	193.9	203.0	209.9	217.9	1,009.3
Proposed Changes						
Farm Loans (ACIF)	-4.4	-4.4	-4.0	-3.9	-3.8	-20.5
Civilian Agency Pay	-2.0	-3.1	-3.7	-4.6	-5.7	-19.1
Rural Housing (RHIF)	-2.0	-3.1	-3.6	-4.0	-4.4	-17.1
HUD Housing Subsidies	-1.8	-2.5	-2.8	-3.2	-3.9	-14.2
Mass Transit	-0.8	-1.3	-1.9	-2.3	-2.8	-9.2
Strategic Petroleum Reserve	-0.9	-1.9	-1.8	-1.8	-1.4	-7.8
Export-Import Bank	-0.3	-1.1	-1.7	-1.9	-2.0	-7.1
Student Financial Aid	-0.5	-1.3	-1.4	-1.5	-1.7	-6.4
Training and Employment Services	-0.2	-1.0	-1.3	-1.4	-1.7	-5.6
Highway Grants	-0.2	-0.8	-1.3	-1.5	-2.0	-5.6
Small Business Loans	-0.2	-0.8	-1.2	-1.5	-1.4	-5.2
Rural Electrification Administration	0.0	-0.5	-1.2	-1.6	-2.0	-5.2
Health Research (NIH)	-0.3	-0.8	-0.9	-1.0	-1.2	-4.3
Grants to Amtrak	-0.6	-0.7	-0.8	-0.8	-0.8	-3.7
Postal Subsidies	0.2	-1.4	-0.7	-0.7	-0.5	-3.2
Subtotal	-14.0	-24.5	-28.3	-31.9	-35.2	-134.0
Other	-3.4	-7.7	-10.4	-13.9	-17.7	-53.0
Total	-17.4	-32.2	-38.7	-45.8	-52.9	-187.0
President's Budget as Estimated by CBO	167.1	161.7	164.4	164.1	165.0	822.3

make additions to farms--for which $650 million was authorized in 1985. It would also reduce direct loans for farm operations from $1.9 billion in 1985 to $0.4 billion in 1986, and eliminate them by 1990. Interest rates on the direct operating loans remaining would be raised to one and one-eighth percentage points above Treasury costs, and the limited resource loan program would be eliminated. The limitation on guaranteed operating loans would be increased from $650 million in 1985 to $3 billion in 1986, but the origination fee would be raised from 1 percent to 5 percent.

Legislation will also be proposed to exclude disaster loans in counties where federal crop insurance is available, which the Administration expects would eliminate most eligibility for such loans. In total, the Administration proposes to reduce direct loans authorized from $4.5 billion in 1985 to $0.4 billion in 1986. No direct loans would be made after 1989, though the authority would be retained to make disaster loans when crop insurance assistance is not sufficient to meet emergency needs resulting from natural disasters. Outlay savings would average $4 billion per year.

Civilian Agency Pay

The Administration proposes cuts in federal civilian employee pay and retirement benefits. (The retirement proposals are discussed in Chapter IV.) The pay of most federal civilian employees would be cut by 5 percent in January 1986. In 1987 through 1990, pay would be increased 3 percent each January. On the other hand, the CBO baseline assumes that all federal employees will receive pay rate adjustments equal to the annual rate of growth in private-sector pay, ranging from 3.0 percent in October 1985 to 5.6 percent in October 1989.

CBO estimates that the proposed 5 percent pay reduction, by itself, would reduce outlays by about $1.1 billion in 1986 and by more than $1.6 billion annually in subsequent years, compared with current pay rates. The Administration's overall pay adjustment plans, including reduced future pay raises, would save about $2.0 billion in 1986, increasing to $5.7 billion in 1990, compared with the CBO baseline. 2/

Rural Housing Programs

The President's budget proposes the complete elimination (except for minor housekeeping activities) of the Farmers Home Administration's rural housing

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2. Excluding offsets for federal agencies' share of employee retirement.

programs beginning in 1986. Most of this assistance is provided by the Rural Housing Insurance Fund (RHIF) in the form of reduced interest-rate mortgage loans to low-income households or to developers of low-income rental housing. Over $3.2 billion was authorized for this purpose in 1985. The Administration expects that after the two-year moratorium on HUD commitments, a portion of HUD's rental assistance will be allocated to rural areas.

This proposal would result in significant budgetary savings. In 1984, interest subsidies and losses associated with the loan programs cost over $2.1 billion. Outlay savings from terminating the programs are projected at $2.0 billion in 1986, increasing to $4.4 billion in 1990.

HUD Housing Subsidies

The Administration is proposing a two-year moratorium on additional housing assistance commitments and a large reduction in funding for modernizing public housing. The CBO baseline (based on fiscal year 1985 appropriations) contains authority in each year estimated to be sufficient to support 100,000 incremental housing units and increases modernization funding to account for inflation. The Administration plans to resume commitments in 1988 at the annual rate of 100,000 units, but with assistance heavily weighted toward five-year vouchers rather than the more traditional 15- to 20-year rental assistance contracts. In addition to the moratorium, the President has proposed a one-year freeze on rent increases for much of the assisted housing inventory. Annual rent adjustments to allow for cost increases would resume in 1987. The CBO baseline assumes rent adjustments for each year. The net reduction for HUD's housing subsidy programs would be $1.8 billion below the baseline level in 1986, and $3.9 billion below in 1990.

Mass Transit

The President proposes to eliminate two-thirds of the funding for mass transit programs of the Urban Mass Transportation Administration. The Administration's budget includes funds for the Washington Metro (expected to cover the remaining costs of building 89.5 miles of the planned 101-mile system), a small amount to cover reduced administrative and research costs, and $1.1 billion annually for capital grants from the Highway Trust Fund. As a result, the $875 million operating assistance to local governments would be eliminated, and the amount of capital assistance apportioned by formula would be reduced by 30 percent. (The latter is used primarily for purchasing buses and improving existing rail systems.) No funding would be provided after fiscal year 1985 for major capital programs, such as new subway systems, and no discretionary funds would be available for modernization and extensions to existing rail systems. Total transit funding would drop from $4.1 billion in 1985 to $1.4 billion in 1986, with total outlay savings of $9.2 billion over the 1986-1990 period.

Strategic Petroleum Reserve

The President is proposing an indefinite moratorium on the future development of the Strategic Petroleum Reserve (SPR). Under this proposal, no additional capacity would be built and no oil purchased after fiscal year 1985, unless either market or fiscal conditions warranted a resumption of SPR development. The Department of Energy estimates that the SPR will contain approximately 489 million barrels of oil by the end of 1985, which is equivalent to about 98 days of current U.S. oil imports. Under existing Congressional policy, the SPR's ultimate capacity would total 750 million barrels, and would be completed by about 1990.

To implement this plan, the President requests no funding for either oil acquisition or construction over the 1986-1990 period, and has deferred $1.1 billion appropriated for 1985 for these purposes. Assuming the moratorium continues through 1990, it would reduce federal outlays over the 1986-1990 period by about $7.8 billion relative to the CBO baseline. 3/

Export-Import Bank

The Export-Import Bank lends money at subsidized interest rates to foreign purchasers of U.S. products. The President is proposing to replace the bank's direct loan program with a $1.8 billion program of guaranteed loans, coupled with direct subsidy payments for exports facing competition from official export credits offered by other nations. Outlays from the direct loan program arise when loan disbursements in any period are in excess of repayments. Under the interest subsidy program, these cash flows are between the private financial institution and the borrower, and thus not in the federal budget. Government outlays are limited to collections of loan application and commitment fees and interest subsidy payments to the lender as the loans are repaid. The elimination of the direct loan program is projected to reduce outlays by $0.3 billion in 1986, with savings increasing to $2.0 billion by 1990.

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3. The CBO baseline includes the 1985 deferrals; thus, the savings estimate does not include the outlay effect of the deferrals.

Student Financial Assistance

The Administration is seeking major changes in all postsecondary student aid programs, including Pell grants, state student incentive grants, and the campus-based loan, grant, and work-study programs. (The Guaranteed Student Loan program is discussed in Chapter IV.) The Administration plans to reduce total federal aid, target the remaining assistance toward the more needy, and lower interest subsidies. Under its proposals, students could not receive more than $4,000 in federal aid per year; students under the age of 22 would be considered financially dependent on their parents; and students from families with adjusted gross incomes of more than $25,000 would not qualify for grants, direct loans, or work-study jobs. The Administration would reduce Pell grant funding, eliminate state student incentive grants and federal capital contributions to the National Direct Student Loan (NDSL) program, and combine the campus-based grant and work-study programs. Students would repay NDSLs at Treasury bill rates instead of the current rate of 5 percent.

The budget projects total funding about 29 percent below CBO baseline levels over the 1986-1990 period, with outlay savings of $0.5 billion in 1986, increasing to $1.7 billion in 1990. These proposals would eliminate Pell grants for about 800,000 students and campus-based assistance for about 500,000 students, some of whom have low family incomes.

Training and Employment Services

Under the Job Training Partnership Act, the Department of Labor provides grants to states for job training programs for the economically disadvantaged, for summer jobs programs for youth, and for assistance to displaced workers. It also finances federal training assistance programs for special segments of the population, including the Job Corps for disadvantaged youth ages 14 to 21. The President's budget proposes to eliminate the Job Corps in 1986, and to continue funding the remaining programs at or below the 1985 level. The recommended appropriation for training and employment services totals $2.8 billion for 1986 and $2.9 billion annually thereafter, compared with the $3.8 billion provided for 1985. Total outlay savings relative to the CBO baseline would reach $1.7 billion in 1990.

Highway Grants

The federal-aid highways program provides grants to states for construction and improvements on the Interstate system and on urban and rural roads. The President proposes to reduce spending by limiting the total funds that can be obligated by states in 1986 to the 1985 level of $13.25 billion, and by including additional programs under the ceiling. The budget assumes that the obligation limit would remain at $13.25 billion in 1987, and increase to $14.2 billion for each of the years from 1988 through 1990. (The CBO baseline reflects the 1986 obligation cap of $14.45 billion enacted in the Surface Transportation Assistance Act of 1982, with adjustments for inflation in subsequent years.)

Outlay savings from the budget proposals would reach $2.0 billion in 1990, and would total $5.6 billion over the 1986-1990 period. Since states are able to choose the projects for which they wish to use their portion of the available funds, those projects deemed less important by the states would be postponed until a later date, or perhaps canceled.

This program is totally financed from gasoline and other excise taxes paid to the Highway Trust Fund. Previous analyses by CBO have shown that, although the trust fund has a cash balance of almost $10 billion, baseline levels of spending would exceed projected revenues and the balance would disappear, perhaps as early as 1989 or 1990. The President's proposal would slow the erosion of the fund's cash balance, but expenditures would continue to exceed revenues.

Small Business Loans

The President proposes to abolish the Small Business Administration (SBA), which provides financial, management, procurement and advocacy assistance to small businesses. The President would terminate the programs providing direct and guaranteed loans and equity investments to small businesses, much of which are targeted to the socially and economically disadvantaged, the handicapped, veterans, and disaster victims. These programs are authorized to make $0.9 billion in direct loans and $3.4 billion in loan guarantees in 1985, and their elimination would reduce outlays relative to the baseline by $5.2 billion from 1986 through 1990.

The President is requesting an appropriation of $2.0 billion in 1986 for the Treasury Department to purchase the SBA direct loan portfolio from the Federal Financing Bank. The formerly off-budget loans, together with SBA's on-budget portfolio, would be sold to the private sector over a four-year period, resulting in receipts of approximately $3.8 billion. Over the 1986-1990 period, the proceeds would be partially offset by an estimated $0.9 million in lost interest to the Treasury relative to the baseline. The budgetary effects of the sale of assets and the interest to the Treasury fall within the offsetting receipts category and are discussed in Chapter VI.

Some existing SBA activities supporting advocacy, management, and procurement assistance would be transferred to the Department of Commerce and combined with the Minority Business Development Administration to form the Administration for Enterprise Development and Opportunity. Beginning in 1987, these programs would receive funding of approximately $100 million annually, or about one-quarter of the baseline program level.

Rural Electrification

The President is proposing to phase out federal loans and loan guarantees for rural electric and telephone cooperatives, and to increase the interest rate on subsidized loans. Existing policy requires the Rural Electrification Administration (REA) to make $1.1 billion a year in direct loans bearing interest at 5 percent, and to guarantee another $1.2 billion in loans. Cooperatives with REA guarantees currently are entitled to borrow funds from the Federal Financing Bank (FFB) at the Treasury interest rate plus 0.125 percent. Under the President's proposal, direct loans would be phased out by 1990, starting with a 50 percent reduction in 1986, while the remaining loans would bear interest at the Treasury rate plus 1.125 percent. Likewise, REA would stop guaranteeing loans by 1990, starting with a 75 percent reduction in 1986. Thus, after 1989, REA would make no new loan or guarantee commitments. The President also would limit cooperatives' access to the FFB, by requiring borrowers to obtain an increasing proportion of their financing from private sources. These changes in REA loan programs would reduce federal outlays by about $5.2 billion relative to the CBO baseline projections for the 1986-1990 period. Most of the estimated savings would result from the reduction in federal lending activity and would appear off-budget under current law.

Health Research (NIH)

Outlays in the President's budget for health research of the National Institutes of Health (NIH) are $0.3 billion below the CBO baseline in 1986, the difference increasing to $1.2 billion in 1990. This results from a 6 percent reduction in funding from 1985 to 1986, and increases in funding thereafter at less than the baseline rate. The President proposes to reduce the number of new and competing research grants funded each year to 5,000, compared with the more than 6,500 provided by the 1985 appropriation.

Grants to Amtrak

The President proposes to eliminate completely the annual subsidy to Amtrak for operating and capital expenses, and for labor protection payments. This would result in outlay savings of $0.6 billion in 1986, and $3.7 billion over the 1986-1990 period, relative to the CBO baseline.

Although Amtrak was established in 1970 as a government-sponsored, for-profit corporation, it has never operated without federal assistance. Without the federal subsidy, Amtrak claims that it would be unable to operate any routes, even the Northeast Corridor. While the President also assumes that any labor protection costs resulting from discontinued service would be solely Amtrak's responsibility, it is unclear whether the government would have a legal obligation to bear these costs, and, if not, whether the Congress would choose to assume the liability, as it has previously done for Amtrak, Conrail, the Rock Island Railroad, and the Milwaukee Railroad. Under current contract provisions that call for up to six years of severance pay, Amtrak estimates its potential liability at more than $2 billion over six years, with a first-year payout of $600 million to $800 million.

Postal Subsidies

The President proposes eliminating the revenue forgone appropriation to the U.S. Postal Service. This payment compensates the Postal Service for revenues lost because the Congress has specified reduced postage rates for certain classes of mailers, primarily religious and other nonprofit organizations, blind and otherwise handicapped people, small-circulation newspapers, and libraries. Rather than continue taxpayer support for these subsidies, the President is proposing to eliminate in 1986 that portion of the subsidy that is currently scheduled to expire in 1987, and to allow, but not require, the Postal Service to cover the difference by increasing rates for other classes of mail. These changes would result in outlay savings of approximately $0.8 billion in 1986, increasing to $1.0 billion in 1990.

The Administration is also proposing to increase by 2 percent annually the Postal Service payments to the Civil Service Retirement fund. As a result, the Postal Service's annual share of the actuarial costs of employee pensions would grow from the current level of 7 percent to 17 percent by 1990. (This would increase certain offsetting receipts, which are discussed in Chapter VI.)

The Postal Service would recover the cost of these two proposals by increasing postal rates. Because of the length and complexity of rate filings, and the effect of rate increases on volume and workload, increases in Postal Service obligations in each year would not always be directly offset by increased revenues, although over time the Postal Service would be required to break even. Estimated savings relative to the CBO baseline are expected to total $3.2 billion from 1986 through 1990.

OTHER SPENDING REDUCTIONS

About 30 percent of the proposed savings in the Administration's budget for discretionary programs would be derived from terminating or reducing funding for many other programs spread throughout the budget. A large proportion of these reductions is concentrated in community and regional development, natural resources, and education programs (see Table V-3).

TABLE V-3. CBO ESTIMATE OF OTHER LARGE DISCRETIONARY SPENDING REDUCTIONS PROPOSED BY THE ADMINISTRATION (By fiscal year, in billions of dollars)

	1986	1987	1988	1989	1990	Cumulative Five-Year Changes
Community and Regional Development	-0.4	-1.4	-2.3	-2.8	-3.2	-10.1
Natural Resources and Environment	-1.1	-1.6	-1.9	-2.3	-3.0	-9.9
Education	-0.4	-1.2	-1.7	-2.0	-2.4	-7.7
Training, Employment and Social Services	-0.6	-0.9	-1.0	-1.1	-1.3	-4.9
Energy	-0.4	-0.7	-0.8	-1.1	-1.5	-4.5

NOTE: Excludes small business disaster loans, student financial assistance, training and employment services, Strategic Petroleum Reserve, and rural electrification programs, which are included in Table V-2. Also excludes the estimated effects of the President's pay reduction and pay-raise proposals.

Community and Regional Development

The President's budget projects large reductions in spending in this category, in addition to the elimination of small business disaster loans discussed earlier. In 1986, the Administration would eliminate Urban Development Action Grants (UDAGs), Rental Housing Development Grants (HODAGs), Economic Development Assistance programs, and Appalachian regional development programs. The Rural Development Insurance Fund (RDIF) and rural water and waste disposal grant programs of the Farmers Home Administration would be limited to new loan and grant obligations totaling $75 million in 1986, a reduction of almost $500 million from the direct loan levels authorized for 1985. After 1986, no new obligations would be permitted for these programs, and potential recipients would be required to compete for Community Development Block Grants (CDBGs). The overall CDBG program level would be reduced 10 percent below the 1985 appropriation, and the percentage of CDBG funds going to rural areas would be increased. The President would eliminate both RDIF and CDBG loan guarantee programs, and would impose a two-year moratorium on rental rehabilitation grants.

These proposals would reduce annual outlays by $3 billion from 1985 to 1990, and would result in total savings relative to the CBO baseline of $10.1 billion over the five-year period. By 1990, outlays in this area would be 39 percent below the baseline level.

Natural Resources and Environment

The Administration has proposed reductions for most discretionary natural resources and environment programs, which would result in outlay savings from the baseline of about $1.3 billion in 1986, rising to $3.3 billion in 1990. About 11 percent of these savings would result from the proposed 5 percent pay cut, but most represent programmatic decreases.

Funding for many land and water resource programs would be reduced in 1986 from 1985 levels--including a 27 percent reduction for the Soil Conservation Service and a 28 percent decrease for construction activities of the Bureau of Reclamation. Forest Service obligations would drop 9 percent in 1986, and several land conservation programs of the Agricultural Stabilization and Conservation Service would be terminated. National Park Service funding in 1986 would be 26 percent below the 1985 level, and reductions are also requested for the Fish and Wildlife Service and the Bureau of Land Management, primarily because of a proposed three-year moratorium on discretionary land acquisition and major cuts in recreational construction. The $2.4 billion sewage treatment plant construction grant program of the Environmental Protection Agency (EPA) would be funded at the 1985 level in 1986, and then phased out completely over the next four years. In addition, funding for the operations and programs of the National Oceanic and Atmospheric Administration would be reduced by about 20 percent in 1986, largely because of terminations or reductions of a number of ocean, coastal, and marine fishery programs.

These decreases would be partially offset by substantial increases in spending for EPA's Hazardous Substance Response Fund (Superfund), with outlays projected to grow from $0.4 billion in 1985 to $1.2 billion in 1990. Funding increases are also requested for EPA's research, enforcement, and regulatory activities, which would grow at close to baseline levels over the 1986-1990 period.

Education

The President proposes a one-year freeze for the two largest grants to local school districts--one for disadvantaged children and the other for educating the handicapped. In addition, impact aid would be eliminated for construction of school facilities and for compensating school districts for so-called "B" children (whose parents either work or live on federal property). Compensation would be frozen at the 1985 level for type "A" children, whose parents both work and live on federal property.

The budget would also freeze all other grants to states and school districts and would drastically reduce or eliminate many of the remaining categorical education grant programs. Compared with the CBO baseline, these proposals would save $0.4 billion in 1986, growing to $2.4 billion by 1990.

Training, Employment, and Social Services

In addition to reducing funding for training and employment services, as discussed earlier, the President's budget would reduce outlays for other training and social service programs by $0.6 billion in 1986, growing to $1.3 billion by 1990. Two programs would be eliminated--the Work Incentive Program (WIN), which provides job training to recipients of Aid to Families with Dependent Children (AFDC), and the Community Services Block Grant to states. In addition, 1986 funding would be held at 1985 levels for the Older Americans program, Head Start, and other grant programs.

Energy

Aside from rural electrification and the Strategic Petroleum Reserve, which are discussed earlier, outlays for discretionary energy programs in the President's budget would be approximately $5 billion, or 17 percent, below the CBO baseline projections for the 1986-1990 period. Approximately $1.5 billion of the total reduction would result from limiting spending on uranium enrichment activities to the amount of revenues collected each year, and requiring the program to earmark certain revenues for the repayment of past appropriations. The Administration also proposes to phase out major conservation grants and reduce conservation research and development. These proposals would reduce outlays by $1.2 billion over the 1986-1990 period relative to the CBO baseline. Although the budget provides for continued funding for nuclear and fusion research at about 90 percent of the 1985 levels, funding for fossil, solar, and other renewable energy research and development programs would be reduced by about one-third.

Other Savings

The President's budget also projects significant savings in a number of other areas. An estimated $4 billion would be saved over the 1986-1990 period by reductions in health care delivery, education, and training programs of the Department of Health and Human Services. The elimination of federally subsidized crop insurance is projected to save $1.4 billion from 1986 through 1990, while reductions in various research and services performed by the Department of Agriculture would save another $1.5 billion during that period.

The budget includes funding for Federal Aviation Administration (FAA) operations at about the 1985 level in all years, and projects reduced funding for FAA grants to airports, facilities and equipment, research and other activities. Total FAA outlays would be slightly below the baseline in 1986, and $2.3 billion below over the 1986-1990 period (excluding the effects of the proposed 5 percent pay cut). The Administration also proposes to reduce spending for low-income home energy assistance grants by using recoveries from petroleum price overcharges to fund part of the program. Although the budget reflects savings of $4.5 billion from this source, CBO projects that only $1.2 billion of the overcharges will be available for this purpose.

PROGRAMS MAINTAINED OR INCREASED

For a number of broad categories in the budget, the President's budget would be above or only slightly below the CBO baseline. Spending for such programs would therefore be maintained at approximately the same real level as in 1985, or above. The largest growth relative to the baseline is projected for the space programs of the National Aeronautics and Space Administration (NASA), and funding for international affairs (excluding the Export-Import Bank) is also above baseline levels. Veterans' programs, justice, and general government activities show relatively small decreases (see Table V-4).

TABLE V-4. CBO ESTIMATE OF SPENDING INCREASES OR SMALL SPENDING REDUCTIONS (-) PROPOSED BY THE ADMINISTRATION
(By fiscal year, in billions of dollars)

	1986	1987	1988	1989	1990	Cumulative Five-Year Changes
Space	0.2	0.2	0.3	0.7	0.9	2.4
International Affairs	0.5	0.4	0.4	-0.1	-0.7	0.5
Veterans	0.1	a/	a/	-0.1	-0.2	-0.2
Justice, General Government, and Fiscal Assistance	-0.3	-0.2	-0.1	-0.2	-0.5	-1.2

NOTE: Excludes Export-Import Bank, which is included in Table V-2. Also excludes the estimated effects of the President's pay reduction and pay-raise proposals.

a. Less than $50 million.

Space

The President's budget includes funding above the baseline level in all years for the space programs of the National Aeronautics and Space Administration (NASA). Outlays are projected to rise from $6.7 billion in 1985 to $8.6 billion in 1990--largely because of funding increases for space station construction and for other research and development. 4/ The budget shows declining spending for space shuttle construction and operations, reflecting completion of the last shuttle and the Administration's expectations of increased reimbursements from more frequent shuttle flights. Under the Administration's proposals, total NASA outlays for space programs would exceed the baseline by $0.2 billion in 1986 and $0.8 billion in 1990, with a total increase in spending of $2.2 billion over the five-year period.

International Affairs

The President is proposing increases for security assistance totaling $0.9 billion over the baseline for the 1986-1990 period. Most of the increase is for military assistance, primarily to Israel and Egypt. The budget does not include a request for aid to Israel from the economic support fund (ESF), pending further negotiations with Israel. Because the Administration has indicated that it will be seeking funds for this purpose, the CBO estimate of the President's budget request includes the CBO baseline level of ESF assistance.

Funding for the State Department's conduct of foreign affairs is also above the baseline level, reflecting both a $0.2 billion 1985 supplemental request for security enhancement and a projected increase in personnel levels. In addition, the budget projects spending increases for the United States Information Agency, including a major upgrading of the Voice of America and increased personnel levels.

These increases are partially offset by proposed reductions in development assistance, totaling $2 billion from 1986 through 1990. Voluntary contributions to international organizations and bilateral aid are both to be reduced below the 1985 level, and sharp reductions are planned in future

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4. The baseline does not include major spending for the space station, because no clear Congressional decision--for example, selection of a specific option or appropriation of construction funds--has yet been made to build a manned space station. Moreover, the uncertainty over the configuration of a possible station precludes accurate estimation of future funding requirements.

replenishments for international development banks. Proposed funding for Public Law 480 food assistance is below the current 1985 level throughout the five-year period; however, the President has requested a 1985 supplemental for appropriation of $185 million for African drought relief.

Veterans

The President's budget maintains discretionary veterans' programs close to but slightly below the CBO baseline level over the 1986-1990 period. Total outlays over the period would be about 3 percent below the baseline, for a total spending reduction of $1.7 billion over the five years. About $1.5 billion of that savings would result from the proposed 5 percent federal pay cut in 1986. As a result, overall programmatic activity would be at just about the CBO baseline level during this period. Total outlays for the 1986-1990 period under the Administration's proposals, however, would be only 88 percent of OMB's current services outlays. In contrast to the CBO baseline, which increases to reflect inflation, OMB's current services projections would accommodate the continued rapid expansion of the Veterans Administration hospital system.

The budget includes an increase in funding for medical care of $0.3 billion (or 3 percent) in 1986, with increases in subsequent years at close to the baseline rate. The President is proposing, however, to institute a means test for eligibility to VA hospital care for most veterans without service-connected disabilities. The Administration estimates that this would save almost $1 billion annually by 1990; CBO expects that at least 20 percent of currently eligible veterans would be excluded by this proposal, and that savings would be even greater.

Justice and General Government

The Administration is proposing funding for justice and general government activities that would result in outlays $3.1 billion below the baseline over the 1986-1990 period. About $1.9 billion of that amount is attributable to the proposed 5 percent pay cut--leaving other reductions totaling $1.2 billion, or less than 2 percent below baseline levels. These savings are primarily attributable to the proposed termination of the Legal Services Corporation, which would save about $1.7 billion over five years, as well as to a proposed 10 percent reduction in Legislative Branch spending.

Most other activities in these areas are projected at or slightly below the baseline level, reflecting the proposed pay cut; these include the Federal Bureau of Investigation, the Drug Enforcement Administration, and the

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Immigration and Naturalization Service. Large increases are proposed for the Judiciary, primarily to provide staff and facilities for the 85 new judgeships provided by law. The budget also includes increased resources, after adjusting for the pay cut, for the Internal Revenue Service, which is seeking to hire 7,500 additional examiners beginning in 1987.

IMPACT ON STATE AND LOCAL GOVERNMENTS

Approximately 30 percent of nondefense discretionary spending is for grants to states and localities. Grant outlays in this category were about $48 billion in 1984, and are estimated at $53 billion in 1985. The President's budget would reduce discretionary grant outlays to about $52 billion in 1986 and to about $50 billion annually through 1990 (see Table V-5). Highway funding would increase over this period, as a result of the spending authorized in the Surface Transportation Assistance Act of 1982. At the same time, other grants would drop from $41 billion in 1985 to about $35 billion per year from 1987 through 1990. In real terms, this would represent a decline in purchasing power of about 30 percent by 1990.

The largest reductions below the 1985 level would occur in two areas. Appropriations for wastewater treatment construction grants would drop from $2.4 billion in 1985 to zero in 1990, and funding for mass transit grants would decline from $4.1 billion in 1985 to $1.2 billion in 1990. In addition, the President is proposing to eliminate or reduce a variety of other discretionary grant programs, particularly in the area of community and regional development. The budget also includes reductions in certain entitlement grant programs, including the elimination of General Revenue Sharing, which are discussed in Chapter IV.

TABLE V-5. CBO ESTIMATE OF THE ADMINISTRATION'S OUTLAYS FOR MAJOR DISCRETIONARY GRANT PROGRAMS, 1985-1990 (By fiscal year, in billions of dollars)

	1985	1986	1987	1988	1989	1990
Highways	12.5	13.7	13.9	14.1	14.6	14.8
Education	7.0	7.1	7.1	7.2	7.4	7.6
Housing Assistance	6.1	5.4	5.3	5.4	5.7	6.0
Other Income Security	4.3	4.1	4.2	4.4	4.5	4.7
Training, Employment and Social Services	5.5	5.1	4.5	4.4	4.5	4.5
Community Development Block Grants	3.9	3.6	3.4	3.2	3.3	3.5
Mass Transit	3.7	3.2	3.2	2.4	2.1	1.7
Wastewater Treatment Construction Grants	2.7	2.6	2.3	2.2	2.0	1.6
Other Community and Regional Development	1.6	1.6	1.3	0.8	0.5	0.4
All Other	5.9	5.6	5.6	5.6	5.2	5.0
Total	53.2	52.0	50.8	49.7	49.8	49.8

CHAPTER VI

OFFSETTING RECEIPTS AND NET INTEREST

The Administration's fiscal year 1986 budget proposes substantially larger offsetting receipts and lower net interest outlays than under current policy. Offsetting receipts--receipts that are treated as offsets to outlays rather than as revenues--are projected to account for an increasing portion of the budget under current policies. The Administration's proposals would hasten this trend, primarily by requiring people and businesses that use government services to bear a larger portion of their cost. Net interest--the cost of servicing the government's debt--is currently the fastest growing major component of federal spending. The Administration's proposals, by reducing the growth of the debt, would restrain some of the increase in this category.

OFFSETTING RECEIPTS

Offsetting receipts comprise federal government proprietary receipts from the public as well as certain intragovernmental payments. Under current policies, offsetting receipts are projected by CBO to total $50 billion in 1986, growing to $64 billion in 1990. The largest component--$29 billion in 1986--is the employer share of federal employee retirement, which offsets the contributions made by government agencies toward their employees' retirement (counted as spending elsewhere in the budgetary totals). The government also collects premiums from participants in the Medicare program, mostly for Part B (Supplemental Medical Insurance) coverage; these premiums are projected to total $6 billion in 1986. Offsetting receipts from rents and royalties on the Outer Continental Shelf are expected to be about $6 billion in 1986. Other offsetting receipts include proceeds from the sale or lease of minerals, timber, and electric power, as well as other miscellaneous sources.

Offsetting receipts collected by the federal government would increase greatly under the Administration's budget, rising by $4 billion in 1986 and totaling an additional $32 billion over the 1986-1990 period (see Table VI-1). About one-third of the increase in receipts would come from

TABLE VI-1. CBO ESTIMATES OF THE ADMINISTRATION'S PROPOSALS FOR OFFSETTING RECEIPTS (By fiscal year, in billions of dollars) a/

	1986	1987	1988	1989	1990	Cumulative Five-Year Changes
CBO Baseline	49.9	53.8	57.7	60.3	64.2	
Proposed Changes						
User fees	1.4	2.1	2.4	2.5	2.7	11.1
Medicare premiums	0.2	0.7	1.7	3.2	4.9	10.8
Employer contributions to employee retirement:						
Postal Service	0.3	0.6	0.8	1.2	1.6	4.4
Military	b/	0.4	0.6	0.7	0.5	2.2
Other	-0.4	-0.6	-0.8	-0.9	-1.2	-4.0
Subtotal	-0.2	0.4	0.5	1.0	0.9	2.6
Third-party reimbursements to Veterans Administration	0.1	0.2	0.2	0.2	0.2	0.8
Small business loan asset sales	1.0	1.0	0.9	0.9	b/	3.8
Sale of Conrail	1.2	--	--	--	--	1.2
Other	0.1	0.4	0.4	0.4	0.4	1.6
Total Changes	3.8	4.7	6.1	8.1	9.2	32.0
President's Budget as Estimated by CBO	53.6	58.6	63.9	68.5	73.5	

a. For purposes of arriving at total budget outlays, offsetting receipts are treated as negative outlays and are subtracted from other spending figures.

b. Less than $50 million.

fees charged to users of government services. Another third would come from higher premiums paid by Medicare participants. Other Administration proposals include the sale of Small Business Administration loan assets and the Conrail system, and changes in the federal government's contributions for employee retirement. Virtually all of the Administration's proposals would require Congressional approval.

User Fees

The federal government recoups part of the cost of providing special facilities or services by charging user fees. Since these fees arise from voluntary, business-type transactions--rather than the government's sovereign taxing power--they are counted as offsets to outlays rather than as revenues. The Administration proposes to charge a number of new or expanded user fees as shown in Table VI-2.

Substantially higher fees would be levied on users of the nation's waterways and ports under the Administration's proposed budget. Commercial users currently pay about 3 percent of the Army Corps of Engineers'

TABLE VI-2. CBO ESTIMATES OF PROPOSED USER FEES IN THE ADMINISTRATION'S BUDGET (By fiscal year, in billions of dollars)

User Fee	1986	1987	1988	1989	1990	Cumulative Five-Year Changes
Waterways and harbors	0.4	0.6	0.6	0.7	0.8	3.2
Customs	0.5	0.5	0.5	0.5	0.5	2.6
Boat and yacht	0.2	0.5	0.5	0.5	0.5	2.1
Meat inspection	0.1	0.3	0.4	0.4	0.4	1.5
Recreation	0.1	0.1	0.1	0.1	0.1	0.4
Government-sponsored enterprise	a/	0.1	0.2	0.3	0.3	1.0
Other	a/	a/	0.1	0.1	0.1	0.3
Total	1.4	2.1	2.4	2.5	2.7	11.1

a. Less than $50 million.

cost of operating, maintaining, and constructing the nation's waterways and harbors. The proposed budget would increase this share to 40 percent in 1986 and about 65 percent by 1990. The Corps would continue to pay most of the operating, maintenance, and construction costs for inland waterways, but would substantially reduce its share of expenditures for harbor construction and improvements, shifting the remaining costs to local port authorities. Offsetting receipts would increase by an estimated $0.4 billion in 1986 and $3.2 billion from 1986 through 1990.

The Administration intends to propose new customs fees for processing passengers and commercial carriers entering the United States. This proposal, which has not been spelled out in detail, is projected by the Administration to yield about $0.5 billion annually in the 1986-1990 period.

New fees also are proposed for nonemergency services provided by the Coast Guard to commercial and recreational boaters. These services include inspection and licensing of vessels and facilities, maintenance of navigational aids, towing, and others. Coast Guard services that benefit the general public (such as law enforcement) and emergency operations would continue to be funded by the taxpayer. These proposed user fees are estimated to total about $0.2 billion in 1986 and $2.1 billion in 1986-1990.

The Administration proposes that meat and poultry processors be required to pay the full costs of inspection by the Food Safety Inspection Service. The amount of costs recovered would increase gradually over three years, totaling $0.1 billion in 1986 and $1.5 billion for the 1986-1990 period. A proposal to increase fees paid by recreational users of national parks and other facilities would raise an estimated $0.4 billion through 1990.

The Administration proposes to levy an annual fee on debt and other securities issued by government-sponsored enterprises beginning in 1986. The affected enterprises include the Federal National Mortgage Association (Fannie Mae), the Federal Home Loan Mortgage Corporation (Freddie Mac), the Student Loan Marketing Association (Sallie Mae), the Farm Credit System, and the Federal Home Loan Bank System. These enterprises have a quasi-government status and receive certain benefits (such as standby lines of credit with the Treasury and exemption from certain securities regulations) unavailable to private issuers. As a result, their securities--like Treasury debt--are perceived as high-quality, low-risk instruments. Net borrowing by these enterprises totaled about $55 billion in 1984. After a short phase-in, the proposed fees would amount to 0.083 percent annually for debt issued in 1987 and beyond. The user fees are estimated to raise $40 million in 1986 and $1.0 billion over the 1986-1990 period, as larger and larger amounts of debt become subject to the fees.

Several of the Administration's user fee proposals were included in budgets of previous years and in recommendations by the President's Private Sector Survey on Cost Control (Grace Commission), the General Accounting Office, and others. Increased waterway and harbor fees, for example, have been proposed in each of the current Administration's annual budget submissions, while boat and yacht fees and recreational fees have also been proposed repeatedly. The Congress so far has only partially agreed to the Administration's proposals to recoup the costs of certain federal government services from those directly benefiting.

Medicare Premiums

Under the proposed 1986 budget, premiums paid by Supplemental Medical Insurance (SMI) participants would increase gradually until they reach 35 percent of program costs in 1990. Premiums now cover about 25 percent of those costs. As part of its entitlement proposals, the Administration also advocates reducing SMI program costs; these changes are discussed in Chapter IV. CBO estimates that the proposals would increase Medicare premiums by $0.2 billion in 1986 and $10.8 billion over the 1986-1990 period. CBO projects that the monthly SMI premium--currently $15.50--would increase by 1990 to $34.90 under this proposal, compared with $21.10 under current policy.

Other Proposals

The Administration proposes to increase the Postal Service's contributions to the Civil Service Retirement Trust Fund to equal, over time, the full actuarial cost of employee pensions. CBO estimates that offsetting receipts to the trust fund would be $0.3 billion greater in 1986 and $4.4 billion greater in the 1986-1990 period.

Employer contributions for federal government employee retirement would also be affected by the Administration's proposals either to raise or cut salaries of government workers. Higher pay raises for members of the military, as sought by the Administration, would lead to larger offsetting receipts for military retirement accruals. In contrast, the Administration's proposal to cut civilian salaries by 5 percent in 1986 and limit the annual increases thereafter, as well as delaying pay raises until January in each year, would lead to smaller offsetting receipts. Table VI-1 shows the change in employer contributions attributable to the Administration's military and civilian pay proposals.

Included in the President's budget is a proposal to have private health insurers reimburse the Veterans Administration for care provided to their policyholders, except in the case of veterans with service-connected disabilities. At present, exclusionary clauses in private insurance contracts bar payment for services rendered in VA facilities. Requiring such third-party reimbursement would save the government an estimated $0.1 billion in 1986, and $0.8 billion over the 1986-1990 period.

In addition to terminating new credit extensions by the Small Business Administration, the Administration proposes the sale of the SBA's existing loan portfolio to the public. Proceeds from these sales are projected to be $1.0 billion in 1986 and $3.8 billion over the 1986-1990 period.

The Administration also plans to sell Conrail, the government-owned freight railroad, to the private sector in 1986. Receipts from the sale are projected at $1.2 billion.

NET INTEREST

Net interest outlays reflect the cost of financing the government's burgeoning debt. As offsets, net interest also includes interest income received by the government--such as interest on loans extended by the government, interest on the Treasury's cash balances, and so forth. As shown in Table VI-3, net interest outlays under current policy are projected by CBO to rise rapidly from $146 billion in 1986 to $234 billion in 1990. The President's budget proposes to restrain the projected growth of the federal debt, thereby reducing net interest costs. A small part of this savings would be offset by lower interest income to the government as a result of reduced lending. Even with the President's proposed changes, however, net interest would run a close second to defense as the fastest-growing major component of federal spending--growing from $146 billion in 1986 to $212 billion in 1990.

The Administration's own projections of interest costs differ sharply from CBO's. The Office of Management and Budget (OMB) projects that net interest outlays will rise from $143 billion in 1986 to $148 billion in 1989, and will actually fall to $138 billion in 1990. These differences result almost entirely from the use of different interest rate assumptions by CBO and the Administration. OMB assumes that short-term Treasury bill rates will fall to 5.0 percent by 1990, while CBO assumes that they will level off at 8.2 percent--only slightly below their current levels. Because of the uncertain economic consequences of possible fiscal policy changes, CBO compares alternative budget programs by using a consistent set of economic assumptions--in this case, assumptions that posit only modest declines from current interest rates. By using the same interest rate assumptions for the baseline and the Administration's budget proposals, CBO's projections provide a basis for evaluating the direct budgetary effects of the Administration's policies, abstracting from the changes in the economy that might result from changes in government spending.

TABLE VI-3. CBO ESTIMATES OF THE ADMINISTRATION'S PROPOSALS FOR NET INTEREST (By fiscal year, in billions of dollars)

	1986	1987	1988	1989	1990	Cumulative Five-Year Changes
CBO Baseline Outlays	145.7	163.6	187.3	207.6	233.6	
Proposed Changes						
Interest from FFB and SBA	a/	1.0	2.2	3.4	4.6	11.2
Other intragovernmental interest	1.9	2.3	2.9	3.4	3.8	14.3
Interest on foreign military sales	a/	a/	a/	a/	-0.1	-0.1
Interest savings due to lower deficits	-1.5	-5.8	-11.9	-19.6	-29.6	-68.5
Total Changes	0.3	-2.5	-6.9	-12.9	-21.2	-43.1
President's Budget as Estimated by CBO	146.0	161.1	180.4	194.7	212.4	

a. Less than $50 million.

Changes in net interest in the President's budget result exclusively from proposed policy changes in other spending programs and in revenues. As a result of the proposed curtailment of the Federal Financing Bank's (FFB's) lending activity and the sale of SBA's loan assets, interest receipts from the FFB and the SBA are projected to decrease--only slightly in 1986 but by $11.2 billion over the 1986-1990 period (see Table VI-3). By the end of 1990, total FFB loans outstanding are projected to be $137 billion under the President's proposals, compared with $189 billion under the continuation of current policies. The SBA loan portfolio is expected to be fully sold by 1990.

A number of other federal agencies are permitted to borrow from the Treasury to finance parts of their program costs. Interest on this borrowing is an outlay of the agency, and an intragovernmental interest receipt to the Treasury. The President's budget proposes that the Department of Housing and Urban Development's obligation to pay interest on certain Treasury borrowing in 1985 and earlier years be forgiven, leading to smaller intragovernmental interest receipts. The Administration also proposes to curtail the need for borrowing from the Treasury by other federal agencies, especially the Commodity Credit Corporation. If all of these proposals are enacted, intragovernmental interest receipts are projected to be $1.9 billion smaller in 1986 and $14.3 billion smaller over the 1986-1990 period. Since these interest payments are intragovernmental, they do not affect total outlays or the deficit.

By far the largest change in net interest spending in the proposed budget would result from lower deficits. The President's proposed nondefense spending cuts--offset somewhat by defense spending increases and small revenue reductions--would reduce the federal government's borrowing needs. The interest savings compound dramatically over time. If all of the Administration's proposed changes were enacted, interest savings would grow from $1.5 billion in 1986 to $29.6 billion in 1990 (see Table VI-3).

These interest savings would reflect a marked slowdown in the growth of the federal debt. As Table VI-4 shows, federal debt held by the public at the end of 1990 is projected to reach $2,452 billion under the Administration's proposed policies, compared with $2,820 billion in CBO's baseline. The growth in the debt-to-GNP ratio would be slowed--but not stopped--by the Administration's program. By 1990, the debt-to-GNP ratio is projected to reach 43.7 percent under the budget's proposed policies, substantially lower than the 50.3 percent projected assuming no changes in policy.

Such high ratios of debt to GNP have not been seen since the late 1950s and early 1960s, when the bulk of the government's debt was traceable

TABLE VI-4. CBO ESTIMATES OF FEDERAL DEBT HELD BY THE PUBLIC (By fiscal year)

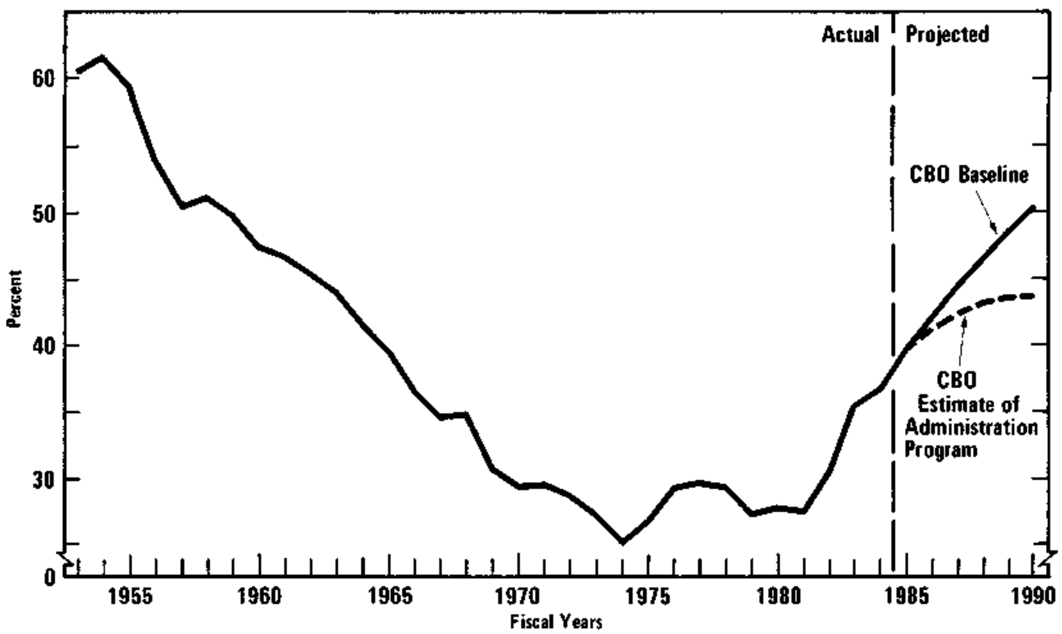
	1985	1986	1987	1988	1989	1990
	In Billions of Dollars					
CBO Baseline	1,526	1,745	1,984	2,240	2,519	2,820
CBO Estimate of Administration Program	1,527	1,712	1,896	2,081	2,266	2,452
	As a Percent of GNP					
CBO Baseline	39.6	42.0	44.3	46.4	48.4	50.3
CBO Estimate of Administration Program	39.6	41.2	42.3	43.1	43.6	43.7

to the World War II effort (see Figure VI-1 on next page). A sustained rise in the debt-to-GNP ratio during peacetime had never occurred before the 19 0s. A rising debt-to-GNP ratio spurs concern about the effects on private capital investment, foreign capital flows, and other economic variables, while substantially complicating the conduct of monetary policy. 1/ While the Administration's proposed policies, if fully enacted, are projected to reduce deficits, they would not stop the growth in the debt-to-GNP ratio--a necessary first step in stemming the rising cost of interest payments.

1. The consequences of a rising debt-to-GNP ratio are discussed in Congressional Budget Office, The Economic and Budget Outlook: Fiscal Years 1986-1990 (February 1985).

Figure VI-1.

Federal Debt Held by the Public as a Percentage of GNP



SOURCE: Congressional Budget Office.

CHAPTER VII

THE FEDERAL CREDIT BUDGET

The federal government provides assistance to individuals, firms, and political subdivisions by extending loans on favorable terms directly to borrowers and by guaranteeing repayment of loans made by others. In both cases, the borrower benefits from lower interest rates, longer repayment periods, higher loan-to-value ratios, and relaxed borrower qualification standards than would otherwise be available.

In providing these benefits, the government incurs two types of costs: cash-flow and subsidy costs. Cash-flow costs for a budget year are the funds the government pays out during that year in excess of current-period receipts: for example, loan disbursements in excess of current-period repayments; and guaranteed loan-claim outlays in excess of current-period fees and recoveries. The cash-flow costs of credit programs are the outlay effects in a particular year. Subsidy costs, in contrast, are calculated for the life of the credit agreement and consist of costs incurred in excess of repayments, fees, and all other eventual recoveries.

Cash-flow needs are of great importance in managing the government's cash position and are the primary focus of the unified budget. Knowledge of subsidy costs is necessary for budgeting scarce fiscal resources. Although both subsidy costs and cash-flow costs tend to increase and decrease with direct loan and guarantee activity, credit policy changes can have markedly different effects on these two measures.

In the past, the cash-flow costs of federal credit were recognized as not directly comparable to the cash cost of other forms of assistance. The recognition of these differences contributed to the off-budget status of some credit programs. The concern that credit activity was not adequately controlled by the budget process led to the establishment of a separate credit budget in 1981. Neither the cash-based unified budget nor the activity-based credit budget permits cost comparisons between spending and credit programs. Recently, the Office of Management and Budget and CBO have developed means of identifying the spending-equivalent, subsidy costs of federal credit. 1/ These developments could permit credit activity to be reintegrated into the unified budget.

Preceding chapters of this report have examined the President's spending proposals in relation to the CBO baseline projections. This chapter analyzes the President's proposals for federal credit, first by assessing their consequences for aggregate measures of credit activity, outlays, and subsidy costs. The principal finding is that the outlay or cash-flow savings from proposed reductions in credit activity are about double the savings in resource or subsidy costs. The chapter then provides details of the effects on individual programs for which major policy changes are requested.

THE PRESIDENT'S CREDIT PROPOSALS IN AGGREGATE

The Administration proposes to reduce future direct lending relative to amounts expected if current policies are not changed. Primary loan guarantees would be increased slightly compared with current policy while secondary guarantees would stay at current policy levels. 2/ If the President's proposals are adopted, 1986 direct lending, relative to the baseline projection, would be reduced by 38 percent or $15.8 billion, and primary guarantees would increase by 3 percent or $2.4 billion. Total assisted credit--the sum of the direct and guaranteed lending--would decrease by $13.4 billion.

Over the next five years, 1986-1990, the cumulative projected effects of the Administration's credit proposals are:

- Direct loan obligations: $-108.9 billion.

- Primary loan guarantee commitments: $10.3 billion.

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1. See Office of Management and Budget, Executive Office of the President, Circular A-70 (August 1984); and Congressional Budget Office, New Approaches to the Budgetary Treatment of Federal Credit Assistance (March 1984).

2. Secondary guarantees in which government provides a second guarantee on top of an earlier, primary one, arise principally from Government National Mortgage Association guarantees of securities already backed by FHA and VA guaranteed mortgages. Secondary guarantees have no significant cash-flow or subsidy cost, and thus are not treated further here.

- o Outlays attributed to credit assistance: $-79.8 billion.
- o Credit subsidies: $-48.4 billion.

Subsidized government lending would be cut back most in agriculture, export financing, housing, electricity production and distribution, and general business. Increases in loan guarantees are offered as a substitute for some direct loan programs slated for reduction. Growth in guarantees is projected for agriculture, export financing, and housing. Reductions in guarantee activity are requested for business and student loans.

Credit Budget Activity Levels

Assuming the continuation of current policy, CBO projects that direct loan obligations by the federal government would reach $43.6 billion while federal primary guarantee commitments would climb to $89.7 billion in 1990 (see Table VII-1). These projections and the President's credit proposals are stated in terms of loan obligations and guarantee commitments rather than in some other measure--disbursements, for example--to focus on the point at which government makes an irrevocable offer to provide assistance and to bear the associated subsidy costs. Obligations and commitments are the last points of control for credit activity and costs. Table VII-1 also shows the Administration's request for loans and guarantees. The Administration's proposed reduction from current policy in direct loans is $15.8 billion in the first year, reaching $25.9 billion in the fifth year, a cumulative reduction of more than 50 percent over the five-year period. Primary guarantees would be higher than in the baseline projection by approximately $2 billion per year through 1990. Total assisted credit is reduced by more than $98 billion over the five years.

Outlay Savings and Deficit Reductions

Changes in obligations and commitments do not translate immediately into dollar-for-dollar changes in cash outlays. Direct loan obligations may be paid out over several years in accord with the cash needs of the borrower who may be, for example, constructing an electric power plant. As loans mature into the repayment stage, they yield a positive cash inflow that reduces outflow financing requirements. Similarly, years may pass before a commitment to guarantee loans leads to claims for payment (default); only a fraction of guaranteed loans end in default and foreclosure. Changes in direct loans and guarantees, therefore, are unlikely to produce equal changes in cash disbursements and the deficit. A comparison of Tables VII-1 and VII-2 confirms year-to-year differences between changes in the volume

TABLE VII-1. CBO ESTIMATE OF ADMINISTRATION'S CREDIT BUDGET PROPOSALS (By fiscal year, in billions of dollars)

Major Program	1986	1987	1988	1989	1990	Cumulative Five-Year Changes
			CBO Baseline			
Direct loan obligations	41.6	42.2	42.4	42.8	43.6	212.6
Primary guarantee commitments	75.7	75.2	79.9	85.7	89.7	406.2
Total, new lending	117.3	117.4	122.3	128.5	133.3	618.9
Secondary guarantees	43.1	45.0	46.9	48.8	50.9	234.7
			Proposed Changes			
Direct loan obligations	-15.8	-20.0	-22.7	-24.5	-25.9	-108.9
Primary guarantee commitments	2.4	1.7	1.8	2.0	2.5	10.3
Total,new lending	-13.4	-18.3	-20.9	-22.5	-23.4	-98.5
Secondary guarantees	0.0	0.0	0.0	0.0	0.0	0.0
			President's Budget as Estimated by CBO			
Direct loan obligations	25.8	22.2	19.7	18.3	17.8	103.8
Primary guarantee commitments	78.1	76.9	81.7	87.7	92.2	416.6
Total new lending	103.9	99.1	101.3	106.1	109.9	520.3
Secondary guarantees	43.1	45.0	46.9	48.8	50.9	234.7

SOURCE: Congressional Budget Office.

of assisted credit and outlays. In 1986, for example, total assisted lending is projected to decline by $13.4 billion under the President's proposal, whereas cash outlays fall by $9.7 billion (see Table VII-2).

Subsidy Cost Savings

Neither obligations and commitments nor outlays for a particular year measure the value of resources consumed by federal credit assistance. Nor do changes in obligations, commitments, and outlays measure changes in subsidy costs. In 1984, for instance, total federal direct loan obligations and guarantee commitments amounted to $39.1 billion and $70.8 billion, respectively. Cash disbursements less repayments of principal and interest, however, totaled only $6.3 billion. Neither the total of $109 billion in assisted credit nor the contemporaneous cash outlay indicates the amount that the government will eventually lose, over and beyond recoveries, in administrative expenses, defaults, and negative interest spreads.

To obtain a useful measure of these subsidy costs, the value of assets exchanged in credit transactions must be compared. In a loan transaction, the government gives up cash and receives a promissory note for the same amount. In every case, the note signed by the borrower would be worth less in private markets than the cash disbursed. The government gives up cash now for a promise of repayment of principal and some interest in the future. But the value of the promissory note is reduced by the government's cost (in excess of fees) of processing the loan and monitoring collections, by

TABLE VII-2. IMPACT ON THE UNIFIED BUDGET OF THE PRESIDENT'S PROPOSED CHANGES IN THE CREDIT BUDGET (By fiscal year, in billions of dollars)

	1986	1987	1988	1989	1990	Cumulative Five-Year Changes
Outlay Impact of Changes	-9.7	-13.7	-17.8	-19.4	-19.2	-79.8

SOURCE: Congressional Budget Office.

the certainty of some defaults and late payments, and by the lower interest on some government loans than on government borrowings. The value of the loan note is less than the value of the principal by virtue of present and future subsidy costs, expressed in terms of their present value. If the government lends $100 under such terms that the loan note received is worth $90, the subsidy cost of the loan is $10. For loan guarantees, subsidy cost is the difference between the present value of future costs to be incurred by government under the guarantee agreement and the present value of fees to be received by government.

A reasonable measure of subsidy cost is the difference between the amount paid by a borrower without government assistance--to a private lender--and the amount paid with assistance, adjusted for differences in the time of payments. This difference is revealing because the private lender must recover all expected costs--defaults, administrative expenses, interest--from the borrower. The difference between payments to the private lender and to the government reflects expected, unrecovered costs or subsidy costs. Subsidy costs for both direct loans and guarantees are conveniently expressed as a percent of principal. For 1984, the Office of Management and Budget (OMB) estimates that the average subsidy value for federal direct loans was approximately 21 percent of principal and for guarantees approximately 10 percent of principal. OMB estimated subsidy costs of federal credit in 1984, amounted to $8.3 billion for direct loans and $7.4 billion for guarantees.

These subsidy costs are estimates rather than observed market values and are therefore subject to substantial error. One proposal for obtaining market valuations of subsidy cost is the Credit Accounting Reform Act of 1984 introduced by Congressman Gradison and Senator Trible. Under this plan, the government would sell its direct loans to private investors at competitive auction and reinsure its guarantee liabilities with private insurance specialists.

Until such market value subsidies are available, estimates must be used. For the purposes of this analysis, CBO has in general applied the OMB subsidy estimates for 1984 to the proposed credit reductions to obtain projected subsidy cost savings. The OMB subsidy estimates have been adjusted, as noted, to account for changes in the portfolio mix. These estimates are shown in Table VII-3. Adoption of the President's request would save an average of over $9.7 billion in resources per year. This number is 61 percent of the projected reductions in cash outlays. It indicates the value of resources that would be freed for other uses by adoption of the proposed program changes.

TABLE VII-3. MAJOR CHANGES IN SUBSIDIES ESTIMATED FOR FEDERAL CREDIT PROGRAMS (By fiscal year, in billions of dollars)

	1986	1987	1988	1989	1990	Cumulative Five-Year Changes
Proposed Changes						
Direct loans	-4.7	-5.2	-5.5	-5.9	-6.4	-27.7
Guaranteed loans	-2.8	-3.9	-4.4	-4.7	-4.9	-20.7
Total	-7.5	-9.1	-9.9	-10.6	-11.3	-48.4

SOURCE: Subsidy estimates are calculated using OMB's estimated subsidies from Special Analysis Tables F-11, F-12, and F-13 in the Budget, CBO's credit budget baseline, and CBO's reestimate of the President's credit budget proposals.

MAJOR PROGRAM CHANGES PROPOSED BY THE ADMINISTRATION

The aggregate savings projected from adoption of the President's request result from a mix of cutbacks and increases spread across a number of programs. This section describes these changes for programs in which the projected effects are especially large.

Tables VII-4, VII-5, and VII-6 show the effects of the Administration's credit proposals on loan and guarantee activity, outlays, and subsidies, respectively. The assumptions used by CBO in compiling these tables are summarized below:

- **Table VII-4. Major Changes in Credit Program Levels Proposed in the President's Budget.** The CBO baseline estimate maintains 1985 credit program levels through 1990. Discretionary programs--those limited by annual appropriation action--have been increased to adjust for inflation. Open-ended credit programs, such as guaranteed student loans and VA mortgage assistance, are projected on the basis of policies in place in 1985 and CBO economic and technical assumptions.

- **<u>Table VII-5.</u> Major Changes in Baseline Outlays for Credit Programs Resulting from the President's Budget.** CBO outlay estimates for the President's proposals include all identifiable credit program outlays: loan disbursements, interest subsidies, administrative costs, repayments and prepayments, and loan guarantee defaults and fees.

- **<u>Table VII-6.</u> Major Changes in Subsidies for Credit Programs Resulting from the President's Budget.** Subsidy estimates are based on OMB subsidy ratios shown in Special Analysis F of the Budget--Tables 11, 12, and 13. The OMB subsidy estimates are calculated from a comparison of the terms on government loans with the terms on hypothetical private loans to the same borrower or class of borrowers. The baseline subsidy estimates apply the OMB subsidy ratios assuming continuation of the 1985 mix of loan programs and average depth of subsidy. Subsidy estimates for the President's proposals for 1986 through 1990 show reductions in the subsidies provided by many programs as a result of proposed changes in loan terms.

The remainder of this section examines individual loan programs. The terms of the government loan and the extent of the subsidy under current policy are described. Then the President's proposal is assessed in terms of loan volume, impact on outlays, and the resource costs or subsidy effects.

<u>Export-Import Bank</u>

Under current policies, the Export-Import Bank (Eximbank) provides direct loans to foreign countries and firms to purchase U.S. exports at an estimated subsidy of 16.1 percent of loan principal. Guaranteed loan subsidies are estimated to be 4.1 percent. The Administration is proposing to eliminate direct lending by Eximbank, which otherwise would be expected to obligate $3.8 billion in 1986. As a partial offset, loan guarantees are to be increased by $1.6 billion in 1986. These changes are reflected in Table VII-4. Eximbank would also be authorized to spend up to $100 million (plus $36 million for application fees) per year to "buy down" the interest rates on $1.8 billion of federally guaranteed private loans to foreign importers of U.S. goods. Table VII-5 shows the projected $7.1 billion reduction in Eximbank outlays for direct loans. The subsidy cost savings from implementing the President's proposal is $2.3 billion over five years (see Table VII-6). This total consists of a $3.5 billion reduction in subsidy savings for direct loans offset by $1.2 billion in increased subsidies for the $3.1 billion in increased guarantees over the period.

Foreign Military Sales Credit

The FMSC program provides a mix of forgiven loans--effectively grants--and concessional and Treasury rate loans to foreign countries and organizations to purchase U.S. defense articles and services. In 1985 the mix of forgiven and less deeply subsidized loans resulted in an average subsidy of 64 percent of loan volume. The Administration's budget proposes both to increase the volume of FMSC loans over the baseline assumptions and to increase the proportion of forgiven loans. Direct loan volume would exceed the baseline by $1.4 billion, and subsidies would increase by $1.3 billion. Outlays would increase by $0.8 billion.

AID Housing Loan Guarantee Program

The housing guarantee program extends guarantees to assist developing countries in providing housing for lower-income groups. Under current policy all guarantees are coguaranteed by the receiving countries. The loans bear interest of approximately 11 percent for 30 years. OMB estimates that completely private financing would cost 14.7 percent interest for 20-year loans. Given these rates, the baseline subsidy is 19.6 percent of principal. The Administration is proposing to eliminate the program after 1986. Its proposal would reduce the loan volume by $865 million over the next five years, but save $170 million in subsidies for the period. The resource savings are therefore much smaller than the reduced loan volume might suggest.

Rural Electrification and Telephone Revolving Fund

REA direct loans are made at 5 percent and guaranteed loans at the Treasury rate plus 1/8 of 1 percent for 35 years under current policy. Comparable private loans are estimated by OMB to bear 14.6 percent interest for 15 years in the case of direct loans and 3 years for guaranteed loans. The Administration proposes to phase down government lending to rural electric and telephone cooperatives to zero by 1990. The Administration also proposes to increase the interest rate on REA direct loans to the Treasury rate plus 1 and 1/8 percent. REA direct loan obligations and Federal Financing Bank-originated direct loans are projected to be reduced by $11 billion over the five-year period. Subsidies would decline because of both the lower loan volume and the proposed increase in rates for the REA direct loans. Baseline subsidies would be reduced by $4.1 billion. Outlays are estimated to be cut by $5.2 billion.

TABLE VII-4. MAJOR CHANGES IN THE BASELINE CREDIT PROGRAM LEVELS PROPOSED IN THE PRESIDENT'S BUDGET (By fiscal year, in billions of dollars)

Major Program	1985	1986	1987	1988	1989	1990	Cumulative Five-Year Changes
<u>Direct Loan Obligations</u>							
CBO Baseline	51.9	41.6	42.2	42.4	42.8	43.6	212.6
President's Proposals							
Foreign Military Sales Credit	---	0.5	0.4	0.3	0.2	0.0	1.4
Export-Import Bank	1.1	-4.0	-4.3	-4.4	-4.6	-4.8	-22.1
Rural Electrification and Telephone Revolving Fund	0.0	-1.6	-1.9	-2.2	-2.5	-2.8	-11.0
Agriculture Credit Insurance Fund	0.0	-4.3	-4.6	-4.6	-4.9	-5.2	-23.6
Commodity Credit Corporation	0.0	0.0	-1.8	-3.6	-4.1	-4.2	-13.7
Rural Housing Insurance Fund	0.0	-3.4	-3.5	-3.7	-3.8	-4.0	-18.4
Small Business Administration	0.0	-1.3	-1.6	-2.2	-2.5	-2.7	-10.3
Community development grant guarantee	0.1	-0.1	-0.1	-0.1	-0.1	-0.1	-0.7
Rural Development Insurance Fund	0.0	-0.4	-0.5	-0.5	-0.5	-0.6	-2.5
Low-rent public housing	0.0	0.0	-0.9	-1.1	-1.1	-1.2	-4.3
Other	0.0	-1.1	-1.2	-0.6	-0.4	-0.3	-3.6
Direct Loan Change	1.3	-15.8	-20.0	-22.7	-24.5	-25.9	-108.9
President's Request	53.2	25.8	22.2	19.7	18.3	17.8	103.8

(Continued)

Table VII-4. (Continued)

Major Program	1985	1986	1987	1988	1989	1990	Cumulative Five-Year Changes
Guaranteed Loan Commitments							
CBO Baseline	68.8	75.7	75.2	79.9	85.7	89.7	406.2
President's Proposals							
AID housing guarantees	---	-0.1	-0.2	-0.2	-0.2	-0.2	-0.9
Export-Import Bank	---	1.6	1.1	0.6	0.2	-0.3	3.1
Agriculture Credit Insurance Fund	0.0	2.3	2.2	2.2	2.2	2.1	11.0
Commodity Credit Corporation	0.0	-1.5	-1.5	-1.5	-1.5	-1.5	-7.5
Federal Housing Administration	7.0	7.9	8.4	8.5	8.6	8.6	42.0
Small Business Administration	0.5	-2.4	-2.5	-2.6	-2.7	-2.8	-13.1
Rural Development Insurance Fund	---	-0.2	-0.2	-0.2	-0.2	-0.2	-0.9
Guaranteed student loans	0.0	-1.5	-3.3	-3.4	-3.6	-3.7	-15.4
VA loan guaranty revolving fund	0.0	-3.5	-2.1	-1.4	-0.4	0.9	-6.5
Other	0.0	-0.2	-0.3	-0.3	-0.3	-0.4	-1.5
Guaranteed Loan Change	7.6	2.4	1.7	1.8	2.0	2.5	10.3
President's Request	76.4	78.1	76.9	81.7	87.7	92.2	416.6

SOURCE: Congressional Budget Office.

TABLE VII-5. MAJOR CHANGES IN BASELINE OUTLAYS FOR CREDIT PROGRAMS RESULTING FROM THE PRESIDENT'S BUDGET (By fiscal year, in billions of dollars)

Major Program	1986	1987	1988	1989	1990	Cumulative Five-Year Changes
Foreign Military Sales Credits	0.0	0.1	0.3	0.2	0.2	0.8
Export-Import Bank	-0.3	-1.2	-1.7	-1.9	-2.0	-7.1
Rural Electrification and Telephone Revolving Fund	0.0	-0.5	-1.2	-1.6	-2.0	-5.2
Agriculture Credit Insurance Fund	-4.4	-4.4	-4.0	-3.9	-3.8	-20.5
Commodity Credit Corporation	0.2	0.0	-1.7	-1.7	-1.4	-4.6
Rural Housing Insurance Fund	-2.0	-3.1	-3.6	-4.0	-4.4	-17.2
Small Business Administration	-1.2	-1.5	-1.7	-1.9	-0.7	-7.0
Community Development Grant Guarantee	0.0	0.0	-0.1	-0.2	-0.2	-0.5
Rural Development Insurance Fund	0.0	-0.1	-0.2	-0.4	-0.5	-2.2
Low-rent public housing	-0.7	-1.7	-2.0	-2.0	-2.1	-8.6
Federal Housing Administration	-0.3	-0.4	-0.4	-0.5	-0.5	-2.2
Guaranteed student loans	-0.5	-0.5	-1.0	-1.3	-1.8	-5.2
VA loan guaranty revolving fund	-0.5	-0.5	-0.4	-0.2	0.0	-1.6
Outlay Changes for Loan Programs	-9.7	-13.7	-17.8	-19.4	-19.2	-79.8

SOURCE: Congressional Budget Office.

Agriculture Credit Insurance Fund (ACIF)

The Farmers Home Administration finances direct loans and guarantees for purchasing, operating, and improving farms. Emergency disaster loans are also provided to assist recovery from natural disasters, including to compensate for loss of income from reduced crop yields. Most borrowers are not acceptable credit risks for commercial or Farm Credit banks. Although the average ACIF loan conveys a subsidy of about 27 percent of principal, this average is significantly raised by the 53 percent subsidy on emergency disaster loans, which may bear interest as low as 5 percent for terms of up to 40 years. Under the CBO baseline, ACIF lending would average $5 billion annually and new guarantees would average $800 million. The subsidy on guarantees is estimated to be 4 percent of principal.

The President proposes to limit direct loans to $400 million in 1986 and to reduce the ceiling $100 million per year until 1990 when direct lending would be halted. Guarantees for farm operating loans would be increased to $3 billion but the guarantee would be limited to 70 percent of principal--rather than the current 100 percent figure--and borrowers would be charged a 5 percent loan guarantee/origination fee. Emergency disaster loans would be available only where federal crop insurance is not available. Because federal all-risk crop insurance is currently available in virtually all counties of the United States, emergency lending would fall to insignificant levels--a five-year reduction of $9.7 billion.

If adopted, the President's proposal would significantly reduce ACIF activity and shift it away from deep-subsidy direct lending. Total assisted credit would decline by more than $2 billion per year. Outlay reductions would also exceed $4 billion per year and subsidy costs would drop to about $50 million annually from the current rate of $1.3 billion.

Commodity Credit Corporation (CCC)

The two major credit activities of the CCC are price support, nonrecourse direct loans to producers, and guarantees of loans made to finance U.S. agricultural exports. CCC price support "loans" are more closely related to purchase agreements than to pure credit transactions but are treated here as loans, for consistency with Administration practice. The CCC makes direct loans to producers with the crop serving as collateral. On the maturity date of a loan, the borrower can either pay off the loan or forfeit the commodity collateral to the CCC. If the market price is near or below the loan support price, the farmer has an incentive to default. If the market price is above the loan support price, the farmer typically then sells the crop, pays off the loan, and pockets the difference. These loans are called

TABLE VII-6. MAJOR CHANGES IN SUBSIDIES ESTIMATED FOR CREDIT PROGRAMS RESULTING FROM THE PRESIDENT'S BUDGET (By fiscal year, in billions of dollars)

Major Program	1985	1986	1987	1988	1989	1990	Cumulative Five-Year Changes
<u>Direct Loans</u>							
President's Proposals							
Foreign Military Sales Credit	---	0.4	0.3	0.3	0.2	0.1	1.3
Export-Import Bank	---	-0.6	-0.7	-0.7	-0.7	-0.8	-3.5
Rural electrification and telephone revolving fund	---	-0.7	-0.8	-0.8	-0.9	-1.0	-4.1
Agriculture Credit Insurance Fund	---	-1.2	-1.3	-1.2	-1.3	-1.4	-6.4
Commodity Credit Corporation	---	0.0	0.0	-0.1	-0.1	-0.1	-0.2
Rural Housing Insurance Fund	---	-2.3	-2.4	-2.5	2.6	2.7	-12.3
Small Business Administration	---	-0.2	-0.3	-0.4	-0.4	-0.5	-1.8
Community development grant guarantee	---	0.0	0.0	0.0	0.0	0.0	0.0
Rural Development Insurance Fund	---	-0.1	-0.1	-0.1	-0.1	-0.1	-0.5
Low-rent public housing	---	0.0	0.0	0.0	0.0	0.0	-0.1
Direct Loan Change	0.0	-4.7	-5.2	-5.5	-5.9	-6.4	-27.7

(Continued)

Table VII-6. (Continued)

Major Program	1985	1986	1987	1988	1989	1990	Cumulative Five-Year Changes
<u>Guaranteed Loans</u>							
President's Proposals							
AID housing guarantees	---	0.0	0.0	0.0	0.0	0.0	-0.2
Export-Import Bank	---	0.3	0.3	0.2	0.2	0.2	1.2
Agriculture Credit Insurance Fund	---	0.0	0.0	0.0	0.0	0.0	0.0
Commodity Credit Corporation	---	-0.1	-0.1	-0.1	-0.1	-0.1	-0.4
Federal Housing Administration	---	-0.1	-0.1	-0.1	-0.1	-0.1	-0.5
Small Business Administration	---	-0.6	-0.6	-0.6	-0.6	-0.7	-3.0
Rural Development Insurance Fund	---	0.0	0.0	0.0	0.0	0.0	-0.1
Guaranteed student loans	---	-0.8	-1.8	-1.9	-1.9	-2.0	-8.4
VA loan guaranty revolving fund	---	-1.6	-1.7	-1.8	-2.1	-2.2	-9.4
Guaranteed Loan Change	0.0	-2.8	-3.9	-4.4	-4.7	-4.9	-20.7

SOURCE: Congressional Budget Office.

nonrecourse because the government has no further claim on the farmer other than the commodity collateral. The CCC's loss, therefore, depends on crop prices. OMB estimates that CCC commodity loans entail a subsidy of only 1.3 percent of principal. This small subsidy does not consider the nonrecourse provision, which would not be included in a private loan. The existence of the nonrecourse provision potentially converts the loan subsidy to a price support equal to the difference between the crop price and the level specified in the nonrecourse agreement. Export loan guarantees against defaults are also assigned a shallow subsidy of 2.9 percent.

The President proposes to set loan support prices at 75 percent of the three-year average price of the commodity and to limit nonrecourse crop loans to $200,000 per farmer. An origination fee of 5 percent of the principal is proposed to be levied on export guarantees and a small direct loan program for exports is to be terminated.

If the President's proposal is adopted, direct commodity loans would decline by $3.4 billion annually over 1987-1990. Lending would decline because price support loan rates would fall relative to market prices, thus reducing farmers' incentives to use nonrecourse loans. Fiscal year 1986 lending would not be affected since the proposed changes begin with the 1986 crop year. New loan guarantees are projected to be $1.5 billion per year lower over 1986-1990 because of the origination fee.

Federal Housing Administration (FHA)

The FHA revolving fund finances about 40 separate credit programs including the basic Section 203(b) home mortgage insurance plan. The only significant proposed change affecting these programs is to raise the mortgage insurance fee from 3.8 percent of principal to 5 percent. This increase is expected to eliminate the $105 million annual subsidy on single-family mortgage guarantees and to increase revenue by $400 million per year over the next five years.

Rural Housing Insurance Fund (RHIF)

The Rural Housing Insurance Fund finances some of the government's deepest subsidy loan programs. Zero-downpayment homeownership loans are made at 3 percent interest for 33 years, for example. The next largest category, after homeownership loans, consists of rental housing loans which can carry effective rates of 1 percent for 50-year terms. The average subsidy on RHIF loans is 67 percent of principal. Current lending is about $3.2 billion per year, projected to reach $4.0 billion in 1990 under current policy.

The President proposes to terminate Farmers Home housing loans (except for those to finance essential repairs to existing, occupied dwellings), to shift rural housing assistance to the Department of Housing and Urban Development, and to adopt a two-year moratorium on new assistance. If adopted, this would reduce subsidies by about $2.5 billion per year for 1986 through 1990 and outlays by $3.4 billion.

Small Business Administration (SBA)

The SBA provides direct and guaranteed loans to small businesses and to victims of physical disasters who are otherwise unable to obtain such loans on reasonable terms. Under current policy, the terms of SBA's major loan programs and comparable private loans are as follows:

	Government Loan		Private Loan	
	Rate	Term (years)	Rate	Term (years)
Direct Loans				
Disaster loans	8.00	3.0	17.8	1
General business loans	13.50	7.0	17.8	2
Small Business Investment Corporation	13.50	0.5	14.0	15
General business guarantees	13.05	9.0	17.8	2

OMB estimates that the average subsidy for SBA direct loans was 17.1 percent and for SBA guaranteed loans, 22.9 percent in 1984. The Administration has proposed to eliminate the SBA loan programs. This would reduce baseline direct loans by $10.3 billion and baseline primary guarantees by $13.1 billion over five years. CBO estimates the outlay savings from 1986 to 1990 to be $7.0 billion. Assuming a constant subsidy level and mix of SBA programs in the baseline, the subsidy costs would be reduced by $4.8 billion.

Rural Development Insurance Fund (RDIF)

This revolving fund is the smallest of the three major Farmers Home funds and finances three credit programs: direct loans for water and waste disposal; direct loans for community facilities such as fire stations, town halls, and social centers; and loan guarantees to facilitate commercial and industrial development. Loan obligations are currently running at almost $500 million annually; new commitments to guarantee are less than $200 million per year. Direct loans are made at rates as low as 5 percent for 40 years. The average RDIF loan subsidy is 20 percent of principal. For guarantees, the subsidy is 8 percent of the principal amount.

The President's proposal is to terminate RDIF credit programs, except for $50 million in water and waste disposal loans in 1986, and to transfer responsibility for these activities to the Community Development Block Grant program. If adopted, this proposal would reduce total assisted lending by $3.4 billion and Farmers Home Administration credit subsidies by $577 million.

Community Development Block Grant (CDBG) Guarantees

The Secretary of Housing and Urban Development guarantees the debt securities of Community Development Block Grant recipients to finance the acquisition of property and preparation of sites in anticipation of CDBG development. The guarantees are financed by and converted to direct federal loans by the Federal Financing Bank at a rate of 1/8 of a percent above the Treasury rate. The loans are largely repaid from the CDBG grants. Because the loan is made at approximately the Treasury rate and repaid with government funds, the subsidy is minimal. OMB estimated the subsidy to be 1.6 percent of principal for funds committed in 1984. The Administration has proposed the elimination of the program. Baseline direct loans would be reduced by $0.7 billion, outlays by $500 million, and subsidy cost by $10 million.

Guaranteed Student Loans (GSL)

Loans to students and parents are guaranteed and the interest on the loans subsidized. During 1984, OMB estimated that while GSLs were made at 8 percent for a term of 14 years, comparable private loans would cost 15 percent for a term of 10 years. The subsidy was estimated to be 52 percent of the face value of the loans. In its budget the Administration has proposed a number of restrictions on the GSL program: a $4,000 per year cap on all subsidized grant and loan aid per student; a $32,500 cap on income eligibility; and reductions in the GSL allowances to lenders. CBO estimates that GSL loan volume would fall by $15.4 billion from the baseline between 1986 and 1990 and that outlays would be reduced by $5.2 billion between 1986 and 1990. Applying the OMB subsidy estimates yields a reduction in subsidy costs of $8.7 billion.

Low-Rent Public Housing

In 1984, federal guarantees of the tax-exempt borrowing of public housing authorities were converted to direct federal loans. These loans financed outstanding obligations for the construction of low-rent public housing and will be repaid from federal rental assistance payments. OMB estimated the subsidy to be 3 percent of loan principal for 1984. The Administration's budget assumes the continuation of approximately $1.4 billion in new loans in 1986 and 1987, a significant decrease in 1988 through 1990. In total, from 1986 to 1990, the Administration proposes reductions of $4.3 billion from baseline estimates for direct loan obligations. Subsidies would be reduced by $129 million and outlays by $8.6 billion.

VA Loan Guaranty Revolving Fund

The Veterans Administration insures or guarantees the purchase or construction of new homes for veterans. OMB estimated that the subsidy cost was equal to 9 percent of loan volume in 1984. The Administration has proposed a 5 percent upfront fee on the full principal of VA guaranteed mortgages. While the fee can be financed, CBO projects that the increased fee will decrease loan volume by 6 percent below baseline estimates. Guarantee volume would be reduced by $6.5 billion, and outlays by $3.8 billion between 1986 and 1990. The subsidy cost of individual loans would be reduced by $9.2 billion because of the higher fees.

CLOSING COMMENT

When the Congress considers the possible savings from adopting the President's budget proposals for federal credit, these savings--all in relation to baseline projections--should be viewed in terms of reductions in assisted credit, outlay savings, and resources freed for other uses. Each of the proposed changes would affect the volume of credit, outlays, and subsidies and, in fact, most would reduce these three measures. The concept of savings that is relevant will depend on the motivation for Congressional action. Where the objective is to reduce the credit market presence of federally assisted borrowers, the credit budget measure of activity will provide the appropriate gauge for savings. Where the current budget deficit is the object of concern, the outlay savings indicate the potential gain. Where the goal is to reduce the consumption of economic resources by federal credit programs, subsidy cost savings should be the guide. It should be noted that where federal credit is being traded off against spending, the appropriate cost saving from credit cutbacks is subsidy cost rather than outlay savings, which tend to overstate most credit program reductions.

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APPENDIXES

APPENDIX A

CBO REVENUE REESTIMATES

This appendix explains CBO's reestimates of the Administration's budget revenues. It is a companion to Appendix B, which explains CBO's reestimates of the Administration's spending program.

Almost all of the differences between the CBO and Administration revenue estimates are attributable to CBO's use of different economic assumptions, primarily lower taxable incomes (see Table A-1). The differ-

TABLE A-1. CBO'S REESTIMATES OF THE ADMINISTRATION'S BUDGET REVENUES (By fiscal year, in billions of dollars)

	1985	1986	1987	1988	1989	1990
President's Budget	737	794	862	950	1,030	1,108
CBO Reestimates						
Different economic assumptions	-1	-4	-9	-18	-22	-18
Technical reestimates	a/	-1	2	2	-1	a/
Subtotal	-2	-5	-7	-16	-23	-18
President's Budget as Estimated by CBO	735	789	855	934	1,007	1,090

SOURCES: Budget of the United States Government for Fiscal Year 1986 and Congressional Budget Office.

a. Less than $500 million.

ences attributable to technical assumptions are very small in the aggregate. The net result of CBO's reestimates is to reduce revenues below the Administration's budget estimates by amounts ranging from $2 billion in 1985 to $23 billion in 1989 and $18 billion in 1990.

Estimated revenues can be measured as percents of GNP, allowing a comparison that abstracts from differences in GNP assumptions. CBO's estimates of revenues as a share of GNP are higher than the Administration's by 0.1 percent in 1986 and 0.2 percent in 1987, and lower by 0.1 percent in 1989 and 1990 (see Table A-2).

DIFFERENCES IN ECONOMIC ASSUMPTIONS

CBO's economic assumptions are distinguished from the Administration's primarily by their slightly lower economic growth and higher interest rates. The lower GNP path projected by CBO is reflected in lower taxable personal income through 1989. CBO taxable personal income is $28 billion below the Administration's projection in 1987 and $19 billion below in 1989. By 1990, CBO's projection of taxable personal income rises above that of the Administration because of the assumption that property income (nonwage personal income) will claim a higher share of GNP. This assumption partially explains why CBO's estimate of total revenues is closer to that of the Administration in 1990 than in 1989 even though the GNP paths continue to diverge.

TABLE A-2. BUDGET REVENUES AS PERCENTS OF GNP
(By fiscal year)

	1985	1986	1987	1988	1989	1990
President's Budget	19.0	18.9	18.9	19.3	19.4	19.5
President's Budget as Estimated by CBO	19.1	19.0	19.1	19.3	19.3	19.4

SOURCES: Budget of the United States Government for Fiscal Year 1986 and Congressional Budget Office.

In every year except 1986, CBO's projection of corporate profits before tax and before adjustment for the Accelerated Cost Recovery System (ACRS) is lower than the Administration's, with the difference increasing to $25 billion by 1990. About two-thirds of this difference stems from differences in the profits share of GNP; the rest is the result of the Administration's higher GNP projection.

The effect of CBO's different economic assumptions is to reduce revenues in each year by amounts ranging from $1 billion in 1985 to $22 billion in 1989 and $18 billion in 1990 (see Table A-3). Revenues from personal income and social insurance taxes are lower in each year after 1985. The

TABLE A-3. CBO REVENUE REESTIMATES REFLECTING DIFFERENT ECONOMIC ASSUMPTIONS (By fiscal year, in billions of dollars)

	1985	1986	1987	1988	1989	1990
Individual Income Taxes	-1	-3	-5	-5	-4	a/
Corporate Income Taxes	-1	-1	-1	-6	-8	-8
Social Insurance Taxes	1	a/	-3	-8	-12	-15
Windfall Profit Taxes	a/	a/	a/	1	1	1
Federal Reserve Payments	a/	a/	a/	a/	2	4
Other b/	a/	a/	a/	a/	a/	a/
Total Reestimates	-1	-4	-9	-18	-22	-18

SOURCE: Congressional Budget Office.

a. Less than $500 million.
b. Estate and gift taxes, customs duties, excise taxes other than windfall profit taxes, and miscellaneous receipts other than Federal Reserve payments.

relatively smaller income tax reestimates result from the partially offsetting effects of lower CBO wage and salary income projections and higher CBO property income projections after 1986. The social insurance reestimates reflect the full effects of the lower wage and salary projections.

CBO's corporate income tax estimates reduce revenues about $1 billion in 1985, $0.5 billion in 1987, and afterward by larger amounts, reaching $8 billion in 1990--because of CBO's assumption of generally lower taxable profits. The slightly higher windfall profit tax estimates result from CBO's assumption of higher oil prices. The higher Federal Reserve payments result from CBO's higher interest rates.

TECHNICAL ESTIMATING DIFFERENCES

Technical differences between CBO and the Administration are largely offsetting and consequently small in the aggregate, not exceeding $2 billion in any year (see Table A-4).

Most of the individual income tax technical reestimates, positive in 1985 and 1986 and negative in 1987-1990, result from differences between CBO and Administration statistical estimation techniques. These differences are small relative to income tax collections (about 1.5 percent in 1989 and 1990). The Administration continues to estimate somewhat higher outyear receipts when starting from common economic assumptions. Since it does not detail its estimation techniques, this differential cannot be fully explained.

The negative corporate income tax reestimates in 1985 and 1986 reflect different assumptions about refunds. The Administration assumes that the fall-off in corporate tax refunds in recent months will be sustained through the year, implying fiscal year 1985 refunds as much as 24 percent below their 1984 level. CBO assumes a higher level of refunds. The positive technical corporate reestimates in 1988-1990 are primarily due to different methods of estimating the revenue effects of ACRS. For any given level of investment, Administration estimation methods produce greater corporate revenue losses from ACRS.

The positive social insurance tax technical reestimates for the 1988-1990 period reflect, for the most part, different assumptions about state unemployment insurance tax rates. The Administration projects lower rates than does CBO, on the assumption that lower rates generate smaller, more realistic trust fund balances. CBO's higher tax rates and higher projected benefit levels also produce realistic fund balances for 1988-1990.

CBO's estimate of the proposed federal civilian pay-cut proposal also contributes to the positive technical reestimate for social insurance. Although this proposal is an outlay proposal, the Administration includes in its budget estimates the effects of associated reductions in Social Security

TABLE A-4. CBO REVENUE REESTIMATES REFLECTING TECHNICAL ESTIMATING DIFFERENCES (By fiscal year, in billions of dollars)

	1985	1986	1987	1988	1989	1990
Individual Income Taxes	1	1	a/	-3	-8	-7
Corporate Income Taxes	-3	-3	a/	2	3	4
Social Insurance Taxes	a/	a/	1	1	3	4
Windfall Profit Taxes	a/	a/	a/	a/	a/	a/
Other Excise Taxes	1	a/	1	1	1	1
Customs Duties	1	1	1	1	1	1
Federal Reserve Payments	a/	a/	a/	a/	-1	-2
Other b/	a/	a/	a/	a/	a/	a/
Total Reestimates	a/	-1	2	2	-1	a/

SOURCE: Congressional Budget Office.

a. Less than $500 million.

b. Estate and gift taxes and miscellaneous receipts other than Federal Reserve payments.

and Civil Service Retirement contributions. 1/ CBO treats this proposal like others in the budget and includes only first-round effects of the initiative. Therefore, the CBO reestimate of the proposal does not include any revenue effects.

The excise tax technical reestimates primarily reflect CBO's assumptions of higher levels of smoking and of liquor consumption. The reason for the positive reestimate of customs duties is unclear because of a lack of specific import data for comparison.

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1. Budget of the United States Government for Fiscal Year 1986, Special Analyses, p. A-14.

APPENDIX B

CBO OUTLAY REESTIMATES

As part of its analysis of the Administration's budget, CBO has reestimated the Administration's spending program to reflect CBO baseline economic assumptions and technical estimating methods. The effect of these reestimates on outlays is summarized in Table B-1 and explained in the next two sections of this appendix. Most of the CBO reestimates result from the use of different economic assumptions--primarily higher interest rates. These different economic assumptions increase outlays by only small amounts in the first few years, but they add $21 billion in 1988, $46 billion in 1989, and $75 billion in 1990. Technical estimating differences reduce CBO's 1985 and 1986 outlay estimates by $9 billion and $1 billion, respectively, but increase estimated outlays thereafter. By 1990 technical estimating differences

TABLE B-1. CBO'S REESTIMATES OF THE ADMINISTRATION'S SPENDING PROPOSALS (By fiscal year, outlays in billions of dollars)

	1985	1986	1987	1988	1989	1990
President's Budget	959	974	1,027	1,095	1,137	1,190
Preliminary CBO Reestimates						
Different economic assumptions	a/	3	7	21	46	75
Technical reestimates	-9	-1	6	5	10	11
Subtotal	-9	2	13	26	56	86
President's Budget as Estimated by CBO	950	975	1,039	1,120	1,193	1,276

a. Less than $500 million.

reach $11 billion, of which $6 billion is in the national defense function. The appendix concludes with a description of the revisions that have been made to CBO's baseline budget projections.

DIFFERENCES IN ECONOMIC ASSUMPTIONS

Differences in interest costs account for almost all of the economic differences between CBO and Administration outlay estimates, as shown in Table B-2. As the federal government's debt swells, budget estimates are becoming increasingly sensitive to interest rates. CBO assumes that the three-month Treasury bill rate will average 8.3 percent in calendar year 1985, 8.7 percent in 1986, and 8.2 percent in 1987 through 1990. In contrast, the Administration assumes that the bill rate will decline to 7.9 percent in 1986 and to 5.0 percent by 1990. Differences in assumed longer-term rates are even greater--CBO assumes a 10.0 percent three- to five-year note rate for 1987 through 1990, while the Administration rate falls to 5.5 percent by the end of the period. (These differences in assumptions are assessed in Chapter I.) CBO estimates that these higher interest rates will directly

TABLE B-2. CBO OUTLAY REESTIMATES RESULTING FROM DIFFERENT ECONOMIC ASSUMPTIONS (By fiscal year, in billions of dollars)

	1985	1986	1987	1988	1989	1990
Interest Costs						
Due to different interest rates	a/	3	5	16	36	56
Due to different deficits	a/	1	2	4	9	17
Subtotal	a/	3	7	21	45	73
Social Security and Other Indexed Benefits	a/	a/	a/	a/	1	2
Medicare and Medicaid	a/	a/	a/	-1	-1	-1
Unemployment Compensation, Food Stamps, and AFDC	a/	a/	a/	a/	1	1
Total	a/	3	7	21	46	75

a. Less than $500 million.

increase interest costs and other interest-sensitive outlays by $3 billion in 1986 and $56 billion in 1990. In addition, economic reestimates of outlays and revenues indirectly increase interest costs by increasing the amount of debt to be financed. In total, differences in interest outlays total $3 billion in 1986, $7 billion in 1987, and $73 billion by 1990.

CBO's projected inflation rates are slightly below those of the Administration in the early years but a little higher later on. As a result, CBO estimates that outlays for Social Security and other indexed benefits will be within $500 million of the Administration's estimates in 1985 through 1988, $1 billion higher in 1989, and $2 billion higher in 1990. Outlays for Medicare and Medicaid are sensitive to medical care costs, of which employee compensation rates are the most important component. Because CBO projects slower wage growth than does the Administration, CBO's outlay estimates for Medicare and Medicaid are $1 billion lower than the Administration's figures in 1988 through 1990.

CBO's unemployment rate assumptions are generally higher than the Administration's. CBO therefore estimates higher outlays for unemployment compensation and other unemployment-sensitive programs. These differences are negligible in 1985 through 1988, but grow to $1 billion in 1989 and 1990.

TECHNICAL ESTIMATING DIFFERENCES

Table B-3 lists the major technical estimating differences between CBO and the Administration. The next section of this appendix discusses the differences in defense estimates. The concluding section discusses the remainder of the budget.

National Defense

CBO estimates that defense outlays under the Administration's request will be $6 billion higher over the 1985-1990 period than the Administration estimates. This figure is relatively small, given the inherent error in such estimates, but results in large part from differences in the research, development, test, and evaluation (RDT&E) account estimates. Other differences may be found in the operations and procurement accounts.

RDT&E. As noted above, most of the difference between CBO and Administration estimates is concentrated in the RDT&E account. The estimates differ by small amounts in the 1985-1986 period, and by increasingly larger amounts thereafter, reaching $9.3 billion in 1990. Table B-4 shows how CBO arrived at its estimate. The outlay rates used are consistent with recent experience and differ only slightly from those published by the Administration. While it is possible that the difference represents a change in the mix of goods and services purchased through this account, the difference remains unexplained.

TABLE B-3. CBO OUTLAY REESTIMATES RESULTING FROM TECHNICAL ESTIMATING DIFFERENCES
(By fiscal year, in billions of dollars)

	1985	1986	1987	1988	1989	1990
National Defense						
Procurement	1	a/	-2	-3	-2	-2
RDT&E	-1	-1	a/	2	5	9
Operations and other	-2	-1	1	1	1	a/
Subtotal	-1	-1	-2	a/	4	6
International Affairs	-2	a/	1	2	2	2
Energy	-2	a/	-1	-1	-1	-1
Agriculture	1	-1	3	a/	1	1
Commerce and Housing Credit	a/	a/	1	3	1	1
Transportation	-1	a/	1	1	1	1
Medicare	-1	1	2	3	3	4
Social Security	-2	-2	-2	-2	-3	-3
Net Interest						
Estimating differences	a/	1	3	1	2	1
Differences in deficits	a/	-1	-1	a/	a/	1
Subtotal	-1	a/	2	1	2	2
OCS Receipts	a/	1	a/	-2	-1	-2
Other, Net	a/	a/	1	1	a/	a/
Total	-9	-1	6	5	10	11

a. Less than $500 million.

Procurement. CBO's outlay estimates for the procurement accounts differ from the Administration's by small amounts given the size of the budget. The differences are spread over several accounts, with the largest in Army ammunition and weapons and tracked combat vehicles.

Operations and Other. As defined by CBO, operations consists of the sum of the operations and maintenance (O&M) and the revolving and management accounts. They are grouped together because an outlay change in one is often balanced by a change in the other; the O&M accounts are the main customers of the revolving funds, and receipts in the latter are

TABLE B-4. CBO OUTLAY ESTIMATES FOR DEFENSE RESEARCH, DEVELOPMENT, TEST, AND EVALUATION BASED ON THE PRESIDENT'S FEBRUARY BUDGET AUTHORITY REQUEST (By fiscal year)

	1985	1986	1987	1988	1989	1990
	Billions of Dollars					
Budget Authority	31.2	39.3	42.6	49.3	55.9	65.9
Outlays from						
1984 and prior BA	11.3	2.2	0.7	0.0	0.0	0.0
1985 BA	16.0	11.0	2.3	0.8	0.0	0.0
1986 BA		20.0	14.0	2.7	1.1	0.0
1987 BA			21.8	15.0	2.9	1.2
1988 BA				25.2	17.4	3.4
1989 BA					28.6	19.7
1990 BA						33.7
Total Outlays	27.3	33.2	38.8	43.8	50.0	58.0
	Percent					
Implicit Outlay Rates from New BA for						
1985	51.2	28.0	5.4	1.7	0.0	0.0
1986		50.8	32.8	5.5	1.9	0.0
1987			51.2	30.5	5.3	1.7
1988				51.2	31.1	5.2
1989					51.2	29.9
1990						51.2

often disbursements from the former. Because of this relationship, they are difficult to estimate separately. For operations and the remaining categories of defense spending, the estimating differences between CBO and the Administration are attributable to different interpretations of historical spending patterns.

Nondefense Spending

For a number of reasons, CBO estimates of international affairs outlays are below the Administration's in 1985 and 1986 and higher thereafter. Export-Import Bank outlays are lower initially because of lower estimated loan levels in 1985; the resulting reduction in estimated loan repayments causes outlays to be higher in later years. For foreign military sales loans, CBO estimates lower rates of disbursement in the early years and lower repayments later in the budget projections period. The CBO estimate of the President's program also adds over $1 billion in outlays in each year for nonmilitary economic assistance for Israel. Although the Administration states in the budget document that a request for appropriations will be forthcoming, no money for Israel is included in the budget totals.

CBO estimates lower energy outlays in all years except 1986. Estimated outlays for loans by the Rural Electrification Administration and for production of synthetic fuels are consistently lower, reflecting recent spending patterns. Outlays in 1985 are also lower because recent data indicate higher payments of nuclear waste disposal fees by private utilities. Finally, CBO projects that the proposal to increase loan repayments by power-marketing administrations will achieve smaller savings in 1986 because of delays in implementation.

The major reestimates in agriculture programs involve the Agricultural Credit Insurance Fund (ACIF) and the price support programs of the Commodity Credit Corporation (CCC). CBO's estimate of ACIF outlays is $2 billion above the Administration's in each year except 1986. While details behind the Administration's ACIF estimate are not available, the estimating difference is probably related to less optimistic CBO assumptions about loan repayments. For CCC, CBO's estimate of the export credit contingency is lower than the Administration's by about $1 billion each year. CBO also projects that the Administration's proposed changes in farm price supports will not achieve their full savings as rapidly as assumed.

In the commerce and housing credit function, CBO estimates that net outlays of the Federal Deposit Insurance Corporation will exceed the Administration's estimate by $1 billion in 1987 through 1990. CBO projects that the need for assistance to troubled banks will decline less rapidly than the Administration assumes. Based on the latest data from the Postal Service, CBO also estimates that the Postal Service Fund will run a deficit of $2 billion in 1988 and $1 billion in 1989; because of the variability of the fund, the Administration assumes no net outlays in all years from 1987 through 1990.

Recent data on transportation spending suggest that appropriations for discretionary mass transit grants and Federal Aviation Administration facilities and equipment will initially result in outlays at a slower rate than the Administration assumes. This results in lower CBO spending estimates for these programs in 1985 and 1986 and higher spending thereafter. In addition, CBO has upped the Administration's estimate of spending for federal-aid highways and mass transit formula grants in 1986 through 1990 that will result from obligations made before 1985. On balance, CBO's transportation estimates are below the Administration's in 1985, about the same in 1986, and higher in 1987-1990.

Projections of Medicare outlays are especially uncertain because of recent major legislative changes. The prospective payment system for hospital admissions will be fully implemented by 1986. Under this approach, hospitals are reimbursed according to a fixed payment schedule for each of 468 diagnosis related groups (DRGs). The 1984 Deficit Reduction Act also froze physician fees for 15 months. The CBO and Administration differ in their estimates of the future impact of these recent changes. CBO also assumes higher levels of utilization of medical services by beneficiaries than does OMB. The 1985 reestimates are attributable primarily to actual year-to-date spending patterns.

Technical reestimates in the Old-Age and Survivors Insurance portion of Social Security in 1985 reflect recent spending patterns. CBO's downward reestimate in 1985 lowers the base for future-year increases, resulting in lower outlays in 1986 through 1990. CBO projects lower outlays for Disability Insurance in 1985 than the Administration, based on a smaller number of beneficiaries, but the differences are relatively small in later years.

Estimating differences in net interest total from $1 billion to $3 billion in fiscal years 1986 through 1990. CBO assumes that the Treasury will continue its strategy of lengthening the average maturity of the federal debt, raising most of its new money in notes and bonds. OMB assumes a larger proportion of short-term financing, which carries lower interest rates but must be refinanced frequently. CBO projects different interest on Outer Continental Shelf escrow releases consistent with its assumptions about the timing and amount of settlements, as discussed below. Interest receipts from foreign military sales credits are projected by CBO to be lower, primarily because loan disbursements are expected to occur more slowly. CBO projects smaller intragovernmental interest receipts consistent with its outlay projections for agencies that borrow from the Treasury. Partially offsetting these upward reestimates, CBO projects lower interest costs on Internal Revenue Service refunds and larger interest receipts from Treasury tax and loan accounts and the International Monetary Fund. Technical reestimates in other spending categories and in revenues lower the amounts of deficits to be financed in 1985 but increase estimated borrowing requirements in 1987 through 1990.

The major difference in CBO and OMB projections of Outer Continental Shelf (OCS) receipts lies in differing assumptions about escrow releases. The federal government is currently embroiled in a dispute with seven states concerning the equitable distribution of receipts from tracts near the boundary between federal and state waters. The funds are invested in interest-bearing escrow accounts pending resolution of the controversy. The Administration assumes that the states will accept settlements giving them 17 percent of the disputed funds, and that the remaining 83 percent will be disbursed to the federal government mostly in fiscal years 1986 and 1987. Because of the uncertain outcome of these disputes, and because some of the states have recently been prevailing in court, CBO assumes that the federal government will receive only 50 percent of the disputed funds, spread over fiscal years 1986 through 1988. The remaining technical reestimates stem from different assumptions about royalties and bonus receipts. Because a long-term auction schedule is unavailable, CBO and the Administration both assume roughly constant bonus receipts after 1986. Both CBO and OMB have lowered their estimates since last summer because of the oil price situation, but CBO assumes annual bonuses of $2.5 billion after 1986 in contrast to the Administration's $1 billion.

REVISIONS TO CBO BASELINE PROJECTIONS

Since the release of the President's budget on February 4, CBO has updated its baseline outlay projections. These new projections are slightly higher than those published earlier this month in The Economic and Budget Outlook: Fiscal Years 1986-1990. The major revisions to the baseline are listed in Table B-5.

Most of the changes in the projections are for public enterprise funds--such as the Agricultural Credit Insurance Fund, Commodity Credit Corporation Fund, Rural Housing Insurance Fund, Postal Service Fund, and Low-Income Public Housing Fund--where the Executive Branch has considerable administrative flexibility. Most of these funds receive large offsetting collections from the public, which are netted against gross spending. As a result, a change in gross spending or collections causes a far more than proportional change in net outlays. The changes in the projections reflect additional information that CBO has obtained regarding lending plans, repayment schedules, rate increases, and other aspects of the businesslike activities of these funds.

Many offsetting receipts estimates--notably for mineral and timber leases, royalties on Outer Continental Shelf lands, and military retirement contributions--have been revised to correspond more closely to the figures in the budget. In the case of foreign military credit sales, the changes in the projections are based on updated information on the expected borrowing requirements of Egypt and Israel. Finally, by increasing outlays, the foregoing changes cause an increase in net outlays. Changes not discussed above are small and largely offsetting.

TABLE B-5. REVISIONS TO CBO BASELINE OUTLAY PROJECTIONS (By fiscal year, in billions of dollars)

	1985	1986	1987	1988	1989	1990
Foreign Military Credit Sales	-1	1	1	1	a/	a/
Agricultural Credit Insurance Fund	1	1	1	1	1	a/
Commodity Credit Corporation Fund	-2	-1	-1	a/	a/	1
Rural Housing Insurance Fund	a/	1	1	1	1	1
Postal Service Fund	a/	a/	a/	1	1	-1
Housing Assistance	3	1	2	1	1	1
Offsetting Receipts	a/	2	2	2	1	1
Net Interest	a/	a/	1	1	2	3
Other	-1	a/	1	1	a/	-1
Total Revisions	a/	5	7	8	8	6

a. Less than $500 million.

APPENDIX C

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