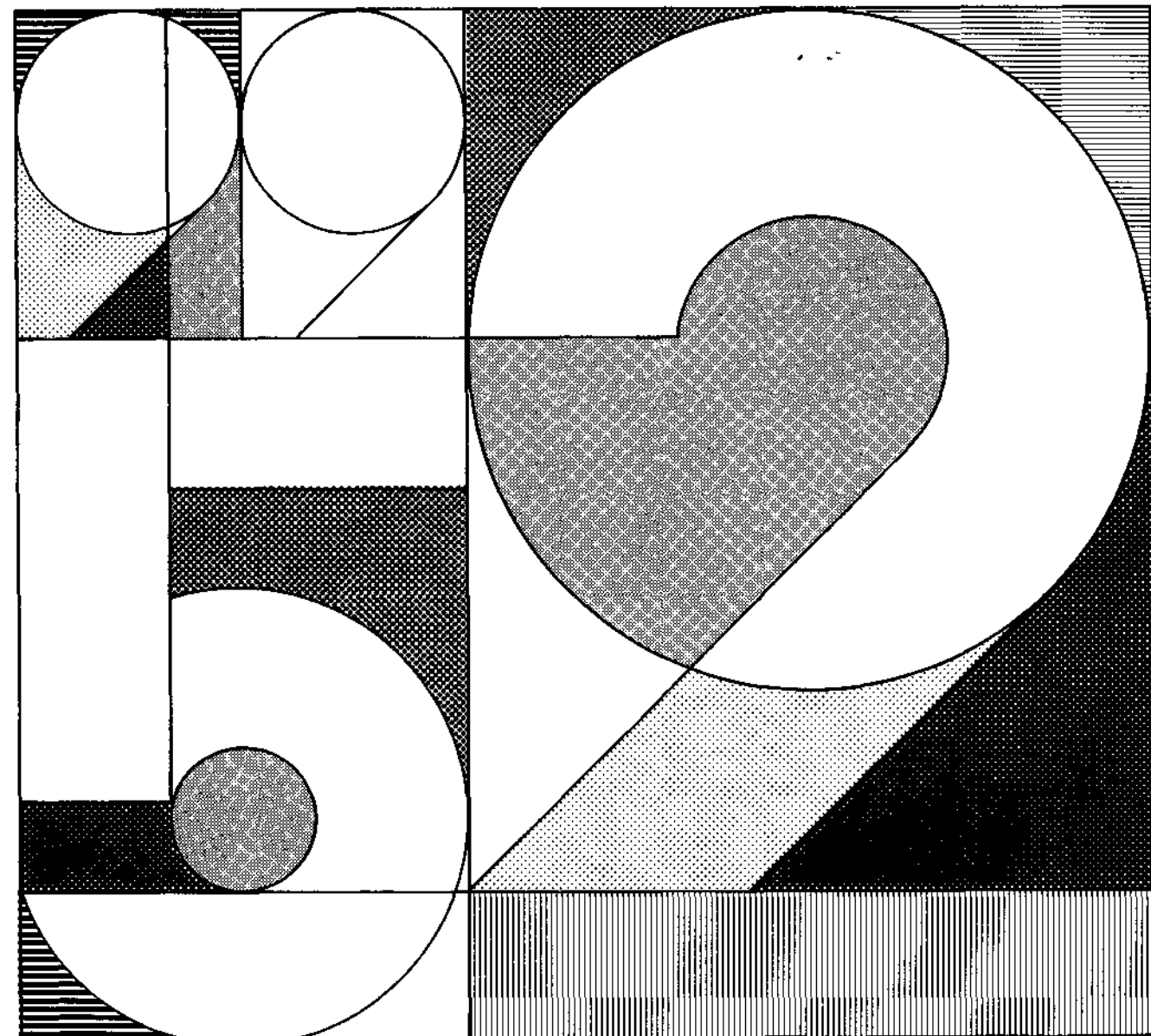




Reducing the Deficit: Spending and Revenue Options

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



February 1990

CBO REPORT ON REDUCING THE DEFICIT

In *Reducing the Deficit: Spending and Revenue Options*, the Congressional Budget Office compiles in one volume dozens of specific options for increasing federal revenues or reducing spending in a wide variety of federal programs, and calculates the deficit reduction achieved annually and cumulatively for a five-year period for each option. The report is intended as a resource for the Congress as it develops the fiscal year 1991 budget resolution, which by law may not yield an estimated deficit exceeding \$64 billion. Currently, CBO's baseline deficit estimate for 1991 is \$138 billion.

This edition of *Reducing the Deficit*, Volume II of CBO's annual report to the Congress, is the eleventh such compendium furnished to the House and Senate Budget Committees. It contains 124 alternatives to current spending policies in the major budget categories of national defense, entitlements, agriculture, nondefense discretionary programs, and the federal work force. It also includes 36 alternatives for revenue policy. Each option gives a brief description of the current policy, the proposed change, and the possible consequences, along with the estimated savings or revenues to be generated. Savings in each spending category are calculated from the CBO baseline, including national defense options, which are also calculated as savings from the Bush Administration's 1991 budget proposals. The economic assumptions underlying the analysis are the same as those in Volume I of CBO's annual report, *The Economic and Budget Outlook: Fiscal Years 1991-1995*, where they are described in detail.

Options included in *Reducing the Deficit* are not CBO recommendations, as is often reported. The material presented here is intended to be informational, an aid to the Congress as it proceeds with the federal budgeting process. Most of the options included in the analysis have been considered by the Congress at some time in the past. Many worthy options for reducing the deficit may have been omitted because of constraints of time or space, not because they lack merit. To make the report more accessible, an appendix and an index have been included. The appendix lists the options under the budget functions that would be affected. The index cross-lists the options by subject using key words.

Reducing the Deficit is an agencywide effort, and questions regarding the various aspects of the analysis can be directed to CBO's Congressional liaison office, the Office of Intergovernmental Relations, at (202) 226-2600. For additional copies of the report, please call the Publications Office at 226-2809.



CONGRESSIONAL
BUDGET OFFICE

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Washington, D.C. 20515

**REDUCING THE DEFICIT:
SPENDING AND REVENUE OPTIONS**

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NOTES

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

The notation "n.a." in tables means "not available" and N.A. indicates "not applicable."

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

The Balanced Budget and Emergency Deficit Control Act of 1985 (popularly known as Gramm-Rudman-Hollings) is also referred to in this volume more briefly as the Balanced Budget Act. This act was amended by the Balanced Budget and Emergency Deficit Control Reaffirmation Act of 1987.

PREFACE

The Congressional Budget Office (CBO) is required by section 202(f) of the Congressional Budget Act of 1974 to submit an annual report on budgetary options to the Senate and House Committees on the Budget. This year, the report is in two parts, with this report constituting Part II. Part I is entitled *The Economic and Budget Outlook: Fiscal Years 1991-1995*.

Chapter I of this report provides general background information on trends in federal spending, revenues, and the deficit. Formula approaches for reducing the deficit are also discussed. The next several chapters present specific options in each of the major spending areas, and the last chapter reviews specific revenue options. For each option, an attempt is made to present both sides of the case as fairly as possible. CBO does not endorse the options included, nor does exclusion imply any recommendation. This report concludes with an appendix and an index. The appendix lists the options under the budget functions that would be affected. The index groups the options by subject (key words) for those who want to turn to only a few program areas. Readers' comments are welcome on these or other aspects of the report.

All divisions of the Congressional Budget Office contributed to this report, which was coordinated by Robert W. Hartman. He also prepared Chapter I from contributions by Frederick C. Ribe, Kathy A. Ruffing, and Paul N. Van de Water. Chapters II through VII were coordinated by John D. Mayer, Wilhelmina A. Leigh, David Trechter, Elizabeth Pinkston, Earl Armbrust, and Joseph Cordes and Jon Hakken, respectively. Budget authority and outlay estimates were coordinated by Charles E. Seagrave, Robert A. Sunshine, Michael A. Miller, and William P. Myers. Paul T. Christy prepared the estimates of formula-type budget options in Chapter I. Revenue estimates were prepared by staff of the Congressional Budget Office and by the Joint Committee on Taxation and were reviewed by the Tax Analysis Division of CBO under the supervision of Rosemary D. Marcuss.

Paul L. Houts supervised the editing and production of the report. Major portions were edited by Francis S. Pierce, Sheila Harty, and Sherry Snyder. Sherry Snyder also compiled the index. Nancy H. Brooks provided editorial assistance during production of the report. The authors owe special thanks to Mary V. Braxton, Jill Bury, Gwen Coleman, Sharon Corbin-Jallow, Angela Z. McCollough, Ronald Moore, Denise Thomas, Robert T. Whitney, and Rhonda Wright, who typed the many drafts. Kathryn Quattrone prepared the report for publication.

Robert D. Reischauer
Director

February 1990



CONTENTS

I	REDUCING THE DEFICIT: AN OVERVIEW	1
II	NATIONAL DEFENSE	37
	DEF-01 Cancel the B-2 Bomber	40
	DEF-02 Cancel the C-17 Aircraft	43
	DEF-03 Cancel the Binary Munitions Program	45
	DEF-04 Cancel the Tacit Rainbow Missile Program	47
	DEF-05 Limit Production of the Trident Submarine to One Every Other Year	49
	DEF-06 Slow Procurement of F-16 Aircraft	51
	DEF-07 Slow Procurement of DDG-51 Guided-Missile Destroyers	53
	DEF-08 Reduce Procurement of SSN-21 Seawolf Submarines	55
	DEF-09 Reduce the Goal for Amphibious Lift	57
	DEF-10 Restructure the Army's Forward Area Air Defense Program	59
	DEF-11 Delay New Program Starts One Year	61

-
- DEF-12 Limit Funding for Supporting Procurement 63
 - DEF-13 Reduce Spending for the Strategic Defense Initiative 65
 - DEF-14 Cancel the National Aerospace Plane 68
 - DEF-15 Limit Payments for Independent R&D 71
 - DEF-16 Reduce Funding for Operation and Maintenance 74
 - DEF-17 Reduce Funding for School Training 76
 - DEF-18 Reduce the DoD Civilian Acquisition Work Force 78
 - DEF-19 Close or Realign Selected Military Bases 80
 - DEF-20 Retire the Navy's Four Battleships 82
 - DEF-21 Transfer the 401st Air Force Tactical Fighter Wing to the Reserves 84
 - DEF-22 Reduce the Number of Active-Duty Military Personnel 86
 - DEF-23 Eliminate Naval Reserve Augmentation Units 90
 - DEF-24 Reduce Drills for Noncombat Reserve Units 92
 - DEF-25 Change Compensation for the Selected Reserve 94

	DEF-26	Restrict Reserve Retirement Benefits	98
	DEF-27	Increase Cost-Sharing for Military Health Care	101
	DEF-28	Limit Military Pay Raise	103
III	ENTITLEMENTS		107
	ENT-01	Reduce Subsidies for Stafford Loans	109
	ENT-02	Require Postsecondary Institutions to Share the Financial Risk of Defaults on Stafford Loans	112
	ENT-03	Eliminate or Reduce Federal Funding of the Social Services Block Grant Program	115
	ENT-04	Eliminate Federal Matching in Medicaid for Medicare's Premiums	117
	ENT-05	Reduce Medicare's Payments to Physicians for All Overvalued Services	119
	ENT-06	Rebase PPS Payments to Hospitals Under Medicare	121
	ENT-07	Eliminate the Disproportionate Share Adjustment in Medicare's Prospective Payment System	123
	ENT-08	Reduce Medicare's Payments for the Indirect Costs of Patient Care That Are Related to Hospitals' Teaching Programs	125

-
- ENT-09** Reduce Medicare's Direct Payments for Medical Education 127
- ENT-10** Reduce Reimbursements for Capital Expenditures Under Medicare 129
- ENT-11** Continue Medicare's Transition to Prospective Rates for Facility Costs in Hospitals' Outpatient Departments 132
- ENT-12** Tax a Portion of the Insurance Value of Medicare Benefits 134
- ENT-13** Increase the Premium for Physicians' Services Under Medicare 136
- ENT-14** Increase Medicare's Deductible for Physicians' Services 138
- ENT-15** Collect 20 Percent Coinsurance on Clinical Laboratory Services Under Medicare 140
- ENT-16** Collect 20 Percent Coinsurance on All Home Health and Skilled Nursing Facility Services Under Medicare 142
- ENT-17** Tax Employer-Paid Health Insurance 144
- ENT-18** Increase the States' Share of Costs for AFDC, Medicaid, and Food Stamp Benefits 147
- ENT-19** Reduce the Matching Rate for Administrative Costs in AFDC, Medicaid, and Food Stamps 150
- ENT-20** Require a Two-Week Waiting Period for Unemployment Insurance Benefits 153

-
- ENT-21 End or Scale Back Trade
Adjustment Assistance 155**
- ENT-22 Reduce the Subsidy in Child
Nutrition Programs for Children
from Higher-Income Families 157**
- ENT-23 Eliminate the \$50 Child-Support
Payment to AFDC Families 159**
- ENT-24 Reduce the Federal Matching Rate
for Child-Support Enforcement
Costs 161**
- ENT-25 Restrict Cost-of-Living Adjustments
in Non-Means-Tested Benefit
Programs 163**
- ENT-26 Reduce the Replacement Rate
Within Each Bracket of the Social
Security Benefit Formula 169**
- ENT-27 Eliminate Social Security
Benefits for Children of Retirees
Ages 62-64 171**
- ENT-28 Lengthen the Social Security
Benefit Computation Period
by Three Years 172**
- ENT-29 Restrict Eligibility for Veterans'
Compensation Payments 174**
- ENT-30 Raise the Loan Fee for Housing Loans
Guaranteed by the Department
of Veterans Affairs 177**

IV	AGRICULTURAL PROGRAMS	181
	AGR-01 Reduce Deficiency Payments to Farmers Participating in USDA Commodity Programs by Lowering Target Prices 183	
	AGR-02 Charge an Insurance Premium for the Income Protection Offered by Target Prices 186	
	AGR-03 Replace Deficiency Payments in the Wheat, Feed Grains, Cotton, and Rice Programs with Declining Direct Payments 188	
	AGR-04 Raise Domestic Commodity Prices by Increasing Unpaid Acreage Reduction Programs 190	
	AGR-05 Establish an Origination Fee of 3 Percent for Nonrecourse Loans from the Commodity Credit Corporation 192	
	AGR-06 Restrict Eligibility for Benefits from Price Support Programs and Reduce the Payment Limitation 194	
	AGR-07 Adopt the Triple Base Option to Reduce the Portion of Each Farmer's Land Eligible for Deficiency Payments 196	
	AGR-08 Adopt the Production Entitlement Guarantee (PEG) Option to Reduce the Portion of Each Farmer's Production That Is Eligible for Government Payments 198	

- AGR-09** Reduce Deficiency Payments to Farmers Participating in Commodity Programs by Reducing the Crop Yields Used to Calculate Program Payments 200
- AGR-10** Eliminate the Export Enhancement Program 202
- AGR-11** Eliminate the Targeted Export Assistance Program 204
- AGR-12** Cut Program Costs for Dairy Price Supports by Requiring Producer Contributions 206
- AGR-13** Reduce the Direct Lending Authority of the Farmers Home Administration for Farm Ownership and Operating Loans 208
- AGR-14** Reduce the Federal Subsidy for Crop Insurance by Requiring Participants in Commodity Programs to Purchase Coverage 210

V**NONDEFENSE DISCRETIONARY SPENDING 213**

- NDD-01** Eliminate the PL-480 Title I Food Aid Program 215
- NDD-02** Eliminate the Export-Import Bank 217
- NDD-03** Cancel the NASA International Space Station Program 219
- NDD-04** Postpone New Spacecraft Development Projects in One of the Major NASA Program Areas for Space Science and Applications 222

- NDD-05 Cancel NASA Research and Technology Programs for the Moon/Mars Initiative 224**
- NDD-06 Suspend Construction of the Superconducting Super Collider for Two Years 226**
- NDD-07 Reduce Subsidies Provided by the Rural Electrification Administration 228**
- NDD-08 Reform Debt Repayment Policy for Power Marketing Administrations 231**
- NDD-09 Eliminate Further Funding for the Clean Coal Technology Program 233**
- NDD-10 Change Revenue-Sharing Formula from a Gross to a Net Receipt Basis for Commercial Activity on Federal Lands 235**
- NDD-11 Improve Pricing for Commercial and Recreational Uses of Public Lands 237**
- NDD-12 Increase the Harbor Maintenance Tax 244**
- NDD-13 Eliminate Federal Grants for Construction of Wastewater Treatment Plants 245**
- NDD-14 Reduce Federal Support for Agricultural Research and Extension Activities 247**
- NDD-15 Include Foreign Deposits of U.S. Banks in the FDIC Insurance Base 249**

-
- NDD-16** Discontinue Postal Subsidies for
Not-for-Profit Organizations 251
- NDD-17** Scale Back the Rural Housing
Loan Program 253
- NDD-18** Scale Back the Rural Rental
Housing Assistance Program 256
- NDD-19** End SBA Loans and Loan
Guarantees 258
- NDD-20** Improve Pricing of Licenses to
Use the Electromagnetic
Spectrum 260
- NDD-21** Impose a Royalty Payment on
Communications Users of the
Electromagnetic Spectrum 263
- NDD-22** Reduce Federal Aid for Mass
Transit 266
- NDD-23** End Support for Aviation
Development 268
- NDD-24** Establish Charges for Airport
Takeoff and Landing Slots 271
- NDD-25** Impose User Fees on the Inland
Waterway System 273
- NDD-26** Establish User Fees for Certain
Coast Guard Services 275
- NDD-27** Reduce New Spending Authority
for Highways to the Level of
Highway Tax Collections 277
- NDD-28** End Funding of the Economic
Development Administration 279

-
- NDD-29 Eliminate or Restrict Community Development Block Grants 281
 - NDD-30 Reduce Untargeted Funding for Elementary and Secondary Education 284
 - NDD-31 Eliminate or Reduce Funding for Impact Aid to School Districts 286
 - NDD-32 Eliminate Federal Funding for Campus-Based Student Aid 289
 - NDD-33 Reduce Pell Grant Funding and Increase Targeting 291
 - NDD-34 Eliminate or Reduce Funding for the Arts and Humanities 293
 - NDD-35 Reduce Funding for Research Supported by the National Institutes of Health 295
 - NDD-36 Reduce the Maternal and Child Health Care Block Grant and the Preventive Health Services Block Grant 296
 - NDD-37 Eliminate Subsidies for Health Professions Education 298
 - NDD-38 Modify the Fee Structure for Local and State Agencies That Administer Federal Housing Programs 300
 - NDD-39 Shift Housing Assistance from New Construction to Vouchers 302
 - NDD-40 Reduce Federal Rental Subsidies by Shifting Some Costs to the States or Tenants 305

	NDD-41	Maintain the Current Number of Housing Assistance Commitments	307
	NDD-42	Eliminate or Scale Back Low-Income Home Energy Assistance	310
	NDD-43	Close or Convert Inefficient or Underused Facilities in Veterans' Hospitals	312
	NDD-44	Promote More Efficient Management and Delivery of Health Care for Veterans	314
	NDD-45	End Funding for the Legal Legal Services Corporation	317
	NDD-46	Modify the Davis-Bacon Act by Allowing Unrestricted Use of Helpers and Raising the Contract Threshold	319
	NDD-47	Modify the Service Contract Act by Eliminating the Successorship Provision	321
VI		FEDERAL WORK FORCE	323
	FWF-01	Limit Pay Adjustments for Federal Civilian Employees	325
	FWF-02	Reduce Federal Employee Retirement Benefits	328
	FWF-03	Restrict Cost-of-Living Adjustments for Federal Retirees Under Age 62	334
	FWF-04	Prefund the Government's Share of Federal Retirees' Health Insurance Costs	337

	FWF-05	Modify the Way Hospitals Are Paid Under the Federal Employees Health Benefits Program	341
VII	REVENUES		345
	REV-01	Raise Marginal Tax Rates for Individuals and Corporations	347
	REV-02	Amend or Repeal Indexing of Income Tax Schedules	352
	REV-03	Increase the Alternative Minimum Tax Rate	354
	REV-04	Limit Mortgage Interest Deductions	357
	REV-05	Tax Capital Gains from Home Sales	360
	REV-06	Decrease Limits on Contributions to Qualified Pension and Profit-Sharing Plans	363
	REV-07	Impose a 5 Percent Tax on Investment Income of Pensions and IRAs	366
	REV-08	Tax Capital Gains Held Until Death	368
	REV-09	Decrease the Exemption and Broaden the Base for Estate and Gift Taxes	373
	REV-10	Phase Out the Dependent-Care Credit	376
	REV-11	Tax the Income-Replacement Portion of Workers' Compensation and Black Lung Benefits	378

-
- REV-12 Tax Nonretirement Fringe Benefits 380**
- REV-13 Repeal the Possessions Tax Credit 384**
- REV-14 Amortize a Portion of Advertising Costs 386**
- REV-15 Impose a 0.5 Percent Tax on the Transfer of Securities 388**
- REV-16 Increase Taxation of Social Security and Railroad Retirement Benefits 390**
- REV-17 Expand Medicare and Social Security Coverage 394**
- REV-18 Include ESOP Cash Dividends in the Social Security Tax Base 397**
- REV-19 Repeal the Medicare Taxable Maximum 399**
- REV-20 Index the Unemployment Insurance Taxable Wage Base 401**
- REV-21 Reduce Tax Credits for Rehabilitation of Older Buildings 403**
- REV-22 Tax Credit Unions Like Other Thrift Institutions 405**
- REV-23 Repeal Tax Preferences for Extractive Industries 407**
- REV-24 Further Restrict Deductions for Business Meals and Entertainment 410**
- REV-25 Eliminate Private-Purpose Tax-Exempt Bonds 411**

- REV-26 Eliminate or Restrict Deductibility
of State and Local Taxes 414
- REV-27 Impose a Value-Added or
National Sales Tax 417
- REV-28 Impose a 5 Percent Tax on
Net Business Receipts 421
- ✓ REV-29 Increase Energy Taxes 423
- REV-30 Increase Excise Taxes 429
- ✓ REV-31 Impose Excise Taxes on
Air Pollutants 432
- ✓ REV-32 Impose an Excise Tax
on Water Pollutants 437
- ✓ REV-33 Impose a Carbon-Based Excise
Tax on Fossil Fuels 440
- ✓ REV-34 Impose a Tax on Agricultural
Chemicals 443
- REV-35 Increase Aviation-Related
Excise Taxes 445
- REV-36 Replace Import Restrictions
on Sugar, Dairy Products, Peanuts,
and Beef with Tariffs That Decline
Over Time 448

APPENDIX Spending and Taxation Options
by Budget Function 451

INDEX

463

TABLES

1.	Baseline Budget Projections and Underlying Assumptions	2
2.	On- and Off-Budget Totals	5
3.	CBO Baseline Outlay Projections for Major Spending Categories	7
4.	CBO Baseline Outlay Projections for Entitlements and Other Mandatory Spending	14
5.	CBO Baseline Revenue Projections by Source	19
6.	Components of CBO Baseline Spending Projections	25
7.	Hypothetical Savings from Alternative Defense Budget Paths Compared with the CBO Baseline	27
8.	Illustrative Formula-Type Budget Options	29
9.	Illustrative One-Year Budgetary Freeze	30
10.	Target Prices Under CBO Baseline Assumptions and Under 3 Percent Annual Reductions	184
11.	Sample Calculation of Broad and Narrower Value-Added Tax Bases, 1988	418

FIGURES

1.	Baseline Deficits and Targets	1
2.	Outlays by Category as Shares of GNP	8
3.	Defense Budget Authority and Outlays	9
4.	Nondefense Discretionary Spending as a Share of GNP	11
5.	Revenues by Source as Shares of GNP	20
6.	Sources of Growth in Outlays	26

**REDUCING THE DEFICIT:
SPENDING AND REVENUE OPTIONS**



CHAPTER I

REDUCING THE DEFICIT:

AN OVERVIEW

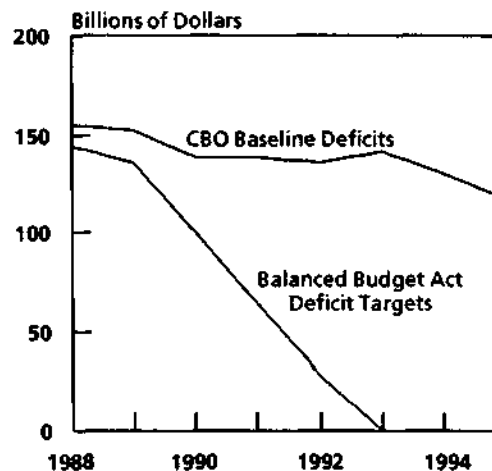
The Congressional Budget Office (CBO) forecasts that the U.S. economy will grow by almost 2 percent in 1990 and slightly faster next year, avoiding a recession without boosting inflation over this period.

CBO estimates that the federal budget deficit will fall from \$152 billion in fiscal year 1989 to \$138 billion in 1990. Over the next few years, no further progress in reducing the deficit can be expected under current budgetary policies. The Balanced Budget Act (commonly called Gramm-Rudman-Hollings) requires a deficit of \$64 billion in 1991 and a balanced budget in 1993. But without spending cuts or tax increases, the deficit in 1993 is likely to be no lower than in 1990. Figure 1 and Table 1 compare CBO's baseline budget projections for 1990 through 1995 with the targets under the Balanced Budget Act.

THE ECONOMIC OUTLOOK

CBO expects that the Federal Reserve will safely steer the economy between the shoals of a recession and higher inflation by further re-

Figure 1.
Baseline Deficits and Targets



SOURCE: Congressional Budget Office.

TABLE 1. BASELINE BUDGET PROJECTIONS
AND UNDERLYING ASSUMPTIONS

	1989	1990	1991	1992	1993	1994	1995
Budget Projections (By fiscal year)^a							
In billions of dollars							
Revenues	991	1,067	1,137	1,204	1,277	1,355	1,438
Outlays	1,143	1,205	1,275	1,339	1,418	1,484	1,555
Deficit	152	138	138	135	141	130	118
Deficit Targets ^b	136	100	64	28	0	b	b
As a percentage of gross national product							
Revenues	19.2	19.6	19.6	19.5	19.4	19.3	19.3
Outlays	22.2	22.1	22.0	21.7	21.5	21.2	20.8
Deficit	2.9	2.5	2.4	2.2	2.1	1.8	1.6
Economic Assumptions (By calendar year)							
GNP (Billions of current dollars)	5,235	5,534	5,893	6,279	6,688	7,121	7,579
Real GNP Growth (Percentage change)	2.9	1.7	2.4	2.5	2.5	2.4	2.4
Implicit GNP Deflator (Percentage change)	4.2	4.0	4.0	4.0	4.0	4.0	4.0
Fixed-Weighted GNP Price Index (Percentage change)	4.5	4.1	4.3	4.3	4.3	4.3	4.3
CPI-U (Percentage change) ^c	4.8	4.0	4.3	4.3	4.3	4.3	4.3
Civilian Unemployment Rate (Percent)	5.3	5.6	5.5	5.5	5.5	5.5	5.5
Three-Month Treasury Bill Rate (Percent)	8.1	6.9	7.2	6.9	6.5	6.1	5.8
Ten-Year Government Note Rate (Percent)	8.5	7.8	7.7	7.6	7.5	7.4	7.3

SOURCE: Congressional Budget Office.

- a. The budget figures include Social Security, which is off-budget but is counted for purposes of the Balanced Budget Act targets. For comparability with the targets, the projections exclude the Postal Service, which is also off-budget.
- b. The Balanced Budget Act established targets for 1988 through 1993.
- c. CPI-U is the consumer price index for all urban consumers.

ducing interest rates this year. CBO forecasts that real gross national product (GNP) will grow 1.8 percent on a fourth-quarter-to-fourth-quarter basis in 1990. This is near the 1989 rate of 2.0 percent, when real GNP is adjusted to exclude the rebound of the farm sector from the previous year's drought. Lower interest rates in 1990 are expected to contribute to slightly faster growth of 2.5 percent in 1991. Short-term interest rates are projected to rise in 1991 as the Federal Reserve moves to head off inflationary pressures.

The CBO forecast envisions little change in inflation. Continued high rates of employment and factory utilization and rising import prices, which tend to increase inflation, will be balanced by slower growth in labor costs stemming from higher productivity growth. The consumer price index (CPI) is expected to rise 4.1 percent in 1990 and 4.4 percent in 1991, only slightly below the 1989 rate of 4.6 percent. The implicit GNP deflator is projected to rise 4.1 percent in 1990 and 4.0 percent in 1991, about the same as in the past two years.

For 1992 through 1995, CBO's economic assumptions are not a forecast of future economic conditions but are projections based on historical trends. Real GNP is projected to grow at an average annual rate of 2.4 percent, in line with labor force and productivity growth. Inflation and unemployment both hold steady. Interest rates are projected to decline throughout the 1992-1995 period until they reach the historical average of inflation-adjusted rates. CBO's five-year economic assumptions are shown in Table 1.

THE BUDGET OUTLOOK

The budget baseline shows what would happen if current budgetary policies were continued without change. It is not a forecast of future budget outcomes, since many policy changes will doubtless be made over the next five years. The baseline methodology hews to the rules contained in the Balanced Budget Act. For revenues and entitlement spending, the baseline generally assumes that laws now on the statute books will continue. For defense and nondefense discretionary spending, the projections for 1991 through 1995 are based on the 1990 appropriations, increased only to keep pace with inflation.

Baseline Projections Through 1995

Under CBO's baseline budget projections, the deficit is projected to remain near its 1990 level of \$138 billion in 1991 through 1993. The baseline deficit then falls to \$130 billion in 1994 and \$118 billion in 1995.

The Balanced Budget Act calls for a deficit of \$64 billion in 1991, \$28 billion in 1992, and zero in 1993. CBO's 1991 projection of \$138 billion exceeds the target by \$74 billion. Unless other spending cuts or tax increases were enacted, the act would require eliminating the excess deficit through automatic across-the-board cuts of 19 percent in defense and 28 percent in nondefense programs. Under the terms of the Balanced Budget Act, however, the Office of Management and Budget, not CBO, determines whether automatic spending cuts are necessary and how large the cuts must be.

The budget outlook is not as gloomy if the deficit is compared with the size of the economy. As a share of gross national product, the baseline deficit falls from 2.5 percent in 1990 to 2.4 percent in 1991 and 1.6 percent in 1995. The assumption of no real growth in discretionary spending causes outlays to fall from 22.1 percent of GNP in 1990 to 20.8 percent of GNP in 1995. Revenues also decline slightly, however, from 19.6 percent of GNP in 1990 to 19.3 percent in 1995.

At more than 2 percent of GNP, the federal deficit is high by historical standards. When coupled with a low private saving rate, it implies that the United States is consuming more than it is producing, resulting in a large international trade deficit. Low saving slows the growth in living standards by reducing the accumulation of productive capital by Americans. The low rate of saving is particularly disturbing because the retirement of the post-World War II baby-boom generation will also cause living standards to grow less rapidly starting in about 2010. A smaller portion of the population will be working then, and what those workers produce will have to be shared--through Social Security and other means--with the relatively large number of retired people. Increasing savings will help to increase the size of the economy over the next 20 years, thereby helping to ease the transition to an older population.

Social Security Projections

The Balanced Budget Act currently includes Social Security in its calculations and makes Social Security subject to the same fiscal discipline as the rest of the budget. From an economic perspective, this approach makes sense. The purpose of reducing the deficit is to increase national saving, which can spur economic growth and capital formation. To the extent that it exceeds government investment, the federal budget deficit absorbs private saving, thereby impairing the growth of living standards. The annual flows of taxes and spending in the Social Security programs affect national saving in exactly the same way as the flows in any other government account.

TABLE 2. ON- AND OFF-BUDGET TOTALS
(By fiscal year, in billions of dollars)

	1990	1991	1992	1993	1994	1995
On-Budget (Excludes Social Security and Postal Service)						
Revenues	779	828	874	924	978	1,037
Outlays	984	1,041	1,095	1,163	1,220	1,283
Deficit	204	212	221	239	242	246
Off-Budget (Social Security) ^a						
Revenues	288	309	330	352	376	401
Outlays	222	234	244	254	264	273
Surplus	66	74	85	98	112	128
Total^a						
Revenues	1,067	1,137	1,204	1,277	1,355	1,438
Outlays	1,205	1,275	1,339	1,418	1,484	1,555
Deficit	138	138	135	141	130	118

SOURCE: Congressional Budget Office.

a. For comparability with the Balanced Budget Act targets, the projections exclude the Postal Service, which is also off-budget.

Thus, the most appropriate measure of the impact of the federal budget on the economy is the total deficit, not any part of it. The total government deficit, including the Social Security and other trust funds, determines the government's fiscal stance, its drain on credit markets, and the amount of saving that it diverts from uses that promote growth in living standards.

Nevertheless, the Balanced Budget Act requires that the Social Security trust funds be shown as off-budget to highlight their contribution to the totals. With income of these trust funds exceeding benefits and other costs, the Social Security surplus grows from \$66 billion in 1990 to \$128 billion in 1995, as shown in Table 2 on the preceding page. An increasing amount of this surplus, however, reflects interest payments received from the Treasury. Because these interest payments are merely intragovernmental transfers, they do not affect the government's need to borrow in the market. Excluding interest, Social Security's contribution to holding down the total deficit looks much smaller--about \$50 billion in 1990 and \$78 billion in 1995--and the on-budget deficit remains roughly constant.

THE FIVE-YEAR OUTLOOK FOR SPENDING

In 1990, the government is projected to spend \$1,205 billion, an increase of about 5½ percent over last year. Under current policies, outlays continue growing at about the same rate, reaching \$1,555 billion in 1995. Total outlays grow faster than inflation, but less rapidly than gross national product, in all years.

Federal spending can be described in many ways. The following section presents projections for five broad categories of spending that are commonly used by the Congress in making budget decisions (see Table 3). Their past and present sizes, relative to GNP, are depicted in Figure 2.

National Defense

This spending category is dominated by activities of the Department of Defense, but also includes defense-related functions of other agencies, such as the Department of Energy's nuclear weapons programs, the

intelligence agencies, and so forth. Total budget authority for defense programs in 1990 is about \$302 billion, and outlays are about \$297 billion.

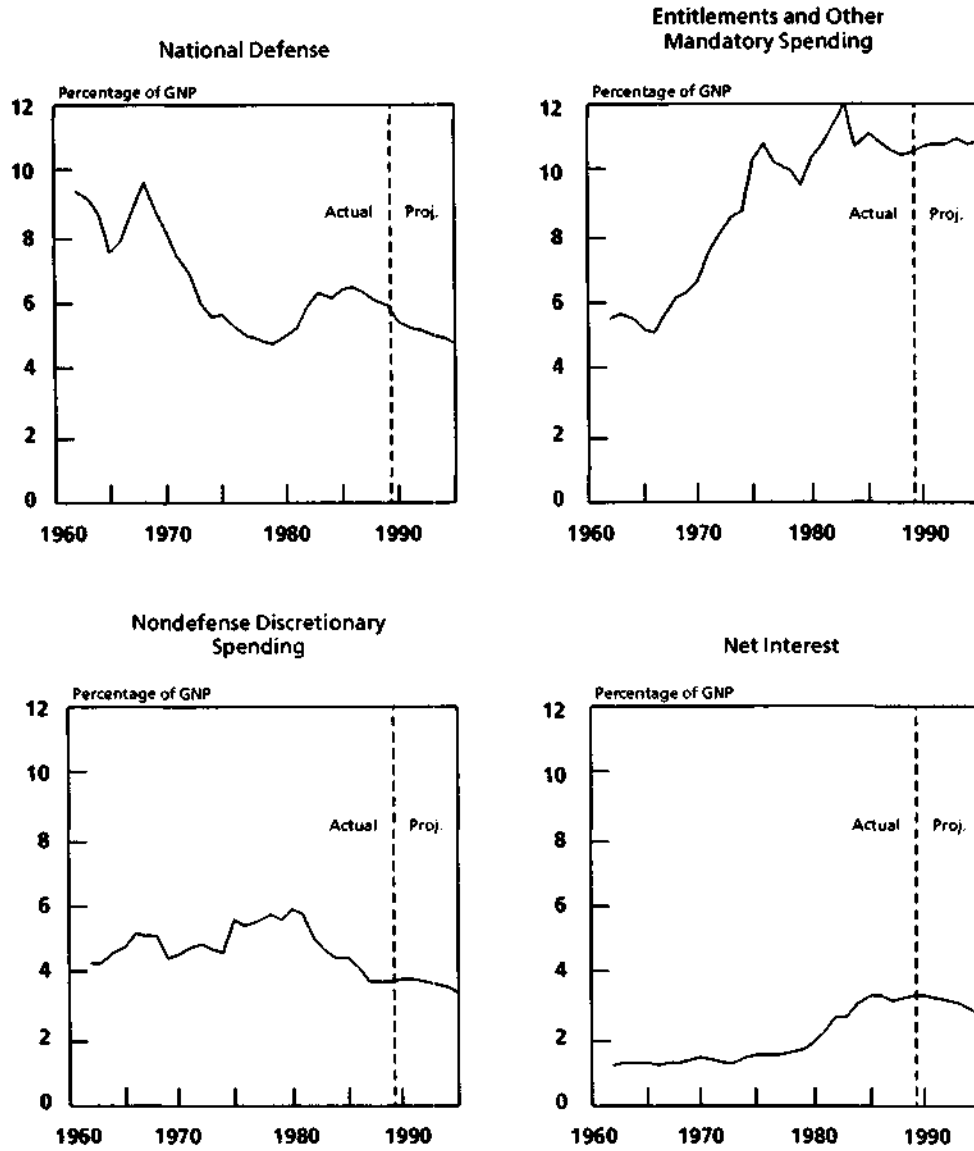
Budget authority for national defense in the baseline increases to keep pace with inflation, about 4 percent a year. Pay for this category's 3 million uniformed employees (including more than 1 million in the reserve forces) and 1 million civilians is also assumed to keep pace with inflation. Defense outlays grow somewhat less rapidly, as the relatively small increases in budget authority approved since the mid-1980s continue to constrain spending.

TABLE 3. CBO BASELINE OUTLAY PROJECTIONS FOR MAJOR SPENDING CATEGORIES (By fiscal year)

Spending Category	Actual 1989	Base 1990	Projected				
			1991	1992	1993	1994	1995
In Billions of Dollars							
National Defense	304	297	307	318	328	345	355
Nondefense Discretionary Spending	191	205	219	229	237	245	254
Entitlements and Other							
Mandatory Spending	544	584	624	664	718	758	809
Net Interest	169	180	185	192	199	205	209
Offsetting Receipts	-64	-60	-60	-63	-65	-69	-72
Total	1,143	1,205	1,275	1,339	1,418	1,484	1,555
As a Percentage of GNP							
National Defense	5.9	5.4	5.3	5.1	5.0	4.9	4.8
Nondefense Discretionary Spending	3.7	3.8	3.8	3.7	3.6	3.5	3.4
Entitlements and Other							
Mandatory Spending	10.6	10.7	10.8	10.7	10.9	10.8	10.8
Net Interest	3.3	3.3	3.2	3.1	3.0	2.9	2.8
Offsetting Receipts	-1.2	-1.1	-1.0	-1.0	-1.0	-1.0	-1.0
Total	22.2	22.1	22.0	21.7	21.5	21.2	20.8

SOURCE: Congressional Budget Office.

Figure 2.
Outlays by Category as Shares of GNP

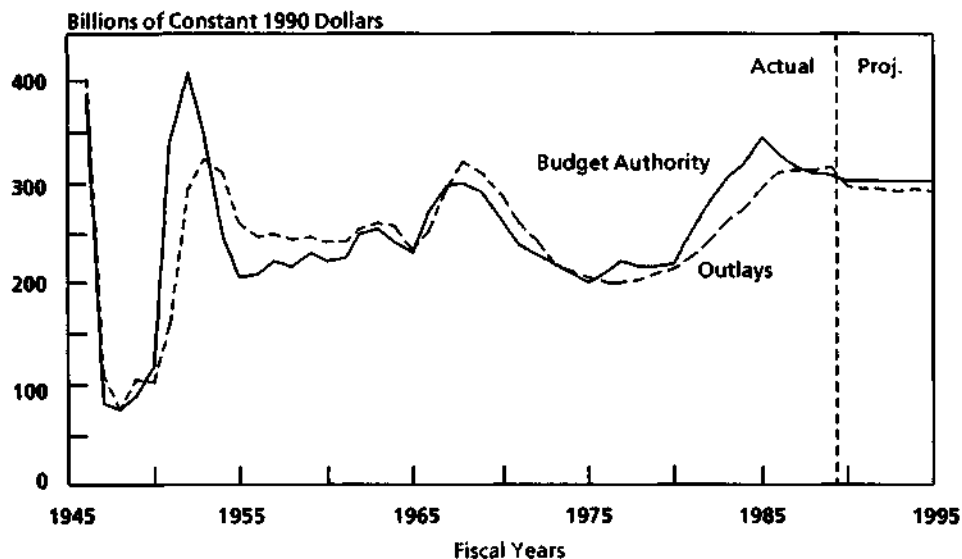


SOURCE: Congressional Budget Office.

The relationship between defense budget authority and outlays since the end of World War II, in constant 1990 dollars, is depicted in Figure 3. Defense spending surged in the early and mid-1980s, following the large increases in budget authority approved in the last years of President Carter's Administration and during President Reagan's first term. In the 1981-1985 period, annual dollar increases in defense budget authority averaged more than 15 percent; even with the high inflation that characterized this period, annual real increases averaged over 9 percent. For the past five years, however, increases in defense budget authority have failed to keep pace with inflation. Final appropriations for fiscal year 1990 contained a slim 1 percent increase for defense budget authority over the 1989 level, well below the rate of inflation.

A different perspective emerges from analyzing defense spending as a share of the total economy versus analyzing it in dollar terms. Under the baseline assumptions, defense spending would claim a shrink-

Figure 3.
Defense Budget Authority and Outlays



SOURCE: Congressional Budget Office.

ing portion of the nation's output. As a share of GNP, defense outlays fall from about 5.4 percent at present to 4.8 percent by 1995--about the same percentage as in the years immediately following the Vietnam War, and the smallest since the late 1940s (see Figure 2). But the nation's economy has expanded greatly during the same period. Therefore, even while defense is smaller relative to GNP than during recent decades, real defense spending remains high. As Figure 3 shows, real outlays still equal or surpass typical levels of the past 45 years with only three distinct exceptions: the Korean War, the Vietnam War, and the defense buildup of the Reagan years.

The defense baseline preserves the mix of activities reflected in the 1990 appropriation. Of the \$302 billion in defense budget authority, the largest amounts are for military personnel (about \$79 billion), operation and maintenance (\$87 billion), and procurement (\$83 billion). Another \$37 billion is earmarked for research, development, test, and evaluation; and \$7 billion is slated for other Department of Defense activities. The remaining \$10 billion goes to other federal agencies, mainly the Department of Energy.

Nondefense Discretionary Spending

Nondefense discretionary spending, an extremely varied category, encompasses most of the government's activities in the areas of science and space, transportation, medical research, environmental protection, and law enforcement, to name only a few. Such spending is expected to total \$205 billion in 1990. About one-fifth of nondefense discretionary spending goes toward pay and benefits for civilian agency employees; about one-third reflects grants to state and local governments.

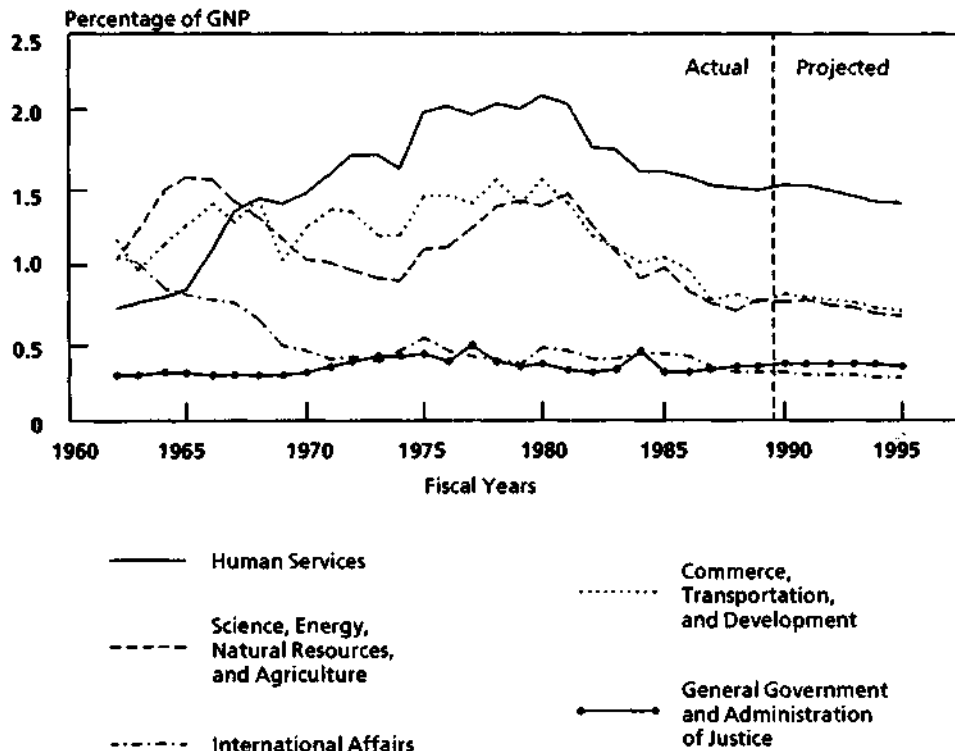
The Congress sets funding levels for nondefense discretionary programs in annual appropriation bills. As with defense programs, the baseline assumes that appropriations keep pace with inflation. Outlays grow slightly faster, climbing about 5 percent a year on average.

Relative to the nation's GNP, nondefense discretionary spending falls slightly from 3.8 percent in 1990 to about 3.4 percent in 1995. Such spending is already at its smallest share of GNP since the early 1960s and lies well below its peaks during the late 1970s, when it generally represented 5½ percent to 6 percent of GNP.

Broad clusters of nondefense discretionary spending have waxed and waned relative to GNP since the early 1960s. While individual programs within these broad clusters may have fared better or worse than others, the priorities of the federal government have shifted during this period (see Figure 4).

Spending for international affairs--primarily security and humanitarian assistance to other nations--has declined fairly steadily since the early 1960s. It currently represents less than 0.5 percent of GNP. A longer historical perspective than that depicted in Figure 4 would show an even steeper decline; during the late 1940s and early 1950s--years in which the United States was contributing heavily to

Figure 4.
Nondefense Discretionary Spending as a Share of GNP



SOURCE: Congressional Budget Office.

postwar reconstruction--such spending typically ranged between 2 percent and 2½ percent of GNP.

Outlays for general government and administration of justice have not fluctuated greatly. Spending in the areas of science, energy, natural resources, and agriculture shows two distinct peaks. The first occurred during the race to the Moon in the late 1960s; the second reflected the boom in spending for energy and, to a lesser extent, the environment in the late 1970s and early 1980s. Commerce and housing credit, transportation, and community development are currently about half as large, relative to GNP, as they were during most of the 1970s.

Finally, human services programs--encompassing activities such as education, training, social services, medical research, subsidized housing programs, and the administrative costs of many benefit programs--have accounted for the largest share of nondefense discretionary spending for 20 years. These programs, too, have shrunk from their peaks and are currently only about three-fourths as large, relative to GNP, as in the late 1970s.

Entitlements and Other Mandatory Spending

About half of federal government spending consists of entitlement and mandatory programs, which amount to \$584 billion in 1990. Such programs make payments to any person, business, or unit of government that seeks the payments and meets the criteria set by law. The Congress controls spending for these programs indirectly, by defining eligibility and by setting the benefit or payment rules, rather than directly through the appropriation process.

The best-known entitlements are the two biggest benefit programs--Social Security and Medicare--run by the government. The category also includes less obvious benefit programs such as farm price supports, Stafford student loans, and the school lunch program. Mandatory programs, such as the government's deposit insurance spending to resolve troubled financial institutions, are also included because the government must fulfill the commitments it has made.

Entitlements and other mandatory spending were by far the fastest-growing category of federal spending over the last quarter century, roughly doubling in size relative to GNP (see Figure 2 on page 8). In the baseline, this category is the only one that keeps pace with GNP, remaining just shy of 11 percent of GNP throughout the five-year period. Thus, entitlements are projected to grow at an average annual real rate of just under 3 percent.

This huge category of spending is further divided into its two major components--means-tested and non-means-tested programs (see Table 4). Only about one-sixth of entitlements meets the common definition of welfare programs, paying benefits to those who demonstrate need. Other entitlements, while some of their spending may benefit poor people, are not means-tested.

Means-Tested Programs. Means-tested entitlements grow from \$97 billion in 1990 to \$146 billion in 1995. Medicaid, a joint federal and state program, is the largest and fastest-growing member of this category. Medicaid primarily covers participants in certain income support programs such as Supplemental Security Income (SSI) and Aid to Families with Dependent Children (AFDC), other participants with greater incomes but high medical expenses, and selected groups targeted by recent program expansions (such as poor children and pregnant women). At present, almost three-fourths of Medicaid spending goes to the aged, although they represent less than one-quarter of participants. Much of this spending goes to pay the costs of long-term care in nursing homes.

Rapid growth in Medicaid is fueled by growth in the eligible population, greater use of covered services, rising costs of medical care, and decisions at the federal and state levels, after cuts in the early 1980s, to expand coverage to additional needy people. The recent expansions have targeted specific groups: low-income pregnant women, young children, and families attempting to leave the welfare rolls. Spending that results from program expansions enacted since 1985 accounts today for roughly 6 percent of Medicaid outlays, growing to about 11 percent in two years.

Other means-tested programs and their estimated spending are also listed in Table 4. The largest programs include Food Stamps; SSI

TABLE 4. CBO BASELINE OUTLAY PROJECTIONS FOR ENTITLEMENTS AND OTHER MANDATORY SPENDING
(By fiscal year, in billions of dollars)

Category	Actual 1989	Base 1990	Projected				
			1991	1992	1993	1994	1995
Means-Tested Programs							
Medicaid	35	39	45	51	57	63	70
Food Stamps ^a	14	15	16	17	18	19	19
Supplemental Security Income	11	11	13	14	15	18	18
Family Support	11	12	13	14	15	15	16
Veterans' Pensions	4	4	4	4	4	4	4
Child Nutrition	5	5	5	6	6	6	6
Earned Income Tax Credit	4	4	4	5	5	5	5
Stafford Loans ^b	4	4	4	4	4	4	3
Other	1	2	2	2	2	3	3
Total, Means-Tested Programs	89	97	108	116	125	137	146
Non-Means-Tested Programs							
Social Security	230	247	263	280	298	316	335
Medicare	94	104	116	131	147	165	183
Subtotal	325	351	380	411	445	480	518
Other Retirement and Disability							
Federal civilian ^c	32	34	39	41	44	47	51
Military	20	22	23	24	26	27	29
Other	5	5	5	5	6	6	6
Subtotal	57	61	67	71	75	80	86
Unemployment Compensation	14	16	16	17	17	18	19
Other Programs							
Veterans' benefits ^d	15	14	15	15	15	17	16
Farm price supports	11	8	12	12	12	11	10
Deposit insurance	21	22	12	8	14	1	2
Social services	5	5	6	6	5	5	5
Other ^e	8	11	10	9	9	8	8
Subtotal	59	60	54	50	56	42	41
Total, Non-Means-Tested Programs	455	487	517	548	593	621	664
Total							
All Entitlements and Other Mandatory Spending	544	584	624	664	718	758	809

SOURCE: Congressional Budget Office.

NOTE: Spending for major benefit programs shown in this table includes benefits only. Outlays for administrative costs of most benefit programs are classified as nondefense discretionary spending, and Medicare premium collections as offsetting receipts.

- a. Includes nutrition assistance to Puerto Rico.
- b. Formerly known as Guaranteed Student Loans.
- c. Includes Civil Service, Foreign Service, Coast Guard, and other retirement programs, as well as annuitants' health benefits.
- d. Includes veterans' compensation, readjustment benefits, life insurance, and housing programs.
- e. Excludes Postal Service outlays after 1989.

for the aged, blind, and disabled; Family Support Payments (another joint federal/state program, primarily consisting of AFDC); pensions for needy veterans who are aged or disabled; child nutrition (the largest of which is the school lunch program); and several others.

Non-Means-Tested Programs. The rest of entitlement spending is not means-tested. Social Security and Medicare are by far the largest such programs, accounting for 60 percent of entitlement spending in 1990. Social Security now pays monthly benefits to 39 million recipients--retired and disabled workers and their spouses, dependents, and survivors. The baseline projections for Social Security reflect continued growth in the beneficiary population, tapering off from about 1.4 percent a year at present to about 1.1 percent by the mid-1990s, as the relatively small cohort born during the Depression reaches eligibility. In addition, the average benefit rises, both because of cost-of-living adjustments and the addition of retirees with recent, relatively high earnings.

Medicare is a smaller program than Social Security but grows much faster under current policies, despite several legislative and regulatory cutbacks in recent years. Medicare was among the fastest-growing major spending programs during the 1980s, outpacing defense and Social Security and second only to net interest; Medicare growth outpaces all other major spending categories in the baseline projections. Medicare growth has been fueled by growth in the eligible population, by inflation in the medical sector that far outstrips general inflation, and by trends in the mix of cases and the use of medical care. Growth in spending has been particularly strong in the Supplementary Medical Insurance (SMI) program, which primarily pays for physician services. Attempts to curtail Hospital Insurance (HI) spending may have shifted costs onto SMI--for example, by encouraging outpatient procedures. The spending totals shown in Table 4 reflect all the benefits paid by Medicare. Premiums collected from SMI enrollees defray a fraction of that program's costs but are included in the off-setting receipts category of the budget.

Last fall, the Congress repealed the year-old expansions in Medicare catastrophic coverage following widespread opposition to the program's financing provisions. In passing the 1988 law, the Congress sought to pay for the new benefits through added levies on the elderly themselves--through higher premiums for all beneficiaries and a spe-

cial income tax surcharge that applied to the higher-income elderly. With the repeal of virtually all provisions of this legislation, the baseline no longer includes significant expansions in Medicare benefits in 1990 and beyond, such as unlimited hospital stays, a cap on out-of-pocket costs for physician services, and prescription drug benefits.

Other retirement and disability programs--which account for 10 percent of spending for entitlements--are dominated by the government's civilian and military retirement programs and by retirement payments to railroad workers. Included in the federal retirement category is the government's fast-growing contribution for annuitants' health benefits, which climbs to \$8 billion by 1995. Another large program, unemployment compensation, grows little under the baseline assumptions about the economy.

All other entitlements and mandatory programs--the remaining 10 percent of this category--are projected to total \$60 billion in 1990, declining to \$41 billion by 1995. The drop can be traced to a single volatile category of spending--deposit insurance; other programs in this category are essentially flat or grow modestly. Non-means-tested veterans' benefits currently total about \$14 billion and grow slowly. Another large program, farm price supports, peaked in 1986 at \$26 billion and averages \$11 billion a year in the 1990-1995 period under the baseline assumptions. Outlays for farm price supports fall below 1989 levels this year because of the sharp decline in drought-related disaster payments. Spending for farm price supports is also artificially depressed in 1990 by the Administration's decision to shift into 1989 some payments that would ordinarily have occurred this year, thus reducing the 1990 deficit. The five-year projections assume average weather and growing conditions, since forecasting the weather accurately for even a few months into the future is clearly impossible. In the absence of special assistance, poor weather conditions translate into smaller crops, higher prices, and reduced outlays for farm price supports; the opposite is true for good growing conditions.

Spending for deposit insurance has been an extraordinarily volatile category of federal spending. Through the mid-1980s, premiums and other income to the deposit insurance funds typically exceeded their costs of aiding troubled financial institutions. But this is no longer the case. Deposit insurance spending has greatly added to the deficit in the past few years and will continue to do so through the

mid-1990s under baseline assumptions. Most of the outlays are for troubled savings and loans (thrift institutions). Budget outlays would be even larger, except that about \$30 billion is effectively excluded from the budget in 1990 and 1991 because the funds are technically borrowed by an off-budget, government-sponsored enterprise and turned over to the Treasury.

Net Interest

Net interest, one of the fastest-growing spending categories in the 1980s, continues to climb in the baseline projections as the government borrows to finance its deficit and to refinance its existing debt. Net interest primarily reflects the government's payments to holders of its debt; as an offset, it also reflects interest income received by the government on loans and cash balances. This interest income shrinks over the forecast horizon.

Net interest grows by about 7 percent between 1989 and 1990. Annual growth tapers off thereafter under the baseline assumptions. This pattern stems in part from modestly declining deficits and, hence, borrowing in the baseline projections. But more important, this pattern reflects the declines in interest rates that are assumed to occur. After climbing modestly later this year, both short- and long-term interest rates begin gradual declines, falling by 1995 to about two percentage points and one-half of a percentage point, respectively, below their current levels. If interest rates remained at today's levels--as is plausible if the deficit is not reduced further--net interest costs would be about \$15 billion higher in 1995.

Clearly, net interest projections are extremely sensitive to assumptions about interest rates. This sensitivity stems directly from the huge amounts of financing and refinancing conducted by the Treasury. Of the marketable debt outstanding at the end of 1995 in the baseline, about one-fourth reflects new securities issued in 1990 through 1995 to finance deficits; over one-half represents debt issued before 1990 but refinanced at some point during the six-year period; and only one-fifth reflects debt borrowed before 1990 and not refinanced during the six-year period.

Offsetting Receipts

Offsetting receipts are funds collected by the government that are recorded as negative outlays. More than half are intrabudgetary--that is, they simply balance payments elsewhere in the budget. These intrabudgetary receipts reflect payments by agencies to retirement and other funds on their employees' behalf; such payments are included in agency budgets, and a corresponding receipt is simultaneously recorded to reflect that the funds have not actually left the government.

The remaining offsetting receipts come from the public and represent voluntary, business-type transactions. Unlike revenues, they do not stem from the government's sovereign taxing powers. The largest item, Medicare premiums, grows from \$12 billion in 1990 to \$15 billion in 1995; these premiums mainly represent payments for SMI, the optional (and heavily subsidized) portion of Medicare that is elected by almost all eligible people. Other receipts from the public include timber and oil lease receipts, proceeds from the sale of electric power, and similar income.

THE FIVE-YEAR OUTLOOK FOR REVENUES

Baseline revenues are projected to exceed \$1 trillion for the first time in 1990, totaling \$1,067 billion. Revenues will grow by more than 6 percent in 1991 and by about 6 percent a year thereafter. This path puts total revenues at \$1,137 billion in 1991 and at \$1,438 billion in 1995. Revenues in 1990 and 1991 represent 19.6 percent of GNP. After that, revenues grow somewhat slower than the overall economy, and the revenue share of GNP drifts down to 19.3 percent by 1994 (see Table 5). Over the past several decades, the federal government's major tax sources have shifted in relative importance, both because of changes in tax policy and changes in the economy. The trends in the relationship of tax sources to GNP are depicted in Figure 5.

Personal Taxes

Over 81 percent of all federal revenues in fiscal year 1989 was collected from the individual income tax and social insurance contribu-

tions, and CBO projects this share to increase slightly to 84 percent by 1995. This represents a significant rise over the last three decades from 60 percent in 1960, primarily as a result of legislated increases in social insurance taxes.

The individual income tax brings in close to 50 percent of all federal tax dollars collected, as it has most years over the last 30 years. It has accounted for a stable 8 percent to 9 percent of GNP virtually every year (see Figure 5). Income taxes exceeded 9 percent of GNP in periods of high inflation (before the system was indexed in 1985) but generally fell to about 8 percent in years following legislated tax

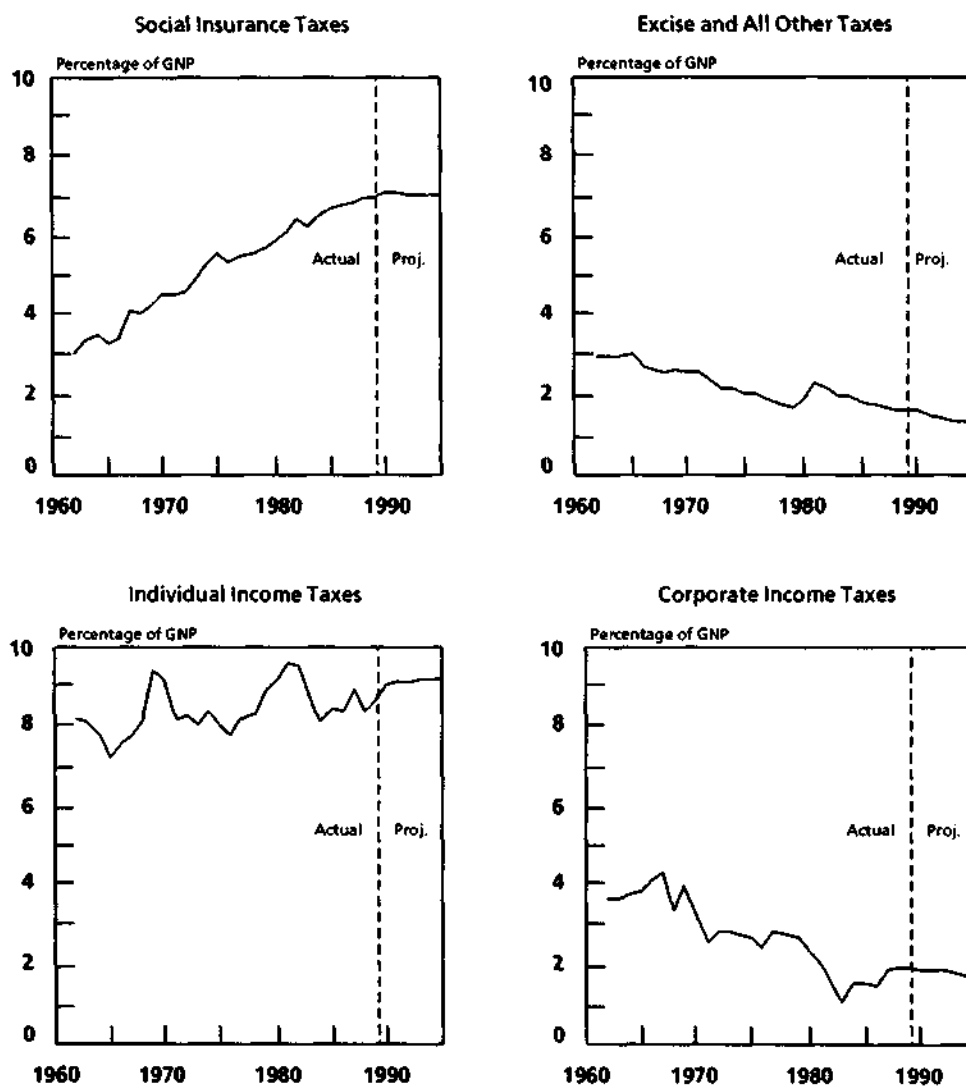
TABLE 5. CBO BASELINE REVENUE PROJECTIONS BY SOURCE
(By fiscal year)

Major Source	Actual 1989	Base 1990	Projected				
			1991	1992	1993	1994	1995
In Billions of Dollars							
Individual Income	446	490	529	564	602	641	682
Corporate Income	103	102	111	116	120	126	134
Social Insurance	359	388	412	437	465	495	526
Excise	34	36	34	32	33	34	35
Estate and Gift	9	9	10	10	10	11	11
Customs Duties	16	17	18	19	21	22	24
Miscellaneous	23	25	25	25	26	26	27
Total	991	1,067	1,137	1,204	1,277	1,355	1,438
As a Percentage of GNP							
Individual Income	8.7	9.0	9.1	9.1	9.1	9.1	9.1
Corporate Income	2.0	1.9	1.9	1.9	1.8	1.8	1.8
Social Insurance	7.0	7.1	7.1	7.1	7.1	7.1	7.0
Excise	0.7	0.7	0.6	0.5	0.5	0.5	0.5
Estate and Gift	0.2	0.2	0.2	0.2	0.2	0.2	0.2
Customs Duties	0.3	0.3	0.3	0.3	0.3	0.3	0.3
Miscellaneous	0.4	0.5	0.4	0.4	0.4	0.4	0.4
Total	19.2	19.6	19.6	19.5	19.4	19.3	19.3

SOURCE: Congressional Budget Office.

reductions to offset inflation's tendency to push taxpayers into higher brackets. With the income tax brackets, the standard deduction, and the personal exemption now indexed to protect taxpayers from such inflation-induced automatic tax increases, the individual income tax is projected to maintain a stable relationship to GNP, even without

Figure 5.
Revenues by Source as Shares of GNP



SOURCE: Congressional Budget Office.

legislative intervention. The baseline projects this share to be 9 percent of GNP each year through 1995.

Social insurance contributions have increased dramatically, both as a fraction of total revenues and in relation to GNP. An overwhelming share (92 percent) of these contributions represent Social Security and Hospital Insurance taxes; the remainder are for unemployment insurance, railroad retirement, and federal employee retirement. In the early 1960s, these contributions represented 16 percent to 17 percent of total revenues; they have more than doubled, now contributing 36 percent. They represent 7 percent of GNP, up from about 3 percent 30 years ago.

The sharp upward trend in social insurance taxes is the result of legislated increases in payroll tax rates and expansions in both the portion of the population participating in the work force and the fraction of the work force covered by these taxes. These tax increases have largely corresponded to the expansions of the entitlement programs for which these taxes are earmarked--Social Security, Medicare, and federal retirement. The last two increases in Social Security tax rates mandated by the 1983 Amendments have taken effect, one in January 1988 and the other in January 1990. One result of these and previous increases is that many families now pay more Social Security tax than income tax.

No additional increases in Social Security taxes (or other social insurance contributions) are scheduled under current law. Therefore, receipts from these tax sources are projected to remain stable relative to GNP. Because Social Security and other social insurance tax rates are flat and the tax bases are indexed to keep pace with inflation, this stability is built into the payroll tax system. Baseline projections show social insurance taxes at 36 percent to 37 percent of total revenues through 1995, and at 7 percent of GNP throughout the projection period.

Corporate Income Taxes

Corporate income taxes contributed over 10 percent of total taxes in 1989, and are projected to be 9 percent to 10 percent of the total each year from 1990 through 1995. This is just below 2 percent of GNP. As

a fraction of total revenues, corporate taxes decline slowly to around 9 percent by 1995.

These projections represent a continuation of a long-established trend--the falling contribution of corporate taxes to funding federal activities. In the early 1960s, corporate income taxes represented more than 20 percent of tax collections and about 4 percent of GNP. Both these ratios have fallen more or less steadily since then. Like the increase in social insurance contributions, this long-run decline results partially from legislated changes in taxation. The enactment of the investment tax credit, the increasingly generous acceleration of asset cost recovery, the reduction of the corporate tax rate, and the proliferation in the number of industry-specific tax deductions have eroded this source as a major contributor to federal coffers. In addition, the tax base has declined relative to GNP because, among other reasons, companies have relied more heavily on debt financing than on equity financing, thereby increasing deductions for interest payments.

Although the Tax Reform Act of 1986 increased corporate taxes by several billions of dollars a year, this amount was not enough to reverse the overall trend. CBO projects that corporate tax payments will remain below 2 percent of GNP, about the same relationship as in 1981 before the tax cuts of the early 1980s reduced it further.

Excise and Other Tax Sources

The remainder of federal revenues is generated by excise taxes on goods and services, tariffs on imported merchandise, estate and gift taxes, net earnings of the Federal Reserve System that are turned back to the Treasury, and numerous miscellaneous fees and charges. Taken together, they made up 8 percent of total 1989 collections and about 1.6 percent of GNP. They are projected to decline over the five-year period to below 7 percent of total revenues and 1.3 percent of GNP. This drop is consistent with a longer trend: at the beginning of the 1960s, they contributed 17 percent of all taxes and measured slightly more than 3 percent of GNP.

The largest component of this group is excise taxes, itself made up of more than 50 separate tax sources. Of these, Highway Trust Fund taxes on gasoline, diesel fuel, truck and tire sales, and road use by

heavy trucks account for more than 40 percent. Taxes on sales of alcoholic beverages contribute about 15 percent, and those on cigarettes and other tobacco products another 12 percent. Airport and Airway Trust Fund taxes have been about 11 percent of all excise taxes, but are projected to decline to 9 percent when scheduled reductions in these taxes take place in 1991. The remaining one-fifth cover a variety of goods and services, ranging from sporting equipment to environmental pollutants to use of the nation's waterways.

Roughly two-thirds of excise taxes are dedicated to specific spending purposes, such as the gasoline tax that funds the nation's interstate highway program, taxes on coal that fund benefits for coal miners afflicted with black lung disease, the airline passenger ticket tax that helps fund aviation spending, and Superfund taxes on chemical feedstocks that fund environmental cleanup.

Many excise taxes are levied on a per unit basis; some have not been addressed by legislation in many years. For example, the tax on wine of 3 cents per bottle (750 ml) was last changed in 1951. The value of such taxes, relative to the economy, has therefore fallen. Some are scheduled to expire during the projection period. As a group, excise taxes have declined in importance consistently for many years, with the enactment in 1980 of the windfall profit tax on oil producing the only major break in the trend. The windfall profit tax dwindled in importance as oil prices fell and has since been repealed.

The Federal Reserve System earns profits on its portfolio, which includes both U.S. government securities of various maturities and foreign currencies. After covering its own costs, the Federal Reserve returns its excess earnings to the Treasury as federal receipts. As interest rates have risen since the 1970s, this revenue source has grown considerably, but not enough to keep pace with overall economic growth or with total revenues. The downward drift in the ratio of Federal Reserve earnings to GNP and to total receipts continues in the forecast period as interest rates are projected to decline over time.

Other tax sources include customs duties on imported products, estate and gift taxes, and miscellaneous receipts, which are composed of many fees, penalties, and other charges. In total, these receipts account for a constant share of GNP.

MAJOR COMPONENTS OF SPENDING GROWTH

Baseline revenues and outlays are both projected to grow by \$70 billion in 1991. Table 6 shows that \$59 billion of the growth in outlays occurs automatically under current law. These built-in increases stem from such factors as cost-of-living increases and growth of caseloads for Social Security and other retirement and disability programs. Spending for Medicare and Medicaid, two of the fastest-growing programs, is driven up by increases in the price of medical care and by the wider use of more expensive medical technologies. Net interest outlays--arguably the least controllable component of spending--are determined by the government's deficit and by interest rates.

Just three programs are responsible for half of the growth in spending (see Figure 6 on page 26). Social Security and Medicare account for \$29 billion, or over 40 percent of the growth in 1991. Another \$6 billion--almost 10 percent of the growth--is added by net interest. Other increases required under current law total \$24 billion. Only \$11 billion of the projected increase in spending in 1991 stems from discretionary increases in appropriations that are assumed in the CBO baseline.

Alternative Spending Paths

As noted earlier, the baseline projections for discretionary spending simply adjust the 1990 appropriations to allow for inflation. As a result, the baseline makes no explicit allowance for activities not covered in the 1990 appropriations, such as renewing long-term subsidized housing contracts that are about to expire. Conversely, the baseline for 1991 through 1995 includes money for items that were funded in 1990 but may not be needed in the future, such as the decennial census and hurricane and earthquake relief. Adjusting the baseline for these special situations, however, would have little effect on the totals.

Of greater consequence are the assumptions about defense spending. The CBO baseline assumes that defense appropriations are adjusted fully for inflation, the same treatment that applies to non-defense discretionary spending. Nevertheless, real defense appropriations have been falling since 1985. Many observers assume that future

TABLE 6. COMPONENTS OF CBO BASELINE SPENDING PROJECTIONS (By fiscal year, in billions of dollars)

	1991	1992	1993	1994	1995
1990 Level	1,205	1,205	1,205	1,205	1,205
Current Law Increases					
Cost-of-living adjustments for entitlement programs ^a	10	25	41	57	74
Increases in price of medical care ^a	4	9	16	24	32
Increases in entitlement program caseloads	7	14	22	30	40
Increases in use of medical care ^b	11	23	36	48	61
Rising benefits for new Social Security beneficiaries ^b	6	10	13	16	20
Expected changes in offsetting receipts	c	-3	-6	-9	-12
Increased interest costs	6	12	20	25	29
Other	<u>14</u>	<u>15</u>	<u>22</u>	<u>16</u>	<u>13</u>
Subtotal	59	105	164	209	257
Inflation Adjustments to Maintain Real Spending for Discretionary Programs					
Defense purchases	3	9	16	24	32
Defense pay	3	8	12	17	22
Nondefense purchases	3	8	15	22	29
Nondefense pay	<u>1</u>	<u>3</u>	<u>5</u>	<u>7</u>	<u>9</u>
Subtotal	11	28	48	70	93
Total Increases	70	134	212	279	350
CBO Baseline	1,275	1,339	1,418	1,484	1,555

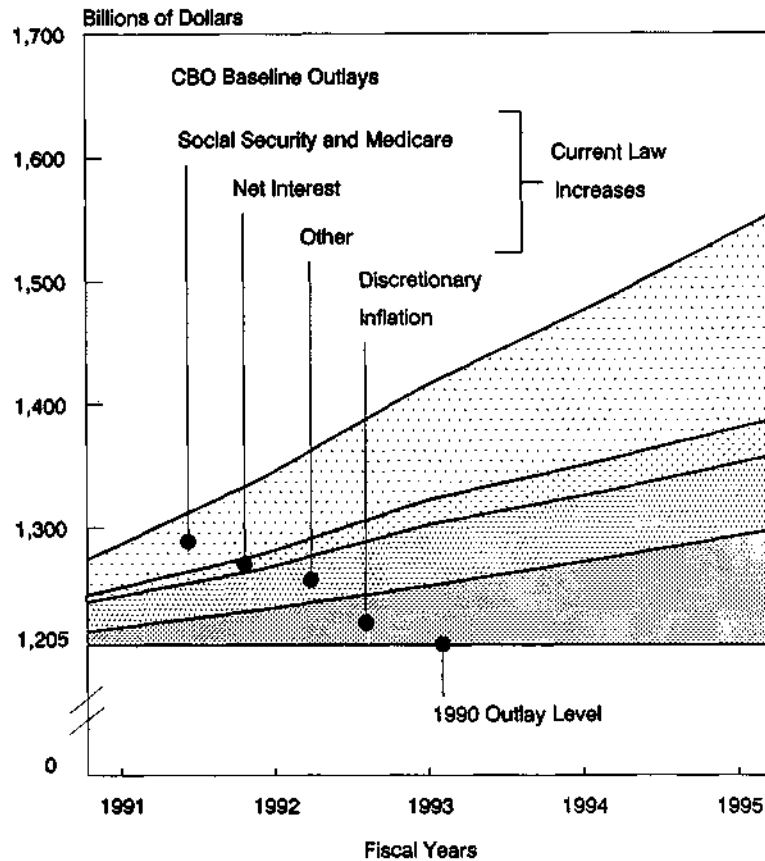
SOURCE: Congressional Budget Office.

- a. Represents program growth that could be eliminated by freezing cost-of-living adjustments and certain medical reimbursement rates.
- b. All growth not explained by increases in caseloads and prices.
- c. Less than \$500 million.

appropriations will similarly fail to match inflation. In their view, large federal deficits will join with reduced East-West tensions to restrain the defense budget, producing a "peace dividend."

Table 7 shows two hypothetical paths for defense spending relative to the CBO baseline. The first involves annual real declines in defense budget authority at roughly the rate of the last three years. A 2 percent annual real decline in defense budget authority would generate up to \$4 billion in defense outlay savings next year, growing to about \$30 billion in 1995, compared with the CBO baseline. Annual real

Figure 6.
Sources of Growth
in Outlays



SOURCE: Congressional Budget Office.

declines of 4 percent double the savings and roughly correspond to a five-year freeze in nominal defense budget authority. This second path would reduce federal spending by \$33 billion in 1993 and \$68 billion in 1995, including reductions in interest costs. Even if all these savings were devoted to cutting the deficit, however, they would amount to only a quarter of what is needed to balance the budget in 1993.

Responding to a widespread perception of unmet national needs may offset any savings from the peace dividend. Among these are perceived shortfalls in child care, health insurance coverage, environmental protection, education, infrastructure, and support for research and development. Moreover, the baseline does not provide for unexpected natural events or a bad turn in the many governmentally provided insurance and guarantee programs. The hurricanes and earthquake in 1989, and the savings and loan problems of the late 1980s, demonstrate that such events do happen. Because responding to these

TABLE 7. HYPOTHETICAL SAVINGS FROM ALTERNATIVE DEFENSE BUDGET PATHS COMPARED WITH THE CBO BASELINE
(By fiscal year, in billions of dollars)

	1991	1992	1993	1994	1995
2 Percent Annual Real Decline in Budget Authority					
Change in Defense Spending	-4	-9	-15	-22	-30
Change in Interest Spending	<u>a</u>	<u>-1</u>	<u>-2</u>	<u>-3</u>	<u>-5</u>
Total Change in Deficit	-4	-10	-17	-25	-35
4 Percent Annual Real Decline in Budget Authority					
Change in Defense Spending	-8	-18	-30	-43	-57
Change in Interest Spending	<u>a</u>	<u>-1</u>	<u>-3</u>	<u>-6</u>	<u>-10</u>
Total Change in Deficit	-8	-19	-33	-50	-68

SOURCE: Congressional Budget Office.

a. Less than \$500 million.

needs could offset any peace dividend likely to accrue in the next few years, the previous conclusion--that policy actions need to be taken to reduce the deficit to the Balanced Budget Act targets--still holds.

REDUCING THE DEFICIT

One of the choices in setting a strategy for deficit reduction is whether to adopt a set of broad rules or formulas, or to take a case-by-case approach. A small across-the-board cut or freeze would be appealing if society attached the same social value to the affected programs and if the priorities reflected in the existing budget actually reflected current priorities. The formula approach has certain obvious advantages. It can make a large impact on the deficit; it can be done quickly; and it spreads the burden over broad groups of individuals. Moreover, it also avoids time-consuming debate on specific programs.

The formula approach, however, also has its potential disadvantages. For example, if society values some of the affected programs more highly than others, or if the required cuts are large, proportional reductions in all programs may not be desirable. The formula approach can also have arbitrary and uneven effects on different groups. While formulas that reduce all programs by a fixed percentage or hold all programs constant appear to be evenhanded, a fixed reduction in all spending can have greatly differing effects on different groups of individuals. For some, the cutback in benefits may be hardly noticed, but for others, it can have serious consequences. Thus, even if the cutbacks are completely across the board, inequities occur. Moreover, the longer the rule is in effect, the more important the inequities become.

Table 8 contains a sampling of options for formula reduction that have recently been put forward and shows for each the resulting savings from CBO's baseline projections. Many formula budget plans could be constructed from this table by selecting one option from each category and summing the annual budget savings. Table 9 provides an illustrative one-year budgetary freeze that would produce savings of \$22.1 billion in 1991 and \$50.4 billion in 1995.

TABLE 8. ILLUSTRATIVE FORMULA-TYPE BUDGET OPTIONS
(By fiscal year, in billions of dollars)

	Deficit Reduction from CBO Baseline				
	1991	1992	1993	1994	1995
National Defense^a					
One-year program-level freeze and pay freeze	-5.8	-9.0	-10.7	-11.7	-12.4
Increase in program levels and pay by 2 percent a year	-2.9	-7.5	-13.0	-19.1	-25.7
No increase in program levels or pay	-5.8	-14.8	-25.5	-37.1	-49.5
Cost-of-Living Adjustments (COLAs)^b					
No COLAs for one year	-9.0	-12.3	-12.5	-12.5	-12.4
COLAs of 2 percent a year	-4.8	-11.8	-19.3	-27.3	-35.3
No COLAs for five years	-9.0	-21.9	-35.4	-49.4	-63.4
Nondefense Discretionary Spending					
One-year program-level freeze	-3.0	-4.9	-5.7	-6.2	-6.6
Increase in program levels by 2 percent a year	-1.5	-4.2	-7.3	-10.8	-14.5
No increase in program levels	-3.0	-8.4	-14.7	-21.6	-29.0
Medicare					
One-year freeze in reimbursement rates	-2.4	-3.6	-4.0	-4.5	-4.9
Increase in reimbursement rates by 2 percent a year	-1.4	-3.7	-6.6	-9.9	-13.7
Civilian Agency Pay^a					
One-year freeze in pay raises	-1.1	-1.7	-1.8	-1.9	-2.0
Increase in pay by 2 percent a year	-0.6	-1.4	-2.3	-3.2	-4.2
No pay raises	-1.1	-2.7	-4.4	-6.1	-7.9

SOURCE: Congressional Budget Office.

a. These calculations are net of offsets for employer payments to employee retirement funds.

b. These calculations exclude means-tested programs.

One broad formula plan is the sequestration procedure found in the Balanced Budget Act. While the procedure was conceived as a way to distribute broadly the burden of deficit reduction, it reflects a specific set of spending priorities. For example, some programs, such as Social Security, are fully exempt from sequestration. Other programs, while not exempt, are subject to special rules that limit the amount of spending reduction. Specifically, Medicare and health programs for veterans and Native Americans may be reduced by no more than 2 percent. The first-year outlay reductions required by the deficit targets are divided evenly between defense and nondefense programs.

TABLE 9. ILLUSTRATIVE ONE-YEAR BUDGETARY FREEZE
(Deficit reduction from CBO baseline, by fiscal year,
in billions of dollars)

	1991	1992	1993	1994	1995
CBO Baseline Deficit	138	135	141	130	118
Policy Changes					
One-year program-level and pay freeze for defense ^a	-5.8	-9.0	-10.7	-11.7	-12.4
One-year COLA freeze ^b	-9.0	-12.3	-12.5	-12.5	-12.4
One-year program-level freeze for nondefense discretionary programs	-3.0	-4.9	-5.7	-6.2	-6.6
One-year freeze in Medicare reimbursement rates	-2.4	-3.6	-4.0	-4.5	-4.9
One-year freeze in civilian agency pay raises ^a	-1.1	-1.7	-1.8	-1.9	-2.0
Subtotal	<u>-21.3</u>	<u>-31.5</u>	<u>-34.7</u>	<u>-36.8</u>	<u>-38.3</u>
Debt Service Savings	-0.8	-3.0	-5.8	-8.8	-12.1
Total Changes	-22.1	-34.5	-40.5	-45.6	-50.4
Resulting Deficit	116	101	100	84	67

SOURCE: Congressional Budget Office.

a. These calculations are net of offsets for employer payments to employee retirement funds.

b. These calculations exclude means-tested programs.

The required outlay reductions for each of these two groups (after subtracting the savings from the special-rule programs from the non-defense share) are achieved by cutting the resources in each category by a uniform percentage. For 1991, the deficit target is \$64 billion, and the deficit must be held below \$74 billion to avoid sequestration. Allowing sequestration to do the deficit reduction job would imply reductions of 19 percent in defense budget authority and 28 percent in nonexempt domestic programs.

PROGRAMMATIC APPROACHES TO REDUCING THE DEFICIT

The alternative to a formula approach is to focus on the policy implications of various deficit reduction options. Public policy principles or themes may be useful in formulating an overall deficit reduction package. Most of the outlay reductions reviewed in this volume involve one or more of the following themes:

- o *Reduce Public Consumption.* Reduce the public sector's role by cutting back on federal activities. Give priority to public investments and cut back on public consumption.
- o *Reassign Responsibilities to State and Local Governments.* Cut federal support for social programs, leaving the responsibility to state and local governments.
- o *Limit the Benefits of Programs to Those in the Greatest Need.* For instance, tighten eligibility criteria for federal programs to include only the economically needy.

Most of the revenue options discussed in this volume fall into the following categories:

- o *Broaden the Income Tax Base.* Tax all forms of labor compensation and capital income on a more uniform basis. Eliminate the preferential treatment of income from certain activities.
- o *Increase Income Tax Rates.* Raise the rates for existing tax brackets or add another bracket for high-income taxpayers. Raise the minimum tax rate.

- o *Tighten Taxation on Transfers of Wealth.* For instance, lower the exemption for estate and gift taxes.
- o *Expand Coverage of Payroll Taxes.* Tax state and local government employees like private-sector employees.
- o *Increase Reliance on Consumption Taxes.* Raise existing excise taxes or adopt a new broad-based consumption tax such as a value-added tax.
- o *Increase the Use of User Fees.* Make the price of government services reflect their true costs.
- o *Increase the Use of Corrective Excise Taxes.* Tax activities whose prices may not fully reflect their social cost.

CONSTRAINTS ON DEFICIT REDUCTION

Both the formula approach and the specific program approach to cutting outlays, or raising taxes, have limits. These involve technical constraints, legal and moral constraints, and limits arising from concerns about effects on the income distribution, regions of the country, and the overall economy.

Technical Constraints

The planning period for government programs varies considerably, and for some programs is quite long. Building an aircraft carrier, for instance, takes many years; once the process is begun, it may be highly inefficient to cancel or delay construction. While it may be feasible to stretch out or delay procurement of some other weapons systems, doing so could raise the unit cost if efficiencies can be gained from large production runs.

Legal and Moral Constraints

Legal constraints occur because the government may have already contracted to purchase resources. In general, contracts can be broken,

but breaking them usually involves penalties. Moral constraints occur because people plan their lives based on understandings--perhaps implied--about how the government, their employers, and other significant institutions will behave. In many instances, these understandings are implicit rather than contractual. But sudden changes can nonetheless violate understandings and obligations.

Concerns About the Distribution of Income

Recent trends in income distribution and poverty also constrain decisions about where to cut budget outlays or increase taxes. In general, the distribution of personal income has become more unequal during the 1980s than it was in the earlier post-World War II period. Family income, in terms of real purchasing power and adjusted for family size, has increased slowly since the early 1970s, but some groups have fared better than others. For instance, income rose relatively rapidly for the elderly, but single mothers with children experienced only a slight growth in income. Families headed by people under age 25 and families with children and no full-time, full-year workers experienced substantial drops in real income between 1970 and 1986. The percentage of families in poverty rose sharply in the early 1980s, reflecting in part the severe recession during that period. More recently, the poverty index has slowly drifted down, but it remains substantially above the level of 1979. Poverty rates are particularly high for single mothers with children.

Concerns about the distributional effects of budgetary actions are, therefore, particularly important. For example, the growth in average benefit levels for poor families with dependent children--the AFDC program--has lagged behind the rate of inflation during the 1980s. Also, on the tax side, an increase in payroll taxes, a new consumption tax, or a selective increase in excise taxes--say, on gasoline or tobacco--could impose a disproportionate burden on lower-income groups.

Regional Considerations

Many deficit reduction options assign a disproportionate burden to one region of the nation. An oil import fee, for example, will have greater adverse effects on regions that are heavy consumers of oil than on oil-

producing regions. Options concerning farm programs, development of water projects, canceling weapons programs or tax preferences for extractive industries (primarily oil and gas) all have obvious regional implications.

Regional considerations may be particularly important where local economies are already distressed and where unemployment is relatively high. Although labor markets are generally quite strong and the aggregate unemployment rate has not been this low since 1974, unemployment--especially for disadvantaged groups--remains high in some regions of the country. For instance, although unemployment rates for black teenagers have dropped considerably, they remain extremely high in the Midwest.

Short-Term Macroeconomic Effects

Sharp reductions in the budget deficit could temporarily weaken aggregate demand, causing economic growth to slow in the short term and unemployment to rise. Cutting the budget deficit makes room for shifting resources toward net exports and domestic investment, thereby improving long-run prospects for the economy. But if the deficit reduction is too fast, these expanding sectors may be unable to absorb unemployed resources fast enough; as a result, the economy might tip into a recession. The risk of causing serious weakness in the economy would be mitigated or eliminated if the Federal Reserve responded by easing monetary policy. The risks could also be reduced by spreading the deficit cuts over several years.

HOW TO USE THIS VOLUME

The remainder of the volume is divided into chapters on national defense, entitlements, agricultural programs, nondefense discretionary spending, federal work force, and revenues. Each of the chapters analyzes a large number of specific options for reducing the deficit. Each option includes a short description of its pros and cons, and an estimate of the savings or revenue gains for each of the years from 1991 through 1995, as well as a five-year total. Variations on any option may, of course, be constructed, with corresponding variations in savings.

Because there would be interactions among the options if many of them were enacted, the deficit reduction effects of the separate options cannot be added to a grand total. Their interactions could magnify or nullify their individual effects. In fact, some of the options are mutually exclusive. In addition, any reduction in outlays or increase in revenues would result in a lower public debt and therefore in lower net interest costs than would otherwise be the case. The estimates for the specific options do not include these savings on interest, although they would have to be taken into account in analyzing a complete budget plan. Moreover, a budget plan that significantly reduced the path of federal deficits could cause some easing of interest rates, thus lowering interest payments on the debt.

Finally, the Congressional Budget Office does not make substantive policy recommendations. Thus, the appearance of an item among the listed options should not be interpreted as a CBO endorsement. Similarly, the absence of an item should not be construed as CBO opposition to its enactment.



CHAPTER II

NATIONAL DEFENSE

Although funding for national defense has been falling in real terms since 1985, the Administration's 1991 request of \$306.9 billion contains substantial growth for many programs. This section presents 28 options to limit spending for national defense. The first 11 offer lower spending levels by reducing the funds for procurement of major weapons systems, such as the B-2 bomber, the C-17 cargo aircraft, the chemical binary munitions program, and the new DDG-51 guided-missile destroyer. Savings would be achieved by canceling systems, as in DEF-01 and DEF-03, or by slowing the rate of procurement as in DEF-06 and DEF-07.

Limits on spending in other investment programs are considered in options DEF-12 through DEF-15. The Administration has proposed spending large amounts over the next five years on programs such as the Strategic Defense Initiative (SDI, DEF-13) and the National Aerospace Plane (DEF-14). The options presented here would achieve savings by slowing the growth in these programs or by canceling specific programs.

Limiting further improvements in military readiness is discussed in DEF-16, while reducing funding and improving management of the Department of Defense's school training program is addressed in DEF-17. The possible effects of closing additional military bases is discussed in DEF-19.

Options for reducing the active-duty military forces are presented in DEF-20 through DEF-22. Some reductions could be achieved by retiring some forces such as the Navy's battleships (DEF-20) or by transferring some forces to the reserves (DEF-21). In response to military and political changes in the Soviet Union and Eastern Europe, large reductions in military forces might also be possible (DEF-22).

Finally, DEF-23 through DEF-26 offer savings by eliminating some reserve units (DEF-23) or by limiting the benefits for the Selected Reserve (DEF-24 and DEF-25) and reserve retirees (DEF-26). DEF-27 considers increases in the charges for health care for military dependents, and DEF-28 discusses limiting the growth in military pay.

The estimates of savings for all options are discussed in terms of budget authority rather than outlays and were made relative to both the Administration's proposed budget for 1991 (using CBO's current economic assumptions) and the CBO baseline. The CBO baseline for national defense is constructed by adjusting the 1990 budget authority for major accounts--a higher level of aggregation than individual weapons systems--for inflation only. Since the options discussed in this report are based on more specific items in the defense budget and since they are prepared well in advance of the Administration's 1991 request, certain assumptions are necessary to assess the value of an option's savings relative to the CBO baseline.

For nearly all options, the amounts planned in the budget for 1990--as adjusted for Congressional action and CBO inflation assumptions--fit neatly into the account-by-account baseline projections. In other words, the 1991-1995 amounts planned for these programs could be funded within the baseline amounts and still leave sufficient funds for other programs funded in 1990. Consequently, this volume defines the CBO baseline as including these programs as planned nine months ago, with adjustments for Congressional action and CBO inflation assumptions. In three cases (the B-2, the C-17, and SDI), the plan for 1990 is inconsistent with the adjusted-for-inflation-only baseline because the plan called for large amounts of real growth after 1990. In these instances, the CBO base for the specific savings proposals is estimated by simply inflating the 1990 budget authority levels for the programs in question.

Entries labeled "Savings from Administration's Request" in this chapter, by contrast, evaluated the specific proposal against the Administration's request for 1991 submitted last month. When the savings from the request and the CBO baseline are identical, the implication is that the Administration's current plan is not a significant departure from what is assumed in the baseline. When savings from the request are smaller than savings from the CBO baseline, the implication is that the Administration has significantly lowered its previous

plan. Conversely, when savings from the request are greater than from the CBO baseline, the implication is that the Administration has increased its plan, although there may be instances where this may not be true (for example, the B-2, the C-17, and SDI).

DEF-01 CANCEL THE B-2 BOMBER

	Annual Savings (In millions of dollars)					Cumulative Five-Year Savings
	1991	1992	1993	1994	1995	
Savings from CBO Baseline						
Budget Authority	4,500	4,600	4,800	5,000	5,200	24,100
Outlays	1,100	2,600	3,800	4,400	4,800	16,700
Savings from Administration's Request						
Budget Authority	5,540	n.a.	n.a.	n.a.	n.a.	n.a.
Outlays	1,030	n.a.	n.a.	n.a.	n.a.	n.a.

NOTE: The 1991 Department of Defense budget request does not provide sufficient detail to compute annual savings beyond 1991 for this alternative.

The B-2 bomber, also referred to as the Advanced Technology or "stealth" bomber, is designed to be nearly invisible to most Soviet ground-based air defense radars. Thus, it should be better able than other aircraft to penetrate the airspace of the Soviet Union to deliver nuclear weapons. The Pentagon believes that penetrating bombers are needed to accomplish certain missions such as finding and destroying mobile targets, assessing damage caused by earlier nuclear attacks, and reconnoitering targets. Bombers are also one of several different means the United States employs to deliver nuclear warheads. This redundancy of delivery systems is intended to provide insurance against failure of one or more of the delivery systems and to enhance deterrence by convincing a would-be nuclear attacker that the United States could retaliate.

This option would cancel the B-2 bomber program, leaving the United States with a mix of the new B-1B and the older B-52 bombers. (B-52 bombers that carry air-launched cruise missiles are thought to be capable of flying well beyond the year 2000.) Savings under this alternative would amount to \$5.5 billion in 1991 relative to the Administration's request. Relative to the CBO baseline, savings would be \$4.5 billion in 1991 and total \$24.1 billion over the next five years.

Although early flight tests of the B-2 have been proceeding well, it is too soon to draw firm conclusions about the aircraft's ability to effectively penetrate Soviet airspace. Tests to determine the B-2's effectiveness in this mission will not be completed for several years. In addition, while the Air Force believes penetrating bombers hold the most promise for locating and destroying mobile targets, significant and costly technology advances for detecting and discriminating movable and concealable targets will be necessary if the B-2 is to acquire these capabilities.

Cost is also a major concern for this aircraft. In the years beyond 1990, the Air Force will have to spend at least \$40 billion to complete the planned procurement of 132 aircraft. According to the Administration's 1990 plan, the B-2 bombers bought in 1991 would cost nearly \$4 billion and would consume about 19 percent of the Air Force's planned 1991 aircraft procurement budget. This share would probably increase as the number of aircraft planned per year increases and the total Air Force budget decreases. Unit costs could also grow if, as often happens with a new weapon, technical changes are needed so that the bomber can perform its missions effectively, or if the program is stretched out over a longer period of time.

Moreover, the United States and the Soviet Union plan to conclude a nuclear arms agreement that would reduce the number of strategic nuclear weapons that each side can deploy. Although the counting rules favor penetrating bombers (by discounting the weapons they carry), the general reduction in tensions between the two countries may also argue against spending so much money to purchase a new strategic bomber.

Canceling the B-2, however, would leave the United States without a bomber capable of penetrating the Soviet Union with high confidence after the turn of the century. This capability could be important because penetrating bombers are able to threaten most types of strategic targets--including mobile targets and targets hardened against nuclear attack--better than any other strategic system. Furthermore, the B-52 bombers are old; by the year 2010, the newest version of the B-52--the "H" model--will be about 50 years old. If a new strategic bomber is not well into production by then, the strategic deterrent of the United States might be limited to submarine-launched ballistic missiles, intercontinental ballistic missiles, and the remaining B-1B

bombers. Having less redundancy in U.S. delivery systems might decrease confidence in the ability of the United States to deter a nuclear attack.

DEF-02 CANCEL THE C-17 AIRCRAFT

	Annual Savings (In millions of dollars)					Cumulative Five-Year Savings
	1991	1992	1993	1994	1995	
Savings from CBO Baseline						
Budget Authority	2,500	2,600	2,700	2,800	2,900	13,500
Outlays	570	1,360	2,060	2,400	2,610	9,000
Savings from Administration's Request						
Budget Authority	2,700	n.a.	n.a.	n.a.	n.a.	n.a.
Outlays	400	n.a.	n.a.	n.a.	n.a.	n.a.

NOTE: The 1991 Department of Defense budget request does not provide sufficient detail to compute annual savings beyond 1991 for this alternative.

The C-17 is a four-engine transport aircraft that can carry up to 167,000 pounds of cargo for a distance of 2,400 nautical miles. The Air Force plans to purchase 210 C-17s by the year 2000 to augment U.S. capability to transport forces overseas rapidly. Assembly of the first C-17 began in August 1988; its first flight is now planned for June 1991. A squadron of 12 C-17s was to be operational by September 1992, but that date has slipped because of delays in development.

The Congress has authorized production of 10 C-17s through 1990. The 1991 budget submission requests six additional aircraft. This option would cancel the C-17 program. Savings relative to the CBO baseline would amount to \$2.5 billion in 1991 and total \$13.5 billion over the next five years. Savings relative to the Administration's request would be \$2.7 billion in 1991.

Canceling the C-17 would mean that the Department of Defense would not meet its goal of being able to move 66 million ton-miles of cargo per day (by air) across intercontinental distances. Were the program to continue as planned, the goal would be met around the year 2000. But because of current political events in Europe, the United States may not need additional airlift beyond what is available today.

Furthermore, according to recent press reports, revised intelligence estimates suggest that U.S. forces may have more time to deploy to Europe in the event of a war. Thus, airlift requirements should be lower.

Nor would canceling the C-17 aircraft leave the United States without airlift assets. Existing strategic airlift assets include 267 C-141 Starlifter aircraft built between 1963 and 1968, 77 C-5A Galaxy aircraft built in the late 1960s and early 1970s, and 50 C-5B aircraft bought between 1983 and 1987. With these aircraft, and with civilian cargo aircraft available to DoD in an emergency, the United States can move about 47 million ton-miles per day, or 72 percent of DoD's goal. This capability dwarfs that of any other nation, including the Soviet Union.

This current airlift capability would suffice in regional conflicts involving a limited commitment of U.S. forces. Only a major war would require greater capability. Recent political events in the Soviet Union and Eastern Europe make the likelihood of such a war extremely small at the present time.

There are, however, arguments in favor of continued production of C-17 aircraft. Commanders-in-chief of combat theaters have expressed their need for improved ability to move cargo by air and have made the C-17 program one of their highest priorities. Moreover, the existing C-141 fleet is about 25 years old and has, at best, another 10 years of useful life without major modifications. The C-17s are meant to replace C-141s in both active and reserve squadrons. If the C-17s are canceled, these squadrons could be deactivated as the C-141s are retired, leaving the United States with less capability than exists today. Although today's C-5 fleet will be in service many more years, the Air Force is concerned about its high peacetime operating costs and its inability to land on smaller airfields. Thus, should the Congress elect to cancel the C-17 program, it will soon have to consider how it will supply the future airlift needs of the U.S. military.

DEF-03 CANCEL THE BINARY MUNITIONS PROGRAM

	Annual Savings (In millions of dollars)					Cumulative Five-Year Savings
	1991	1992	1993	1994	1995	
Savings from CBO Baseline						
Budget Authority	100	100	100	110	110	520
Outlays	40	70	90	100	110	410
Savings from Administration's Request						
Budget Authority	140	n.a.	n.a.	n.a.	n.a.	n.a.
Outlays	60	n.a.	n.a.	n.a.	n.a.	n.a.

NOTE: The 1991 Department of Defense budget request does not provide sufficient detail to compute annual savings beyond 1991 for this alternative.

The United States manufactured no new chemical weapons from 1969 to 1986. During this time, however, the services developed a binary chemical munition to replace the older existing arsenal of U.S. chemical munitions. These new munitions contain two chambers, each of which holds a nontoxic chemical. After the munition is fired from a cannon or dropped by an airplane, the two chemicals mix to form a toxic or debilitating chemical agent.

Although the binary munitions allegedly are much safer to store and transport than the older unitary munitions, the Congress refused to approve production funds for them for several years. Production was finally approved in 1985, but only by the slimmest of margins and with the understanding that no munitions would be produced for several years. Indeed, the authorization for funds in 1987 stipulated that no artillery shells be assembled before October 1, 1987, and that the chemical bomb called "Bigeye" not undergo final assembly before October 1, 1988. This alternative would cancel all programs for manufacturing binary munitions, saving \$140 million in 1991 relative to the Administration's plan. Relative to the CBO baseline, savings would amount to \$100 million in 1991 and total \$520 million over the next five years.

The binary munitions program has experienced technical difficulties. In particular, the Bigeye bomb, designed to be delivered by Air Force and Navy aircraft, exploded prematurely during testing because of defective fuses. Although the services claim that all technical problems have been corrected, the program has fallen behind schedule. Because of these problems and delays, the Congress has in the past precluded production of the Bigeye bomb until after the bomb successfully completed its follow-on test and evaluation.

Doubts about the need for additional chemical munitions have been heightened now that a worldwide ban on chemical munitions is being seriously considered. The Joint Chiefs of Staff, as well as the House Committee on Armed Services in its 1990 committee report for Defense Department authorizations, have argued, however, that the very decision to produce these munitions has given new impetus to a negotiated ban on chemical weapons. If the United States chooses unilaterally to stop production, it could send the wrong signal to potential adversaries and reduce the chance of obtaining a meaningful ban. Moreover, according to the Department of Defense, the Soviet Union has the most extensive chemical warfare capability in the world. Advocates of U.S. chemical weapons production argue that, in the absence of a ban, the United States must have a modern stockpile of weapons to deter the Soviet Union and others from using theirs. They argue further that these newer weapons are safer to store and, if necessary, to use than the older weapons now in the U.S. stockpile.

**DEF-04 CANCEL THE TACIT RAINBOW
MISSILE PROGRAM**

	Annual Savings (In millions of dollars)					Cumulative Five-Year Savings
	1991	1992	1993	1994	1995	
Savings from CBO Baseline						
Budget Authority	180	100	160	160	170	770
Outlays	40	60	120	150	160	530
Savings from Administration's Request						
Budget Authority	240	n.a.	n.a.	n.a.	n.a.	n.a.
Outlays	50	n.a.	n.a.	n.a.	n.a.	n.a.

NOTE: The 1991 Department of Defense budget request does not provide sufficient detail to compute annual savings beyond 1991 for this alternative.

The Tacit Rainbow missile is a cruise missile designed to loiter in the vicinity of enemy radar installations. When the radar turns on, the missile homes in on the radar's emissions and destroys it. The missile is powered by a turbofan engine that permits extended flight. Its radar seeker scans a broad range of frequencies to detect and home in on enemy radar transmissions. The Tacit Rainbow can be carried internally by the B-52G bomber or externally on the Navy's A-6E aircraft. Development of a ground-launched version is also being considered. Although the development program for the air-launched version was originally a joint effort of the Air Force and Navy, the Navy has decided not to provide funds after 1989.

The primary mission for the Tacit Rainbow missile would be to destroy enemy radars and the missile sites that rely on them. The Air Force and Navy currently use the High-speed Antiradiation Missile (HARM) to perform this mission. The major advantage the Tacit Rainbow missile enjoys over the HARM is its ability to position itself over the target area and remain until the enemy radar becomes active. To perform the same mission, aircraft carrying the HARM or older antiradiation missiles must expose themselves to attack from enemy

aircraft as well as from the surface-to-air missiles that are their targets. In contrast, the Tacit Rainbow could be launched from secure positions well away from the target area.

The Tacit Rainbow was supposed to be less expensive than the HARM, which costs about \$250,000 each. The Department of Defense, however, notified the Congress in May 1989 that the estimated acquisition cost per missile had increased by 38 percent over the development estimate. This increase leads many analysts to question whether the Tacit Rainbow missile will be cheaper than existing alternative missiles.

Moreover, the development program for Tacit Rainbow, which began in 1981, has been delayed significantly. Flight tests designed to aid in developing the missile were suspended in 1987 after an initial failure; they resumed in 1988. Of the four test flights in which the missile functioned on its own, only one could be considered fully successful. Recent test results have been somewhat more encouraging, with the missile scoring eight successes in nine attempts. Nevertheless, doubts remain about the missile's cost and its performance.

Canceling the Tacit Rainbow missile would save \$180 million in 1991 and about \$770 million through 1995, relative to the CBO baseline. Savings relative to the Administration's plan would be \$240 million in 1991. These savings might be reduced if canceling Tacit Rainbow led to an increase in the requirements for the HARM. But political developments in Europe may lead to reductions in enemy air defenses that could eliminate the need to acquire additional antiradiation missiles.

**DEF-05 LIMIT PRODUCTION OF THE TRIDENT
SUBMARINE TO ONE EVERY OTHER YEAR**

	Annual Savings (In millions of dollars)					Cumulative Five-Year Savings
	1991	1992	1993	1994	1995	
Savings from CBO Baseline						
Budget Authority	1,300	0	1,400	0	1,500	4,200
Outlays	50	220	360	430	590	1,650
Savings from Administration's Request						
Budget Authority	1,400	n.a.	n.a.	n.a.	n.a.	n.a.
Outlays	55	n.a.	n.a.	n.a.	n.a.	n.a.

NOTE: The 1991 Department of Defense budget request does not provide sufficient detail to compute annual savings beyond 1991 for this alternative.

The Trident submarine will eventually be the mainstay of the sea-based leg of the triad of strategic forces, which includes forces operating on land, sea, and air. Current plans call for each submarine to carry 24 Trident missiles, and for each missile to be equipped with eight nuclear warheads. As of January 1990, the Navy has ten of these ships and has funding to construct seven more. The Navy has indicated that it intends to request funds for at least four additional submarines; planned funding for advance procurement suggests that the Navy may request two more beyond that.

This option would delay authorization of the eighteenth Trident submarine until 1992 and would then procure one every other year through 1998. Savings would amount to \$1.4 billion in 1991 relative to the Administration's request. Relative to the CBO baseline, savings would be \$1.3 billion in 1991 and total \$4.2 billion over the next five years.

The Administration currently is negotiating with the Soviet Union to limit the number of nuclear weapons that each side has deployed. These negotiations, known as the Strategic Arms Reduction

Talks (START), could lead to a limit of 6,000 nuclear warheads on 1,600 launchers, of which only 4,900 warheads could be on ballistic missiles. The United States has proposed a counting rule that would exempt submarines in overhaul from being counted under these limits. If the United States proposal is not accepted, however, the United States may wish to limit the number of Trident submarines it buys. Otherwise, it will not be able to maintain large land-based nuclear forces. Indeed, if the Navy deployed 21 Trident submarines, the United States would have more than 4,000 sea-based warheads and, depending on the final form of the START counting rules, might be allowed fewer than 900 land-based warheads. Under these assumptions, the United States would have 24 percent fewer sea-based warheads and 65 percent fewer land-based warheads than it has today. Slower procurement of Trident submarines under this alternative would give planners more time to see what limits will prevail under START and to make decisions about how best to allocate warheads among the three types of U.S. strategic forces.

The Navy has indicated, however, that changing the procurement plan for the Trident submarine would increase the unit cost by more than \$100 million--about 8 percent of the production cost of a Trident submarine. Furthermore, if the purpose of slowing the Trident program is to gain more flexibility in planning strategic forces under possible treaty limits, other alternatives--such as limiting the number of missiles each submarine can carry--could also be explored without reducing the number of Trident submarines available for deployment.

DEF-06 SLOW PROCUREMENT OF F-16 AIRCRAFT

	Annual Savings (In millions of dollars)					Cumulative Five-Year Savings
	1991	1992	1993	1994	1995	
Savings from CBO Baseline						
Budget Authority	700	800	900	700	900	4,000
Outlays	40	230	520	680	740	2,210
Savings from Administration's Request						
Budget Authority	600	n.a.	n.a.	n.a.	n.a.	n.a.
Outlays	30	n.a.	n.a.	n.a.	n.a.	n.a.

NOTE: The 1991 Department of Defense budget request does not provide sufficient detail to compute annual savings beyond 1991 for this alternative.

The F-16 is the second of the two aircraft being procured by the Air Force for its tactical air forces (the other plane, the F-15, is scheduled to end production after 1991). The F-16 was developed in the late 1970s when the Air Force determined that the F-15 was too expensive to procure in large quantities. F-16s are about half the cost of F-15s but are smaller and somewhat less capable. The Air Force has already bought about 2,000 F-16s and plans to buy 750 more over the next five years at an annual rate of 150. This alternative would reduce F-16 procurement to 72 per year, saving \$600 million in 1991 relative to the Administration's plan. Relative to the CBO baseline, savings would be \$700 million in 1991 and total \$4 billion over the next five years.

Slowing procurement of the F-16s should bring future inventories of Air Force fighters more in line with the requirements associated with an anticipated smaller force. Previous procurement rates supported earlier Air Force plans to increase its force to 40 wings, but the Air Force now operates 36 tactical fighter wings in the active and reserve forces. The alternative also could bring Air Force aircraft procurement more in line with lower requirements for forces that might result from successful negotiations on conventional arms in Europe and from the changing political climate both in the Soviet Union and

in Eastern Europe. The option would keep the F-16 production line open, thus allowing flexibility to increase production rates in the future if the political situation should change significantly.

Slowing the rate of procurement, however, would effectively slow the modernization of the tactical air forces. Combined with planned reductions in the number of wings and cancellation of the F-15 in 1991, this slowdown could prevent the Air Force from keeping pace if there were enhancements in Soviet tactical air capabilities. Also, the slower rate envisioned in this option would presumably make procurement less efficient and lead to a higher unit cost for the F-16. Some of the savings shown above could be offset by penalties associated with buying fewer planes than the quantities specified in the F-16 multiyear procurement contract.

**DEF-07 SLOW PROCUREMENT OF DDG-51
GUIDED-MISSILE DESTROYERS**

	Annual Savings (In millions of dollars)					Cumulative Five-Year Savings
	1991	1992	1993	1994	1995	
Savings from CBO Baseline						
Budget Authority	800	1,500	1,500	700	800	5,300
Outlays	30	200	500	750	840	2,320
Savings from Administration's Request						
Budget Authority	800	n.a.	n.a.	n.a.	n.a.	n.a.
Outlays	30	n.a.	n.a.	n.a.	n.a.	n.a.

NOTE: The 1991 Department of Defense budget request does not provide sufficient detail to compute annual savings beyond 1991 for this alternative.

The DDG-51 destroyers of the Arleigh Burke class would be used in a war to protect aircraft carrier battle groups and to attack land- and sea-based targets. The DDG-51s will incorporate the AEGIS combat system and other improvements in speed, weapons, and armor. The Navy states that the DDG-51s also will be more difficult for enemy forces to detect because of design features that reduce their radar, sonar, and infrared signatures. To date, the Congress has funded 13 of the DDG-51s. The Administration has requested an additional five ships in 1991. This option would limit the Navy to three DDG-51s per year and a total of 15 over the next five years. Savings would be \$800 million from the Administration's request in 1991. Relative to the CBO baseline, the option saves \$800 million in 1991 and a total of \$5.3 billion over the next five years.

Reducing DDG-51 procurement would cause problems. The Navy would have to revise its planning for the surface fleet. The Navy's 1988 Surface Combatant Force Requirements Study (SCFRS) determined that the Navy requires 120 surface ships capable of protecting aircraft carrier battle groups. The study asserted that stable procurement of ships with like designs would save money, as would main-

taining a fleet composed of nearly identical vessels. The study concluded that all new carrier escorts should be DDG-51s or improved ships based on the DDG-51's design, and that five to six DDG-51s per year would be required to reach and sustain the Navy's force goals. The SCFRS also called for using older carrier escorts for less demanding missions such as protecting convoys, and extending ships' service lives rather than buying new vessels to carry out these missions. Maintaining DDG-51 production at three per year would probably preclude the Navy from carrying out the study's recommendations.

Reducing the number of destroyers procured through 1995 would also exacerbate the shortfall of aircraft carrier escorts already anticipated for the 1990s. According to CBO estimates, by 1999, the year in which destroyers procured in 1995 would be delivered to the fleet, the Navy would have only 96 carrier escorts, far less than its goal of 120.

Older, less capable ships could, however, be kept in service to compensate at least partially for reduced purchases of DDG-51 destroyers. And a slower rate of procurement would not necessarily result in a loss of competition or of the savings generally associated with stable production or competition. With three ships authorized per year, DDG-51 procurement would mirror the recently completed purchase of CG-47 AEGIS cruisers. In the CG-47 program, the Navy purchased three ships a year for six years, using two shipyards, and claimed to have achieved substantial savings through competition. It seems reasonable to expect similar results from a similarly structured DDG-51 program.

**DEF-08 REDUCE PROCUREMENT OF SSN-21
SEAWOLF SUBMARINES**

Savings from Admin. Request	Annual Savings (In millions of dollars)					Cumulative Five-Year Savings
	1991	1992	1993	1994	1995	
Budget Authority	1,900	n.a.	n.a.	n.a.	n.a.	n.a.
Outlays	80	n.a.	n.a.	n.a.	n.a.	n.a.

NOTE: The 1991 Department of Defense budget request does not provide sufficient detail to compute annual savings beyond 1991 for this alternative.

The SSN-21 Seawolf is the Navy's new class of nuclear-powered attack submarines. The first SSN-21 was authorized by the Congress in 1989 and is scheduled to enter the fleet in 1995. Its wartime mission is to attack enemy submarines and surface ships as well as targets on land. According to the Navy, the SSN-21's improved sensors, quieter performance, faster speed, deeper operating depth, and larger weapons load will make it three times more capable than the previous attack submarine.

The Administration plans to buy two SSN-21s in 1991. This option would buy one SSN-21 in 1991 and two per year from 1992 through 1995. Savings under this alternative would be \$1.9 billion from the Administration's request in 1991. Relative to the CBO baseline, there would be no savings under this option.

Reducing procurement of SSN-21s would slow the introduction of new, highly capable submarines that might be needed to counter recent improvements in Soviet submarines. Indeed, by some estimates, current U.S. attack submarines will find detecting new Soviet submarines increasingly difficult because of advances the Soviet Union has made in hull and propeller design and quieting techniques. In addition, this option would leave the Navy further from its goal of having 100 attack submarines. Under the Administration's plan, CBO projects that the Navy would deploy 95 submarines in 2000, the first year in which all of the submarines authorized from 1991 through 1995

will be in service. Under this option, the Navy would deploy 90 submarines.

Limiting procurement of SSN-21s would, however, help address concerns raised by some Members of the Congress that the Navy will be building too many SSN-21s before the first one has undergone adequate operational testing. Although numerous individual subsystems will have been tested beforehand, operational tests of the entire submarine and its new combat system are not scheduled to begin until 1995. The test results could lead to changes in the SSN-21's design, and reducing procurement could limit the number of submarines that might require expensive modifications.

DEF-09 REDUCE THE GOAL FOR AMPHIBIOUS LIFT

	Annual Savings (In millions of dollars)					Cumulative Five-Year Savings
	1991	1992	1993	1994	1995	
Savings from CBO Baseline						
Budget Authority	1,200	300	1,300	600	1,600	5,000
Outlays	50	220	380	490	700	1,840
Savings from Administration's Request						
Budget Authority	1,200	n.a.	n.a.	n.a.	n.a.	n.a.
Outlays	50	n.a.	n.a.	n.a.	n.a.	n.a.

NOTE: The 1991 Department of Defense budget request does not provide sufficient detail to compute annual savings beyond 1991 for this alternative.

The Navy currently operates 64 amphibious warfare ships. These vessels were designed to transport and support Marine Corps troops and equipment. The Navy's goal is to have enough capacity in the amphibious fleet to transport simultaneously the assault echelons of one Marine Expeditionary Force (MEF) and one Marine Expeditionary Brigade (MEB)--about 50,000 troops and associated vehicles, cargo, aircraft, and landing craft. (Landing craft are vessels that ferry equipment from ship to shore.) That goal represents roughly a one-third increase over today's capability.

According to the Administration's most recent shipbuilding plan, in the 1991-1995 period the Navy planned to buy three LHD-1 Wasp class amphibious assault ships and five LSD-41(CV) cargo variants of the Whidbey Island class dock landing ships. The Wasp class ships are large helicopter carriers that can also transport about 1,900 troops, substantial vehicle and cargo loads, and three LCACs (landing craft, air cushion). The Whidbey Island class ships are smaller than the Wasp class vessels and transport about 450 troops, vehicles, cargo, and two LCACs. The Navy also planned to buy 48 LCACs during this period.

This option would reduce the Navy's current goal for amphibious shipping to roughly today's capability. Today the Navy can transport one MEB from each coast, plus a modest additional force. This option would provide shipping for one MEB on each coast, plus an additional 15 percent on each coast to allow for ships that might be undergoing overhauls or are otherwise unavailable. While leading to a much smaller amphibious fleet than the Administration would prefer, this option would provide a fleet large enough to carry out an amphibious operation equivalent to any conducted since World War II, including the landing at Inchon, South Korea, in 1950.

This reduced goal could be met without procuring any new amphibious warfare ships from 1991 through 1995. Canceling the amphibious ships in the Administration's plan would save \$1.2 billion in 1991 relative to the Administration's request. Relative to the CBO baseline, this alternative would save \$1.2 billion in 1991 and a total of \$5.0 billion over the next five years. Procurement of LCACs could be reduced because the smaller fleet would require fewer landing craft. Savings associated with canceling 19 LCACs are about \$500 million and are included in this option.

A key disadvantage of this option is that it would curtail the procurement of newer amphibious ships that can support amphibious assaults launched from over the horizon--about 25 to 50 miles from shore. According to the Navy and the Marine Corps, assaults launched from this distance help protect amphibious ships from enemy fire and help exploit the element of surprise. Many older amphibious ships cannot support over-the-horizon operations because they lack the capabilities on which such operations depend, including well-decks that can accommodate LCACs. This option also would preclude the United States from launching on short notice a very large amphibious assault of the sort carried out in World War II.

**DEF-10 RESTRUCTURE THE ARMY'S FORWARD
 AREA AIR DEFENSE PROGRAM**

	Annual Savings (In millions of dollars)					Cumulative Five-Year Savings
	1991	1992	1993	1994	1995	
Savings from CBO Baseline						
Budget Authority	360	370	390	400	420	1,940
Outlays	60	180	320	370	390	1,320
Savings from Administration's Request						
Budget Authority	270	n.a.	n.a.	n.a.	n.a.	n.a.
Outlays	10	n.a.	n.a.	n.a.	n.a.	n.a.

NOTE: The 1991 Department of Defense budget request does not provide sufficient detail to compute annual savings beyond 1991 for this alternative.

Following the cancellation of the Sergeant York Division Air Defense Gun (DIVAD) in August 1985, the Army initiated a program to improve its ability to defend troops positioned well forward in the battle area against enemy aircraft, particularly helicopters. This Forward Area Air Defense (FAAD) program contains five elements designed to (1) improve communications among air defense weapons and sensors; (2) purchase a new weapon to perform the mission of the canceled DIVAD; (3) develop and procure a system, commonly known as the pedestal-mounted Stinger, to provide air defense for the rear of the battle area; (4) develop and procure a system to attack enemy helicopters hiding behind hills, trees, or buildings (a non-line-of-sight system); and (5) improve the air defense capability of the Army's existing helicopters, tanks, and fighting vehicles. Reports indicate that the total cost of this five-part program could be as much as \$11 billion.

This alternative would restructure the FAAD program, shifting the emphasis from sophisticated and expensive dedicated (that is, devoted to a single purpose) air defense weapons to programs for upgrading Army tanks, fighting vehicles, and helicopters so that they will be able to protect troops from enemy aircraft. Since the principal threat

to the Army's forward area comes from helicopters, the program would provide all Army weapons with some ability to destroy enemy helicopters. For example, each fighting vehicle would be equipped with missiles for use against either tanks or helicopters, Army helicopters would carry missiles for destroying enemy helicopters, and Army tanks would carry ammunition with enhanced capability against hovering helicopters.

With each Army tank and fighting vehicle capable of defending troops against enemy helicopters, dedicated air defense weapons would be needed primarily to counter fixed-wing aircraft. The Stinger missile system, currently used by the Army, is designed to destroy fighter-bomber aircraft. A vehicle-mounted version of Stinger, which is being bought as part of the FAAD program, could replace the older Chaparral system currently in the field.

Savings under this alternative would be about \$270 million in budget authority in 1991 relative to the Administration's plan. Relative to the CBO baseline, savings would be \$360 million in 1991 and total \$1.9 billion over the next five years. Savings reflect termination of the Air Defense Antitank System (ADATS) program, selected by the Army as the follow-on to the DIVAD program, offset by the costs of developing a missile to provide the Army's fighting vehicles with an air defense capability.

Restructuring the FAAD program might provide better defense from enemy helicopters than the Army's plan. The ability to destroy helicopters is, in part, a function of the total number of weapons that can intercept helicopters at a specific range. By this measure, this option could eventually provide twice as much capability as the Army's plan. Such a restructuring of the FAAD program, however, would require infantry and tank commanders to assume greater responsibility for air defense, a situation that could adversely affect their ability to perform their primary mission of destroying tanks.

DEF-11 DELAY NEW PROGRAM STARTS ONE YEAR

Savings from Admin. Request	Annual Savings (In millions of dollars)					Cumulative Five-Year Savings
	1991	1992	1993	1994	1995	
Budget Authority	540	n.a.	n.a.	n.a.	n.a.	n.a.
Outlays	240	n.a.	n.a.	n.a.	n.a.	n.a.

NOTE: The 1991 Department of Defense budget request does not provide sufficient detail to compute annual savings beyond 1991 for this alternative.

Since 1985, the combination of reduced funding for defense procurement, the initiation of many new major weapons systems, and the failure to cancel ineffective or low-priority programs has contributed to delays and higher costs for existing weapons programs. Delaying by one year the start of new research and development (R&D) programs, along with a one-year delay in the production of programs scheduled for initial production in 1991, could yield near-term savings and improve overall affordability for existing weapons systems. It would also give the Administration more time to reevaluate the requirement for these weapons in light of the changing political environment in the Soviet Union and Eastern Europe.

This option identifies new R&D and production programs planned by the Department of Defense for 1991. The Congress could choose to defer development or production of these new programs for a year to preserve the planned development and production rates of existing systems. Deferring all these new program starts might save as much as \$540 million in budget authority in 1991.

Production. Funding for defense procurement programs has decreased in real terms each year since 1985. Moreover, DoD asserts that the request for procurement funding in 1991 is approximately 6.6 percent below the 1990 appropriated level in real terms.

Despite these recent real reductions, DoD has begun production of 33 major new weapons systems since 1985. Because few major wea-

pons programs have been canceled during this period, budgetary reductions and funding for new programs have been accommodated by slowing--or stretching out--procurement of existing systems. The costs of such stretch-outs have been significant. For example, reduced procurement of the F-15 from levels planned for 1983 through 1988 increased the unit cost of the aircraft by 31.5 percent.

The Administration's budget for 1991 contains a request for nearly \$115 million in procurement funding for four new production programs. Delaying initial production and providing no real increases in research funding for these programs would save about \$125 million in 1991.

Research and Development. From 1985 through 1990, the real rate of growth of R&D slowed dramatically. Research and development budget authority experienced no average annual real growth during that period compared with annual average real growth of nearly 13 percent from 1981 through 1985. Using the Administration's economic assumptions, R&D funds requested by DoD for 1991 are nearly 1 percent lower in real terms than the R&D appropriations for 1990.

Despite slower growth and reductions in recent R&D funding, many new major R&D programs have been initiated since 1985. The Administration's budget request for 1991 contains 11 new R&D programs. Delaying their start by one year could save about \$415 million in 1991. Although the possible near-term savings from postponing these programs are modest, a delay could help make existing research programs more affordable. Moreover, since many programs that have been started since 1980 are now approaching the point where production should begin, a delay of new R&D programs could help to moderate future demands for scarce production funding.

Delaying new R&D and production programs might in turn delay the fielding of improvements in military capability. This effect, however, could be somewhat offset by minimizing stretch-outs of existing research and production programs. At the same time, a delay might provide an opportunity to resolve technical problems and reduce production risks for the new programs planned for 1991.

**DEF-12 LIMIT FUNDING FOR SUPPORTING
PROCUREMENT**

	Annual Savings (In millions of dollars)					Cumulative Five-Year Savings
	1991	1992	1993	1994	1995	
Savings from CBO Baseline						
Budget Authority	3,670	4,560	5,460	6,400	7,390	27,480
Outlays	670	1,640	3,290	4,620	5,740	15,960
Savings from Administration's Request						
Budget Authority	960	1,230	1,450	1,660	1,870	7,170
Outlays	310	630	990	1,270	1,520	4,720

While most debate on the defense budget centers on the major procurement programs for aircraft, missiles, combat vehicles, and ships, about one-fourth of the defense procurement budget buys other types of equipment such as trucks, communications equipment, and computers. Funds for that equipment are requested in the "Other Procurement" and "Procurement, Defense Agencies" accounts--collectively referred to here as supporting procurement.

The 1991 defense budget request includes \$19.1 billion for supporting procurement, a decrease of 9 percent from the 1990 appropriation. This option would set the 1991 appropriation for supporting procurement at \$18.1 billion, 5 percent below the request, and would maintain this level of funding through 1995. Savings in budget authority relative to the Administration's request would be \$960 million in 1991 and would total more than \$7.1 billion through 1995. Savings relative to the CBO baseline would be greater--nearly \$3.7 billion in 1991 and \$27.5 billion over the five-year period.

A reduction of this magnitude, in addition to those made by the Administration in earlier budget plans, would undoubtedly limit U.S. military capabilities. Many of the items purchased with these funds--including such items as communications gear, trucks, medical supplies and equipment, and materials-handling equipment--are essential to

supporting military operations. Other items, such as training devices and office computers, promote efficient peacetime operations of the military.

Deferring certain of these purchases, however, is always possible. If the Congress imposed limits through general reductions rather than by cutting particular line items, the military departments and defense agencies could apportion the reductions so as to minimize their impact.

**DEF-13 REDUCE SPENDING FOR THE
STRATEGIC DEFENSE INITIATIVE**

	Annual Savings (In millions of dollars)					Cumulative Five-Year Savings
	1991	1992	1993	1994	1995	
Savings from CBO Baseline						
Budget Authority	980	730	610	290	120	2,730
Outlays	500	740	670	460	240	2,610
Savings from Administration's Request						
Budget Authority	1,700	n.a.	n.a.	n.a.	n.a.	n.a.
Outlays	860	n.a.	n.a.	n.a.	n.a.	n.a.

NOTE: The 1991 Department of Defense budget request does not provide sufficient detail to compute annual savings beyond 1991 for this alternative.

Since 1984, the Department of Defense has invested about \$19 billion to study a wide variety of technologies--including space-based lasers, particle-beam weapons, and antiballistic missiles--that might help defend this country against attack by ballistic missiles armed with nuclear warheads. Annual funding for this Strategic Defense Initiative (SDI) increased at an average real rate of about 45 percent between 1984 and 1987. But in 1988 it grew only slightly, and for 1989 and 1990 the Congress reduced SDI funding in real terms.

The Bush Administration's commitment to SDI, while apparently not as strong as the previous Administration's, is substantial. It apparently still plans to deploy a system of ballistic missile defenses as soon as technology permits, perhaps by the late 1990s. But most of the fundamental issues in the SDI debate--whether defenses would work, whether they would increase or reduce the likelihood of a crisis developing into nuclear war, and whether they would be worth the large costs--remain unresolved.

This option would forgo the goal of deploying strategic defenses in the near term but would maintain a research program as a hedge

against the Soviet Union's achieving a technological breakthrough and deploying defenses of its own. Maintaining such a research program would require spending about \$2.8 billion in 1991, a decrease of about \$0.8 billion from the 1990 approved level. Funding through 1995 would grow slightly in real terms but would remain below \$3.5 billion (in 1991 dollars) at the end of that period. Compared with the Administration's plan, savings under this alternative would amount to \$1.7 billion in 1991; relative to the CBO baseline, they would be nearly \$1.0 billion in 1991 and would total \$2.7 billion over the next five years.

This reduced level of funding for strategic defenses would be greater than the real level before the Anti-Ballistic Missile (ABM) Treaty was signed in 1972, and over twice as much as the average amount spent annually between 1974 and 1984. It would allow the continuation of a large-scale research and development program, including the development of countermeasures against future Soviet defensive systems. It also would permit full-scale development of some components of an ABM system, such as a ground-based radar and interceptor. Although this hedge-level funding would not permit the production and deployment of any system of defenses, forgoing deployment would offer advantages. The United States could continue to abide by the ABM Treaty, which prohibits the Soviet Union from deploying a large system of defenses. If the Soviet Union does not deploy a system of its own, there should be no race to develop a better defensive system or to develop offensive weapons capable of overwhelming a potential adversary's defenses. Such an offense/defense arms race could prove dangerous and costly.

Recent developments may have made hedge-level funding even more attractive. The Soviet Union has recently allowed U.S. observers to visit its research centers that are working on strategic defenses. Soviet leaders have also admitted that their Krasnoyarsk radar violates the ABM Treaty and have said the radar will be dismantled. As a consequence, recent fears that Moscow is preparing to deploy large-scale strategic defenses may no longer be as serious or troublesome. Recent events may also make a vigorous SDI program less necessary as a bargaining chip for future arms talks. The Strategic Arms Reduction Talks (START) aimed at limiting strategic offensive warheads appear to be progressing well even though the United States has made real reductions in SDI funding in recent years. Indeed, the

Soviet Union has maintained that deployment of strategic defenses could undermine the START process.

Proceeding with a large system of strategic defenses, however, could yield appreciable long-term benefits. Even if the system was not totally effective, having strategic defenses might further deter another country from attacking the United States. A limited system might provide the capability to shoot down a small number of missiles--whether launched accidentally, or launched by a third party with only a fledgling nuclear arsenal. Moreover, if both superpowers deployed effective defenses, the basis for deterring a major nuclear attack might shift from the threat of retaliation--which could destroy humanity--to the promise of effective defense. Such a shift would be reassuring, but this option would slow progress toward that goal.

**DEF-14 CANCEL THE NATIONAL
AEROSPACE PLANE**

	Annual Savings (In millions of dollars)					Cumulative Five-Year Savings
	1991	1992	1993	1994	1995	
Savings from CBO Baseline						
Budget Authority	260	270	280	300	310	1,420
Outlays	130	230	260	280	300	1,200
Savings from Administration's Request						
Budget Authority	280	n.a.	n.a.	n.a.	n.a.	n.a.
Outlays	150	n.a.	n.a.	n.a.	n.a.	n.a.

NOTE: The 1991 Department of Defense budget request does not provide sufficient detail to compute annual savings beyond 1991 for this alternative.

In January 1986, the Department of Defense initiated a joint effort with the National Aeronautics and Space Administration (NASA) to design and build a National Aerospace Plane (NASP) that can deliver civilian and military payloads into orbit from conventional runways. The NASP, or X-30 aircraft, is envisioned as an experimental hypersonic aerospace aircraft that will employ highly advanced propulsion, structures, and materials technologies.

In 1987, DoD estimated that, by 1994, it would cost \$3.1 billion to develop, build, and flight-test two experimental vehicles. Since then, however, the program has been fraught with problems, including budget reductions, changes in management structure, and major adjustments in scope and schedule. Costs have also increased. The Administration estimates that the current program will cost more than \$5 billion. The first flight is now planned for mid-1997.

In April 1989, the Administration proposed transferring program management responsibilities from DoD to NASA along with \$100 million in 1990 funding. NASA officials, however, believed that the agency would be unable to support the program fully within its pro-

jected budget. The National Space Council then reviewed the NASP program and recommended retaining the current management structure but delaying the decision to build the NASP from September 1990 to early 1993. The Administration approved the council's recommendations and increased its budget request for 1990 from \$227 million to \$254 million to be funded equally between DoD and NASA. The Congress appropriated the requested amount for 1990 but increased DoD's share to \$194 million and reduced NASA's portion to \$60 million.

This alternative would cancel further funding for the NASP. Estimated savings from the CBO baseline would be \$260 million in 1991 and total \$1.4 billion over the next five years. Relative to the Administration's plan, this option would save \$280 million in 1991.

The NASP is intended to be the technological base for the nation's long-range plan for space transport for both civilian and military missions. According to current plans, the NASP will be capable of horizontal takeoffs and landings using conventional airfields. Using advanced technology, the X-30's engines--called "scramjets"--will enable it to cruise at high speed (4,000 to 6,000 miles per hour) in the earth's atmosphere, or to approach speeds that will allow it to orbit the earth. The plane's speed and ability to operate both in space and in the earth's atmosphere may be the most important capabilities for various military missions. Although the Air Force has not approved a military requirement for the NASP, its missions might include delivering payloads into space, attacking enemy targets with nuclear weapons, intercepting high-value targets such as enemy strategic aircraft, and space control and reconnaissance.

DoD could still accomplish these missions even without the NASP. For example, payloads are now delivered into space by lift programs that include the space shuttle and Titan IV rockets. In addition, plans exist for an advanced launch system to provide a more timely lift capability. Strategic attack missions can be accomplished by existing programs such as the MX ICBM, the Trident submarine, and the B-1 bomber. For enhanced attack capabilities, DOD plans to use the B-2 bomber, the Midgetman missile, and the Trident D-5 missile. The Strategic Defense Initiative (SDI) is planned to meet the need for intercepting strategic attack vehicles and would provide some space con-

trol. Intelligence satellites and planes currently provide reconnaissance capability and would continue to do so.

The NASP, however, could enhance the performance of some missions. The aircraft's hypersonic capability, combined with its ability to operate from a conventional airfield, promises quicker execution of various military missions. Unlike other delivery vehicles such as rockets, the NASP could be recalled or reassigned during a military operation. The NASP also could provide important spinoff benefits to other programs as a result of advanced technology research in the areas of propulsion, materials, and aeronautics.

DEF-15 LIMIT PAYMENTS FOR INDEPENDENT R&D

	Annual Savings (In millions of dollars)					Cumulative Five-Year Savings
	1991	1992	1993	1994	1995	
Savings from CBO Baseline						
Budget Authority	3,130	3,250	3,380	3,520	3,660	16,940
Outlays	1,630	2,810	3,180	3,360	3,530	14,510
Savings from Administration's Request						
Budget Authority	3,090	n.a.	n.a.	n.a.	n.a.	n.a.
Outlays	1,610	n.a.	n.a.	n.a.	n.a.	n.a.

NOTE: The 1991 Department of Defense budget request does not provide sufficient detail to compute annual savings beyond 1991 for this alternative.

One of the categories of Department of Defense funding for research and development is known as independent research and development (IR&D). These funds enable contractors to undertake R&D on projects of their own choosing, and DoD reimburses their cost to the extent that it considers the research to be of military relevance. DoD subsidies for IR&D currently total about \$4.1 billion, of which \$1.7 billion is for bid and proposal costs. Expressed as a share of total DoD spending on procurement and R&D, the IR&D program has grown about 36 percent since 1983. This option illustrates the effects of canceling the \$4.1 billion program, on the grounds that its value is uncertain and its costs are substantial, and instead providing direct subsidies for defense basic research. Savings would amount to \$3.1 billion in 1991 relative to the Administration's request. Relative to the CBO baseline, savings would be \$3.1 billion in 1991 and total \$16.9 billion through 1995.

The empirical literature on IR&D presents mixed views of how much additional research is undertaken (besides what contractors would have done on their own), whether DoD could have obtained the same research at lower cost, and whether the subsidies are being spent on projects of the highest priority to DoD.

How much additional research does IR&D create? A Congressionally mandated study by the RAND Corporation concluded that IR&D subsidized less than 25 percent of contractors' costs and that each dollar spent on IR&D increased total R&D spending by contractors by \$2.20. These results suggest that DoD spending on IR&D is an efficient way to generate defense-related research. But two other studies found that the average subsidy was much larger--up to 80 percent--and that the subsidy caused a negligible increase in total R&D spending by contractors. Moreover, critics argue that at least some IR&D spending is unnecessary, because contractors would undertake these projects even without subsidy.

As to whether the funds are spent on projects of importance to DoD, the evidence also is mixed. Advocates of the program contend that it provides a hedge against the narrow decisions of agency research managers by letting private contractors develop their own research ideas. Case studies of the transfer of technology support the use of IR&D to give contractors an incentive to pursue R&D.

The bulk of IR&D spending appears to be allocated to development rather than basic research that might arguably be of greater long-run benefit to DoD, although of less value to contractors. And the amount of subsidy received by any individual contractor depends more on that company's total contract volume with DoD than on the merits of the contractor's research program.

The need for a program of subsidies such as IR&D, however, could be affected by future reductions in defense procurement. If contractors' income from sales to DoD is reduced and the volume of new orders falls off, the ability and willingness of private firms to undertake R&D on their own could be diminished. In that case, more of the burden of financing R&D would fall directly on the department than has occurred in the past.

This option takes a moderate position with regard to the effectiveness of the IR&D program. It assumes that each dollar of IR&D subsidy increases R&D spending by 30 cents--less than the \$2.20 found in the RAND report but more than the negligible amounts estimated by two other analyses. And it accepts that at least some of the specific research subsidized by IR&D has military relevance, so that can-

cellation of the program should be accompanied by an alternative provision for supporting the same type of research.

The assumption that each dollar of IR&D subsidies expands total R&D spending by 30 cents implies that cancellation would reduce total spending on DoD research and development by about \$1 billion. To offset this consequence, the option provides for a substitute program of \$1 billion in direct R&D grants that DoD would use primarily for basic research. The overall volume of DoD's R&D efforts would thus be unchanged, but the focus of that R&D would be shifted away from development projects selected by contractors and toward basic research selected by DoD.

**DEF-16 REDUCE FUNDING FOR
OPERATION AND MAINTENANCE**

	Annual Savings (In millions of dollars)					Cumulative Five-Year Savings
	1991	1992	1993	1994	1995	
Savings from CBO Baseline						
Budget Authority	4,260	8,140	12,140	16,320	20,690	61,550
Outlays	3,300	7,060	10,960	15,070	19,340	55,730
Savings from Administration's Request						
Budget Authority	3,330	4,960	6,410	7,620	8,840	31,160
Outlays	2,580	4,430	5,930	7,210	8,430	28,580

About 29 percent of the 1990 defense appropriations supports the operation and maintenance (O&M) of existing plant and equipment. Part of this account pays for civilian workers. The rest of the account purchases goods and services for maintenance of existing equipment, training, fuel and spare parts, base operations, and many other things. Spending for these activities is commonly referred to as spending for military readiness since some of it contributes directly to the day-to-day capability of the military forces.

The Administration's plan for 1991 calls for an increase of 3.8 percent in O&M spending, slightly below inflation. This funding should allow the military forces to operate at about the same level or higher than they did in 1990 if 38,000 people are eliminated from the military by the end of 1991, as the Administration now indicates. Even this funding level, however, may be more than is necessary to maintain a ready force.

This alternative would maintain O&M funding in each of the next five years at the 1990 funded level. Savings would amount to \$3.3 billion in 1991 and total \$31.2 billion through 1995 relative to the Administration's plan. Relative to the CBO baseline, savings would be \$4.3 billion in 1991 and total \$61.6 billion through 1995.

Increases in O&M spending, even for inflation, may not be necessary if the operating tempo of some forces is reduced. Congressman Aspin, Chairman of the House Committee on Armed Services, has suggested that, in response to an easing of the threat in Europe, forward-deployed U.S. troops might be able to relax the intensity of their operations and training. The number and duration of overseas naval deployments might be reduced also. These actions would not affect forces whose primary mission is to protect U.S. interests in areas other than Europe, but they would offer savings relative to today's real level of spending.

However, failure to increase O&M funds over the next five years might eventually lead to an unacceptably low level of readiness if forces are not reduced substantially. Sophisticated weapons, which may be very expensive to maintain, will continue to enter the military inventory, and the consequences of lower readiness could be serious. Forces that do not have enough funds to train and prepare for war generally suffer low morale and become ineffective. Should the political situation in Eastern Europe and the Soviet Union change for the worse, the United States may wish to have ready, effective forces forward deployed.

DEF-17 REDUCE FUNDING FOR SCHOOL TRAINING

Savings from Admin. Request and CBO Baseline	Annual Savings (In millions of dollars)					Cumulative Five-Year Savings
	1991	1992	1993	1994	1995	
Budget Authority	360	370	390	410	420	1,950
Outlays	280	350	380	400	410	1,820

During the 1980s, the quality and retention of military personnel rose to all-time highs and remain near those high levels today. Generally, these high-quality recruits (those who both hold a high school diploma and score well on the recruit entrance examination) can be trained more quickly and cheaply. Yet, between 1982 and 1988, funding for school training of military personnel grew faster than the rate of inflation while student man-years decreased slightly, resulting in a real per capita increase of more than 30 percent. In 1990, the Department of Defense will spend roughly \$3 billion on school training for its forces.

Per capita costs have increased because student loads--that is, the man-years of students who are in training--have decreased slightly and because DoD has not completed all of the training it projected in its budget but has still spent its budgeted request. This experience is most pronounced in the Army. Between 1982 and 1988, DoD used only 94 percent of the total loads they requested, and the Army used only 85 percent.

An alternative to the current program would be to reduce funding for school training to reflect lower per capita training costs and actual student loads. Per capita costs of training for 1991 would be rolled back to 1982 levels plus annual increases of 2 percent above inflation. This limit would yield savings of \$240 million in 1991. Savings for 1992 through 1995 are based on no real growth, in accordance with the CBO baseline. Though illustrative, 2 percent real growth provides flexibility to allow for increased training needs to accommodate the recent influx of new, more complex weapons. This alternative would recognize the potential for lower training costs resulting from a better qualified force with less turnover. At the same time, it would reduce

requested student loads by 4 percent to reflect actual experience, providing additional savings of \$120 million in 1991. Total savings in 1991 would be \$360 million, with five-year savings of \$1.9 billion.

The Department of Defense could argue, however, that all of the increases in per capita training costs reflect the complexity of modern weapons systems, and that this option would therefore jeopardize adequate training. That risk may be of particular concern if arms control treaties and political changes lead to a substantially smaller active-duty military. In that case, having a well-trained military, almost regardless of the cost, might be even more important than it is today.

**DEF-18 REDUCE THE DoD CIVILIAN
ACQUISITION WORK FORCE**

	Annual Savings (In millions of dollars)					Cumulative Five-Year Savings
	1991	1992	1993	1994	1995	
Savings from CBO Baseline						
Budget Authority	170	540	930	1,350	1,810	4,800
Outlays	170	520	920	1,340	1,790	4,740
Savings from Administration's Request						
Budget Authority	50	240	530	840	1,170	2,830
Outlays	50	230	520	830	1,160	2,790

In 1986, the President's Blue Ribbon Commission on Defense Management (the Packard Commission) examined ways to improve the Department of Defense's acquisition process. The commission concluded that having too many acquisition personnel--burdened by too many laws, regulations, and layers of review--resulted in a cumbersome and inefficient process. The commission recommended that defense acquisition policy and oversight be consolidated, reporting chains be reduced, and duplicative functions and excessive regulations be eliminated. These measures, the commission stated, could substantially reduce the number of defense acquisition personnel.

Primary responsibility for managing a major weapons acquisition program rests with particular commands within the military departments--for example, the Naval Sea Systems Command, the Air Force Systems Command, and the Army Materiel Command. If a major reduction in force is possible, it will occur in these commands. About 552,000 civilian employees work for these buying commands, although not all are involved directly in the acquisition process. About 30,000 military personnel are assigned to these commands as well. Thus, civilians account for 95 percent of the acquisition work force.

The President, in his February 1989 address to the Congress, charged the Secretary of Defense with undertaking a review of defense

management practices. The Secretary has recently announced the findings and recommendations of his Defense Management Review. Carrying out these recommendations is expected to reduce the civilian DoD acquisition work force by 18,000 workers by 1995--a reduction of 3 percent.

Previous experience in consolidating functional components within DoD would indicate that reductions in personnel could be achieved. Bringing logistics support functions of the various services into the Defense Logistics Agency in 1961, for example, reduced personnel by 13 percent.

Decreasing the number of DoD acquisition programs would be one way to reduce the number of personnel, but CBO has not performed a detailed analysis of personnel savings that could result from streamlining the acquisition process. Instead, CBO assumed for illustration that a 10 percent reduction in the civilian acquisition work force could be achieved through reform measures like those recommended by the Packard Commission. Eliminating around 11,000 positions in each of the next five years would result in savings from the CBO baseline of \$170 million in 1991 and \$4.8 billion over the 1991-1995 period. Savings from the Administration's plan would be lower: \$50 million in 1991 and about \$2.8 billion through 1995.

Reducing the acquisition work force at a pace about three times faster than that in the Administration's plan would entail some risks. In the short run, the acquisition workload will not greatly diminish. Furthermore, implementing the recommendations of the Defense Management Review will take time, and many changes will require Congressional approval. By placing the burden of managing DoD's acquisition program in fewer hands, this option may worsen, rather than improve, the procurement process.

Furthermore, an important element of DoD's program is to improve the professionalism of the acquisition work force and create stronger incentives to attract capable managers. A 10 percent reduction in force, however, is unlikely to improve morale among workers and may hinder efforts to attract new talent to acquisition management careers.

**DEF-19 CLOSE OR REALIGN SELECTED
 MILITARY BASES**

Savings from Admin. Request and CBO Baseline	Annual Savings (In millions of dollars)					Cumulative Five-Year Savings
	1991	1992	1993	1994	1995	
Budget Authority	20	-60	-30	-150	440	220
Outlays	60	-50	-40	-20	260	210

The military services currently operate over 900 bases and facilities in the United States and its territories. In 1988, the Secretary of Defense established the Commission on Base Realignment and Closure to make recommendations on how to achieve a more efficient military base structure. Under the 1989 Defense Authorization Amendments and Base Closure and Realignment Act, the Congress authorized the Secretary of Defense to close 86 bases, partially close 5 bases, and realign 54 bases. The commission estimated that these actions will eventually result in average annual savings of \$693.6 million. Some initial cost would also be associated with closing the bases. But over the next 20 years, the present value of net savings should total \$5.6 billion.

The General Accounting Office (GAO) recently reviewed the commission's savings estimates for 15 base closures that represented about 90 percent of the estimated savings. The GAO concluded that the commission's estimates for these bases were overstated by more than 25 percent but that substantial annual savings would still accrue, and that the commission's recommendations were "sound and logical."

In November 1989, the Secretary of Defense indicated that further savings could be gained by closing and realigning additional military bases. A number of bases, for example, met the stringent savings criterion established by the commission but were not recommended for closure for various reasons. (The commission's charter directed that candidates for closure should achieve net savings within six years following completion of the closure or realignment.) At the request of the Congress, the commission identified nine such bases: Fort Dix, Fort Devens, Myrtle Beach Air Force Base, Fort Jackson, Tooele Army

Depot, Savannah Army Depot, Sacramento Army Depot, Fort Hamilton, and Fort DeRussy. Four of these bases were affected by the commission's recommendations. Fort Dix will be retained on a standby status, while Fort Devens, Fort Jackson, and the Tooele Army Depot are scheduled to increase in size as they absorb missions from other bases affected by the realignments.

This option would close the remaining five bases not affected by the commission's recommendations. The Congress could choose to direct that these five bases be closed. The military requirements that led the commission to leave them open may be less critical in view of the reduction in U.S. military forces that is likely within the next few years.

The commission estimated potential annual savings of \$35 million associated with closing these five bases. If the GAO estimates of savings for prior base closures are taken into account, these savings could be lower than the commission's estimates by 25 percent. Annual recurring savings would then be \$26 million.

Initial costs of realignment would be incurred if the units assigned to these five bases were transferred to other bases. These costs could be funded through the Congressionally authorized Base Closure Account, but the initial costs would reduce the present value of net savings. According to the commission's analysis of these five bases, the initial costs of closure and realignment could reach \$330 million from 1991 through 1995. At the same time, one-time savings such as revenue generated by property sales could total \$550 million. As a result, net savings from these closures and realignments would total \$220 million through 1995. In keeping with the commission's practices, these estimates do not include the costs of environmental cleanup or the potential costs to the communities affected by the closures.

Before recommending closure or realignment of specific bases, the Congress could request a detailed review of military requirements of the sort performed by the commission. Such a review could, of course, conclude that some or all of these five bases are still needed. CBO has not conducted such a review. These five bases are included in this option because they meet the savings criterion established by the commission and because they illustrate the potential for cost savings associated with further closures and realignments of military bases.

DEF-20 RETIRE THE NAVY'S FOUR BATTLESHIPS

	Annual Savings (In millions of dollars)					Cumulative Five-Year Savings
	1991	1992	1993	1994	1995	
Savings from CBO Baseline						
Budget Authority	200	400	500	500	500	2,100
Outlays	150	330	370	390	400	1,640
Savings from Administration's Request						
Budget Authority	100	200	250	250	250	1,050
Outlays	75	165	185	195	200	820

In 1982, the Navy initiated a program to reactivate four Iowa class battleships from the World War II era. The total cost of modernizing and reactivating the battleships was \$1.7 billion.

Each 57,000-ton battleship houses nine 16-inch guns--the largest guns in Navy service--and each ship was modified to carry 32 Tomahawk cruise missiles, 16 Harpoon antiship cruise missiles, and new electronic equipment. The most important missions for the battleships are to attack enemy targets on land and ships using the cruise missiles. The Navy plans to use the 16-inch guns to support amphibious landings of Marine Corps troops. In addition, the Navy deploys the battleships in peacetime to demonstrate U.S. interest and resolve.

Peacetime use of battleships is both new and unique. Except for the 20-month reactivation of one battleship during the Vietnam War, the Navy did not operate any battleships between 1958 and 1984, when the first of the reactivated ships put to sea; no foreign navies operate battleships.

The Administration plans to retire two battleships in 1991. This option would retire all four battleships in 1991, saving \$100 million in 1991 relative to the Administration's plan. Relative to the CBO baseline, this option would save \$200 million in 1991 and a total of \$2.1 billion over the next five years. Opponents of the battleships argue

that they require too many people, are expensive to operate and maintain, and that their missions can be performed more economically by other ships. Each battleship, for example, requires more than four times the number of people that serve on a typical modern cruiser or destroyer, and operating costs for a battleship are roughly two and one-half times those of cruisers or destroyers. Furthermore, cruisers and destroyers are more cost-effective carriers of cruise missiles than battleships. Substituting cruisers and destroyers for the battleships would forfeit the limited benefits of the latter's 16-inch guns, but would greatly expand the capacity to carry cruise missiles.

Battleships, however, provide the Navy with unique capabilities, including the 16-inch guns and the most heavily armored hulls in the Navy. The battleships are highly effective for demonstrating U.S. interests through peacetime deployments. They also ease problems of scheduling deployments for aircraft carriers, which frequently perform this same mission but often are in high demand for other missions--including crisis situations that may demand air power.

**DEF-21 TRANSFER THE 401st AIR FORCE TACTICAL
FIGHTER WING TO THE RESERVES**

Savings from Admin. Request and CBO Baseline	Annual Savings (In millions of dollars)					Cumulative Five-Year Savings
	1991	1992	1993	1994	1995	
Budget Authority	120	250	260	260	250	1,140
Outlays	50	160	200	210	220	840

The 401st tactical fighter wing, with 72 F-16 aircraft, is currently based at Torrejon Air Force Base in Spain. In 1988, at the behest of the Spanish government, the United States agreed to remove all of these aircraft from Spain by 1992. Because of concerns about fighter support for the North Atlantic Treaty Organization's (NATO's) southern region, NATO defense ministers offered to assist in relocating the wing at Crotone in southern Italy. But the Congress appropriated none of the \$15 million requested in 1990 for military construction and cut \$77 million out of NATO infrastructure funds, arguing that sufficient funds were available in current and prior unobligated balances.

Rather than move the 401st to Crotone, this option would deactivate the fighter wing and return the planes to the United States. They would be used to increase the number of aircraft in 12 guard and reserve fighter squadrons to 24 planes--the number typically found in active-duty squadrons. (Guard and reserve units train only part-time in peacetime but are available for active duty in the event of war.) Savings under this alternative would be \$120 million in 1991 and total \$1.1 billion over the next five years.

In addition to saving money, this alternative offers several advantages. The Air Force has suggested that increasing the amount of time that personnel associated with fighter units spend overseas is detrimental to retention. Deactivating the wing would avoid increases in the amount of time these people have to spend overseas in relation to time spent in the United States. Furthermore, it would modestly decrease the number of active pilots needed at a time when the active Air Force is having problems retaining pilots. The Air Force Reserve and

Air National Guard apparently are not experiencing problems hiring pilots. Nor would there be any significant loss in capability associated with this option: the reserves perform at a level roughly comparable with that of their active counterparts.

Under this alternative, however, the Air Force would have fewer tactical forces deployed overseas, an issue that could be important while the United States and the Soviet Union are negotiating a conventional forces agreement. Deactivating the wing and placing the aircraft in reserve units in the United States could indicate a willingness on the part of the United States to make unilateral cuts in its Europe-based forces, which might give the Soviet Union less incentive to accept NATO's current treaty proposal. The Soviet Union is concerned about the number of NATO fighters deployed in Europe.

The Administration has also argued that such changes could damage U.S. diplomatic relationships with NATO and especially with Italy. This argument, however, is difficult to accept because it was Spain--a NATO ally--that forced the wing to move. Furthermore, Italy agreed to accept the wing only if NATO or the United States paid all the costs.

**DEF-22 REDUCE THE NUMBER OF ACTIVE-DUTY
MILITARY PERSONNEL**

	Annual Savings (In millions of dollars)					Cumulative Five-Year Savings
	1991	1992	1993	1994	1995	

Reduce Active-Duty Military Personnel by 250,000
Savings from CBO Baseline

Budget Authority	1,610	5,180	9,470	14,540	20,450	51,250
Outlays	1,050	3,550	6,890	11,000	15,880	38,370

Savings from Administration's Request

Budget Authority	100	n.a.	n.a.	n.a.	n.a.	n.a.
Outlays	60	n.a.	n.a.	n.a.	n.a.	n.a.

Reduce Active-Duty Military Personnel by 500,000
Savings from CBO Baseline

Budget Authority	2,480	8,410	16,520	27,040	40,220	94,670
Outlays	1,630	5,780	11,950	20,250	30,860	70,470

Savings from Administration's Request

Budget Authority	880	n.a.	n.a.	n.a.	n.a.	n.a.
Outlays	510	n.a.	n.a.	n.a.	n.a.	n.a.

NOTE: The 1991 Department of Defense budget request does not provide sufficient detail to compute annual savings beyond 1991 for this alternative.

More than 2.1 million people serve in the active-duty U.S. military. Combat forces are distributed among 18 Army divisions, 14 aircraft carrier battle groups, 3 Marine Corps divisions, and 24 Air Force tactical fighter wings. The remaining personnel operate the strategic nuclear forces and mobility forces and support the combat elements listed above.

Since 1980, the number of military personnel on active duty has increased by about 3 percent. This increase occurred exclusively in the Navy and the Air Force; the Army maintained a relatively constant level until 1989, when it decreased. This overall increase in personnel did not correspond directly with an increase in the number of combat forces. The Army added combat divisions without increasing personnel, while the Air Force basically maintained its combat forces but slightly increased its personnel level. The Navy, however, added 89 deployable battle force ships (an increase of about 19 percent) and increased its military personnel about 12 percent.

Justification for these increases was based on the Reagan Administration's assessment of the threat posed by the Soviet Union and the Warsaw Pact. Between 1980 and 1985, fear of that threat fueled the country's biggest peacetime military buildup since World War II. But the world has changed since 1985. Because of political changes in the Soviet Union and Eastern Europe, these countries may no longer pose such a serious threat. Indeed, Secretary of Defense Cheney has indicated that the probability of war in Europe is at its lowest postwar level. Evidence also suggests that the Soviet Union is decreasing its defense spending and making some of the unilateral troop reductions that Chairman Gorbachev promised in December 1988.

The Administration plans to reduce personnel below the 1990 level by 38,000 in 1991, partly in response to these changes. The options presented below examine two levels of personnel reductions that might be made over the next five years. The first option would reduce active-duty military personnel by 250,000 and save \$51.3 billion relative to the CBO baseline over the next five years. The second option considers a reduction of 500,000 and would save \$103.2 billion over five years.

Reduce Active-Duty Military Personnel by 250,000

This option would reduce the number of active-duty military personnel by 250,000 below the 1990 level by 1995. The reductions would consist of 40,000 people in 1991 and would increase by 5,000 each year through 1995. Personnel savings would be \$40 million in 1991 relative to the Administration's plan. Relative to the CBO baseline, savings would be \$670 million in 1991 and total \$20.8 billion over the next five years.

Savings would occur in other areas as well--in civilian personnel and in the nonpay costs of operating forces, for example. These savings cannot be estimated with confidence without a precise plan indicating how many units would be eliminated. But if operating costs other than those for military personnel were reduced in proportion to personnel reductions, then added savings relative to the CBO baseline would be \$940 million in 1991 and total \$30.4 billion through 1995. Relative to the Administration's plan, additional savings in 1991 would be \$60 million. With fewer forces to modernize, procurement costs would drop. Though small initially, procurement savings would grow substantially over time.

This alternative would allow for a gradual transition to a much smaller military, but one that would undergo major change. Indeed, although the reduction in manpower would be only about 12 percent by 1995, the resulting active-duty military force would be the smallest the United States has maintained since 1950. It is likely that several active Army divisions would be deactivated or reduced to a caretaker or cadre status, a number of Air Force tactical fighter wings and strategic bomber wings would be deactivated, and many Navy ships would be retired or placed in an inactive reserve status. The exact reduction in combat forces would depend largely on the amount of support structure that was eliminated. For example, if the Army removed from active duty one of its Europe-based mechanized divisions, and if reductions were limited to personnel directly assigned to the division, about 17,000 people would be removed. But if the additional combat and support personnel that traditionally accompany the division were removed also, the reduction would exceed 38,000. Similar analogies apply to forces in the other services.

Although the Department of Defense acknowledges that force reductions are imminent, it points out that the Soviet Union and the Warsaw Pact are not the only threats facing the United States. But even with the reductions in this option, remaining U.S. military forces would probably be able to react to most, if not all, situations directly affecting U.S. national security interests but not involving direct military confrontations with the Soviet Union.

Reduce Active-Duty Military Manpower by 500,000

Greater reductions in the military forces might be possible if the current trends in the Soviet Union and the Eastern European countries continue. This option would reduce the number of active-duty military personnel by 500,000 below the 1990 level by 1995. The reductions would consist of 60,000 people in 1991 and would increase by 20,000 each year through 1995. Personnel savings would amount to \$350 million in 1991 relative to the Administration's plan. Relative to the CBO baseline, savings would be \$1.1 billion in 1991 and total \$38.9 billion over the next five years.

Large operating savings could also be achieved. If operating costs other than those for military personnel were reduced in proportion to personnel reductions, then added savings relative to the CBO baseline would be \$1.4 billion in 1991 and total \$55.8 billion over the next five years. Relative to the Administration's plan, savings would be \$530 million in 1991. Substantial savings in procurement could also be expected, although their exact nature and timing are less certain.

Although these savings are large, a force reduction of this magnitude, combined with the short period of time in which to accomplish it, could cause significant disruptions. For example, the career military may have to undergo a reduction in force (RIF) to meet the personnel reductions because it is unlikely that retirements and reduced enlistments would be able to accommodate all of the cuts envisioned here.

Spreading these force reductions over ten years instead of five might mitigate some of their negative effects. By allowing more time to watch and evaluate developments in the Soviet Union and Eastern Europe, it would also pose less risk to the security of the United States. Although savings over the next five years would be lower, long-term savings--those beyond 10 years--would be the same.

**DEF-23 ELIMINATE NAVAL RESERVE
AUGMENTATION UNITS**

Savings from Admin. Request and CBO Baseline	Annual Savings (In millions of dollars)					Cumulative Five-Year Savings
	1991	1992	1993	1994	1995	
Budget Authority	90	190	200	200	210	890
Outlays	70	170	180	180	190	790

The major function of the reserve components is to equip and train a part-time force that would be ready to fight in the event of a wartime mobilization. A part of the Naval Reserve operates 56 ships and 317 aircraft that are assigned to the reserves. The part-time Naval Reservists provide about one-third to one-half of the personnel for these reserve ships and aircraft; the remainder are provided by full-time Navy personnel.

Another portion of the Naval Reserve is not responsible for operating specific ships or aircraft but would reinforce active-duty units in the event of war. The mission of these reservists, who serve in so-called augmentation units, is to provide trained personnel who can quickly bring active-duty units to full wartime personnel levels.

The need for these augmentation units is unclear, however, because the active units they would join now operate at an average of almost 92 percent of authorized wartime personnel levels. Active-duty units that would need additional personnel in wartime could turn to other sources such as the inactive reserve, which includes skilled personnel who do not actively train but who retain a military service obligation and remain on Department of Defense rolls, or to active-duty retirees. Furthermore, a 1985 study by the Center for Naval Analyses, which examined the readiness of the Naval Reserve, stated that the reserve augmentation units would add little to the personnel readiness levels of the active-duty units they would augment during a war. The conclusions may still be applicable because manning levels are roughly the same today as they were in 1985.

This alternative would eliminate the augmentation units, decreasing the number of part-time reservists by about 28,800. Savings in the first year would be \$90 million, with cumulative five-year savings totaling close to \$900 million.

Eliminating these units would entail some disadvantages. Savings would be modest relative to the total defense budget. Eliminating these units would also reduce the number of Naval Reserve personnel by about 20 percent. Even if all the reserves in augmentation units are not critically needed in the units they would join, they provide insurance against unforeseen needs that could occur during a wartime mobilization. This insurance may be particularly important if the number of active-duty Navy personnel is reduced in response to factors such as political changes in Eastern Europe.

**DEF-24 REDUCE DRILLS FOR NONCOMBAT
RESERVE UNITS**

Savings from Admin. Request and CBO Baseline	Annual Savings (In millions of dollars)					Cumulative Five-Year Savings
	1991	1992	1993	1994	1995	
Budget Authority	280	300	310	320	330	1,540
Outlays	230	260	270	280	290	1,330

The National Guard and Reserve play an important role in U.S. defense policy by providing a trained, combat-capable force that can be mobilized quickly in the event of a war. Some of these reserve units are included in the forces that would deploy overseas within the first 10 days of a major war. Other reserve units would supplement existing active units, bringing them up to wartime strength and providing much of the combat support needed to fight a war.

Some reserve units, however, have noncombat-related missions. Included in this category are bands and units in areas such as administration, processing and registration of combat casualties, and laundry services. Like other units more directly involved in combat, reservists in these noncombat units are paid to train full time for two weeks each year. They are also paid to drill for one weekend each month, which means they are paid for a total of 48 weekend drills since each weekend includes four drill periods.

This alternative would reduce from 48 to 24 the number of weekend drills for the roughly 100,000 reservists in these noncombat reserve units. Members would still be paid to train full time for two weeks each year, but on average they would train for one weekend every other month instead of each month. Legislation would not be required to implement this option. The secretary of each service has the authority to change the number of drills required for Guard and Reserve units.

Savings the first year would be \$280 million, with cumulative five-year savings totaling \$1.5 billion. Savings in retirement accrual

costs, which are the funds that must be set aside to pay future retirement costs, would amount to about \$30 million in 1991 and \$40 million by 1995. Although they represent a real reduction in long-term costs, these retirement accrual savings appear only in the budget authority savings noted above because they would not affect government outlays for many years.

Reducing drills for these noncombat units may not greatly harm readiness and warfighting capabilities. In many cases, required skills could probably be maintained even with the reduced amount of weekend training. Because total pay would be reduced under this option, fewer reservists might be willing to serve in these noncombat units, and shortages could occur during a mobilization. But most of the general skills required are readily available in the civilian sector, and so qualified personnel could be recruited in the event of a war.

A decline in the number of personnel willing to serve in these units could, however, create some problems in peacetime. Increased recruiting efforts may be needed to maintain the size of the noncombat units. Costs for this extra effort are not reflected in the savings shown above. If the size of these noncombat units declines, some of their peacetime functions--particularly in the areas of administration and finance--might need to be transferred elsewhere, resulting in increased workloads for other units or individuals.

**DEF-25 CHANGE COMPENSATION FOR
 THE SELECTED RESERVE**

Savings from Admin. Request and CBO Baseline	Annual Savings (In millions of dollars)					Cumulative Five-Year Savings
	1991	1992	1993	1994	1995	
Budget Authority	890	930	960	1,000	1,040	4,820
Outlays	770	860	910	940	980	4,460

In 1990, 1.2 million people will serve in the Selected Reserve, at a cost of \$9.2 billion in pay and allowances. About 1.1 million of these are part-time military personnel who are expected to participate in 48 training drills per year, which usually involve one weekend of reserve duty each month. Reservists also serve on active duty for two weeks each year. Selected reservists are compensated with pay and allowances for time spent training as well as with credit toward military retirement benefits.

This alternative would make four changes in the reserve compensation system: it would (1) eliminate payments for basic allowance for quarters (BAQ) made to reservists with dependents; (2) eliminate dual compensation for reservists who are federal civilian employees; (3) redefine and reduce pay for weekend drills; and (4) change the calculation of retirement points. For all four of the changes together, annual savings could amount to \$890 million in 1991 and total \$4.8 billion through 1995. In addition to realizing considerable savings, these alternatives would make the reserve compensation system less complex, would treat various types of reserves more equitably, and would be more efficient.

Eliminate BAQ Payments Made to Reservists with Dependents. Reservists generally serve two weeks of active duty each year and may serve on short periods of additional duty for school or special training. While on training for periods of less than 140 days, reservists with dependents receive a basic allowance for quarters even when on-base quarters are provided for them, but reservists without dependents do not. These payments compensate reservists for maintaining the homes

of their dependents while serving on active duty. As with active-duty personnel, BAQ is tied to quarters used at one's permanent duty station. For reservists, the permanent duty station is wherever training occurs.

The appropriateness of BAQ payments for such duty is questionable. Some reservists remain at home while serving their annual active duty; others serve on field exercises and live in quarters provided by the service. Individuals engaged in school or special training may receive a per diem in addition to their pay and allowances to cover costs. The report from the Sixth Quadrennial Review of Military Compensation, an official DoD study, acknowledged the argument that the government has no obligation to help defray the permanent housing costs of reservists in their civilian community.

One possible rationale for this policy is that civilian housing costs continue during training, putting more of a financial burden on a reservist with a family than one without. However, a reservist's civilian housing decisions are primarily based on civilian income, not military. Reservists do not incur additional housing costs when on active duty because they either receive quarters in kind or get a per diem to cover costs. Moreover, this policy primarily benefits officers and enlisted personnel in higher pay grades, while any shortfalls in the number of available reserves usually occur among those in lower pay grades.

If reservists were only paid for housing expenses incurred out-of-pocket during the two weeks of annual training, savings would be about \$100 million in each of the next five years.

Eliminate Dual Compensation for Reservists Employed by the Federal Government. More than 136,000 reservists are employed in civilian jobs in the federal government. Among officers, depending on pay grade, between 30 percent and 50 percent have civilian government jobs. For enlisted personnel, the range is 10 percent to 50 percent. These individuals benefit from the government's strong support of reserve training and may well experience fewer conflicts with employers than do reservists who work in the private sector. In addition, reservists employed by the government receive dual compensation--both their government and reserve pay--during their two weeks of annual training without having to use vacation time or annual leave. Although some larger private-sector employers follow this practice,

dual compensation is not the general rule for reservists employed outside the federal government. Thus, reservists who are federal civilian employees enjoy a special advantage.

This alternative would eliminate dual compensation for reservists who are given time off from their federal jobs to carry out their active-duty commitment. Instead, they would only receive the higher of the two payments during the service period. Savings would be about \$150 million in each of the five years.

Redefine and Reduce Pay for Weekend Drills. Most reservists train for 48 drills a year. For each drill, they receive basic pay but none of the allowances for food and quarters they receive while on active-duty training. They are also credited with two retirement points for each day, because each day of weekend service counts as two drill periods. On average, a reservist is paid about 130 percent of the total pay and allowances provided to an active-duty person for a single day's work.

An alternative would be to redefine drill pay so that one day of drill would be compensated with one day's total pay. Thus, a reservist would receive basic pay and allowances for each day of training, regardless of whether that training was annual active-duty training or weekend drills. Savings from this proposal would be about \$590 million in direct costs in each of the next five years, plus a decrease in accruals for retired pay not reflected in the savings.

Change Calculation of Retirement Points. Reservists who accumulate 360 retirement points are credited with one year of service for purposes of computing retirement benefits. Retirement points are earned during drills (one per drill) and during the annual two-week period of active duty (one per day of service). In addition, 15 gratuitous points are awarded annually to each reservist who serves in a unit, and extra points can be earned by completing tasks such as correspondence courses. Thus, a typical reservist might accumulate about 80 points a year (48 points for drills, 15 for active duty, and 15 gratuitous points). At least 50 points must be earned in a year for that year to count toward the minimum of 20 years of service required to qualify for regular retirement pay. This option would change these rules by limiting yearly accumulation of points to no more than 360 points and

eliminating the 15 gratuitous points received for simply being in the reserves.

The 360-point ceiling would limit the amount of retirement credit received to exactly one year of credit, and would be consistent with the active-duty system. It would maintain the formula of providing one-thirtieth of one month's pay and allowances for each day of active duty. The 15 gratuitous points that would be eliminated are not related to a specific service performed by the reservist. To reflect this change, the minimum number of points required for a creditable retirement year would be reduced from 50 to 35.

These changes in the calculation of retirement points would save about \$50 million in accrual costs each year and have been endorsed by the Sixth Quadrennial Review of Military Compensation and by the Department of Defense.

The four changes in compensation described above would result in reduced paychecks for some reservists, which could mean that fewer would be willing to join and remain in the reserves. In some cases, that could create problems. For example, compared with active-duty forces, attrition is higher among reservists who are at the early stages (that is, in the first term) of their reserve careers; further increases in losses of first-term reservists could leave some reserve units without enough first-term personnel to be fully effective in wartime.

If this option resulted in such problems, bonus payments could be increased. Bonuses could be offered in cash or in the form of educational benefits and could be targeted toward reserves that were most in demand. For example, payments could be made at various points during a reservist's first term of service in order to retain those with needed skills. Bonuses could also be made available to attract enough recruits into areas that are difficult to fill. The added cost of bonuses is not reflected in the savings noted above, but a part of those savings might have to be used to offset any adverse effects of the four specific changes discussed.

DEF-26 RESTRICT RESERVE RETIREMENT BENEFITS

	Annual Savings (In millions of dollars)					Cumulative Five-Year Savings
	1991	1992	1993	1994	1995	
Savings from CBO Baseline						
Budget Authority	44	97	145	193	247	725
Outlays	0	0	0	0	0	0
Savings from Administration's Request						
Budget Authority	36	75	115	153	215	593
Outlays	0	0	0	0	0	0

The United States is the only country that offers retirement benefits to part-time military reservists. These benefits parallel those provided for the active-duty service and have remained largely unchanged since 1948, when the current program of reserve retirement was enacted. Reservists are entitled to receive retired pay after 20 years of creditable service, of which at least the last eight must be served in a reserve component. Unlike active-duty personnel, who can receive retired pay immediately upon retirement, reservists must wait until age 60. Reservists' retired pay is calculated in a manner similar to that for active-duty retirees, on the basis of length of service and average highest three years' pay.

When the Congress modified the active-duty program in 1986, changes in reserve retirement were put off pending the report of the Sixth Quadrennial Review of Military Compensation (Sixth QRMC). This report, which was released in 1989, offered a number of proposals dealing with reserve retirement. None, however, proposed terminating the program. The farthest-reaching change would have maintained the average value of reserve retired pay, while restructuring the system to provide stronger retention incentives for reservists with critical military skills.

Reserve retirement benefits are provided at considerable cost. In 1989, reservists received \$1.4 billion in retired pay. The accrual

charge for that pay was 25.7 percent of reservists' total basic pay, or \$915 million. (The accrual charge represents dollars set aside now to pay the future retirement costs of today's reserves.) Changes in actuarial assumptions approved by the Board of Actuaries in 1988 lowered the accrual charge for 1990 and beyond. The accrual charge for 1991 is 13.3 percent, or \$553 million. Despite the reduction in the accrual charge, no change has occurred in the benefits earned by individual reservists.

To reduce the costs of reserve retirement benefits, this option would terminate the reserve retirement program for those entering the reserve components after the end of fiscal year 1990. All current reservists under the present retirement system would be grandfathered but no new reservists, including those who enter the reserves from active duty, would be eligible to accumulate benefits. Savings in accrual charges for reserve retirement would grow steadily, but savings in total federal outlays would not be realized for many years.

The Sixth QRMC concluded, on the basis of recent trends in retention among reservists, that reserve retirement is a major factor in the retention decisions of enlisted personnel as well as officers. The current distribution of benefits, however, suggests that the reserve retirement program has been a stronger incentive for reserve officers than for enlisted personnel to stay in the reserves. More than 80 percent of the 1989 benefits--over \$1.1 billion--was paid to retired officers, who constitute 72 percent of the population of reserve retirees. Enlisted retirees received only \$238 million in benefits, or 17 percent of the total, although enlisted personnel account for 85 percent of the reserve forces.

Terminating the reserve retirement program could be expected to generate savings without having major adverse effects on the ability of the reserve components to meet their personnel objectives. Personnel shortages in the reserves generally have been concentrated in junior enlisted ranks, typically in pay grades E-3 and E-4, and thus have not been alleviated much by the incentive of reserve retired pay. If terminating the program aggravated personnel shortages in particular skills, some of the savings in retirement costs could be used to increase selective reenlistment or continuation bonuses.

Terminating the reserve retirement system, however, might entail some other adverse effects. Reserve retirement benefits appear to achieve their stated purpose of holding reservists for longer careers, since a larger fraction of reservists remain for more than 20 years of service than do active-duty personnel. In addition, the reserve retirement program makes the reservists' compensation package more comparable with that of active-duty personnel. This comparability may help to maintain a substantial reserve, which the Congress has strongly supported in the past.

**DEF-27 INCREASE COST-SHARING FOR
MILITARY HEALTH CARE**

Savings from Admin. Request and CBO Baseline	Annual Savings (In millions of dollars)					Cumulative Five-Year Savings
	1991	1992	1993	1994	1995	
Budget Authority	290	290	290	290	290	1,450
Outlays	220	270	280	280	280	1,330

Nonactive-duty beneficiaries of the military health care system pay little for care given by military physicians. As inpatients in military hospitals, dependents of active-duty and retired military personnel generally pay about \$8 a day, retired officers pay about \$4 a day, and retired enlisted personnel pay nothing. As outpatients in military clinics, dependents and retired personnel pay nothing. Nor do they pay for prescription drugs from military pharmacies. When care is not available in military facilities, the Civilian Health and Medical Program of the Uniformed Services (CHAMPUS) will help beneficiaries pay for civilian services, after they pay a deductible of \$50 a person or \$100 a family--an amount that has not changed since first set in 1966.

Because the charges are so low, beneficiaries may make greater use of health care services, thus contributing to overcrowding in outpatient clinics and the rising costs of health care. This option would both curb excessive use and raise revenue by calling on beneficiaries to pay for a larger share of the costs of the care they receive in the United States. All nonactive-duty inpatients would pay \$23 a day (10 percent of CHAMPUS's daily hospital charge). In military clinics in the United States, outpatients from senior enlisted families would pay \$5 a visit; outpatients from officers' families, \$10 a visit. Outpatients overseas still would pay nothing. Prescriptions filled in military pharmacies would cost \$3. Dependents of junior enlisted personnel below pay grade E-5 and survivors of deceased personnel, the military's least well-off beneficiaries, would still pay nothing for visits to military physicians or for prescription drugs. Finally, to compensate somewhat for the change in the cost of living since 1966, the CHAMPUS outpatient deductible would increase to \$150 a person and \$300 a family. To-

gether, these changes could save the Department of Defense about \$290 million a year. The revenue increase reflected in these savings does not include the cost of modifying existing automated information systems to collect the higher fees.

Since medical care is a key part of military compensation, military families would view increased charges as an erosion of benefits. Recruitment and especially retention could suffer, although the parallel trend in civilian medicine toward wider cost-sharing might mitigate beneficiaries' dissatisfaction. Indeed, increased cost-sharing would bring the military health care system somewhat more in line with medical plans offered to civilian employees of the federal government. Nor should rising charges necessarily harm health, a potential concern, since evidence shows that people at ages and incomes typical of military beneficiaries seek needed care even when they share the costs.

DEF-28 **LIMIT MILITARY PAY RAISE**

	Annual Savings (In millions of dollars)					Cumulative Five-Year Savings
	1991	1992	1993	1994	1995	
Savings from CBO Baseline						
Budget Authority	1,440	2,690	3,960	5,300	6,720	20,110
Outlays	960	1,920	2,880	3,890	4,970	14,620
Savings from Administration's Request						
Budget Authority	800	2,030	3,300	4,540	5,760	16,430
Outlays	560	1,460	2,430	3,370	4,310	12,130

Since 1982, military pay has not risen as fast as has average pay in the private sector. By one measure, the difference between the pay of military personnel and their counterparts in the private sector--the so-called comparability gap--now exceeds 8 percent, and press reports of even larger gaps are common. Nonetheless, the approved raises have apparently been competitive--that is, sufficient for the military services to attract and retain the desired number and quality of personnel. Moreover, the Administration has proposed cuts in military personnel of more than 4 percent between 1989 and 1991, and further cuts through 1995 probably will be proposed. If fewer personnel are needed in the future, military pay could be even lower than it is today and still be competitive.

This option illustrates one possibility for limiting military pay. Holding annual raises in 1991 through 1995 to two percentage points below the previous year's rate of inflation as measured by the consumer price index would yield savings of \$16.4 billion in defense budget authority over the next five years, relative to budget authority under the Bush Administration's proposed raises, and \$20.1 billion relative to the CBO baseline. (FWF-01 examines the same option applied to federal civilian employees.)

Two factors explain most of the differences between the savings relative to the Administration's plan and relative to the CBO baseline.

First, the personnel reductions proposed by the Administration, but not assumed in the CBO baseline, reduce the savings from a given reduction in pay raises. Second, this option assumes that raises in each year would be effective January 1, in keeping with recent practice and as the Administration has requested for 1991, rather than the October 1 date prescribed by law and assumed in the CBO baseline. In addition, savings relative to the Administration's plan are based on the Administration's proposed raises and projected inflation rates, while savings relative to the CBO baseline are based on CBO's higher inflation projections and generally higher pay-raise assumptions.

In past years limited raises could have been expected to make the services' recruiting and retention goals more difficult to meet. With personnel cuts in the offing, however, these adverse effects are less worrisome. Indeed, large-scale personnel reductions create the problem of how to encourage experienced personnel to leave the military, rather than how to get them to stay. Achieving most of these reductions by decreasing enlistments--the alternative to increasing the number of separations of more senior personnel--would diminish the budget savings from a given reduction in total personnel because new recruits are paid less. Furthermore, sharply cutting enlistments during the period of the personnel reductions could seriously disrupt initial training operations, force a slowdown in promotions, and severely complicate personnel management in the future when the small incoming cohorts reached reenlistment, promotion, and other key points in the military career.

Limiting raises would help to spread the Administration's planned cuts across personnel in all years of service. Voluntary separations among enlisted personnel would increase by roughly 4,000 in the first year, and by as many as 19,000 in 1995, relative to what they would be if military pay kept pace with private-sector raises. The increase in voluntary separations over the five years could total 60,000. This would reduce the need for involuntary separations, which under current law could require separation payments of up to \$30,000 to some officers. Equity considerations might argue for extending such payments to enlisted personnel.

Limited raises would have several disadvantages. First, most of the additional separations would be among personnel at their first or second reenlistment points (or, for officers, probably at the end of their

initial service obligations). Personnel at these points account for most reenlistment decisions, and those further along in their military careers probably respond less to changes in pay than do more junior personnel. Thus, although this approach would reduce the size of the career force, it would allow that force to become increasingly senior and more expensive per person. Second, limited raises could tend to encourage some of the services' best people to leave, rather than poorer performers who could be required to leave by tightened reenlistment standards and selective involuntary separations. Third, the higher separation rates caused by lower military pay would not disappear once desired reductions in strength had been achieved; they would continue and, in the long run, both officer and enlisted forces would be more junior than they are today. As a result, the military could face higher training costs, have fewer people available for assignment to operational units, and suffer from diminished capability. More junior forces would, however, have lower average personnel costs.

Finally, the reduction in military pay under this option (relative to pay in the private sector) is large by historical standards, making accurate projections of its effects very difficult and the option correspondingly risky. Relative to private-sector pay, military pay would fall by more than 10 percent over the next five years. The resulting ratio of military to civilian pay would be well below any experienced since the inception of the All-Volunteer Force. One possible effect would be a sharp decline in the morale of military personnel, which could adversely affect military readiness.

The effect of the pay cut on the quality of recruits--a concern during the 1980s--would depend on how the planned personnel reductions are managed. Lower pay would make it harder for the services to attract well-qualified recruits. Despite this, average recruit quality (as measured by test scores and education) could rise if the personnel cuts were made by taking in fewer new recruits. If the Department of Defense instead moved aggressively to separate senior personnel, and kept the annual requirement for new recruits relatively high, it might have to accept a decline in recruit quality.



CHAPTER III

ENTITLEMENTS

Entitlement programs provide benefits to all people or jurisdictions who are eligible to receive aid and who choose to participate. The level of spending in entitlement programs is largely determined, not by the annual appropriation process, but rather by the program rules that govern eligibility, the extent of participation, the benefit levels, and the cost of providing noncash benefits. But a variety of other factors that are beyond the control of the Congress also cause outlays for entitlements to rise or fall--for example, demographic shifts, changes in providers' practices, and rates of inflation. Spending is, therefore, only partly under the direct control of the Congress.

In recent years, the Congress has modified many entitlement programs, and this chapter includes 30 options for further changes. All but two of these options would lower outlays for entitlements and other mandatory spending. For example, ENT-04 through ENT-17 deal with health care programs, while ENT-25 through ENT-29 discuss alternatives for reducing net federal outlays for Social Security and other retirement and disability programs. ENT-12 and ENT-17 would increase revenues. Agricultural price support programs, included in the broad budget category Entitlements and Other Mandatory Spending, are covered in the next chapter.

Several of the options are substitutes for one another. Also, in some instances, the individual summaries describe more than one specific policy alternative. In general, the savings from the separate options--or from the variations within a single option--cannot be added together to arrive at a total.

All estimates of outlay savings and revenue gains from these options are calculated relative to CBO's baseline projections. These projections are based on CBO's short-run economic forecast and longer-run projections as described in its recent report, *The Economic and Budget Outlook: Fiscal Years 1991-1995*. Baseline spending projections for entitlements and other mandatory spending programs reflect

changes forecasted for several factors, such as caseloads and the average federal cost per beneficiary. The latter may rise over time as a result, for example, of cost-of-living adjustments in benefit payments or increases in either the price of medical services or the intensity of their use.

ENT-01 REDUCE SUBSIDIES FOR STAFFORD LOANS

Savings from CBO Baseline	Annual Savings (In millions of dollars)					Cumulative Five-Year Savings
	1991	1992	1993	1994	1995	
Require Students to Pay In-School Interest						
Budget Authority	-30	150	400	610	790	1,900
Outlays	-35	90	330	550	740	1,700
Raise Students' Interest Rates After They Leave School						
Budget Authority	a	15	50	90	120	280
Outlays	a	10	40	80	110	240
Raise Students' Interest Rates and Accrue Interest During the After-School Grace Period						
Budget Authority	5	60	170	290	390	920
Outlays	a	50	140	260	370	820
Reduce Lenders' Subsidies by One-Half of a Percentage Point						
Budget Authority	20	65	110	140	180	520
Outlays	10	50	95	130	170	460

a. Less than \$2.5 million.

The Robert T. Stafford Student Loan Program (formerly the Guaranteed Student Loan Program) authorizes the federal government to guarantee loans for postsecondary students against default. The program pays the interest while students are enrolled in school. Lenders receive a rate of return that varies with market interest rates equal to 3.25 percentage points above the rate of interest on 91-day Treasury bills. Because students do not begin repayments on Stafford Loans until after they leave school, and because they repay loans at fixed interest rates that are generally below market rates, they receive a substantial subsidy from the federal government.

In 1989, interest payments on loans to students attending school (net of a 5 percent student-paid origination fee) accounted for about 40 percent of the cost of the Stafford Student Loan Program. Special allowance payments to lenders on all outstanding loans accounted for 25 percent. These payments are intended to compensate lenders for the difference between the interest rates they charge students and current market interest rates. Default payments net of collections equaled about 30 percent, and other costs equaled 5 percent. In recent years, in-school interest payments have remained relatively stable; special allowance payments have fluctuated as interest rates changed; and default costs have grown substantially. The options presented below suggest ways subsidies for students and lenders could be reduced. (See ENT-02 for ways to lower the federal cost of defaults.)

Require Students to Pay In-School Interest or Raise Students' Interest Rates After They Leave School. Federal subsidies could be reduced by requiring students to repay larger amounts than they do under current law. Charging interest on loans to new borrowers while they are in school, but deferring actual payments until they leave school, would reduce federal outlays by \$1.7 billion between 1991 and 1995 if the 5 percent student origination fee, which is used to offset federal interest subsidies, were eliminated at the same time; if it were not eliminated, savings would be \$3.3 billion.

Alternatively, raising the interest rates of new borrowers after they leave school to the full amount of interest the government now pays to lenders, but continuing the interest subsidy to students while they are in school (which would include the current six-month grace period during which students can defer repaying), would reduce federal spending by \$240 million during the 1991-1995 period and by considerably more in future years. A variation of this option would also require new borrowers to begin accruing interest on their loans immediately after leaving school, but would allow a grace period of six months before the first payment is due. This approach would save about \$820 million over the 1991-1995 period.

These measures would not cause cash-flow problems for students while they are in school because students would be allowed to defer interest payments during that period. With the added costs generally occurring only after leaving school--when students would most likely

be able to afford them--most students would still be able to continue their education.

The larger repayments that would result from these changes might, however, cause some students not to attend school or to limit their choice to lower-priced institutions. In addition, a few lenders might drop out of the program because of somewhat increased servicing costs and more complex interest calculations, which could make loans more difficult for some students to obtain.

Reduce Lenders' Subsidies. The federal government currently pays lenders a special allowance so that their annual rate of return on every new Stafford Loan equals 3.25 percentage points above the bond equivalent rate for 91-day Treasury bills. Each reduction of one-half of one percentage point in this yield for new loans while students are still in school (when lenders have the lowest loan servicing costs) would lower federal spending by a total of \$460 million during the next five years and by substantially more in future years.

Reducing lenders' subsidies would lower federal expenditures without increasing students' costs. Moreover, although some people argue that reducing the special allowance to lenders while borrowers are in school would limit the availability of loans for most students, this fear is probably overstated. During 1988, the 100 largest lenders--making up less than 1 percent of all lenders--disbursed at least 65 percent of all loans. Although a few small lenders might leave the program if the special allowance were reduced, large lenders currently receive a subsidy worth significantly more than the costs they incur, including the small risk they bear related to defaults on loans. However, if this option made some loans unprofitable for lenders in a few locations, some students could have more difficulty financing their education.

**ENT-02 REQUIRE POSTSECONDARY INSTITUTIONS
TO SHARE THE FINANCIAL RISK OF
DEFAULTS ON STAFFORD LOANS**

Savings from CBO Baseline	Annual Savings (In millions of dollars)					Cumulative Five-Year Savings
	1991	1992	1993	1994	1995	
Have Postsecondary Institutions Pay a Coorigination Fee						
Budget Authority	380	490	490	500	500	2,350
Outlays	240	480	490	500	500	2,200
Have Postsecondary Institutions Pay a Loan Default Fee						
Budget Authority	250	230	230	240	240	1,200
Outlays	120	240	230	240	240	1,050

In recent years, along with changes in the types of students who are eligible to borrow (now only those having financial need), the volume of defaulted loans in the Stafford Student Loan Program has grown. In 1989, default payments net of collections equaled \$1.4 billion, about 30 percent of the total cost of the program. The options presented below suggest ways to lower the federal costs of defaults by having postsecondary institutions share the financial risk of defaults on Stafford Loans. (See ENT-01 for options to reduce subsidies to students and lenders.)

Have Postsecondary Institutions Pay a Coorigination Fee. The direct beneficiaries of Stafford Loans are students, postsecondary institutions, lenders, and guarantee agencies. Currently, however, these beneficiaries unequally share the risk of loan defaults. Students help pay for defaults through the insurance fees charged by guarantee agencies. These agencies bear risk through reinsurance payments that depend on the default level of the loans they guarantee. In contrast, lenders do not directly share the risk of defaults since they are fully reimbursed for loans that default if they follow "due diligence" in seeking repayment. (An option discussed in ENT-01 would reduce the

lenders' subsidies in part because some consider their current return to be too high for the slight risks they bear.) Finally, postsecondary institutions currently bear almost no direct financial risk for loan defaults, although beginning in 1991 the Secretary of Education does have discretion to sanction schools with high default rates.

One alternative would be to place some of the risk of loan defaults on postsecondary institutions by requiring them to pay the federal government a 5 percent coorigination fee on the amount of every loan taken out by their students--the same charge their students must pay. The coorigination fee would raise an estimated \$2.2 billion in the 1991-1995 period.

The primary argument for postsecondary institutions sharing in the financial risk of loan defaults is that they benefit directly, along with the students, from these loans. Sharing this risk through a coorigination fee would reinforce the requirement that postsecondary institutions inform their students of their obligation to repay their loans. An argument against this proposal, however, is that postsecondary institutions with relatively low default rates would subsidize those with high default rates.

Have Postsecondary Institutions Pay a Loan Default Fee. Another option would be to charge postsecondary institutions a sliding annual fee related to the percentage of loans entering repayment on which students default. The Department of Education determines this figure when it calculates each institution's "fiscal year default rate." In this option, institutions with fiscal year default rates above 30 percent would have to pay a fee set at 15 percent of the amount of loans on which students defaulted that year, while those with default rates between 10 percent and 30 percent would pay a 10 percent fee. Those with default rates below 10 percent would pay nothing.

This alternative would raise an estimated \$1.1 billion over the 1991-1995 period. An advantage of this option is that it would provide institutions with strong incentives not to overstate the economic benefits that students will derive from their education and to ensure that their students are aware of their obligation to repay loans. A disadvantage is that, unless postsecondary institutions could pass on

the fee to students through higher charges, this approach could create financial stress for some postsecondary institutions having high default rates--for example, proprietary schools, many of whose disadvantaged students take out loans.

**ENT-03 ELIMINATE OR REDUCE FEDERAL FUNDING
OF THE SOCIAL SERVICES BLOCK
GRANT PROGRAM**

Savings from CBO Baseline	Annual Savings (In millions of dollars)					Cumulative Five-Year Savings
	1991	1992	1993	1994	1995	
Eliminate Funding						
Budget Authority	2,800	2,800	2,800	2,800	2,800	14,000
Outlays	2,650	2,800	2,800	2,800	2,800	13,850
Reduce Funding by 50 Percent						
Budget Authority	1,400	1,400	1,400	1,400	1,400	7,000
Outlays	1,350	1,400	1,400	1,400	1,400	6,950

Title XX of the Social Security Act--the Social Services Block Grant (SSBG) program--provides funds to states for social services such as day care, foster care, home help for the handicapped and elderly, and child protective services. Funds are allocated to states in proportion to their population and, currently, there are no federally mandated criteria for targeting spending on low-income groups. Federal funding for this program has been about \$2.7 billion in each year since 1983.

Eliminating the SSBG program would reduce federal outlays by nearly \$14 billion in the 1991-1995 period by curtailing spending over which the federal government exercises little control. This program is similar to general revenue sharing--a program that the Congress did not renew after 1986. The impact of this option would depend on the extent to which state and local governments would replace lost revenue or limit services. Services would, however, probably be denied to needy people in states with the least fiscal capacity. Moreover, in 1988, 23 states transferred funds from the Low Income Home Energy Assistance Program to supplement their SSBG funds, indicating the relatively high value that states place on these services.

Alternatively, cutting funding by half would save almost \$7 billion over the 1991-1995 period. Remaining funds could be targeted toward

people with the greatest need by reinstating income limits for eligibility. Moreover, the government could either allocate funds to each state based on the number of residents with incomes below federal poverty thresholds or provide funds only to states with the lowest incomes or fiscal capacities. If some funding were retained and federal targeting requirements were reestablished, adverse impacts on people with the greatest need would be limited. Adding income restrictions would, however, limit the flexibility of states in using the available funds. If funding were eliminated for some states, some needy people would probably no longer receive services.

**ENT-04 ELIMINATE FEDERAL MATCHING IN
MEDICAID FOR MEDICARE'S PREMIUMS**

Savings from CBO Baseline	Annual Savings (In millions of dollars)					Cumulative Five-Year Savings
	1991	1992	1993	1994	1995	
Outlays	610	660	710	760	810	3,550

States are allowed to enroll Medicaid beneficiaries for Medicare Part B--that is, Supplementary Medical Insurance (SMI)--when the beneficiaries are eligible for both Medicaid and Medicare. To do so, the state pays the same SMI premium as the beneficiary would have paid--an amount equal to about 25 percent of SMI's average cost for an enrollee. Since the states' contributions toward premiums are matched by federal funds, however, states effectively pay an amount equal to only about 11 percent of the average cost of SMI. Because Medicare is the primary payer in cases of dual eligibility, states save more than 65 percent, on average, of what would otherwise be costs for their Medicaid programs.

If state spending for SMI premiums generally were not matched with federal funds, about \$3.6 billion would be saved over the 1991-1995 period. States would, however, continue to receive matching federal funds under this option for premiums paid on behalf of certain indigent Medicare beneficiaries whose coverage was mandated by the Medicare Catastrophic Coverage Act of 1988. (This part of the act was left intact when most of its provisions were repealed in 1989.)

This option would reduce a substantial subsidy to states. That subsidy now effectively transfers a higher proportion of this group's medical costs from the states to the federal government than is typical for Medicaid beneficiaries. Nearly all states currently choose to pay the SMI premiums for their Medicaid beneficiaries who also are eligible for Medicare. Even without federal matching funds for the SMI premiums, states would almost certainly continue to enroll those eligible for Medicare to keep their Medicaid costs down for dually eligible beneficiaries.

If some states decided to quit paying the Medicare premiums in response to the elimination of federal matching, some of the federal savings would come from those elderly and disabled who chose to enroll in the Medicare program at their own expense instead of receiving all their care through the Medicaid program. Others who did not enroll in Medicare might face restricted access to physicians and other ambulatory services because Medicaid's reimbursement rates are usually substantially lower than those of Medicare.

**ENT-05 REDUCE MEDICARE'S PAYMENTS TO
PHYSICIANS FOR ALL OVERVALUED SERVICES**

Savings from CBO Baseline	Annual Savings (In millions of dollars)					Cumulative Five-Year Savings
	1991	1992	1993	1994	1995	
Outlays	560	990	1,100	1,250	1,400	5,300

Under Medicare's current payment system for physicians' services, payment rates are the lowest of the physician's actual charge, the physician's customary charge for that service, or the prevailing charge for that service in the community. This system is to be replaced by a Medicare fee schedule (MFS) derived from a resource-based relative value scale. The new payment rates will more accurately reflect the resource costs of providing the services. A phased transition is to begin in 1992. When the MFS is fully in place, rates for many surgical procedures are expected to fall, while those for visits and consultations will typically increase.

For 1990, the Congress reduced payment rates for a limited number of "overvalued" procedures--that is, procedures for which prevailing rates are substantially higher than the corresponding MFS values. Additional savings could be achieved by reducing the 1991 prevailing charges for all procedures with charges above the MFS level. If prevailing charges were reduced to eliminate half the difference, with a maximum reduction of 15 percent, savings are estimated to be \$560 million in 1991 and \$5.3 billion over the 1991-1995 period. Savings in 1992 and beyond would occur because implementation of the MFS is to be budget neutral, and this option would lower the base for setting the new rates for all physicians. These estimates assume that the MFS will be completed in time to make this change for 1991. If this option could not be put in place for all procedures because final MFS values were not available for some of them, or if final MFS values varied from those assumed here, savings would be somewhat different.

This option would accelerate the planned move toward MFS rates for services that are now overvalued. As a result, it would hasten some of the benefits to be expected from establishing the MFS, such as eliminating or reducing distortions in physicians' decisions about specializa-

tion, geographic location, and patterns of treatment. In addition, this option would address the concerns of people who think that aggregate payments to physicians are too high.

One objection to the option arises because of its asymmetry--payments for overvalued services would be reduced more quickly than payments for undervalued services would rise. In addition, if this reduction in payments made physicians less willing to treat Medicare patients at Medicare's approved rates, some enrollees' access to care might be adversely affected.

**ENT-06 REBASE PPS PAYMENTS TO
HOSPITALS UNDER MEDICARE**

Savings from CBO Baseline	Annual Savings (In millions of dollars)					Cumulative Five-Year Savings
	1991	1992	1993	1994	1995	
Immediately Reduce Rates to 1983 Level Adjusted for Inflation and Other Factors						
Outlays	2,300	2,900	3,200	3,500	3,800	15,700
Gradually Reduce Rates to 1983 Level Adjusted for Inflation and Other Factors Less 10 Percent						
Outlays	3,100	4,750	6,300	8,050	10,100	32,250

In 1983, the Congress changed Medicare's system of paying for hospital inpatient services from a retrospective, cost-based reimbursement system to a prospective payment system (PPS). The main objectives of the PPS were to lower the growth of Medicare's payments to hospitals and encourage efficiency in the provision of hospital care, while not adversely affecting its quality. Specifying payment rates in advance and requiring hospitals to bear the loss if their costs are higher is one way to lower payments and encourage efficiency. In exchange, hospitals are allowed to keep the difference if their costs are lower than the payments. Thus, hospitals face strong financial incentives to provide care as efficiently as possible.

During the first year of PPS, hospitals received payments that were 17 percent higher, in aggregate, than their costs. Two factors accounted about equally for these profit margins. First, hospitals improved their efficiency. Second, the initial payment rates were set too high because the only available data on which to base them were unaudited and several years old.

In response to these high profit margins, the Congress raised the 1986-1990 PPS rates by less than the rate of inflation, as measured by the cost of hospitals' inputs. Despite this restraint, payments per case

in 1991 will remain above the 1983 inflation-adjusted level. Furthermore, even if payments were reduced to the level that would have prevailed in 1983 (adjusted for inflation), the Medicare program still would not share any of the hospitals' savings as they improved their efficiency.

If PPS rates were rebased to 1983, adjusted to account for inflation, and raised by an additional two percentage points annually to allow for increases in the complexity of cases, payments in 1991 would be 5.6 percent lower than currently projected. This rebasing would result in a reduction in outlays of \$15.7 billion during the 1991-1995 period.

The federal government might also share the savings from more efficient hospital care, rather than allow hospitals to retain all the gains. Although the full extent to which payments could be cut without lowering the quality of care is not known, efficient hospitals should be able to deliver services at a considerably lower real cost than that which prevailed under cost-based reimbursement. For example, hospitals' per-case payments could be set at 1983 levels less 10 percent, adjusted for inflation and increases in the complexity of cases. If the 10 percent downward adjustment were phased in over a five-year period, outlays would be reduced by \$32.3 billion during the 1991-1995 period.

There are several justifications for rebasing the PPS rates. First, the original PPS rates were developed using data that substantially overestimated hospitals' real costs. Second, hospitals have demonstrated that they can provide care more efficiently, and therefore at lower costs per case, and Medicare could share in the savings from these gains in efficiency. Finally, unless the PPS rates are lowered to approximate more closely the costs of providing care efficiently, the goals of the legislation would not be realized.

This approach has two potential disadvantages, however. The first is that substantial reductions in PPS payments could cause financial difficulties for some hospitals and, if these hospitals eventually closed, access to hospital care for some Medicare beneficiaries might be reduced. The second potential disadvantage is that some hospitals might respond to reductions in PPS payments in ways that could lower the quality of care provided to Medicare beneficiaries.

**ENT-07 ELIMINATE THE DISPROPORTIONATE SHARE
ADJUSTMENT IN MEDICARE'S PROSPECTIVE
PAYMENT SYSTEM**

Savings from CBO Baseline	Annual Savings (In millions of dollars)					Cumulative Five-Year Savings
	1991	1992	1993	1994	1995	

Eliminate the Disproportionate Share Adjustment

Outlays	1,300	1,650	1,800	2,000	2,150	8,900
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**Gradually Eliminate the
Disproportionate Share Adjustment**

Outlays	260	620	1,050	1,550	2,100	5,550
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NOTE: The disproportionate share adjustment is based on an index that is the sum of two ratios: the proportion of all Medicare patient days that are attributable to Medicare patients receiving benefits from the means-tested Supplemental Security Income (SSD) program plus the proportion of all patient days for which Medicaid is the primary payer.

Under Medicare's prospective payment system (PPS), higher rates are paid to hospitals with a disproportionately large share of low-income patients. In 1985, the Congress added this "disproportionate share" adjustment to account for the presumed higher costs of treating Medicare beneficiaries at these hospitals. One rationale for the adjustment is that low-income Medicare patients may be sicker and, therefore, more expensive to treat than other Medicare patients. Another rationale is that hospitals with large numbers of low-income patients--regardless of whether they are Medicare enrollees--may provide additional staffing, facilities, and services (such as social workers and translators) in response to such patients' needs. In 1991, disproportionate share payments are expected to total about \$1.6 billion, or 3.2 percent of all PPS payments. Large urban hospitals--that is, those with more than 100 beds--will receive roughly 96 percent of the disproportionate share payments, compared with 82 percent of all PPS payments.

The latest available data provide scant support for any disproportionate share adjustment. In fact, the only group for which such an

adjustment would be supported by the data is large urban hospitals that have extremely high values of the disproportionate share index. This group contains roughly 100 hospitals and accounts for only about 2 percent of all PPS payments.

If the disproportionate share adjustment were eliminated, outlays would fall by almost \$8.9 billion over the 1991-1995 period. Alternatively, phasing out the disproportionate share adjustment by the end of 1994 would reduce outlays by \$5.6 billion over the same five years. If hospitals with the highest disproportionate share indices had their adjustments reduced but not eliminated, annual savings would be about \$100 million less under the first option and about \$50 million less under the second one.

Even without the disproportionate share adjustment, Medicare's payments to these hospitals would, on average, be sufficient to cover their costs for treating Medicare beneficiaries. Hospitals currently receiving the adjustment would, in general, be adequately reimbursed for their higher-than-average costs through other aspects of the PPS--namely, the adjustments for differences in case mix, wage level, location, and the presence of teaching programs. Nevertheless, many disproportionate share hospitals are in poor financial condition. If this option led some of them to reduce their provision of charity care or if some hospitals were forced to close, the access to and quality of care could fall for residents of the areas they serve. Phasing out the adjustment over several years would provide time for current recipients to adjust, but would significantly lower federal savings.

If the disproportionate share adjustment were eliminated, the reduction in Medicare's payments could be returned to hospitals by increasing payment rates overall or through other adjustments, or could be removed from the PPS as budget savings. The former approach would be consistent with the original financing of the disproportionate share adjustment, which lowered payment rates for all hospitals and reduced the teaching adjustment rather than increasing outlays. It would, however, do nothing to lower the federal budget deficit.

**ENT-08 REDUCE MEDICARE'S PAYMENTS FOR THE
INDIRECT COSTS OF PATIENT CARE THAT
ARE RELATED TO HOSPITALS' TEACHING
PROGRAMS**

Savings from CBO Baseline	Annual Savings (In millions of dollars)					Cumulative Five-Year Savings
	1991	1992	1993	1994	1995	
Reduce the Teaching Adjustment to 6.0 Percent						
Outlays	480	600	660	720	790	3,250
Reduce the Teaching Adjustment to 4.0 Percent						
Outlays	1,050	1,300	1,450	1,600	1,750	7,150

The Social Security Amendments of 1983 established the current prospective payment system (PPS) under which Medicare reimburses hospitals for inpatient services provided to beneficiaries. Higher rates are paid to hospitals with teaching programs to cover their additional costs of caring for Medicare patients. In particular, payments to these hospitals are raised by approximately 7.7 percent for each 0.1 increase in the hospital's ratio of full-time equivalent interns and residents to its number of beds. This adjustment was included both to compensate hospitals for their indirect teaching costs--such as the greater number of tests and procedures thought to be prescribed by interns and residents--and to cover higher costs caused by a variety of factors that are not otherwise accounted for in setting the PPS rates. These factors include severity of illness within diagnosis-related groups, location in inner cities, and a more costly mix of staffing and facilities--all of which are associated with large teaching programs.

Estimates of the indirect teaching adjustment based on cost data from the 1984-1987 period suggest that the teaching adjustment could be lowered to a value in the range of 3 percent to 7 percent, depending on which year's data are used and which of many possible estimating assumptions are chosen. If the teaching adjustment were lowered to 6.0 percent, outlays would fall by almost \$3.2 billion over the 1991-1995 period. Alternatively, if the teaching adjustment were lowered

to 4.0 percent, outlays would fall by about \$7.1 billion over the 1991-1995 period.

This option would better align payments with the actual costs incurred by teaching institutions; between 1981 and 1984, these costs fell substantially in real terms relative to those of nonteaching hospitals. This alternative would, however, considerably reduce payments to teaching hospitals. If these hospitals now use some or all of the excess payments to fund activities such as charity care, the access to and quality of care could diminish for some people.

If it were agreed that the indirect teaching adjustment should be lowered, the reductions in Medicare's payments could be returned to hospitals in general by increasing payment rates, or could be removed from the PPS as budget savings. The first approach would be consistent with the original financing of the indirect teaching adjustment, which lowered payment rates for all hospitals rather than increasing outlays. It would, however, do nothing to lower the federal budget deficit.

**ENT-09 REDUCE MEDICARE'S DIRECT PAYMENTS
FOR MEDICAL EDUCATION**

Savings from CBO Baseline	Annual Savings (In millions of dollars)					Cumulative Five-Year Savings
	1991	1992	1993	1994	1995	
Outlays	110	140	140	150	150	690

Medicare's prospective payment system does not include payments to hospitals for the direct costs they incur in providing graduate medical education (GME)--that is, residents' and teachers' salaries, administrative costs, classroom expenses, and hospitals' associated overhead costs. Instead, these payments are made separately, but also prospectively, based on Medicare's share of the hospital's 1984 cost per resident indexed for subsequent increases in the level of consumer prices. Medicare's GME payments, which are received by about one in six hospitals, represent approximately 2 percent of Medicare's payments for inpatient care but cover nearly one-third of hospitals' total GME costs.

If the Congress were to reduce Medicare's total GME payments by 15 percent, savings over the 1991-1995 period would total about \$690 million. (This option would not change Medicare's direct payments to hospitals for training programs in nursing and allied health professions.) About this level of savings could be generated in several ways: reducing the per-resident payment for every hospital by 15 percent; capping each hospital's per-resident payment at the median amount; or eliminating per-resident payments to hospitals for graduates of foreign medical schools (FMGs).

Several considerations provide support for reducing Medicare's payments for GME. Such subsidies might be unwarranted since the United States is facing a projected aggregate surplus of physicians. Moreover, since physicians earn much higher incomes as a result of their GMEs, they might reasonably contribute more to these costs themselves. Reducing per-resident payments by a uniform 15 percent might be advocated on grounds of fairness to hospitals with varying patterns of expenditures. The alternative approach that imposes a cap

on GME payments would affect hospitals with historically high per-resident costs and, thus, would generally penalize the most inefficient hospitals. Eliminating payments for FMGs would discourage their employment by hospitals, potentially reducing the contribution of FMGs to projected surpluses of physicians.

Reducing Medicare's GME payments could have some drawbacks, however. Many hospitals have built their training programs based on expectations about Medicare's reimbursements for GME. Decreasing or eliminating them could force some hospitals to reduce the resources they commit to training, and a few hospitals might eliminate their training programs altogether. This response could, in turn, reduce access to health care services in some communities.

**ENT-10 REDUCE REIMBURSEMENTS FOR CAPITAL
EXPENDITURES UNDER MEDICARE**

Savings from CBO Baseline	Annual Savings (In millions of dollars)					Cumulative Five-Year Savings
	1991	1992	1993	1994	1995	
Move Immediately to a Prospective Reimbursement System						
Outlays	170	370	590	840	1,150	3,100
Extend the 15 Percent Reduction						
Outlays	810	1,000	1,150	1,250	1,400	5,600
Extend the 15 Percent Reduction and Move Slowly to a Prospective Reimbursement System						
Outlays	780	910	930	1,000	1,200	4,850

The Social Security Amendments of 1983 set up a prospective payment system (PPS) to reimburse hospitals for operating costs associated with treating Medicare beneficiaries in various diagnosis-related groups (DRGs). They did not, however, change the retrospective, cost-based method of reimbursing capital-related expenses such as interest, rent, and depreciation. Under the Omnibus Budget Reconciliation Act of 1987, these cost-based reimbursements were reduced by 12 percent effective January 1988, and by 15 percent in fiscal year 1989. Under the Omnibus Budget Reconciliation Act of 1989, cost-based reimbursements for capital-related expenses incurred between January 1, 1989, and September 30, 1990, were reduced by 15 percent. In fiscal year 1991, after the legislated reduction expires, reimbursements for capital expenses will again equal hospitals' actual expenditures; these reimbursements will account for almost 12 percent of Medicare's payments to hospitals, or roughly \$7.2 billion.

Two of the three options discussed here would introduce prospective payment for capital-related expenses, which the Congress has stated it intends to do. The first one would do so immediately, while the third would partially retain cost-based reimbursement during a five-year transition to a fully prospective system. The second option

would continue cost-based reimbursement for capital-related expenses. Both the second and third options would extend indefinitely the current 15 percent reduction in the level of payments for capital expenses.

Move Immediately to a Prospective Reimbursement System. The current cost-based method of reimbursement for capital-related expenses could be replaced immediately by a prospective system under which capital expenses would be reimbursed by increasing the DRG rates to reflect the capital costs involved in treating each diagnosis. Once the PPS was expanded, the payment for each case would increase only to reflect inflation in the prices of the inputs hospitals buy, such as labor, food, and utilities. (The new index of input prices would reflect changes in the cost of capital goods, as well as changes in the prices of other inputs such as wages, food, and utilities.) Under the expanded PPS, outlays would be reduced by about \$3.1 billion during the 1991-1995 period. These savings would accrue because the increase in DRG payments from including capital costs in the PPS is projected to be less than hospitals' actual expenditures for capital under cost-based reimbursement.

Reimbursing capital expenses by increasing the current DRG rates would have several advantages. First, hospitals would have incentives to reduce their capital costs as well as their operating costs. For example, most interest costs are reimbursed under the current system, but a prospective one would encourage hospitals to delay projects when interest rates were high. In addition, this approach would avoid the current incentive to substitute capital for labor--the incentive that comes from combining prospective reimbursement for operating costs with cost reimbursement for capital expenses--even when that substitution would raise the hospital's total costs. Finally, prospective payment would make federal outlays for Medicare more predictable and controllable--for example, outlays could be controlled even if a hospital building boom occurred in the coming years.

The major drawback to this approach is that the capital expenditures of individual hospitals tend to be large and to occur infrequently. As a result, most hospitals have capital expenses that are much higher than average in some years and much lower in others. In other words, an add-on based on the average level of capital costs per case in a base year would generally not match any particular hospital's current

expenses. Instead, some would receive less, while others would receive more.

Extend the 15 Percent Reduction. The simplest method to reduce outlays for capital would be to extend the 15 percent reduction indefinitely, exactly as enacted for fiscal year 1990. Under this option, outlays would be reduced by \$5.6 billion during the 1991-1995 period.

The advantage of this option is that it would not require any major adjustments by hospitals. Capital expenses have been cut by varying amounts since fiscal year 1987, and hospitals have presumably taken into account the fact that reductions might continue. The disadvantage is that this option would not change the incentive to overinvest in plant and equipment that is created by cost-based reimbursement for capital expenses. Moreover, every hospital--no matter how frugal its investment decisions--would find that its payments from Medicare would fall short of its capital costs.

Extend the 15 Percent Reduction and Move Slowly to a Prospective Reimbursement System. Another approach would be to move gradually from the current cost-based system--with an extended 15 percent reduction--to a prospective system. For example, during a five-year transition period, the reimbursement for capital costs could be based partially on actual costs less 15 percent, and partially on the prospective payment described in the first option. If the portion based on actual costs less 15 percent was set at 95 percent, 80 percent, 60 percent, 40 percent, and 20 percent in the successive years, \$4.8 billion would be saved in the 1991-1995 period.

The advantage of this approach is that partially basing reimbursements on costs during a transition period would lessen financial stress for two large groups of hospitals: those with high capital costs and those planning large capital investments during the transition period. This option would also reduce the extent to which some hospitals would receive more than their actual costs compared with the first option. The disadvantages of this approach are that it would reduce budgetary savings, compared with a 15 percent reduction, and delay some of the positive incentives of immediately paying prospectively.

ENT-11 CONTINUE MEDICARE'S TRANSITION TO PROSPECTIVE RATES FOR FACILITY COSTS IN HOSPITALS' OUTPATIENT DEPARTMENTS

Savings from CBO Baseline	Annual Savings (In millions of dollars)					Cumulative Five-Year Savings
	1991	1992	1993	1994	1995	
Outlays	140	400	570	660	760	2,550

About \$7 billion--or 19 percent of total costs under the Supplementary Medical Insurance (SMI) program--was paid in 1989 for facility and ancillary costs in hospitals' outpatient departments. These operating costs include wages for nonphysician personnel, rent, and expenses for utilities, among other things.

The Omnibus Budget Reconciliation Act of 1986 changed Medicare's payment for facility costs associated with most surgical procedures in the outpatient departments of hospitals. Previously, hospitals were fully reimbursed for their costs. Under the act, they receive the lesser of costs or a blend of hospital-specific costs and a prospective rate based on the average resource costs of the procedure performed. In 1987, a similar change was enacted for paying facility costs associated with outpatient radiology and diagnostic services. In both these areas, for 1990 and all subsequent years, the blend will be 50 percent for each component. If, instead, the hospital-specific portion were phased out (with a transitional blend for 1991 of 25 percent of costs and 75 percent of the prospective rate), savings would be \$140 million in 1991 and \$2.5 billion over the 1991-1995 period.

In addition to reducing Medicare's costs, this option would have Medicare pay hospitals' outpatient departments the same way as ambulatory surgical centers (ASCs) are currently paid. Thus, it would reduce the greater incentive and ability of hospitals to compete for patients through costly capital acquisitions. (ASCs provide outpatient surgery in facilities that are independent of hospitals. Use of these facilities by Medicare enrollees has increased rapidly in recent years.) Further, this option would give the outpatient departments of hospi-

tals more incentive to provide care in a cost-effective manner by ending the automatic pass-through of half of their costs to Medicare.

Nevertheless, experience with the partially prospective rates for outpatient departments is just beginning, and it is not yet known whether the 50/50 blended rate will be sufficient to ensure continued access for Medicare's enrollees. If, for example, patients at risk for complications are advised to receive treatment in hospitals' outpatient departments rather than ASCs because of the ready availability of advanced support systems in hospitals, then it might be appropriate to pay higher rates to hospitals than to ASCs. Retaining hospital-specific costs as a portion of the payment rate until current experience has been examined would be one way to maintain higher rates for the outpatient departments that have higher costs.

**ENT-12 TAX A PORTION OF THE INSURANCE
VALUE OF MEDICARE BENEFITS**

Addition to CBO Baseline	Annual Added Revenues (In billions of dollars)					Cumulative Five-Year Addition
	1991	1992	1993	1994	1995	
Without Income Threshold	1.0	3.3	3.8	4.3	4.7	17.1
With Income Threshold	0.5	1.8	2.1	2.4	2.5	9.3

Eligibility for Hospital Insurance (HI) benefits is based on working-year tax contributions, half of which are paid by employees from after-tax income and half by employers from pretax income. Hence, 50 percent of the insurance value of HI benefits might be treated as taxable income for all Medicare enrollees, reflecting the portion of contributions that was not originally subject to the income tax. This proposal is analogous to taxing part of Social Security benefits, which is already in effect for higher-income beneficiaries whose modified adjusted gross income plus half of Social Security benefits exceeds \$25,000 (for individuals) or \$32,000 (for couples). The rationale for this option is similar to the one for taxing employer-paid health benefits discussed in ENT-17.

If no income thresholds were used to limit the application of the tax on HI benefits, additional revenues would be \$1.0 billion in 1991 and \$17.1 billion over the five-year period. Alternatively, the current income thresholds for the tax on Social Security benefits could be used to limit the application of the tax on HI benefits. In this case, 50 percent of the HI insurance value would be added to modified adjusted gross income plus half of Social Security benefits to compare with the threshold. Taxing HI benefits would then yield additional revenues of \$0.5 billion in 1991 and \$9.3 billion over the 1991-1995 period.

A tax on HI benefits would reduce the federal deficit and strengthen the HI trust fund if the proceeds were placed there. If income thresholds were used, low- and middle-income enrollees would not be liable for the tax. In fact, fewer than half of enrolled tax units in 1991

would be affected by this proposal even if no income thresholds were used. Furthermore, since this option would use the mechanism already in place for taxing Social Security benefits, it would present no additional administrative difficulty.

Unlike the tax on Social Security benefits, however, this tax would be imposed on the insurance value of in-kind benefits rather than on the dollar benefits actually received, thereby modifying current tax policy. (There would be little to recommend basing the tax on actual benefits received because it would then be directly related to enrollees' health care costs. Such a tax would reduce the insurance protection Medicare is intended to provide.) Some might object to this option unless enrollees could alter their tax liability by renouncing all benefits under the HI program, an option that might be particularly important to enrollees for whom Medicare is a secondary payer to their employment-based coverage. For the approximately 10 percent of enrollees in or above the 28 percent tax bracket, the additional tax liability would be substantial--up to \$300 in 1991 for individuals with adjusted gross income above \$26,650, and \$600 for couples with adjusted gross income above \$45,000.

ENT-13 INCREASE THE PREMIUM FOR PHYSICIANS' SERVICES UNDER MEDICARE

Savings from CBO Baseline	Annual Savings (In millions of dollars)					Cumulative Five-Year Savings
	1991	1992	1993	1994	1995	
Set Premium to Cover 25 Percent of Costs in All Years						
Outlays	-70 ^a	1,010	2,510	4,010	5,790	13,240
Gradually Increase Premium to Cover 30 Percent of Costs						
Outlays	260	1,920	4,170	6,600	9,550	22,500

a. Assumes reduction of excess reserves.

Benefits under Medicare's Supplementary Medical Insurance (SMI) program are partially funded by monthly premiums paid by enrollees, with the remainder paid from general revenues. The SMI premium for 1990 is \$28.60.

Although the SMI premium was initially intended to cover 50 percent of the cost of benefits, between 1972 and 1982 premium receipts covered a declining share of SMI costs--falling from 50 percent to 25 percent. This drop occurred because premium increases were limited by the cost-of-living adjustment (COLA) for Social Security benefits (which is based on the consumer price index), but the per capita cost of SMI increased faster. In 1982, premiums were set through 1985 (later extended through 1990) to cover 25 percent of average benefits for an aged enrollee. Under current law, beginning in 1991, the premium increase will again be limited by the COLA for Social Security benefits, so that the share of SMI benefits it finances will almost certainly fall increasingly below 25 percent.

If the premium were set to cover 25 percent of benefits for 1991 and for all years thereafter, instead of being linked it to the COLA for Social Security benefits, there would be costs of \$70 million in fiscal year 1991, but savings of \$13.2 billion over the five-year period. Net outlays for SMI would be reduced by about 4 percent over this period.

Alternatively, if the premium were gradually increased by one percentage point each year to cover 30 percent of benefits by 1995, savings would be \$22.5 billion over the five-year period, reducing net outlays by about 7 percent. These estimates assume a continuation of the current "hold harmless" provision, which ensures that no enrollee's monthly Social Security check will fall as a result of the Social Security cost-of-living adjustment (which is based on the whole benefit) being smaller than the SMI premium increase.

Under this option, all SMI enrollees would pay a little more, in contrast to proposals--such as increasing copayments--that would affect only the users of medical services but that could substantially increase their out-of-pocket costs. This option would not affect the poorest enrollees because of the hold harmless provision and also because poor enrollees are likely to be eligible for Medicaid, which usually pays the SMI premium on their behalf. (By 1992, all enrollees with incomes below the poverty level will be eligible to have Medicaid pay their Medicare premium and copayment costs.)

Low-income enrollees who are not eligible for Medicaid, however, could find the increased premium burdensome. A few might drop SMI coverage and either do without care or turn to sources of free or reduced-cost care, which could increase demands on local governments. In addition, states' expenditures would rise because states would pay part (or all, if the option in ENT-04 were adopted) of the higher premium costs for Medicare enrollees who are also eligible for Medicaid.

**ENT-14 INCREASE MEDICARE'S DEDUCTIBLE
FOR PHYSICIANS' SERVICES**

Savings from CBO Baseline	Annual Savings (In millions of dollars)					Cumulative Five-Year Savings
	1991	1992	1993	1994	1995	
Fixed \$100 Deductible						
Outlays	360	600	620	650	670	2,900
Indexed \$100 Deductible						
Outlays	360	750	1,040	1,380	1,810	5,330

One way to achieve appreciable federal savings in Medicare's Supplementary Medical Insurance (SMI) program is to increase the deductible--that is, the amount that enrollees must pay for services each year before the government shares responsibility. The deductible is now \$75 a year. This deductible has been increased only twice since Medicare began in 1966, when it was set at \$50. Hence, the deductible has fallen relative to average annual per capita benefits from 70 percent in 1967 to less than 7 percent for 1989. Relative to the average annual Social Security benefit, the deductible has dropped from 5 percent in 1967 to 1 percent for 1989.

Increasing the SMI deductible to \$100 on January 1, 1991, would save \$360 million in fiscal year 1991. Savings would total nearly \$3 billion over the 1991-1995 period, reducing net SMI outlays by about 1 percent. If the new deductible were indexed to the rate of growth in SMI charges per enrollee for 1992 and later years, savings would be more than \$5 billion over the five-year period.

An increase in the deductible amount would enhance the economic incentives for prudent consumption of medical care, while spreading the burden among most enrollees. Each enrollee's out-of-pocket costs would rise by no more than \$25 in 1991. Moreover, because fewer enrollees would have sufficient costs to exceed the deductible, administrative costs for processing claims might be slightly reduced.

The additional out-of-pocket costs under this option might, however, discourage some low-income enrollees who are not eligible for Medicaid from seeking needed care. In addition, the costs to states would increase because their Medicaid programs pay deductible amounts for dual Medicaid/Medicare beneficiaries.

**ENT-15 COLLECT 20 PERCENT COINSURANCE ON
CLINICAL LABORATORY SERVICES UNDER
MEDICARE**

Savings from CBO Baseline	Annual Savings (In millions of dollars)					Cumulative Five-Year Savings
	1991	1992	1993	1994	1995	
Outlays	470	840	970	1,110	1,280	4,670

Medicare currently pays 100 percent of the approved fee for clinical laboratory services provided to enrollees. Medicare's payment is set by a fee schedule, and providers must accept that fee as full payment for the service. Beneficiaries pay coinsurance of 20 percent for most other services provided under Medicare's Supplementary Medical Insurance (SMI) program (as they did for clinical laboratory services before July 1984, when a fee schedule that, among other things, reduced payment rates was implemented).

Reimposing the coinsurance requirement for laboratory services could yield appreciable savings to Medicare. If coinsurance of 20 percent of laboratory fees were imposed beginning January 1, 1991, federal savings would be \$470 million in fiscal year 1991. Savings would total \$4.7 billion over the five-year period from 1991 through 1995, reducing net SMI outlays by about 1 percent.

In addition to reducing Medicare costs, this option would make cost-sharing requirements under the SMI program more uniform and therefore easier to understand. Moreover, enrollees might be less likely to have laboratory tests with little expected benefit if they paid part of the costs.

Cost-sharing probably would not affect enrollees' use of laboratory services substantially, however, because decisions about what tests are appropriate are generally left to physicians, whose decisions do not appear to depend on enrollees' cost-sharing. Hence, although a small part of the savings under this option might be the result of more prudent use of laboratory services, most of the expected savings would reflect the transfer to enrollees of costs now paid by Medicare. Further,

billing costs for some providers, such as independent laboratories, could be greatly increased because they would have to bill both Medicare and the enrollees to collect their full fees. Currently, they have no need to bill enrollees directly.

ENT-16 COLLECT 20 PERCENT COINSURANCE ON ALL HOME HEALTH AND SKILLED NURSING FACILITY SERVICES UNDER MEDICARE

Savings from CBO Baseline	Annual Savings (In billions of dollars)					Cumulative Five-Year Savings
	1991	1992	1993	1994	1995	
Outlays for Home Health	560	800	850	910	970	4,100
Outlays for Nursing	-320	-600	-630	-650	-690	-2,890
Total	240	200	220	260	280	1,210

Currently, no copayments are required from enrollees for home health services under Medicare. Copayments for skilled nursing facility (SNF) services are required for each day after the first 20 days of care; the coinsurance amount per day is equal to one-eighth of the deductible amount for hospital care and is unrelated to SNF costs.

If enrollees were required to pay coinsurance amounts equal to 20 percent of the projected average cost for each home health visit and each SNF day, there would be net savings to Medicare of \$240 million in fiscal year 1991, with higher Medicare costs for SNF services more than offset by savings for home health services. Over the five-year projection period, savings would total \$1.2 billion.

This option, together with the laboratory coinsurance requirement discussed in ENT-15, would establish a uniform coinsurance rate of 20 percent on almost all Medicare services. This uniform rate would make Medicare's copayment requirements easier for providers and patients to understand. Further, because coinsurance amounts would be based on the cost of services, it would encourage those enrollees without supplementary insurance coverage to consider relative costs appropriately when choosing among alternative treatment options. As a result, the use of home health services might fall and the use of SNF services might increase. Only hospital inpatient services would have no copayment requirement (for most stays) except for the deductible

amount. But under the prospective payment system, patients are unlikely to remain hospitalized longer than necessary because hospitals have strong incentives to discharge them quickly.

However, many enrollees have supplementary insurance coverage that eliminates their Medicare copayment costs, and this option would have no effect on the use of services by those enrollees. Moreover, this option would increase the risk of very large out-of-pocket costs for about 25 percent of enrollees without any supplementary coverage, and would probably increase medigap premiums for about 45 percent of enrollees who purchase supplementary insurance for themselves.

ENT-17 TAX EMPLOYER-PAID HEALTH INSURANCE

Addition to CBO Baseline	Annual Added Revenues (In billions of dollars)					Cumulative Five-Year Addition
	1991	1992	1993	1994	1995	

Tax Some Employer-Paid Health Insurance

Income Tax	3.4	5.9	6.3	6.9	7.7	30.2
Payroll Tax ^a	1.9	3.3	3.5	3.7	4.1	16.5
Total	5.4	9.2	9.7	10.6	11.7	46.7

**Tax Employer-Paid Health Insurance, but Allow a Credit
for Some Employer and Individual Contributions**

Income Tax	1.9	3.3	3.6	3.8	4.1	16.6
Payroll Tax ^a	8.7	14.9	15.6	16.4	17.2	72.8
Total	10.6	18.2	19.2	20.2	21.3	89.4

a. Net of reduced income tax revenues.

Employees do not pay taxes on income received in the form of employer-paid health care coverage. This exclusion will reduce income tax revenues and Social Security payroll tax revenues by a total of about \$48 billion in 1991.

Tax Some Employer-Paid Health Insurance. One way to limit the exclusion would be to treat as taxable income for employees any employer contributions (including those in cafeteria plans and flexible spending accounts) that exceed \$250 a month for family coverage and \$100 a month for individual coverage (in 1991 dollars); these amounts would be indexed to reflect future increases in the general level of prices. This option, which would affect about 50 percent of individual tax filing units in 1991, would raise income tax revenues by about \$30 billion and payroll tax revenues by about \$17 billion over the 1991-1995 period. Including employer-paid health care coverage in the Social Security wage base, however, would lead to increased outlays on benefit payments that would offset most of the added payroll tax revenues from this option over the long run. The option would also

raise the state income tax liabilities of individuals in those states with tax bases linked to the federal tax base, unless those states took offsetting actions.

An advantage of this approach is that it would eliminate the tax incentive to purchase additional coverage beyond the ceiling. Without such coverage, there would be stronger incentives to economize in the medical marketplace, thereby reducing upward pressure on medical care prices. Over the long run, indexing the ceilings would limit their erosion by inflation. Finally, the Congress has already limited the exclusion for employer-paid, group term life insurance in a similar way (see REV-12).

One disadvantage of limiting the tax subsidy is the difficulty of determining just when extensive coverage becomes excessive. Moreover, a uniform ceiling would have uneven effects, since a given employer's contribution purchases different levels of coverage depending on such factors as geographic location and the demographic characteristics of the firm's work force. Finally, if health insurance costs continue to rise faster than the general level of prices, the indexing provision of this option would gradually reduce subsidies for employer-paid health insurance. This effect is of concern to people who argue that current subsidies for private-sector benefits help avoid the need for public provision of similar benefits.

Tax Employer-Paid Health Insurance, but Allow a Credit for Some Employer and Individual Contributions. Another option would be to treat all employer-paid health insurance premiums as taxable income, but offer an individual income tax credit of 20 percent for health insurance premiums up to the amounts described above for family and individual coverage. The credits would be available to taxpayers regardless of whether the coverage was paid for or sponsored by an employer. At this credit percentage and with these premium ceilings, the proposal would increase income tax revenues by about \$17 billion over the 1991-1995 period. If there were no credit, taxing all employer-paid premiums would increase income tax revenues by \$133 billion. The new income tax credit would reduce revenues by \$117 billion. Payroll tax revenues would also rise substantially, by about \$73 billion over the same period. As under the first option, however, increases in Social Security outlays would offset most of the added payroll tax revenues in the long run. This alternative would substantially raise the state

income tax liabilities of individuals in states with tax bases linked to the federal tax base, unless these states took offsetting actions.

In addition to eliminating the tax incentive to purchase health insurance above the limits, as under the first alternative, an added advantage of this option is that the subsidy would be made available to all taxpayers having health insurance, without regard to their employment status. Moreover, the subsidy per dollar's worth of the eligible health insurance would no longer be higher for taxpayers with higher marginal tax rates (and higher incomes).

A drawback of this option is that the benefits of the tax credit would not be available to low-income individuals and families who have no liability under the federal personal income tax, unless the credit were made refundable. Such a refund, however, would substantially reduce the net revenue gain discussed above. Moreover, as with the first option, opponents of this one have several concerns: it would be difficult to determine at what level health insurance coverage becomes excessive, effects would vary among geographic areas, and the subsidy for health insurance would be likely to decline over time.

**ENT-18 INCREASE THE STATES' SHARE OF
COSTS FOR AFDC, MEDICAID, AND
FOOD STAMP BENEFITS**

Savings from CBO Baseline	Annual Savings (In millions of dollars)					Cumulative Five-Year Savings
	1991	1992	1993	1994	1995	

**Reduce the Floor on the AFDC and Medicaid
Matching Rate to 45 Percent**

Budget Authority	2,700	2,950	3,250	3,550	3,900	16,250
Outlays	2,700	2,950	3,250	3,550	3,900	16,250

**Require States to Pay for
a Portion of Food Stamp Benefits**

Budget Authority	700	720	760	800	830	3,800
Outlays	700	720	760	800	830	3,800

The Aid to Families with Dependent Children (AFDC) program provides cash assistance to low-income families with children in which one parent is absent or incapacitated, or to families in which the primary earner is unemployed. The Medicaid program provides medical assistance to low-income people who are recipients of Supplemental Security Income (SSI), current or recent recipients of AFDC, and certain other low-income people. The Food Stamp program provides coupons redeemable for food to low-income households to enable them to buy a nutritionally adequate low-cost diet.

The federal government and the states jointly fund benefits in the AFDC and Medicaid programs, whereas the federal government currently funds Food Stamp benefits with no state contribution. This option would lower federal costs for benefits in each of the programs, generating savings of \$3.4 billion in 1991 and \$20.1 billion over the next five years.

Reduce the Floor on the AFDC and Medicaid Matching Rate to 45 Percent. The federal share of costs for both the AFDC and Medicaid programs varies with the state's per capita income, with high-income states paying for a larger share of benefits than low-income states. By

law, the federal share can be no less than 50 percent and no more than 83 percent. The 50 percent federal floor applies to 13 jurisdictions in fiscal year 1991: Alaska, California, Connecticut, Delaware, the District of Columbia, Illinois, Maryland, Massachusetts, Nevada, New Hampshire, New Jersey, New York, and Virginia. The current system of setting the federal matching rate, a sliding scale with a floor, requires low- and middle-income states to pay for a greater share of AFDC benefits and Medicaid costs relative to income than it requires of high-income states. If the floor were reduced to 45 percent, the federal contribution levels would be more directly related to state income.

Federal savings for the AFDC program would be \$0.6 billion in 1991 and \$3.4 billion over the 1991-1995 period; outlays for Medicaid would be reduced by \$2.1 billion in 1991 and \$12.9 billion over the five-year period. An alternative option--lowering the floor on the matching rate only to 48 percent--would reduce the combined five-year savings from AFDC and Medicaid to \$7.0 billion.

Seven of the 13 jurisdictions affected by this proposal paid AFDC benefits in 1989 that were in the upper third when states were ranked by the size of benefits. The higher benefit levels in these states mean that more families are eligible for AFDC and, hence, automatically eligible for Medicaid. Some argue that if the high-income states wish to be more generous, they should pay a higher portion of the cost to reflect more accurately their greater tax capacity.

Nevertheless, the high incomes and benefit levels in these states may in part reflect higher costs of living. Moreover, relatively large savings from this proposal would come from four states--California, Massachusetts, New Jersey, and New York--which have just under three-fourths of the AFDC recipients of all affected states, but would bear about 86 percent of the new costs. If this proposal were adopted, the states affected would need to compensate for the lost federal grants by reducing AFDC and Medicaid benefits, lowering spending on other state services, or raising taxes. If states chose to compensate by reducing AFDC and Medicaid benefits, recipients of these programs would be adversely affected, while federal savings would be greater.

Require States to Pay for a Portion of Food Stamp Benefits. The Food Stamp program offers coupons redeemable for food to individuals and families with low incomes and low levels of assets. The federal gov-

ernment funds all benefits, but states pay one-half of most state and local administrative costs. This proposal would require the states to share a proportion of Food Stamp benefit costs. For illustration, the table shows federal savings when states pay 5 percent of those costs--\$0.7 billion in 1991 and \$3.8 billion over the 1991-1995 period.

Paying a share of benefits would increase the states' financial stake in the program, which could cause them to improve their program administration. Currently, they are penalized only when their errors in determining benefits exceed a certain rate. In addition, states currently have little financial incentive to design employment and training programs that will successfully move able-bodied recipients off the Food Stamp program and into jobs. This option would provide such an incentive.

Since benefits in the Food Stamp program are determined by the same rules nationwide, however, this approach would be more difficult for low-income states to fund than for high-income states. In addition, states might object to paying a share of the cost of benefits for a program in which they have no discretion to set either conditions for eligibility or benefit levels.

**ENT-19 REDUCE THE MATCHING RATE FOR
ADMINISTRATIVE COSTS IN AFDC,
MEDICAID, AND FOOD STAMPS**

Savings from CBO Baseline	Annual Savings (In millions of dollars)					Cumulative Five-Year Savings
	1991	1992	1993	1994	1995	
Reduce Most Higher Matching Rates to 50 Percent						
Budget Authority	290	320	350	380	420	1,750
Outlays	290	320	350	380	420	1,750
Reduce Most Matching Rates to 45 Percent						
Budget Authority	720	780	840	910	980	4,200
Outlays	720	780	840	910	980	4,200

The Aid to Families with Dependent Children (AFDC) program provides cash assistance to low-income families with children in which one parent is absent or incapacitated, or to families in which the primary earner is unemployed. The Medicaid program provides medical assistance to low-income people who are recipients of Supplemental Security Income (SSI), current or recent recipients of AFDC, and certain other low-income people. The Food Stamp program provides coupons redeemable for food to low-income households to enable them to buy a nutritionally adequate low-cost diet.

The federal government pays half of most administrative costs in all three programs; state and local governments pay the remaining share. Higher matching rates have been instituted for some types of expenses as an incentive for local administrators to undertake more of a particular administrative activity than they would if such expenses were matched at 50 percent. For example, enhanced matching rates are applied in all of these programs to the costs of some computer operations and some antifraud activities. In addition, in the Food Stamp program, states that reduce errors leading to overpayment of benefits are rewarded with a slightly higher matching rate for all administrative expenses. In 1988, however, only two states qualified for this enhanced matching rate. Finally, the Family Support Act of

1988 introduced enhanced matching rates for operating expenses and some administrative costs of the new Job Opportunities and Basic Skills (JOBS) program.

The administrative activities matched at higher rates currently represent a relatively small proportion of all administrative costs in the Food Stamp and AFDC programs, but constitute a larger share of Medicaid administrative costs. In the Food Stamp and AFDC programs, administration mainly consists of determining eligibility and benefit amounts. In the Medicaid program, however, determining eligibility represents a relatively small share of administration, since the AFDC and SSI programs largely carry out this function. Consequently, activities that are matched at higher rates--including the costs of automated claims processing, reviewing medical and health care use, and establishing and operating a fraud control unit--constitute a much higher percentage of Medicaid administrative costs.

Reducing most of the higher matching rates to 50 percent in the three programs would decrease federal outlays by \$0.3 billion in 1991 and by \$1.8 billion over the 1991-1995 period. Over 85 percent of the reduction would be in the Medicaid program. Because of the importance of computers for administrative efficiency, this option would not lower the higher matching rates for establishing computer systems in the Food Stamp and AFDC programs. In addition, the recently enacted enhanced matching rates for expenses associated with the JOBS program would also be left in place. Nonetheless, the 50 percent rate would apply to almost all administrative spending in the three programs.

Considerably greater savings would be generated if most of the matching rates were reduced to 45 percent, since an additional 5 percent of almost all current administrative expenses would be shifted to the states. Federal outlays would fall by \$0.7 billion in 1991 and by \$4.2 billion over the 1991-1995 period. About 60 percent of the savings would be in Medicaid, with the remainder split about equally between the AFDC and Food Stamp programs. The same exceptions as described above were assumed to apply to this option as well.

Reducing most higher matching rates to 50 percent might be appropriate because the need to provide special incentives for these activities no longer exists. This option would most affect the Medicaid

program, for which all states have already established computer systems and are currently operating fraud and abuse units. Reducing most matching rates to 45 percent would provide states with stronger incentives in all three programs to reduce administrative inefficiencies, since the states would be liable for a greater share of the cost of such inefficiencies.

States might respond to either version of this option by reducing their administrative efforts, however, and might thereby raise program costs and offset some of the federal savings. Specifically, AFDC and Food Stamp benefits might increase if errors or fraud occurred more often in spite of the penalties states already face when errors exceed a certain rate. States might also make less effort to eliminate waste and abuse in payments to providers under Medicaid, especially if the matching rates that apply to antifraud activities were cut. In addition, this proposal might harm recipients by encouraging states to slow the growth of benefits over time or to limit services provided under Medicaid in order to constrain state costs. Alternatively, other state services would have to be cut or state taxes would have to be raised to cover the states' higher share of administrative costs.

**ENT-20 REQUIRE A TWO-WEEK WAITING PERIOD
FOR UNEMPLOYMENT INSURANCE BENEFITS**

Savings from CBO Baseline	Annual Savings (In millions of dollars)					Cumulative Five-Year Savings
	1991	1992	1993	1994	1995	
Outlays	--	1,100	1,150	1,150	1,200	4,600

NOTE: These estimates assume that the requirement becomes effective in fiscal year 1992 to allow time for changes in state Unemployment Insurance laws.

Current federal law imposes no mandatory waiting period before jobless workers can receive Unemployment Insurance (UI) benefit payments, although the Omnibus Reconciliation Act of 1980 does require states to adopt a one-week waiting period on regular UI benefit payments or lose some federal benefits under the extended UI program. About three-quarters of the states now require a one-week waiting period for regular UI benefits, while the remainder generally have no waiting requirement.

If all jobless workers were required to wait two weeks before receiving UI benefits, program outlays would be reduced and beneficiaries in all states would be treated uniformly. Such a change would not affect the maximum length of time during which jobless workers could collect benefits; for example, a person otherwise eligible for 26 weeks of benefits would retain that eligibility, but would receive payments for the third through the twenty-eighth weeks of joblessness. Benefits would be reduced, however, for those recipients not using the maximum number of covered weeks. If the requirement became effective in 1992 (to allow time for states to change their UI laws), this option would cut UI outlays by nearly 7 percent, or by \$4.6 billion during the 1992-1995 period.

This option would reduce the incentive of workers to become unemployed and collect UI benefits by increasing the initial cost of joblessness; yet it would not greatly affect the program's ability to help the long-term unemployed. Restricting aid in this way might lower the number of workers who apply for assistance and would reduce the duration of benefits paid to many who do apply.

However, because this change would reduce the benefits provided to jobless workers who do not use all of their entitlement, it would diminish the income support role of UI. Moreover, the change would reduce the unified budget deficit primarily by reducing state--rather than federal--spending because the bulk of the savings would result from reductions in UI benefits provided by the states. The budgetary savings resulting from this option could be diminished in the future if states liberalized other UI benefit provisions or reduced their UI taxes.

**ENT-21 END OR SCALE BACK TRADE
ADJUSTMENT ASSISTANCE**

Savings from CBO Baseline	Annual Savings (In millions of dollars)					Cumulative Five-Year Savings
	1991	1992	1993	1994	1995	
End Trade Adjustment Assistance						
Budget Authority	220	220	230	230	230	1,150
Outlays	220	220	230	230	230	1,150
Eliminate Trade Adjustment Assistance Cash Benefits						
Budget Authority	150	150	150	150	150	750
Outlays	150	150	150	150	150	750

The Trade Adjustment Assistance (TAA) program offers income replacement benefits, training, and related services to workers unemployed because of import competition. To obtain assistance, such workers must first petition the Secretary of Labor for certification and then meet other requirements for eligibility. Cash benefits are available to certified workers receiving training, but only after their unemployment insurance benefits are exhausted.

Ending the TAA program would reduce federal outlays by \$220 million in 1991 and by \$1.1 billion during the 1991-1995 period. Affected workers could apply for benefits under Title III of the Job Training Partnership Act (JTPA), which authorizes a broad range of employment and training services for displaced workers regardless of the cause of their job loss. Given that funding for Title III is limited, however, another alternative would be to eliminate only TAA cash benefits and shift the remaining TAA funds for training and related services to Title III. Savings under this option would total \$750 million from 1991 through 1995.

The rationale for these options is to secure more equivalent treatment under federal programs of workers who are permanently displaced as a result of changing economic conditions. Since Title III of JTPA provides cash benefits only under limited circumstances, work-

ers who lose jobs because of foreign competition are now treated more generously than workers who are displaced for other reasons.

Eliminating TAA cash benefits would, however, cause economic hardship for some of the long-term unemployed who would have received them. In addition, TAA now compensates some of the workers adversely affected by changes in trade policy. Some argue, therefore, that eliminating TAA benefits could lessen political support for free trade, which economists generally view as beneficial to the overall economy.

**ENT-22 REDUCE THE SUBSIDY IN CHILD
NUTRITION PROGRAMS FOR CHILDREN
FROM HIGHER-INCOME FAMILIES**

Savings from CBO Baseline	Annual Savings (In millions of dollars)					Cumulative Five-Year Savings
	1991	1992	1993	1994	1995	
Budget Authority	410	450	470	500	520	2,350
Outlays	360	440	470	500	520	2,300

Federal child nutrition programs were developed to improve the health and well-being of children by providing them with nutritious meals. The programs provide cash and commodity assistance to schools, child care centers, and family day care homes that serve meals to children.

Although most of the funds are targeted toward low-income children, some of the aid benefits middle- and upper-income children as well. For example, in the National School Lunch Program (the largest of the child nutrition programs), most schools receive \$1.53 in cash reimbursement for each meal served to children from households with incomes at or below 130 percent of the poverty line; a smaller subsidy of \$1.13 for each meal served to children from households with incomes between 130 percent and 185 percent of poverty; and a subsidy of 15 cents per meal for children with household incomes above 185 percent of poverty. Schools are also given approximately 13 cents' worth of commodities for each lunch served, regardless of the household income of the child. Comparable reimbursement structures are used in the School Breakfast Program and in the portion of the Child Care Feeding Program devoted to child care centers.

Eliminating the cash reimbursement for all meals served in schools and child care centers to children from households with incomes above 185 percent of the poverty line (about \$22,400 per year for a family of four in the 1989-1990 school year) would reduce federal expenditures by about \$0.4 billion in 1991, and by nearly \$2.3 billion during the 1991-1995 period. In these estimates, CBO assumes that the reductions in federal subsidies would lead some schools to discontinue the program for all students. The savings resulting from schools

dropping out of the program are relatively small (\$120 million over five years), since the schools most likely to drop out are those serving relatively few meals to children from families with incomes below 185 percent of poverty.

Although most of the federal funds are targeted toward low-income children, an estimated 53 percent of the school lunches served in fiscal year 1989 went to children whose household income was above 185 percent of the poverty line. These children are less in need of federal subsidies, and the targeting of this assistance would be improved by limiting it to those from households with the lowest incomes.

Such a change might, however, result in lower participation among nonpoor children because participation falls when prices are raised. Participating schools and child care centers would probably make up the loss in reimbursements by increasing the price charged to nonpoor children unless state and local governments provided additional support. Children who dropped out of the program could receive meals of lower quality, since the meals qualifying for reimbursement are nutritionally adequate, while those from alternative sources might not be. Moreover, if the decline in participation were substantial, low-income children could become the main recipients of the meals and thus would be identifiable as poor by their peers. Finally, some schools and child care centers where nonpoor children provide a large share of the total revenue for the meal program would probably drop out when participation fell, thereby eliminating federally subsidized meals for some low-income children.

**ENT-23 ELIMINATE THE \$50 CHILD-SUPPORT
PAYMENT TO AFDC FAMILIES**

Savings from CBO Baseline	Annual Savings (In millions of dollars)					Cumulative Five-Year Savings
	1991	1992	1993	1994	1995	
Budget Authority	120	130	140	150	150	680
Outlays	120	130	140	150	150	680

The Child Support Enforcement (CSE) program collects child-support payments from absent parents on behalf of families receiving Aid to Families with Dependent Children (AFDC). These payments are used to offset federal and state costs for AFDC. Amounts up to the first \$50 in monthly child support collected, however, are paid to the AFDC family, with no effect on the level of AFDC benefits. In essence, this policy means that AFDC families for whom absent parents contribute child support get as much as \$50 more per month than do otherwise identical families for whom such contributions are not made. (This policy is sometimes referred to as the child-support disregard in the AFDC program, since it is equivalent to not counting the first \$50 of child support as income in calculating AFDC benefits.)

Eliminating the \$50 child-support payment to AFDC families would save the federal government \$120 million in fiscal year 1991 and \$680 million over the next five years. Stopping such payments would also end the differential treatment of AFDC families that depends on whether the absent parent pays child support.

Nevertheless, the child-support payment continues to provide incentives for custodial parents to make an effort to obtain support. If the payment were eliminated, AFDC recipients would be no better off when absent parents paid child support than if no child support were paid. If this option made them less cooperative in seeking such payments, savings would be less than estimated. In addition, the requirement of the Family Support Act of 1988 that child-support payments be withheld from the pay of absent parents may be difficult to enforce in some cases--especially for parents who live in different

states from their children or who do not have steady employment. These parents might reduce their child-support payments if this option were enacted, thereby adversely affecting the well-being of their children.

**ENT-24 REDUCE THE FEDERAL MATCHING RATE
FOR CHILD-SUPPORT ENFORCEMENT COSTS**

Savings from CBO Baseline	Annual Savings (In millions of dollars)					Cumulative Five-Year Savings
	1991	1992	1993	1994	1995	
Budget Authority	320	350	370	400	420	1,850
Outlays	320	350	370	400	420	1,850

Enacted in 1975, the Child Support Enforcement (CSE) program provides administrative tools and funding for states to improve the payment of child support by absent parents. Legislation enacted in 1988 strengthened efforts to enforce child support in a number of ways, including mandating that states use child-support guidelines in making awards and requiring employers to withhold child-support payments from wages even when payments are not in arrears. The federal government helps states finance their CSE efforts by paying 66 percent of the costs and making incentive payments. Because of this federal funding and because they keep a portion of child-support collections, states saved an estimated \$400 million in 1989, relative to having no CSE program. In contrast, the federal government incurred costs in 1989 of about \$450 million, net of its share of child-support collections.

Reducing the federal share of CSE costs would alter the balance of costs and savings between the federal and state governments, decreasing both federal costs and state savings. Lowering the federal matching rate to 50 percent in 1991 and subsequent years is estimated to save about \$320 million in 1991 and almost \$1.9 billion over five years, although the amount of savings could vary, depending on how states reacted to the change. Furthermore, while a higher matching rate may have been needed in the past to induce states to set up CSE programs, such programs are now fully operating and states cannot dismantle them without financial penalty. Even with a 50 percent matching rate, states would continue to save money. Finally, this option would encourage states to improve the efficiency of their CSE efforts, since they would pay a larger share of the costs of inefficiencies, and could thus lead to even lower program costs overall.

Lowering the matching rate would entail some risks, however. Because states probably could not improve efficiency enough to offset fully the reduction in federal payments, they might cut CSE services, thereby reducing child-support collections on behalf of both welfare and nonwelfare families. While the lower CSE collections for AFDC families would decrease state revenues from that source, states still might be better off financially, since they may receive only a small share--in the extreme, less than 20 percent--of moneys collected. Further, states receive only small financial benefits from child-support collections for non-AFDC families. They might, therefore, be even more likely to cut back on efforts for those families, thereby lowering the children's living standards.

ENT-25 RESTRICT COST-OF-LIVING ADJUSTMENTS IN NON-MEANS-TESTED BENEFIT PROGRAMS

Savings from CBO Baseline	Annual Savings (In millions of dollars)					Cumulative Five-Year Savings
	1991	1992	1993	1994	1995	
Eliminate COLAs for One Year						
Social Security/ Railroad Retirement	7,600	10,400	10,500	10,450	10,200	49,150
Other Non-Means- Tested Programs	2,000	2,750	2,800	2,950	3,050	13,600
Offsets in Means- Tested Programs and Medicare Premiums	-620	-810	-830	-870	-910	-4,050
Total	9,000	12,300	12,500	12,550	12,350	58,700
Limit COLAs to Two-Thirds of the CPI Increase for Five Years						
Social Security/ Railroad Retirement	2,600	6,250	10,150	14,250	18,450	51,750
Other Non-Means- Tested Programs	680	1,650	2,700	3,850	5,000	13,900
Offsets in Means- Tested Programs and Medicare Premiums	-80	-320	-610	-940	-1,300	-3,250
Total	3,200	7,600	12,250	17,150	22,200	62,400
Limit COLAs to the CPI Increase Minus Two Percentage Points for Five Years						
Social Security/ Railroad Retirement	3,700	8,950	14,450	20,200	26,100	73,400
Other Non-Means- Tested Programs	990	2,350	3,800	5,450	7,050	19,650
Offsets in Means- Tested Programs and Medicare Premiums	-120	-400	-750	-1,150	-1,550	-3,950
Total	4,550	10,900	17,500	24,500	31,650	89,100
Pay the Full COLA on Benefits Below a Certain Level and 50 Percent of the COLA on Benefits Exceeding That Level for Five Years						
Social Security/ Railroad Retirement	870	2,100	3,450	4,750	6,100	17,300

Outlays for Social Security and other non-means-tested cash transfer programs whose benefits are indexed to the consumer price index (CPI) are expected to total \$310 billion this year and to rise to \$420 billion by 1995 under current policies. Reducing the automatic cost-of-living adjustment (COLA) for these programs is commonly proposed as one way to slow the growth in entitlement spending. Four strategies for reducing COLAs and the savings in outlays resulting from each are shown in the preceding table. The programs in which COLAs would be reduced under the first three options are: Social Security Old-Age, Survivors, and Disability Insurance (OASDI); Railroad Retirement; Civil Service Retirement; Military Retirement; Federal Employees Workers' Compensation; Veterans' Compensation; and retirement benefits for the Foreign Service, the Public Health Service, and the Coast Guard. The fourth option would affect only Social Security and Railroad Retirement Tier I COLAs. Other options for achieving savings in Social Security are given in ENT-26, ENT-27, ENT-28, and REV-16.

COLA restrictions would achieve considerable savings by exacting small reductions in benefits from a large number of people. This broad-based and small effect would be in sharp contrast to other budget options that would impose large reductions in benefits on smaller groups of recipients. Moreover, by limiting these options to the non-means-tested cash benefit programs, many of the poorest beneficiaries of entitlements--for example, recipients of Supplemental Security Income--would be protected from losses of income. Finally, because the benefit levels would be permanently lowered for those eligible when the COLA limitation was established, significant reductions in outlays would persist beyond the five-year projection period. The savings would eventually disappear, however, as beneficiaries died or stopped receiving payments for other reasons, unless the COLA limitation was accompanied by a permanent reduction in the initial benefits of newly eligible workers as well (see ENT-26).

Budget reduction strategies that institute less-than-complete price indexing would, however, result in financial difficulties for some recipients--particularly if COLAs were restricted for an extended period--although excluding means-tested benefit programs would limit the impact for many low-income beneficiaries. COLA reductions also encounter opposition from those who fear that changes made to reduce budget deficits would undermine the entire structure of retirement

income policy. For example, because private pension plans generally do not offer complete indexing, restricting Social Security COLAs would further reduce protection for beneficiaries against inflation. Some people also think that these programs should be altered only gradually and then only for programmatic reasons, because Social Security and other retirement programs represent long-term commitments to both current retirees and today's workers. Thus, any changes in benefits should be announced well in advance to allow people to adjust their long-run plans.

Unless COLA limitations were accompanied by commensurate changes in determining initial benefits for new recipients, disparities in benefit levels would develop among different cohorts of retirees. This situation is particularly relevant for Social Security, where benefits for newly eligible individuals are based on an indexed benefit formula and on indexed earnings histories. For example, if prices rose by 4 percent in a year and the wage index used to compute benefits for newly eligible recipients increased by 5 percent, eliminating that year's COLA without any change in the calculation of initial benefits would result in benefits for new beneficiaries that were about 5 percent higher than for recent retirees; under current law, benefits would be only about 1 percent higher for the new retirees. To mitigate this problem and to achieve additional savings, efforts to slow the growth in benefits through COLA limitations might be extended to the formulas for determining initial benefits (see ENT-26).

Several options that would restrict COLAs for current beneficiaries are examined below. Except for the option to limit COLAs to two percentage points less than the increase in the CPI, the magnitude of the savings in each case--as well as the impact on beneficiaries--would be very sensitive to the level of inflation in the years in which the COLAs would be reduced. If prices were to rise faster than currently assumed, savings would be greater than shown, and recipients would bear larger costs. Alternatively, if prices were to rise less quickly, both budget savings and the effect on recipients would be smaller.

The following sections describe the savings from specific versions of COLA restrictions and discuss any effects unique to the individual versions.

Eliminate COLAs for One Year. One option would be to eliminate COLAs in fiscal year 1991 for non-means-tested benefit programs, while allowing them to be paid in subsequent years, but with no provision for making up the lost adjustment. If this approach were taken, federal outlays would be reduced by about \$9.0 billion in 1991 and \$58.7 billion over five years, with Social Security and Railroad Retirement accounting for most of the total.

Limit COLAs to Two-Thirds of the CPI Increase for Five Years. Under this approach, recipients would be compensated for only a certain proportion of inflation, such as two-thirds of the annual CPI increase. Under current CBO economic assumptions, applying this restriction for five years would save about \$3.2 billion next year and \$62.4 billion over the 1991-1995 period. As a result, benefits for people who received payments throughout the five-year period would be about 5 percent less in 1995 than they would have been under full price indexing. Furthermore, the effects of this option would grow over time, reducing the real income of beneficiaries at the same time that they are becoming less able to supplement their income by working.

Limit COLAs to the CPI Increase Minus Two Percentage Points for Five Years. An approach similar to the proportionate COLA reduction would be to reduce the adjustment by a fixed number of percentage points--for example, set the adjustment at the CPI increase less two percentage points. Unlike other options to restrict COLAs, however, both savings and effects on beneficiaries would be roughly the same regardless of the level of inflation--about \$89.1 billion over the next five years, if extended for the full period. As in the last option, this approach would be cumulative and would therefore significantly reduce the real incomes of beneficiaries at the same time that their ability to supplement their incomes by working declines.

Pay the Full COLA on Benefits Below a Certain Level and 50 Percent of the COLA on Benefits Exceeding That Level for Five Years. Another alternative would tie the COLA reductions to beneficiaries' payment levels, starting in 1992. The example discussed here--based only on Social Security and Railroad Retirement Tier I benefits--would award the full COLA for benefits based on the first \$500 of a retiree's monthly Primary Insurance Amount (PIA) and 50 percent of the COLA on benefits above this level. The \$500 per month threshold is about

equal to the 1990 poverty threshold for an elderly person and would be indexed to maintain its value over time.

This approach would save about \$2.1 billion in 1992 and \$16.4 billion over the 1992-1995 period. Because the Social Security Administration has stated that this proposal could not be implemented in time to affect the January 1991 COLA, these estimates assume that it would be in place by January 1992. For comparison with other options--which could be carried out earlier--the 1991-1995 budget savings would be \$17.3 billion if this option were effective for the January 1991 COLA.

Because the full COLA would be paid to beneficiaries with low PIAs, this option would ensure that low-income recipients would not be adversely affected. Moreover, its percentage impact would be greater for recipients with higher benefits. Nonetheless, benefit levels are not always good indicators of total income. Some families with high benefits have very little other income, while some with low benefits have substantial income from other sources. Furthermore, many people object to any changes in retirement programs that might be construed as introducing a means test for benefits, even if the test is limited only to the COLA.

A variation would extend this approach to include the other non-means-tested benefit programs besides Social Security; this variation is not shown in the table. Such an option would spread the effects among a wider group of recipients, although it might be somewhat more complicated to design because the different benefit structure in each program could require separate determinations of the appropriate benefit levels on which to pay reduced COLAs.

Eliminating COLAs for recipients whose benefits are based on PIAs above a certain level is another option. Because this reduction would affect the entire benefit of each recipient above the threshold, not just the portion of the benefit above that level, both the savings and the impacts on beneficiaries would be considerably greater. Moreover, unless adjustments were made at the threshold, recipients with benefits just below the threshold could be made better off than those with benefits just above the threshold. Still another approach that would

address some of the administrative problems of these two options would involve increased taxation of Social Security benefits (see REV-16).

**ENT-26 REDUCE THE REPLACEMENT RATE WITHIN
EACH BRACKET OF THE SOCIAL SECURITY
BENEFIT FORMULA**

Savings from CBO Baseline	Annual Savings (In millions of dollars)					Cumulative Five-Year Savings
	1991	1992	1993	1994	1995	
Outlays	130	550	1,150	1,800	2,700	6,350

Under current law, the basic Social Security benefit is determined by a progressive formula that provides workers with 90 percent of their Average Indexed Monthly Earnings (AIME) up to the first bend point (which defines the first earnings bracket), plus 32 percent of the AIME in the second bracket, plus 15 percent of the AIME above the second bend point. One method of reducing initial Social Security benefits would be to lower these three rates by a uniform percentage.

Lowering the three rates in the benefit formula from 90, 32, and 15 to 85.5, 30.4, and 14.2, respectively, would achieve an essentially uniform 5 percent reduction in the benefits of newly eligible workers starting in 1991. Thus, a 62-year-old retiree who has always earned the average wage would receive initial benefits in 1990 of about 34 percent of preretirement earnings, compared with 32 percent if no change were made.

This reduction in the replacement rates would lower Social Security outlays by about \$6.3 billion over the 1991-1995 period and by more in later years. Moreover, this option would reduce the benefits of all future retirees by essentially the same percentage. Furthermore, the option could be combined with a cut in the cost-of-living adjustment to ensure that benefits for both current and future recipients would be reduced to a similar extent (see ENT-25). The combination would generate substantial budgetary savings, while having roughly the same impact on all current and future beneficiaries.

Some people contend that the Social Security Amendments of 1983 have already sharply reduced the benefits of future retirees and that further reductions would be unfair. In particular, the age at which un-

reduced Social Security retirement benefits are first available will rise in stages from 65 to 67 for workers turning age 62 between the years 2000 and 2022. As a consequence, benefits for workers retiring after the turn of the century will be less than what would have been received had the full retirement age not been increased. For example, a worker who retires at age 62 in 2022 will receive 70 percent of the Primary Insurance Amount rather than 80 percent.

An alternative method of reducing Social Security benefits would leave replacement rates unchanged but narrow the AIME brackets over which those rates apply, perhaps by reducing the pace at which the brackets are indexed for inflation. This approach would exempt beneficiaries with the lowest AIMEs from the cut, but would impose benefit reductions unevenly among other recipients.

**ENT-27 ELIMINATE SOCIAL SECURITY BENEFITS
FOR CHILDREN OF RETIREES AGES 62-64**

Savings from CBO Baseline	Annual Savings (In millions of dollars)					Cumulative Five-Year Savings
	1991	1992	1993	1994	1995	
Outlays	80	250	440	560	580	1,900

Unmarried children of retired workers are eligible for Social Security benefits for dependents as long as they are under age 18, or attend elementary or secondary schools and are under age 19, or become disabled before age 22. A child's benefit is equal to one-half of the parent's basic benefit, subject to a dollar limit on the maximum amount receivable by any one family. If such benefits were eliminated for the children of retirees ages 62 through 64, beginning with retirees reaching age 62 in October 1990, the savings would total \$1.9 billion over the next five years.

This option might encourage some early retirees to stay in the labor force longer. At present, though benefits for retired workers and their spouses are actuarially reduced if retirement occurs before age 65, children's benefits are not. Further, the younger the workers are, the more likely they are to have children under age 18. Thus, workers under age 65 now have an incentive to retire while their children are still eligible for benefits. This incentive is quite small, however, for families in which spouses are also entitled to dependents' benefits. For these families, the maximum family benefit generally limits the increase in total benefits attributable to eligible children to no more than 38 percent of the worker's Primary Insurance Amount.

However, for families with workers whose retirement was not voluntary--because of poor health or unemployment, for example--the loss in family income might cause some hardship. Moreover, since spouses under age 62 receive benefits only if their children under age 16 also receive benefits, eliminating children's benefits for families of early retirees would also result in the loss of entire benefits for spouses in some families. In such cases, the total loss of income could be large.

**ENT-28 LENGTHEN THE SOCIAL SECURITY BENEFIT
COMPUTATION PERIOD BY THREE YEARS**

Savings from CBO Baseline	Annual Savings (In millions of dollars)					Cumulative Five-Year Savings
	1991	1992	1993	1994	1995	
Outlays	25	110	290	560	860	1,850

Social Security retirement benefits are based on the Average Indexed Monthly Earnings (AIME) of workers in employment covered by the system. At present, the number of years that must be included in the benefit computation formula is determined by the year in which the retiree reaches age 62. People who turn age 62 in 1990 must count 34 years, while those reaching age 62 in 1991 or later must count 35 years. Lengthening the averaging period even more would generally lower benefits slightly, by requiring more years of lower earnings to be factored into the benefit computation. One option would continue to increase the AIME computation period until it reaches 38 years for people turning age 62 in 1994 or beyond. This approach would save \$1.9 billion over the next five years and more in later years.

One argument for a longer computation period is that people are now living longer and the normal retirement age for the Social Security program will be raised beginning in the year 2000. Using more years to calculate the AIME would also lower Social Security outlays and would reduce incentives for early retirement. In addition, lengthening the averaging period would reduce the advantage that workers who postpone entering the labor force have over those who get jobs at younger ages. Because many years of low or no earnings can be ignored in calculating AIME, the former group currently experiences little or no loss of benefits for their additional years spent not working and thus not paying Social Security taxes.

Because some beneficiaries elect early retirement for such reasons as poor health or unemployment, an argument against this proposal is that a longer computation period would reduce benefits for recipients who are least able to continue working. Other workers who would be disproportionately affected include those with significant periods

outside the Social Security system, such as parents--usually women--who interrupted their careers to rear children, and workers who experienced long periods of unemployment or employment not covered by Social Security.

**ENT-29 RESTRICT ELIGIBILITY FOR VETERANS'
COMPENSATION PAYMENTS**

Savings from CBO Baseline	Annual Savings (In millions of dollars)					Cumulative Five-Year Savings
	1991	1992	1993	1994	1995	

**Adopt Three Measures Ending Compensation Payments for All
Veterans with Low-Rated Disabilities and for New Veterans
with Disabilities Unrelated to Military Duties^a**

Budget Authority	1,200	1,400	1,550	1,750	2,000	7,900
Outlays	1,650	1,850	2,000	2,150	2,300	9,900

End Disability Benefits for Low-Rated Disabilities

Budget Authority	1,450	1,500	1,600	1,650	1,700	7,900
Outlays	1,350	1,500	1,550	1,650	1,700	7,800

**End Dependents' Allowances for Veterans
with Low-Rated Disabilities**

Budget Authority	270	280	290	310	320	1,450
Outlays	260	280	290	310	320	1,450

**End Disability and Death Compensation Awards in Future
Cases When a Disability Is Unrelated to Military Duties**

Budget Authority	-520	-420	-310	-180	-40	-1,450
Outlays	20	75	140	220	310	770

a. This option combines the three measures shown separately below. Aggregate savings would be less than the sum of the savings from carrying out each more specific measure on its own because some new disabilities may be both low-rated and unrelated to military duties.

Approximately 2.2 million veterans with service-connected disabilities receive veterans' disability compensation benefits. Service-connected disabilities are currently defined as those resulting from diseases, injuries, or other physical or mental impairments that occurred or were aggravated during military service, excluding those resulting from willful misconduct. Disabilities need not be incurred or aggravated while performing military duties to be considered service connected; for example, disabilities incurred while on leave qualify.

The amount of compensation is based on a rating of the individual's impairment and an average reduction in the ability to earn wages in civilian occupations. Demonstrated loss of income, however, is not a requirement for eligibility. Veterans' disability ratings range from 0 percent to 100 percent (most severe). Veterans unable to maintain gainful employment who have ratings of at least 60 percent are eligible to be paid at the 100 percent disability rate. Additional allowances are paid to veterans who have disabilities rated 30 percent or higher and who have dependent spouses, children, or parents. Receiving veterans' disability compensation does not affect the level of Social Security disability benefits to which an individual may be entitled.

Currently, 1.2 million veterans have disability ratings below 30 percent and they receive benefits of between \$76 and \$144 per month. Of the 680,000 veterans receiving dependents' allowances, about 420,000 have disability ratings of 30 percent, 40 percent, or 50 percent; their dependents' allowances average \$49 monthly. According to a 1989 survey by the Department of Veterans Affairs (VA), compensable injuries or diseases were unrelated to the performance of military duties for about 50 percent of veterans receiving compensation payments, while the relationship to military duties was uncertain for a further 5 percent. Nearly half the veterans compensated for disabilities unrelated to military duties, however, would be eligible for military retirement benefits if their veterans' compensation claims were denied. (This offset is reflected in the table.)

Federal outlays could be reduced by \$9.9 billion between 1991 and 1995 by adopting three measures that would target veterans' compensation payments on those with higher-rated disabilities and, for new veterans, on those with disabilities related to military duties. Ending disability benefits for low-rated disabilities would, on its own, achieve more than three-quarters of these savings. None of these measures would affect veterans' eligibility for Social Security disability benefits.

Eliminating compensation benefits for those with disability allowances below 30 percent would target spending for disabled veterans on the most impaired. Because performance on civilian jobs depends less on physical labor than when the disability ratings were originally set, and because improved reconstructive and rehabilitative techniques are now available, physical impairments rated below 30 percent may not

reduce veterans' earnings. Low-rated disabilities include conditions such as mild arthritis, moderately flat feet, or amputation of part of a finger--conditions that would not affect the ability of veterans to work in many occupations today.

Similarly, eliminating dependents' benefits for veterans with disability ratings of 30 percent to 50 percent would target compensation on the families of those disabled veterans who are most impaired. In addition, the continuing increase in the proportion of households where both spouses work means that dependents' allowances for veterans with disability ratings below 60 percent may not be necessary to maintain adequate family incomes.

Ending disability and death compensation awards in future cases when a disability is neither incurred nor aggravated while performing military duties would make disability compensation of military personnel comparable with disability compensation of federal civilian employees under workers' compensation arrangements. In both cases, diseases, injuries, or impairments unrelated to employment tasks would not create an entitlement to compensation. The VA's formal appeals system could be extended to cover rulings that disabling conditions were unrelated to military duties.

Some disabled veterans--especially older ones who have retired--might, however, find it difficult to increase their working hours or otherwise make up the loss in compensation payments. Moreover, removing dependents' allowances because a spouse may have income could be interpreted as an indirect means test on veterans' family income--a test that uses a poor proxy for this income. One objection to the last measure is that, because military personnel are assigned to particular geographic locations where situations may sometimes be volatile, they have less control than civilians over where they spend their off-duty hours.

**ENT-30 RAISE THE LOAN FEE FOR HOUSING
LOANS GUARANTEED BY THE
DEPARTMENT OF VETERANS AFFAIRS**

Savings from CBO Baseline	Annual Savings (In millions of dollars)					Cumulative Five-Year Savings
	1991	1992	1993	1994	1995	
Raise Maximum Fee to 2 Percent						
Budget Authority	85	130	120	130	130	590
Outlays	95	95	90	65	35	390
Raise Maximum Fee to 4 Percent						
Budget Authority	75	120	110	110	120	530
Outlays	310	340	350	320	270	1,600

The Department of Veterans Affairs (VA) supports homeownership by veterans through the home loan guaranty program, which allows veterans to obtain mortgage credit from private lenders on more favorable terms than usual, such as without a downpayment. In the event of foreclosure, the federal guarantee reduces the lender's potential loss. The amount and proportion of the loan principal that are guaranteed vary with the size of the loan. In 1989, net federal outlays for the program were \$900 million.

From January 1990, when a restructuring of the VA's loan guaranty program took effect, one-time loan fees for borrowers became permanent. The fee is now 1.25 percent of the mortgage amount for loans with downpayments of less than 5 percent, 0.75 percent for loans with downpayments of 5 percent up to 10 percent, and 0.5 percent for loans with downpayments of 10 percent or more.

Even allowing for an additional 1 percent loan-origination fee that the private lender may charge the veteran for such loans, the maximum fee of 1.25 percent is appreciably below mortgage insurance costs for private loans without government guarantees. Program participants therefore receive a substantial subsidy. Before recent program changes, the Bush Administration estimated that, compared with bor-

rowing and mortgage-insurance costs in the private sector, the 1990 subsidy for VA-guaranteed loans would average 5.2 percent of the loan amount.

Another possible comparison is with the Federal Housing Administration's (FHA's) Section 203(b) program, which insures private mortgage loans with low downpayments for one-to-four-family housing and which is the main federal program to assist borrowers purchasing low-cost housing. The Administration estimates that, compared with costs in the private sector, the 1990 subsidy for FHA loans will average 1.2 percent of the loan amount.

This option, which has two variations, would reduce net federal outlays for the VA loan guaranty program by reducing the average subsidy for new loans. Based on the Administration's estimate of federal liability on these loans, raising the maximum loan fee paid by the borrower to 2 percent would make borrowers alone cover the expected costs of defaults and foreclosures under the program. (Under this variation, the loan fee would be raised to 1.5 percent for loans with downpayments of at least 5 percent, and to 1 percent for loans with downpayments of at least 10 percent.) If this variation were in place by October 1, 1990, it would reduce federal outlays by \$390 million over the next five years.

The second variation would aim in principle to establish comparable average rates of effective subsidy in the VA program and the FHA's Section 203(b) program. In practice, setting fees for VA loans on this basis would require an estimate of the restructured VA program's effective subsidy rate. A maximum loan fee of at least 4 percent, however, would apparently be needed in the new VA program to reduce the average VA subsidy to 1.2 percent. Raising the maximum loan fee to 4 percent from 1991 (and similarly doubling the fees in the first variation for loans with larger downpayments) would reduce federal outlays by \$1.6 billion over the next five years.

The primary justification for these options is that they would reduce or eliminate the disparity in the subsidies provided under two similar federal programs. Moreover, although new participants in the VA program would pay more than under current law, they should still pay less to obtain VA mortgages than they would pay in the conventional private market. The primary disadvantage of these

measures is that increased charges might discourage participation by some low-income potential homebuyers who are targeted for housing assistance.



CHAPTER IV

AGRICULTURAL PROGRAMS

The financial condition of the agricultural sector continues to show steady improvement relative to conditions existing in the mid-1980s. By most measures, the sector has enjoyed three strong years in a row with net farm income in excess of \$40 billion a year. This strong financial performance has come despite severe droughts during the last two summers. Net farm income for 1990 is not expected to be as great as in 1989 but should again exceed \$40 billion.

The improving financial condition of the sector has been matched by reductions in the cost of farm programs. After reaching a historic peak of nearly \$26 billion in fiscal year 1986, spending on commodity programs has declined in each year since. Spending in fiscal year 1989 for farm programs was \$10.4 billion, substantially less than half of the amount spent in 1986. Over the next five years, farm program spending is projected to dip to \$7.6 billion in 1990, increase to \$12.0 billion in 1992, and decline modestly thereafter. By 1995, agricultural program spending is projected to be \$9.9 billion.

Outlays in the agricultural baseline are expected to remain fairly constant during the 1991-1995 period because target prices are assumed to remain constant and demand for agricultural commodities is expected to be relatively strong. The modest declines in spending that are projected over the next five years occur because corn prices are projected to rise slightly, participation rates for some crops fall slightly, and the dairy support price also falls.

The next two years could hold dramatic developments for agriculture. Two events have the greatest potential to change farm policy: the new farm bill that will have to be written in 1990; and the Uruguay Round of the General Agreement on Tariffs and Trade (GATT) that is scheduled to be completed by the end of 1990.

But the outlook for GATT and the farm bill is far from settled. Widespread satisfaction exists within the agricultural community

with the performance of the 1985 farm bill, and the positions of key players in the GATT (especially the United States and the European Community) appear to be very far apart. Pressures to cut farm spending, however, are certain to remain. Furthermore, agreement on the entire GATT Round, encompassing many trade items, may hinge on agreement in the agricultural negotiations; this would provide strong incentives to reach some sort of compromise. The Congress will probably be faced with an up-or-down vote on the entire GATT agreement, meaning that it would not be possible to amend the agricultural agreement. Given these factors, some significant changes in agricultural policy could emerge from the GATT negotiations.

Most of the program changes discussed in this chapter would make marginal changes to existing policies. The first 12 options affect outlays of the commodity programs; the remainder would affect the Farmers Home Administration (AGR-13) or the federal crop insurance program (AGR-14). All outlay savings are estimated relative to CBO's January 1990 baseline. Some of the options are substitutes for one another and cannot all be selected. The savings from individual options generally cannot be added to arrive at a total because of interactions that would occur among the various program changes.

Some of the options discussed would require significant changes in the form or structure of U.S. farm policy. One proposal, AGR-03, would separate program payments from production decisions by making direct transfers to farmers. A second, AGR-07, is aimed at increasing the flexibility of planting decisions by farmers via the so-called "triple base" option. A third, AGR-08, would provide support in a way that would minimize distortions to international trade. Common to most of the options considered, however, is an adverse impact on income for the farm sector.

**AGR-01 REDUCE DEFICIENCY PAYMENTS TO
FARMERS PARTICIPATING IN USDA
COMMODITY PROGRAMS BY LOWERING
TARGET PRICES**

Savings from CBO Baseline	Annual Savings (In millions of dollars)					Cumulative Five-Year Savings
	1991	1992	1993	1994	1995	
Budget Authority	310	1,200	2,250	3,350	4,100	11,200
Outlays	310	1,200	2,250	3,350	4,100	11,200

The Food Security Act of 1985 allows the Secretary of Agriculture to make annual reductions in target prices for wheat, feed grains, cotton, and rice. Target prices are used to calculate deficiency payments, which are the primary form of direct government payments to farmers. The annual reductions in target prices began with the 1988 crops of wheat and feed grains and the 1987 crops of cotton and rice. The minimum target price for wheat was \$4.38 per bushel for the 1986 and 1987 crops and is projected to fall to \$4.00 per bushel for the 1990 crop, the final year covered by this legislation. Over the same time period, the target price for corn dropped from \$3.03 to \$2.75 per bushel. The target price for cotton was \$0.81 per pound for the 1987 crop and falls to \$0.729 per pound by 1990. The decline for rice over the same period is from \$11.90 to \$10.71 per hundredweight. The Omnibus Budget Reconciliation Act of 1987 reduced target prices for the 1988 and 1989 crops by about 1.5 percent from levels specified in the 1985 act, but did not affect the 1990 crop levels. Table 10 shows the target price levels set by current law through the 1991 crops. The CBO baseline assumes that target prices are maintained at 1990 levels during the 1991-1995 period.

Budget savings could be achieved by reducing target prices in the years after 1990. The greater the rate of reduction, the greater would be the savings. One alternative, shown in the table, would be to reduce target prices by 3 percent per year starting with the 1990 crops. Outlay savings are estimated to be \$11.2 billion over the 1991-1995 period.

An advantage of a continued decline in target prices is that it would increase the degree to which farmers respond to market prices, rather than to government program benefits, in making their production decisions. Further target price reductions would be viewed by U.S. competitors and trading partners as evidence of an intention to reduce the effects of domestic farm policies on world trade in agricultural commodities. Additional reductions could have a positive benefit in the ongoing trade negotiations under the auspices of the General Agreement on Tariffs and Trade.

Another argument for further target price reductions is provided by the continuing relaxation of acreage reduction requirements in feed grains and wheat. The 1988 drought and its aftereffects on these crops, along with relatively high acreage reduction requirements during the 1986 and 1987 crop years, have helped bring commodity stocks

TABLE 10. TARGET PRICES UNDER CBO BASELINE ASSUMPTIONS AND UNDER 3 PERCENT ANNUAL REDUCTIONS (By crop year)

	1990	1991	1992	1993	1994	1995
CBO Baseline Assumptions						
Wheat ^a	4.00	4.00	4.00	4.00	4.00	4.00
Corn ^a	2.75	2.75	2.75	2.75	2.75	2.75
Rice ^b	10.71	10.71	10.71	10.71	10.71	10.71
Cotton ^c	0.729	0.729	0.729	0.729	0.729	0.729
3 Percent Annual Reductions						
Wheat ^a	4.00	3.88	3.76	3.65	3.54	3.43
Corn ^a	2.75	2.67	2.59	2.51	2.43	2.36
Rice ^b	10.71	10.39	10.08	9.77	9.48	9.20
Cotton ^c	0.729	0.707	0.686	0.665	0.645	0.626

SOURCE: Congressional Budget Office.

a. Dollars per bushel.

b. Dollars per hundredweight.

c. Dollars per pound.

under control. Most of these stocks are owned by the Commodity Credit Corporation or used as collateral for government loans. These stock reductions are leading to smaller acreage reduction requirements. Relaxing acreage reduction requirements, while maintaining relatively high target prices, only expands the size of the crop on which this high price protection is provided. Indeed, extending this price protection to more acreage could lead to higher total deficiency payments, even if target prices are gradually reduced.

In part, deficiency payments are compensation to farmers for participating in supply control programs. Lowering the acreage reduction requirement without changing target prices increases the rate of compensation. Reduced target prices could be tied, therefore, to the size of the reduction in the amount of land that must be taken out of production in order to participate in the program.

Lower target prices would reduce farm income by reducing direct government payments. Farm income would not fall as much as government outlays because some farmers would choose not to participate in the commodity programs. Though these farmers would give up all of their government payments, they would not be required to idle part of their acreage and thus would generate income from additional production. In addition, livestock producers might benefit from lower feed costs.

Despite an improved outlook for agricultural markets, many farmers are still facing severe financial difficulties. In some cases, financial problems were worsened by droughts during the past two growing seasons. Further reductions in target prices would exacerbate these difficulties. Providing financial assistance directly to needy farmers, however, might be more appropriate and would certainly be more cost effective.

**AGR-02 CHARGE AN INSURANCE PREMIUM
FOR THE INCOME PROTECTION OFFERED
BY TARGET PRICES**

Savings from CBO Baseline	Annual Savings (In millions of dollars)					Cumulative Five-Year Savings
	1991	1992	1993	1994	1995	
Budget Authority	660	1,700	1,650	1,650	1,800	7,450
Outlays	660	1,700	1,650	1,650	1,800	7,450

A primary mechanism of current agricultural policy is the deficiency payment made to participants in the U.S. Department of Agriculture's (USDA) wheat, feed grain, cotton, and rice programs. The deficiency payment is calculated as the difference between a crop's target price (defined by law) and the greater of the market price or the loan rate (also defined by law) times the program yield (a historically based farm yield).

The deficiency payment has three main functions: to supplement farm income; to provide compensation for acreage reduction requirements; and to stabilize farm income. The third function is a form of insurance protection for farm income because it provides counter-cyclical benefits--that is, payments increase when prices are low and decrease when prices are high.

One option for reducing farm program spending would be to charge farmers a direct monetary fee for the insurance protection. This fee would compensate the government for part or all of the insurance cost. The fee could be structured in a number of different ways. For example, the fee could be low initially, even increase over time. In this way, USDA's commodity programs could evolve into self-financing insurance programs. In that event, the other two functions of deficiency payments--supplementing farm income and compensating farmers for acreage reduction programs--might cease to exist. Alternatively, fees could be structured so as to favor one group of farmers, such as beginning farmers or poor farmers, in which case deficiency payments would continue to be used to supplement farm income for the targeted group.

Farmers could be paid to divert land from production if acreage reduction programs were needed. If participants in the commodity programs during the five crop years beginning with 1991 were charged an annual fee equal to 5 percent of the target prices, outlays over the 1991-1995 period would fall by \$7.5 billion.

This option for an insurance premium would have several advantages. The addition of an insurance premium could make the current commodity programs more equitable because farmers would pay directly for a benefit received. The insurance premium could also be targeted toward groups meriting special assistance. To the extent that this evolved into a self-financing insurance program, many incentives to overproduce would be eliminated because market signals could be efficiently transmitted to farmers (via increases in the cost of coverage) and because government subsidies would be reduced or eliminated. Such a program could be consistent with the current U.S. position in the negotiations of the General Agreement on Tariffs and Trade. If this were to become a farm revenue insurance program offering combined price and yield protection, farmers would also have more comprehensive protection from uncontrollable events (natural disasters or abrupt changes in economic or trade policy) than is currently available to them.

The primary disadvantage of such a program, at least from the farmer's point of view, is that it would cause farm income to fall. Charging a fee to participate in Commodity Credit Corporation programs is, in this respect, similar to reducing target prices by a similar amount. Implementation of the fee program would entail additional administrative costs, particularly if the ultimate goal were to evolve into an insurance-oriented program.

**AGR-03 REPLACE DEFICIENCY PAYMENTS IN
THE WHEAT, FEED GRAINS, COTTON,
AND RICE PROGRAMS WITH DECLINING
DIRECT PAYMENTS**

Savings from CBO Baseline	Annual Savings (In millions of dollars)					Cumulative Five-Year Savings
	1991	1992	1993	1994	1995	
Budget Authority	150	360	340	320	300	1,450
Outlays	150	360	340	320	300	1,450

In recent years, a number of proposals have been offered that would "decouple" or separate farm support payments from the volume of crop production. The ultimate goal of decoupling is to reduce government influence on production decisions and to increase the responsiveness of farmers to market signals. Current farm programs incorporate aspects of decoupling. Two examples of current programs that partially decouple support payments are the 0-92 program (participating farmers receive 92 percent of the deficiency payment, while not being required to produce more than a cover crop) and the frozen program yields (the number of bushels per acre for which farmers receive benefits is not affected by current production levels).

One way of decoupling income support from production decisions would be to make direct payments to producers based on their production histories. In such a program, payments would be made to participants irrespective of current market prices. Anyone now participating in the commodity programs could opt to participate in the new direct farm income support program. The actual payment rate would be expressed per unit of historical output and could be set at any level. The rates assumed in this option were chosen so that total annual payments would be 4 percent less than annual direct payments projected in the CBO baseline from crop years 1991 to 1995. This assumption, of course, assures savings relative to the current baseline. Estimated savings total \$1.5 billion over the 1991-1995 period. Price supports, as currently provided by the Commodity Credit Corporation's nonrecourse loans, would no longer exist in a decoupled program. (A low-

cost recourse loan might facilitate farmers' marketing decisions.) Likewise, acreage controls other than the Conservation Reserve Program would be phased out. Export programs could be maintained as a bargaining tool for negotiations to liberalize international trade.

The direct farm income support program would have several advantages. This decoupled program would avoid the excess production and inequities across crop types characteristic of the current program. U.S. farm policy would thus move toward conformity with this country's negotiating position in the General Agreement on Tariffs and Trade. In addition, most studies indicate that a decoupled agricultural policy would produce a relatively small but significant improvement in the overall performance of the U.S. economy. This improvement is considered to be the result of a more efficient use of resources than now takes place in farming. Finally, a decoupled program would increase the predictability of agricultural budget costs, thereby facilitating the budget process.

Decoupling would not be without its disadvantages. Many farm groups have voiced hostility to decoupling, which they characterize as farm welfare. Further, a decoupling program like the one discussed in this option would simply lock in the current distribution of benefits, which has been criticized as inequitable. Also, the impact that decoupling would have on agriculture is not clear. While decoupling might make more land available for production as well as increase efficiency and output, it would probably result in a net outflow of resources from agriculture, leading to lower production and higher prices. Most analysts feel that aggregate farm income would fall under a decoupling program and that landowners could experience losses on the value of their property.

**AGR-04 RAISE DOMESTIC COMMODITY PRICES BY
INCREASING UNPAID ACREAGE REDUCTION
PROGRAMS**

Savings from CBO Baseline	Annual Savings (In millions of dollars)					Cumulative Five-Year Savings
	1991	1992	1993	1994	1995	
Budget Authority	1,100	3,100	3,200	2,850	2,500	12,750
Outlays	1,100	3,100	3,200	2,850	2,500	12,750

Participants in federal price and income support programs for wheat, feed grains, cotton, and rice are required to set aside some portion of the land on which they would normally plant these crops. Acreage reduction requirements are imposed by the U.S. Department of Agriculture to restrict supply and thereby reduce farm program costs by limiting excess commodity stocks and by raising market prices for those crops.

For the 1989 crop year, the acreage reduction requirement for wheat, corn, sorghum, and barley was 10 percent of base acreage (base acreage is that normally devoted to each crop); the requirement for cotton and rice was 25 percent. The CBO baseline assumes similar or lower levels of acreage reduction requirements in later years.

Raising the acreage reduction requirement in all these crops by five percentage points in each year, beginning with the 1991 crops, would reduce outlays by \$12.8 billion over the 1991-1995 period. Raising acreage reduction requirements would reduce outlays for several reasons: less production would be eligible for deficiency payments and other program benefits; prices would tend to rise, causing lower deficiency payment rates; and fewer producers would participate in the federal programs.

By raising the unpaid acreage reduction requirement, farmers could get a "fairer" price from the market, thereby reducing their dependence on direct government payments.

A disadvantage of this option is that U.S. commodities would be more expensive and, as a result, less competitive in world markets. In addition, acreage reduction requirements reduce the efficiency of U.S. production, again eroding U.S. international competitiveness. Budget savings from this option could be short term, at best, because the price increase induced by lower U.S. production could cause other countries to expand output and drive prices back down. In addition, increasing the acreage reduction requirement would adversely affect businesses serving agriculture--both upstream (chemical suppliers, implement dealers) and downstream (grain elevator operators, food manufacturers, livestock owners). Increasing the unpaid diversion would simply shift agricultural program costs from taxpayers to consumers.

**AGR-05 ESTABLISH AN ORIGINATION FEE
OF 3 PERCENT FOR NONRECOURSE
LOANS FROM THE COMMODITY
CREDIT CORPORATION**

Savings from CBO Baseline	Annual Savings (In millions of dollars)					Cumulative Five-Year Savings
	1991	1992	1993	1994	1995	
Budget Authority	40	300	210	210	200	960
Outlays	40	300	210	210	200	960

Participants in price and income support programs can receive loans using their crops as collateral. A producer may either repay the loan or forfeit the crop to the Commodity Credit Corporation (CCC) as full payment when the loan matures. Currently, participants are not charged anything for receiving such-a loan. The Congress could consider the imposition of an origination fee to be charged when farmers take out a loan from the CCC.

Cash repayment of a loan for wheat, feed grain, or soybean production includes the loan principal and the interest that has accrued. Interest rates on CCC loans are based on the government's cost of borrowing and are lower than would be available for similar types of loans from private sources. In the marketing loan programs that apply to cotton and rice, the cash repayment required to redeem the loan depends on market prices and thus can be considerably less than the principal value of the loan. No interest is charged when loans are repaid in these marketing loan programs.

Some of the costs of the commodity program could be recovered by imposing an origination fee of 3 percent on participants who take out a CCC loan. Such a relatively small fee would have small effects on market prices, yet would save \$960 million over the 1991-1995 period.

A major objective of the nonrecourse loan program is to support the incomes of farmers; an origination fee would undermine this function of the program. Moreover, the nonrecourse loan program benefits all

producers, even those not participating in government programs, because it supports market prices (except in crops with marketing loans). Charging producers who participate in the loan program, while ignoring those who receive indirect benefits, might be considered inequitable.

**AGR-06 RESTRICT ELIGIBILITY FOR BENEFITS FROM
PRICE SUPPORT PROGRAMS AND REDUCE
THE PAYMENT LIMITATION**

Savings from CBO Baseline	Annual Savings (In millions of dollars)					Cumulative Five-Year Savings
	1991	1992	1993	1994	1995	
Budget Authority	0	530	510	500	500	2,050
Outlays	0	530	510	500	500	2,050

Current law governing eligibility for benefits under price support programs for crops limits participants to no more than \$100,000 in deficiency payment benefits from the Commodity Credit Corporation during any crop year. The maximum in deficiency payments that can be received is \$50,000 for an individual, plus \$25,000 as a shareholder in a maximum of two corporate farms (each of which is entitled to a maximum payment of \$50,000). This maximum can be achieved only by those who are actively engaged in the operations of relatively large farms and who have organized their farm businesses to maximize payments. These recently enacted rules are tighter than those previously in force, which did not effectively limit the number of corporations through which program participants could receive benefits.

Government costs could be reduced further by allowing each farm operator to receive only the individual payment and by eliminating the two corporate farm payments. This option would also reduce the maximum direct payment from \$50,000 to \$40,000 per year. The option would not change the types of payments that are or are not subject to the limitation. Estimated savings total \$2.1 billion over the 1991-1995 period. An alternative to reducing the \$50,000 payment limit would be to broaden the definition of payments that are subject to the limitation.

Support for this change could be based on the belief that current payment limits are too high. If reductions in program spending are required, they should come from relatively large farming operations rather than relatively small ones. In addition, reducing the limit on direct government payments would reduce their influence on the pro-

duction decisions of operators of large farms, causing them to be more responsive to market returns. Operators of smaller farms, more likely to be in need of government assistance, would continue to receive program benefits as before.

This change could harm relatively efficient-sized farm operations. In addition, until operating and price subsidies are reduced for producers in foreign countries, increasing the exposure of the most efficient U.S. farmers to market forces would hurt long-term prospects for the farm sector.

**AGR-07 ADOPT THE TRIPLE BASE OPTION TO
REDUCE THE PORTION OF EACH FARMER'S
LAND ELIGIBLE FOR DEFICIENCY PAYMENTS**

Savings from CBO Baseline	Annual Savings (In millions of dollars)					Cumulative Five-Year Savings
	1991	1992	1993	1994	1995	
Budget Authority	140	260	200	250	230	1,100
Outlays	140	260	200	250	230	1,100

Outlays of the Commodity Credit Corporation (CCC) would be reduced under the "triple base option" by cutting the number of acres eligible for deficiency payments. Currently, wheat, feed grains, cotton, and rice producers who participate in commodity programs receive a deficiency payment. The size of the deficiency payment is generally equal to the difference between the target price for the commodity and its market price times the program yield assigned to the farm times "permitted acres." Permitted acres equal the farm's crop acreage base less land idled to comply with the acreage reduction program in effect for that crop during that crop year.

Under the triple base option, acres on which payments are made (payment acres) would be less than permitted acres. If payment acres equaled 85 percent of permitted acres for all crops, CCC outlays would be reduced by an estimated \$1.1 billion over the 1991-1995 period. Farmers would be permitted to grow any crop on the unpaid portion of permitted acres. Under current law, farmers generally must plant the program crop on all permitted acres to maintain their eligibility for future program benefits and to receive maximum program benefits in the current year.

The triple base option would allow farmers more flexibility in planting decisions since they could plant any crop on the unpaid portion of their permitted acres. Plantings of some crops, such as soybeans and oats, would probably increase with the triple base option. These crops are currently less attractive to many farmers because they receive low or no government subsidies. Also, some analysts support the

triple base option because it would increase the market's influence on farmers' decisions regarding plantings and use of inputs, such as fertilizers and pesticides, at least on a portion of their farms. Producers now respond to program benefits when making decisions. These decisions result in less efficient use of farm resources, in some cases, and cause farm program administrators to discourage production of subsidized crops by requiring productive farm land to be idle.

A disadvantage of the triple base option is that it would cause a loss in farm income both for most participants of current commodity programs and for people now raising crops that do not directly receive federal support. Current program participants shift production away from program crops on land no longer earning subsidies and toward alternative crops. As a result of these changing production patterns, incomes of growers of nonprogram crops would be hurt by the new competition.

**AGR-08 ADOPT THE PRODUCTION ENTITLEMENT
GUARANTEE (PEG) OPTION TO REDUCE
THE PORTION OF EACH FARMER'S
PRODUCTION THAT IS ELIGIBLE FOR
GOVERNMENT PAYMENTS**

Savings from CBO Baseline	Annual Savings (In millions of dollars)					Cumulative Five-Year Savings
	1991	1992	1993	1994	1995	
Budget Authority	1,050	2,000	1,150	1,050	950	6,200
Outlays	1,050	2,000	1,150	1,050	950	6,200

Current commodity price and income support programs base their support largely on acreage under cultivation. An alternative, known as the Production Entitlement Guarantee (PEG), would base support on a set volume of production. The volume of production that would receive support payments would be set at a level less than the amount demanded by the market. In this way, the production decisions of farmers would be based on market conditions. The volume of production for which individual farmers are provided support would be some percentage of their base acreage times their program yield. The level of support provided could be based on historical levels or on a targeted level of income protection. Farmers would be required to produce a certain quantity of crops in order to receive these support payments. PEGs could be distributed to farmers according to the size of their base acreage, and farmers could buy and sell the rights to these benefits. In the PEG analyzed for this option, the amount of production supported is 50 percent of base acreage times the program yield. Annual acreage reduction programs (ARPs) would be eliminated if a PEG system was adopted.

The PEG program would be a means of supporting agriculture that does not distort market signals and hence would not distort production decisions. Consequently, U.S. trading partners would probably not view a PEG as adversely affecting international trade. The PEG could be targeted to smaller farms and to farms that are economically weak. The fact that PEGs could be traded between farmers would allow the

most efficient producers to acquire PEGs for additional production and, conversely, would give farmers who are leaving agriculture an additional resource that they could sell. Consumers could also benefit from lower food prices. Finally, eliminating ARPs would be expected to increase the efficiency of agricultural production.

The major drawback of the PEG support program is that it would reduce farm income. To the extent that PEGs are viewed as "welfare" payments, farmers might resist implementation of such a program.

**AGR-09 REDUCE DEFICIENCY PAYMENTS TO
FARMERS PARTICIPATING IN COMMODITY
PROGRAMS BY REDUCING THE CROP
YIELDS USED TO CALCULATE PROGRAM
PAYMENTS**

Savings from CBO Baseline	Annual Savings (In millions of dollars)					Cumulative Five-Year Savings
	1991	1992	1993	1994	1995	
Budget Authority	190	490	490	470	460	2,100
Outlays	190	490	490	470	460	2,100

The deficiency payments paid to farmers participating in the U.S. Department of Agriculture's (USDA) price and income support programs are based, in part, on a measure called the program payment yield. These deficiency payments are generally equal to the program payment yield multiplied by the deficiency payment rate (computed as the difference between the target price for the commodity and the market price). This product is then multiplied by the number of acres on which the producer is entitled to program benefits.

Program payment yields are assigned to each farm based on the average of program yields in effect during the 1981-1985 period, excluding the years with the highest and lowest yields. The Secretary of Agriculture was given the discretion in the Food Security Act of 1985 to make subsequent adjustments to the program payment yield assigned to each farm, but this discretion has not been used. Keeping program payment yields fixed, rather than adjusting them for actual yields, reduces the incentive for producers to boost them--for example, by applying more fertilizers. If farmers are convinced that actual yields will not affect future program yields (and program payments), then expected returns from the market rather than government payments will determine fertilizer use and other input decisions.

In general, market returns are better guides to decisions about input use than returns that also include government subsidies. If a farmer's input decisions were based on a return including government

payments equal to the crop's target price (\$2.75 per bushel for corn, for instance), rather than on the expected market price (say, \$1.90 per bushel), more fertilizer would be applied. From the farmer's perspective, this decision would increase profits. From the economy's perspective, however, too much fertilizer would be used for this crop. Productivity would increase if additional fertilizer were applied to some other crop or if the resources used to produce the fertilizer were devoted to some other activity. In addition, excessive agricultural chemical use has been blamed for several environmental problems.

Program payment yields, which have been held constant for several years, are now quite different from average or expected yields for many farmers. Reducing program yields would confirm the lack of relationship between actual yields and program payment yields by freezing them at a new, lower level. Reducing the program yield by 5 percent for each supported commodity in crop year 1991, and freezing it thereafter, would result in savings of more than \$2.1 billion in Commodity Credit Corporation outlays during the 1991-1995 period.

An argument in support of this option is that not raising program yields to reflect more recent yield histories would be a convincing signal to farmers. This would confirm the need for farmers to respond only to market signals when making decisions about the use of fertilizer and other inputs. Also, some farmers would choose not to participate in these government programs as their benefits would become somewhat less attractive. This would marginally reduce the programs' influence on planting decisions.

However, some commodity groups argue that program yields instead should be raised and brought more in line with recent actual yields. They argue that payment yields should more closely reflect actual yields as a matter of fairness. An additional argument against this option is that the incomes of farmers would also be reduced.

AGR-10 ELIMINATE THE EXPORT ENHANCEMENT PROGRAM

Savings from CBO Baseline	Annual Savings (In millions of dollars)					Cumulative Five-Year Savings
	1991	1992	1993	1994	1995	
Budget Authority	450	310	210	210	220	1,400
Outlays	450	310	210	210	220	1,400

The U.S. Department of Agriculture (USDA) subsidizes the export of agricultural commodities through the Export Enhancement Program (EEP). The U.S. exporters participating in EEP negotiate directly with buyers in a targeted country, then submit bids to the USDA for bonuses. The bids include the sale price, tentatively agreed upon with the buyer, and the amount of the subsidy or bonus requested by the exporter. If the bids are accepted, the exporters receive their bonuses in the form of generic commodity certificates that can be used by the exporters to acquire government-owned commodities.

Recently, new guidelines for the operation of the EEP program were published. Under the former guidelines, EEP sales had to be budget neutral, cost effective, and not displace commercial sales. In addition, only countries in which the United States had lost market share to competitors who subsidize exports were eligible for EEP. Under the new guidelines, only two criteria are given for EEP sales: that they be available only in countries in which the United States has lost market share; and that they satisfy the general goal of longer-term market development.

Since its inception, over \$2.6 billion of EEP bonus payments have been made, mostly to assist wheat exports. The CBO baseline assumes that \$2.5 billion in additional subsidy payments will be made during the 1991-1995 period. Eliminating the EEP program would save nearly \$1.4 billion during this period. This estimate assumes a small increase in the acreage reduction requirement for 1991 in order to moderate the expected price decline.

One disadvantage of eliminating the EEP program is that it has increased U.S. exports above the level they would otherwise have reached. In addition, one of the underlying motivations for the EEP has been to encourage competitors, particularly the European Community, to negotiate reduced subsidies in trade negotiations currently being conducted under the General Agreement on Tariffs and Trade (GATT). Unilateral elimination of the EEP would deprive U.S. negotiators of a bargaining chip in the GATT negotiations.

How much the EEP program has increased U.S. grain sales, particularly in the current and relatively tight grain markets, is not clear. The EEP program has depressed world commodity prices and failed the targeting criteria (since most major U.S. markets now benefit from EEP sales). The two biggest recipients of subsidized grain sales under EEP are the Soviet Union and the People's Republic of China. Finally, many critics question the usefulness of EEP in advancing the agricultural trade negotiations in the GATT.

**AGR-11 ELIMINATE THE TARGETED
EXPORT ASSISTANCE PROGRAM**

Savings from CBO Baseline	Annual Savings (In millions of dollars)					Cumulative Five-Year Savings
	1991	1992	1993	1994	1995	
Budget Authority	80	150	200	200	200	830
Outlays	80	150	200	200	200	830

The Targeted Export Assistance (TEA) program was authorized under the 1985 Food Security Act, enabling U.S. agricultural exporters to counter unfair trading practices abroad. TEA offers support to exporters by means of generic commodity certificates issued by the Commodity Credit Corporation (CCC) of the U.S. Department of Agriculture. Payments are made to offset partially the costs of market building and commodity promotion undertaken by state-related, private nonprofit, and private profit-making firms. During fiscal years 1986 through 1989, more than 6,000 activities have received federal support, totaling about \$330 million. TEA is aimed mainly at specialty crops, such as fruits and nuts, but has also targeted wine, plywood, tobacco, feed grains, meat, eggs, and several other agricultural products for promotion. The current CBO baseline assumes that \$200 million in generic commodity certificates would be obligated annually for the program in the 1991-1995 period. Elimination of this program would reduce outlays by \$830 million over the next five years. Net budget authority of the CCC would be reduced by the same amount over the same period.

An argument for reducing TEA funding is that the assisted groups benefit directly from the market development activities; thus, these groups should bear the full costs. Activities promoting exports of non-agricultural goods do not receive similar support. A report from the General Accounting Office also concluded that the administration of the TEA program has been lax. Few controls exist over the use of resources provided under TEA. Moreover, the rationales for funding that are provided in requests for TEA resources have not been investigated, nor has the effectiveness of the TEA program been substantiated.

Elimination of the TEA program could place U.S. exporters at a disadvantage in international markets. TEA may have been responsible for increased exports of promoted products in target countries, and its elimination would result in lower levels of exports. Those concerned about U.S. exports of high-valued agricultural products consider TEA as a useful tool for the development of markets for these products.

**AGR-12 CUT PROGRAM COSTS FOR DAIRY PRICE
SUPPORTS BY REQUIRING PRODUCER
CONTRIBUTIONS**

Savings from CBO Baseline	Annual Savings (In millions of dollars)					Cumulative Five-Year Savings
	1991	1992	1993	1994	1995	
Budget Authority	320	330	350	350	360	1,700
Outlays	320	330	350	350	360	1,700

The incomes of dairy producers are protected and increased through the purchase of storable dairy products by the U.S. Department of Agriculture's (USDA) dairy price support program. The incomes of dairy farmers are further supported by marketing orders that set price minimums for milk going to various uses. The U.S. dairy industry is also protected from foreign competition by quotas on imports of dairy products.

Consumers may benefit because the dairy price support program helps to stabilize prices of milk and milk products. Needy families, schools, and other institutions gain through the free distribution of dairy products that are purchased by the USDA. Costs of the program to the taxpayer are substantial. Net outlays averaged \$1.7 billion per year over the 1981-1989 period and are projected to average \$0.5 billion during the 1991-1995 period. The program can also raise the prices of dairy products and thus consumer costs above the levels they would reach without government intervention.

One method of reducing dairy program costs would be to assess dairy farmers, who are the primary beneficiaries of the program, according to their production. Assessments have been levied on marketing in the past, most recently the \$0.025 per hundredweight assessment in effect through December 1988. If assessments were set at the \$0.20 per hundredweight level, the industry would be paying for about half of the federal price support program costs. Outlay savings would total an estimated \$1.7 billion over the 1991-1995 period.

This method of reducing dairy program costs would be straightforward and relatively easy to administer. Many dairy producers would favor this approach to cutting program costs over alternatives, such as further or more rapid reductions in federal price supports. A cut in the price support level for milk would cause a drop in the price that both consumers and the government pay for milk and milk products. Government purchases account for a relatively small portion of the total dairy market. Thus, in order to generate a significant amount of savings, the price cut would have to be relatively large. In contrast, an assessment would apply to the marketing of all milk products, so a relatively small assessment would generate significant savings. As a result, the incomes of dairy farmers would be reduced less by the assessment than by a support price cut generating similar budget savings.

This option would reduce the net incomes of dairy farmers. One argument against the assessment is that the triggered price cuts included in the 1985 Food Security Act already place a significant burden on the dairy industry and will, over time, achieve a reasonable balance between production and use. This option would mean that the dairy industry would be paying part of the costs for disposing of surplus dairy production. Most of this surplus is used in domestic food assistance programs, which arguably should be paid for by the taxpayer, not the dairy industry.

**AGR-13 REDUCE THE DIRECT LENDING AUTHORITY
OF THE FARMERS HOME ADMINISTRATION
FOR FARM OWNERSHIP AND OPERATING
LOANS**

Savings from CBO Baseline	Annual Savings (In millions of dollars)					Cumulative Five-Year Savings
	1991	1992	1993	1994	1995	
Budget Authority	0	230	0	210	170	610
Outlays	240	230	230	200	160	1,050

Under current law, the Farmers Home Administration (FmHA) will have authority to make \$80 million in direct loans under the Farm Ownership Program and an additional \$900 million in direct loans under the Farm Operating Program in 1990. CBO projects total direct lending by the FmHA under these two programs during the next five years to be \$5.5 billion. Historically, the FmHA has used all of its direct lending authority for these programs. Reducing total direct lending authority in these two programs by 25 percent per year would result in net savings of \$1.1 billion over the next five years.

During fiscal year 1989, FmHA made more than 21,500 direct loans to finance farm operations or the purchase of farms. The average value of these loans was slightly less than \$44,000. In addition, FmHA guaranteed nearly \$1.2 billion in farm ownership and operating loans. The average size of the nearly 12,000 guaranteed loans was \$98,000. FmHA borrowers often benefit from below-market interest rates and greater availability of credit. The size of the subsidy varies depending upon the loan category considered.

One rationale for reducing subsidized lending to agriculture is that the farm sector already has excess capacity; subsidizing investment, some of which would increase that capacity, is counterproductive. Furthermore, evidence suggests that ample credit is available from commercial sources for FmHA to completely satisfy its original mission, providing financial services to young farmers and those with limited resources by means of loan guarantees.

A disadvantage of reducing direct and guaranteed lending authority is that it could leave the FmHA less able to fulfill its mission. A smaller program could be maintained, however, in order to satisfy the policy goal of providing credit to a specific group of farmers.

**AGR-14 REDUCE THE FEDERAL SUBSIDY FOR
CROP INSURANCE BY REQUIRING
PARTICIPANTS IN COMMODITY PROGRAMS
TO PURCHASE COVERAGE**

Savings from CBO Baseline	Annual Savings (In millions of dollars)					Cumulative Five-Year Savings
	1991	1992	1993	1994	1995	
Phase Out Premium Subsidies						
Budget Authority	100	220	340	460	570	1,700
Outlays	90	210	330	440	550	1,600
Make FCIC Coverage Mandatory for CCC Participants						
Budget Authority	-80	110	110	120	150	410
Outlays	-20	110	110	120	150	470

The federal government offers all-risk crop insurance to farmers through the Federal Crop Insurance Corporation (FCIC). Estimates indicate that, in 1989, FCIC insurance policies were available on 49 crops in about 3,000 counties. The insurance offers protection from most natural phenomena, such as drought, flood, and hail, that result in poor crop yields.

FCIC insurance is not actuarially sound, however, meaning that premiums paid by farmers do not cover the cost of the insurance offered (indemnities plus administrative costs). Under the Crop Insurance Act of 1980, the government subsidizes this insurance by covering all administrative costs of the program, as well as a portion (originally intended to be 25 percent) of the insurance premiums. Over the 1980-1988 period, indemnities exceeded premiums by an average of 58 percent. As a result, a substantially greater subsidy is currently being provided than was originally intended. Phasing out the premium subsidy could be expected to save \$1.6 billion over the next five years.

Requiring participants in the Commodity Credit Corporation (CCC) programs to purchase crop insurance could improve FCIC's insurance pool. Participation in the FCIC program has always been rela-

tively low. An estimated 24 percent of eligible acres were insured in 1988. Widespread concern also exists that the current FCIC program can only attract the highest-risk farmers. So long as the benefits of participating in CCC programs remain high, requiring FCIC coverage could increase the diversity of the insured pool of farmers. Mandatory coverage would increase insured acreage to an estimated 67 percent of eligible acreage. Such a large increase in the insurance pool could significantly improve the loss ratio for the FCIC.

Mandatory coverage could generate large increases in insured acreage without providing premium subsidies to CCC program participants. Large increases in insured acreage would tend to drive up FCIC administrative costs. However, these increases could be minimized because marketing and advertising expenses, which are a large part of current administrative costs, would not need to be increased. Finally, mandatory FCIC coverage would be expected to reduce participation in CCC programs, resulting in additional savings. Mandatory coverage could result in savings of \$0.5 billion during the next five years.

Phasing out the FCIC premium subsidy would improve the incentives for risk-bearing by farmers. To the extent that farmers are able to reduce their exposure to risk at the expense of taxpayers, they are less likely to invest in other mechanisms for controlling risk. Furthermore, a more effective crop insurance program covering a greater proportion of farmers would reduce the necessity for extending emergency disaster relief (though this potential saving is not included in the deficit reduction estimates). Combining crop insurance with the commodity programs would provide relatively complete coverage against both price and production risks.

The primary disadvantage of this option is that it would cause farm income to decline. More would be paid for crop insurance, and government transfers in the commodity programs would decline. The FCIC might also face higher expenditures for the data gathering and analysis needed to achieve an actuarially sound program. Mandatory coverage, in the absence of improved actuarial data, could result in greater indemnity payments by the FCIC.



CHAPTER V

NONDEFENSE DISCRETIONARY

SPENDING

Federal activities in the nondefense discretionary (NDD) category include a broad range of programs that are generally controlled by annual appropriations. Accounting for just over 16 percent of annual government outlays, these programs encompass national infrastructure development and maintenance, energy development, natural resource management, educational and housing assistance, international aid, and research and development. Although pay for federal workers in civilian agencies is included in this budgetary category, options for reducing costs associated with the government's civilian work force are discussed in the next chapter.

The 47 deficit reduction options presented here would affect, to varying degrees, all of these major program areas. The intent and the mechanics of these options vary substantially, reflecting differences in program goals and methods; nevertheless, all of the deficit reduction themes discussed in Chapter I are represented in these options. In many cases, reductions are described in terms of complete elimination or cancellation of a program. In other cases, illustrative percentage reductions are introduced. In general, partial reductions of a greater or lesser degree than those presented here would generate roughly proportionate savings to the estimates given.

Unless otherwise noted, estimates of savings are relative to CBO's baseline projections. In some cases, however, the estimates are compared with the Administration's budget and are identified as such.

The options in this chapter are grouped by subject matter. Options NDD-01 and NDD-02 concern international aid. NDD-03 through NDD-06 address reductions in the level of federal commitment to space and science programs. NDD-07 through NDD-14 analyze reductions or changes in federal support and management of energy, natural resources, and environmental initiatives. NDD-15 through NDD-21 cover banking, commerce, housing credit, and communications. NDD-22 through NDD-27 describe options for transportation programs.

NDD-28 and NDD-29 deal with community and regional development. NDD-30 through NDD-37 focus primarily on education and health. NDD-38 through NDD-42 concentrate on housing and income security programs. NDD-43 and NDD-44 relate to veterans' programs. NDD-45 centers on the administration of justice. NDD-46 and NDD-47 involve labor contract rules.

Several options presented in this section would impose fees for services provided by the federal government. In most of these cases, the budgetary savings shown here are in the form of offsetting receipts, which reduce outlays. Depending on the form of implementing legislation, however, some of these options might be categorized as revenues rather than as offsetting receipts. As in previous years, no options are presented that would rely on federal asset sales, although reforms in programs that manage federal assets are considered. Finally, some options would require action by both the authorizing and the appropriating committees in order to realize budgetary savings.

**NDD-01 ELIMINATE THE PL-480 TITLE I FOOD
 AID PROGRAM**

Savings from CBO Baseline	Annual Savings (In millions of dollars)					Cumulative Five-Year Savings
	1991	1992	1993	1994	1995	
Budget Authority	880	910	880	890	910	4,450
Outlays	800	860	870	890	900	4,300

The Title I program of Public Law 480, the Food for Peace program, provides low-cost loans to developing countries for the purchase of commodities designated by the Secretary of Agriculture to be in excess of U.S. commercial export goals. Loan repayments by developing countries can be stretched over 40 years with low interest rates (averaging 2 percent to 3 percent). This Title I program has been used to achieve a variety of objectives: to assist foreign countries in their economic development; to serve U.S. foreign policy; and to expand markets for U.S. agricultural products abroad. Emergency assistance to countries facing short-term food shortages is not included in this option.

Under the Title I program, loans are made to subsidize the purchase of specified U.S. agricultural products by foreign governments. These subsidies typically average 70 percent of the free market price. Recipient governments sell these commodities on their domestic markets. The proceeds from these sales may then be used for development projects or for any other government expenditures within the recipient country.

Since the 1960s, the importance of food aid has declined, both as a portion of total economic assistance to developing nations and as a share of total U.S. agricultural exports. The marketing of some food commodities, most notably wheat and wheat flour, still relies significantly on food aid programs. Both the intent and the effect of U.S. food aid have been criticized. Some developing countries complain that Title I sales are not true food aid, since most of the loan must eventually be repaid. The effectiveness of the Title I food aid sales for economic development is also questionable. Food aid can depress prices for local farmers and become a disincentive to production. At the same

time, subsidizing the purchase of food exports makes less sense from the U.S. standpoint when food stocks are low, as they are now, especially the main crop in this program, wheat. Also, many argue that a sizable portion of Title I sales is made at the expense of commercial sales that would have taken place in the absence of this program.

Support for the Title I program is based on the argument that it is being used increasingly and, in some cases, effectively despite its flaws to promote economic development in recipient countries. Moreover, food aid sales remain one of the few really flexible policy tools for quick response to changing international political conditions. In addition, food aid (from all sources) continues to represent over 40 percent of all food imports by low-income developing countries. Cutting off any kind of food aid would represent a severe hardship to people in developing countries who depend on it for subsistence.

This option would eliminate the Title I program with a consequent savings of \$800 million in outlays in 1990 and \$4.3 billion through 1995. These savings assume that the prices of agricultural commodities in the program do not change. This option could also affect other agricultural programs, depending on the extent to which new commercial sales replace formerly subsidized sales. To the degree that this option decreases total demand for food commodities, market prices may be lower and government support payments may be higher than would otherwise be the case. The Secretary of Agriculture may counteract this effect through administrative action, however, by decreasing the supply of land available for food production. This action would increase the price of agricultural commodities and, if properly calibrated, return prices and program costs to their previous levels.

NDD-02 ELIMINATE THE EXPORT-IMPORT BANK

Savings from CBO Baseline	Annual Savings (In millions of dollars)					Cumulative Five-Year Savings
	1991	1992	1993	1994	1995	
Outlays	100	220	280	270	260	1,150

The Export-Import Bank of the United States (Eximbank) attempts to increase U.S. exports by providing credit to foreign purchasers of U.S.-manufactured products. Eximbank has three main programs: loans that offer subsidized interest rates; loan guarantees that encourage commercial banks to provide loans to foreigners by reducing the risk inherent in export financing; and medium-term insurance. Recently, the Congress has provided Eximbank with \$100 million in grant aid to be reserved for countries that use Eximbank programs to purchase U.S. merchandise. Eliminating Eximbank and thus the new aid program would save \$100 million in 1991 and \$1.2 billion over the five-year period.

Support for Eximbank programs is commonly based on three perceived benefits. First, Eximbank credit programs offset similar export subsidy programs offered by other industrialized nations to their exporters. Second, Eximbank credit programs allow U.S. high-technology manufacturing firms to maintain high rates of output and hence enjoy economies of scale. Third, the exports stimulated by Eximbank programs create domestic manufacturing jobs.

These benefits of Eximbank programs, however, are subject to substantial qualification. First, much of the export credit aid is given for exports that do not face subsidized competition, and no subsidy test exists for either the loan guarantee or the insurance programs. Second, Eximbank has focused considerable effort on markets where U.S. producers have a substantial backlog--notably, passenger jets. (In 1987, airplane-related credit accounted for three-quarters of loan guarantees.) Economies of scale may not be threatened in these markets, nor are subsidies needed when large backlogs exist. Third, Eximbank credit programs are an inefficient way to create jobs because so much of

the credit subsidy goes to foreigners. Direct subsidies to U.S. manufacturing would be more cost effective.

The effect of Eximbank programs on export volume raises further questions. Export flows are largely determined by factors beyond the control of Eximbank--that is, loan interest rates and currency exchange rates. The percentage of U.S. exports funded by Eximbank is small, and the percentage of U.S. exports actually dependent on Eximbank is smaller still. U.S. negotiators are currently attempting to remove development aid and other economic distortions from world trade. Providing such aid only serves to undercut the trade position of the United States.

Ending Eximbank and its related aid programs would affect less developed countries and newly industrializing countries disproportionately. Most of Eximbank credit goes to countries other than European nations and Japan. In some cases, private sources of financing may not meet the credit needs of the countries purchasing U.S. products for their industrial development plans.

**NDD-03 CANCEL THE NASA INTERNATIONAL
SPACE STATION PROGRAM**

	Annual Savings (In millions of dollars)					Cumulative Five-Year Savings
	1991	1992	1993	1994	1995	
Savings from CBO Baseline						
Budget Authority	1,800	1,900	1,950	2,050	2,150	9,850
Outlays	900	1,500	1,850	2,000	2,050	8,300
Savings from Administration's Request						
Budget Authority	2,450	2,900	3,050	2,850	2,550	13,800
Outlays	1,250	2,200	2,750	2,900	2,750	11,850

The National Aeronautics and Space Administration (NASA) is set to begin construction of an international space station. The Administration is committed to a \$13 billion (in 1984 dollars) ceiling on the development cost of the facility. The National Research Council (NRC) has estimated that the total cost of the program, including transportation and operations, could be as high as \$25 billion (in 1984 dollars). In 1990 dollar terms, NASA's cost estimate for development is \$15 billion; the NRC cost estimate for the total program is \$29 billion. The permanently manned station is to be operational sometime before the year 2000. NASA contends that the space station will provide an infrastructure to support scientific and commercial activity as well as a departure point for future manned and unmanned exploration of the solar system. In 1990, the Congress increased funding for the space station from \$900 million to \$1.8 billion.

Since 1985, the Congress has provided the space station with \$2.8 billion in budget authority. Canceling the current space station program without initiating an alternative could save as much as \$9.9 billion in budget authority in the 1991-1995 period, relative to the CBO baseline. The actual costs of proceeding with the space station program, however, would be greater than the amount in the CBO baseline. NASA has indicated that in order to complete the project on schedule, it will require funding levels of \$2.5 billion for 1991 and \$2.9

billion for 1992. Therefore, canceling the space station would save roughly \$13.8 billion in budget authority and \$11.9 billion in outlays, relative to current estimates of the program costs from 1991 through 1995.

An alternative to cancellation would be to proceed with a more modest program, using shuttle spacelab flights and intermittently manned and unmanned facilities rather than a permanently manned facility. These activities could be accommodated within or below the current CBO baseline. Restricted manned space activity of this type could provide a foundation in the 1990s for a more modest overall NASA program, which would not require increases in the agency's funding level above the CBO baseline from 1991 through 1995.

Advocates of canceling the space station point out that many of the traditional objectives of U.S. space policy will not be served by the current program. No significant national security purpose will be served, as the Department of Defense has expressed very limited interest in using the NASA station. Many civilian scientific goals could be met earlier, and at a lower cost, with a more modest program. Some scientists argue that the space station will absorb funds that would be better spent on space science and exploration, where the known returns are greater. President Bush's proposal to set the course in space policy--toward a lunar base around the turn of the century and a manned flight to Mars sometime after 2010--included an endorsement of the current space station program. Yet the announcement revived debate in the policy community, not only about the usefulness of the current design of the space station for this purpose, but also about the difficulty of meeting the many requirements NASA claims its current design would fulfill.

The arguments for the current space station program emphasize its possibilities, both known and unknown, and U.S. commitments to cooperating countries. Manned exploration of the solar system requires the type of long-duration flight provided by the current program. More modest alternatives do not. The prospects for research on materials and, ultimately, manufacturing may be sufficient to justify continuing the program at some level. Advocates further contend that other significant uses for a space station will be discovered after it is operational. If the United States were to cancel the current program, it would renege on agreements recently signed with European nations,

Japan, and Canada. If the United States were to withdraw from these agreements, its partners could choose to continue a space station effort of their own or to increase cooperation with the Soviet Union.

**NDD-04 POSTPONE NEW SPACECRAFT DEVELOPMENT
PROJECTS IN ONE OF THE MAJOR NASA
PROGRAM AREAS FOR SPACE SCIENCE
AND APPLICATIONS**

Savings from CBO Baseline	Annual Savings (In millions of dollars)					Cumulative Five-Year Savings
	1991	1992	1993	1994	1995	
Budget Authority	100	140	230	260	270	1,000
Outlays	50	100	170	220	250	790

The National Aeronautics and Space Administration's (NASA's) space science and applications program is currently funded at \$2 billion for eight program areas. Three program areas--physics and astronomy, planetary exploration, and environmental observation--accounted for 85 percent of 1990 funding. Each of these areas includes development funding to plan and build new spacecraft, and operations funding to support the flights of existing spacecraft and analyze their data. If new activities in only one of the three program areas were postponed, NASA could save \$1 billion in budget authority and \$790 million in resulting outlays over the 1991-1995 period. To realize these savings, NASA would have to cancel or postpone one of the following programs: the Advanced X-ray Astrophysics Facility (AXAF) in the physics and astronomy area, the Comet Rendezvous Asteroid Flyby/Cassini mission in the planetary exploration area, or the Earth Observation System (EOS) in the environmental observation area.

Postponing major new spacecraft development in any of these areas would not prevent scientific work from continuing. In fact, the public purpose of gaining scientific knowledge may be better served by allowing intensified efforts in the program areas where new spacecraft development continues. In the physics and astronomy area, existing ground facilities and the launch of two orbiting observatories in the next several years will provide the scientific community with new data, even if two additional planned orbiting observatories (the Advanced X-ray Astrophysics Facility and the Space Infrared Telescope Facility) are postponed. In the environmental observation area, multi-

ple sources of new data will be available regardless of whether new spacecraft are developed and launched over the next five years. In the planetary exploration area, although obtaining samples from other bodies orbiting the sun would require new missions, data from completed missions and those likely to be operating in the near future will be available to planetary scientists.

Significant reductions in one space science program area, rather than smaller reductions across all programs, would concentrate resources in the areas not cut. This reduction strategy would avoid extending projects in many areas with no near-term results. An aggressive pursuit of international cooperation in the area chosen for cutbacks could also decrease scientific losses.

The cost of postponing new spacecraft development in a major program area would be incurred both immediately and in the long term. Immediately, U.S. prestige would fall in the area where new development projects were postponed, and the prestige of other countries would rise in this area of space science. In the long term, cutbacks might also discourage the entry of new scientific and engineering talent into the fields where cuts were made, leaving the U.S. permanently behind.

**NDD-05 CANCEL NASA RESEARCH AND TECHNOLOGY
PROGRAMS FOR THE MOON/MARS INITIATIVE**

	Annual Savings (In millions of dollars)					Cumulative Five-Year Savings
	1991	1992	1993	1994	1995	
Savings from CBO Baseline						
Budget Authority	65	70	70	75	75	360
Outlays	35	65	70	70	75	320
Savings from Administration's Request						
Budget Authority	280	670	900	1,300	1,850	5,000
Outlays	150	470	750	1,100	1,550	4,050

The National Aeronautics and Space Administration (NASA) proposes to expand research and technology development programs, which aim to establish a U.S. base on the Moon around the turn of the century and to carry out a manned mission to Mars after 2010. The Administration's 1991 budget request includes significant new funding above the CBO baseline for the Moon/Mars initiative. Not expanding the nation's space program in this direction could yield five-year savings of \$5.0 billion in budget authority and \$4.1 billion in resulting outlays over the 1991-1995 period, relative to the Administration's request. Savings relative to the CBO baseline would be \$360 million in budget authority and \$320 million in resulting outlays over the same period.

Human exploration of the solar system is a long-standing goal of space enthusiasts and, implicitly, of the NASA program. Since the earliest days of the U.S. space program, its supporters have foreseen progress toward manned spaceflight from Earth's orbit to the Moon and interplanetary space travel to Mars. Presidential commissions in 1969 and 1986 refined the basic goal and recommended that the nation proceed with these objectives. Finally, in 1989, President Bush endorsed a program that would establish a base on the Moon around the year 2000 and send a manned mission to Mars sometime after 2010.

The main disadvantage of proceeding with this program is the cost. Preliminary estimates from NASA indicate that, in order to accommodate this initiative, the agency's annual budget might triple in real terms by the turn of the century. The entire Moon/Mars initiative is estimated to cost as much as \$400 billion. Even if radical and less expensive options were available, the benefits of returning to the Moon or visiting Mars for the first time are both controversial and difficult to quantify.

Many of the subsidiary benefits of the Moon/Mars initiative could be more certainly and less expensively realized by pursuing alternative federal science programs. Within the space science program itself, alternatives could be pursued that are far less costly yet are as productive. In a broader context, equivalent federal spending on a variety of science and technology areas would have many of the same beneficial effects on technology, education, and the competitive strength of U.S. industry associated with manned exploration of the solar system. In the presence of technical uncertainty, the expected return from a more diversified national science portfolio would arguably be even greater than that expected for a narrower focus on human exploration of the solar system.

Successful human exploration of the solar system, however, could offer some unique benefits. Such an enterprise would offer the American people a tangible symbol of national achievement. An aggressive, manned spaceflight program may be particularly effective in attracting young people to careers in science and technology. Finally, the technical assets of the United States may be better suited to the manned exploration of the solar system than to other science and technology options.

**NDD-06 SUSPEND CONSTRUCTION OF THE
SUPERCONDUCTING SUPER COLLIDER
FOR TWO YEARS**

	Annual Savings (In millions of dollars)					Cumulative Five-Year Savings
	1991	1992	1993	1994	1995	
Savings from CBO Baseline						
Budget Authority	130	140	-10	-10	0	250
Outlays	80	120	50	10	-10	250
Savings from Administration's Request						
Budget Authority	170	430	200	-70	-50	680
Outlays	100	310	260	60	-50	680

In fiscal year 1990 the Superconducting Super Collider (SSC), whose total costs were then estimated to be \$5.9 billion, received \$218 million in budget authority. The SSC is the latest generation of particle accelerators designed to investigate the nature of matter and the origins of the universe through physics research. Of the \$218 million available, \$90 million was for research and development (R&D) and \$129 million for construction, making this the first year the Congress has provided the SSC with funding for construction. Since the Congress provided those funds, the Department of Energy's (DOE's) report from the SSC Collider Dipole Review Panel has begun to circulate. The report criticizes the current state of the SSC's dipole magnet design, implicitly raising questions about the wisdom of beginning construction. Suspending construction for two years, while a strong magnet R&D and design effort is mounted, would save \$100 million in 1991 and \$680 million over the five-year period, relative to the Administration's budget request. Savings relative to the CBO baseline would be only \$250 million because the Congress has not yet begun to appropriate the high funding levels this project will require during the peak years of its construction.

Despite continuing assertions by the DOE that only fine-tuning remains on the overall magnet design, the DOE review panel found

that the superconducting magnets could not provide the necessary operating margin, as currently designed, to ensure that the SSC would function as expected. Despite years of effort, magnet strength seems to have reached a plateau below that needed to produce reliably the desired measure of collision energy. The review panel reported that the current "magnets are not satisfactory for operation. . .and therefore the magnet design cannot be considered completed at this time." The review panel called for a "strong magnet R&D effort," including the consideration of design changes that would probably lead to a two-year delay in production. The follow-up advisory panel is recommending design changes to correct the magnet and other design deficiencies that could add more than \$1 billion to project costs. Between these changes and separate revisions in the cost estimates for other parts of the project, total costs are expected to rise by between \$1 billion and \$2 billion.

DOE and some members of the review panel believe that, if properly done, changes in magnet design need not cause substantial delay in production. Even so, allowing more time for the DOE's magnet R&D program might be well advised. Construction began on a previous accelerator before the magnet problems were solved, leading to cancellation of the project after \$224 million had been spent.

Alternatively, the Congress could cancel the SSC. The funding already in this project is still quite modest (\$423 million), relative to the total investment. The report on the magnets' performance raises more questions about proceeding with the SSC. Furthermore, technical risks surrounding less expensive alternatives to the SSC, notably an electron-positron collider, have been substantially reduced during the last year. The Stanford Linear Collider operated successfully and proved that this new type of particle accelerator could perform the "next step" experiments. Canceling the SSC would save \$190 million in 1991 and \$2.1 billion over the five-year period, relative to the Administration's budget request.

**NDD-07 REDUCE SUBSIDIES PROVIDED BY THE
RURAL ELECTRIFICATION ADMINISTRATION**

Savings from CBO Baseline	Annual Savings (In millions of dollars)					Cumulative Five-Year Savings
	1991	1992	1993	1994	1995	
Budget Authority	480	510	540	570	580	2,700
Outlays	70	190	330	430	500	1,500

The Rural Electrification Administration (REA), an agency within the Department of Agriculture, provides financial assistance to rural electric and telephone cooperatives. In 1973, the Congress set up the Rural Electrification and Telephone Revolving Fund (RETRF) to provide direct loans to rural utility cooperatives, at an interest rate of 5 percent, and to authorize the REA to guarantee loans made to cooperatives by other lenders. In 1989, the REA provided \$836 million in direct loans and \$40 million in loan guarantees. When the RETRF was created, the 5 percent rate on REA direct loans was about one percentage point below the long-term Treasury borrowing rate then prevailing. Since then, the gap has widened between the 5 percent rate paid by the cooperatives and the interest rate paid by the REA to finance the direct loans. Although this interest-rate differential has decreased since its widest margin of ten percentage points in 1984, the gap still remains at more than three percentage points today.

Because the RETRF's expenses have consistently exceeded its loan repayment receipts, the RETRF must borrow funds from the Federal Financing Bank (FFB) at a rate equal to the long-term Treasury rate, plus one-eighth of 1 percent. The Treasury rate is projected at 8 percent in 1990. The federal government incurs large budgetary costs from REA lending activities because of the interest-rate subsidy REA borrowers have been provided over the years and because of a few large loan defaults. The Congress has appropriated about \$1 billion to the RETRF over the last five years to cover some of these costs. To achieve budgetary savings, this option would lower the levels of REA lending set by the Congress, raise the interest rate on REA direct loans, and charge a fee on new loan guarantees that would partially offset the

administrative costs of the program and the costs incurred from loan defaults.

Lowering REA lending levels, particularly for direct loans, would produce the largest budgetary savings. (Demand has been low for new loan guarantees because few new power generation plants, for which the guarantees are used, are being built or planned.) If the Congress reduced the minimum requirements for new REA direct loans to 50 percent of the 1990 loan level of \$861 million, REA outlays would fall by about \$60 million in 1991 and by about \$1.3 billion over the 1991-1995 period. If the REA targeted its direct loans toward cooperatives most in need of federal financial assistance, the effect of reducing REA's lending levels might be small and more equitable.

If new direct loan levels are cut to \$430 million in 1991, raising their interest rate to equal the Treasury rate would not generate much additional income for the RETRF during the next decade because the gap between current and future Treasury interest rates and the REA's 5 percent interest charge is expected to be small. This additional income would amount to about \$220 million over the 1991-1995 period and would continue to grow in the future. This income would also make the RETRF less dependent on appropriations and future borrowing from the FFB. In addition, charging a fee of 1 percent on the full amount of new loan guarantees would raise roughly \$35 million over the 1991-1995 period. Carrying out this option--that is, increasing REA's interest rate to equal the Treasury rate, decreasing the levels of REA direct loan obligations by about 50 percent, and charging the 1 percent fee on new loan guarantees--would reduce REA program outlays by about \$1.5 billion over the 1991-1995 period.

The REA has largely fulfilled its original goal of making electric and telephone service available in rural communities. Many cooperatives, however, still depend on the low-interest REA loans to expand and maintain viable electric services to rural communities. Increasing the interest charges or reducing the amount of REA loans provided to these cooperatives would raise the utility bills of their customers, affecting in particular the more rural, less densely populated regions. Raising the REA interest rate would have little effect on the rates of most cooperatives, however, as interest charges account for only a small percentage of the average ratepayer's bill. Furthermore, reducing the level of REA direct loans could decrease federal subsidies to

financially sound cooperatives that are capable of obtaining private financing, while still providing federal financing to the more unsound cooperatives that would have to pay significantly higher rates for privately financed loans.

**NDD-08 REFORM DEBT REPAYMENT POLICY FOR
POWER MARKETING ADMINISTRATIONS**

Savings from CBO Baseline	Annual Savings (In millions of dollars)					Cumulative Five-Year Savings
	1991	1992	1993	1994	1995	
Budget Authority	5	140	90	110	100	450
Outlays	5	350	290	280	270	1,200

Federal power marketing administrations (PMAs) include the Alaska Power Administration, the Bonneville Power Administration, the Southeastern Power Administration, the Southwestern Power Administration, and the Western Area Power Administration. These PMAs sell electricity at wholesale rates from hydroelectric generating plants owned and operated by the federal government. Capital investments for these hydroelectric power and irrigation facilities are financed by federally appropriated funds, which must be repaid at interest rates ranging from 0 percent to 16 percent, averaging about 3 percent. The outstanding debt obligations of these PMAs to the federal government totaled about \$13.7 billion at the end of fiscal year 1988.

By law, the PMAs must use income from electricity sales to cover all operating costs and must repay all federal investments within a "reasonable period," nominally 50 years, though not at a set rate or on a fixed timetable. Department of Energy policies currently allow the PMAs to determine their own schedules for repaying the principal portion of their outstanding debt. In some cases, the principal payments on the federal loans are being deferred until the end of the asset lives of the capital investments. Since the Treasury is not receiving any regular repayments on the loan principal--only interest costs--the amount of deferred loan repayments increases the federal budget deficit.

Requiring the PMAs to repay all federal appropriations on fixed repayment schedules over the lifetime of these projects would increase Treasury revenues and thus lower federal outlays by about \$1.2 billion over the 1991-1995 period. (Such receipts enter the budget as offsets to outlays.) The resulting increase in principal repayments could in-

crease electricity rates for wholesale customers in certain service areas.

Although the PMAs have strengthened regional industrial bases by providing electricity, the prices they charge for electricity may not fully reflect the actual cost of delivery. A disadvantage of the below-market rates and unregulated repayment schedules is that they may represent an inequitable subsidy to certain regions. This cost is borne by all taxpayers. Requiring the PMAs to repay their federal debt obligations on fixed repayment schedules might not disrupt local economic activity, since electricity prices in areas served by the power agencies would still remain below the national average. Enforcing a strict debt repayment schedule, however, could translate into higher product prices and lower market shares for some industries, such as the aluminum industry in the Pacific Northwest.

**NDD-09 ELIMINATE FURTHER FUNDING FOR THE
CLEAN COAL TECHNOLOGY PROGRAM**

Savings from CBO Baseline	Annual Savings (In millions of dollars)					Cumulative Five-Year Savings
	1991	1992	1993	1994	1995	
Budget Authority	600	600	620	650	680	3,150
Outlays	5	35	160	340	490	1,050

The Clean Coal Technology Program (CCTP) was created in 1984 to assist private industry, especially the electric utility sector, in developing commercial technologies that would use coal in environmentally sound ways. The technologies developed under the CCTP are intended primarily to reduce the emissions of sulfur dioxide (SO₂) and nitrogen oxides (NO_x) from coal combustion. These emissions are suspected to cause acid rain. The Department of Energy (DOE) will spend nearly \$400 million to fund and administer the projects in "round one." Selection of these projects began in July 1986. In September 1988, DOE announced the preliminary selection of the "round two" projects, totaling almost \$538 million. Preliminary selection of "round three" projects was in December 1989 and totaled \$540 million. Completing these projects, but rescinding the \$600 million advance appropriation for 1991 and 1992 and eliminating future project funding, could save about \$1 billion in projected outlays over the 1991-1995 period.

Opponents of CCTP argue that the private sector is fully capable of sponsoring commercial research on combustion and pollution abatement equipment. For example, the Electric Power Research Institute directs a variety of projects involving clean coal technologies. In addition, several states concerned about the long-term outlook for their high-sulfur coal industries support research on coal cleaning, emission controls, and combustion technology. Federal CCTP support, which is approximately 60 percent of project costs, may not be necessary to stimulate research on technologies with potentially high commercial appeal.

This argument is particularly true for one set of CCTP activities--those involving repowering technologies. Repowering projects adapt advanced combustion technologies to older plants, thereby increasing their efficiency, capacity, and expected lifetimes, while controlling emissions to very low levels. To the extent that electricity demand grows and repowering technologies improve through private or state-sponsored research, utilities may increasingly turn to repowering existing coal-fired sources. The extent to which CCTP results in the development and adoption of new repowering technologies depends also on the outcome of the current Clean Air Act debate. Legislative acid rain controls that are poorly timed to developments in clean coal technology create little incentive for industry to develop new repowering technologies or for utilities to apply new technologies as they become available.

The commercial market for the second category of CCTP projects (improved retrofit equipment) also depends on the enactment of legislative acid rain controls. Installed solely for emission abatement, retrofit equipment is unnecessary under most current state regulations governing the SO₂ and NO_x emissions from older power plants. Uncertainty over the eventual form and extent of possible federal legislation reduces private incentives for innovation. If no acid rain controls are enacted, then retrofit technologies may have little commercial appeal. If controls are legislatively mandated, however, then the market for appropriate technologies will be known, reducing the justification for federal support.

Finally, although CCTP technologies, especially repowering, may marginally increase the amount of usable energy derived from coal, the long-term CCTP policy aims to expand the use of coal. Such a policy may run counter to proposed federal programs to reduce the emissions of carbon dioxide from fossil fuel combustion, given concern over the possibility that continued coal use may contribute to long-term global warming (see REV-33).

Alternatively, the importance of CCTP also depends on the role that coal plays in national energy policy. In the absence of acid rain legislation, CCTP funding could hasten the deployment of cleaner technologies that will provide environmental benefits and, if acid rain controls are mandated, could alleviate some of the adverse economic impacts on electric utilities, electric ratepayers, and coal miners.

**NDD-10 CHANGE REVENUE-SHARING FORMULA FROM
A GROSS TO A NET RECEIPT BASIS FOR
COMMERCIAL ACTIVITY ON FEDERAL LANDS**

Savings from CBO Baseline	Annual Savings (In millions of dollars)					Cumulative Five-Year Savings
	1991	1992	1993	1994	1995	
Budget Authority	250	240	240	240	240	1,200
Outlays	180	230	240	240	240	1,150

The federal government owns over 700 million acres of public lands--nearly one-third of total U.S. land. These public lands contain a rich supply of renewable and nonrenewable natural resources, such as timber, forage for livestock, oil and natural gas, coal, and many non-fuel minerals. Private interests are allowed access to much of this land to develop the resources found there and, generally, pay fees to the federal government based on the commercial returns from this activity. In many cases, the federal government allots a percentage of these receipts to the states and counties in which the resources are found as compensation for lost tax revenues from the federal lands in their boundaries. The government does this based on gross receipts--that is, on receipts not including federal program costs. Providing federal sharing of receipts on a gross rather than on a net basis causes, in some cases, federal program costs to exceed the government's share of receipts. This revenue-sharing formula may encourage overuse of national resources.

By law, the U.S. Forest Service allots 25 percent of its gross receipts from commercial activities in the national forests--including timber sales, grazing fees, and receipts from mining of "common variety" materials, such as sand, gravel, limestone, and cement--to the respective states and localities. The Bureau of Land Management must allot 4 percent of its timber receipts, about 12.5 percent of its grazing fees, 4 percent of its mining fees from common variety materials, and 50 percent of its onshore oil, gas, and other mineral receipts to the states. (On certain federal lands, called the Oregon and California grant lands, gross federal receipts from all commercial

activities, primarily timber sales, are shared with the states and counties on a 50/50 basis.)

Federal savings would be substantial if the Congress required these agencies to deduct their program costs from their gross receipts before making payments to the states. The regional jurisdictions would continue to receive the same allotted percentage of net federal receipts and would accrue receipt shares totaling about \$550 million in 1991. Certain federal costs would increase, however, under the federal Payment in Lieu of Taxes (PILT) program, which was established in 1976 to offset the effects of nontaxable federal lands on the budgets of local governments. These PILT payments to the states are partially reduced by the amount of revenue-sharing payments from federal agencies. These costs have been netted out of the projected savings. Basing the revenue-sharing formula on net rather than gross receipts would reduce net federal outlays by \$1.2 billion over the 1991-1995 period.

Deducting costs from federal receipts for commercial activities on public lands before making payments to local governments would probably reduce uneconomic commercial uses on these lands. Many local areas that depend for jobs and revenue on the federal programs associated with these activities, particularly the federal timber sales programs, might be hurt economically. To help mitigate this hardship, the federal agencies could switch gradually to the net receipt basis over a period of several years and could promote other uses such as tourism and recreation on these public lands.

**NDD-11 IMPROVE PRICING FOR COMMERCIAL AND
RECREATIONAL USES OF PUBLIC LANDS**

Savings from CBO Baseline	Annual Savings (In millions of dollars)					Cumulative Five-Year Savings
	1991	1992	1993	1994	1995	
Hardrock Mining Claims						
Budget Authority	0	75	75	75	75	300
Outlays	0	75	75	75	75	300
Grazing Fees						
Budget Authority	20	20	20	20	20	100
Outlays	20	20	20	20	20	100
Timber Sales from National Forests						
Budget Authority	40	45	50	50	50	240
Outlays	30	40	50	50	50	220
Federal Water Sales						
Budget Authority	15	15	15	15	15	75
Outlays	15	15	15	15	15	75
Recreation Fees						
Budget Authority	150	150	160	160	180	800
Outlays	150	150	160	160	180	800

The federal government owns and manages over 700 million acres of land in the United States. These lands have a wide range of uses, including mining, grazing, timber harvesting, and varied recreational activities. For most commercial and some recreational uses, the government receives compensation in the form of fees, royalties, and bonuses. Disadvantages of several of these compensation schemes are that a fair return to the government may not be provided and that underpricing may lead to overuse. Better pricing could increase federal receipts and limit commercial and recreational activity to more economically justified levels.

Hardrock Mining Claims

Private access to public domain lands for hardrock mining (for example, the mining of gold, copper, and molybdenum) is controlled by the Bureau of Land Management (BLM). Under the Mining Law of 1872, the discovery of a "valuable mineral deposit" and the staking of a mining claim gives a prospector the right to mine and sell public domain minerals without paying fees or royalties to the federal government. The only condition is an annual expenditure of \$100--a "diligence requirement"--to develop the claim. Moreover, under current provisions, public hardrock mining lands can be patented and allowed to pass into private hands for a nominal fee of \$2.50 to \$5.00 an acre and, it is argued, without a thorough assessment of their alternative uses. S. 1126, a bill that has been referred to the Senate Energy Committee, would impose an annual fee of \$100 and charge a federal royalty of 8 percent of the gross value of hardrock minerals extracted on patented land.

While the budgetary effects of this bill have not been evaluated, the savings from several changes in the current mining law have been estimated. The current annual fee proposed in S. 1126 could be increased from \$100 to \$1,000 (roughly the equivalent of the diligence requirement of \$100 imposed in 1872). This fee would be paid directly to the U.S. Treasury beginning two years after a claim is staked. The patenting provision could also be revoked to prevent a rush of patent applications, which may occur under an imposed annual fee, although this revocation might raise certain legal questions. These amendments would free public lands of inactive claims and would raise an estimated \$75 million annually, beginning in 1992. This revenue would partially compensate the federal government for the value of the minerals extracted and the cost of reclaiming abandoned sites.

Opposition to these amendments stems from arguments that any change in the current law reducing the prospector's expected return would significantly decrease overall prospecting, including that for strategic minerals important to national security. While a \$1,000 yearly fee would probably reduce prospecting and possibly some current mining, these effects might be somewhat offset by clearing inactive claims and opening up land formerly closed to hardrock mining. In S. 1126, a production royalty is proposed as a way for the government to extract a fair share of the rents from mining on federal land. A

royalty system would be administratively expensive, however, since the BLM would have to estimate ore content and processing costs for approximately 150,000 active claims.

Grazing Fees

The Forest Service (FS) and the BLM administer livestock grazing on approximately 307 million acres of public rangelands. These lands can provide ranchers with over 21 million animal unit months (AUM) of grazing each year. A 1986 study by the FS and the BLM estimated the market value of forage in six western regions to be between \$6.10 and \$11.10 per AUM (in 1988 dollars). The BLM and FS spend, on average, \$2.50 per AUM to manage these rangelands. In contrast, the 1989 permit fee was \$1.86 per AUM under the fee formula established by the Congress. Thus, the current fee structure represents a large subsidy for a relatively small group of ranchers.

Various bills have been introduced in the Congress recently to increase the fee charged for grazing. These bills would either adjust the indices used in setting the fee to reflect livestock markets and leasing rates for private rangeland or replace the existing fee structure with a new modified market value. The increase in federal receipts resulting from either of these measures depends on the degree to which ranchers reduce the size of their grazing stock as a result of the increased fees.

The potential budgetary savings that would result under a revised fee structure was estimated by inflating the 1966 base value of these grazing lands. The base value of \$1.23 per AUM used in the current fee structure was inflated to \$4.28, using the GNP deflator, and then increased by a rate that reflects the fair market value of these lands. Assuming a 20 percent to 50 percent decrease in total AUMs over the 1991-1995 period, the adjusted fee of \$6.50 per AUM would raise about \$20 million in additional receipts in 1991 and \$100 million over the 1991-1995 period. Currently, 50 percent of all grazing fees go into the Range Betterment Fund. In estimating these savings, deposits to the fund were capped at \$30 million a year, roughly three times the current level. This cap reflects an estimate of how much the fund could spend, at least over the next several years.

Increased fees for grazing on public lands may overstate the value of public lands compared with private lands that may be in better condition or have more favorable lease terms. In addition, low fees may encourage permit holders to invest in range improvements and to practice good stewardship over the land by grazing only at permitted levels. A potential disadvantage of increased fees is that they would cut ranchers' profit margins and thus might encourage them to break the grazing limits and forgo range improvements. Between 1979 and 1983, however, ranchers spent, on average, only \$0.16 per AUM per year for range improvements. Increased funding from the Range Betterment Fund would offset any decrease in private range improvements. Providing ranchers with longer-term leasing agreements, regardless of their fee level, could promote efforts to minimize overgrazing.

As an alternative to setting fees, grazing rights could be allocated through a competitive bid process similar to the system used by the Bureau of Indian Affairs. Disadvantages of this approach may be high administrative costs and limited competition. In many cases, only the owners of private lands adjacent to federal lease tracts would be willing to bid for grazing rights. (Current law requires permit holders to own a base property adjacent to the federal lease tracts.)

Timber Sales from National Forests

The Forest Service within the Department of Agriculture manages federal timber sales from 119 national forests in the National Forest System. Roughly 12 billion "board feet" of public timber, sold under contract to private lumber companies, was harvested from the national forests in 1989. This harvest is about 26 percent of total U.S. timber production, providing about \$1.4 billion in federal timber receipts. The FS spent approximately \$600 million on timber management, reforestation, timber road construction, and other timber program costs, resulting in net federal timber receipts of \$800 million.

In three of the nine regions in the National Forest System, however, annual cash receipts from federal timber sales consistently have not covered annual cash expenditures of the FS in that region. These so-called below-cost timber sale regions include the Rocky Mountain Region, the Northeastern Region, and the Intermountain Region. On

average, cash expenditures in these regions over the past decade have exceeded cash receipts by a ratio of three to one. (Annual timber program costs in these regions still exceed annual timber receipts, even if FS expenditures for timber road construction are excluded.) The FS does not maintain the data to estimate annual timber receipts and expenditures associated with individual timber sales; thus, the budgetary savings that could be achieved by phasing out all below-cost timber sales in the National Forest System are hard to determine precisely. As an illustration of the potential savings, however, eliminating all future timber sales from the three regions mentioned above would reduce FS outlays by about \$40 million to \$110 million, including savings in the timber road budget. Timber receipts would be reduced by about \$10 million to \$60 million. Net savings in federal budget outlays over the 1991-1995 period would be about \$220 million.

Potential disadvantages of federal below-cost timber sales are that they lead to an increase in the federal deficit, wasteful depletion of federal timber resources through uneconomic timber harvests, economically unwarranted destruction of roadless forests valued by many recreational visitors; and government interference with private timber markets.

One advantage of these sales, however, is that the FS timber program generates benefits other than receipts to the federal government. Among these is community stability in areas dependent on the federal timber industry for logging and other jobs related to timber products. The risk of economic hardship from eliminating the federal timber program in these areas could be reduced by gradually lowering the level of below-cost timber sales, by providing federal programs for job replacement skills, and by encouraging greater development of other activities in the national forests, such as tourism and recreation.

Federal Water Sales

The Bureau of Reclamation (BOR) provides water resources from federal water projects for industrial and agricultural uses in the western states as well as supplying municipal water systems. This water is made available through long-term contracts with water district commissions that are composed of individual users. The prices for water charged under these contracts are generally much lower than the

economic value of the water. For many agricultural users, the water charges rarely cover the federal costs associated with water projects. Frequently, federal water is provided at less than its full costs for agricultural commodities, such as rice, that are subject to price-support programs.

In recent years, the Congress has considered several reforms aimed at reducing the subsidy to agricultural users of federal water and at increasing receipts to the federal government. One reform would require that farms of more than 960 acres be charged full costs for federal irrigation water. (Current law contains this requirement but is vague concerning the definition of a "farm" and, therefore, is often circumvented. BOR is required, however, to investigate possible abuses of the acreage limitation rule.) The other reform would allow those who grow agricultural commodities that are in surplus to receive only one of the federal subsidies currently provided: either the crop price-support payments, or the water provided at federally subsidized costs. While only addressing a portion of the federal subsidy to water users, these two reforms illustrate the changes in the current system that could increase federal receipts from water sales. Taken together, the two proposals could lead to increased receipts of \$75 million over the 1991-1995 period.

Recreation Fees

All of the major federal landholding agencies allow recreational access and provide some visitor services. These services range from maintaining rough hiking trails to operating fully developed recreational facilities, such as campsites and marinas. While entrance and user fees are charged at some locations, these fees generally cover only a small portion of the direct costs of providing visitor and recreational services. For example, in 1990, the National Park Service will spend an estimated \$190 million out of an operating budget of \$778 million on visitor services and will recover only \$56 million in fees. Requiring land management agencies to charge fees to cover the direct costs of visitor and recreational services would shift the burden of those costs to the beneficiaries of these services and would result in improved pricing of public land use. Charging fees to cover the direct costs of visitor and recreational services on National Park Service land would lower

net federal costs by \$150 million in 1991 and by \$800 million over five years.

Disadvantages of increased fees reflect the notion that the national parks and public lands play an integral role in the history of the United States and are the just benefits of the country's heritage. The social benefits of visits to the parks far exceed the government costs. Thus, visits to public lands--especially visits by the elderly and the poor--should be encouraged, not discouraged by increasing fees for such use.

Under an increased fee structure, however, taxpayers would not have to bear the costs of police protection and other forms of visitor assistance that benefit only the users, though taxpayers may be willing to pay some costs of maintaining public lands. Overcrowding at many parks could also be partially alleviated through an appropriate fee structure. Finally, visits by the poor and the elderly could be encouraged by free-access days or by the cross-subsidization of urban parks, whereby fees collected at some parks would be used to offset the costs of maintaining other parks that have lower or no fee charges. Cross-subsidization of some parks may be necessary because multiple access points, too few visitors, and deed restrictions would limit the economic and technical feasibility of charging fees at each facility.

NDD-12 INCREASE THE HARBOR MAINTENANCE TAX

	Annual Added Revenues (In billions of dollars)					Cumulative Five-Year Addition
	1991	1992	1993	1994	1995	
Addition to CBO Baseline	0.2	0.3	0.3	0.4	0.4	1.6

NOTE: Estimates are net of reduced income and payroll tax revenues.

The Army Corps of Engineers now spends about \$500 million per year to maintain channel depths in harbors for more than 180 ports nationwide. In 1990, the government will recover about 30 percent of these expenses through a tax on the value of commercial cargo loaded or unloaded at ports that are not part of the inland waterway system. Raising the harbor maintenance tax from 0.04 percent to 0.12 percent of the cargo's value would lower the deficit by \$0.2 billion in 1991 and by \$1.6 billion over the 1991-1995 period.

Two arguments have been made in favor of raising the harbor maintenance tax. First, the Corps' dredging activities provide a commercial service to identifiable beneficiaries. Shippers save money both through the lower unit costs of shipping on larger vessels and through minimizing inland transport costs. Second, increasing the tax would have little effect on economic activity. Average charges for port use (which include, among other things, wharfage, dockage, and stevedoring) would increase by less than 1 percent as a result of increasing the tax.

Because the tax rate is the same at all ports, a higher rate would increase the extent to which the more efficient, low-cost ports (where operations and maintenance now cost less than one cent per ton of cargo handled) subsidize the less efficient, high-cost ports (where operations and maintenance costs exceed \$100 per ton of cargo). This disadvantage could be mitigated if the tax structure were revised to make taxes a function of costs.

**NDD-13 ELIMINATE FEDERAL GRANTS FOR
CONSTRUCTION OF WASTEWATER
TREATMENT PLANTS**

Savings from CBO Baseline	Annual Savings (In millions of dollars)					Cumulative Five-Year Savings
	1991	1992	1993	1994	1995	
Wastewater Treatment Plant	2,050	2,150	2,200	2,300	2,400	11,100
Budget Authority	2,050	2,150	2,200	2,300	2,400	11,100
Outlays	180	530	1,120	1,590	1,850	5,250

The Environmental Protection Agency (EPA) now offers grants to local governments for meeting the requirements of the Clean Water Act. These grants cover 55 percent of the construction costs for the wastewater treatment plants that are needed. Funding for construction grants will end after 1990. The EPA also provides "capitalization" grants, as authorized by the Water Quality Act of 1987, to support state revolving loan funds (SRF). Under the 1987 act, capitalization grants will replace all funding for construction grants beginning in 1991. For each dollar in federal capitalization grants, a state contributes 20 cents to its SRF. States are required to use SRF monies primarily to provide local governments with low-interest loans to pay for the construction of these wastewater treatment facilities.

Under CBO baseline assumptions, federal support for the construction of local wastewater treatment facilities is projected to continue at the 1990 appropriated level of \$2.0 billion, adjusted for inflation. For 1992 and beyond, this sum is above the amount authorized in the Water Quality Act of 1987. If all funding were instead terminated after 1990, the federal government would save approximately \$180 million in 1991 and about \$5.3 billion through 1995.

Support for such cuts is based partly on the fact that federal wastewater treatment grants originally were intended to be temporary. Support also rests on the argument that ending these grants before the date required by current law would have little effect on water pollution. The grants have done little to stimulate spending on wastewater treatment. In some cases, the grants have even encouraged inefficient

decisions about treatment systems by state and local governments. In particular:

- o Studies indicate that state and local governments reduce their own wastewater treatment expenditures between 40 cents and 70 cents for every dollar that they receive from the federal government. Thus, most of the federal grants have replaced rather than supplemented state and local spending.
- o Prospects for federal grants have prompted some communities to wait until federal assistance was available (sometimes for more than 10 years), rather than promptly correct known pollution problems--thus delaying compliance with the Clean Water Act.
- o Grants provided for construction, but not for operation and maintenance, have reduced incentives for local governments to find less capital-intensive and less costly alternatives for controlling water pollution.

Opponents of such cuts note three effects. First, states and localities would find it more difficult to meet the wastewater treatment deadlines in the Clean Water Act without the funding levels called for by current law. Second, the capitalization grants may be more efficient than the construction grants because states will have some ability to tailor the terms of loans from their SRFs to the particular circumstances of each recipient. Third, the capitalization grants would assist future wastewater control efforts by state and local governments. Eliminating these grants would increase the financial burden that states and local governments will bear in coping with future water pollution problems.

**NDD-14 REDUCE FEDERAL SUPPORT FOR
AGRICULTURAL RESEARCH AND
EXTENSION ACTIVITIES**

Savings from CBO Baseline	Annual Savings (In millions of dollars)					Cumulative Five-Year Savings
	1991	1992	1993	1994	1995	
Budget Authority	350	360	380	400	410	1,900
Outlays	250	330	370	390	410	1,750

The U.S. Department of Agriculture (USDA) has three agencies that conduct and support agricultural research and education. The Agricultural Research Service (ARS), the internal research arm of the USDA, operates at various locations throughout the country. The Cooperative State Research Service (CSRS) provides support for research conducted at land-grant universities and other eligible state institutions. The USDA's Extension Service (ES) informs farmers and other rural residents about farming methods and conducts a nutrition education program aimed at low-income families. The 1990 appropriations for these three USDA agencies totaled \$1.3 billion. Reducing funding levels by 25 percent would save \$1.7 billion in outlays over the 1991-1995 period.

One advantage of reducing support for the activities of these agencies is that federal research often works at cross purposes with other federal policies and programs. In addition, money spent on research aimed at increasing agricultural productivity, when there is already excess capacity in the sector, could be better spent elsewhere. Opposition to some types of research, such as those involving genetically engineered organisms, is based on the belief that they pose unknown threats and should not be funded. Furthermore, some applications of research directly benefit groups that should either fund it themselves or share more fully in its costs.

Reducing funding for ES activities would have a relatively minor direct impact on farmers. For example, the Expanded Food and Nutrition Education Program and money earmarked for urban gardening

projects could be eliminated without harming the ES's basic mission of educating and assisting farmers.

Historically, research and extension activities have played important roles in the development of an efficient farm sector. Reduced funding could compromise the future development of the agriculture sector and its competitiveness in world markets. In addition, significant benefits from research accrue to U.S. consumers through an abundant and relatively inexpensive food supply. In a recent report, the Board on Agriculture of the National Research Council recommended that funding for agricultural research be increased. The report stated that more should be spent on research to maintain the competitive position of U.S. agriculture in world markets; to develop more convenient and nutritious foods that contribute to human health and well-being; and to create more environmentally sound farming practices to conserve or stop the degradation of water, air, and soil.

**NDD-15 INCLUDE FOREIGN DEPOSITS OF U.S. BANKS
IN THE FDIC INSURANCE BASE**

Savings from CBO Baseline	Annual Savings (In millions of dollars)					Cumulative Five-Year Savings
	1991	1992	1993	1994	1995	
Budget Authority	0	0	0	0	0	0
Outlays	300	320	320	320	320	1,580

Under current law, the Federal Deposit Insurance Corporation (FDIC) annually assesses insured banks at the rate of 0.12 percent on a bank's average domestic deposit liability, minus certain exclusions and deductions. This rate will increase to 0.15 percent on January 1, 1991. The FDIC, in turn, insures these deposits against default, up to \$100,000 per account. Deposits at foreign branches of insured banks are neither covered by the insurance nor charged premiums. Typically, such foreign deposits amount to about 13 percent to 18 percent of total bank deposits. This option would amend current law to include deposits at foreign branches of insured banks with respect to both insurance and premiums.

An advantage of this option is that extending insurance coverage to foreign deposits of U.S. banks would make explicit a policy that is now implicit regarding free coverage of such deposits to these banks. This implied coverage was stated by the Comptroller of the Currency, among others, who in the wake of the Continental Illinois Bank rescue said that the government would not allow big banks to fail. Since big banks hold over 80 percent of the foreign deposits of U.S. banks, these deposits are effectively insured. Big banks have a competitive advantage in other ways. They now pay a lower insurance premium on their total deposits (much of which are held in foreign branches) than do smaller banks, which rely exclusively on domestic deposits. Some analysts have argued that insuring such deposits would raise the exposure of the FDIC to a prohibitive level, since it would add new potential liabilities rather than simply recognize existing implied coverage. Moreover, increased premiums could reduce the overseas competitiveness of U.S. banks by increasing their costs.

The additional income that the FDIC would receive from assessments on these deposits is uncertain. Deposits in foreign branches of U.S. banks have varied considerably over the past decade. Some analysts believe that banks may easily evade the fee by converting deposits to financial instruments that would be exempt from the assessment. FDIC collections under this option would increase by about \$300 million in fiscal year 1991 given three assumptions: that foreign deposits grow at a rate comparable with that of recent years; that the current statutory premium be maintained; and that the option be implemented before January 1, 1991. Beyond that, increased assessments could provide additional annual income to the FDIC of approximately \$1.6 billion through 1995, depending on the rate of growth of foreign deposits and other factors. In budgetary terms, these additional collections would reduce FDIC outlays in each year. The potential liability base could increase by as much as \$350 billion (the approximate size of foreign deposits). Because the FDIC's bank insurance program operates through a revolving fund that is self-financed and has a surplus cash balance, no immediate effect on budget authority would result.

**NDD-16 DISCONTINUE POSTAL SUBSIDIES FOR
NOT-FOR-PROFIT ORGANIZATIONS**

Savings from CBO Baseline	Annual Savings (In millions of dollars)					Cumulative Five-Year Savings
	1991	1992	1993	1994	1995	
Budget Authority	350	370	380	400	410	1,900
Outlays	350	370	380	400	410	1,900

The Postal Reorganization Act of 1970, which replaced the federal Post Office Department with the independent U.S. Postal Service, intended that the mail system operate as a largely self-sufficient enterprise with mail users paying the full costs of postal service. However, certain bulk mailers--notably religious, educational, and other charitable organizations, as well as state and national political committees--receive favored statutory treatment. These favored mailers pay reduced postage rates that, on average, cover only about 70 percent of the costs of service received. The taxpayer subsidizes the remaining costs through annual federal payments made by the Congress, referred to as revenue forgone appropriations. In 1989, the subsidy for not-for-profit bulk mailers totaled about \$365 million. More than \$1.9 billion could be saved through 1995 if such payments were discontinued and subsidized postage rates were eliminated. Subsidies supporting reduced rates for blind and otherwise handicapped persons, libraries, and others could be continued.

Increasing rates for favored mailers would further the goal of requiring mail users to pay for the costs of postal service. The overuse of mail services that reduced rates engender might also be discouraged. Such overuse causes households, especially those with higher incomes, to receive more mail than they may want. The Philanthropic Advisory Service, a branch of the Better Business Bureau that monitors the activities of charitable organizations, reports frequent complaints from citizens who have received multiple solicitations for support from the same not-for-profit groups. Furthermore, the Advisory Service has found that fundraising costs for some not-for-profit organizations consume a very high percentage of the contributions received from these

fundraising campaigns. (President Reagan repeatedly proposed virtually eliminating appropriations for reduced rates. The 1990 budget, for example, proposed restricting eligibility for such rates and shifting to other mailers the cost of the remaining subsidized rates. Proposals in President Bush's budget focus on restricting eligibility for subsidized rates. If adopted, such restrictions could reduce mail appropriations by an estimated \$0.1 billion.)

While discontinuing reduced rates could cause financial difficulties for some groups, the total subsidy represents only a small part of federal assistance to not-for-profit organizations. In 1989, such organizations received about \$4 billion in federal grants. Support in the form of tax deductions for charitable contributions cost the government, through lower tax revenues, an additional \$12 billion. Finally, subsidized postage represents an additional burden on taxpayers who, before taxes, contributed about \$87 billion to charitable organizations of their choice in calendar year 1988.

Eliminating this postal subsidy could curb the flow of educational, cultural, charitable, and other public interest information. It could also cause rates for not-for-profit organizations to increase by an average of about 45 percent. (If the Congress reduces appropriations below required levels, the Postal Service is required to increase postage rates paid by favored mailers.) Such rate hikes could pose financial difficulties for some organizations, especially those that depend heavily on mail solicitation for fundraising. The burden on such organizations would be particularly heavy in light of upcoming general rate hikes that affect all mailers.

NDD-17 SCALE BACK THE RURAL HOUSING LOAN PROGRAM

Savings from CBO Baseline	Annual Savings (In millions of dollars)					Cumulative Five-Year Savings
	1991	1992	1993	1994	1995	
Eliminate New Lending						
Budget Authority	1,350	840	1,050	1,350	1,300	5,900
Outlays	1,150	1,300	1,350	1,300	1,300	6,400
Reduce New Lending by 50 Percent						
Budget Authority	680	670	670	670	660	3,350
Outlays	570	660	670	660	660	3,200
Increase Borrowers' Payments to 28 Percent of Income						
Budget Authority	60	150	240	330	420	1,200
Outlays	60	150	240	330	420	1,200

The Section 502 housing program, administered by the Farmers Home Administration (FmHA), provides mortgages to rural low-income borrowers, many of whom live in areas with shortages of private mortgage credit. The FmHA's major cost for this program is the difference between the rates it pays to borrow to finance the program and the rates borrowers pay to obtain the FmHA mortgages. The latter rates can be as low as 1 percent. During 1989, more than 25,000 rural households in the continental United States with adjusted incomes averaging about \$14,100 purchased single-family homes with loans at reduced interest rates from the FmHA. The total value of all new Section 502 loans in 1989 was nearly \$1.3 billion.

Through this program, eligible borrowers can purchase homes generally by spending 20 percent of income on mortgage payments, property taxes, and insurance throughout the full mortgage term, usually 33 years. (Eligible borrowers pay somewhat more than 20 percent of income, if necessary, to amortize the loan at 1 percent.) Incomes are recertified annually, and necessary adjustments in payments are made. In contrast, about two-fifths of all low-income homeowners in

both metropolitan and nonmetropolitan areas spent more than 30 percent of income for housing in 1985.

The costs of this program could be cut by eliminating or reducing new lending or by increasing borrowers' payments.

Eliminate or Reduce New Lending by 50 Percent. If new lending under the Section 502 program were eliminated, federal outlays would be about \$1.1 billion lower in 1991 and \$6.4 billion lower over the 1991-1995 period. Alternatively, if new lending were reduced by half, federal outlays would be reduced by \$3.2 billion over the same period.

On the one hand, the current program may not be the best use of scarce federal resources. The program makes payments, which are sizable, to relatively few of the eligible households, thereby treating them more generously than similar households that do not receive aid. On the other hand, if either option were enacted, low-income rural households in areas where the program currently operates would probably experience greater difficulty becoming homeowners, both because the cost of homeownership would rise and because many of these loans are made in areas with shortages of private mortgage credit.

Increase Borrowers' Payments to 28 Percent of Income. If these rural housing loans were continued at the current volume but borrowers' payments were increased to 28 percent of income, federal outlays would be reduced by \$60 million in 1991 and \$1.2 billion in the 1991-1995 period. This option assumes that the increase in payments would be effective immediately for new borrowers and would be phased in over eight years for current borrowers.

On the one hand, increasing the percentage of income paid for FmHA loans would eliminate a disparity between the FmHA Section 502 program and a comparable program sponsored by the Department of Housing and Urban Development (HUD). In the HUD program, in which assistance for new households was terminated at the end of fiscal year 1989, urban borrowers pay 28 percent of income for housing costs. On the other hand, increasing the percentage of income that rural households pay toward homeownership would shift the composition of borrowers away from households with the very lowest incomes.

In addition, higher costs, relative to income, might raise default rates among new borrowers; historically, the foreclosure rate has been around 2.5 percent.

**NDD-18 SCALE BACK THE RURAL
 RENTAL HOUSING ASSISTANCE PROGRAM**

Savings from CBO Baseline	Annual Savings (In millions of dollars)					Cumulative Five-Year Savings
	1991	1992	1993	1994	1995	
Stop Expansion						
Budget Authority	730	750	770	790	810	3,850
Outlays	65	430	570	630	680	2,350
Slow Expansion						
Budget Authority	15	35	55	70	90	270
Outlays	a	10	25	40	55	130
Increase Developers' Interest Rate to 5 Percent						
Budget Authority	a	5	15	30	50	100
Outlays	a	5	15	30	50	100

a. Less than \$2.5 million.

The Section 515 housing program, administered by the Farmers Home Administration (FmHA), provides low-interest, 50-year mortgage loans to developers of multifamily rental projects in rural areas. These mortgages have interest credits that reduce the effective interest rates to 1 percent and, in turn, lower rental costs for Section 515 tenants.

Under current rules, assisted tenants contribute toward their housing expenses the greater of 30 percent of adjusted income or the minimum project rent. The minimum project rent for each unit includes a proportionate share of the amortization costs of the 1 percent mortgage and of the project's operating expenses. The developer keeps the minimum rent, and the FmHA collects any payments above this minimum and treats them as additional interest payments to reduce the program's cost. The estimated average annual federal cost for newly assisted households under the Section 515 program exceeds \$4,500. During 1989, new Section 515 loans, valued at over \$550 million, were made to finance about 16,000 new rental units.

Stopping all new commitments for assistance under the Section 515 program would reduce federal outlays by nearly \$2.4 billion over the 1991-1995 period. Slowing the expansion of this assistance would reduce federal costs by less but could allow for some increase in the number of households served. For instance, making only enough additional loans to keep the share of the eligible population served at its current level would reduce federal outlays by \$130 million from 1991 through 1995. Alternatively, increasing the interest rate on loans to project developers--from 1 percent to 5 percent, on average--would save \$100 million over the same period and more in subsequent years.

Another method to reduce federal outlays under the rural rental housing assistance program would be to raise the rental payments of tenants to 35 percent of income. This approach might be of particular interest if a similar increase were enacted for subsidized urban renters (see NDD-40). Data are not available, however, to estimate the savings from this alternative for subsidized rural renters.

All four options would cut the federal deficit and would eliminate or reduce the deep subsidies currently provided to developers of rural rental projects and their tenants. Such deep subsidies raise issues of fairness unless selected tenants can be shown to be worse off than other eligible people who are not assisted. Stopping or slowing expansion of the Section 515 program would, however, cut the number of rural families being assisted compared with a continuation of current policy. Moreover, doing so would probably result in slower growth in the supply of standard-quality, low-income rental projects in rural areas.

In contrast, increasing the interest rates paid by developers would have two major effects. First, developers could choose to construct fewer projects, thereby reducing the supply of units made available through the Section 515 program. Second, the projects that were built would almost certainly have higher rents because developers would pass along their higher interest rates (and mortgage payments) to tenants. As a result of higher rents, the Section 515 program would increasingly serve tenants with somewhat higher incomes, which would be required to cover the increased rental payments.

NDD-19 END SBA LOANS AND LOAN GUARANTEES

Savings from CBO Baseline	Annual Savings (In millions of dollars)					Cumulative Five-Year Savings
	1991	1992	1993	1994	1995	
End All Credit Programs						
Budget Authority	20	75	220	310	340	960
Outlays	130	290	400	510	570	1,900
Keep Minority and Disaster Programs						
Budget Authority	-30	20	150	260	320	720
Outlays	-40	15	140	250	310	670

The Small Business Administration (SBA) provides both direct loans and loan guarantees to qualified small businesses. SBA's lending objectives are to promote business development generally, to aid economically disadvantaged groups, and to assist small businesses and homeowners in recovering from disasters. SBA outlays could be reduced by about \$2 billion over the 1991-1995 period by eliminating all SBA loan and loan guarantee programs. An alternative to eliminating all SBA loans would be to retain only the loan programs that provide assistance to minorities and disaster victims. Continuation of these programs could be justified as aid to those who are socially or economically disadvantaged because of factors beyond their control. Eliminating all but these two types of programs could reduce SBA outlays by \$0.7 billion over the 1991-1995 period. In the first year, however, outlays would actually increase because the loss in fees from loan guarantees would not be fully offset by the reductions in other credit programs.

Under the loan guarantee program, the federal government guarantees 90 percent of the principal for business loans up to \$155,000 and between 70 percent and 85 percent for loans exceeding \$155,000. The interest rate on guaranteed loans is about two and one-half percentage points above the prime rate. In addition, the SBA guarantee has a charge equal to 2 percent of the amount guaranteed. In 1989, SBA guaranteed about 20,000 loans, totaling nearly \$3.3 billion. The SBA

share of the guaranteed loans was about \$2.7 billion. About 3,600 guaranteed loans, totaling nearly \$0.5 billion, defaulted and were subsequently purchased by SBA in 1989.

Under the direct loan program, SBA provides loans to businesses located in areas of high unemployment or low income and to businesses owned by minorities, handicapped individuals, and Vietnam veterans or disabled veterans. SBA also provides direct loans to homeowners recovering from natural disasters. Direct loans generally do not exceed \$150,000, although certain disaster loans are as high as \$500,000. The interest rate on direct loans currently ranges from 3 percent to about 9 percent, depending on the specific loan program. In 1989, SBA disbursed about 9,500 direct loans, totaling nearly \$210 million and bringing the total direct loan portfolio to nearly \$6.7 billion. About 8,800 direct loans, totaling nearly \$450 million, defaulted and were subsequently charged off in 1989. The credit extended by SBA in both the direct loan and guaranteed loan programs is for a term of up to 25 years--significantly longer than would be available to small businesses in the absence of SBA assistance.

SBA assistance is favored by those who view it as a way of aiding small businesses, which generally create more jobs, improve technology more rapidly, and satisfy some markets more efficiently than do large firms. In addition, small businesses may need assistance in their struggle against inadequate information or discrimination.

The main drawback is that SBA assistance tends to flow to the firms least likely to create stable employment, improve technology, or enhance national productivity. SBA assistance is used primarily by businesses that have been rejected by conventional providers of finance. SBA loans have a high default rate. Moreover, financial markets are now more efficient and less susceptible to the types of market failure that justified the SBA program when it first began.

**NDD-20 IMPROVE PRICING OF LICENSES TO USE
THE ELECTROMAGNETIC SPECTRUM**

	Annual Added Receipts (In millions of dollars)					Cumulative Five-Year Addition
	1991	1992	1993	1994	1995	
Addition to CBO Baseline	375	375	N.A.	N.A.	N.A.	750

The Federal Communications Commission (FCC) has the responsibility of allocating licenses to use the electromagnetic or radio spectrum in accord with the public interest. Currently, six megahertz on the spectrum are available for allocation. Auctioning licenses for this unassigned portion of the radio spectrum could generate \$750 million over the next two years. The proceeds from an auction could be considered revenues or offsetting receipts, depending on the form of the enacting legislation.

Current FCC policy does not require users to pay (beyond an application fee) for the right to use the electromagnetic spectrum, which is a public resource. Uses include traditional radio and television broadcasting as well as new commercial areas, such as cable television, satellite and microwave communications, and cellular telephone and paging services. Current policy also allocates large parts of the spectrum to other specific uses to assure clear transmissions. Technical advances, however, have made possible a greater variety of spectrum uses than current policy permits. If the FCC permitted the broadest access--based on technical feasibility--to the unallocated spectrum, more efficient use would be made of it.

Until 1982, the FCC allocated the spectrum through an administrative hearing process that compared the merits of contending applicants. In 1982, in response to criticisms that the hearing process was too long and too costly for the government and for the public interest, the Congress permitted the FCC to experiment with assigning portions of the spectrum by a lottery open to all applicants who meet minimum eligibility criteria. Currently, the FCC employs both

administrative hearings and lotteries for allocating non-mass-media licenses.

Initiating an auction process for spectrum allocation, analogous to the process used for auctioning oil drilling rights on the Outer Continental Shelf, provides the FCC with revenues and offers two advantages. An auction process would provide a fair market value of the license rights to unassigned portions of the spectrum and thus encourage economically efficient use. An auction process would also decrease the cost to the government of spectrum allocation and allow private-sector resources invested in the application process to be more profitably applied elsewhere. As an auction process does not include changes in licensee requirements, the FCC's role in guarding the public interest would not be compromised.

The principal disadvantage of an auction process is that it may preclude small, less wealthy applicants--for example, local telephone cooperatives--from expanding their use of the spectrum. The financial strength of large firms, however, is already a determining factor in the hearing process (given regulatory and legal expenses) and also in the lottery process (given the secondary market for spectrum allocation that the process creates). As a deficit reduction measure, a disadvantage of an auction process is that it would not provide a stable, continuous inflow of revenues, since no additional portions of the spectrum beyond the current quantity are available for use. Some future revenues could be expected, however, if technological change created profitable uses for currently unused, higher-energy parts of the spectrum or if the Congress made available to the private sector those portions of the spectrum currently reserved for public use. Public-sector users--such as police, fire, and other emergency providers--have expressed concern that an auction process, with its revenue-raising potential, would lead the Congress to transfer too much of the public spectrum to private use and, ultimately, would leave the public with too small an allocation.

Substantial uncertainty surrounds any estimate of proceeds from auctioning parts of the spectrum. If undertaken, such an auction would be the first by the FCC. If the terms of the auction were specified to allow any technically feasible use, rather than constrained to a particular use, proceeds could be higher. The CBO estimate assumes that licenses would be granted on a local basis. If they were

auctioned on a national basis--that is, a block of spectrum was allocated to one successful bidder for use nationwide, rather than broken up geographically for separate local bidding--the proceeds for the federal government could be much greater. The Administration has estimated that auctioning 6 megahertz of spectrum on a national basis could produce proceeds of \$3.4 billion--\$2.3 billion in 1991, and \$1.1 billion in 1992.

**NDD-21 IMPOSE A ROYALTY PAYMENT ON
COMMUNICATIONS USERS OF THE
ELECTROMAGNETIC SPECTRUM**

	Annual Added Receipts (In millions of dollars)					Cumulative Five-Year Addition
	1991	1992	1993	1994	1995	
Addition to CBO Baseline	1,700	1,800	1,900	2,050	2,150	9,600

This option would institute royalty payments on scarce parts of the electromagnetic or radio spectrum used for communications. To retain their licenses, users of the electromagnetic spectrum who earn revenues from generating or relaying a signal would be charged an annual royalty payment equal to 4 percent of their gross revenues. Royalty payments by major communications users of the electromagnetic spectrum could raise \$9.6 billion through 1995. This estimate does not take account of reduced income tax revenues. The receipts from these royalty payments could be considered revenues or offsetting receipts, depending on the form of the enacting legislation.

The Communications Act of 1934 established the public nature of the electromagnetic spectrum. The Federal Communications Commission (FCC) allocates frequencies to private users through a variety of licensing procedures. While the FCC already charges user fees to cover the cost of the application and licensing process, license holders have profited from using this scarce public resource without compensating the public. Establishing a royalty payment would be consistent with federal policy in other areas, for example, petroleum production on the Outer Continental Shelf. Since 1979, proposals have been made in the Congress to charge communications users of the electromagnetic spectrum. Previous legislative proposals would have charged a royalty payment based on a market's population and number of license holders. This payment structure was designed to capture the size and competition level of local markets. Basing the royalty payment on gross revenues, as in this option, would also reflect these conditions.

Arguments for a royalty payment emphasize the public nature of the electromagnetic spectrum and its role as a key unpriced factor in the production of communications services. The prices paid for licenses in the private market are indicative of the value of this public resource. The absolute scarcity of spectrum available for some uses--VHF television, cellular telephones, satellite communications--also provides general support for a royalty payment. Many holders of FCC licenses producing communications services earn higher-than-average profits, or economic rents, through their use of this public resource. In these circumstances, royalty payments to the government would leave the economic efficiency of service providers unaffected.

Arguments against a royalty payment are both general and specific. In general, arguments note that, at the time most spectrum licenses were issued, this public resource had little or no value. The economic value of the resource was created only through its development by spectrum users and, thus, use of the spectrum is essentially a property right of private users. Regarding economic rents, the federal income tax already secures a portion for the government. Moreover, a royalty payment based on a formula is likely to capture only the average level of rents in affected industries, permitting some licensees but not others to continue to earn above average profits. A final general objection to a royalty payment is that license holders in some markets will increase their prices and pass along the payment to consumers.

More specifically, arguments against a royalty payment note that some groups of users have experienced decreased profits--for example, AM radio license holders. In a few cases, these license holders have gone out of business, abandoning their FCC spectrum allocation. A cap on the royalty payment of 10 percent of net income before federal income tax was included in a previous proposal. Broadcasters argue that free use of the spectrum compensates license holders for adhering to public interest regulations. Other proposals recognized this concern by eliminating content regulation when a royalty payment was implemented.

Several alternative strategies could be pursued in implementing a royalty payment. As proposed, the Congress could specify the details of a royalty payment, including the royalty rate and those spectrum users who would pay. Alternatively, the Congress could provide legislative

guidance and specify revenue targets, but could empower an executive agency to determine the users subject to the payment and the royalty rate. Or, the Congress could mandate "royalty bidding," by which a royalty would be required of all license holders, but a competitive bidding process would be used to determine the amount. Royalty bidding could offer both the minimal disruption of a flat rate system and an incentive to improve the economic efficiency of spectrum use.

NDD-22 REDUCE FEDERAL AID FOR MASS TRANSIT

Savings from CBO Baseline	Annual Savings (In millions of dollars)					Cumulative Five-Year Savings
	1991	1992	1993	1994	1995	
Budget Authority	1,550	1,650	1,700	1,750	1,850	8,500
Outlays	610	930	1,200	1,350	1,550	5,600

The federal government now provides about \$3.5 billion a year in capital and operating assistance to mass transit agencies. Federal assistance pays up to 80 percent of the costs of assisted capital projects (which amount to over 70 percent of all investment in transit systems) and up to 50 percent of operating deficits (roughly 16 percent of annual operating costs) for transit services. Savings of \$606 million in outlays in 1991 and \$5.6 billion over the 1991-1995 period could be obtained by reducing the federal match on capital grants to 50 percent and by eliminating all operating assistance.

The high federal shares in investment spending and operating assistance do not appear to have improved the productivity or use of mass transit services. Despite modernization of transit systems, only 5 percent of journeys to or from work are made by mass transit. Transit agencies serve mainly downtown areas, while most of the growth in urban travel has been in the suburbs. Moreover, productivity of the transit fleet is low--fewer than 20 percent of seats are occupied, on average, and labor costs per mile of travel rose by 60 percent during the 1970s, when overall assistance levels were highest. A reduction in the federal share to 50 percent of investment in mass transit might improve investment choices, as it has in the wastewater treatment program. Ending operating assistance could encourage local authorities to make better use of existing capital by improving services, by using more cost-effective smaller vehicles, or by taking other steps to lower the operating costs of transit services.

Sudden changes in financial assistance, however, could cause dislocation of services to the poor, the young, the elderly, and the handicapped who are particularly dependent on public transportation.

Moreover, an across-the-board cut would be inefficient, since further investment in some places--such as the rehabilitation of rail transit in older cities--could have a high payoff.

NDD-23 END SUPPORT FOR AVIATION DEVELOPMENT

Savings from CBO Baseline	Annual Savings (In millions of dollars)					Cumulative Five-Year Savings
	1991	1992	1993	1994	1995	
Establish the FAA as a Private Corporation						
Budget Authority	4,700	4,900	5,100	5,350	5,550	25,650
Outlays	2,950	3,850	4,450	4,900	5,350	21,550
Eliminate Airport Grants-in-Aid						
Budget Authority	1,800	1,800	1,850	1,950	2,050	9,450
Outlays	250	550	1,250	1,450	1,550	5,050
Total Savings						
Budget Authority	6,500	6,700	7,000	7,300	7,600	35,100
Outlays	3,200	4,450	5,650	6,350	6,950	26,550

Airline deregulation has improved the efficiency of air transportation, making it cheaper and more accessible. Many of the benefits of deregulation arise from the development of airline hubs that allow large passenger interchanges between flights. Hubs make more flexible use of aviation infrastructure and federal aviation services as well as place more demands on them during peak use. But neither the air traffic control system nor the airport grants program can respond quickly to demands for new capacity at emerging hubs.

Establish the FAA as a Private Corporation. Transferring management of air traffic control from the Federal Aviation Administration (FAA) to private interests would encourage development of an aviation infrastructure that is more responsive to the demands of newly competitive airlines. This transfer of management could yield the following benefits. First, private financing would require full recovery of the system's costs and thus give managers incentives to minimize these costs and to charge them to users and beneficiaries of the services. Second, physical capacity, investment, and air traffic control operations would be more closely matched to the demands of users and their willingness to finance them. Finally, establishing and enforcing safety

and consumer regulations would remain federal responsibilities and would thus be separate from the promotion and operation of the airway system.

Eliminate Airport Grants-in-Aid. The major argument for eliminating airport grants is that most commercial airports would have little trouble financing capital improvements from the fees paid for their services and, therefore, do not need a federal program. Further, federal grants create incentives to build additional capacity where it is less needed; as a result, little of the current grants program helps to eliminate airport congestion. Indeed, continuing the grants program could undermine the benefits of private management of air traffic control capacity if grants for airport expansion were not coordinated with increases in that capacity. The current federal prohibition on airport passenger taxes (head taxes) could be eliminated so that airports could substitute their own financing for the federal funds withdrawn.

One argument for retaining the current program is that the benefits provided by the airport and airway systems are nationwide in scope. Therefore, a federal role in funding and planning is appropriate and required. Further, since air traffic control services may be provided most efficiently by a single supplier, federal oversight of such a private monopoly may be needed to protect the public interest. Supporters of the airport grants program argue that more assistance is needed to overcome airport congestion. Rather than eliminate airport grants, aviation excise taxes could be raised to cover existing or increased spending, or subsidies from the general fund for the operating costs of air traffic control could be continued.

Total Savings. Cost savings under this option would stem from reduced federal spending on operations and investment and would total \$26.6 billion over five years. The estimates presented here make no allowance for any sale or transfer of air traffic control assets. The estimates assume continuing federal responsibility for government use of airspace, safety, and consumer regulation. They also assume that excise taxes, now paid into the Airport and Airway Trust Fund, would revert to general revenue. Some of these taxes were originally general revenue taxes before being earmarked by the Airport and Airway Revenue Act of 1970. Moreover, federal spending on commercial and private aviation has consistently exceeded excise tax revenues in every year since the trust fund was established. This has been made possible

because of expenditures from the general fund. The uncommitted balance in the trust fund is a direct result of these general fund expenditures. Allowing the taxes to revert to general revenues would provide some offset to the \$18 billion general fund subsidy of commercial and private aviation over the past 19 years. If significant tax-exempt bonding were used in lieu of airport grants, the annual savings would be lower than those shown above.

**NDD-24 ESTABLISH CHARGES FOR AIRPORT
TAKEOFF AND LANDING SLOTS**

	Annual Added Receipts (In millions of dollars)					Cumulative Five-Year Addition
	1991	1992	1993	1994	1995	
Addition to CBO Baseline	300	300	300	300	300	1,500

The Congress considered imposing charges in the current fiscal year for the use of takeoff and landing slots at the four airports where the Federal Aviation Administration (FAA) has established capacity controls: Kennedy International and La Guardia in New York; O'Hare International in Chicago; and Washington National in the metropolitan D.C. area. That proposal would have required the FAA to raise \$239 million through these charges for this fiscal year.

These takeoff and landing slots were instituted in 1968 to control capacity and thus were allocated without charge by the FAA. A total of about 3,300 air carrier slots exist, with an additional 1,300 commuter and general aviation slots at the four controlled airports. Airlines are currently allowed to buy and sell slots among themselves with the understanding that the FAA retains ultimate control and can withdraw the slots or otherwise change the rules on their use at any time. These slots have value because the demand for flights exceeds the capacity of the airports and of the air traffic control system at certain times. Though the original allocation of slots was administrative, the current system of allowing purchases and sales of slots by airlines injects market factors into the allocation.

This option would establish slot charges on a permanent basis at the four large airports with a target of \$300 million in annual receipts. This estimate is based on charging only for the air carrier slots, which the Congress also considered for fiscal year 1990. Commuter carriers and general aviation, however, could also be charged for their slots. But if these users had to compete for slots with air carriers, they would probably find themselves priced out of the market. For example, a 20-seat commuter aircraft or a 6-seat corporate jet is unlikely to be able to pay as much as a 150-seat aircraft. If slots were reserved for

commuter carriers and general aviation (as they are now), the market price for such slots would probably be substantially lower than the price of air carrier slots, and additional revenues would be relatively small. Efficiency and revenues could be enhanced by putting all slots in the same market--that is, allowing free competition among all classes of users. Then the slots would be leased to the users who placed the highest value on them.

The main argument for this option is that since the slots reflect the right to use scarce public airspace and air traffic control capacity, private firms and individuals should not capture all the benefits of this scarcity. They should share it instead with the public owners of these rights. Further, they would serve as incentives to put these scarce resources to their best use.

The main argument against this proposal is that the scarcity of slots at these airports arises principally from a lack of land and runway space; these fees are not intended to provide increased capacity. Further, if the current prices paid by airlines in the private sale of slots already accurately reflect their value, then this option might not improve the allocation of these scarce resources. The benefits from their use would merely be redistributed between the public and private sectors.

**NDD-25 IMPOSE USER FEES ON THE
INLAND WATERWAY SYSTEM**

	Annual Added Receipts (In millions of dollars)					Cumulative Five-Year Addition
	1991	1992	1993	1994	1995	
Addition to CBO Baseline	330	340	360	370	390	1,800

The Army Corps of Engineers will spend about \$700 million on the nation's system of inland waterways in 1990, according to CBO estimates. Expenditures for operation and maintenance (O&M) will total about \$300 million; new construction outlays will equal about \$400 million. Current law allows up to 50 percent of inland waterway construction to be funded by revenues from the inland waterways fuel tax, a tax on the fuel consumed by barges using most segments of the inland waterway system. Revenues from the tax currently fund about 20 percent of federal outlays for inland waterway construction. All O&M expenditures are paid by general taxpayers.

Imposing user fees that would recover the cost of O&M outlays for inland waterways would reduce the federal deficit by \$330 million in 1991 and \$1.8 billion during the 1991-1995 period. The receipts could be considered tax revenues or offsetting receipts, depending on the form of the implementing legislation. The estimates do not take into account any resulting reductions in income tax revenues.

The advantage of this option is the beneficial effect of user fees on efficiency. Reducing subsidies to water transportation should improve resource allocation by leading shippers to choose the most efficient transportation route, rather than the most heavily subsidized one. Moreover, user fees would encourage more efficient use of existing waterways, thus reducing the need for new construction to alleviate congestion. Finally, user fees send market signals that point to which additional waterway projects are likely to provide the greatest net benefits to society.

The effects of user fees on efficiency would depend in large measure on whether the fees were set at the same rate for all waterways or

were set according to the cost of each segment. Since costs vary dramatically among the segments, systemwide fees would offer far weaker incentives for cost-effective O&M spending. In 1985, O&M costs on the inland waterways ranged from \$0.47 per thousand ton-miles on segments of the Ohio River to about \$950 per thousand ton-miles on the Pearl River. A systemwide fee of \$1.61 per thousand ton-miles would recover all O&M outlays but would do little to ration use of the system. Segment-specific fees, in contrast, could substantially change use of the waterways. A Department of Transportation study found that fees to recover even 50 percent of all federal outlays (both O&M and construction) would close 4 out of 12 waterway segments for lack of traffic.

An argument in favor of federal subsidies is that they may promote regional economic development. Assessing user fees would limit this promotional tool. Reducing inland waterway subsidies would also lower the income of barge operators and grain producers in some regions, but these losses would be small in the context of overall regional economies.

**NDD-26 ESTABLISH USER FEES FOR
CERTAIN COAST GUARD SERVICES**

	Annual Added Receipts (In millions of dollars)					Cumulative Five-Year Addition
	1991	1992	1993	1994	1995	
Addition to CBO Baseline	710	740	780	810	840	3,800

The Coast Guard provides numerous services to commercial and pleasure users of the nation's coastal waters and inland waterways. While much of the Coast Guard's budget can be attributed to activities performed in the public interest--such as coastal defense, drug interdiction, and enforcement of other laws and treaties--significant costs are also incurred each year while providing services directly to individuals or businesses. These services include aids to navigation, search and rescue, and marine safety and account for nearly half of the agency's operating budget, or about \$910 million in 1989. Currently, almost all of the costs to operate these services are financed through annual appropriations from the general fund. An additional \$80 million a year is also appropriated for related capital expenditures on marine safety and navigation programs. Much of these costs could be recovered through the imposition of fees that would save the federal government about \$710 billion in fiscal year 1991 and approximately \$3.8 billion over the 1991-1995 period. The receipts could be considered tax revenues or offsetting receipts, depending on the form of the implementing legislation. The estimates do not take into account any resulting reductions in income tax revenues.

The Coast Guard provides substantial, uncompensated benefits to civilian navigation, especially to the commercial shipping industry. Without navigational aids, such as buoys and other channel markings, commercial shipping in U.S. inland and coastal waters would be considerably more difficult, hazardous, and costly. The capital and operating costs of these navigational aids could be recovered from the shipping industry, just as the costs of roads are recovered from highway users. The Coast Guard also conducts search-and-rescue operations for lost or disabled vessels, the majority of which assist recrea-

tional boaters. The costs of search-and-rescue operations could be recovered from the beneficiaries.

User fees might be difficult to collect from recreational boaters. They would also increase costs for the fishing industry, although fees for fishing vessels could be phased in over a number of years to avoid imposing too sudden a financial burden.

**NDD-27 REDUCE NEW SPENDING AUTHORITY
FOR HIGHWAYS TO THE LEVEL OF
HIGHWAY TAX COLLECTIONS**

Savings from CBO Baseline	Annual Savings (In millions of dollars)					Cumulative Five-Year Savings
	1991	1992	1993	1994	1995	
Budget Authority	2,050	2,350	2,650	2,950	3,250	13,250
Outlays	320	1,350	1,950	2,300	2,650	8,550

Between 1991 and 1995, taxes from highway users will provide an estimated \$71.5 billion to the highway account of the Highway Trust Fund. Over the same period, \$81.5 billion is projected to be spent under current policies on federal highway programs, such as interstate highway construction and rebuilding, bridges, and primary and secondary roads. This spending includes programs financed from the highway account and those financed from the general fund. Holding new spending authority to the level of tax revenues--by reducing budget authority and obligation ceilings--would save \$8.6 billion over the five-year period. Eventually, annual outlays and tax revenue would converge.

Since 1957, the highway account of the Highway Trust Fund has collected \$205 billion from highway users and paid \$209 billion for highway development. In addition, \$3.3 billion has been spent on highways from the general fund, mostly in the 1980s. The cash balance in the highway account has remained around \$10 billion throughout the 1980s. Had all federal spending been paid from earmarked excise taxes on highway users, this balance would have dropped below \$1 billion because of the extra spending and the reduction in investment income. Nationally, the share of excise taxes from highway users to finance highways has dropped from 73 percent at the beginning of the interstate highway construction program to 65 percent now. Federal, state, and local taxpayers have been financing an increasing share of highway spending. The cash balance in the highway account reflects these subsidies from general taxpayers rather than unspent highway tax revenues.

Matching highway spending with the level of excise tax revenues dedicated to highway development would enhance efficiency in highway spending because users would pay for the services they receive. Cuts in budget authority of \$13.2 billion below CBO baseline levels would match spending authority and tax revenues over the 1991-1995 period. Lower obligation ceilings would delay outlays from existing unpaid authorizations of \$31 billion as well as those from current budget authority. Cuts could also be made in programs now outside obligation limits--about \$2.5 billion in 1991--or these programs could be included under new obligation ceilings. Alternatively, rates on excise taxes dedicated to highway development could be increased (see REV-30).

Arguments for maintaining the current program are that more could be spent to maintain highways in good condition and that highway rebuilding projects have high economic benefits. Reducing federal aid for rebuilding might induce states to spend less on maintaining highways. Such reductions might also lead states to redirect spending away from the main routes of interstate commerce, thus undermining the national benefits from highway investments of the past 30 years.

**NDD-28 END FUNDING OF THE ECONOMIC
DEVELOPMENT ADMINISTRATION**

Savings from CBO Baseline	Annual Savings (In millions of dollars)					Cumulative Five-Year Savings
	1991	1992	1993	1994	1995	
Budget Authority	210	230	240	250	260	1,200
Outlays	30	110	170	220	240	770

The Economic Development Administration (EDA) provides grants to state and local governments for public works, technical assistance, and job programs, as well as direct loans and loan guarantees to firms for business development. In 1990, appropriations for EDA programs totaled about \$210 million. Disbanding the EDA would reduce federal outlays by about \$30 million in 1991 and \$770 million over the 1991-1995 period.

One criticism of EDA programs is that federal assistance should not be provided for activities whose benefits are primarily local and, therefore, whose responsibility should be that of state and local governments. In addition, EDA programs have been criticized for allowing federal dollars to be used for projects that would have been supported anyway, for substituting federal credit for private credit, and for facilitating the relocation of businesses from one distressed area to another through competition among communities using federal funds. The EDA has also been criticized for its broad eligibility criteria, which allow areas containing 80 percent of the U.S. population to compete for benefits, and for providing aid with little proven effect compared with other programs having similar goals. Furthermore, because of the competitive nature of EDA programs, local governments do not incorporate this type of aid into their budget plans; hence, eliminating future EDA funding would not impose unexpected hardships on communities.

The reduction in aid associated with this option would, however, curtail economic development activities in some financially distressed communities that have no other available resources. This cutback

could result in deterioration of infrastructure, loss of prospective jobs, and decreases in local tax receipts in these areas. Eliminating this source of aid might have especially serious consequences for the most distressed communities, particularly in view of overall federal cut-backs in urban aid provided, for example, through the Community Development Block Grant program and the Urban Development Action Grant program.

**NDD-29 ELIMINATE OR RESTRICT COMMUNITY
DEVELOPMENT BLOCK GRANTS**

Savings from CBO Baseline	Annual Savings (In millions of dollars)					Cumulative Five-Year Savings
	1991	1992	1993	1994	1995	
Terminate CDBG						
Budget Authority	3,050	3,150	3,300	3,400	3,550	16,400
Outlays	120	1,350	2,650	3,200	3,350	10,700
Restrict Eligibility and Reduce Funding						
Budget Authority	420	430	450	470	490	2,250
Outlays	15	190	370	440	460	1,450

The Community Development Block Grant (CDBG) program provides annual grants, by formula, to all metropolitan cities and urban counties under its entitlement component. The program also allocates funds, by formula, to each state. The latter funds are distributed among nonentitlement areas, typically through a competitive process. Nonentitlement areas generally are units of local government that have a population of under 50,000 and that are not metropolitan cities or part of an urban county. Finally, a specified amount of the total funds is set aside to provide so-called special purpose grants to recipients meeting certain criteria.

CDBG funds in general must be used to aid low- and moderate-income households, to eliminate slums and blight, or to meet emergency needs. In accomplishing these goals, CDBG grants may be used for a wide range of community development activities, including rehabilitation of housing, improvement of infrastructure, and economic development. Funds from the entitlement component may also be used to repay principal and interest on obligations that are issued by local governments to finance certain activities--such as the acquisition or rehabilitation of public property--and that are guaranteed by the federal government under the Section 108 loan guarantee program.

For 1990, the appropriation (adjusted for sequestration) for the CDBG program amounts to \$2.87 billion. Another \$0.05 billion is to be transferred to CDBG from unspent funds of the Urban Development Action Grant program, which was last funded in 1988. Of this total of \$2.92 billion, about \$2.0 billion is allocated to metropolitan cities and urban counties, \$0.86 billion to nonentitlement government units, and the remaining \$0.06 billion to special purpose grants.

Substantial federal savings could be realized either by terminating the CDBG program or by restricting eligibility for the entitlement component to exclude the least needy jurisdictions while reducing funding levels. Least needy jurisdictions could be defined by measuring relative economic well-being and fiscal capacity using factors such as number and percentage of families below the poverty level and per capita income.

Terminate CDBG. If the CDBG program were eliminated, savings in federal outlays would amount to \$120 million in 1991 and a total of \$10.7 billion over the 1991-1995 period. One argument for terminating the program is that federal funds should be targeted toward programs whose benefits are national rather than local. Accordingly, programs such as CDBG, which generate primarily local benefits, should be funded by state and local governments. Moreover, to the extent that local jurisdictions use CDBG funds to attract business by competing against each other, benefits are shifted away from local jurisdictions to private firms.

A disadvantage of terminating the CDBG program would be that a number of activities financed by the program are not now generally undertaken by local governments--particularly the rehabilitation of low-income housing and, to some extent, economic development. Thus, eliminating the CDBG program--the largest source of federal aid for many cities--would probably curtail these types of activities in many areas and, in general, reduce resources benefiting low-income households. Furthermore, CDBG funding has presumably been figured into the budgets of entitlement recipients. Ending that support could impose at least temporary stress on many governments.

Restrict Eligibility and Reduce Funding. If the entitlement component were cut 20 percent by eliminating funding for the least needy jurisdictions, federal outlays could be reduced by \$15 million in 1991 and

\$1.5 billion over the 1991-1995 period. Such a cutback would change the distribution between the entitlement and nonentitlement components from 70 percent and 30 percent to 65 percent and 35 percent. The entitlement component of the CDBG program now provides aid to all eligible jurisdictions, although jurisdictions with greater needs (as measured by factors such as population, poverty levels, and housing conditions) receive larger grants than others. Among nonentitlement jurisdictions, the typically competitive nature of the distribution process would presumably ensure the targeting of funds toward the neediest areas. Carrying out this option would require both changing the authorizing legislation and cutting the program's annual appropriation.

Proponents argue that no pressing interest is served by supporting jurisdictions that have above-average ability to fund projects themselves. For example, 7 of the 10 counties that had the highest per capita income in the nation in 1985 currently receive funds under the CDBG entitlement component. Eliminating funding for such jurisdictions, rather than reducing grants across the board, would ensure that the most distressed jurisdictions would retain the same level of aid. A reduction in federal funds for affluent jurisdictions would, however, probably curtail activities designed to aid low- and moderate-income households in any pockets of poverty in those areas, unless local governments offset the reduction.

**NDD-30 REDUCE UNTARGETED FUNDING FOR
ELEMENTARY AND SECONDARY EDUCATION**

Savings from CBO Baseline	Annual Savings (In millions of dollars)					Cumulative Five-Year Savings
	1991	1992	1993	1994	1995	
Eliminate Untargeted Portion of Vocational Education						
Budget Authority	390	400	420	440	450	2,100
Outlays	50	310	390	420	430	1,600
Eliminate Untargeted Portion of Mathematics and Science Education						
Budget Authority	75	75	80	80	85	400
Outlays	10	60	75	80	80	300
Eliminate Untargeted Funding and Redirect Half of the Savings to Compensatory Education						
Budget Authority	230	240	250	260	270	1,250
Outlays	30	190	230	250	260	950

Most federal aid for elementary and secondary education is targeted toward students with special needs. Federal funds for compensatory education under Chapter 1 of the Elementary and Secondary Education Act of 1965, for example, are intended for low-achieving students in schools with many poor children. Federal funds are also provided to help educate handicapped children.

Substantial amounts of federal money, however, are provided with no federal requirement for targeting funds on students with special needs. Two examples are the portions of vocational education grants and mathematics and science education grants not targeted on specific groups of students. Ending funding for this portion of vocational education would reduce budget authority by about \$2.1 billion, and outlays by about \$1.6 billion, over the 1991-1995 period. Similarly, ending untargeted mathematics and science education funding would

reduce budget authority by about \$400 million, and outlays by about \$300 million, over the the 1991-1995 period.

On the one hand, this option would generate substantial federal savings and affect total spending for elementary and secondary education only minimally because the reduction would constitute considerably less than 1 percent of total local, state, and federal expenditures on education. Moreover, districts might offset part or all of the reduction in federal funding for the activities of most concern to them. Using half of the savings to increase Chapter 1 spending would address the substantial unmet need for additional compensatory education, especially at the secondary level where little is currently available.

On the other hand, these programs have purposes other than increasing services to students with special needs. The reductions could pose hardships for some jurisdictions trying to improve the quality of their programs. For example, one goal of the program innovation portion of the vocational education program is to help districts alter their training programs as the skills needed for employment change. Similarly, students' knowledge of mathematics and science might improve more slowly if federal funding were eliminated.

**NDD-31 ELIMINATE OR REDUCE FUNDING FOR
IMPACT AID TO SCHOOL DISTRICTS**

Savings from CBO Baseline	Annual Savings (In millions of dollars)					Cumulative Five-Year Savings
	1991	1992	1993	1994	1995	

Eliminate All Impact Aid

Budget Authority	760	790	820	860	890	4,150
Outlays	610	760	820	850	880	3,900

Eliminate All But Half of Aid for "a" Children

Budget Authority	460	480	500	520	540	2,500
Outlays	370	460	490	510	530	2,350

Eliminate Impact Aid for "b" Children

Budget Authority	130	130	140	140	150	700
Outlays	110	130	140	140	150	670

School Assistance in Federally Affected Areas--also known as Impact Aid--is intended to compensate school districts that have children who are enrolled because their parents live and/or work on federally owned or subsidized property. Since federally owned or subsidized property is tax-exempt, Impact Aid compensates school districts for the forgone property tax revenues that would have supported the schools.

Impact Aid goes to school districts for two categories of children: "a" children, whose parents both live and work on federal property; and "b" children, whose parents either live or work on federal property. A minimum of 3 percent of the children enrolled in a school district (or at least 400 children) must be federally connected for a district to be eligible. In 1988, Impact Aid went to approximately 2,500 school districts spread across all states. Payments for "a" children--at an average of \$1,543 per child in 1988--went disproportionately to school districts with high expenditures per pupil and to school districts with low average property values. Payments for "b" children--at an average of \$74 per child in 1988--were relatively evenly distributed across school districts with high and low expenditures per pupil. School districts in

at least 6 of the 10 richest counties in the United States are among the beneficiaries of the Impact Aid program.

Eliminating all funding for Impact Aid would reduce federal outlays by \$3.9 billion in the 1991-1995 period. Opponents of the program argue that the economic benefits from federal installations outweigh the demands placed on the schools, making the program unnecessary. These economic benefits are considered so substantial that local jurisdictions compete vigorously for new federal installations and lobby intensely to forestall closing existing ones.

Proponents of the program counter that the presence of federal installations does not adequately compensate local governments and school districts for losses in property tax revenues. Additional revenues resulting from federal installations are collected primarily by the state through income and sales taxes. Moreover, many school districts--especially those having military installations with large numbers of "a" children--would face severe financial hardship if such funding were eliminated.

A second option would eliminate all Impact Aid except for half of the "a" payments by targeting the remaining Impact Aid on school districts enrolling large numbers of "a" children. This alternative, which would require changes in authorizing legislation, would reduce federal spending by \$2.4 billion over the 1991-1995 period; it would also ensure that scarce federal funds go to the school districts most affected by federal activities. School districts with only "b" children or relatively few "a" children, however, would have slightly less funding unless state or local resources were increased.

A third option would eliminate Impact Aid only for "b" children, thereby reducing federal outlays by \$670 million over the 1991-1995 period. This alternative would significantly limit any negative effects on school districts compared with ending larger portions of Impact Aid. Proponents of this alternative note that school district operations do not generally depend on "b" payments, which constitute less than half of 1 percent of total expenditures in over half of the districts receiving them. The parents of "b" children also pay state and local taxes, which fund educational expenditures, at almost the same rate as the parents of children who are not federally connected. Opponents of this option argue that "b" payments are important for a few school districts--for

example, where large numbers of military families live in the community but shop at military exchanges, which do not collect state and local sales taxes.

**NDD-32 ELIMINATE FEDERAL FUNDING FOR
CAMPUS-BASED STUDENT AID**

Savings from CBO Baseline	Annual Savings (In millions of dollars)					Cumulative Five-Year Savings
	1991	1992	1993	1994	1995	
Eliminate Campus-Based Aid						
Budget Authority	1,250	1,300	1,350	1,400	1,500	6,850
Outlays	130	1,250	1,300	1,350	1,400	5,450
Eliminate Campus-Based Aid and Redirect Half of the Savings to Pell Grants						
Budget Authority	630	660	680	710	740	3,400
Outlays	65	610	660	680	710	2,750

The federal government provides campus-based student aid through three programs: Supplemental Educational Opportunity Grants, Perkins Loans (formerly National Direct Student Loans), and Work-Study. Financial aid administrators at postsecondary institutions determine which eligible students receive aid under general federal guidelines. In 1990, the federal government provided \$1.2 billion of campus-based aid, which will go to an estimated 1.5 million students.

Eliminating federal funding of these programs would lower outlays by about \$5.5 billion during the 1991-1995 period. Alternatively, half of the savings from eliminating these programs could be redirected to the Pell Grant Program, which provides grants for undergraduate students on the basis of national standards of financial need. Accordingly, the Pell Grant Program is more closely targeted to low-income students. The extent of the reduction in total student aid would depend on the responses of postsecondary institutions, some of which would make up part or all of the lost federal funds. Moreover, since postsecondary institutions currently retain over \$5 billion in revolving funds under the Perkins Loan Program, an estimated 700,000 students would receive loans, averaging about \$1,100 in 1990, even if the federal government did not fund any new campus-based aid.

The primary justification for this option reflects the view that the main goal of federal student aid is to provide access to postsecondary education for those with low incomes. In contrast, campus-based aid is less closely targeted on low-income students than other federal student aid. In addition, campus-based aid is tied to specific institutions so students with greater need at poorly funded schools may receive less than those with less need at well-funded institutions.

Postsecondary institutions object to this option, however, because eliminating campus-based aid would reduce their discretion in packaging student aid to address the special situations of some students while also reducing total available aid. Moreover, these programs disproportionately help students at private nonprofit institutions (whose students get over 40 percent of this aid, compared with 20 percent of Pell Grant aid). Thus, cutting campus-based aid would make this type of school less accessible to needy students.

Redirecting half of the savings from eliminating campus-based aid to the Pell Grant Program would mitigate the effects of less total aid on lower-income students. The Pell Grant Program is authorized to provide maximum awards of \$2,900 in academic year 1990-1991, but its appropriation only allows for a maximum award of \$2,300. If redirected funds from campus-based programs were added to the Pell appropriation, the Appropriations Committee could increase the maximum grant to approach its authorized level. In addition, Pell Grants allow students to choose freely among postsecondary institutions rather than be limited to institutions that offer them campus-based aid. Redirecting funds to the Pell Grant Program would result, however, in only half the reduction in the federal deficit that could otherwise be accomplished by eliminating campus-based aid.

**NDD-33 REDUCE PELL GRANT FUNDING
AND INCREASE TARGETING**

Savings from CBO Baseline	Annual Savings (In millions of dollars)					Cumulative Five-Year Savings
	1991	1992	1993	1994	1995	
Budget Authority	250	260	270	280	290	1,350
Outlays	50	250	260	270	280	1,100

The Pell Grant Program provides grants to undergraduate students on the basis of financial need and, among federal student aid programs, focuses the most on low-income students. Since 1987, however, Pell Grants have been somewhat less targeted on the needy because the Higher Education Amendments of 1986 expanded eligibility.

Funding appropriated for 1989 will support grants for an estimated 3.2 million students during the 1989-1990 school year. Grants will range between \$200 and \$2,300, averaging an estimated \$1,450 per student. About 45 percent of this aid will go to dependent students--virtually all of them from families with annual incomes below \$30,000 and over 55 percent of them from families with incomes below \$15,000. Students who are financially independent of their parents will receive the other 55 percent of the aid.

Outlays could be reduced by more than \$1 billion during the 1991-1995 period by cutting federal appropriations 5 percent and using a formula for reduction available under current law. Such a cut could also be combined with changes in the rules determining Pell Grant eligibility and awards. The number and types of students affected would depend on how the cuts were structured and on how institutions responded. If current law were left in place, the Secretary of Education would have some discretion over the particular formula used to reduce grants, although the grants of the neediest recipients would have to be protected. Alternatively, the Congress could change the eligibility rules while still protecting awards for needier students--for example, by eliminating small grants, by eliminating the income offset for state

and local taxes, or by increasing the proportion of income that families would be expected to contribute to educational costs.

These changes would probably not have a large impact on students' enrollment decisions because the grants of the neediest students would be protected. Other types of federal aid, notably Stafford Loans (formerly Guaranteed Student Loans), would also be available for some affected students. (The costs of these other programs would then increase, but indirect costs are not reflected in the estimated savings for this option.) In addition, some colleges, universities, and states might increase their student aid, thereby partially offsetting reductions in federal funding.

Students who would lose grant aid under this option would, however, generally have lower family incomes than many students who receive other types of federal student aid. (See NDD-32 for an option to reduce less targeted aid.) Furthermore, less assistance would probably be available in the aggregate because the federal cut would probably not be fully offset.

NDD-34 ELIMINATE OR REDUCE FUNDING FOR THE ARTS AND HUMANITIES

Savings from CBO Baseline	Annual Savings (In millions of dollars)					Cumulative Five-Year Savings
	1991	1992	1993	1994	1995	
Eliminate Funding						
Budget Authority	970	1,000	1,000	1,100	1,100	5,200
Outlays	970	1,000	1,000	1,100	1,100	5,200
Reduce Funding by 50 Percent						
Budget Authority	490	520	520	540	560	2,600
Outlays	480	520	510	530	560	2,600

The federal government subsidizes various arts and humanities activities. In 1990, federal funding for the Corporation for Public Broadcasting, the Smithsonian Institution, the National Gallery of Art, the National Endowment for the Arts, and the National Endowment for the Humanities totaled \$870 million.

Eliminating funding for these programs would reduce federal outlays by \$5.2 billion in the 1991-1995 period, while cutting funding in half would save \$2.6 billion during that period. The final effect of either option on arts and humanities activities would depend on the extent to which other funding sources--states, private individuals, firms, and foundations--increased their contributions and on whether admission fees to these activities were used to make up for reduced federal funding.

Proponents of this option argue that federal funding for the arts and humanities is not affordable in a time of fiscal stringency, especially as federal programs addressing central federal concerns are not fully funded. Moreover, because many arts and humanities programs benefit predominantly higher-income people, instituting or raising admission fees could substitute for federal aid in many cases.

Reducing or eliminating federal appropriations for the arts and humanities would, however, probably result in fewer of these activities because other funding sources would not be likely to offset fully the loss in federal subsidies. In fact, a substantial increase in private contributions is less likely now that tax reform has reduced the extent to which taxpayers benefit (through reduced tax liabilities) from their charitable contributions. As a result, activities that preserve and advance the nation's cultural heritage would be likely to decline.

**NDD-35 REDUCE FUNDING FOR RESEARCH
SUPPORTED BY THE NATIONAL
INSTITUTES OF HEALTH**

Savings from CBO Baseline	Annual Savings (In millions of dollars)					Cumulative Five-Year Savings
	1991	1992	1993	1994	1995	
Budget Authority	760	790	820	850	890	4,100
Outlays	310	710	800	830	870	3,500

The federal government provided \$7.3 billion in 1990 for research funded through the National Institutes of Health (NIH). About 80 percent of the NIH research budget is awarded to universities and hospitals through research grants and contracts. The remainder is spent on research within the institutes and for administration. For 1990, \$740 million is specifically designated for research related to Acquired Immune Deficiency Syndrome (AIDS).

A reduction in funding for NIH research could be justified by its rapid growth in recent years. Between 1983 and 1990, NIH expenditures increased by about 90 percent, or approximately 60 percent after allowing for inflation. If funds for NIH research were reduced by 10 percent, the 1991-1995 savings in outlays would be about \$3.5 billion.

The NIH could lower research spending in several ways. It could limit the overhead reimbursements for research grants, which might have only limited effects on the amount of research actually undertaken. Alternatively, research projects could be funded at a reduced proportion of their costs, thereby encouraging researchers to find additional sources of support. The NIH could also cut the number of grants awarded. Since funding of projects is based on a rating system, proposals with the highest ratings would continue to be supported.

A reduction in NIH funding could, however, have adverse effects on biomedical research. Some researchers who received less or no funding might leave the field because private support would probably not increase enough to offset fully the reduction in federal support.

**NDD-36 REDUCE THE MATERNAL AND CHILD
HEALTH CARE BLOCK GRANT AND THE
PREVENTIVE HEALTH SERVICES
BLOCK GRANT**

Savings from CBO Baseline	Annual Savings (In millions of dollars)					Cumulative Five-Year Savings
	1991	1992	1993	1994	1995	
Budget Authority	330	350	360	370	390	1,800
Outlays	200	300	340	370	380	1,600

In its appropriations for 1990, the Congress provided about \$640 million in block grants for programs in maternal and child health and preventive health services. About 90 percent of these funds goes to the states, while the remainder is used for federal initiatives. The block grants, which are funded through the Public Health Service, allow states much flexibility in choosing the programs to fund within the specified areas. These grants do not generally restrict benefits to categories of recipients, such as low-income families.

Each block grant supports a wide range of programs. The Maternal and Child Health Care Block Grant subsidizes programs that provide services, such as preventive care, prenatal care, health assessments for children, and children's rehabilitation. The 1990 funding for this block grant is \$554 million. The Preventive Health Services Block Grant supports programs in areas, such as immunization, hypertension control, dental health, environmental health, and injury protection. Funding for 1990 is \$84 million.

If funding for each of these block grants were reduced by half, the savings in outlays for the 1991-1995 period would be about \$1.6 billion. The principal justification for this reduction is that the federal commitment to other programs directed at maternal and child health and preventive health services has increased substantially in recent years. For example, Medicaid's coverage of low-income women and young children has expanded in several ways. Most recently, states have been required to provide Medicaid coverage by July 1990 to all

pregnant women and infants in families with incomes below the federal poverty level. Thus, the block grants are not essential for ensuring access to health services for these individuals. In addition, states have the option of providing Medicaid coverage for pregnant women and infants in families with incomes up to 185 percent of the poverty line. At least 10 states now have thresholds set above 100 percent of the poverty line. Similarly, between 1988 and 1990, funding for the Centers for Disease Control's immunization program was increased by \$58 million (or about 60 percent), and funding for its activities regarding chronic and environmental disease and injury control was raised by \$35 million (or about 80 percent). Proponents of a reduction in the block grants also note that the states would probably respond by assuming a greater share of financial responsibility for the affected programs. The programs most highly valued by the states would be cut back the least, if at all.

Increases in the states' contributions, however, would probably not fully offset reductions in the federal block grants. Consequently, the cuts could adversely affect the health of individuals assisted through the subsidized programs. Since many of the programs are directed at prevention, reductions might also increase future needs for health services.

**NDD-37 ELIMINATE SUBSIDIES FOR HEALTH
PROFESSIONS EDUCATION**

Savings from CBO Baseline	Annual Savings (In millions of dollars)					Cumulative Five-Year Savings
	1991	1992	1993	1994	1995	
Budget Authority	220	230	240	250	260	1,200
Outlays	130	200	230	250	260	1,050

The Congress provided \$215 million in 1990 to the Public Health Service (PHS) to support education for physicians, nurses, and public health professionals. These funds primarily furnish institutional support through grants and contracts to schools for designated training programs in the health professions. Student assistance is provided through loans, loan guarantees, and scholarships. The major funded programs promote physician training in primary care, advanced nursing education, and increased enrollment of minority and economically disadvantaged students:

- o Primary care training. Several programs provide federal grants to medical schools and teaching hospitals to develop, expand, or improve graduate medical education programs in primary care specialties. Funding for 1990 is \$66 million.
- o Nursing education. The subsidies to nursing schools are to increase graduate training for nurse administrators, educators, supervisors, researchers, and nursing specialists, including nurse midwives and nurse practitioners. Funding for 1990 is \$58 million.
- o Support for minority and economically disadvantaged students. About 70 percent of these funds are provided to professional schools for recruiting and counseling minority and economically disadvantaged students. The remaining 30 percent goes directly to students in the form of scholarships. Funding for 1990 is \$43 million.

The other federal subsidies from the PHS support a variety of educational efforts including training in health administration and public health, on-site training in areas with shortages of medical personnel, and guarantees for educational loans. PHS funding for all other health professions activities in 1990 is \$48 million.

Eliminating all of these subsidies would save about \$1.1 billion over the 1991-1995 period. The principal justification for this option is that market forces provide strong incentives for individuals to seek training and jobs in the health professions. Physicians--the principal health profession targeted by the subsidies--rapidly increased in number from 142 physicians for every 100,000 people in 1950, to 161 in 1970, and to 228 in 1985. Projections by the American Medical Association indicate that the total number of physicians per capita will continue to rise through the year 2000. In addition, if a shortage of nurses exists, higher wages and better working conditions for nurses will attract more individuals to the profession and more trained nurses to nursing jobs. Moreover, because the subsidies go mainly to institutions, they may have little effect on the numbers or characteristics of people studying to be health professionals. For example, most of the subsidies for training nurses are directed at increasing the skills of nurses through baccalaureate degree programs and advanced education in nursing, rather than at raising the number of new entrants into the profession. Similarly, about 70 percent of the funds for increasing enrollment of minority and economically disadvantaged students are used to support schools' recruitment and counseling efforts. Many of those who oppose the subsidies contend that since schools in the health professions have a strong commitment to recruiting students from diverse backgrounds, eliminating these subsidies would have little effect on their efforts.

The major disadvantage of eliminating these subsidies is that the incentives supplied by market forces may not be sufficient to meet the goals of these programs. For example, third-party reimbursement schedules may not reward primary care well enough to encourage physicians toward those specialties and may not include appropriate differentials across rural, urban, and inner-city areas. In addition, fewer people might choose nursing as a career, which could exacerbate any existing shortage of nurses. Finally, if schools did not fully offset the cut in federal funds for scholarships, fewer minority and low-income students might enter the health professions.

**NDD-38 MODIFY THE FEE STRUCTURE FOR
LOCAL AND STATE AGENCIES THAT
ADMINISTER FEDERAL HOUSING PROGRAMS**

Savings from CBO Baseline	Annual Savings (In millions of dollars)					Cumulative Five-Year Savings
	1991	1992	1993	1994	1995	
Budget Authority	30	30	35	35	35	170
Outlays	140	140	140	140	140	700

The Department of Housing and Urban Development (HUD) pays fees to local and state public housing agencies (PHAs) for administering the Section 8 existing-housing program and the voucher program. For each assisted household, PHAs receive an ongoing annual fee, as well as a one-time fixed fee, when the new assistance commitment from HUD is first issued. Under current policy, the annual fee for commitments funded from pre-1989 appropriations ranges from 6.5 percent (for vouchers) to 7.65 percent (for Section 8 existing-housing) of the local two-bedroom Fair Market Rent (FMR). In both programs, the annual fee for commitments funded from the 1989 and 1990 appropriations is set at 8.2 percent. The one-time fee is now generally \$275 for each new commitment.

A recent study based on new data from a sample of large urban PHAs estimates that annual administrative costs for both the Section 8 existing-housing and the voucher programs average about 5 percent of the two-bedroom FMR. The average start-up costs, however, amount to about \$590 per household. Changing the current fee structure to reflect these estimated costs would reduce federal outlays by \$140 million in 1991 and by \$700 million over the 1991-1995 period. In general, realizing these savings would require changing the authorizing legislation as well as cutting the appropriations for vouchers to reflect the lower fee payments.

Such a fee structure would more accurately reflect the best available information about the costs of providing these types of housing assistance. Moreover, this option would equalize fees for programs

that appear to have similar administrative costs and would eliminate the disparity among fees that now vary according to the year the commitment was first funded. In doing so, the fees would also be easier to administer.

This option could impose financial difficulties, however, on some PHAs. For example, in areas where FMRs are low relative to the overall cost of living, reduced fees might not cover actual administrative costs. Also, some PHAs may now use their excess reimbursements to cover shortfalls in the funds for other subsidized housing programs that they administer. Moreover, it is unclear whether the study on which these estimated costs are based can be generalized. Smaller urban and rural PHAs may have patterns in their administrative costs that are different from those of the large urban PHAs covered by the study. Thus, some further modifications in the fee structure might be necessary, which could change the ultimate federal savings.

**NDD-39 SHIFT HOUSING ASSISTANCE FROM
NEW CONSTRUCTION TO VOUCHERS**

Savings from CBO Baseline	Annual Savings (In millions of dollars)					Cumulative Five-Year Savings
	1991	1992	1993	1994	1995	

Replace New Construction with Vouchers

Section 202/8						
Budget Authority	1,450	1,500	1,550	1,600	1,650	7,750
Loan Authority	490	510	530	550	580	2,650
Outlays	a	-5	60	130	190	370
Public Housing						
Budget Authority	270	290	300	310	320	1,500
Outlays	a	b	120	240	330	690

Partially Replace New Construction with Vouchers

Section 202/8						
Budget Authority	730	750	770	800	830	3,900
Loan Authority	250	260	270	280	290	1,350
Outlays	a	-5	30	65	95	190
Public Housing						
Budget Authority	140	140	150	150	160	740
Outlays	a	b	60	120	170	350

a. Increase in outlays of less than \$2.5 million.

b. Decrease in outlays of less than \$2.5 million.

A number of federal programs administered by the Department of Housing and Urban Development (HUD) subsidize the housing costs of lower-income households. These programs provide rental assistance through two basic approaches: subsidies that are tied to projects specifically constructed for lower-income households; and subsidies that enable renters to choose standard housing units from existing private housing. In recent years, construction of low-income housing has been sharply curtailed in favor of the less costly use of existing housing. For 1990, roughly one-fifth of additional assistance commit-

ments are for construction of new dwellings, while the remaining additional commitments are provided through the Section 8 existing-housing program and the voucher program. The only construction programs under which new commitments are still being made are the Section 202/8 program for the elderly and handicapped and the public housing program.

Appreciable long-term savings could be realized in both the Section 202/8 program and the public housing program by eliminating new commitments or by making only half as many; in either case, the lost commitments would be replaced with vouchers on a one-for-one basis. Over the 1991-1995 period, net savings under the first option would amount to \$370 million for the Section 202/8 program and \$690 million for the public housing program. Net savings under the second option would be half those amounts. Additional savings under both options would continue to accrue for some time after 1995. Moreover, although not reflected in the table, appropriations for operating subsidies for public housing could be lower in the future because of the reduced number of new units under this option.

Unlike much of the short-term savings associated with these options, longer-term savings in both programs would be real, since the cost of subsidizing the rental payments for a unit in the existing housing stock over a given period is inherently lower than the combined costs of constructing a new unit and then subsidizing its operating, maintenance, and modernization costs over the same period. Short-term savings in both budget authority and outlays would be, at least in part, the result of budgetary and accounting conventions and the large up-front costs of financing new construction. For example, the short-term savings in budget authority for the Section 202/8 program would be derived mainly from the shorter contract term of vouchers (5 years) compared with Section 8 subsidies in Section 202 projects (usually 20 years). These savings would be offset by higher budget authority in future years, if expiring vouchers were renewed for 15 more years. The short-term savings in outlays for both programs would be explained primarily by the reduction or elimination of large up-front expenditures related to the construction of public housing and Section 202/8 units.

Proponents of these options see little need for subsidizing new construction. The overwhelming housing problem today, they argue, is

the inability of poor households to afford the rents of existing units, rather than a shortage of rental units. For example, the nationwide rental vacancy rates have consistently been over 7 percent since 1986, the highest levels since 1968. Furthermore, even if there are shortages, subsidizing new construction may merely displace private activity rather than adding to the total housing stock. Moreover, the construction of subsidized housing can be a slow process and can, at best, have an impact only after a long lag. Vouchers could help alleviate high expenditures for housing among poor households at a faster rate and at a much lower cost to the federal government than new construction. In addition, vouchers would give households greater flexibility in choosing where to live.

National statistics on the supply of rental units, however, may mask local shortages of certain types of units that rent within HUD's guidelines for vouchers. In particular, many elderly and handicapped households need housing that can provide special social and physical services not available in their current residences. Supporters of subsidized construction of units for elderly and handicapped households contend that the private sector does not respond adequately to these demands because it produces units that are typically not affordable to those with low incomes, even when rents are subsidized with vouchers. Similarly, a relatively large proportion of lower-income families with children live in crowded conditions. Many of them need units with three or more bedrooms. A number of the nation's large public housing authorities report that their jurisdictions have shortages of these large units within the HUD rental guidelines.

**NDD-40 REDUCE FEDERAL RENTAL SUBSIDIES BY
SHIFTING SOME COSTS TO THE STATES
OR TENANTS**

Savings from CBO Baseline	Annual Savings (In millions of dollars)					Cumulative Five-Year Savings
	1991	1992	1993	1994	1995	
Reduce Section 8 Subsidies						
Budget Authority	10	20	30	45	60	160
Outlays	160	320	490	680	880	2,550
Reduce Public Housing Operating Subsidies						
Budget Authority	100	220	340	480	630	1,800
Outlays	45	150	270	410	550	1,450

Most lower-income renters who receive federal rental assistance are aided through the Section 8 programs or the public housing program, which are administered by the Department of Housing and Urban Development (HUD). These federal programs, in general, aid lower-income renters by paying the difference between 30 percent of a household's adjusted income and either the actual cost of the dwelling or, under the voucher program, a payment standard. In 1989, average federal expenditures per household for all of HUD's rental housing programs combined were close to \$3,500. This amount includes both housing subsidies and fees paid to administering agencies.

Savings in outlays could be achieved by reducing federal payments on behalf of recipients and requiring state governments to make up the decrease as a condition for receiving federal rental assistance commitments from newly appropriated funds. In this way, state governments, which currently contribute no funds toward federal housing assistance programs, could diminish the impact of this option on affected renters. The option could be carried out by increasing combined tenant and state rental contributions over a five-year period from 30 percent to 35 percent of a tenant's adjusted income. This option would save \$160 million in federal outlays for the Section 8 programs in 1991 and a total of \$2.5 billion over the 1991-1995 period. Savings in outlays for

public housing would amount to \$45 million in 1991 and \$1.4 billion over the five-year period. Realizing these savings would, however, require changing the authorizing legislation for these programs as well as cutting the annual appropriations for vouchers and public housing operating subsidies.

One rationale for involving states in housing assistance is that these programs generate substantial local benefits, such as improved quality of the housing stock. If all states paid 5 percent of the adjusted incomes of their recipients, housing costs for assisted families would not rise. Moreover, since eligibility for housing assistance is determined by each area's median income, tying states' contributions to renters' incomes would ensure that lower-income states would pay relatively less per assisted family than would higher-income states. Finally, if a state chose not to participate and consequently rental payments by its households increased to 35 percent of their adjusted incomes, these out-of-pocket costs would still be well below the nearly 50 percent of income that the typical renter who is eligible for assistance now pays.

Unless all states made up the reduction in federal assistance, however, this strategy would increase housing costs for some current recipients of aid and thus generate unequal treatment of assisted renters across the nation. Moreover, raising rental payments could prompt some stable, slightly higher-income households to leave assisted housing projects in areas of the country where unassisted housing of the same quality would now be cheaper. This outcome would change the economic mix of households in these projects, reduce the projects' viability, and increase the average cost of subsidizing them.

**NDD-41 MAINTAIN THE CURRENT NUMBER OF
HOUSING ASSISTANCE COMMITMENTS**

Savings from CBO Baseline	Annual Savings (In millions of dollars)					Cumulative Five-Year Savings
	1991	1992	1993	1994	1995	
Savings from CBO Baseline						
Budget Authority	-3,600	-2,650	-1,150	-370	-620	-8,400
Outlays	-390	-950	-1,250	-1,300	-1,300	-5,250
Savings from Administration's Request						
Budget Authority	2,550	2,950	3,300	3,300	3,300	15,500
Outlays	10	360	890	1,550	2,200	5,050

NOTE: These estimates are preliminary and subject to change because detailed information about the Administration's request is not yet available and because of other data limitations.

Since 1975, the Department of Housing and Urban Development (HUD) has made new commitments each year under the Section 8 program and the public housing program. These new commitments provide housing assistance for additional lower-income households, thereby increasing the total number receiving assistance. Currently, these commitments last between 5 years and 20 years. By the end of fiscal year 1989, about 4.7 million commitments for housing assistance were outstanding for all housing programs combined. Because some of these commitments were still being processed and some households received assistance from more than one program, only about 4.3 million households were actually assisted, mostly through rent subsidies. In 1989, however, commitments that were made some time ago started to expire; more than 1 million are estimated to expire over the 1991-1995 period. The Congress has indicated its intention to renew at least some of these commitments.

Under the assumptions in CBO's baseline, up to 400,000 fewer households would receive housing assistance by the end of 1995 com-

pared with the end of 1990. This decline would occur because CBO's baseline assumes that the program mix and the real level of funding stipulated by the 1990 appropriation will continue. These assumptions translate into replacing about 200,000 of the 1 million expiring commitments and adding about 400,000 new commitments during the five-year period. In spite of the resulting decline in the number of assisted households, estimated outlays in current dollars for all housing programs combined would continue to rise in CBO's baseline from \$16.6 billion in 1991 to about \$17.9 billion by 1995. This increase is caused by inflation in rents and also by relatively large expenditures being incurred for up-front grants that now finance construction and modernization of public housing units.

In its 1991 request, the Administration has proposed renewing all expiring commitments with five-year contracts of the same type, as well as funding additional units so that the total number of outstanding assistance commitments would rise. An alternative would be to renew all expiring commitments but to fund only enough additional ones in each of the next five years to replace the commitments that would be lost for other reasons. In other words, this option would freeze the total number of commitments at the current level. Modernization of public housing would be funded at the level requested by the Administration for 1991, adjusted in later years for inflation. Relative to the CBO baseline, the option to freeze the total number would increase outlays by \$390 million in 1991 and by \$5.2 billion over the 1991-1995 period. Compared with the Administration's request, however, outlays would decrease by about \$10 million in 1991 and by about \$5.0 billion over the 1991-1995 period.

Besides lowering outlays relative to the Administration's request, one argument in favor of this option is that expanding rental assistance programs would be inappropriate at present in light of cutbacks in other areas. Furthermore, the outstanding commitments under this option would continue to assist many new income-eligible households each year because of turnover among assisted renters. Finally, no current recipients would lose their housing assistance as a result of carrying out this option.

One argument against this option is that the number of new commitments funded annually has dropped significantly during the 1980s. Consequently, the upward trend in the proportion of eligible renters

actually receiving assistance has almost leveled off at about 35 percent. Under this option, the proportion of eligible renters receiving assistance would fall because of continued growth in the number of eligible households.

**NDD-42 ELIMINATE OR SCALE BACK LOW-INCOME
HOME ENERGY ASSISTANCE**

Savings from CBO Baseline	Annual Savings (In millions of dollars)					Cumulative Five-Year Savings
	1991	1992	1993	1994	1995	
Eliminate Program						
Budget Authority	1,450	1,500	1,550	1,650	1,700	7,850
Outlays	1,300	1,500	1,550	1,600	1,700	7,700
Scale Back Program						
Budget Authority	720	750	780	820	850	3,900
Outlays	660	750	780	810	850	3,850

The Low Income Home Energy Assistance Program (LIHEAP) provides assistance to low-income households for reducing home energy costs. Authorized by the Omnibus Budget Reconciliation Act of 1981 and administered by the Department of Health and Human Services, the LIHEAP provides about \$1.5 billion annually in block grants to states. The states may use their program allotments to help eligible households pay their home heating or cooling bills, to meet energy-related emergencies, or to fund low-cost weatherization projects. Although the states can establish additional criteria for program eligibility, federal rules specify that they must start with one of two basic criteria. Households in a state may be eligible for assistance if their incomes are less than the greater of 60 percent of the median income in their state or 150 percent of the appropriate poverty guideline. Alternatively, households may be eligible if they receive assistance from certain other programs, such as Aid to Families with Dependent Children or Supplemental Security Income.

In addition to these basic criteria for providing assistance, federal law requires that states give preference to households with the highest energy costs, relative to income, when disbursing LIHEAP funds. Although precise data are not available, there is evidence that many households that satisfy these conditions do not actually receive assistance. In some cases, additional state eligibility requirements, com-

bined with constraints on federal funding, limit the number of eligible households actually assisted. In other cases, states may assist all the eligible households that apply, although applicants may represent only a fraction of those who are eligible.

Eliminating the LIHEAP would save \$7.7 billion in federal outlays from 1991 through 1995. Reducing future appropriations by 50 percent would lower outlays by about half that amount.

The LIHEAP and its predecessor energy assistance programs were created in response to the rapid price increases between 1972 and 1980 of energy used in the home (most notably fuel oil). Since then, the real costs of many types of energy have returned to their levels of the early 1970s. These lower levels could now justify either eliminating or reducing the LIHEAP. In addition, 23 states recently transferred funds from their LIHEAP block grants to supplement Title XX spending on social services. These transfers are evidence that some states believe spending for energy assistance does not have as high a priority as spending in other areas.

If LIHEAP appropriations are reduced or eliminated, some low-income households in states with severe winter or summer weather could be forced to choose between paying their energy expenses or paying for other household necessities. Moreover, an advantage of retaining the LIHEAP at some level would be the flexibility to distribute quickly any future increases in funding that might be needed to respond to future growth in energy prices.

**NDD-43 CLOSE OR CONVERT INEFFICIENT OR
UNDERUSED FACILITIES IN VETERANS'
HOSPITALS**

Savings from CBO Baseline	Annual Savings (In millions of dollars)					Cumulative Five-Year Savings
	1991	1992	1993	1994	1995	
Budget Authority	240	250	260	270	280	1,300
Outlays	210	250	260	270	280	1,250

The Department of Veterans Affairs (VA) operates a nationwide medical care system that in 1988 included 172 medical centers, 119 nursing homes, and 233 outpatient clinics. Most of the hospitals are large, modern, and well staffed, thereby providing access to high-quality care for eligible veterans. Many of them are treating increasing numbers of patients, but other facilities have experienced a declining demand for services, such as major surgery or common acute-care procedures. In response, the VA already plans to convert 159 of these hospital beds to nursing home beds in 1991.

The VA could achieve greater efficiency by closing additional small hospitals or underused facilities within hospitals or by converting them into facilities that offer services in greater demand. The criteria for closure could include the existence of adequate alternative sources of care, as well as low numbers of veterans using the VA facilities. Carrying out this option would require changes in both the program's authorization and its appropriation.

The level of savings achieved would depend on several factors: whether complete hospitals or merely wings within hospitals were closed or converted; whether conversions substituted for construction of new nursing homes that would otherwise have occurred; and the extent to which gross savings from closure or conversion would be absorbed by the increased costs for transportation or private care incurred for some veterans under the restructured arrangements. If overall savings were equal to those from closing 4 percent of VA

hospital beds, federal savings would total about \$1.2 billion from 1991 through 1995.

This option would reduce the number of expensive surgical and other acute-care medical facilities with low average caseloads or occupancy rates. Closing or converting these facilities would not eliminate VA care for veterans, as patients would be transferred to other VA hospitals or appropriate private facilities, but needed care would be provided more economically. To the extent that veterans were transferred to facilities that had greater professional resources or that undertook relevant surgical procedures more frequently, closure or conversion would also improve the quality of the care veterans receive.

This option could have the effect, however, of reducing access to health services for some veterans who receive care on a "space available" basis within underused VA facilities. Some veterans could also find care more difficult to obtain if closures were in rural areas without other facilities.

**NDD-44 PROMOTE MORE EFFICIENT MANAGEMENT
AND DELIVERY OF HEALTH CARE
FOR VETERANS**

Savings from CBO Baseline	Annual Savings (In millions of dollars)					Cumulative Five-Year Savings
	1991	1992	1993	1994	1995	
Budget Authority	0	170	350	550	770	1,850
Outlays	0	150	330	530	740	1,750

The Department of Veterans Affairs (VA) operates a nationwide medical care system that in 1988 included 172 medical centers, 119 nursing homes, and 233 outpatient clinics. The VA spent \$5.5 billion in 1988 on inpatient health care services in VA hospitals. Evidence exists, however, that one-quarter or more of inpatient days in these hospitals are inappropriate or unnecessary. The excessive use has been attributed to inappropriate admissions and unnecessarily long stays. The latter stem both from inefficient management practices (such as performing certain diagnostic tests after, rather than before, admission) and from the lack of less costly levels of care (including nursing home care that could facilitate timely discharges). Moreover, the availability of empty or underused beds in some VA hospitals reduces the pressure to avoid unnecessary inpatient days.

The VA has adopted a system known as the Resource Allocation Methodology (RAM) to promote more efficient resource use, although its impact on the allocation of VA funds has been limited. Use of the RAM to adjust VA hospital budgets will be suspended in 1991 for one year while technical problems are addressed.

The Congress and the Administration could require the VA to allocate resources for hospital care using a prospective payment system (PPS) similar but not identical to Medicare's system, while increasing the VA's freedom to allocate resources more efficiently. In essence, under a PPS, each patient would be classified in a diagnosis-related group (DRG), which would entitle the hospital to a fixed payment designed to reflect the average cost of efficient care for such a patient. In

turn, the VA health care system would receive an overall level of operational funding related to the sum of these amounts. For this option to be effective, however, the VA would also have to be given considerably greater control over the nature and location of VA facilities, the total number of its health care beds, and its total staffing levels. If a PPS were introduced to the VA hospital system between 1992 and 1995 with a rate structure, for instance, that assumed gains in efficiency of 10 percent after full implementation, federal savings would total \$1.7 billion through 1995. Carrying out this option would require changes in both the program's authorization and its appropriation.

PPS-based funding for VA hospitals would strengthen their incentives to use resources efficiently. In the first year after PPS was introduced within Medicare, estimated gains in efficiency averaged about 5 percent. Because the government cannot walk away from operating deficits, government health care facilities cannot be placed fully at risk. Nevertheless, this option would identify inefficiently managed hospitals, thereby providing strong incentives for better performance; it would also identify hospitals that would be better converted to other uses (for example, nursing homes) or closed entirely (see NDD-43). Finally, this option would promote efficient use of resources in the next century as the declining number of World War II veterans reduces demand for veterans' health care.

One disadvantage of this option is that hospitals serving rural areas that have few alternative facilities might be among the underused hospitals on which a PPS would place the greatest financial pressure. Furthermore, implementing a PPS would be complex. For example, doing so would require defining patient categories covering a broader range of conditions than Medicare's PPS system covers, especially for psychiatric care, which accounts for about 45 percent of inpatient days in VA hospitals but less than 20 percent of the associated costs. Improved review procedures would also be necessary to avoid inappropriate admissions and to ensure that quality of care remained satisfactory. Finally, some people would prefer the nature and location of VA facilities to be determined by the legislative branch rather than the executive branch.

This option would only peripherally address the VA hospitals' use of capital resources, which is largely determined by the Congress. Separate measures regarding capital investments could yield signifi-

cant additional savings by avoiding costly investments in new or refurbished VA facilities that would last well beyond the period when their services are needed.

**NDD-45 END FUNDING FOR THE
 LEGAL SERVICES CORPORATION**

Savings from CBO Baseline	Annual Savings (In millions of dollars)					Cumulative Five-Year Savings
	1991	1992	1993	1994	1995	
Budget Authority	330	340	360	370	390	1,790
Outlays	290	340	350	370	380	1,730

The Legal Services Corporation (LSC), an independent, not-for-profit organization, supports free legal aid to the poor in civil matters. About 300 state and local agencies receive LSC grants from federally appropriated funds. In 1988, more than one million of the nation's poor received legal assistance under such funding. The Congress continued to fund LSC despite repeated attempts by the Reagan Administration to abolish the program. President Bush's budget proposes freezing funds for LSC at the 1990 level. Terminating federal appropriations to LSC would generate five-year savings in outlays of about \$1.7 billion through 1995.

From its inception in 1974, the LSC has been the subject of much controversy. Critics of LSC charge that the activities of legal aid lawyers focus too often on the advancement of social causes rather than on the needs of poor people with routine legal problems. The Reagan Administration and others argued that the responsibility for legal aid to the poor should rest not with the federal government but with states and localities. From this perspective, support obtained from other federal grants and expanded support from private sources, including donated services, could help to meet local needs for legal aid. Federal funds for social services block grants totaled \$2.8 billion in 1989, about nine times the funding level for LSC. Such an approach would give localities more control over legal aid programs and thus would permit services to be more responsive to local needs.

Reliance on uncertain and indirect forms of support, rather than on a specifically targeted federal assistance program, cannot ensure that legal aid is available to the poor. The inadequacy of local and

private support was one of the factors that led to direct federal financing in the first place. A strong federal program also allows essential oversight and national direction. Instead of eliminating the program, the Congress could continue to curtail activities that some observers find objectionable. Operating limitations notwithstanding, some analysts even argue that the level of federal support should be increased.

**NDD-46 MODIFY THE DAVIS-BACON ACT BY
ALLOWING UNRESTRICTED USE OF
HELPERS AND RAISING THE
CONTRACT THRESHOLD**

Savings from CBO Baseline	Annual Savings (In millions of dollars)					Cumulative Five-Year Savings
	1991	1992	1993	1994	1995	
Budget Authority	700	680	700	720	750	3,550
Outlays	190	420	560	630	680	2,500

Since 1935, the Davis-Bacon Act has required that "prevailing wages" be paid on all federally funded or federally assisted construction projects of \$2,000 or more. Procedures for determining prevailing wages in the area of a construction project, as well as the classifications of workers receiving them, favor union wage rates in some cases. Recent changes in regulations, however, have lessened this effect. The act also restricts use of lower-wage, less-skilled workers such as "helpers." Under current regulations, wages for helpers are usually not determined separately, with the result that most helpers on covered projects are paid at the higher rate of journeymen's wages.

Federal outlays for construction could be reduced by allowing unrestricted use of helpers, by raising the threshold for determining the projects to be covered by Davis-Bacon, or by doing both. The specific option depicted in the table would allow unrestricted use of helpers and would raise the threshold from \$2,000 to \$250,000, thus excluding about 6 percent of the value of all contracts currently covered by the act. These measures would reduce outlays by about \$190 million in 1991 and by about \$2.5 billion over the 1991-1995 period, of which about 21 percent would be in the national defense budget function. These estimates assume that federal agency appropriations would be reduced to reflect the anticipated reduction in costs.

Most of the savings would result from the increased use of helpers. Allowing unrestricted use of helpers without changing the project threshold would reduce outlays by about \$2.2 billion over the 1991-

1995 period. Allowing unrestricted use of helpers and raising the project threshold to \$100,000 or to \$1 million would reduce outlays by about \$2.4 billion or \$2.7 billion, respectively, over this five-year period. Setting the threshold at \$100,000 would exclude less than 2 percent of the value of contracts currently covered; setting it at \$1 million would exclude about 17 percent.

Relaxing Davis-Bacon requirements would help reduce the cost of federal construction projects. In addition, easing restrictions on the use of helpers would probably increase employment opportunities for less-skilled workers on federal projects. Such changes would, however, lower the earnings of some construction workers. In addition, opponents of this option argue that relaxing Davis-Bacon requirements could jeopardize the quality of federally funded or federally assisted construction projects.

**NDD-47 MODIFY THE SERVICE CONTRACT ACT
BY ELIMINATING THE
SUCCESSORSHIP PROVISION**

Savings from CBO Baseline	Annual Savings (In millions of dollars)					Cumulative Five-Year Savings
	1991	1992	1993	1994	1995	
Budget Authority	140	150	150	160	160	760
Outlays	130	150	150	160	160	750

The McNamara-O'Hara Service Contract Act of 1965 sets basic labor standards for employees on government contracts whose principal purpose is to furnish labor, such as laundry, custodial, and guard services. Contractors covered by this act generally must provide these employees with wages and fringe benefits at least equal to those prevailing in their locality or those contained in a collective bargaining agreement of the previous contractor. The latter provision applies to successor contractors, regardless of whether their employees are covered by a collective bargaining agreement.

The cost of services procured by the federal government could be reduced by permitting successor contractors to pay lower wage rates or to provide less costly fringe benefits than their predecessors. Under this option, successor contractors would still be subject to the rules on prevailing wages and fringe benefits. This change in requirements would reduce outlays by about \$130 million in 1991 and by about \$750 million over the 1991-1995 period, of which about 60 percent would be in the national defense budget function. These estimates assume that federal agency appropriations would be reduced to reflect the anticipated reduction in costs.

Federal procurement costs would fall because this option would promote greater competition among contractors. The current rule discourages potential successors from bidding on contracts in which the existing provider has a collective bargaining agreement, unless they have similar agreements.

The provision for successor contractors is intended, however, to prevent bidders from undermining existing collective bargaining agreements. Eliminating this provision would reduce the compensation of workers in some firms that provide services to the government. Some supporters of the provision argue that a reduction in compensation would, in turn, reduce the quality of such services.

CHAPTER VI

FEDERAL WORK FORCE

In 1990, the federal government will disburse about \$145 billion to meet its civilian employee payroll and to cover the costs of benefits, including those for former employees and their families. Such spending, representing about 12 percent of federal outlays, is often targeted for reduction in debates on the federal budget deficit. This section presents five areas for reducing the costs of federal employee pay and benefits. Most of the items in the chapter are variations on or extensions of measures the Congress has considered or adopted in past efforts to reform government operations and control costs. Some derive a substantial portion of their savings from the Department of Defense, which employs almost half of all civilian employees outside the Postal Service.

Consistent with past actions on federal pay, the first option (FWF-01) suggests different approaches to limiting the size of annual pay raises for federal civilian employees. Options FWF-02 and FWF-03 present several ways to achieve savings by providing less generous retirement benefits. The restrictions on future cost-of-living adjustments described in FWF-03 build on reforms adopted in 1986 for both military and civilian retirement.

The last two options address financing changes in the Federal Employees Health Benefits Program. FWF-04 would improve the recognition of costs by requiring agencies to prefund, on an accrual basis, the government's expenses for health care provided to its retirees. (The net budgetary savings derive from an associated increase in postage rates that would be necessary to cover the additional accrual costs placed on postal operations.) FWF-05 describes how the costs of employee health insurance could be reduced by extending to the Federal Employees Health Benefits Program a hospital payment reform similar to that adopted earlier for military health insurance.

The options in this section would require changes in authorizing legislation. To assure that the savings were used to reduce the budget

deficit rather than to fund increases in other areas, some of the options would also require the Congress to cut agency appropriations or to direct the Office of Management and Budget to withhold funds from agencies. All the savings estimates set out in this section assume that each reduction measure would be implemented alone. If they were implemented together, savings would be less than the sum of the separate amounts.

**FWF-01 LIMIT PAY ADJUSTMENTS FOR FEDERAL
CIVILIAN EMPLOYEES**

Savings from CBO Baseline	Annual Savings (In millions of dollars)					Cumulative Five-Year Savings
	1991	1992	1993	1994	1995	

**Eliminate Increase for One Year and Delay
Effective Date for Subsequent Adjustments by Three Months**

Budget Authority	2,300	3,850	4,000	4,150	4,300	18,600
Outlays	1,900	3,650	4,050	4,250	4,450	18,300

**Limit Adjustments to CPI Increase Minus Two Percentage Points
for Five Years and Delay Effective Date by Three Months**

Budget Authority	1,450	2,800	4,200	5,650	7,250	21,350
Outlays	1,200	2,600	4,000	5,550	7,150	20,500

The nation's 2.2 million federal white- and blue-collar employees are entitled to receive annual pay increases under procedures that compare federal and private-sector salaries for comparable jobs. Largely because of budgetary pressures, however, annual governmentwide federal pay raises have been strictly curtailed for more than a decade. In 1986, no increase was allowed; in other years, the increase was held well below the level necessary to achieve comparability. From January 1986 through January 1990, annual raises in federal wage and salary scales have averaged 2.5 percent--about one percentage point below increases in both private-sector rates and the rate of inflation.

The Congress could again target federal civilian employee pay for budget reduction. The affected payroll, excluding the U.S. Postal Service, accounts for about 6 percent of net federal spending. This option includes two alternatives, both of which would maintain the current practice of delaying the annual effective date of raises by three months. (White-collar workers' pay would rise in January, rather than in the preceding October as authorized by law.) The first alternative would also eliminate the pay increase in 1991. In this case, five-year savings would accumulate to \$18.3 billion. If, as in the second alternative, annual January pay raises through 1995 were kept two percentage points below the previous year's rate of inflation, outlay savings would

accumulate to \$20.5 billion over the same period. In both cases, about half the savings derive from civilians employed in national defense activities. (DEF-28 would limit raises for uniformed military personnel.)

The savings estimates are measured against CBO's baseline, which uses the authorized effective dates. (President Bush's budget assumes a continuation of the practice that amends the law each year to make federal white-collar adjustments effective in January. The Administration's projected increases in federal civilian pay through 1995 average 3.5 percent, 0.5 percentage points below the average for the raises assumed in CBO's baseline.) To realize savings, the Congress would need either to lower appropriations in recognition of reduced agency spending for pay, or to institute a mechanism that prevents agencies from spending funds already appropriated.

Limits on pay may be viewed as part of a general belt tightening necessitated by federal budget deficits. Financially strapped private firms, after all, have been forced to limit personnel costs through pay limits, layoffs, and other measures. The options set forth here, moreover, would not differ that much from recent practice. Capping adjustments, after all, would result in average annual pay adjustments of about 2.3 percent--only about 0.2 percentage points under the average annual adjustments over the preceding five years. Some critics support pay limits because their analysis suggests that federal employees receive higher pay than their counterparts in the private sector with similar experience, education, and other demographic characteristics.

Limits on federal pay, however, raise a question of fairness when viewed in light of the sacrifices federal workers have already made on behalf of the federal budget. Not once since October 1977 have federal pay adjustments reached the levels recommended under law to make federal pay comparable with private-sector rates. The case against pay limits, however, rests largely on concerns about the ability of the federal government to compete with the private sector to get and keep a well-qualified work force. Concerns about the competitive position of government have been reinforced by recent reports from the federal Office of Personnel Management and the private Commission on the Public Service. They predict that changes in the nature of federal work and the people available to do it will make hiring and retention much more difficult in the future. Major regional offices of the FBI and other

federal law enforcement agencies already have lost many of their most experienced special agents and have had problems in finding suitable replacements. The Department of Defense has experienced some problems in hiring and retaining scientists and engineers, and the General Accounting Office finds that the government has had trouble attracting and retaining flight controllers, revenue agents, and computer specialists.

Such personnel problems could become more widespread if the government adopted federal pay limits that would cause real wages to decline by as much as 10 percent. Surveys done for the President's Pay Agent show that salaries for white-collar federal jobs already lag behind rates for comparable private-sector jobs by around 20 percent at the lower grades and by as much as 37 percent at higher grades. A recent report by the Wyatt Company confirms that, overall, federal pay lags well behind the private sector's. Such information suggests that what is needed is higher federal pay, not a cap on annual adjustments. In fact, the budget states that the President will seek legislation to authorize higher pay for entry-level occupations requiring a college education, for all personnel in certain geographic areas, and for selected critical occupations.

Finally, instead of specifically targeting federal pay for reduction, the Congress could always consider pay limits as part of a broad effort to curtail cost-of-living adjustments for federal programs. (ENT-25 would limit COLAs on non-means-tested entitlements like Social Security, and REV-02 would repeal the indexing of income-tax schedules.)

**FWF-02 REDUCE FEDERAL EMPLOYEE
RETIREMENT BENEFITS**

Savings from CBO Baseline	Annual Savings (In millions of dollars)					Cumulative Five-Year Totals
	1991	1992	1993	1994	1995	

**Restrict Agency Match on Thrift Plan
Contributions to a Uniform 50 Percent Rate**

Outlays	120	180	200	220	240	960
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**Curtail COLAs for Nondisabled
CSRS Retirees by 0.5 Percentage Points**

Outlays	90	200	340	470	620	1,720
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**Base Initial Benefit on
Four-Year Average Annual Salary**

Outlays	10	40	90	140	190	470
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**Raise Employee Pension Contributions
by 0.5 Percent of Pay**

Additional Revenues	440	450	470	490	510	2,360
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About 2.9 million federal civilian employees (including postal workers) are covered by government-sponsored retirement systems. Those hired after December 1983 must participate in the Social Security retirement and disability program. To supplement this coverage, the Congress enacted the Federal Employees' Retirement System (FERS) in 1986. It provides these post-1983 workers with a defined-benefit pension plan and a tax-deferred Thrift Savings Plan that includes matching employer contributions. The number of FERS employees, currently estimated at 1 million, will continue to grow over the next decade because all new hires will be covered. The Congress also provided the 2.2 million workers hired before January 1984 with a choice of retirement plans. They could remain covered by the Civil Service Retirement System (CSRS), or they could join FERS. More than 2 million workers elected to continue their CSRS coverage; since then, mainly as

the result of retirements, the number has declined to 1.8 million. These CSRS workers can also participate in the Thrift Savings Plan, but without the benefit of matching employer contributions.

The combined benefits under FERS were designed to compete with the best private-sector plans, but to be less costly in the long run than the CSRS benefits they replaced. Although the reforms are fairly recent, the Congress could again take up the question of curtailing retirement costs. Possibilities include increasing employee contribution rates for CSRS and FERS, moderating initial benefit levels, curtailing cost-of-living adjustments (COLAs) for nondisabled CSRS retirees, or restricting the matching rate on voluntary contributions made by FERS employees to the Thrift Savings Plan. A lower matching rate would not automatically result in budgetary savings, however, unless commensurate reductions in agency spending were achieved--either by authorizing the Office of Management and Budget to withhold funds or by appropriating lower funding levels.

The strongest case against these options is that the relative generosity of federal retirement programs has served as recompense for below-market pay. Erosion of the value of the retirement package, with no change in federal pay practices, would lower total compensation and eventually the quality of the federal work force.

Restrict Agency Match on Thrift Plan Contributions. On behalf of any worker covered by FERS, federal agencies automatically contribute 1 percent of individual earnings to the Thrift Savings Plan. In addition, any voluntary deposits made to the Thrift Plan by a FERS participant, up to 5 percent of earnings, are matched by the employing agency. The marginal rate of the agency match declines with the level of voluntary savings: agencies match employee deposits up to 3 percent of earnings at a 100 percent rate, and deposits between 3 percent and 5 percent at a 50 percent rate. If an employee deposits 5 percent of pay, for example, the agency match equals four percentage points of that, or an average match rate of 80 percent. (For FERS employees who save at least 5 percent, the government's match plus the automatic 1 percent result in a federal contribution equal to 5 percent of pay.)

This option would continue the automatic 1 percent contribution, but would match employee deposits up to 5 percent of pay at a uniform rate of 50 percent. The total maximum agency contribution to the

Thrift Savings Plan would thus decline from 5 percent of covered earnings to 3.5 percent. Assuming a January 1991 effective date, reducing the employer match would produce five-year outlay savings estimated at \$1 billion. (Agency contributions to the Thrift Savings Plan are treated as federal outlays, similar to disbursements for wages and salaries. About half of the outlay savings would derive from national defense activities. The estimates exclude savings realized by the Postal Service, which would total \$0.3 billion through 1995, because the USPS is now off-budget and because its operating cost reductions eventually benefit mail users rather than U.S. taxpayers.)

Alignment with practices representative of private employers is a long-standing goal for federal employees' compensation. But total federal compensation is less than what it would be if the government adopted typical private-sector pay and benefit provisions. Higher federal pay rates coupled with lower deferred compensation from the government's retirement and thrift plans would be more in line with private-sector practice. Private employers typically match an individual's voluntary thrift plan deposits up to 6 percent of pay at a 50 percent rate. As modified by this option, the federal thrift plan would remain superior to most employer-provided matches because of the 1 percent automatic agency contribution. Reducing the government's thrift plan contributions could help justify higher federal pay--at least for those positions for which it is difficult to attract and retain highly qualified workers--although doing so would diminish the budgetary savings.

Because the FERS program is relatively new, changing a major element like the Thrift Savings Plan could be perceived as unfair. It would tend to discredit new retirement system commitments--reached after more than three years of analysis and debate by the Administration, the Congress, and employee representatives. Especially hard-hit by changes in FERS would be higher-salaried professional and administrative employees. These workers, who already face some of the widest salary disparities with the private sector, are more likely than other FERS employees to participate in the savings program. Many of them elect to make voluntary contributions at or above 3 percent of earnings, and halving the 100 percent agency match would be roughly equivalent to a 1.5 percent pay cut for this relatively small group. The former CSRS employees who elected to transfer their future federal retirement coverage to the FERS program (about 100,000) would also

feel cheated. If the government sought to renege on its commitment to the original thrift matching rates, these workers might demand a chance to rejoin CSRS.

Curtail COLAs for Nondisabled CSRS Retirees by 0.5 Percentage Points. This option would limit COLAs for nondisabled CSRS retirees to the yearly rate of inflation, as measured by the consumer price index, minus 0.5 percentage points (CPI minus 0.5). Relatively small savings would occur in 1991. By 1995, however, annual outlay savings would total \$0.6 billion. Other approaches are available to reduce the costs of federal pension adjustments (see ENT-25 and FWF-03). President Bush's proposed budget would disallow any COLA in 1991 and limit subsequent annual adjustments, so long as the inflation rate remained at 3 percent or higher, to CPI minus one percentage point.

Indexing CSRS benefits to the CPI is very expensive, and overly generous when compared with private-sector practices or with the relatively new FERS program. FERS was created, as described earlier, to supplement the mandated extension of Social Security coverage to federal employees. The defined-benefit part of FERS is generally indexed at inflation less one percentage point (CPI minus one). Benefits provided by Thrift Plan contributions plus annual COLAs for Social Security help moderate the impact of inflation on FERS annuitants. No COLAs are awarded, however, to nondisabled FERS retirees under age 62.

This option amounts to complete indexation for half of the CSRS pension and to an indexation rate of CPI minus one for the other half. (Roughly half the CSRS pension is akin to Social Security coverage and the remainder to an employer-provided supplement.) The option's reduced indexation (CPI minus 0.5) would continue to exceed typical private-sector practice because it would be automatic and would begin before age 62; indexation of survivor benefits would not be reduced. A possible weakness is that the option would treat all retirees alike, regardless of their income level and associated federal income tax liabilities. This treatment differs from Social Security under which benefits for lower-income retirees are tax-free and tilted to provide a higher wage replacement rate. The option would also renege on the understanding that workers who had refused to join FERS would retain the better inflation protection provided by CSRS.

Base Initial Benefit on Four-Year Average Annual Salary. Both CSRS and FERS calculate initial benefits based on an average of the employee's three highest salaried years. This option would institute a four-year average (five years is generally used for defined-benefit pension plans in the private sector). Adopting the four-year average would cut new retirees' pensions on average by 2 percent to 3 percent. To discourage workers from accelerating their planned date of retirement in order to avoid a benefit cutback, any change in calculating benefit levels could be phased in. For estimating purposes, CBO assumed that the salary base would increase from 36 months to 48 months during 1991. Through 1995, this would save less than \$0.5 billion. Another approach would grandfather the three-year average for employees currently eligible to retire. But this would produce even smaller five-year savings. Over the long run, however, either approach would generate significant savings as more and more employees retired. On an actuarial or long-term accrual cost basis, the change in the salary base used for calculating retirement benefits would save the equivalent of 0.7 percent of payroll for CSRS and about 0.4 percent for FERS. (The savings would be relatively larger for CSRS because the pension for CSRS is larger than the defined-benefit portion of the FERS annuity.)

CSRS and FERS employees would argue that their retirement benefits have already been cut indirectly by caps on annual federal pay raises. During the 10 years ending December 1989, the rise in private-sector salaries and wages as measured by the employment cost index exceeded the cumulative increase in federal pay rates by nearly 30 percent. A 1 percent federal civilian pay raise over a 12-month period costs about \$0.75 billion. Thus, any serious attempt to correct the existing imbalance between federal and private pay rates would cost much more than the retirement savings available from adopting a four-year average salary base.

Raise Employee Pension Contributions. Compared with the typical cost of private employer-provided retirement benefits (pensions and capital accumulation plans coupled with the costs of Social Security), CSRS and FERS benefit costs are high. Although mandatory retirement contributions for most CSRS employees are 7 percent of pay (and FERS employees pay less than 1 percent in addition to their Social Security contributions), the cost to the employer is still higher than in private plans. Thus, increasing CSRS and FERS employee contributions by 0.5 percent of pay would improve the alignment between the

federal government's cost of retirement benefits and those of private employers. It would also lower the 1991 deficit by \$0.4 billion and generate cumulative savings through 1995 of \$2.4 billion. (The estimated savings represent the increase in federal revenues without regard to the corresponding outlay increases for workers who leave the government and elect to withdraw their pension contributions plus applicable interest earnings. In 1995, these additional outlays would total less than \$50 million.)

By reducing take-home pay, this option would equal a cut in the next general pay adjustment of 0.5 percentage points. (See FWF-01 for options to curtail federal pay raises directly.) From the employees' perspective, a pay cut affects career and noncareer workers equally, whereas hikes in pension contributions can be recovered by noncareer workers when they leave federal service.

**FWF-03 RESTRICT COST-OF-LIVING ADJUSTMENTS
FOR FEDERAL RETIREES UNDER AGE 62**

Savings from CBO Baseline	Annual Savings (In millions of dollars)					Cumulative Five-Year Savings
	1991	1992	1993	1994	1995	
Eliminate COLAs						
Military Retirement	390	940	1,550	2,250	2,950	8,080
Civilian Retirement	90	180	260	310	350	1,190
Total	480	1,120	1,810	2,560	3,300	9,270
Cap COLAs to CPI Increase Minus One Percentage Point						
Military Retirement	90	230	370	540	720	1,950
Civilian Retirement	20	40	60	90	120	330
Total	110	270	430	630	840	2,280

NOTE: Amounts represent outlay savings.

The Civil Service Retirement System (CSRS) and the Military Retirement System (MRS) now provide benefits for about 3.7 million people at an annual cost of \$53 billion. Continued indexing of these benefits to inflation, as measured by the consumer price index (CPI), will generate cumulative outlays through 1995 of \$32 billion. About 980,000 annuitants, including 55 percent of those under MRS and 10 percent of those under CSRS, are nondisabled retirees under age 62. Benefit payments in 1990 for this relatively young group will exceed \$15 billion. Cost-of-living adjustments (COLAs) for federal retirees under age 62 are fully paid for by the government and are expensive relative to adjustments available under the largest and most generous private pension plans.

Eliminating COLAs or capping COLAs at the inflation rate less one percentage point (CPI minus one) for nondisabled federal retirees until they reach age 62 would reduce five-year outlays by \$9.3 billion and \$2.3 billion, respectively. Each of these alternatives would grant a catch-up raise at age 62 to adjust for the inflation since retirement.

Full COLAs would be provided after age 62. (Although the catch-up adjustment restores the monthly pension to what it otherwise would have been at age 62, the annuitant is never compensated for the smaller benefit payments received during the period COLAs were either eliminated or capped.) Over 90 percent of the losses would be taken by current retirees, and the rest by those retiring in the next five years.

Military and civilian retirement reforms enacted in 1986 reduced the future cost of federal pensions for newly hired employees. The military system reforms will curtail pension benefits for newly hired armed-services personnel by reducing most initial annuities and by capping COLAs at CPI minus one. These future military retirees will receive a catch-up adjustment, at age 62, that restores the purchasing power lost since retirement. In contrast to the practice under CSRS, nondisabled civilian retirees under the new system will not receive any COLA until age 62, nor any catch-up raise for price increases since their retirement. For both groups, future civilian and military annuitants alike, COLAs awarded after age 62 are generally limited to CPI minus one. But COLAs for retirees who remain covered by the old CSRS and MRS systems are unaffected--still set at 100 percent of the CPI. (Repeating a proposal advanced by the previous Administration, President Bush's budget would deny next year's COLA regardless of age and, with some variations, limit annual adjustments for 1992 and subsequent years to CPI minus one. The Balanced Budget and Emergency Deficit Control Act of 1985 denied the COLA for 1986. But subsequent action by the Congress insulated COLAs from future budget sequestration cuts.)

Eliminating or capping COLAs for retirees before age 62 who are now covered by the old CSRS and MRS systems would moderate the government's cost for early retirement. Either approach would reduce protection from inflation and thus real benefits for federal retirees of working age. The loss in retirement income would be especially pronounced for nondisabled MRS employees who retire at an average age of 43. But at age 62 and beyond, COLAs for federal pensions affected by this option would remain more generous, with the catch-up, than would the partial inflation protection for those receiving private pensions combined with Social Security. (FWF-02 includes an option that would attempt to bring CSRS indexation more into line with private-sector practice by reducing the size of COLAs for all annuitants regardless of age.)

Because considerable planning and changes in personal affairs often precede decisions to retire, changing the rules for people after they retire could be perceived as unfair. CSRS employees who elected not to join the new retirement program mainly because of its smaller COLAs would also feel shortchanged. (Another proposal, FWF-02, would reduce benefits under the new retirement system.) Moreover, federal workers traditionally have accepted a compensation package that provides superior pensions at the expense of lower pay. They may distrust the option's reliability--believing that future budgetary pressures could either erode the size of the proposed catch-up adjustment or delay it beyond age 62.

Finally, restricting COLAs for military retirees would diminish the financial reward for many now making a career of military service. Estimates indicate that, over the long term, adopting the no-COLA approach would cause approximately 55,000 officer and enlisted personnel to depart early--eventually lowering average military service and experience levels by about 5 percent. The increase in departures of personnel with more than four years of service would result, over time, in a less experienced military force. The acceleration of voluntary separations, however, might facilitate a future restructuring of military force levels that would require fewer uniformed personnel.

The Congress could consider other restrictions on COLAs to generate near-term savings. One possibility would be to curtail adjustments for all nondisabled CSRS, MRS, and Social Security annuitants (see ENT-25, which would restrict federal retirement and Social Security COLAs). Other possibilities could pivot directly--or indirectly, like the two options introduced above--on the beneficiary's earnings capability. In general, financial hardships from smaller COLAs would be more pronounced for disabled and survivor annuitants than for the relatively young retirees targeted here, who should be in a better position to face a temporary loss in real benefits. Presumably, these young retirees would be able to supplement their pensions by working--as most military retirees already do.

**FWF-04 PREFUND THE GOVERNMENT'S SHARE
OF FEDERAL RETIREES' HEALTH
INSURANCE COSTS**

Savings from CBO Baseline	Annual Savings (In millions of dollars)					Cumulative Five-Year Savings
	1991	1992	1993	1994	1995	
Budget Authority	-510	-800	-940	-1,100	-1,250	-4,600
Outlays	210	330	370	440	500	1,850

NOTE: The negative amounts for budget authority represent payments by nonpostal agencies into a trust fund for annuitant health care.

Upon retirement, more than 80 percent of federal workers elect to continue their employer-provided health insurance coverage. The federal share of continued protection under the Federal Employees Health Benefits (FEHB) program cannot exceed 75 percent of the annual premium cost; however, it can be as low as 32 percent depending upon the particular health care plan. Currently these costs are recognized as an annual expense throughout the annuitant's retired years and, as such, are financed on a pay-as-you-go basis. Instead, the government could prefund its share of annuitants' premiums by annually investing a fixed percentage of covered payroll. This method of financing health care for federal retirees and their dependents would shift the recognition of federal costs from the years of retirement to the years of active employment that contribute to the delivery of governmental services. (The Bush Administration, as did the previous one, proposes broadening the Postal Service's pay-as-you-go requirements to cover postal annuitants and survivors who now are excluded because they were on the benefit rolls before October 1986. The Administration is preparing a legislative package for reforming various aspects of the FEHB program.)

Prefunding annuitant health insurance generally--that is, excluding the Postal Service--would not increase or decrease governmentwide spending. In the near term, most agencies would respond to the new cost requirement by requesting larger annual appropriations. The

increased payments by these agencies would represent offsetting income to a new on-budget trust fund and would earn interest until expended. In the case of the U.S. Postal Service (USPS), however, the additional contribution required by this option would represent new costs to the USPS that eventually would be financed through higher postage rates. Estimated five-year outlay savings from the increased postal receipts, assuming a January 1991 effective date, exceed \$1.8 billion.

The option's net budgetary impact would reduce near-term deficits as certain costs shifted, through higher postage rates, to the current generation of mail users. The additional payments from the now off-budget Postal Service would, as offsetting income, reduce net spending from on-budget accounts that fund annuitant health care. The reduction would not be accompanied by a commensurate increase in off-budget deficits so long as postage rates were increased to cover the higher Postal Service payments. For nonpostal activities, the added costs from prefunding health care (shown in the table as budget authority) would represent budgetary transactions from one account to another that do not alter receipts from the public or federal disbursements.

Determining the appropriate rate for agency payroll contributions would require a comprehensive actuarial evaluation of costs. This would incorporate key assumptions about projected changes in the price and use of health care services, and about retirement age and numbers of annuitants' dependents. For estimating purposes, this option uses an annual contribution set at 3 percent of payroll as the minimum rate necessary to prefund future federal outlays. In addition, the option would apply the advanced-funding procedure only for those workers covered by the relatively new Federal Employees' Retirement System (FERS), which is financed on an accrual cost basis. For these employees, the government's cost of providing deferred compensation in the form of annuitant health benefits would be financed as if it were a pension benefit--no longer when the cash payments occur, but throughout the years that the beneficiaries are employed by the government. (The proposal would not alter the level or timing of contributions made by annuitants.)

The additional employer contributions required by this option would supplement payments already being made on a pay-as-you-go basis for federal workers who are covered by the old Civil Service

Retirement System (CSRS). Under current law, a single appropriation is enacted each year for CSRS annuitants participating in the health insurance program, except for certain postal retirees and their survivors. Starting in 1987, the USPS began paying the federal share of premiums for its newly retired workers and more recently for the survivors of these post-1986 annuitants. In 1995 these pay-as-you-go payments under current law will amount to an estimated \$0.6 billion from the Postal Service and \$7.1 billion from general appropriations. In the same year, this option would add another \$1.8 billion, with the Postal Service accounting for more than one-fourth of this amount.

The changes set forth in this option would, if enacted, parallel health care accounting changes under way in the private sector. The Financial Accounting Standards Board (the private body that sets financial reporting standards) proposes that corporate financial statements recognize the firm's liability for postretirement health care. Such liabilities are substantial. According to a June 1989 report from the General Accounting Office, private employers confront a \$400 billion annuitant health insurance liability--\$300 billion for today's workers and \$100 billion for those already retired. About half of the large firms included in one 1989 survey are considering changing from pay-as-you-go financing of annuitant health care to some form of pre-funding.

This option would improve cost recognition and allow better decisions on the compensation, size, and composition of the federal work force. The lifetime federal contribution for annuitant health benefits is akin, in many ways, to having a larger retirement pension with a set-aside for health care. Moreover, future measures to control federal costs for annuitant health care would be facilitated, as a first step, by a shift to accrual cost accounting. The need for such a change in cost recognition and financing grows each year as the size of the annuitant population and the price of medical care continue to increase.

Some critics of this option believe the pension analogy is flawed for several reasons. They point to the voluntary rather than mandatory nature of the federal employees' health benefits program. For eligible annuitants, moreover, the level of health benefits is not influenced by the number of years in the federal work force. A final and more meaningful difference is that calculating future liabilities for annuitant health care insurance is much more complex and uncertain than for

pensions. The insurance protection provided does not directly relate to the employee's salary. And the cost of insurance premiums could be greatly influenced by changes in the price and use of health services, and by the adoption of proposals to reform the federal health care program and its relationship to Medicare. From this perspective, adopting a new prepayment scheme for federal annuitants seems ill-advised. Moreover, accounting practices found in the private sector need not apply to the vast majority of governmental operations that, unlike mail service, are not self-financing.

In addition, mail users would be likely to claim that the prefunding requirement is advanced--at their expense--largely to improve the near-term cash flow position of the Treasury. The Congress in 1985, moreover, addressed the issue of funding health care for postal annuitants by requiring the Postal Service to pay the employer's share for workers retiring after September 1986. President Bush, following the practice of his predecessor, proposes extending pay-as-you-go to all postal annuitants regardless of retirement date. The Congress has not acted on such extensions. Continuing to finance postretirement benefits on a pay-as-you-go basis, however, means subsidizing today's postal operations at the expense of future postal customers. (A more detailed discussion of this option as it relates to the USPS is presented in the CBO staff working paper, "Alternatives for U.S. Postal Service Funding of Certain Employee Benefits," August 1988.)

**FWF-05 MODIFY THE WAY HOSPITALS ARE PAID
UNDER THE FEDERAL EMPLOYEES HEALTH
BENEFITS PROGRAM**

Savings from CBO Baseline	Annual Savings (In millions of dollars)					Cumulative Five-Year Savings
	1991	1992	1993	1994	1995	
Budget Authority	0	0	140	370	670	1,180
Outlays	0	0	140	370	670	1,180

The Federal Employees Health Benefits (FEHB) program offers health insurance coverage for federal employees, retirees, and their dependents. The program covers about 4 million enrollees at a yearly cost to the federal government of about \$7 billion. About one-third of this amount, the subject of this option, pays for certain inpatient services provided by hospitals to FEHB enrollees. Federal costs will continue to grow because of higher health care expenses and greater numbers of retirees. (The estimated government costs exclude amounts paid by the U.S. Postal Service because such costs are eventually paid by mail users rather than by taxpayers.) Reforming hospital reimbursement, as described below, would reduce such costs and thus lower federal outlays in 1995 by an estimated \$0.7 billion. The savings result from a gradual reduction in the rate that hospital costs would be allowed to rise. For calendar year 1995, relative to the level otherwise expected for systemwide costs, the reductions would total 15 percent. To realize budgetary savings, over one-fourth of them in national defense functions, the Congress would need to reduce agency funding accordingly. (To allow time for implementation, the new reimbursement system would begin to take effect for the FEHB contract year beginning January 1992. No net budgetary savings would be expected to materialize, however, until the following year.)

FEHB insurance carriers pay hospitals primarily in two ways--some on the basis of actual charges, and others on the basis of predetermined rates that have been negotiated with the hospitals and that reflect certain discounts. An alternative reimbursement system could require carriers to use a prospective payment system patterned

after the one instituted in 1987 by the Civilian Health and Medical Program of the Uniformed Services (CHAMPUS) for military dependents and retirees. The military program modified the diagnosis-related group (DRG) payment schedules used by Medicare to reflect the health care needs of younger patients. Under a modified DRG system, hospitals receive a fixed payment per case based primarily on a patient's diagnosis, and adjusted for certain hospital characteristics that affect the costs of treating that diagnosis. Hospitals that accept federal reimbursement from Medicare would be required to accept the predetermined rate as payment for FEHB enrollees, just as they are for CHAMPUS. In some cases, the payment schedules might need refinement to consider the insureds' demographic characteristics and other pertinent cost considerations. The size and timing of premium reductions would depend on rate negotiations with more than 400 FEHB insurance carriers. Savings realized under this prospective payment system eventually would allow for lower premium payments by both the federal government and enrollees. The reductions realized in 1992 through 1995 could save enrollees nearly \$0.7 billion.

With few exceptions, such as the Washington, D.C., area, FEHB enrollees represent a relatively small portion of hospital cases. An expanded DRG reimbursement system should save the government money without adverse financial effects on most hospitals. The current system seems to drive up costs because hospitals tend to provide FEHB and other insured patients more amenities, more technology, and more staff than are necessary. Several states have implemented DRG systems, although most have had little initial success in reducing hospital costs. Initial budgetary impacts aside, the information generated by a DRG approach would provide a valuable management tool for long-term cost control.

This proposal would raise some of the same concerns about jeopardizing the quality of health care that were raised during debate on adopting the DRG scheme for Medicare and again for CHAMPUS. The DRG payment system has not yet been refined to the point where it recognizes all of the appropriate cost variations for treating different patients with the same diagnosis; nor can it identify all of the relevant cost variations among alternative hospitals. As a result, some hospitals might realize a profit from cases for which an identical diagnosis in a different hospital could represent a financial loss. Such economic forces might cause hospitals, especially in localities with significant

numbers of FEHB patients, to shift care to a local competitor or to limit the amount of care provided. In other cases, especially in areas with a relatively high concentration of federal workers or annuitants, hospitals might try to collect excess expenses directly from FEHB patients or to shift some costs and procedures to outpatient services not covered by DRG fee schedules. (Vigilant program monitoring should, of course, limit the opportunity for such abuse.) Finally, federal budgetary pressures might lead to future DRG payments that were lower than the cost of providing adequate care to a typical patient, causing hospitals to accentuate the selection of patients on the basis of financial considerations.

CHAPTER VII

REVENUES

This section presents a broad range of options for increasing federal revenue. For example, additional federal revenue could be raised from existing tax sources by raising tax rates, broadening tax bases, or extending the coverage of taxes to include additional taxpayers. Revenue could also be raised by tapping new tax sources.

Although most of the spending options in this volume would take effect on October 1, 1990, the revenue options generally have an effective date of January 1, 1991, because changes in income tax law usually take effect at the beginning of a calendar year. The excise and energy tax options, however, are assumed to take effect on October 1, 1990. For the value-added tax (VAT), an effective date of January 1, 1992, is assumed because a VAT could not be implemented before then, even if it were enacted by mid-1990. The effective dates and transition rules for specific bills will invariably differ. As a result, revenue estimates for such bills may differ slightly from those for similar options shown here.

Although all of the options raise revenue, they create different economic incentives and, ultimately, have different effects on the allocation of economic resources and on tax burdens for different taxpayers. REV-01 would increase the tax rate on all sources of income currently subject to federal income tax, while REV-27 would impose a new tax on a broad consumption base. Both options seek to reduce the effects of taxes on resource allocation by imposing a small incremental tax on a broad base. Many of the options, however, would increase the tax burden on specific types of income and economic activity that currently benefit from relatively favorable tax treatment. For example, REV-03 through REV-09 would reduce or eliminate differences in the tax treatment of alternative sources of capital income, REV-11 and REV-12 would tax labor income on a more uniform basis, and REV-14 and REV-24 would limit deductions for certain business expenditures that may enjoy preferential tax treatment. Options such as REV-13, REV-21, and REV-23 would repeal or limit tax preferences that

encourage capital to be invested in specific sectors of the economy. Several of the options would tax behavior that some have argued is in the public interest to restrict. For example, REV-30 would increase excise taxes on tobacco and alcohol, while REV-31 through REV-34 would tax various forms of environmental pollution.

The revenue estimates for REV-17, REV-19, REV-20, REV-31 through REV-34, and REV-36 were prepared by staff of the Congressional Budget Office. Revenue estimates for the other options, as well as for ENT-17, were prepared by the Joint Committee on Taxation at the request of the Congressional Budget Office.

**REV-01 RAISE MARGINAL TAX RATES FOR
INDIVIDUALS AND CORPORATIONS**

Addition to CBO Baseline	Annual Added Revenues (In billions of dollars)					Cumulative Five-Year Addition
	1991	1992	1993	1994	1995	
Individuals						
Raise Marginal Tax Rates to 16 Percent and 30 Percent	18.7	35.4	38.2	41.2	44.8	178.3
Add a 5 Percent Surtax	13.5	25.7	27.7	30.0	32.6	129.3
Raise the Top Marginal Tax Rate to 30 Percent	10.4	19.9	21.8	23.9	26.1	102.1
Add a 33 Percent Bracket	3.8	7.6	8.7	10.1	11.7	41.9
Add a 38 Percent Bracket	9.6	18.8	21.0	24.1	27.6	101.2
Corporations						
Raise the Top Marginal Tax Rate to 35 Percent	1.4	2.5	2.7	2.8	3.0	12.4
Add a 5 Percent Surtax	3.3	5.7	6.0	6.3	6.7	28.0

Rate increases have several advantages over other tax changes as a means for raising revenue. First, they do not add to costs of enforcement or compliance because they do not increase the complexity of the tax code or the recordkeeping requirements of taxpayers. Second, the Treasury begins to receive the additional revenues relatively quickly because rate increases are reflected in withholding and estimated tax schedules. But rate increases have drawbacks as well. Higher tax rates reduce incentives to work and save, and worsen

any inefficiencies associated with remaining preferences in the income tax code. They also run counter to the spirit of the Tax Reform Act of 1986 (TRA), which reduced statutory marginal tax rates significantly for both individuals and corporations in exchange for broadening the tax base.

Individuals. Under current law, the income tax structure has two explicit marginal tax rates--15 percent and 28 percent. (The marginal tax rate is the percentage of an extra dollar of income that a taxpayer must pay in taxes.) Some taxpayers face an effective marginal tax rate of 33 percent because a 5 percent surtax is imposed on taxable income over a range in which the tax benefits from personal exemptions and the 15 percent bracket are phased out. The surtax raises the average tax rate on taxable income to 28 percent for taxpayers with taxable income above the phase-out range. In 1991, the projected phase-out range of taxable income is \$48,950 to \$113,640 for single taxpayers, and \$81,600 to \$217,510 for a couple with two children.

Increasing all marginal tax rates for individuals by approximately the same percentage--to 16 percent and 30 percent (with a 5 percent surtax for income in the phase-out range)--would increase revenues by a large amount: about \$178 billion in 1991 through 1995. This option is roughly equivalent to imposing a surtax on regular tax liability before credits. Although taxes would increase proportionately for most taxpayers under this option, there would be exceptions. The option would not increase taxes for those whose taxes are computed according to the alternative minimum tax, unless that tax rate were also increased (see REV-03), while families with tax credits would face a somewhat larger percentage increase in their tax liabilities than other taxpayers. Some families whose earned income credit (EIC) gives them a zero tax liability or an EIC refund could incur a positive tax liability as the result of this option.

An alternative to a rate increase would be to impose a surtax applied to tax liability after credits. A surtax of 7 percent would raise about the same revenues, and result in roughly the same marginal tax rates, as raising marginal tax rates to 16 percent and 30 percent, but the tax increase would be distributed differently among taxpayers. Higher taxes would be paid by all taxpayers who now face a positive tax liability, even those who pay the alternative minimum tax, but those whose tax liability was exactly offset by tax credits under current

law would have no additional tax liability. Recipients of EIC refunds would also not be affected by this form of a surtax. A 5 percent surtax applied to tax liability after credits would not increase tax rates as much as a 7 percent surtax, but would increase revenues by about \$129 billion in 1991 through 1995.

Another option would be to increase only the top marginal tax rate. Increasing only the current 28 percent rate to 30 percent (resulting in an effective 35 percent marginal rate for income in the phase-out range) would raise revenues by about \$102 billion in 1991 through 1995. For 1991, this option would increase taxes for married couples with taxable incomes over \$33,750.

The three preceding options do not eliminate the "bubble" in tax rates that causes very-high-income taxpayers to face a lower marginal tax rate than some taxpayers with lower taxable income. This bubble occurs for taxpayers with taxable income in the phase-out range. Those taxpayers have an effective marginal tax rate of 33 percent. Taxpayers with taxable income above the phase-out range have a marginal tax rate of 28 percent. An alternative with uniformly progressive marginal tax rates would be to drop the 5 percent surtax on taxable income in the phase-out range and create an explicit 33 percent bracket that would apply to all taxable income in and above the current phase-out range. The effect of this option would be to raise taxes only for the relatively small number of high-income families for whom the tax benefits of the 15 percent bracket and personal exemptions have been completely phased out under current law. This option would raise about \$42 billion in 1991 through 1995, increasing taxes for about 600,000 taxpayers. For example, a married couple with two children would pay higher taxes if their taxable income for 1991 was \$217,510 or higher.

A second alternative would be to drop the 5 percent surtax and create an explicit 33 percent bracket and a final top bracket with a tax rate of 38 percent. The 33 percent rate would apply to all taxable income in the current phase-out range for the 15 percent bracket. The 38 percent rate would apply to all taxable income in and above the current phase-out range for personal exemptions. This option would raise taxes for high-income families for whom the 15 percent bracket has been completely phased out under current law. In 1991, the 38 percent tax rate would apply to single filers with taxable income of \$101,600 or

more and to joint filers with taxable income of \$169,350 or more. This option would raise about \$101 billion in 1991 through 1995, increasing taxes for about 1 million taxpayers.

Under current law, capital gains are subject to a maximum tax rate of 28 percent. Long-term capital gains, however, are treated as ordinary income under current law and thus are subject to the 5 percent surtax for taxpayers with taxable income in the phase-out range. Some long-term capital gains thus are taxed at an effective rate of 33 percent. These options assume that the maximum rate on gains would be maintained at 28 percent, as provided under current law, if the surtax was replaced either with a 33 percent bracket or with a 33 percent and a 38 percent bracket. Taxpayers with taxable income in the phase-out range would thus have a lower tax rate on gains under these options than under current law.

Corporations. The top statutory tax rate on corporate income is 34 percent. Lower marginal rates apply to the first \$75,000 of taxable income, but corporations with taxable income between \$100,000 and \$335,000 pay an additional 5 percent surtax in order to phase out the benefits of the lower marginal rates.

About \$12 billion could be raised in 1991 through 1995 by increasing the top marginal rate to 35 percent. While only 10 percent of corporate taxpayers pay the top rate, these firms earn approximately 90 percent of all corporate taxable income. Corporations that continue to pay the alternative minimum tax would be unaffected by the change, and those with unused credits could offset some of the tax increase.

An alternative to raising the top corporate rate would be to impose a surtax on tax liabilities after credits. A 2 percent surtax would raise about the same revenues as an increase in the top rate to 35 percent; under this surtax, the top rate would be 34.7 percent. A 5 percent surtax would raise \$28.0 billion in 1991 through 1995. In contrast to a rate increase, a surtax would apply to corporate liabilities from the alternative minimum tax, and it would not expand the amount of credits that corporations could claim.

Increasing the corporate rate, either directly or through a surtax, could affect the decision a business makes about its form of organization. Income earned by businesses organized as corporations is taxed

at both the corporate and individual levels. Income earned by non-corporate businesses is taxed only at the individual level. As a result, there is a tax incentive for businesses to choose a noncorporate form of organization. TRA set the maximum individual income tax rate below the corporate rate, increasing the incentive for corporations to reorganize into noncorporate forms. Any rate change that widened the distance between the corporate and individual rates would further increase this incentive.

**REV-02 AMEND OR REPEAL INDEXING
 OF INCOME TAX SCHEDULES**

Addition to CBO Baseline	Annual Added Revenues (In billions of dollars)					Cumulative Five-Year Addition
	1991	1992	1993	1994	1995	
Delay Indexing Until 1992	5.4	10.2	10.8	11.4	12.0	49.8
Repeal Indexing	5.4	16.0	28.2	41.7	58.8	150.1

Under current law, the personal exemption, the standard deduction, the minimum and maximum dollar amounts for each tax rate bracket, and the earned income credit (EIC) are indexed annually to offset the effects of inflation. Without indexing, the bracket creep caused by inflation would gradually raise the average tax rate paid by most taxpayers.

Repealing indexing beginning with the adjustment scheduled for 1991 (except for the EIC) would raise revenues by about \$150 billion in 1991 through 1995, if the annual rate of inflation were to average 4.3 percent over the period as projected. Revenues from the repeal would grow rapidly as the cumulative effects of inflation drove up the consumer price index. Although suspending indexing for 1991 would raise the same amount of revenues in the first year, it would raise much less in later years--about \$50 billion over the five-year budget period.

Repealing or suspending indexing would not burden all taxpayers equally. For example, high-income taxpayers who itemize their deductions would not bear any tax increase because the tax benefit from personal exemptions and the 15 percent bracket has already phased out for them. All of their income, after itemized deductions, is subject to a single rate of 28 percent and, therefore, is unaffected by indexing. Also, taxpayers who itemize would generally bear a smaller tax increase than those who use the standard deductions. Because the additional tax burden from repealing or suspending indexing would not be shared equally, some argue that a surtax or a general rate increase would be preferable (see REV-01).

Another argument for retaining indexing is that it requires the Congress to decide explicitly on tax increases. Without indexing, inflation causes many taxpayers to move into higher tax brackets, so that tax liabilities increase at a faster pace than income. This results in an increase in real tax liabilities without legislative action, even for taxpayers whose real income has not increased.

**REV-03 INCREASE THE ALTERNATIVE
MINIMUM TAX RATE**

Addition to CBO Baseline	Annual Added Revenues (In billions of dollars)					Cumulative Five-Year Addition
	1991	1992	1993	1994	1995	
Individuals						
Raise AMT Rate to 25 Percent	0.3	1.4	1.1	1.0	0.8	4.7
Corporations						
Raise AMT Rate to 25 Percent	2.4	3.5	2.5	1.6	1.1	11.1

The alternative minimum tax (AMT) limits taxpayers' use of tax preferences to reduce their liability. Increasing the AMT rate would raise revenues from the individuals and corporations that benefit the most from tax preferences. Revenue gains from these rate increases are somewhat uncertain, however, because taxpayers can avoid the AMT to some extent by careful tax planning. Some tax practitioners attribute the recent growth in leasing activity to avoidance of the AMT by taxpayers.

Raise the Individual AMT Rate to 25 Percent. The AMT for individuals is 21 percent of alternative taxable income in excess of the exemption amount--\$40,000 for a joint return or \$30,000 for a single return. The exemption is phased out for high-income taxpayers. Some adjustments and deductions that are allowed in computing regular taxable income are disallowed when computing taxable income for the alternative tax. These adjustments are of two types: deferral preferences, such as accelerated depreciation, excess intangible drilling costs, and profit or loss from long-term contracts; and exclusion preferences, such as the charitable deduction for appreciated property, itemized deductions of state and local taxes, some tax-exempt interest, percentage depletion, and miscellaneous itemized deductions.

Taxpayers must pay the larger of the regular tax or the AMT. To the extent that the individual AMT results from deferral preferences, one year's AMT can be credited against future years' regular tax liability. Thus, a portion of the revenue gain from a higher AMT rate results from a shift of some future tax liabilities to earlier years.

Increasing the AMT rate to 25 percent would raise about \$5 billion in 1991 through 1995. Some preferences in the tax code are designed to encourage certain kinds of behavior, but taxpayers who pay the AMT are denied the full benefit of these preferences. Raising the AMT rate would further reduce these incentives by reducing the maximum combined tax benefit from these preferences for upper-income taxpayers.

This option would not appreciably increase the number of AMT filers. Even under current law, many more taxpayers than the number who owe an alternative tax are required to file for the AMT. This would, however, more than double the number of filers who would owe an alternative tax, from about 150,000 to over 300,000.

Raise the Corporate AMT Rate to 25 Percent. While the corporate AMT resembles the individual AMT very closely, the two taxes have different tax bases, credits, and rates. First, the corporate AMT base includes a special preference that was designed to increase the fairness of the corporate income tax. Through 1989, this special preference was computed as half of the excess of pretax book income reported to shareholders over other alternative taxable income. Beginning in 1990, this book income preference is replaced by a provision that adds 75 percent of the excess of adjusted current earnings (ACE) over other alternative taxable income. (ACE is a measure derived from earnings and profits as computed for purposes of Subchapter C of the tax code, with certain specified adjustments for depreciation and other deductions.) Second, beginning in 1990, corporations receive minimum tax credits for the tax that arises from all preferences, not just deferral preferences--as is still the case for individuals. Finally, the current AMT rate is 20 percent for corporations, lower than the 21 percent individual AMT rate. Raising the AMT corporate rate to 25 percent would increase revenues by about \$11 billion through 1995.

The corporate AMT, with its ACE preference, is intended to ensure that corporations reporting profits to shareholders cannot avoid paying corporate tax. Proponents of the minimum tax argue that it improves

the perceived fairness of the tax system and spreads the tax burden more evenly.

Critics argue that the corporate AMT places a greater tax burden on rapidly growing and heavily leveraged corporations and provides corporations with an incentive to engage in tax-motivated transactions. For example, a firm that expects to pay the AMT may be able to reduce its tax by leasing its equipment, rather than owning the equipment and using the accelerated depreciation tax preference. Raising the AMT rate, therefore, would only increase the use of these nonproductive tax minimization transactions, as well as increase the disparity in the tax burden on new investment between those corporations that are hit by the AMT and those that are not.

REV-04 LIMIT MORTGAGE INTEREST DEDUCTIONS

Addition to CBO Baseline	Annual Added Revenues (In billions of dollars)					Cumulative Five-Year Addition
	1991	1992	1993	1994	1995	
Limit Deductions to \$12,000 per Return (Single) or \$20,000 (Joint)	0.6	1.6	1.8	2.0	2.2	8.2
Limit Tax Benefit of Deductions to 15 Percent	3.6	10.0	11.4	13.0	14.8	52.9
Limit Deductions for Second Homes	0.1	0.3	0.3	0.3	0.4	1.3

A home is both the largest consumer purchase and the main investment for most Americans. The tax code has historically treated homes more favorably than other investments. Current law allows homeowners to deduct mortgage interest expenses even though homes do not produce taxable income, and exempts most capital gains from home sales (see REV-05). This preferential treatment has been defended because it encourages homeownership and home improvement, which is thought to improve neighborhoods for all residents. Some have argued, however, that these preferences are larger than needed to maintain high rates of homeownership. For example, Canada, which grants preferential tax treatment to capital gains from home sales but does not allow deductions for mortgage interest, has achieved about the same rate of homeownership as the United States.

The tax advantages accorded to owner-occupied housing are also criticized because they encourage investment to shift into homes and away from less subsidized investments. This shift may contribute to a relatively low rate of investment in business assets in the United States compared with countries that do not allow such large mortgage interest deductions. Currently, about one-third of national investment goes into owner-occupied housing, so even a modest shift of investment to other sectors could have important effects.

Tax preferences for owner-occupied homes could be reduced by limiting mortgage interest deductions. Current law allows interest payments on most loans secured by first and second homes to be deducted. Interest is deductible on up to \$1 million of debt used to acquire and improve first and second homes and up to \$100,000 of other loans secured by a home, regardless of purpose (referred to as home-equity loans). Only 10 percent of other consumer interest is deductible in 1990, and none of it thereafter. Current law also limits the extent to which interest deductions for carrying assets other than first and second homes can exceed income from such assets. One way for taxpayers to circumvent the limits on consumer and investment interest deductions is to finance consumer purchases and investments in assets other than homes with loans secured by homes.

The current limits on mortgage interest deductions are criticized for several reasons. The amounts are so high that the tax code still provides a generous subsidy for relatively expensive homes. Further, only taxpayers who are fortunate enough to have substantial home equity are able to circumvent the limits on consumer and investment interest. For example, many homeowners are able to deduct interest on home-equity loans used to finance automobiles while renters and those with small amounts of home equity are not allowed to deduct interest on auto loans. In addition, some find it unfair that the same limits apply to single taxpayers as to larger households.

About \$8 billion in revenues could be raised in 1991 through 1995 by capping the mortgage interest deduction at \$12,000 per single return, \$20,000 per joint return, and \$10,000 per return for married couples who file separately. These limits are much higher than the deductions claimed on most tax returns. For example, less than 2 percent of taxpayers who claimed home mortgage interest deductions in 1987 had deductions that exceeded these amounts, while the average deduction for home mortgage interest was only about \$4,900. Even in regions of the country with the highest housing costs, the annual interest payments for the average new mortgage in 1989 are under \$17,000. At current mortgage interest rates, the proposed \$20,000 cap would allow full interest deductions on mortgages as large as about \$203,000. This is almost double the average size of new mortgages closed last year. Capping mortgage interest deductions would retain the basic tax incentive for homeownership without subsidizing the luxury component of the most expensive homes and vacation homes. Because the

caps are higher than the deductions now taken by nearly all homeowners, their effects on home prices and homebuilding would be minor.

An advantage of capping mortgage interest is that this form of limit would be easier to comply with and enforce than restrictions based on the use of borrowed money. Also, because the caps are not indexed for inflation, their real value would gradually decline, which would encourage a shift to more productive activities over time. By phasing down the deduction gradually, the effects on current homeowners and the homebuilding industry would be cushioned.

Opponents of the interest caps point out that their effects would be highly uneven across the country. In the high-priced markets of many large cities, the caps would affect many upper-middle-income homeowners, while in most other areas they would affect only those with the most luxurious homes. Further, in periods of high interest rates, recent homebuyers and those with adjustable-rate mortgages could find themselves affected by the limits, while longer-term owners with fixed-rate mortgages would not be.

Another way to reduce the tax subsidy for upper-income taxpayers would be to limit the tax savings from the current deduction to 15 percent of interest paid, the value of the deduction to those in the lowest tax bracket. This limit would increase revenue by about \$53 billion in 1991 through 1995. It would affect about half of the taxpayers who use the mortgage interest deduction and therefore would probably cause some home values to decline.

A final option would be to limit deductibility to interest on debt incurred to acquire and improve a primary residence, plus \$100,000 of other debt secured by that home. This option would require interest deductions for second homes to qualify under the \$100,000 limit on home-equity loans. This option would raise about \$1 billion in revenues in 1991 through 1995. Most second homes are vacation homes, and some people argue that nearly unlimited deductions for such a luxury are inappropriate when most interest on loans for education, medical expenses, and other consumer purchases is not deductible. Opponents argue that many owners and builders of vacation homes would suffer losses, and resort areas would face reduced growth.

REV-05 TAX CAPITAL GAINS FROM HOME SALES

Addition to CBO Baseline	Annual Added Revenues (In billions of dollars)					Cumulative Five-Year Addition
	1991	1992	1993	1994	1995	
Tax 30 Percent of Gain	0.6	6.4	8.4	9.1	9.5	34.0
Tax Lifetime Gains in Excess of \$125,000	0.2	2.2	2.9	3.2	3.5	12.0

Capital gains on most assets are taxed as ordinary income at the time an asset is sold. Capital gains on home sales, however, generally escape taxation. The tax on the capital gain from the sale of a principal residence is deferred if the seller purchases another home of at least equal value within two years. If the gain does not become taxable during the homeowner's lifetime, the gain is never taxed at all. Further, taxpayers age 55 and over are allowed one opportunity to exclude up to \$125,000 of gain from a home sale even if another home of equal or greater value is not purchased within two years. If the above provisions were replaced with a tax on 30 percent of capital gains from home sales, about \$34 billion could be raised in 1991 through 1995. If lifetime gains in excess of \$125,000 were taxed, about \$12 billion could be raised over the same years.

The preferential treatment of capital gains from home sales is only one of the ways that the tax code strongly favors owner-occupied homes over other investments. (For a discussion of other tax preferences for owner-occupied homes, see REV-04.) All of these tax preferences divert saving from more productive investments into housing. One way to make the tax treatment of housing more like that of other assets would be to replace the capital gains deferral and exclusion provisions with a low-rate tax on gains from home sales. If 30 percent of the gain from home sales was included in taxable income, the tax would be only 9.9 percent for taxpayers facing a 33 percent marginal tax rate, 8.4 percent for those in the 28 percent tax bracket, and 4.5 percent for those in the 15 percent tax bracket.

A tax on gains from home sales would discourage home sales, just as current law provides an incentive for taxpayers to hold, rather than sell, other capital assets. The economic losses caused by this "lock-in" effect might be more serious in the case of home sales than of other assets, especially if families were discouraged from relocating to change jobs. The tax might also deter some homeowners (especially older taxpayers with large accrued gains) from changing homes as family requirements change.

The mobility of most homeowners could be protected by allowing the first \$125,000 of capital gains on homes to be exempted from the capital gains tax for taxpayers of all ages. Gains in excess of this amount would be fully included in income. If gains on the sale of a taxpayer's first home were less than \$125,000, the unused portion could be applied to future home sales. This exclusion would actually increase the mobility of homeowners under age 55 relative to current law because they could move to homes of lesser value without incurring a tax so long as the gain on the home sold was less than \$125,000. While this proposal would increase mobility for most homeowners, it would reduce it for those whose homes have gains over \$125,000. This additional gain could not be rolled over if a larger home was purchased, and would be fully taxed as income.

Taxing gains on home sales without the rollover and exclusion allowed by current law would also burden taxpayers with additional recordkeeping on home improvements. These records would be needed to establish the tax basis of a home upon sale. Currently, many taxpayers do not keep such records because the probability of any future tax on gains from a home sale is remote and the present value of such a tax is small. Recordkeeping would be further complicated by allowing a lifetime exemption of \$125,000, especially when people buy and sell successive homes with different spouses.

For many homes, most of the gain is the result of inflation, and taxing inflationary gains seems unfair. Taxing inflationary gains may, however, be an appropriate way to offset the tax benefit homeowners enjoy from inflation by being able to fully deduct mortgage interest payments, which include an inflation premium. The partial inclusion of gain upon sale of a home represents a possible compromise between these two views.

Any reduction in the tax benefit from home ownership would tend to lower the value of existing housing relative to other assets such as stocks. The loss in value would hurt primarily middle-income taxpayers because homes are their principal asset. If the tax benefit for homeownership needs to be reduced, limiting mortgage interest deductions instead of taxing gains on sale may be preferable, because taxing gains creates a lock-in effect and imposes a greater record-keeping burden.

**REV-06 DECREASE LIMITS ON CONTRIBUTIONS TO
QUALIFIED PENSION AND PROFIT-SHARING
PLANS**

Addition to CBO Baseline	Annual Added Revenues (In billions of dollars)					Cumulative Five-Year Addition
	1991	1992	1993	1994	1995	
Decrease Limits for Defined Benefit Plans to the Social Security Wage Base (with Equivalent Reductions for Defined Contribution Plans)	1.0	3.2	3.6	4.0	4.4	16.2
Decrease the Limit for Deferrals in Salary Reduction Plans to \$4,000	0.2	0.5	0.6	0.6	0.7	2.6

Saving for retirement through employer-provided qualified pension and profit-sharing plans provides two tax advantages: the employment income contributed to qualified plans is not taxed until retirement, when the marginal tax rate is often lower, and the investment income earned within qualified plans is effectively not taxed.

Decrease Limits on Employer Contributions. Retirement payments from defined contribution plans depend on annual contributions during a person's working years and on the subsequent investment earnings of those contributions. The contributions are usually expressed as a percentage of the employee's annual earnings. Currently, contributions to defined contribution plans are limited to the lesser of 25 percent of compensation or \$30,000 per employee.

Defined benefit plans specify the pension to be received, usually expressed as a percentage of preretirement earnings. Contributions to defined benefit plans are limited to amounts that will result in annual benefits for pensions that begin at age 65 of the lesser of 100 percent of wages or \$108,400 (estimated for 1991). For pensions that begin at an

earlier age, this limit is reduced on an actuarial basis. When an employee is eligible for payments from both types of plans sponsored by the same employer, a combined limit applies--the lesser of 140 percent of wages or \$135,500 (estimated for 1991).

These funding limits are far higher than the preretirement earnings of most workers. Fewer than 1 percent of employees are likely to earn more than \$135,500 in 1991. Many analysts have questioned the need to subsidize such high levels of retirement income. They note further that many workers (especially in the lower half of the income distribution) are not covered by qualified plans and thus do not have access to these subsidies for retirement saving.

If funding for defined benefit plans was limited to amounts necessary to pay benefits equal to the Social Security wage base (projected to be \$54,600 in 1991), with equivalent reductions in limits for defined contribution plans, the limits would still be higher than the earnings of all but about 6 percent of earners. Limiting defined benefit funding to pensions of \$54,600 and limiting defined contribution funding to \$15,100 in 1991, and indexing the limits thereafter, would raise about \$16 billion in 1991 through 1995. Alternatively, the limits could be lowered to amounts between current law and the Social Security wage base. For example, setting maximum pension benefits of \$81,500 in defined benefit plans in 1991, and \$22,600 in defined contribution plans, would allow pensions in excess of the earnings of all but about 2 percent of earners, and would raise about \$3 billion over five years.

The principal argument against reducing funding limits is that it would make participation less attractive to high-income business owners and top managers, and thus might discourage them from sponsoring these plans both for themselves and for their employees.

Change Salary Reduction Arrangements. Most salary reduction arrangements are part of employer-sponsored profit-sharing plans that allow employees to choose to receive lower current (taxable) compensation and to defer the remainder of compensation as a contribution to the plan. These arrangements typically are called 401(k) plans after the provision of the tax code that authorizes them. Similar arrangements are possible for workers in the nonprofit sector (403(b) tax-sheltered annuities), for federal workers, and for workers enrolled in some Simplified Employer Plans (SEPs).

The Tax Reform Act of 1986 capped employee deferrals for 1987 in salary reduction arrangements at \$7,000 in the case of 401(k) plans, SEPs, and the federal plan. The cap is indexed for inflation and is estimated to reach \$8,400 by 1991. A separate cap of \$9,500 applies for 403(b) tax-sheltered annuities. This cap is frozen until inflation raises the other caps above \$9,500.

If elective deferrals in all salary reduction arrangements were limited to \$4,000 in 1991 and indexed thereafter, about \$3 billion would be raised through 1995. The lower contribution limit might not significantly reduce saving. The incentive would only be reduced for employees with salary reduction plans who save between \$4,000 and \$7,000 annually (mostly upper-middle-income employees). Furthermore, since most studies have found saving to be unresponsive to the rate of return, the lower contribution limit might have little effect on saving even for such people.

The benefits of salary reduction arrangements have already been lowered for higher-income employees, however, by the tougher nondiscrimination rules included in the Tax Reform Act. The effect of these rules, which took effect in 1989, might be examined before new limits are imposed. In addition, keeping the maximum limit high may encourage small employers who do not offer pensions to offer salary reduction plans, thereby extending saving incentives to more workers. During the 1980s, salary reduction plans have been spreading among employers of all sizes, even though the overall incidence of pension participation has been declining.

**REV-07 IMPOSE A 5 PERCENT TAX
ON INVESTMENT INCOME
OF PENSIONS AND IRAs**

	Annual Added Revenues (In billions of dollars)					Cumulative Five-Year Addition
	1991	1992	1993	1994	1995	
Addition to CBO Baseline	4.4	7.4	7.9	8.4	9.0	37.1

Under normal income tax rules, deposits to savings accounts are not deductible from taxable income. In addition, the investment income earned by those deposits is taxed in the year in which it is realized. In contrast, most contributions to qualified pension and profit-sharing plans and to individual retirement accounts (IRAs) are deductible, and the investment earnings of the contributions accumulate tax-free. Taxation is deferred until the accumulated amounts are paid out, usually in retirement. The tax due in retirement is essentially the tax originally due on the contributions plus interest for the delay in payment. The investment income, however, is effectively not taxed. A 5 percent tax on the realized investment income of pension and profit-sharing plans and of IRAs would raise about \$37 billion over five years.

Taxing pension and profit-sharing plans and IRAs more favorably than other savings gives taxpayers an incentive to provide for retirement income. The tax benefits are unequally distributed, however, since higher-paid workers, and especially those working long periods for a single employer, receive a disproportionately large share.

A low-rate tax on the realized investment income of these qualified plans and IRAs would retain some incentive for retirement saving. At the same time it would reduce the inequality of taxation between the higher-paid and the longer-term employees who gain the most from the current tax treatment, and the lower-paid and mobile workers who gain the least. But the tax also would reduce retirement income or require larger contributions for those participating. It would also discourage some employers and workers from continuing their plans or setting up new ones. The current failure of many employers and

workers to use pensions or IRAs suggests that the existing incentive may not be strong enough. Finally, taxing the retirement income of qualified plans and IRAs might actually exacerbate inequality in retirement income among some currently covered workers. This is because employers offering qualified plans must provide benefits on a nondiscriminatory basis and if the tax reduced the number of such plans, fewer workers would be protected by requirements for equal treatment.

Taxing the realized investment income of qualified funds and IRAs would encourage these retirement funds to shift from bonds and short-term stock investments to long-term investments in growth stocks and real estate; a large share of the return on such investments comes from appreciation in value that is not realized until the asset is sold. This investment shift would expose retirement funds to greater risk and decrease their responsiveness to changing conditions; both effects may be particularly undesirable for retirement savings. Longer-term commitments by these large institutional investors could, however, benefit the entire economy by enabling corporations to focus more on long-term strategies to modernize production and to develop new products and markets. Reduced trading of stocks by these institutional investors could also reduce the short-run volatility of stock prices.

In addition, taxing realized gains would make pension funds less willing to sell their stock holdings in takeovers, thereby discouraging such takeovers. Pension funds would also be less willing to purchase the high-yielding junk bonds needed to finance many takeovers because they would not be able to defer the realization of interest income.

REV-08 TAX CAPITAL GAINS HELD UNTIL DEATH

Addition to CBO Baseline	Annual Added Revenues (In billions of dollars)					Cumulative Five-Year Addition
	1991	1992	1993	1994	1995	
Include Gains in Last Income Tax Return of Deceased	a	1.9	2.3	2.7	3.2	10.1
Enact Supplemental 10 Percent Estate Tax	a	0.5	0.5	0.6	0.6	2.3
Enact Carryover Basis	a	a	0.9	1.1	1.3	3.4

a. Less than \$50 million.

A capital gain or loss is the difference between the current value of an asset and the owner's "basis," which is defined as the initial cost of the asset plus the cost of any subsequent improvements and minus any depreciation deductions. When an asset is sold, the capital gain or loss is said to be realized, and the realized gain or loss generally is included in taxable income. Even if an asset is given away, as from a parent to a child, the basis is carried over to the person receiving the asset, and the full gain on the asset is taxable income when the asset is sold.

An exception occurs when an asset is held until death and then distributed to heirs. In this case, the basis of the asset is "stepped up" to its value as of the date of death. When an inherited asset is sold, therefore, only the gain accruing after the death of the donor is subject to tax; the gain accruing before the donor's death is never taxed as income. The estate of the donor may be taxed under the separate estate tax, but this tax applies equally to assets that have previously been taxed under the income tax and to accrued capital gains that have never been taxed.

Gains held until death could be taxed as income by one of three methods. They could be included as income on the final income tax return of the deceased; they could be subject to a supplemental tax rate on the estate tax; or, by requiring that the decedent's basis be carried over with the inherited asset, they could be taxed as income when an heir sells the underlying asset.

By taxing gains held at death on the final income tax return of the decedent, \$10.1 billion would be raised in 1991 through 1995. Under this option, gains on assets inherited by the spouse would not be taxed; instead, the decedent's basis would be carried over with the inherited assets. Gains on assets given to charity would also not be taxed. Gains on other assets would be included in taxable income, but three exclusions would be allowed. First, to ease the problem of documenting basis, an alternative basis of one-half of an asset's current value could be elected. Second, the existing \$125,000 exclusion on the gain from sale of a principal residence could be claimed if it had not already been used. Third, a \$75,000 exclusion would be allowed for any remaining gains. Under these rules, only a small fraction of decedents would have gains subject to tax. Furthermore, any taxes paid would be deductible from the gross estate for determination of estate taxes.

By levying an additional 10 percent estate tax on gains held at death, \$2.3 billion would be raised in 1991 through 1995. Under this option, gains subject to tax would be determined as described above. The tax, however, could be offset by any unused credits allowed under the estate tax. Because of these credits, few people would owe additional tax under this option. Only about 1 percent of the estates of decedents currently pay the estate tax, and the fraction paying the additional tax on gains would be about the same.

By carrying over the decedent's basis in an asset to the heirs and taxing the gain when the asset is sold, \$3.4 billion would be raised in 1991 through 1995. Under this option, the basis of an inherited asset could be set at one-half its current value if the actual basis was either lower or could not be determined. In addition, the basis of all assets in the estate would be stepped up by value-based shares of any estate tax paid. Carryover basis would leave the largest fraction of gains in an estate subject to tax, but the amount of tax would depend on when and what assets heirs decided to sell.

Gains held at death have not previously been taxed as income, although proposals for doing so have been advanced. A Treasury Department study completed under President Johnson recommended taxing gains as income on a decedent's final tax return. In 1976, the House Ways and Means Committee considered language for either an additional estate tax or for carryover basis. Carryover basis was enacted in the Tax Reform Act of 1976 but was postponed in 1978 and repealed in 1980 before taking effect.

Taxing gains held until death would reduce the disparity between those who save a portion of their income until death through an appreciating asset and those whose income is entirely from taxable sources. Because asset ownership is highly concentrated, the benefits of the current law's step-up in basis are highly concentrated among the wealthy. Succeeding generations of wealthy families can entirely avoid taxation on a major source of their income.

Taxing gains at death, through either the last income tax return or the estate tax, would also reduce the incentive for investors to hold assets until death in order to avoid tax. Current law encourages taxpayers to hold onto assets longer than they otherwise would, which distorts their investment portfolios and may hinder the flow of capital to activities with higher rates of return. This "lock-in" effect of current law was strengthened in the Tax Reform Act of 1986 by the increase in tax rates on capital gains realized before death. Reduction of lock-in is one of the advantages cited in favor of reducing the income tax rate on realized capital gains; taxing gains at death would also reduce lock-in, but without the revenue loss caused by reducing the tax rate on realized gains.

Carryover basis would not achieve the same unambiguous reduction in lock-in that would be achieved by taxing gains on the final income tax return or on the estate tax. Knowing that one's accrued gains will ultimately be taxed lessens the incentive to hold an asset until death. But an heir receiving an asset with a low basis would have a stronger incentive to hold onto the asset than under current law, which steps up the basis to its value at the date of death.

One of the main drawbacks to taxing gains at death is that the family of the deceased might be forced to sell assets to pay the tax. Having to sell illiquid assets at an inopportune time can reduce their

value substantially; having to sell a family farm or business would impose a particular hardship on families wanting to continue the enterprise. Forced sales would not occur under carryover basis because no tax on gains held at death would be due until the heirs chose to sell the assets. The problem would also be mitigated by taxing gains held at death through the estate tax, which permits family members who continue to operate a family farm or business to defer payment for five years and then spread their repayments over the next ten years. In addition, under the estate tax, family farms and businesses can be valued in their continuing use rather than by their market value, which reduces the amount of taxable gains.

Surviving spouses could also be forced to sell assets to pay the tax if gains were taxed on the final return of the deceased or on the estate tax. Forced sales by spouses would be avoided by allowing them to carry over the basis of the deceased. Then no tax would be due until the spouse either chose to sell the assets or died.

Another argument against taxing gains held until death is the difficulty of determining the basis of assets on closely held businesses, personal property, and assets for which adequate records cannot be found. This difficulty was one of the main arguments made by those urging the delay and repeal of carryover basis in 1978 and 1980. Documenting the basis would be particularly difficult immediately after passage of a law to tax gains held until death because people currently planning to hold assets until death might not have kept adequate records. Once a tax on gains had taken effect, people would have reason to begin keeping better records. In the interim, the problem of determining basis could be reduced by invoking a minimum basis rule such as the one made for the revenue estimates above, which assumes that the basis would be at least as high as half of the current value. Records are most frequently missing for assets that have been held for a long time, and because of inflation the basis of these assets is frequently less than half of current value.

Making gains taxable at death could be seen as unfair to people who have been holding assets for an extended period solely to avoid the tax on their gains. In doing so, they may have passed up opportunities to reinvest in higher-earning assets, or may have held onto their businesses instead of giving them to their children. Setting a minimum basis at half of the current market value would lessen the burden

of the change in law, but would not fully protect those planning to hold until death. People in that category could be more completely protected by allowing the basis of all assets to be set at their value as of the date the legislation was enacted. Allowing such a "fresh start" would, however, substantially reduce the revenue increase from taxing gains in the initial years after the change.

Other arguments against taxing accrued capital gains at death are that the tax could discourage saving, and that a large amount of the gains represent inflation. These arguments, however, apply equally well to taxing realized gains and most other capital income, notably interest income.

**REV-09 DECREASE THE EXEMPTION
AND BROADEN THE BASE
FOR ESTATE AND GIFT TAXES**

Addition to CBO Baseline	Annual Added Revenues (In billions of dollars)					Cumulative Five-Year Addition
	1991	1992	1993	1994	1995	
Decrease the Exemption	a	1.0	1.1	1.3	1.5	4.8
Include Life Insurance Proceeds in the Base	a	0.1	0.2	0.2	0.3	0.8
Substitute a Deduction for the State Credit	a	0.1	0.5	0.6	0.7	2.3

a. Less than \$50 million.

Current law imposes a gift tax on transfers of wealth during a taxpayer's lifetime and an estate tax on transfers at death. The estate and gift taxes together constitute a unified transfer tax, since one progressive tax is imposed on the cumulative transfer during lifetime and at death. The estate and gift tax rates currently range from 18 percent on the first \$10,000 of transfers to 55 percent on transfers of more than \$3 million. (Beginning in 1993, the top rate will be 50 percent on transfers of more than \$2.5 million, and the benefits of graduated rates will be phased out for estates above \$10 million.)

The cumulative amount of estate and gift taxes is reduced by a unified credit. The tax is first computed without any exemption, and then the unified credit is subtracted to determine the amount of tax payable. Since 1986, the amount of the credit has been \$192,800, effectively exempting the first \$600,000 of transfers from estate and gift tax. The Economic Recovery Tax Act of 1981 increased the credit to its present level from \$47,000, primarily to offset the effects of inflation on property values. Also, the Congress had determined that the credit amount, which had not been increased since 1976, failed to provide

relief for estates containing farms, ranches, or small businesses, with the result that legatees were often forced to sell family businesses to pay the estate or gift tax. (Beginning in 1993, the unified credit will be phased out for estates above \$10 million.)

Some would argue that the increase enacted in 1981 was too large because the rate of inflation has been lower than anticipated. Lowering the credit to the 1982 level adjusted for inflation would exempt from taxation the first \$300,000 of transfers, raising nearly \$4.8 billion in 1991 through 1995 and affecting roughly 15 percent of estates. Although the majority of estates would still be untaxed, many large homes, family farms, and small businesses would be made subject to tax. Lowering the credit would increase the tax on mid-sized estates, whose assets might have to be liquidated to pay the tax--an issue that concerned the Congress when it voted to increase the credit in 1981.

Lowering the credit, however, would have a leveling effect on the distribution of wealth. Also, a great deal of wealth consists of capital gains that have never been taxed. Higher estate taxes would be a means of taxing these gains.

Another means of increasing revenues from estate and gift taxes would be to broaden their base--for example, by including proceeds of life insurance policies or by substituting a deduction for the credit now available for state inheritance and gift taxes. Making life insurance proceeds subject to estate and gift taxes would raise \$0.8 billion in 1991 through 1995. A difficulty with this proposal is that it would provide an incentive to seek substitutes for life insurance. Many employers, for example, might substitute survivor benefits for life insurance under pension plans, and, since contributions to pension plans are tax-deferred, revenues from this provision eventually might decline.

Substituting a deduction for the state inheritance and gift tax credit would raise \$2.3 billion from 1991 to 1995. The disadvantage of a deduction over a credit is that, because the value of an additional dollar of deductions increases with the marginal tax rate, the deductions are worth more to higher-bracket taxpayers. An alternative

means of raising revenue might be to maintain the credit, but at a reduced level. For example, providing a partial credit of 8 percent of state inheritance and gift taxes would raise the same amount of revenue as substituting a deduction, without disproportionately benefiting higher-bracket taxpayers.

REV-10 PHASE OUT THE DEPENDENT-CARE CREDIT

Addition to CBO Baseline	Annual Added Revenues (In billions of dollars)					Cumulative Five-Year Addition
	1991	1992	1993	1994	1995	
Phase-out						
Starting at:						
\$30,000	0.1	1.2	1.3	1.5	1.7	5.8
\$50,000	a	0.5	0.6	0.7	0.8	2.6
\$65,000	a	0.3	0.3	0.4	0.4	1.4

a. Less than \$50 million.

Taxpayers who incur employment-related expenses for the care of children and certain other dependents may claim an income-tax credit. The credit per dollar of allowed expenses declines from 30 percent for taxpayers with adjusted gross incomes (AGI) of \$10,000 or less to 20 percent for taxpayers with AGI above \$28,000. Creditable expenses are limited to \$2,400 for one child and \$4,800 for two or more, and cannot exceed the earnings of the taxpayer or, in the case of a couple, the earnings of the spouse with lower earnings. In 1987, about \$3.4 billion in credits were claimed on 8.5 million tax returns.

The tax code first recognized work-related child care costs in 1954, when an itemized deduction of up to \$600 was allowed for all single taxpayers and for lower-income couples when both spouses worked. In 1976, the deduction was converted to a 20 percent credit and the income limitations were removed. In 1981, the credit was raised to 30 percent for the lowest-income taxpayers. In 1987, expenses for overnight camps were made ineligible for the credit. In 1988, the credit was restricted to expenses for children under age 13 and creditable expenses were reduced by the amount of employer-paid dependent care benefits.

Some people view the credit as a tax subsidy intended to encourage workers to provide adequate care for dependents. But 22 percent of the subsidy now benefits families with incomes of \$50,000 or more. The cost of this subsidy could be reduced by targeting it more narrowly on

families who otherwise would have difficulty affording adequate care. One way to target the subsidy would be to reduce the credit percentage as incomes rise. For example, reducing the credit percentage by one percentage point for each \$1,500 of AGI over \$30,000 would raise about \$5.8 billion in 1991 through 1995. This option would reduce the credit for 51 percent of families that would be able to claim the credit under current law and would eliminate it for an additional 10 percent of claimants (families with AGI over \$58,500). Alternatively, phasing out the credit between \$50,000 and \$78,500 would raise about \$2.6 billion in the same period; this option would reduce the credit for about 21 percent of claimants and eliminate it for another 5 percent. Finally, phasing out the credit between \$65,000 and \$93,500 would raise \$1.4 billion in the same period, reducing the credit for 11 percent of claimants and eliminating it for another 2 percent.

Opponents of reducing the credit argue that it is not a subsidy. Instead, they view it as needed for reasons of fairness, arguing that families who pay for dependent care in order to work are less well off, and therefore should pay less tax, than taxpayers with the same income who either have no dependents or have one spouse at home. Phasing out the credit also could be criticized because it would raise the marginal tax rate for taxpayers with incomes in the credit phase-out range, which could discourage some taxpayers from working. For taxpayers with incomes in the phase-out range who claim the full credit, these proposals could raise marginal tax rates by as much as 3.2 percentage points. For taxpayers now in the 15 percent bracket, this would be a 21 percent increase in the marginal rate. These families would be affected only under the option to begin the phase-out at \$30,000. Those in the 28 percent bracket would have an 11 percent increase in the marginal rate.

If the credit was phased out, employees could seek other tax subsidies for dependent care by asking their employers to provide dependent-care assistance plans. Current law allows up to \$5,000 in payments under these plans to be excluded from an employee's income, in effect allowing plan participants to purchase dependent care out of pre-tax income. Repealing this exclusion would make all tax preferences for dependent care subject to the income phase-out of the dependent-care credit described above.

**REV-11 TAX THE INCOME-REPLACEMENT PORTION
OF WORKERS' COMPENSATION AND
BLACK LUNG BENEFITS**

	Annual Added Revenues (In billions of dollars)					Cumulative Five-Year Addition
	1991	1992	1993	1994	1995	
Addition to CBO Baseline	0.9	2.5	2.6	2.7	2.8	11.5

Under current law, unemployment benefits are fully taxable to all recipients, and Social Security and Railroad Retirement (Tier I) benefits are partially taxable to upper-income recipients. Other entitlement benefits are not taxable. Many of these benefits, such as Aid to Families with Dependent Children (AFDC), are means-tested.

Revenue gains from making such benefits taxable would be extremely small because few people who qualify for these programs would have enough income to incur any income-tax liability. However, revenues could be raised by taxing the portion of Workers' Compensation and Black Lung benefits that replaces income lost as the result of work-related injuries or Black Lung disease. Including the income-replacement portion of these benefits in AGI would add about \$12 billion to revenues in 1991 through 1995. The remaining portion that reimburses employees for medical costs (about 30 percent) would not be taxed.

Taxing the income-replacement portion of Workers' Compensation and Black Lung benefits would make the tax treatment of these entitlement benefits comparable with the treatment of unemployment benefits and with the treatment of the employment income that these benefits replace. It would also improve work incentives for disabled workers who are able to return to work. Under current law, the after-tax value of the wages they are able to earn may be less than the tax-free benefits they receive while disabled.

Opponents of taxing these benefits note that legal or insurance settlements for non-work-related injuries are not taxable, even if a portion of them reimburses for income loss, and that taxation of Workers' Compensation benefits would therefore treat these two types of compensation inconsistently.

REV-12 TAX NONRETIREMENT FRINGE BENEFITS

Addition to CBO Baseline	Annual Added Revenues (In billions of dollars)					Cumulative Five-Year Addition
	1991	1992	1993	1994	1995	
Tax Some Health Insurance Premiums						
						(See ENT-17)
Tax Life Insurance Premiums						
Income tax	1.6	2.2	2.3	2.4	2.5	11.0
Payroll tax ^a	0.8	1.1	1.2	1.2	1.3	5.6
Impose a 3 Percent Excise Tax on the Value of Nonretire- ment Fringe Benefits	2.6	3.9	4.3	4.7	5.1	20.6

a. Estimates are net of reduced income tax revenues.

Employee compensation is taxable unless the tax code contains an explicit exception. Such exceptions apply to most employer-paid non-retirement fringe benefits, which are excluded from the income and payroll tax bases even though they constitute current compensation to employees. This exclusion, which has been going up as a percentage of total employee compensation, reduces revenues substantially. For employer-paid health and life insurance premiums alone, the revenue loss will be roughly \$36 billion in income taxes and about \$19 billion in payroll taxes in 1991.

In addition to employer-provided health and life insurance, the law explicitly excludes from gross income employer-paid dependent care and miscellaneous benefits, such as employee discounts, parking, and athletic facilities. (The exclusion of educational assistance benefits, which under prior law was to expire on December 31, 1988, has been extended to September 30, 1990.)

The exclusions can be criticized on the basis of both efficiency and fairness. They are inefficient to the extent that employees receive tax-

free benefits that they might not purchase with after-tax income. The availability of tax-free services affects the nature, amount, and cost of the services. For example, employer-paid health insurance plans may have contributed to the strong growth in the variety and amounts of health care services provided, which in turn may have contributed to sharp rises in health care costs. The higher prices are paid by all who need health care, not just recipients of tax-free insurance.

Some people view the exclusions as unfair because a taxpayer receiving no fringe benefits pays more tax than another with the same total income but a larger share in the form of fringe benefits. Further, the tax savings from the exclusion of fringe benefits are greater for those with higher incomes because they face higher marginal tax rates and because fewer fringe benefits are typically provided for low-wage workers.

Making all fringe benefits taxable would present problems in valuing benefits and in assigning their value to individual employees. Few valuation problems arise when the employer purchases goods or services and provides them to employees, but it is more difficult to determine the value of a facility, such as a parking lot, provided by the employer. Further difficulties arise if the total value of the fringe benefits needs to be assigned to individual employees. In cases where the employer provides a service, such as day care, it might be considered unfair to assign the same value to all employees regardless of their level of use; however, it could be administratively complex to assign values that depend on each worker's use. Further, the costs of collecting taxes on small fringe benefits (such as employee discounts) could exceed the revenue collected.

The per-employee value of employer-paid health and life insurance would be relatively easy to determine. The premiums paid for each employee could be reported on the employee's W-2 form, and withholding computed as it is for other taxable income, as is already done for some life insurance premiums (see below). The measurement of insurance values would be more difficult when benefits are provided directly, as when employers provide medical care or reimburse employees for medical costs incurred under self-insurance plans.

An alternative way to tax nonretirement fringe benefits would be to impose the tax on employers, based on the total cost of the fringe

benefits provided, rather than on employees. Although determining the total cost of fringe benefits would still present some difficulties, this option would eliminate the need to assign the value of fringe benefits to individual employees.

Tax Some Employer-Paid Health Insurance Premiums. Health insurance premiums were made subject to nondiscrimination rules for the first time in the Tax Reform Act of 1986. These rules limit the extent to which employer-paid health plans may favor higher-paid workers. Still, the present exclusion for employer-paid health insurance premiums has been criticized as unfair to those who must pay for their health insurance with after-tax dollars. Taxpayers who pay for their own health insurance can deduct the cost of their insurance only to the extent that their total medical expenses exceed 7.5 percent of adjusted gross income. Two options to tax some employer-paid health insurance premiums are described elsewhere (see ENT-17).

Tax Employer-Paid Life Insurance Premiums. Group term life insurance premiums paid by employers are currently excluded from taxable income, but the exclusion is limited to the cost of the first \$50,000 of insurance, and nondiscrimination rules apply. The Omnibus Budget Reconciliation Act of 1987 made the part of life insurance premiums that is taxable under the income tax also taxable under the payroll tax. The exclusion is not available to the self-employed. Making all employer-paid premiums taxable would add about \$11 billion to income-tax revenues and about \$6 billion to payroll-tax revenues in 1991 through 1995.

A difficulty with this option arises because many employers provide death benefits under pension plans as substitutes for life insurance. Employer contributions to pension plans are income-tax deferred (and the first \$5,000 of death benefits paid are tax-exempt) and are exempt from the payroll tax. If employer-paid life insurance plans were made taxable, employers might choose to offer less life insurance and larger death benefits on pension plans instead.

Impose an Excise Tax on the Value of Nonretirement Fringe Benefits. An alternative to including employer-provided benefits in the income of recipients would be to impose an excise tax on specific benefits, to be paid by employers. These benefits would include the full employer's share of health insurance, premiums to fund the first \$50,000 of life in-

insurance, dependent care, parking, athletic facilities, and employee discounts. A tax imposed at a 3 percent rate, for example, would raise about \$21 billion in 1991 through 1995. The bulk of these revenues would come from taxing employer-paid health insurance. Under this option, employers would need to know only their total fringe benefit costs; they would not have to value the benefits paid to each employee. This tax would maintain most of the incentives for employers to provide fringe benefits instead of taxable wages because the 3 percent excise tax rate would be much lower than the tax rate on wages.

This tax could be criticized as unfair for two reasons: the tax rate would not rise with the income of employees, as it would if the benefits were taxed under the income tax; and the tax might result in lower taxable wages for all employees, regardless of the benefits each receives. The degree of the inequity, however, would be small as long as the tax was imposed at a low rate.

REV-13 REPEAL THE POSSESSIONS TAX CREDIT

Addition to CBO Baseline	Annual Added Revenues (In billions of dollars)					Cumulative Five-Year Addition
	1991	1992	1993	1994	1995	
Repeal the Credit	1.2	2.2	2.4	2.6	2.7	11.0
Replace the Credit with a Wage Credit	0.1	0.3	0.3	0.4	0.5	1.6

Income earned by U.S. corporations operating in Puerto Rico or U.S. possessions is generally treated as foreign-source income, and the U.S. federal tax on such income is offset by the foreign tax credit (FTC) for any tax paid to the possession. Section 936 of the Internal Revenue Code also allows eligible firms to claim a possessions tax credit, which provides a special tax preference for certain business and qualified investment income from Puerto Rico and other U.S. possessions. A corporation that has received at least 80 percent of its gross income for the last three years from sources within Puerto Rico or any U.S. possession (at least 75 percent from the active conduct of a trade or business) may claim a possessions tax credit instead of the FTC. The credit is equal to the U.S. tax on the qualified possessions-source income. The credit effectively exempts most such income from tax because Puerto Rico imposes very little tax on these so-called possessions corporations.

The objective of the possessions tax credit has been to promote employment. The principal argument for repeal is that this incentive has provided significant tax benefits to certain businesses, without stimulating much employment in U.S. possessions. Pharmaceutical manufacturers, who received 46 percent of the tax benefits in 1983 according to the Treasury Department, have been among the largest beneficiaries of the possessions tax credit. Despite very complex limitations enacted in the Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA), the primary incentive provided by the credit is to reallocate artificially to possessions the income from intangible assets developed in the United States rather than to encourage investment in tangible capital, such as plant and equipment. Further limitations were imposed by the Tax Reform Act of 1986 and subsequent regulations,

but the limitations have probably not significantly affected the revenue cost of the credit. Repealing the credit would increase revenues by \$11 billion over five years.

Critics of the credit argue that a better-targeted subsidy, such as a wage credit, would be a more cost-effective way to promote employment. The Treasury Department estimated that the revenue loss from the possessions credit equaled approximately 125 percent of total compensation in possessions corporations in 1983, based on tax return data from Puerto Rico. In 1985 the Treasury Department proposed a wage credit equal to 60 percent of wages up to the federal minimum wage, and 20 percent of wages between one and four times the minimum wage. The wage credit would replace the possessions tax credit and the foreign tax credit on possessions-source income for qualifying corporations. The Treasury proposal would also continue providing possessions credits on active business income of qualifying possessions corporations for five years. Despite the grandfather provision, the wage credit would raise \$1.6 billion over the 1991-1995 period because of the repeal of the subsidy to passive investment income. Over the long term, the revenue gains would be much larger.

One argument against repeal of the possessions tax credit is that the credit is necessary to stimulate investment in high-technology capital-intensive manufacturing such as pharmaceuticals and electronics. The wage credit option, however, attempts to address this critique by providing a subsidy to employment, even at relatively high wages. Moreover, by subsidizing only labor, the wage credit might stimulate more employment than the broader possessions tax credit.

Another argument against repeal is that repeal would cause unemployment in the subsidized industries as well as in other sectors that sell products and services to the possessions corporations and their employees. The generous transition rule and new wage subsidies in the second option are aimed at minimizing these disruptions.

**REV-14 AMORTIZE A PORTION OF
 ADVERTISING COSTS**

	Annual Added Revenues (In billions of dollars)					Cumulative Five-Year Addition
	1991	1992	1993	1994	1995	
Addition to CBO Baseline	2.9	4.8	3.7	2.4	1.5	15.3

Under the income tax, the ordinary costs of doing business can be fully deducted as they are incurred or paid, but capital expenditures cannot. Instead, capital expenditures--including the cost of acquiring assets whose useful lives extend beyond the current tax year--must be capitalized and deducted at a prescribed rate as the assets wear out in order to match costs with income. Advertising is currently treated as an ordinary business cost because providing information about a product is considered essential to its sale, and hence the cost can be fully deducted when incurred.

Because advertising often contributes to brand recognition and product acceptance that may last for years, capitalizing a portion of advertising costs and deducting it over several years might improve the matching of business costs with income. Requiring 20 percent of all advertising costs to be capitalized and deducted at a prescribed rate over four years would raise about \$15 billion in 1991 through 1995.

Because advertising is not always easy to identify, the option would require complex rules to distinguish advertising costs from other ordinary business costs. Some costs such as those of notifying customers of price changes, redesigning product packaging, or changing store displays might or might not be viewed as advertising. Moreover, because the useful life of advertising depends on its unknown effect on customers, any amortization rate would be arbitrary.

Amortizing a portion of advertising costs would raise the after-tax cost of advertising and discourage its use. Some argue that advertising should be discouraged because it is socially wasteful. Some go further

and argue that it is socially harmful because it reduces competition from businesses that cannot afford large advertising budgets.

Alternatively, others argue that advertising is socially useful because it promotes product diversity and gives customers more choice. Moreover, advertising can increase competition in some cases by enabling new entrants to carve out market niches for themselves.

**REV-15 IMPOSE A 0.5 PERCENT TAX
ON THE TRANSFER OF SECURITIES**

	Annual Added Revenues (In billions of dollars)					Cumulative Five-Year Addition
	1991	1992	1993	1994	1995	
Addition to CBO Baseline	7.8	11.6	12.2	12.8	13.4	57.7

Present law does not impose a tax on the transfer of corporate stocks or other kinds of securities, except as income from the transfer is realized as capital gains. A low-rate stamp tax (0.1 percent or less) on the issuance and transfer of stocks and debt was repealed in 1965.

A securities transfer excise tax (STET) could be imposed on 0.5 percent of the value of certain security transfers. To deter avoidance, the tax would have to be broad-based, applying to stocks, debt, options, and trades by Americans on foreign exchanges. The tax would apply to transactions by individuals, corporations, and tax-exempt institutions. A broad-based STET (excluding Treasury securities) would raise about \$58 billion over the 1991-1995 period. Treasuries would have to be excluded from the STET because their free exchange is essential to the banking and thrift industries.

Proponents of a STET argue that new computer and communications technology encourages brokers to engage in short-term speculation, which destabilizes the markets and contributes to disruptive events such as the October 1987 stock market crash. The profitability of this kind of activity has resulted in a disproportionate share of resources being devoted to financial services rather than to production. According to one estimate, the cost of operating securities markets was about one-fourth of corporate profits in 1987. Such a short-term focus on financial markets may prevent corporate managers from concentrating on long-term measures to increase output and productivity.

A STET would discourage short-term trading because the tax would represent a large percentage of income on assets that had not been held for long. For certain kinds of arbitrage transactions, the in-

come earned could be less than the amount of the tax. Even for an asset held for a year, earning a 10 percent pre-tax return, the STET would be equivalent to a surcharge of 5 percent on the income earned. Some suggest that the tax would reduce market volatility. Advocates of a STET also point out that most major U.S. trading partners, including the United Kingdom, Japan, West Germany, France, Italy, Switzerland, Sweden, and The Netherlands, have some kind of securities transfer tax. Their economies appear not to have suffered from the tax, which contributes significantly to their tax receipts. Moreover, since individual asset holders are generally well off, the tax would be progressive. A STET would also subject currently nontaxable traders such as pension funds to some tax, diminishing their relative advantage over taxable investors.

There is, however, no direct evidence that a STET would reduce market volatility. The October 1987 crash seemed to be no less severe in Japan and the United Kingdom, despite the existence of STETs in both. While a STET would discourage short-term trading based on rumors and speculation, it would equally discourage all short-term trading. As a result, market prices might not accurately reflect investors' current valuation of assets, which could be destabilizing.

A STET would add to the tax penalty on realizing capital gains, thereby increasing the "lock-in" effect on holdings of assets. Some argue that the lock-in effect results in an inefficient level of private risk-bearing and prevents investment funds from being allocated efficiently to their most productive uses, such as new ventures.

A STET would also raise the cost of corporate capital. Some analysts are concerned that the Tax Reform Act of 1986 has caused the effective tax rate on corporate capital to be too high, deterring investment. If so, the STET could exacerbate this problem.

A STET would be difficult to administer. Foreign transactions by U.S. nationals should be taxed because otherwise many sales of U.S. stocks would simply move offshore. It would be difficult for the IRS to audit these transactions, however, so compliance would probably be low. Complicated "look-through" rules would be necessary to keep investors from hiding otherwise taxable transfers in partnerships or closely held corporations.

**REV-16 INCREASE TAXATION OF SOCIAL SECURITY
AND RAILROAD RETIREMENT BENEFITS**

Addition to CBO Baseline	Annual Added Revenues (In billions of dollars)					Cumulative Five-Year Addition
	1991	1992	1993	1994	1995	

Increase Fraction of Benefits Included in AGI

Tax up to 60 Percent of Benefits	0.3	1.1	1.2	1.4	1.6	5.6
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Tax up to 85 Percent of Benefits	1.1	3.9	4.4	5.0	5.7	20.1
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Eliminate the Income Thresholds

Tax 50 Percent of Benefits	4.7	7.7	8.1	8.6	9.1	38.2
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Tax 60 Percent of Benefits	6.6	10.8	11.5	12.2	12.9	54.0
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Tax 85 Percent of Benefits	12.0	19.8	21.2	22.5	24.0	99.5
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Social Security and Railroad Retirement (Tier I) benefits constitute the federal government's largest entitlement commitment. These benefits could be reduced directly through changes in the benefit formula (see ENT-26 and ENT-28) or cost-of-living adjustments (see ENT-25), or indirectly by further using the income tax to decrease the net value of benefits paid to recipients with other income. For the same reduction in the federal deficit, an increase in the taxation of benefits would concentrate the burden more on higher-income households than would, for example, a cost-of-living adjustment (COLA) freeze, where the burden would also fall on lower-income households whose principal income source is Social Security. Attempts to curtail the cost of COLAs and, at the same time, protect the poor reduce the deficit very little. Because there is a lack of information on people's comprehensive incomes, protection must be given to many people who have low benefits but who also have other income. In comparison, the tax system can be

used to reduce the deficit more substantially without harming low-income people. Many argue that increased taxation of benefits is, therefore, a preferable way to achieve a given target of deficit reduction among the elderly and disabled.

Increased taxation of benefits could be regarded as a violation of long-held understandings about the implicit promises in the Social Security and Railroad Retirement programs during the time these people were working and paying their payroll taxes. However, numerous changes in Social Security and Railroad Retirement benefits, in the tax treatment of the benefits, and in the taxes used to fund them have been made since the programs were instituted. Another argument that could be made against increased benefit taxation is that up to half of benefits are already taxed under current law, substantially decreasing the rate of return that past and present high-wage workers will receive in Social Security. Taxing a higher percentage would decrease their rate of return even further, thereby possibly eroding support for the program.

The 1983 Social Security Amendments made Social Security and Tier I benefits partially taxable to higher-income households. Under current law, adjusted gross income (AGI) includes the lesser of one-half of Social Security and Tier I benefits, or one-half the excess of the taxpayer's combined income (AGI plus nontaxable interest income plus one-half of Social Security and Tier I benefits) over a threshold amount. The threshold amount is \$25,000 for single returns and \$32,000 for joint returns. Because these thresholds are not indexed, a growing percentage of recipient households will be affected by this 1983 provision; the percentage of families who will pay taxes on their Social Security benefits is expected to grow from 14 percent in 1987 to 25 percent in 1995.

In the immediate future, taxation of Social Security and Tier I benefits could be increased by raising the fraction of benefits included in AGI, or by eliminating or reducing the thresholds.

Increase Fraction of Benefits Included in AGI. Employers pay one-half of workers' combined payroll taxes from before-tax income under current law, while employers pay the remainder out of income that is taxed. Accordingly, many people reason that one-half of Social Security and Tier I benefits are properly includable in AGI.

A competing view is that these benefits should be taxed more like public employee pensions and those few private-sector pensions in which individuals make contributions from after-tax income. Under current law, a fraction of benefits from contributory pension plans is excluded from tax. This fraction, called the exclusion ratio, is based on the nominal amount of after-tax contributions made by employees. The remaining share of these benefits is fully taxable. Because the ratio of after-tax contributions (the employee share of payroll taxes) to Social Security and Tier I benefits varies by each worker's earnings history and marital status, no single exclusion ratio is correct for all beneficiaries. Requiring the Social Security Administration to calculate separate exclusion ratios for each beneficiary would be administratively burdensome. A 15 percent exclusion ratio--that is, including up to 85 percent of benefits in AGI--would make the tax treatment of Social Security for workers with high earnings roughly comparable with that afforded contributory pensions under current law, and would be more generous for those with lower earnings. If current law thresholds were maintained, about \$20 billion would be raised in 1991 through 1995 by increasing includable benefits to 85 percent. This provision would affect 18 percent of couples and individuals receiving benefits in the 1991 tax year.

An alternative view is that the current tax treatment of contributory pensions--and, by extension, Social Security and Tier I--should be changed to allow retirees to recover tax-free the amount of their after-tax contributions adjusted for inflation, a more favorable treatment than that afforded to most private pensions. Under current tax law, however, no such inflation adjustments are made for a taxpayer's investments from after-tax income in pensions, capital assets, or other holdings. Depending on long-term assumptions about inflation, an inflation-adjusted exclusion ratio along the same lines falls between 30 percent and 40 percent; this would mean including up to 60 percent or 70 percent of benefits in AGI. For example, including up to 60 percent of benefits in AGI with current thresholds would raise about \$6 billion in 1991 through 1995. (For more discussion of alternative exclusion ratios, see the Congressional Budget Office Staff Working Paper, "An Analysis of Alternatives for Taxing Social Security as a Private Pension," March 1988.)

Eliminate the Income Thresholds. In addition to the thresholds, the tax code protects lower-income elderly households from income taxa-

tion through personal exemptions, the regular standard deduction, and an additional standard deduction for the elderly. Under current law, 82 percent of elderly couples and individuals with benefits pay no income tax on their benefits. If the benefit taxation thresholds were eliminated, about \$38 billion would be raised in 1991 through 1995, and the share of beneficiary couples and individuals paying no tax on their benefits would decline to 48 percent. Eliminating the thresholds would remove a tax preference that is not well targeted on those with lower incomes and would reduce tax disparities among middle-income households. Under current law, the fraction of income paid in income taxes by middle-income elderly families is less than half the fraction paid by nonelderly families with comparable income. In addition, for a comparable deficit reduction, eliminating the thresholds would have smaller effects on the disposable incomes of the lower-income elderly than curtailing cost-of-living increases or similar measures.

The amount of revenue raised would be greater if eliminating the thresholds was combined with raising the fraction of benefits included in AGI. For example, eliminating the thresholds and raising the fraction of benefits included in AGI from 50 percent to 60 percent would raise \$54 billion in 1991 through 1995.

An argument against complete elimination of the thresholds with no other changes is that it would decrease the disposable incomes of today's elderly with incomes below the median, while leaving upper-income elderly unaffected. To minimize the effects on moderate-income recipients, the thresholds could instead be lowered--for example, to \$12,000 for single filers and \$18,000 for joint returns. With up to 50 percent of benefits includable in AGI, these lower thresholds would raise about \$19 billion in 1991 through 1995, or roughly half of what would be generated by including 50 percent with no thresholds. With up to 60 percent of benefits included in AGI, the lower thresholds would raise \$29 billion in 1991 through 1995 as compared with the \$54 billion that would be raised by including 60 percent with no thresholds. Lowering the thresholds to \$12,000 and \$18,000 while including 85 percent of benefits in AGI would raise \$54 billion as compared with nearly \$100 billion raised by including 85 percent of benefits with no thresholds.

**REV-17 EXPAND MEDICARE AND
SOCIAL SECURITY COVERAGE**

Addition to CBO Baseline	Annual Added Revenues (In billions of dollars)					Cumulative Five-Year Addition
	1991	1992	1993	1994	1995	
Expand Medicare Coverage to State and Local Govern- ment Employees Not Now Covered	1.2	1.7	1.6	1.6	1.6	7.8
Expand Social Security Coverage to New State and Local Government Employees	0.5	1.6	2.6	3.6	4.6	12.8

NOTE: These estimates do not include the effects of any increases in benefit payments that would result from the option. These effects would be small over this five-year period. Estimates are net of reduced income tax revenues.

The largest group of workers not paying Medicare and Social Security payroll taxes are government workers, even though legislation during the past decade has mandated participation by certain groups of federal, state, and local government workers. All federal workers were required to pay Medicare payroll taxes beginning in 1983. Federal employees hired after December 31, 1983, were required to pay Social Security payroll taxes. State and local workers hired after March 31, 1986, were required to pay Medicare payroll taxes.

If state and local workers hired before April 1, 1986, were required to pay Medicare payroll taxes, and all new state and local workers were required to pay Social Security payroll taxes, then coverage of state and local workers would resemble that of federal workers and reduce the inequity of benefits received in relation to payroll taxes paid. Under current law, many state and local employees will qualify for

Social Security and Medicare benefits based on other employment in covered jobs or their spouses' employment. These workers will thus receive benefits in return for a smaller amount of lifetime payroll taxes than paid by those who work continuously in covered employment. This inequity is especially apparent for Medicare benefits: over 90 percent of retired state and local government workers receive benefits, but only about 70 percent worked in a covered state and local government job. Inequitable treatment is less of a problem in the case of Social Security benefits, because these benefits are reduced for retired government workers who have worked a substantial portion of their careers in employment not covered by Social Security.

Although expanding Medicare and Social Security payroll taxes to include more state and local workers would increase the government's liability for future program benefits, additional revenues would more than offset increased benefits in both the short and the longer term. Expanding Medicare coverage would have a small effect on future benefit payments, because most state and local workers are already able to claim Medicare benefits. Expanding Social Security coverage would raise future benefits significantly, but the added payroll tax revenue would exceed any added benefits for many years to come.

Expand Medicare Coverage to State and Local Government Workers Not Now Covered. Expanding Medicare coverage to state and local government workers hired before April 1, 1986, would raise about \$8 billion in 1991 through 1995. This option has been considered during the budget reconciliation process in the last several years, and has been included in the President's budget for the last several years.

Expand Social Security Coverage to New State and Local Government Workers. Expanding Social Security coverage to new state and local workers would raise about \$13 billion in 1991 through 1995, and would ultimately improve the retirement benefits of these workers. It would benefit new state and local government workers and their families in three ways. First, newly hired workers would find it easier to qualify for disability and survivors' benefits under Social Security, because of the portability of coverage, than under many public employee benefit programs. Second, eligibility is not lost under Social Security if the employee changes jobs. Third, because Social Security benefits are calculated on the basis of indexed wages, while benefits from public pension plans are calculated on the basis of nominal wages for a given

amount of covered wages, younger and short-service workers would receive more generous retirement benefits from Social Security than if they were covered solely by a public pension plan.

State and local governments would have to pay the employer share of Social Security taxes on new employees if coverage was made mandatory. Since state and local government participation in Social Security is now voluntary, those states with a low percentage of covered employees would bear most of the cost from mandatory coverage. In eight states--Alaska, California, Colorado, Louisiana, Maine, Massachusetts, Nevada, and Ohio--less than 50 percent of state and local employees are now covered under Social Security. Representatives of some localities argue that the change would impose a difficult financial burden for two reasons. First, state and local governments would have to create separate pension plans for workers newly covered by Social Security, so that their pension benefits would not duplicate Social Security retirement benefits. Maintaining separate pension plans could be administratively complex. Second, the funding for current state and local pension plans might be inadequate for governments operating their pension plans on a pay-as-you-go basis, using current contributions to pay benefits to current retirees. Finally, while increased payroll tax collections would lower the federal deficit, this would not necessarily raise national saving if states reacted by lowering their own contributions to state and local pension plans.

**REV-18 INCLUDE ESOP CASH DIVIDENDS IN
THE SOCIAL SECURITY TAX BASE**

	Annual Added Revenues (In billions of dollars)					Cumulative Five-Year Addition
	1991	1992	1993	1994	1995	
Addition to CBO Baseline	0.1	0.2	0.3	0.3	0.3	1.2

An employee stock ownership plan (ESOP) is a specific kind of employee benefit plan that is similar to a pension plan. In a typical ESOP arrangement, a corporation borrows to buy its own stock and contributes the stock to the ESOP. As the corporation pays off the loan, the stock held by the ESOP is allocated to employees according to rules prescribed by the plan. Although the employees do not receive the stock until they leave the corporation or retire, they do receive dividends on the stock that has been allocated to them.

Unlike most dividends, corporations can deduct the dividends they pay on stock held by their ESOPs as a business expense. The deduction is allowed because the dividend payments are used either to pay interest on the loan, to fund employee pensions, or to pay employees--all of which are deductible business expenses. The dividends paid to employees are a form of cash compensation, just like wages. Like wages, the dividends are taxed under the income tax, but unlike wages, they are not taxed under the payroll tax.

Under the Omnibus Budget Reconciliation Act of 1989, the Congress restricted the deductibility of ESOP dividends to prevent ESOPs from eroding the corporate income tax. By including the ESOP dividends that employees receive in the Social Security tax base, the Congress could prevent ESOPs from eroding the payroll tax as well. This option would raise \$1.2 billion in 1991 through 1995, and even more in later years as the amount of stock allocated to employees grows. In the long run, however, Social Security benefits would also grow because employees would be credited with higher payroll tax payments.

Although some may argue that the ESOP dividends that employees receive are not wages because they are uncertain, other forms of uncertain compensation such as bonuses and commissions are treated like wages and included in the Social Security tax base.

REV-19 REPEAL THE MEDICARE TAXABLE MAXIMUM

	Annual Added Revenues (In billions of dollars)					Cumulative Five-Year Addition
	1991	1992	1993	1994	1995	
Addition to CBO Baseline	3.5	9.9	10.5	11.3	12.0	47.2

NOTE: Estimates are net of reduced income tax revenues.

Under current law, wages above the taxable maximum (\$51,300 in 1990) are exempt from all payroll taxes, including the Medicare Hospital Insurance (HI) tax. For workers now paying payroll taxes, only about 12 percent of wages--earned by about 6 percent of the workers--are above the taxable maximum. If the taxable maximum for Medicare was repealed beginning in 1991, the deficit would decrease by about \$47 billion in 1991 through 1995.

A repeal of the Medicare taxable maximum would improve the solvency of the Medicare trust fund and lessen the regressivity of the Medicare payroll tax. Solvency of the Medicare trust fund is attained if total revenues equal or exceed total obligations over a 75-year period. The HI trust fund is not solvent; in 1988, the fund's trustees projected it will begin showing a negative cash flow in 1998 and will be exhausted by 2005. Repeal of the Medicare taxable maximum would lessen the regressivity of the Medicare payroll tax by ending the current situation in which workers earning more than the taxable maximum pay a smaller share of their income in payroll taxes than other workers.

Opponents of this option argue that the benefits from gains in trust fund solvency and a less regressive Medicare tax would be outweighed by the costs of increasing the subsidy paid by high-wage workers to other workers. High-wage workers already subsidize other workers through their higher tax payments because participants in the Medicare program receive the same benefits regardless of how much is paid in payroll taxes. Repealing the Medicare taxable maximum

would heighten the gap between taxes paid and benefits received by high-wage workers, thereby increasing this subsidy.

Leaving the taxable maximum where it is and increasing the Medicare tax rate from 1.45 percent to 1.64 percent for employer and employees would raise about the same revenue over five years as would repealing the taxable maximum. Funding Medicare benefits in this manner would be less likely to increase the subsidy paid by high-wage workers to other workers, but it would also increase the regressivity of the Medicare payroll tax.

Some people oppose any increase in Medicare taxes. They argue that the financial problems of the Medicare trust fund stem from the unanticipated growth in outlays and that the solution to these problems should be sought by decreasing spending rather than by increasing taxes.

**REV-20 INDEX THE UNEMPLOYMENT INSURANCE
TAXABLE WAGE BASE**

	Annual Added Revenues (In billions of dollars)					Cumulative Five-Year Addition
	1991	1992	1993	1994	1995	
Addition to CBO Baseline	0.3	0.6	0.9	1.0	1.1	3.8

NOTE: Estimates are net of reduced income tax revenues.

The Unemployment Insurance (UI) program is financed primarily by federal and state payroll taxes on employers. The federal UI tax is imposed on the first \$7,000 of wages per worker. Credits against the federal UI tax rate are used to induce states to establish state wage bases that conform with or exceed the federal wage base. All states have adopted a state wage base of at least \$7,000, and most states provide an automatic adjustment to prevent the state wage base from falling behind the federal wage base. Because the federal UI wage base has been increased only three times since 1940, when it was \$3,000, the proportion of wages in covered employment subject to the federal tax has fallen from over 90 percent in 1940 to less than 35 percent today. The ratio of the net aggregate state trust fund balance to total covered wages and salaries has also fallen, from 3.1 percent in 1970 to 1.9 percent in 1989.

Indexing the federal UI wage base by linking it to the change in the national average wage--as is done with the Social Security wage base--would prevent further erosion in the real UI wage base. Indexation would maintain the current relationship between covered wages and unemployment taxes, assuming no change in state UI tax schedules. It would also preserve the current relationship between per capita tax payments and per capita benefits, because UI benefits tend to increase with nominal wages.

Indexing the wage base, beginning January 1, 1991, would increase combined federal and state UI revenues by almost 5 percent, while reducing the federal budget deficit by about \$4 billion in 1991

through 1995 and lessening the regressivity of the UI tax. Because both the federal and state UI taxes are counted as revenue to the federal government, increases in both revenue sources decrease the federal budget deficit. Federal UI tax revenues would rise nearly in proportion to future increases in the federal tax base. In contrast, aggregate state UI tax revenues might rise less than proportionately for two reasons. The first reason is that states with tax bases currently higher than the federal base, about two-thirds of the states, might not be affected by indexation for several years. The second reason is that states with adequate UI trust fund balances might choose to offset the effects of an increased wage base by reducing their tax rates. Indexing the wage base would concentrate the tax increase on wages of workers now earning more than the current tax base; this change would make the UI tax somewhat less regressive than it is now.

Opponents argue that indexing the wage base is unnecessary, and that it would lead to higher labor costs and more unemployment in some states. In addition, because states are now charged interest on loans from the federal UI program, they argue that incentives are already in place to encourage responsible state fiscal behavior without indexing the federal wage base. States should be free to determine their UI wage base for employers in their state without being penalized for nonconformity with the federal UI wage base.

**REV-21 REDUCE TAX CREDITS FOR REHABILITATION
OF OLDER BUILDINGS**

Addition to CBO Baseline	Annual Added Revenues (In billions of dollars)					Cumulative Five-Year Addition
	1991	1992	1993	1994	1995	
Repeal Credit for Nonhistoric Structures and Reduce Credit for Historic Structures to 15 Percent	0.1	0.1	0.1	0.1	0.1	0.4
Repeal the Credits	0.1	0.2	0.2	0.2	0.2	0.9

Tax credits for rehabilitation are intended to promote the preservation of historic buildings, encourage businesses to renovate their existing premises rather than relocate, and encourage investors to refurbish older buildings. The credit rate is 10 percent for expenditures on structures built before 1936, and 20 percent for buildings certified as historic structures by the Department of the Interior because of their architectural significance.

The credits favor commercial use over most rental housing and may, therefore, divert capital from more productive uses. Commercial buildings can qualify for the 10 percent or 20 percent credit, whereas rental housing can qualify only in certified historic structures. Moreover, in favoring renovation over new construction, the credits may encourage more costly ways of obtaining more housing and commercial buildings.

Rehabilitation may have social benefits: for example, it may discourage the destruction of historically noteworthy buildings. This objective, however, might be accomplished at a lower cost by retaining a credit only for the renovation of certified historic buildings. Some surveys have indicated that a 15 percent credit would be sufficient to cover the extra costs both of obtaining certification and of rehabilitating in terms of historical quality.

If the credit for historic structures was reduced to 15 percent and the credit for nonhistoric structures was repealed, revenue gains over the 1991-1995 period would be \$0.4 billion. Repeal of the credit would raise \$0.9 billion over the same period.

**REV-22 TAX CREDIT UNIONS LIKE OTHER
THRIFT INSTITUTIONS**

Addition to CBO Baseline	Annual Added Revenues (In billions of dollars)					Cumulative Five-Year Addition
	1991	1992	1993	1994	1995	
Tax All Credit Unions	0.4	0.7	0.8	0.9	0.9	3.7
Tax Credit Unions with More Than \$10 Million in Assets	0.4	0.7	0.8	0.9	0.9	3.7

Credit unions, organized for the benefit of members and operated without profit, are not subject to federal income taxes and hence are treated more favorably than competing thrift institutions, such as savings and loan institutions and mutual savings banks. Taxing all credit unions like other thrift institutions would raise \$3.7 billion in 1991 through 1995. Virtually the same amount of revenue would be raised by taxing only credit unions with assets above \$10 million, which represent only about 20 percent of the total number of credit unions.

Credit unions, savings and loans, and mutual savings banks were originally all tax-exempt, but in 1951 the Congress removed the tax exemptions for savings and loans and mutual savings banks. These were considered to be more like profit-seeking corporations than non-profit mutual organizations.

Since 1951, credit unions have come to resemble the other thrift institutions in certain respects. Credit union membership is no longer limited to people sharing a "common bond," generally a place of employment. Since 1982, credit unions have been allowed to extend their services to others, including members of other organizations. In addition, most credit unions allow members and their families to participate permanently, even after members have left the sponsoring organization. Credit union membership has grown from about 5 million in 1950 to about 60 million today, indicating that credit unions, like taxable thrifts, now effectively serve the general public. Moreover, credit unions are becoming more like savings and loans and mutual savings

banks in the services they offer. A significant number of credit unions now offer such services as first and second mortgages, direct deposit, automatic teller access, preauthorized payments, credit cards, safe deposit boxes, and discount brokerage services.

Taxable thrift institutions argue that the credit unions' tax-exempt status gives them a competitive advantage that is no longer justified by differences in potential membership or available services. Credit unions contend, however, that the original reason for their special tax treatment--that they operate without profit and solely for the benefit of their members--continues to justify their special status. Credit unions also point out that they tend to be more closely managed by their depositors, since their statutes generally require the boards of directors to be drawn from the membership--a management structure that is not oriented toward making profits.

The credit union industry also argues that only undercapitalized unions would be subject to tax because such credit unions would need to earn profits in order to build up their capital. Collecting a tax on their profits would make it more difficult for undercapitalized credit unions to build up needed capital. The majority of healthy credit unions, however, are not obligated to earn any profits; they could avoid earning profits and thus escape the tax by paying higher deposit rates or charging lower loan rates.

These arguments of the credit union industry may be countered in several ways. First, competing thrift institutions that are profitable but undercapitalized pay taxes. Second, when undercapitalized financial institutions report losses, they can recoup some of their losses from the Treasury as offsets against taxes paid in previous years. Finally, if credit unions were to pay higher deposit rates in an effort to avoid taxes, their depositors would receive more income and pay more income tax. Similarly, if the credit unions charged lower mortgage interest rates, their members would have lower tax deductions for mortgage interest and therefore also pay more income tax.

**REV-23 REPEAL TAX PREFERENCES
FOR EXTRACTIVE INDUSTRIES**

Addition to CBO Baseline	Annual Added Revenues (In billions of dollars)					Cumulative Five-Year Addition
	1991	1992	1993	1994	1995	
Repeal Percentage Depletion	0.4	0.7	0.8	0.9	1.0	3.8
Repeal Expensing of Intangible Drilling, Exploration, and Development Costs	0.5	1.1	1.2	1.3	1.4	5.5

Under the normal rules for cost recovery, purchases of capital assets such as plant and equipment cannot be fully deducted when purchased. Instead, the purchase price must be capitalized as a business asset and written off at a prescribed rate over the asset's useful life either through depreciation or depletion. These rules also apply to so-called "self-constructed" assets, which are constructed by the user rather than purchased. Although oil and gas wells and mineral mines are self-constructed assets, they enjoy special cost recovery rules. The expensing of certain exploration and development costs, including intangible drilling costs, allows an immediate write-off of costs that would otherwise have to be capitalized and written off more slowly. Percentage depletion allows write-offs that often exceed capitalized costs.

Expensible exploration and development costs include costs for excavating mines and drilling wells. They also include prospecting costs for hard minerals, but not for oil and gas. For corporations engaged in hard mineral extraction and for so-called integrated producers of oil and gas who also operate sizable refineries, expensing is limited to 70 percent of these costs, with the remaining 30 percent deducted over a 60-month period.

Percentage depletion allows a certain percentage of a property's gross income to be deducted, regardless of the actual capitalized costs.

Non-integrated oil and gas companies are allowed to deduct 15 percent of the gross income from their first 1,000 barrels per day of oil and gas production each year. (Integrated oil and gas producers are required to use normal cost depletion to recover capitalized costs.) Hard mineral producers are also allowed to use percentage depletion at varying statutory rates. Minerals eligible for percentage depletion include sand (5 percent), coal (10 percent), iron ore (14 percent), dimension stone and mollusk shells (14 percent), oil shale (15 percent), gold (15 percent), and uranium (22 percent). The allowance for percentage depletion is limited to 50 percent of the net income from the mineral property after production costs.

Because percentage depletion depends on the value of production rather than the amount of capitalized costs, it is more akin to a production subsidy than a method of cost recovery. However, the subsidy provides little or no incentive to develop or expand production from marginal properties because the amount of percentage depletion is limited by net income. Higher production costs for marginal properties reduce net income and therefore limit the amount of percentage depletion allowed.

Percentage depletion and the expensing of exploration and development costs encourage oil and gas production and hard mineral extraction, but the incentives are not available to all producers on an equal basis. Integrated oil and gas producers are denied percentage depletion deductions that others receive. Furthermore, most corporations can expense only 70 percent of their exploration and development costs including intangible drilling costs, while noncorporate producers can expense all of them. Finally, producers who pay the alternative minimum tax must defer or even forgo deductions for percentage depletion and expensable exploration and development costs, while producers who pay the regular income tax may take them currently.

Several arguments for repealing expensing and percentage depletion can be made. First, these provisions allocate capital to drilling and mining that could be used more productively elsewhere in the economy. Second, they encourage the use of scarce domestic oil and gas resources--a policy of "draining America first"--which may lead to a greater reliance on foreign energy producers in the future. Third, their effectiveness in encouraging production is lessened by their failure to provide all producers with the same incentive.

Repealing the expensing of intangible drilling costs and other exploration and development costs would raise about \$5.5 billion in 1991 through 1995, assuming that the costs of dry holes, unproductive mines, and worthless mineral rights could still be expensed. Repealing percentage depletion would raise about \$3.8 billion over the same five-year period.

**REV-24 FURTHER RESTRICT DEDUCTIONS FOR
BUSINESS MEALS AND ENTERTAINMENT**

Addition to CBO Baseline	Annual Added Revenues (In billions of dollars)					Cumulative Five-Year Addition
	1991	1992	1993	1994	1995	
Disallow Deductions for Half of Business Meal and Entertain- ment Expenses	2.0	3.4	3.6	3.9	4.1	17.0

The tax code does not generally allow deductions for personal living costs, but it allows full deductions for ordinary and necessary business expenses. Expenses for business meals, entertainment, and travel are only partially deductible: taxpayers are required to show that the purpose of the expenses is related to business, and the portion of expenses that is "lavish and extravagant under the circumstances" is disallowed. In addition, deductions for business meals and entertainment are limited to 80 percent of expenses. The Congress imposed these restrictions because it was concerned that some taxpayers were deducting personal living expenses as business expenses. Even when connected with a taxpayer's business, expenditures for items such as parties, meals, tickets to theater and sports events, and country club dues provide substantial personal benefit to the taxpayer and other recipients. Deductibility of these expenses provides a tax subsidy that is not available to those who make meal and entertainment purchases outside a business setting. This tax subsidy could be further reduced by lowering the 80 percent limit. For example, limiting deductions to 50 percent of expenses for business meals and entertainment would raise revenues by about \$17 billion in 1991 through 1995.

Determining the component of expenses for meals and entertainment that represents ordinary and necessary business expenses is necessarily arbitrary; some might regard 50 percent as too stringent. Also, the proposal could have negative effects on some restaurants and on the professional sports and entertainment industries because business customers provide them with a large fraction of their income.

**REV-25 ELIMINATE PRIVATE-PURPOSE
TAX-EXEMPT BONDS**

Addition to CBO Baseline	Annual Added Revenues (In billions of dollars)					Cumulative Five-Year Addition
	1991	1992	1993	1994	1995	
Eliminate All Private-Purpose Tax-Exempt Bonds	0.2	0.5	0.7	1.2	1.7	4.3
Raise Cap and Extend Volume Limits to New Issues of All Private-Purpose Bonds	0.1	0.2	0.4	0.5	0.6	1.8

State and local governments have for many years issued bonds exempt from federal taxation to finance public investments such as schools, highways, and water and sewer systems. Beginning in the 1970s, these governments began to issue a growing volume of tax-exempt bonds to finance quasi-public facilities, such as ports and airports, and private-sector projects, such as housing and shopping centers. These bonds eventually became known as "private-purpose" bonds because the ultimate users of the facilities financed with them were private nongovernmental entities.

Private-purpose tax-exempt bonds include mortgage revenue bonds for rental housing and single-family homes for low-income and middle-income households; industrial development bonds (IDBs) used by private firms for a wide variety of purposes; student loan bonds issued by state authorities to increase funds available for guaranteed student loans; and bonds for nonprofit institutions, such as hospitals and universities.

Although private-purpose bonds provide subsidies for arguably worthwhile activities, tax-exempt financing is not the most efficient way to provide assistance. With a direct subsidy, the benefit goes entirely to the borrower. With tax-exempt financing, the benefit is

shared between the borrower of funds and the investor in tax-exempt bonds. In addition, because tax-exempt financing is a tax expenditure instead of a budget outlay, it is not routinely reviewed during the annual budget process.

The Congress has placed restrictions on the use of tax-exempt financing several times, beginning in 1968. During the 1980s, these restrictions have included limiting the volume of new issues of tax-exempt bonds for some activities and setting expiration dates on the use of tax-exempt financing for other activities.

The Tax Reform Act of 1986 made the alternative minimum tax applicable to interest earned on newly issued private-purpose bonds and placed a single state-by-state limit on the volume of new issues of IDBs, student loan bonds, and housing and redevelopment bonds. The new state volume limits, which are more restrictive than those previously in force, are the greater of \$50 per resident or \$150 million a year. Bonds for publicly owned airports, ports, and solid waste disposal facilities, and bonds for nonprofit 501(c)(3) organizations (primarily hospitals and educational institutions) are exempt from the new volume limits. Large private universities and certain other nonprofit institutions may not issue tax-exempt bonds if they already have more than \$150 million in tax-exempt debt outstanding.

If the Congress were to eliminate tax exemption for all new issues of private-purpose bonds, revenue gains would be about \$4 billion in 1991 through 1995, assuming that at least some construction of airports, and of sewage and solid waste facilities, would qualify for tax-exempt financing as governmental in nature. Eliminating the tax exemption would eventually raise the cost of the services provided by nonprofit hospitals and other facilities that currently qualify for tax-exempt financing, but the cost increase would be small and gradual.

Including all bonds for private nonprofit and quasi-public facilities in a single state volume limit while raising the limits beginning in 1991 to \$75 per capita or \$200 million a year would raise \$1.8 billion in 1991 through 1995. These changes would curb the growth of all private-purpose bonds without sharply reducing their use. The curb would primarily affect bond issues for nonprofit hospitals, which are not included in the current cap. Advocates of limiting or eliminating these bonds question the need for any subsidy when the supply of

hospital beds seems to be adequate; opponents hold that such limitations will raise health care costs. Bonds for airport facilities for the exclusive private use of airlines under long-term leases, such as departure gates, would also be curtailed, but public airport facilities, such as runways and control towers, could continue to be financed with the tax-exempt bonds as government facilities.

**REV-26 ELIMINATE OR RESTRICT DEDUCTIBILITY OF
STATE AND LOCAL TAXES**

Addition to CBO Baseline	Annual Added Revenues (In billions of dollars)					Cumulative Five-Year Addition
	1991	1992	1993	1994	1995	
Eliminate Deduct- ibility of State and Local Taxes	4.4	29.5	31.4	33.4	35.5	134.2
Maintain Deduct- ibility of Taxes Above Floor of 1 Percent of AGI	0.7	4.9	5.2	5.6	5.9	22.3
Prohibit Deduct- ibility of Taxes Above Ceiling of 9 Percent of AGI	0.7	5.0	5.3	5.7	6.2	23.0

Under current law, taxpayers may deduct state and local income, real estate, and personal property taxes from their adjusted gross income (AGI). The deductions mean, in effect, that the federal government subsidizes the state and local tax payments of taxpayers who itemize. This subsidy may cause itemizers to support higher levels of state and local services than they would otherwise; to the extent that this is true, the deductions may indirectly finance increased state and local government spending at the expense of other uses of federal revenues. The Tax Reform Act of 1986 reduced the subsidy to state and local governments, directly by repealing the deduction for state and local sales taxes, and, indirectly, by increasing the standard deduction and lowering marginal rates, thus reducing both the number of itemizers and the value of the deductions.

Deductibility of state and local taxes has drawn criticism on several grounds. First, the deductions reduce federal tax liability only for itemizers and, because the value of an additional dollar of deductions increases with the marginal tax rate, the deductions are worth more to higher-bracket taxpayers. Second, deductibility favors wealthier communities; the higher the income level in a community, the

more itemizers it will have, and thus the greater the likelihood that residents of the community will support a higher level of spending. Third, deductibility may discourage states and localities from financing services with nondeductible user fees, thus discouraging efficient pricing of some services.

Supporters of deductibility argue that it is needed because a taxpayer with a large state and local tax liability has less ability to pay federal taxes than one with equal total income and a smaller state and local tax bill. However, a taxpayer who pays higher state and local taxes may also receive more benefits from publicly provided services, such as public recreational facilities. In this case, the taxes are more like other payments for goods and services (for example, private recreation) and should not be deductible.

Supporters of deductibility also note that any higher public expenditures resulting from deductibility benefit all members of a community, including lower-income nonitemizers who do not receive a direct tax saving. Increased spending on such public goods as education, transportation, and pollution control may also have spillover benefits for residents outside the taxing jurisdiction. Further, since some direct federal grants-in-aid to states and localities have been reduced or terminated in the past few years, the need for deductibility may have increased.

Limiting the value of the state and local deduction could raise significant revenues. Eliminating deductibility would raise about \$134 billion in 1991 through 1995. In its 1986 consideration of tax reform, however, the Congress chose to continue deductibility. Most of the incentive effect of the present deductions on public spending could be preserved if the deductions were permitted only for state and local tax payments above a fixed percentage of AGI. The average itemizer's state and local tax deductions exceed 1 percent of AGI in every state. If the floor was set at 1 percent, revenues in 1991 through 1995 would increase by more than \$22 billion.

Another alternative would be to prohibit deductions above a fixed ceiling, which also might be a percentage of AGI. A ceiling set at 9 percent of AGI would increase revenues by a roughly similar amount

--\$23 billion in 1991 through 1995. A floor and a ceiling would have very different effects on incentives, however. With a floor, the incentive for increased state and local spending would remain; with a ceiling, the incentive would be reduced, but state taxes might become less progressive.

**REV-27 IMPOSE A VALUE-ADDED OR
NATIONAL SALES TAX**

Addition to CBO Baseline	Annual Added Revenues (In billions of dollars)					Cumulative Five-Year Addition
	1991	1992	1993	1994	1995	
5 Percent Rate, with Comprehensive Base	--	89.4	135.6	147.5	159.1	531.5
5 Percent Rate, with Exemptions for Food, Housing, and Medical Care	--	52.1	79.0	86.0	92.7	309.9

NOTE: Estimates are based on an effective date of January 1, 1992, and are net of reduced income and payroll tax revenues, but do not reflect added administrative costs.

A value-added tax (VAT) is a form of general sales tax in use in 19 of the 24 countries of the Organization for Economic Cooperation and Development, and in many other countries. It is typically administered by taxing the total value of sales of all firms, but allowing firms to claim a credit for taxes paid on purchases from other firms of raw materials, intermediate materials, and capital goods. In the aggregate, the tax base equals sales to final consumers. Another method of taxing the same base would be to impose a national retail sales tax.

A 5 percent VAT on a broadly defined consumption base would increase net revenues by about \$89 billion in fiscal year 1992 and by roughly \$532 billion through 1995. At the same rate, a VAT on a narrower base would net about \$52 billion in 1992 and about \$310 billion through 1995. (See Table 11 for a sample calculation of broad and narrower VAT tax bases.) These projections assume that collections would not begin until January 1, 1992, because the Internal Revenue Service has estimated that it would take approximately 18 months after the date of enactment to begin to administer a VAT. If a large amount of revenue is to be raised, a VAT might be preferable to an income-tax increase because it is theoretically neutral between present and future consumption. Thus, it would not adversely affect incentives for saving and investment, as an equal increase in income taxes would. In addi-

**TABLE 11. SAMPLE CALCULATION OF BROAD AND NARROWER
VALUE-ADDED TAX BASES, 1988**

Items Included in Tax Base	Amount (In billions of dollars)
Total Personal Consumption in GNP	3,235
Less:	
Rental value of housing	501
Net foreign travel expenditures	3
Religious and welfare activities	76
Plus:	
New residential construction	198
 Broad Tax Base	 2,853
 Possible Exclusions from the Base^a	
New residential construction	198
All medical care (including insurance)	443
Food purchased for off-premises consumption (excluding alcoholic beverages)	373
Food furnished to employees	10
Food produced for farm consumption	1
Brokerage, banking, and life insurance services	170
Local transit (excluding taxis)	5
Clubs and fraternal organizations	6
Toll roads, and so forth	2
Private education and research	58
 Narrower Tax Base	 1,588

SOURCE: Congressional Budget Office based on the National Income and Product Accounts.

a. The excluded amount assumes that consumption is taxed at a zero rate.

tion, a broad-based VAT with a single rate would distort economic decisions less than would an equal-revenue increase in selective consumption taxes. The VATs that have been enacted in other countries, however, include many tax preferences and multiple rates. Such a VAT would distort consumption choices more than a single-rate, broadly based VAT and could be more distorting than higher income tax rates.

The major argument used against a VAT is that it is regressive when compared with annual income: the tax per dollar of consumption is the same for all taxpayers, but the ratio of consumption to income falls for people in higher income groups. Regressiveness can also be measured by comparing the tax with annual expenditures, which fluctuate less than annual income and may be a better indicator of long-run income. Under this measure, a VAT appears less regressive (and some forms of VAT appear proportional).

A VAT could be made less regressive by granting tax preferences for goods and services consumed by low-income people, although such exemptions would substantially increase costs of enforcement and compliance and would reduce revenues from a VAT. Another way to offset regressiveness would be to allow additional exemptions or refundable credits for low-income people under the federal income tax, though this would reduce the revenue gains from the VAT and would cause many people to file tax returns who otherwise would have no need to file. Another alternative might be to include food and medical care in the narrower tax base, but to increase payments to low-income individuals through existing means-tested programs.

In addition to concerns about the distributional effects of adopting a VAT, several other arguments are made against the tax. Most analysts believe that imposing a VAT would cause the price level to rise. Such a one-time increase in the price level could lead to further rounds of inflation, though this result would depend on monetary and fiscal policies. State and local governments would regard a federal sales tax as interfering with their traditional revenue base. The large revenue-raising potential of a federal VAT is of concern to some people who fear it might facilitate undue growth of the federal government. Finally, a federal VAT would impose compliance costs on the firms paying the tax and claiming credits, and would require new personnel and procedures for collection and enforcement. In 1984, the Treasury

Department estimated that a VAT would require 20,000 additional personnel at an annual cost of about \$700 million. Because the administrative and compliance costs per dollar of revenue collected would be high when compared with other federal taxes, some analysts argue that it would be inefficient to impose a VAT at rates below 5 percent.

**REV-28 IMPOSE A 5 PERCENT TAX
ON NET BUSINESS RECEIPTS**

	Annual Added Revenues (In billions of dollars)					Cumulative Five-Year Addition
	1991	1992	1993	1994	1995	
Addition to CBO Baseline	29.7	52.0	56.6	60.6	65.9	264.8

A 5 percent tax on the net business receipts of corporations and non-corporate businesses would be an alternative to raising income tax rates to reduce the deficit. The base of this tax would be gross business receipts (net of indirect taxes paid to federal, state, and local governments) less payments for employee compensation, purchases of intermediate goods and services, and purchases of capital assets such as land, plant, and equipment. Only business operations within the United States would be taxed. The tax would be imposed at a flat rate and administered as an add-on to the current individual and corporate income taxes. Imposing a 5 percent business receipts tax on all corporations and noncorporate businesses would raise about \$265 billion in 1991 through 1995.

A flat-rate tax on net business receipts is similar to a subtraction-method value-added tax (VAT) under which businesses are taxed on the difference between their sales and purchases. There are two differences. First, payments for employee compensation would not be included in the base of the net business receipts tax. Second, negative tax liabilities would not be refunded under the net business receipts tax, but would be carried forward with accrued interest to offset positive tax liabilities in future years.

Like the VAT, a flat tax on net business receipts would not discourage new investment because the competitive, or normal, return to new investment would not be taxed. The tax benefit from deducting the purchase price of an asset would offset the subsequent tax on its normal return. Only the extraordinary portion of the asset's return in excess of the competitive return would be taxed.

Because increased debt financing (leverage) reduces the corporate income tax, some argue that the corporate income tax encourages excessive borrowing and that an increase in corporate income tax rates would encourage even more corporate borrowing. By contrast, imposing a tax on net business receipts would not encourage borrowing because the interest expense would not be deductible. Thus, borrowing would not change the amount of tax owed.

If the Congress wanted to discourage leveraged buyouts, it could impose the net business receipt tax on corporations at a much higher rate but allow a credit for corporate income tax payments. Under this alternative scheme, corporations that used excessive debt financing to reduce their corporate income tax would increase the tax on their net business receipts by an equal amount. Normal borrowing would not be discouraged, however, as long as the credit for corporate income tax payments exceeded the tax on net business receipts.

The principal advantage of the net business receipts tax over an increase in income tax rates is that it would not increase the tax rate on new investment. The burden of the additional tax would fall primarily on the return to existing business capital. One could, however, argue that it is unfair to raise revenue by taxing income from existing capital more heavily than other income or by taxing older taxpayers, who own much of the existing capital, more heavily than other taxpayers.

Because a tax on net business receipts would not tax employee compensation, it could not raise as much revenue as a broad-based VAT. A tax on net business receipts would, however, have certain advantages over a VAT as a means of raising modest amounts of additional tax revenue. It uses income tax concepts that are already familiar to most taxpayers. It is easy to compute from income tax records, and could be filed with the business's income tax return. Therefore, it would be less costly than a VAT to administer and comply with.

REV-29 INCREASE ENERGY TAXES

Addition to CBO Baseline	Annual Added Revenues (In billions of dollars)					Cumulative Five-Year Addition
	1991	1992	1993	1994	1995	
Impose Tax on Domestic and Imported Oil (\$5 per barrel)	20.0	20.3	20.6	21.1	21.6	103.6
Impose Oil Import Fee (\$5 per barrel)	8.5	8.8	9.2	9.8	10.5	46.9
Increase Motor Fuel Taxes (12 cents per gallon)	12.1	11.6	11.4	11.6	11.7	58.5
Impose Broad- Based Tax on Energy Consumption (5 percent of value)	14.2	15.0	16.0	17.0	18.1	80.2

NOTE: Estimates are net of reduced income and payroll tax revenues. Increases in federal government expenditures for energy products under these options are not estimated. The revenue estimates are based on CBO's baseline oil price forecast of \$18 per barrel in 1991, rising to \$22 per barrel by 1995. The effective date for all of these proposals is October 1, 1990.

Increasing energy taxes could raise significant amounts of revenue, encourage conservation by making energy more expensive, reduce pollution, and decrease the country's dependence on foreign oil suppliers. The United States depends on foreign sources for nearly half of the oil it consumes, and about a fifth of its total energy. This dependence exposes the U.S. economy to potential interruptions in energy supplies.

Imposing new or higher energy taxes would raise energy prices and reduce energy consumption, thus helping to preserve recent conservation gains that might otherwise be lost because of lower world oil

prices. To the extent that taxes on oil reduce the demand for imported oil, foreign suppliers would absorb part of the tax through low world oil prices. To the extent that energy taxes reduce energy consumption, they would also reduce carbon dioxide emissions and could, therefore, contribute to efforts to reduce global warming.

One argument against energy taxes is that they are regressive because they would absorb a larger fraction of family incomes for low-income taxpayers, who spend a higher percentage of their income on energy than do high-income families. Regressiveness can be measured against annual expenditures, instead of income; using this measure, energy taxes appear almost proportional. Whichever measure is used, the regressiveness of energy taxes would be offset somewhat if the taxes caused an increase in the consumer price index that led to higher benefits from indexed transfer programs. It also could be offset by adjustments in income tax rates and by direct energy subsidies for low-income people.

Energy taxes have been opposed on several other grounds. They could have widely different effects in different parts of the country. For example, taxes that increase the relative price of fuel oil would have the greatest consumer impact in the Northeast, while taxes that increase the relative price of gasoline would have the greatest consumer impact in the West. (See Congressional Budget Office, *The Budgetary and Economic Effects of Oil Taxes*, April 1986.) Further, some observers argue that stockpiling oil is a better way of coping with the risks of increased dependence on imports because it would not artificially reduce current energy use by households and businesses. This argument is based on the premise that, aside from the problem of supply interruption, world energy prices accurately reflect real resource costs and thus already provide an appropriate incentive for energy conservation. Finally, direct taxes on carbon dioxide emissions may be a more efficient means of reducing global warming (see REV-33).

Excise Tax on Domestic and Imported Oil. An excise tax of \$5 per barrel on all crude oil and refined petroleum products--both domestically produced and imported--would raise revenues by about \$21 billion per year. It could increase the price of a gallon of gasoline or fuel oil by as much as 12 cents.

A tax on oil would increase the price that consumers must pay, giving them an incentive to use less oil either through conservation efforts or by switching to an alternative source of energy such as natural gas or coal. The tax would cause oil reserves to decline in value, and coal and gas reserves to increase in value. These shifts in value would discourage the exploration and production of oil and would encourage the production of coal and natural gas.

An oil tax, whether on all oil or only imported oil, would raise the costs for industries that use oil as the primary production input (for example, petrochemicals and paints). It would make it more difficult for domestic companies in these industries to compete with foreign companies that would pay less for oil.

Since 1981, the average cost of a barrel of oil has dropped from about \$35 to under \$20 in 1989. A \$5-per-barrel oil tax would partially offset this price reduction, thereby encouraging the conservation of oil and the development of alternative energy sources. The tax would still leave consumers paying significantly lower prices than nine years ago. It could, however, further depress the after-tax prices that suppliers of oil receive.

Oil Import Fee. As an alternative to an excise tax on all oil, the Congress could impose the tax only on imported crude oil and refined petroleum products. This type of tax was discussed during the deliberations over the budget resolutions for fiscal years 1986, 1987, and 1988. An oil import fee of \$5 per barrel would raise revenues by about \$9 billion per year.

An oil import fee would allow domestic suppliers to charge a higher price and still remain competitive with imports, providing an incentive to increase domestic production and a windfall to domestic oil producers. Like the tax on all oil, the fee would also maintain incentives for conservation by increasing energy prices. These effects would reduce U.S. dependence on foreign oil in the short term, although long-term dependence might be increased if U.S. oil supplies were depleted faster. Opponents of an oil import fee argue that the United States should take advantage of cheap foreign oil to preserve the more costly U.S. reserves for future use.

Because an oil import fee would reduce demand and prices for imported oil, some important U.S. trading partners might object to it (though others who are net energy importers would benefit from lower world energy prices). Exempting oil imports from such trading partners as Canada, Mexico, and the United Kingdom, however, would substantially reduce the fee's revenue potential. Imports from these countries now account for about 25 percent of U.S. oil imports.

An oil import fee would have different effects in different regions of the country. On net, it would benefit oil-producing states because producers would receive higher prices, but oil-consuming states--especially in the Northeast--would bear much of the burden of the tax and of the higher prices U.S. oil producers receive.

An oil import fee would cause expenditures for oil products to increase by about 15 percent, but only about 40 percent of this increase in expenditures would result in added federal revenues. The remainder would increase the incomes of domestic oil producers. Thus, the inflationary effect relative to the revenue collected would be higher for an oil import fee than for most other taxes on selected products.

Additional Motor Fuel Excise Taxes. Federal motor fuel taxes are currently 9.1 cents per gallon of gasoline and 15.1 cents per gallon of diesel fuel. The revenue from these taxes is earmarked for the federal Highway Trust Fund, which pays for construction and improvement of interstate highways, bridges, and mass transit facilities, and for the Leaking Underground Storage Tank Trust Fund, which funds cleanup of leaking petroleum storage tanks when no financially solvent owner can be found. State governments also impose gasoline and diesel taxes ranging from 7.5 cents to almost 21 cents per gallon. Compared with motor fuel tax rates in other countries, many of them well over \$1.00 a gallon, U. S. tax rates are still among the lowest in the world.

An additional 12-cent federal tax on motor fuels would raise revenues by about \$1 billion per year for each cent per gallon of tax. Because the average national price of all grades of gasoline has dropped from a peak of about \$1.39 per gallon in March 1981 to under \$1.15 in 1989 (a reduction of 40 percent in real terms), an additional tax of 12 cents per gallon would not put the total cost of gasoline above what consumers have already experienced. If the additional tax revenues were used to support additional spending from the Highway Trust

Fund that otherwise would not be made, they would not reduce the deficit. One way to ensure that the additional revenues were used for deficit reduction would be not to allocate them to the Highway Trust Fund.

The tax increase would reduce consumption of gasoline and diesel fuel by encouraging people to drive less or purchase more fuel-efficient cars and trucks. Some proponents of the tax view it as an appropriate charge for the costs of pollution and road congestion associated with automobile use. Another advantage of a motor fuel tax increase is that it would not have the same adverse effects on the international competitiveness of U.S. firms as other energy taxes. This advantage results from the fact that most gasoline and diesel fuel is used either by consumers or in the domestic transportation sector, not as an input in industrial production.

Opponents of a motor fuel tax rate increase argue that it would impose an unfair burden on the trucking industry and on people who commute long distances by car, who are not necessarily the highway users who impose the highest costs of pollution and congestion on others. These costs are much higher in densely populated areas, primarily in the Northeast, whereas per capita consumption of motor fuel is highest in sparsely populated states, mostly in the West.

A rate increase could lead to more tax evasion. Compliance with the motor fuel taxes is already a problem. It is particularly difficult to enforce the tax on diesel fuel because the same product can be sold as nontaxable home heating oil or as taxable diesel motor fuel. In addition, sales of motor fuels to some users are tax-exempt. However, recent legislation has reduced opportunities to evade the tax by changing the collection points to earlier stages of the production and distribution process.

Broad-Based Tax on All Energy. An alternative to selective excise taxes would be a broad-based tax on all forms of energy consumption. A national energy tax would heighten incentives for conservation and reduce consumption of all forms of energy. Further, because the tax would apply to all energy sources, it would raise much more revenue at a lower rate than selective taxes. The tax could be imposed as a fraction of the value of fuel, or could be based either on units produced (such as barrels of oil, tons of coal, or cubic feet of gas) or on the heat

content of the fuel measured in British thermal units (Btu). Unlike a Btu or per-unit tax, a tax on the retail value of energy would not change relative fuel prices and would not encourage consumers to switch from one form of energy to another. Tax evasion, however, would be a problem with such a tax because a very large number of retailers would be involved in its collection. If the tax were imposed at an earlier stage of the distribution process, tax evasion would be less of a problem, but the tax would then distort relative prices because different fuels have different markups at the retail level. These distortions, however, would be smaller than for taxes imposed on selected fuels. A 5 percent tax on the value of energy consumption, including coal, petroleum, natural gas, hydroelectricity, and nuclear power, would raise an average of \$16 billion per year in revenues.

Other options would be preferable to a broad-based energy tax if revenue was not the only objective. For example, if the objective was to decrease dependence on imported oil, an oil import fee might be preferred; if the objective was to encourage the use of nuclear energy to reduce global warming, a tax based on the carbon content of fuel might be preferred (see REV-33).

REV-30 INCREASE EXCISE TAXES

Addition to CBO Baseline	Annual Added Revenues (In billions of dollars)					Cumulative Five-Year Addition
	1991	1992	1993	1994	1995	
Raise Cigarette Tax to 32 Cents per Pack	2.8	2.8	2.8	2.7	2.7	13.8
Increase Taxes on Distilled Spirits, Beer, and Wine to \$0.25 per Ounce of Ethyl Alcohol	7.2	7.3	7.4	7.6	7.6	37.1
Index Current Cigar- ette and Alcohol Tax Rates for Inflation	0.3	0.5	0.9	1.3	1.6	4.6

NOTE: Estimates are net of reduced income and payroll tax revenues.

Federal alcohol and tobacco taxes raised over \$10 billion in 1989, including \$3.7 billion from the tax on distilled spirits, \$1.7 billion from the tax on beer, \$0.3 billion from taxes on wine, and \$4.4 billion from taxes on tobacco. Increases in current taxes on alcohol and tobacco would generate additional revenue.

Increasing taxes on alcohol and cigarettes would partially restore their real values, which have declined considerably with inflation. Although the Congress raised the tax on cigarettes from \$0.08 per pack to \$0.16 per pack in 1983, the tax had been \$0.08 per pack since 1951. Consequently, by 1982, the real tax rate on cigarettes was less than one-third of what it had been in 1951. Even with the 1983 increase, the real tax rate on cigarettes in 1989 was only about one-half of what it had been in 1951.

Since 1951, the tax on distilled spirits has been increased only once: from \$10.50 per proof gallon to \$12.50 per proof gallon on October 1, 1985. Taxes on beer and table wine have not changed since 1951, and the tax on champagne was increased to the current level in

1955. Consequently, the real tax rate on distilled spirits in 1989 was less than one-third of the rate in 1951, the real tax rates on beer and table wine were roughly one-fourth of the rates in 1951, and the real tax rate on champagne in 1989 was less than one-third of the rate in 1951.

Current federal excise taxes on beer and wine are much lower than federal excise taxes on distilled spirits in terms of tax per ounce of alcohol. While the tax on distilled spirits is \$12.50 per proof gallon, or \$0.20 per ounce of alcohol, the tax on beer is only \$9 per barrel, or roughly \$0.05 per ounce of alcohol, and the tax on table wine is only \$0.17 per gallon, or roughly \$0.01 per ounce of alcohol.

Smoking and drinking have social costs. To the extent that these costs are not reflected in market prices for cigarettes or alcoholic beverages, higher taxes might be a way to make smokers and drinkers bear more of the social costs of consumption. In addition, by pushing up prices, higher taxes might discourage consumption of cigarettes and alcoholic beverages. Equalizing the taxes on distilled spirits, beer, and wine at the same level per ounce of ethyl alcohol might be justified, if distilled spirits, beer, and wine impose the same external costs per ounce of alcohol consumed.

If higher taxes caused prices to exceed the costs that smokers and drinkers impose on society, however, the taxes would discriminate against smokers (roughly 30 percent of the adult population) and drinkers. Higher taxes would also discriminate against moderate and infrequent smokers and drinkers, if economic costs are chiefly attributable to excessive smoking and drinking. In addition, taxes on cigarettes and alcohol are regressive. Higher taxes would have a heavier impact on households with low incomes than on households with high incomes (see the Congressional Budget Office Staff Working Paper, "The Distributional Effects of an Increase in Selected Federal Excise Taxes," January 1987).

Increase the Cigarette Tax. Doubling the current federal excise tax on cigarettes from 16 cents per pack to 32 cents per pack on October 1, 1990, would increase net revenue by about \$14 billion from 1991 through 1995.

Increase Taxes on Alcoholic Beverages. Increasing the current federal excise taxes on distilled spirits, beer, and wine to \$16.00 per proof gallon effective October 1, 1990, would raise about \$37 billion from 1991 through 1995. A tax of \$16.00 per proof gallon would be roughly equivalent to a tax of \$0.25 cents per ounce of ethyl alcohol. Increasing the tax to \$16.00 per proof gallon would raise the tax on a 750-milliliter bottle of distilled spirits from about \$1.98 to \$2.54, the tax on a six-pack of beer from about \$0.16 to \$0.81, and the tax on a 750-milliliter bottle of table wine from about \$0.03 to \$0.70.

Index Cigarette and Alcohol Tax Rates for Inflation. Indexing current cigarette and alcohol tax rates to changes in the consumer price index after October 1, 1990, would raise about \$5 billion from 1991 through 1995. Indexing these taxes would prevent inflation-induced erosion of real tax rates and would avoid the need for abrupt increases in the future.

An alternative to indexing would be to convert the unit taxes to ad valorem taxes set as percentages of manufacturers' prices. This method would link tax revenues to price increases, although revenue would be tied to prices of taxed goods, not the general price level. A shortcoming of the ad valorem tax is that it might create an incentive for manufacturers to lower sales prices artificially to company-controlled wholesalers, in order to avoid part of the tax.

**REV-31 IMPOSE EXCISE TAXES ON
AIR POLLUTANTS**

Addition to CBO Baseline	Annual Added Revenues (In billions of dollars)					Cumulative Five-Year Addition
	1991	1992	1993	1994	1995	
Tax NO _x from Stationary Sources	1.4	2.1	2.1	2.1	2.1	9.8
Tax SO _x from Stationary Sources	1.8	2.6	2.6	2.6	2.6	12.2
Tax VOCs from Stationary Sources	7.0	10.1	10.1	10.1	10.1	47.5
Tax Emissions from Mobile Sources	1.9	2.8	2.8	2.8	2.8	13.0

NOTE: Estimates are net of reduced income and payroll tax revenues. The effective date for this proposal is January 1, 1991.

The imposition of excise taxes on air pollutants that form acid rain and ozone in the lower atmosphere could raise revenues and create incentives for additional abatement of pollution.

The pollutants believed to be primarily responsible for acid rain are sulfur oxides (SO_x) and nitrogen oxides (NO_x). Large industrial sources, notably coal-fired electric utilities, emit significant quantities of these pollutants. The resulting acid rain is thought to degrade surface waters and damage forests. Ozone pollution is produced when NO_x and volatile organic compounds (VOCs), which are emitted by industrial sources as well as by automobiles and trucks, combine in the presence of sunlight and other compounds. The resulting pollution has kept about 100 U.S. cities from attaining the current health-based ozone standard; other pollutants, such as carbon monoxide (CO), that are emitted by automobiles and trucks might also pose direct health hazards (see REV-29 and REV-33 for other taxes that might affect emissions of air pollutants).

Excise taxes on pollutants might have economic advantages over some alternative revenue sources. First, pollution taxes tend to discourage activities that impose costs on society, such as polluting, and may be preferred to taxes that adversely affect incentives to work and save. Second, to the extent that too little pollution abatement occurs under current regulations, a tax could increase the level of pollution control in an economically efficient manner. Pollution taxes set at or above the "marginal cost of pollution abatement"--that is, the cost to affected firms of eliminating an additional ton of pollutant--might encourage additional pollution abatement. In addition, pollution taxes redistribute the social costs of allowable discharges of pollutants given current control levels. Finally, the process of tax collection, and the observed responses of firms, would provide information that could be used to set future charges with more certainty about their effects on pollution levels.

Under current environmental control laws, firms that emit air pollutants must incur the costs needed to comply with regulations, but are not charged for allowable emissions. Taxing industry for these continuing emissions places an additional burden on producers of goods whose production or use emits air pollutants. Moreover, to the extent that pollution taxes eventually raised the price of consumer goods, including energy, they might be regressive--that is, they might constitute a higher share of the expenditures of low-income households than of households with higher incomes.

The marginal cost of pollution control varies, given the numerous industrial and other sources of SO_x , NO_x , and VOCs. The tax rates considered here can be interpreted as supplementing current regulatory controls. They are high enough to encourage some additional pollution control beyond that required by current regulations. Polluters with marginal pollution control costs lower than the taxes might be induced to take advantage of pollution control options not required by the Clean Air Act, thus reducing emissions of air pollutants below current levels in the least expensive way possible. While the taxes considered here are not indexed for inflation, increasing tax rates over time would prevent inflation from eroding either the abatement potential of the tax or the real value of revenues to the federal government.

Current proposals to reauthorize and strengthen the Clean Air Act address both the acid rain and the ozone problem. Enactment of these

proposals could weaken the rationale for pollution excise taxes, although substantial reductions in emissions of SO_x, NO_x, or VOCs would not be likely to occur during the first few years following the legislation. The revenue estimates presented here do not take into account the extent to which abatement resulting either from the charge or from subsequent legislation might reduce the revenue basis in the future. Similarly, except where specified, the estimates do not allow for changes in emissions that may occur over time because of industrial growth or as a result of compliance with current environmental legislation.

Tax SO_x and NO_x Emissions from Stationary Sources. Taxes of \$150 per ton of SO_x and \$250 per ton of NO_x emissions on electric utilities and large manufacturing plants would raise roughly \$12 billion for SO_x and \$10 billion for NO_x through 1995. The present monitoring and reporting system for stationary sources, operated by the Environmental Protection Agency and state regulators, could be adapted to support implementation of these taxes. The administrative burdens would be minimized if the taxes were based on the terms granted in air pollution permits.

Taxes of this magnitude could promote some additional pollution abatement. Some electric utilities and manufacturing plants might switch to lower-sulfur coals at less cost than paying the charge, while others might choose to operate their most heavily emitting plants less frequently. The charge would be too low, however, to encourage the installation of SO_x control devices. Methods currently available that can reduce NO_x emissions at roughly the same cost as paying the excise tax might be more widely adopted if the \$250 per ton tax was imposed.

Tax Emissions of VOCs from Stationary Sources. Stationary sources of VOCs range in size from huge industrial facilities, such as chemical plants, petroleum refineries, and coke ovens, to small sources such as bakeries and dry cleaners. Their vast number and diversity make it difficult to estimate emissions and costs of abatement. A tax of \$1,000 per ton on all stationary sources could elicit better information (since sources would be forced to compute or estimate tax liability), and might promote some abatement. This tax would generate revenues totaling \$48 billion from 1991 through 1995.

The advantage of a broad-based charge is that it captures small sources, which are estimated to be responsible for approximately 80 percent of all VOC emissions from stationary sources. Since small sources of VOCs are not currently subject to regulation, a broad-based VOC charge might be administratively more difficult to implement than a tax limited to large sources. Confining the tax to large stationary sources would reduce revenues to \$1.9 billion annually. Alternatively, the broad basis for the tax could be preserved if the tax on small sources was assessed on estimated emissions of the technologies used rather than on measured emissions.

Tax Emissions of NO_x, VOCs, and CO from Mobile Sources. A one-time charge imposed on new automobiles and light trucks, based on estimated pollution emissions rates and averaging \$250 per vehicle, could provide nearly \$13 billion in revenues from 1991 through 1995. The current "gas guzzler" excise tax is levied on new automobiles based on their fuel efficiency. Similarly, an emissions charge could be calculated on the emissions certification tests required under existing law for every new vehicle.

Legislation calling for more stringent tail-pipe emissions standards for automobiles and light trucks is being considered by the Congress. The cost of these stricter standards has been estimated to range from \$61 to \$139 per vehicle for new cars and light trucks. A tax on new automobiles and light trucks, based on grams emitted per mile and averaging \$250 per vehicle, could encourage the purchase and manufacture of low-polluting and more fuel-efficient vehicles. This emissions tax would complement Corporate Average Fuel Economy (CAFE) standards for new vehicles, which require automakers to sell models that, on average, attain specified fuel economy ratings. The revenue estimates presented here take into account projected growth in new car sales and assume that new cars meet current tail-pipe standards, on average. If new cars become cleaner over time, or if a slowdown in the economy reduces new car sales, revenues collected may be less than projected.

Since earlier-model vehicles account for more than 90 percent of light-duty vehicles in use, applying a grams-per-mile emissions charge to earlier-model vehicles could encourage owners of these vehicles to retire them sooner in favor of newer lower-emitting vehicles and so could reduce pollution levels. In addition, an emissions tax on earlier-

model vehicles might offset the incentive given owners by the excise tax on new vehicles to keep their older vehicles. Older vehicles have been excluded from the estimate above because of the administrative problems in collecting a tax on older vehicles, and the difficulty of determining how high the tax would have to be to encourage retirement of vehicles. Since relatively more older vehicles are owned by lower-income households, a tax on older vehicles might be regressive.

**REV-32 IMPOSE AN EXCISE TAX
 ON WATER POLLUTANTS**

	Annual Added Revenues (In billions of dollars)					Cumulative Five-Year Addition
	1991	1992	1993	1994	1995	
Addition to CBO Baseline	1.6	2.4	2.4	2.4	2.4	11.1

NOTE: Estimates are net of reduced income and payroll tax revenues. The effective date for this proposal is January 1, 1991.

Over 60,000 facilities discharge nearly 300 billion gallons of wastewater per day directly into lakes, rivers, estuaries, and oceans. Taxing pollutants contained in the wastewater could raise substantial amounts of additional revenue, while creating incentives for additional abatement.

One common indicator of water quality is biological oxygen demand (BOD). BOD measures the effect of pollutants that encourage algae growth, which in turn depletes oxygen necessary to sustain much aquatic life. About 17 million pounds of such pollutants are discharged per day. Nearly 13 million pounds are discharged by publicly owned treatment works (POTWs); most of the remainder is discharged by paper and pulp mills, food processors, metal producers, and chemical plants.

Excise taxes on pollution might have economic advantages over some alternative revenue sources. First, pollution taxes tend to discourage activities that impose costs on society, such as polluting, and may be preferred to taxes that adversely affect incentives to work and save. Second, to the extent that too little pollution abatement occurs under current regulations, an excise tax could increase the level of pollution control in an economically efficient manner. Pollution taxes set at or above the "marginal cost of pollution abatement"--that is, the cost to affected firms of eliminating an additional pound of pollutant--might encourage additional pollution abatement. In addition, pollution taxes redistribute the social costs of allowable emissions of pollut-

ants given current control levels. Finally, the process of tax collection, and the observed responses of firms, would provide information that could be used to set future charges with more certainty about their effects on pollution levels.

Under current environmental control laws, facilities that discharge water pollutants must incur the costs needed to comply with regulations, but are not charged for allowable discharges. Taxing dischargers for these continuing emissions places an additional burden on these facilities. Moreover, to the extent that pollution charges eventually raised the prices of consumer goods, including food, they might be regressive--that is, they might constitute a higher share of the expenditures of low-income households than of households with higher incomes.

The cost of controlling another pound of BOD at POTWs and many industries regulated under the Clean Water Act averages between \$0.40 and \$0.70 per pound removed. A charge on BOD discharges of \$0.50 per pound could encourage abatement at many manufacturing facilities and POTWs that face lower abatement costs. Assuming that the 17 million pounds per day of BOD discharges occur continuously throughout the year, a charge at this level would raise about \$11 billion through 1995. Revenues would be less, however, to the extent that the tax led to abatement measures. While the tax considered here is not indexed for inflation, increasing the tax rate over time would prevent inflation from eroding either the abatement potential of the charge or the real value of revenues to the federal government. Pollutants other than those measured by BOD might also be considered as the basis for a water pollution tax, such as measured chemical oxygen demand, suspended solids, and heavy metals. Since some wastewater treatment processes reduce several pollutants simultaneously, discouraging one pollutant might also encourage reductions in others.

To simplify the implementation of a BOD-based water pollution excise tax, the discharge levels that are specified in the permits issued to every source of water pollution by state or federal governments could be used as the basis for levying a BOD tax. Levying a tax on effluents from POTWs, as well as from large industrial dischargers, would include residential and smaller industrial uses in the charge system, so that all significant point sources of effluents would be taxed.

POTWs could recover costs by raising residential and commercial sewer bills and by increasing the fees charged to industrial sources that pipe wastewater to the facilities. Including POTWs in the charge system might be more politically acceptable if the revenues were placed in a revolving fund used to finance enhanced public investment in pollution control equipment. Alternatively, the tax might be levied only on industrial sources of water pollution, excluding POTWs; doing so would limit the number of collection points and significantly reduce the tax base. Restricting the charge to non-POTW sources of pollution would reduce the revenues collected to \$0.6 billion annually.

Currently, 39 states operate their own water pollution permitting programs under federal approval. Many of these states also collect revenues from fees based on the permits. These states might oppose a federal charge scheme if it was perceived as reducing their own fee revenues. Alternatively, the 39 states might argue that they should be able to keep a major portion of the revenues from a federal charge, thus reducing the charge's contribution to deficit reduction.

**REV-33 IMPOSE A CARBON-BASED EXCISE
TAX ON FOSSIL FUELS**

Addition to CBO Baseline	Annual Added Revenues (In billions of dollars)					Cumulative Five-Year Addition
	1991	1992	1993	1994	1995	
CO ₂ Stabiliza- tion Tax	22.5	33.2	34.3	35.7	37.2	162.9
CO ₂ Reduc- tion Tax	9.1	22.8	37.4	52.6	68.6	190.5

NOTE: Estimates are net of reduced income and payroll tax revenues. The effective date for this proposal is January 1, 1991.

Recent scientific evidence on the potential for global warming through the "greenhouse effect" has prompted concern about the level of fossil fuel use. The greenhouse effect results from the tendency of trace gases to trap excess solar heat in the atmosphere and thus affect the earth's climate. The most abundant trace gas is carbon dioxide (CO₂), which is produced when fossil fuels are burned. An excise tax proportional to the carbon content of coal, oil, and natural gas could generate substantial revenues, promote energy conservation, and stabilize or reduce domestic CO₂ emissions.

Imposing a carbon-based tax at the points where fossil fuels enter the economy--mine-mouth, wellhead, or dockside (for imports)--could discourage fossil fuel use and reduce subsequent carbon dioxide emissions. The tax rate on fossil fuels could be designed either to discourage future increases in CO₂ emissions or to reduce emissions from current levels by some target date. The relative carbon contents of coal, oil, and natural gas would dictate the specific tax rate for each fuel. Since each fuel emits different amounts of CO₂ per unit of useful energy obtained, the tax would not only discourage fossil fuel use, but would discourage using higher-emitting fuels more than lower-emitting fuels. The revenue estimates presented here take into account both the projected growth in fossil fuel use in the absence of a tax, and estimated emissions reductions in response to the tax. Under both options, the tax rate would be indexed for inflation. If the tax rate

was not adjusted over time for inflation, the abatement incentive provided by both these options, or the revenues raised, could be less than projected.

A "CO₂ stabilization" tax of approximately \$28 (in 1991 dollars) per ton of carbon content of the three fossil fuels could nearly eliminate the projected growth in carbon dioxide emissions over the next 10 years. This tax rate is equivalent to a tax of approximately \$17.00 per ton of coal, \$3.60 for each barrel of oil, and about \$0.45 per thousand cubic feet of natural gas (in 1991 dollars, based on average carbon content). In terms of current prices of fossil fuels, the tax equals about 40 percent of the delivered price of coal, and about 10 percent of the prices of refined petroleum and natural gas. Such a tax would raise \$163 billion in additional revenue during the 1991-1995 period.

More ambitious emission targets--such as those considered in some proposed federal legislation--would require higher tax rates. A "CO₂ reduction" tax equal to \$113 (in 1991 dollars) per ton of carbon content of fossil fuels could reduce emissions from current levels by about 10 percent to 20 percent by the year 2000. The potential economic impact of such a high tax rate might warrant phasing it in over time. Phasing in this tax over 10 years could raise \$190 billion in revenues through 1995 (by which time the tax rate would be approximately \$66, in 1991 dollars). This option could reduce CO₂ emissions in the year 2000 to about 7 percent below current levels.

Critics of CO₂ reduction policy contend that the scientific evidence concerning the potential adverse effects of atmospheric CO₂ may not yet warrant immediate efforts to reduce U.S. fossil energy use. Moreover, U.S. action might not significantly reduce global CO₂ concentrations, if other countries did not make similar efforts. In addition, adjusting to lower energy use would be costly, especially in the energy extraction and processing industries and in energy-intensive manufacturing sectors. To the extent that taxes on the carbon content of fossil fuels are similar to other energy taxes, the costs of such taxes might fall disproportionately on lower-income households or on some geo-

graphical regions (see REV-29). Finally, there may be alternative means of slowing global warming, including controls on other greenhouse gases, efforts to slow deforestation, and development of new technologies for improving energy efficiency and using alternative energy sources.

**REV-34 IMPOSE A TAX ON AGRICULTURAL
CHEMICALS**

	Annual Added Revenues (In billions of dollars)					Cumulative Five-Year Addition
	1991	1992	1993	1994	1995	
Addition to CBO Baseline	0	0.9	0.9	0.9	0.9	3.6

NOTE: Estimates are net of reduced income and payroll tax revenues.

Agricultural chemicals are now seen as creating significant environmental hazards, particularly as nonpoint sources of surface and groundwater pollution. Also, concerns about chemical residues on food have increased in recent years. One means of addressing these concerns would be to tax the use of agricultural chemicals--for example, by imposing a 10 percent tax on sales of agricultural pesticides and fertilizers. Such a tax would raise about \$4 billion in additional revenues in 1991 through 1995.

A reduced use of agricultural chemicals would, in the absence of other policy changes, cause production to fall and prices to increase, particularly of those commodities having the most intensive use of chemicals. To offset these effects, the Secretary of Agriculture would probably reduce the number of acres farmers must take out of production to participate in federal commodity programs. In that case, the prices of commodities covered by federal programs (wheat, feed grains, cotton, and rice) would not be substantially affected by the tax. This secretarial change could increase costs in the commodity programs. Prices of crops that do not have federal programs could increase somewhat in response to the tax, but the availability of imports would limit such price increases.

A tax of 10 percent would have relatively little effect on farmers' costs, since agricultural chemicals account on average for slightly less than 10 percent of the variable costs of production. Farm income would be expected to decline modestly, while the prices paid by consumers would not be greatly affected.

Taxation of agricultural chemicals could be expected to reduce both their use and the environmental damage with which they are associated. To the extent that chemical residues on food are directly related to the application of chemicals, the presumptive health hazard should also decline. Federal budget savings and the environmental benefits of the tax would be partially negated if, as assumed, the Secretary of Agriculture relaxed acreage restrictions. Putting more acreage into production would mean that the lower application rates resulting from the tax would be partially offset by use of chemicals on more acres.

To the extent that the tax tended to reduce the incomes of farmers and agricultural chemical manufacturers, it would be at least partially offset by the probable increase in acres planted. The tax could also reduce the competitiveness of U.S. agricultural products in world markets. Its domestic impact would be greatest in the production of crops that use extensive amounts of chemicals and in regions of the United States that especially depend on chemicals for controlling pests.

Levying a flat 10 percent tax on all agricultural chemicals would implicitly assume that all chemicals have equally adverse impacts on the environment. There are reasons to suspect that this is not the case. Chemicals that have been introduced since 1972 have had to go through a more rigorous registration with the Environmental Protection Agency, which requires that manufacturers submit data on the toxicity and environmental risks associated with use of the chemical. Older chemicals have not been subjected to the same scrutiny and might be expected, therefore, to have more negative environmental consequences. Ideally, it might be preferable to tax chemicals on the basis of their impact on the environment. Given the large number of chemicals involved, however, and the limited amount of information regarding their environmental consequences, the design of such a tax would be complex and its administration burdensome. One partial solution would be to tax chemicals that have been registered since 1972 at a lower rate than those in use earlier that have not been re-registered.

**REV-35 INCREASE AVIATION-RELATED
EXCISE TAXES**

Addition to CBO Baseline	Annual Added Revenues (In billions of dollars)					Cumulative Five-Year Addition
	1991	1992	1993	1994	1995	
Repeal the Automatic Tax Rate Reduction	0.9	1.6	1.7	1.8	2.0	7.9
Increase Taxes to Cover Costs Imposed by Aviation Users	1.8	3.1	3.3	3.6	3.9	15.6

NOTE: Estimates are net of reduced income and payroll tax revenues.

Expenditures from the Airport and Airway Trust Fund support airport and airway expansion and improvements as well as a portion of Federal Aviation Administration (FAA) operating expenses. These expenditures are financed by an 8 percent tax on domestic airline tickets, a 5 percent tax on air freight shipping costs, a \$6.00 departure tax for passengers flying to a foreign country, and a tax on general aviation fuel (14 cents per gallon on jet fuel and 12 cents per gallon on gasoline).

The Airport and Airway Safety and Capacity Expansion Act of 1987 reauthorized these taxes at current rates through December 31, 1989. The act also authorized taxes for 1990, but tied the tax rates to 1988 and 1989 trust fund obligations, appropriations, and authorizations. Under the act, tax rates would have been reduced by half in calendar year 1990 if the sum of obligations for airport grants in fiscal years 1988 and 1989, and appropriations for facilities and equipment, and research, engineering, and development in fiscal years 1988 and 1989 amounted to less than 85 percent of the total authorizations for those programs in these years. The Congress delayed the possible rate reduction by one year, however, under the Omnibus Budget Reconciliation Act of 1989. The test now applies to obligations, appropriations,

and authorizations in fiscal years 1989 and 1990, rather than in fiscal years 1988 and 1989.

Actual appropriations to date, and actual and projected obligations for airport and airway programs in 1989 and 1990, are estimated to be less than 85 percent of the total authorizations for those programs in 1989 and 1990. If the provisions of the 1987 act, as amended in 1989, were applied, aviation-related excise tax rates would drop by 50 percent beginning January 1, 1991. (The international departure tax rate would remain at \$6.00.) Although the taxes are scheduled to expire under current law after December 31, 1990, the CBO baseline includes aviation-related taxes at their current rates for calendar year 1990 and at the reduced rates beginning January 1, 1991. Repealing the automatic tax rate reduction and extending these taxes at current rates would reduce the deficit by about \$8 billion in 1991 through 1995.

The Congress enacted this automatic tax rate reduction to keep the trust fund's surplus from growing. The current \$6.9 billion surplus indicates that trust fund spending for aviation has not kept pace with trust fund receipts. Federal government expenditures for aviation, however, are actually much larger than the amounts currently financed from the trust fund. These expenditures include payments for the costs of FAA operations, such as the air traffic control system, that are currently financed primarily by general revenues. Some argue that all the costs imposed by users of the airport and airway system should be financed by aviation-related taxes, implying that current aviation tax rates are too low and should be increased to offset funding from general revenues. (For a detailed analysis of the trust fund, see Congressional Budget Office, *The Status of the Airport and Airway Trust Fund*, December 1988.)

Nongovernmental use of the airport and airway system accounts for about 85 percent of the costs of building, operating, and maintaining the system, according to a Department of Transportation study made in 1986. General taxpayers currently subsidize nongovernmental airway users and are expected to do so in the future; tax revenues deposited into the trust fund are expected to average only 60 percent of FAA spending authority even at current tax rates over the five-year period 1991 through 1995. Therefore, tax revenues would have to increase by 42 percent above projected collections at full rates to cover nongovernmental use of the airway system. Raising taxes by

this percentage would increase aviation-related taxes by \$20.8 billion and reduce the deficit by nearly \$16 billion over the period 1991 through 1995. Under this option, the ticket tax rate would increase to about 12 percent, the freight tax would increase to about 7.5 percent, and the fuel taxes would increase to about 18 cents per gallon on gasoline and about 20 cents per gallon on jet fuel effective January 1, 1991. (The international departure tax would remain at \$6.00 under this option because it was doubled effective January 1, 1990, in the Omnibus Budget Reconciliation Act of 1989.)

Either repealing the automatic tax rate reduction or increasing taxes to cover costs imposed by private-sector airway users would require users to pay a larger portion of the costs they impose on the airway system. Repealing the automatic rate reduction would prevent private-sector airway users from bearing an even smaller share of the total costs of the airway system; increasing taxes to cover all FAA costs imposed by private-sector airway users would raise the portion of total costs borne by users to equal their share of system costs. Neither option, however, would match the costs imposed by different groups of users with the taxes they pay. For this reason, it might be preferable to raise additional revenues in a way that distributed the burden of taxes among user groups in relation to the full costs they imposed on the system--for example, through fees for takeoff and landing slots (see NDD-24).

An argument against raising taxes on private-sector aviation users is that the aviation system is a public good providing benefits to many people who do not use the system directly, and therefore direct users of the system should not pay all of the private costs of operating and maintaining the system. Users of the aviation system, however, also benefit from other federal programs such as the National Transportation Safety Board and the National Aeronautics and Space Administration. If aviation-related spending in these programs was added to total FAA spending, revenue from aviation-related taxes under these options would still be lower than total federal spending for all aviation-related programs.

**REV-36 REPLACE IMPORT RESTRICTIONS ON SUGAR,
DAIRY PRODUCTS, PEANUTS, AND BEEF WITH
TARIFFS THAT DECLINE OVER TIME**

Addition to CBO Baseline	Annual Added Revenues (In billions of dollars)					Cumulative Five-Year Addition
	1991	1992	1993	1994	1995	
Sugar Tariff	0	0.1	0.2	0.1	0.1	0.6
Dairy Tariff	0	a	a	a	a	0.1
Peanut Tariff	0	a	a	a	a	a
Beef Tariff	0	0.1	0.1	a	a	0.2
Total	0	0.2	0.3	0.2	0.2	0.9

NOTE: Estimates are net of reduced income and payroll tax revenues.

a. Less than \$50 million.

Import quotas or agreements to restrict imports are used to increase the domestic prices of sugar, dairy products, peanuts, and beef. Economic returns resulting from these trade barriers are captured by foreign governments and producers, since the quotas allow them to realize higher prices for their products. In this respect, the effect of the quotas is similar to that of a cartel extracting rents from U.S. consumers. Replacing existing trade barriers on these agricultural products with tariffs would allow the U.S. government to capture all or part of these economic returns.

In this option, the initial tariff level for each of the four agricultural commodities would be set equal to the projected difference between domestic and international prices in January 1991. The 1991 tariff levels would be roughly 10 cents per pound for sugar, 27 cents per pound for dairy products, 7 cents per pound for beef, and 15 cents per pound for peanuts. A tariff set at this level would have roughly the same effect on imports and domestic prices as the current quotas and import restrictions.

If these initial tariff levels were left in place, revenues of about \$1.4 billion would be generated in 1991 through 1995. This option assumes, however, that tariff levels would decline by 10 percent annually in future years. This assumption conforms to the U.S. position advanced in the portion of the ongoing General Agreement on Tariffs and Trade (GATT) negotiations dealing with agriculture. With declining tariffs, \$860 million in revenues would be generated.

Reducing tariffs over time would require changes in the domestic support programs for these four crops. If, for example, the initial sugar tariff was set at 10 cents per pound (the U.S. support price is projected to be 21.8 cents per pound, and the world price 11.7 cents per pound) and fell by 1 cent per pound each year thereafter, the support price for sugar would also have to fall by 1 cent per pound annually in order to ensure that the sugar program continued to have no budgetary cost as required by law. If the domestic support price did not decline, the government could end up acquiring virtually the entire sugar crop, since U.S. producers could either sell their crop at the market price or forfeit it to the government and receive the higher support price. This analysis assumes that Department of Agriculture (USDA) programs would be modified in response to the imposition of tariffs so that USDA outlays would be unchanged.

The United States recently introduced a trade reform proposal in the GATT calling for conversion of quotas and other nontariff trade barriers to tariffs. The tariffs suggested in this analysis would be consistent with the spirit of the U.S. proposal (though differing from the structure proposed by U.S. negotiators). Substituting declining tariffs for quotas and nontariff barriers would make the cost of protection more evident. Moreover, this option would facilitate an orderly transition from relatively high import protection to a greater degree of market orientation. Consumers would benefit from lower prices.

One disadvantage of the proposal is that incomes of U.S. farmers who grow protected crops and their substitutes would fall as the tariffs declined. Incomes in sugar and other affected crops are now supported by higher consumer prices than would prevail without the import barriers, and reducing the tariffs would reduce the level of income support. Direct government payments could substitute for lost benefits, but higher federal outlays would result if farmers' losses were fully compensated.

A second disadvantage of replacing quotas with tariffs is that they would eliminate the use of sugar quotas as a foreign policy tool. Substituting tariffs for quotas would deprive policymakers of both the stick (loss of the quota) and the carrot (the opportunity to increase the quota for favored nations). Finally, declining tariffs would require significant changes in domestic farm programs. Not only would the programs for these crops have to be modified, but those for crops that are substitutes would have to be changed as well. For example, high-fructose corn syrup is an important substitute for sugar. As the domestic price of sugar fell with a declining tariff, corn syrup would probably be priced out of the market, resulting in lower prices for corn and probable changes in the corn program.

APPENDIX

SPENDING AND TAXATION OPTIONS

BY BUDGET FUNCTION

050 National Defense

DEF-01	Cancel the B-2 Bomber	40
DEF-02	Cancel the C-17 Aircraft	43
DEF-03	Cancel the Binary Munitions Program	45
DEF-04	Cancel the Tacit Rainbow Missile Program	47
DEF-05	Limit Production of the Trident Submarine to One Every Other Year	49
DEF-06	Slow Procurement of F-16 Aircraft	51
DEF-07	Slow Procurement of DDG-51 Guided- Missile Destroyers	53
DEF-08	Reduce Procurement of SSN-21 Seawolf Submarines	55
DEF-09	Reduce the Goal for Amphibious Lift	57
DEF-10	Restructure the Army's Forward Area Air Defense Program	59
DEF-11	Delay New Program Starts One Year	61
DEF-12	Limit Funding for Supporting Procurement	63
DEF-13	Reduce Spending for the Strategic Defense Initiative	65
DEF-14	Cancel the National Aerospace Plane	68
DEF-15	Limit Payments for Independent R&D	71
DEF-16	Reduce Funding for Operation and Maintenance	74
DEF-17	Reduce Funding for School Training	76
DEF-18	Reduce the DoD Civilian Acquisition Work Force	78
DEF-19	Close or Realign Selected Military Bases	80
DEF-20	Retire the Navy's Four Battleships	82
DEF-21	Transfer the 401st Air Force Tactical Fighter Wing to the Reserves	84
DEF-22	Reduce the Number of Active-Duty Military Personnel	86

DEF-23	Eliminate Naval Reserve Augmentation Units	90
DEF-24	Reduce Drills for Noncombat Reserve Units	92
DEF-25	Change Compensation for the Selected Reserve ...	94
DEF-26	Restrict Reserve Retirement Benefits	98
DEF-27	Increase Cost-Sharing for Military Health Care	101
DEF-28	Limit Military Pay Raise	103

See also:

NDD-46	Modify the Davis-Bacon Act by Allowing Unrestricted Use of Helpers and Raising the Contract Threshold	319
NDD-47	Modify the Service Contract Act by Eliminating the Successorship Provision	321
FWF-01	Limit Pay Adjustments for Federal Civilian Employees	325
FWF-02	Reduce Federal Employee Retirement Benefits	328
FWF-03	Restrict Cost-of-Living Adjustments for Federal Retirees Under Age 62	334
FWF-05	Modify the Way Hospitals Are Paid Under the Federal Employees Health Benefits Program	341

150 International Affairs

NDD-01	Eliminate the PL-480 Title I Food Aid Program	215
NDD-02	Eliminate the Export-Import Bank	217
REV-36	Replace Import Restrictions on Sugar, Dairy Products, Peanuts, and Beef with Tariffs That Decline Over Time	448

250 General Science, Space Technology

NDD-03	Cancel the NASA International Space Station Program	219
NDD-04	Postpone New Spacecraft Development Projects in One of the Major NASA Program Areas for Space Science and Applications	222
NDD-05	Cancel NASA Research and Technology Programs for the Moon/Mars Initiative	224
NDD-06	Suspend Construction of the Superconducting Super Collider for Two Years	226

270 Energy

NDD-07	Reduce Subsidies Provided by the Rural Electrification Administration	228
NDD-08	Reform Debt Repayment Policy for Power Marketing Administrations	231
NDD-09	Eliminate Further Funding for the Clean Coal Technology Program	233
REV-23	Repeal Tax Preferences for Extractive Industries	407
REV-29	Increase Energy Taxes	423

300 Natural Resources and Environment

NDD-10	Change Revenue-Sharing Formula from a Gross to a Net Receipt Basis for Commercial Activities on Federal Lands	235
NDD-11	Improve Pricing for Commercial and Recreational Uses of Public Lands	237
NDD-12	Increase the Harbor Maintenance Tax	244
NDD-13	Eliminate Federal Grants for Construction of Wastewater Treatment Plants	245
REV-31	Impose Excise Taxes on Air Pollutants	432
REV-32	Impose an Excise Tax on Water Pollutants	437
REV-33	Impose a Carbon-Based Excise Tax on Fossil Fuels	440

REV-34	Impose a Tax on Agricultural Chemicals	443
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350 Agriculture

AGR-01	Reduce Deficiency Payments to Farmers Participating in USDA Commodity Programs by Lowering Target Prices	183
AGR-02	Charge an Insurance Premium for the Income Protection Offered by Target Prices	186
AGR-03	Replace Deficiency Payments in the Wheat, Feed Grains, Cotton, and Rice Programs with Declining Direct Payments	188
AGR-04	Raise Domestic Commodity Prices by Increasing Unpaid Acreage Reduction Programs	190
AGR-05	Establish an Origination Fee of 3 Percent for Nonrecourse Loans from the Commodity Credit Corporation	192
AGR-06	Restrict Eligibility for Benefits from Price Support Programs and Reduce the Payment Limitation	194
AGR-07	Adopt the Triple Base Option to Reduce the Portion of Each Farmer's Land Eligible for Deficiency Payments	196
AGR-08	Adopt the Production Entitlement Guarantee (PEG) Option to Reduce the Portion of Each Farmer's Production That Is Eligible for Government Payments	198
AGR-09	Reduce Deficiency Payments to Farmers Participating in Commodity Programs by Reducing the Crop Yields Used to Calculate Program Payments	200
AGR-10	Eliminate the Export Enhancement Program ...	202
AGR-11	Eliminate the Targeted Export Assistance Program	204
AGR-12	Cut Program Costs for Dairy Price Supports by Requiring Producer Contributions	206
AGR-13	Reduce the Direct Lending Authority of the Farmers Home Administration for Farm Ownership and Operating Loans	208

AGR-14	Reduce the Federal Subsidy for Crop Insurance by Requiring Participants in Commodity Programs to Purchase Coverage	210
NDD-14	Reduce Federal Support for Agricultural Research and Extension Activities	247
REV-34	Impose a Tax on Agricultural Chemicals	443
REV-36	Replace Import Restrictions on Sugar, Dairy Products, Peanuts, and Beef with Tariffs That Decline Over Time	448
 <u>370 Commerce and Housing Credit</u>		
NDD-15	Include Foreign Deposits of U.S. Banks in the FDIC Insurance Base	249
NDD-16	Discontinue Postal Subsidies for Not-for-Profit Organizations	251
NDD-17	Scale Back the Rural Housing Loan Program	253
NDD-18	Scale Back the Rural Rental Housing Assistance Program	256
NDD-19	End SBA Loans and Loan Guarantees	258
NDD-20	Improve Pricing of Licenses to Use the Electromagnetic Spectrum	260
NDD-21	Impose a Royalty Payment on Communications Users of the Electromagnetic Spectrum	263
REV-03	Increase the Alternative Minimum Tax Rate	354
REV-04	Limit Mortgage Interest Deductions	357
REV-05	Tax Capital Gains from Home Sales	360
REV-08	Tax Capital Gains Held Until Death	368
REV-14	Amortize a Portion of Advertising Costs	386
REV-15	Impose a 0.5 Percent Tax on the Transfer of Securities	388
REV-22	Tax Credit Unions Like Other Thrift Institutions	405
REV-24	Further Restrict Deductions for Business Meals and Entertainment	410
REV-25	Eliminate Private-Purpose Tax-Exempt Bonds	411

REV-30 Increase Excise Taxes 429

See also:

**FWF-04 Prefund the Government's Share of Federal
Retirees' Health Insurance Costs 337**

400 Transportation

NDD-22 Reduce Federal Aid for Mass Transit 266

NDD-23 End Support for Aviation Development 268

**NDD-24 Establish Charges for Airport Takeoff
and Landing Slots 271**

**NDD-25 Impose User Fees on the Inland
Waterway System 273**

**NDD-26 Establish User Fees for Certain Coast
Guard Services 275**

**NDD-27 Reduce New Spending Authority for Highways
to the Level of Highway Tax Collections 277**

REV-35 Increase Aviation-Related Excise Taxes 445

450 Community and Regional Development

**NDD-28 End Funding of the Economic Development
Administration 279**

**NDD-29 Eliminate or Restrict Community
Development Block Grants 281**

**REV-21 Reduce Tax Credits for Rehabilitation
of Older Buildings 403**

**REV-25 Eliminate Private-Purpose Tax-Exempt
Bonds 411**

500 Education, Training, Employment, and Social Services

ENT-01 Reduce Subsidies for Stafford Loans 109

ENT-02	Require Postsecondary Institutions to Share the Financial Risk of Defaults on Stafford Loans	112
ENT-03	Eliminate or Reduce Federal Funding of the Social Services Block Grant Program	115
ENT-21	End or Scale Back Trade Adjustment Assistance	155
NDD-30	Reduce Untargeted Funding for Elementary and Secondary Education	284
NDD-31	Eliminate or Reduce Funding for Impact Aid to School Districts	286
NDD-32	Eliminate Federal Funding for Campus-Based Student Aid	289
NDD-33	Reduce Pell Grant Funding and Increase Targeting	291
NDD-34	Eliminate or Reduce Funding for the Arts and Humanities	293
REV-10	Phase Out the Dependent-Care Credit	376
REV-12	Tax Nonretirement Fringe Benefits	380

550 Health

ENT-04	Eliminate Federal Matching in Medicaid for Medicare's Premiums	117
ENT-17	Tax Employer-Paid Health Insurance	144
ENT-18	Increase the States' Share of Costs for AFDC, Medicaid, and Food Stamp Benefits	147
ENT-19	Reduce the Matching Rate for Administrative Costs in AFDC, Medicaid, and Food Stamps ...	150
NDD-35	Reduce Funding for Research Supported by the National Institutes of Health	295
NDD-36	Reduce the Maternal and Child Health Care Block Grant and the Preventive Health Services Block Grant	296
NDD-37	Eliminate Subsidies for Health Professions Education	298

FWF-04	Prefund the Government's Share of Federal Retirees' Health Insurance Costs	337
FWF-05	Modify the Way Hospitals Are Paid Under the Federal Employees Health Benefits Program	341
REV-12	Tax Nonretirement Fringe Benefits	380
REV-25	Eliminate Private-Purpose Tax-Exempt Bonds	411

570 Medicare

ENT-05	Reduce Medicare's Payments to Physicians for All Overvalued Services	119
ENT-06	Rebase PPS Payments to Hospitals Under Medicare	121
ENT-07	Eliminate the Disproportionate Share Adjustment in Medicare's Prospective Payment System ...	123
ENT-08	Reduce Medicare's Payments for the Indirect Costs of Patient Care That Are Related to Hospitals' Teaching Programs	125
ENT-09	Reduce Medicare's Direct Payments for Medical Education	127
ENT-10	Reduce Reimbursements for Capital Expenditures Under Medicare	129
ENT-11	Continue Medicare's Transition to Prospective Rates for Facility Costs in Hospitals' Outpatient Departments	132
ENT-12	Tax a Portion of the Insurance Value of Medicare Benefits	134
ENT-13	Increase the Premium for Physicians' Services Under Medicare	136
ENT-14	Increase Medicare's Deductible for Physicians' Services	138
ENT-15	Collect 20 Percent Coinsurance on Clinical Laboratory Services Under Medicare	140
ENT-16	Collect 20 Percent Coinsurance on All Home Health and Skilled Nursing Facility Services Under Medicare	142

REV-17	Expand Medicare and Social Security Coverage	394
REV-19	Repeal the Medicare Taxable Maximum	399

600 Income Security

ENT-18	Increase the States' Share of Costs for AFDC, Medicaid, and Food Stamp Benefits	147
ENT-19	Reduce the Matching Rate for Administrative Costs in AFDC, Medicaid, and Food Stamps ...	150
ENT-20	Require a Two-Week Waiting Period for Unemployment Insurance Benefits	153
ENT-21	End or Scale Back Trade Adjustment Assistance	155
ENT-22	Reduce the Subsidy in Child Nutrition Programs for Children from Higher-Income Families	157
ENT-23	Eliminate the \$50 Child-Support Payment to AFDC Families	159
ENT-24	Reduce the Federal Matching Rate for Child-Support Enforcement Costs	161
NDD-18	Scale Back the Rural Rental Housing Assistance Program	256
NDD-38	Modify the Fee Structure for Local and State Agencies That Administer Federal Housing Programs	300
NDD-39	Shift Housing Assistance from New Construction to Vouchers	302
NDD-40	Reduce Federal Rental Subsidies by Shifting Some Costs to the States or Tenants	305
NDD-41	Retain the Current Number of Housing Assistance Commitments	307
NDD-42	Eliminate or Scale Back Low-Income Home Energy Assistance	310
FWF-02	Reduce Federal Employee Retirement Benefits	328
FWF-03	Restrict Cost-of-Living Adjustments for Federal Retirees Under Age 62	334

REV-06	Decrease Limits on Contributions to Qualified Pension and Profit-Sharing Plans	363
REV-07	Impose a 5 Percent Tax on Investment Income of Pensions and IRAs	366
REV-11	Tax the Income-Replacement Portion of Workers' Compensation and Black Lung Benefits	378
REV-18	Include ESOP Cash Dividends in the Social Security Tax Base	397
REV-20	Index the Unemployment Insurance Taxable Wage Base	401

650 Social Security

ENT-25	Restrict Cost-of-Living Adjustments in Non-Means-Tested Benefit Programs	163
ENT-26	Reduce the Replacement Rate Within Each Bracket of the Social Security Benefit Formula	169
ENT-27	Eliminate Social Security Benefits for Children of Retirees Ages 62-64	171
ENT-28	Lengthen the Social Security Benefit Computation Period by Three Years	172
REV-16	Increase Taxation of Social Security and Railroad Retirement Benefits	390
REV-17	Expand Medicare and Social Security Coverage	394

700 Veterans Benefits and Services

ENT-29	Restrict Eligibility for Veterans' Compensation Payments	174
ENT-30	Raise the Loan Fee for Housing Loans Guaranteed by the Department of Veterans Affairs	177
NDD-43	Close or Convert Inefficient or Underused Facilities in Veterans' Hospitals	312

NDD-44	Promote More Efficient Management and Delivery of Health Care for Veterans	314
--------	---	-----

750 Administration of Justice

NDD-45	End Funding for the Legal Services Corporation	317
--------	---	-----

850 General Purpose Fiscal Assistance

REV-13	Repeal the Possessions Tax Credit	384
REV-26	Eliminate or Restrict Deductibility of State and Local Taxes	414

INDEX

The single numbers shown below indicate the page on which the relevant option begins. Inclusive page numbers indicate that the subject is covered in more than one sequential option, or on more than one page in Chapter I.

Agriculture

Crop insurance	210
Direct loan programs	208
Income support programs	183-191, 194-201
Price support programs	190-197, 202-207
Research	247
Taxes	443, 448
Water sales	237

Aid to Families with Dependent

Children	13, 15, 147-152, 159-162
----------------	--------------------------

Aircraft

Bombers	40
Cargo	43
Fighters	51
National Aerospace Plane	68

Air Force

Operation and maintenance	74-81
Personnel	84-89
Procurement	40-48, 51, 61-64

Airports	268-272, 411, 445
----------------	-------------------

Air Traffic Control	268-272, 445
---------------------------	--------------

Alcoholic Beverages	429
---------------------------	-----

Annuitant Health Care

See Federal Retirees

Army

Operation and maintenance	74-81
Personnel	86
Procurement	45, 59-64

Arts and Humanities	293
---------------------------	-----

Banks	217, 249
Base Closures	80
Baseline Budget Projections	1-23
Battleships	82
Biomedical Research	295
Black Lung	378
Block Grants	115, 281, 296, 310
Budget Freeze	28-31
Business Income Taxes	
Rates	347, 354, 421
Tax deductions	386, 410
Tax preferences	354, 403, 407
Business Meals and Entertainment	410
Business Receipts Taxes	421
Capital Gains	347, 360, 368
Chemical Taxes	443
Chemical Weapons	45
Child and Dependent Care	376, 380
Child Nutrition	157
Child Support	159-162
Cigarettes	429
Civil Service Retirement	163, 328-336
Clinical Laboratories	140
Coast Guard	275
Commodity Credit Corporation	183-207, 210
Community Development	279-283, 403, 411
Consumption Taxes	417
Conventional Programs	
Aircraft	43, 51
Ships	53-58
Vehicles	59
Corporate Income Tax	
See Business Income Taxes	
Cost-of-Living Adjustments	163, 328-336
Credit Programs	
Administration	228-232
Debt repayment	231
Direct lending	208, 217, 253-257, 279, 302, 307
Disaster	210, 258
Loan guarantees	109-114, 177, 208, 228, 258, 279
Loan origination fees	109-114, 177, 192

Minority	258
Small Business	258
Credit Unions	405
Davis-Bacon Act	319
Disability	163-170, 174
Economic Development	279-283
Economic Forecast	1-3
Economic Projections	2-3
Education	
Elementary and secondary	284-288
Medical	125-128, 298
Postsecondary	109-114, 289-292, 298
Energy	
Assistance	310
Electric systems	228
Marketing	231
Research	226, 233
Taxes	423, 440
Environment	222, 233, 237, 245, 423, 432-444
Estate Taxes	373
Excise Taxes	22-23, 388, 417, 423-447
Exports	215-218
Export-Import Bank	217
Farmers Home Administration	208, 253-257
Federal Aviation Administration	268-272
Federal Civilian Employees	
Health benefits	337-343
Pay adjustments	325
Retirement benefits	163, 328-336
Thrift Savings Plan	328
Work-force size	78
Federal Communications Commission	260-265
Federal Deficit	1-5
Federal Deposit Insurance Corporation	249
Federal Retirees	163, 328-340
Food Stamps	147-152
Foreign Aid	215
Forest Service	235-243
Formula-type Budget Options	28-31
Fringe Benefits	
Health care	337-343

Nonretirement	144
Retirement	328-340
Taxation	144, 363-367, 376, 380
Gasoline and Other Motor Fuels	423
Gift Taxes	373
Guaranteed Student Loans	
See Stafford Loans	
Health	
Medical education	125-128, 298
Other	119-146, 295-299, 312-316
See Medicaid	
See Medicare	
Health Insurance	
See Federal Civilian Employees	
See Insurance	
See Medicaid	
See Medicare	
Highways	277, 423
Home Health Care	142
Hospitals	
Civilian	121-133
Military	101
Veterans	312-316
Housing	
Rehabilitation	281, 403
Taxation	357-362
Veterans	177
See Mortgages	
See Subsidized Housing	
Impact Aid	286
Import Tax	448
Income Distribution	33
Income Taxes	
See Business Income Taxes	
See Individual Income Tax	
Individual Income Tax	
Capital gains	347, 360, 368
Fringe benefits	144, 363-367, 376, 380
Indexing	352
Itemized deductions	357, 414
Social insurance benefits	134, 378, 390

Tax rates	347, 354
Other	376
Insurance	
Agricultural programs	186, 210
Deposit	249
Health	144, 337-343, 380
Life	380
Unemployment	153, 401
See Medicaid	
See Medicare	
Interest Deductions	357, 421
Itemized Deductions	357, 414
Legal Services Corporation	317
Leveraged Acquisitions	366, 421
Loans	
Agriculture	192, 208
Disaster	208, 258
Economic development	228-232, 245, 279
Energy	231
Export	217
Foreign	215
Housing	177, 253-257, 302, 307
Minority	258
Small business	258
Student	109-114, 289, 298
See Credit Programs	
Low-Income Home Energy Assistance	310
Marine Corps	
Operation and maintenance	74-79
Personnel	86
Procurement	57, 63
Mass Transit	266
Maternal and Child Health	296
Medicaid	13, 117, 123, 147-152
Medical Education	125-128, 298
Medicare	
Hospital Insurance	
(Part A)	15-16, 121-131, 134, 142, 394, 399
Supplementary Medical Insurance	
(Part B)	15-16, 117-120, 132, 136-143

Military Personnel	
Active-duty	84-89
Medical care	101
Pay	103
Reserve	90-97
Retirement	98, 163, 334
Mineral Extraction	235-243, 407
Minimum Tax	354, 407
Missiles	47, 59
Mortgages	
Interest deductions	357
Subsidies	177, 253-257, 302, 411
National Aeronautics and Space Administration	219-225
National Aerospace Plane	68
National Forests	235-243
National Institutes of Health	295
National Park Service	237
National Saving	4-6
Navy	
Operation and maintenance	74-83
Personnel	86-91
Procurement	49, 53-58, 61-64
Nursing	298
Off-budget	5-6
Oil and Gas	235, 407, 423, 440
Operation and Maintenance	74-89, 244-246, 266, 273
Outpatient Departments	132
Payment in Lieu of Taxes	235
Payroll Taxes	
Fringe benefits	328, 380
Medicare	144, 394, 399
Social Security	144, 394-398
Unemployment Insurance	401
Peace Dividend	26-28, 86
Pell Grants	291
Pension and Profit-Sharing Plans	328-336
Physicians	119, 136-139, 298
Pollution	233, 245
Pollution Taxes	432-444
Possessions Tax Credit	384
Postal Service	251, 337

Power Marketing Administrations	231
Premiums	
Agricultural insurance	186, 210
Bank deposit insurance	249
Health insurance	144, 341, 380
Life insurance	380
Medicare	117, 136
Preventive Health Services	296
Pricing of Public	
Services/Resources	235-244, 249, 260-265, 271-276
Procurement	
Aircraft	40-44, 51
Missiles	47
Ships	49, 53-58
Vehicles	59
Other	45, 61-64
Prospective Payment System	121-133, 314, 341
Public Health Service	295-299
Public Housing	
See Subsidized Housing	
Public Lands	235-243
Public Works/	
Infrastructure	219-225, 244-246, 266-274, 277, 281
Railroad Retirement	163, 390
Research and Development	
Civilian	219-227, 233, 247, 295
Military	61, 65-73
Reserves	84, 90-100
Retirement	
Federal civilian	163, 328-340
Military	98, 163
Pension and profit-sharing plans	363-367, 397
Social Security	163-173, 390-396
Revenue Forgone	251
Rural Electrification Administration	228
Sales Taxes	417
School Breakfast and Lunch Programs	157
Science and Technology	219-227, 233, 247
Security Assistance	215
Security Transfers	388
Sequestration	4, 30-31

Service Contract Act	321
Shipping	244, 273-276
Skilled Nursing Facilities	142
Social Security	5-6, 21, 163-173, 390-396
Social Services	115
Space Programs	65-70, 219-225
Stafford Loans	109-114
State Grants	
Economic development	279-283
Education	284
Highways	277
Mass transit	266
Means-tested	117, 147-152, 159-162, 310
Social services	115
Wastewater treatment construction	245
State and Local Taxes	414
Strategic Defense Initiative	65
Strategic Programs	
Bombers	40
Space	65
Submarines	49
Student Financial Aid	109-114, 289-292, 298
Submarines	49, 55
Subsidized Housing	177, 253-257, 300-309
Superconducting Super Collider	226
Tariffs	448
Tax Credits	
Child and dependent care	376
Rehabilitation	403
Tax-Exempt Bonds	411
Telephone and Telecommunications	228, 260-265
Thrift Savings Plan	328
Tobacco	429
Trade Adjustment Assistance	155
Training	76
Transportation	
Airports	268-272, 411, 445
Air traffic control	268-272, 445
Highways	277, 423
Mass transit	266
Water	244, 273-276

Unemployment Insurance	153
Urban Development	279-283
Value-Added Tax	417-422
Veterans' Benefits	163, 174-179, 312-316
Wastewater Treatment Construction	245
Weapons	40, 45-56, 59
Welfare	
See Aid to Families with Dependent Children	
See Food Stamps	
See Medicaid	
See Subsidized Housing	
Workers' Compensation	163, 378