CBO PAPERS

AN ANALYSIS OF THE PRESIDENT'S FEBRUARY BUDGETARY PROPOSALS

March 1993

CONGRESSIONAL BUDGET OFFICE

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SECOND AND D STREETS, S.W.
WASHINGTON, D.C. 20515

NOTES

Unless otherwise indicated, all years referred to in Chapter 2 are calendar years, and all years in other chapters and the appendix are fiscal years.

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

PREFACE

The Congressional Budget Office (CBO) has prepared this analysis of the President's February budgetary proposals at the request of the Senate Committee on Appropriations. The budget estimates discussed in this report were released by CBO on March 3, 1993. A summary of the report's findings was provided in testimony to the House Committee on Ways and Means on March 16, 1993.

The report was prepared by the staffs of the Budget Analysis, Tax Analysis, and Macroeconomic Analysis Divisions under the supervision of C.G. Nuckols, Rosemary D. Marcuss, and Robert Dennis. Paul N. Van de Water was responsible for Chapter I, John F. Peterson for Chapter II, Eric J. Toder for Chapter III, Michael A. Miller and Robert Hale for Chapter IV, and Kathy A. Ruffing for the appendix. The estimates of the President's revenue proposals were prepared by the Joint Committee on Taxation.

The paper was edited by Paul L. Houts, Sherry Snyder, and Sherwood D. Kohn. Christian Spoor provided editorial assistance and coordinated production. Jeanne Burke, Marion Curry, Janice Johnson, Denise Jordan, Linda Lewis, L. Rae Roy, and Simone Thomas prepared the report for publication.

Robert D. Reischauer
Director

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CHAPTER I. SUMMARY AND INTRODUCTION

The Clinton Administration has proposed an ambitious program to encourage economic growth by cutting the budget deficit and increasing government spending that could have long-term payoffs. The Congressional Budget Office (CBO) estimates that the Administration's proposals would reduce the deficit from $308 billion in 1993 to $205 billion in 1997. In contrast, with no change in budgetary policies, the deficit would swell to $322 billion in 1997.

CBO's analysis is based on the proposals and estimates described in the Administration's document *A Vision of Change for America*, which was released on February 17, 1993. In early April, the President will present a formal budget containing detailed and revised budget proposals as well as updated budget estimates. Because the April budget is likely to modify or clarify some of the Administration's proposals, CBO's current analysis must be viewed as preliminary. The Administration's proposals may also be modified by the Congress, which is currently considering the budget resolution for fiscal year 1994.

CBO BUDGET PROJECTIONS

CBO estimates that under current budgetary policies the federal deficit will total $301.6 billion in 1993, $286.7 billion in 1994, and $359.7 billion in 1998 (see Table I-1). These baseline projections assume that discretionary spending is held to the limits established by the Budget Enforcement Act (BEA) in 1994 and 1995 and grows at the same pace as inflation after 1995. CBO's current baseline budget projections incorporate minor revisions of those that CBO released in January in *The Economic and Budget Outlook: Fiscal Years 1994-1998*.

In CBO's estimation, the Administration's budgetary proposals would add $6.8 billion to the deficit in 1993 and would reduce the deficit every year thereafter. Compared with the CBO baseline, the Administration's plan would reduce the deficit by $18.6 billion in 1994, $27.4 billion in 1995, and $131.2 billion in 1998.

Although the Administration's policies would, on balance, reduce the deficit, its program includes many proposed spending increases and tax reductions. Most of these programmatic increases are labeled as stimulus or investment proposals in the Administration's February 17 document, but some are included in the category of "nondefense discretionary program savings." During the 1993-1998 period, the Administration's plan provides a total of $355

TABLE I-1. CBO ESTIMATES OF THE ADMINISTRATION'S POLICY PROPOSALS (By fiscal year, in billions of dollars)

	1993	1994	1995	1996	1997	1998
CBO Baseline Deficit[a]	301.6	286.7	284.4	290.0	321.7	359.7
Deficit Reductions						
Outlays						
Discretionary spending	0	-3.4	-7.7	-28.4	-56.2	-63.4
Mandatory spending	0	-4.2	-7.5	-17.8	-25.0	-30.8
Debt service	0	-1.6	-5.2	-11.1	-20.4	-32.2
Subtotal, outlays	0	-9.1	-20.5	-57.2	-101.6	-126.4
Revenues[b]	0	-45.8	-52.4	-68.1	-84.8	-86.0
Total, Reductions	0	-55.0	-72.8	-125.3	-186.4	-212.4
Deficit Increases						
Outlays						
Discretionary spending	3.3	13.0	22.6	31.8	39.4	44.5
Mandatory spending	3.3	3.8	5.9	7.0	7.1	7.3
Debt service	0.1	1.4	3.7	6.8	10.6	15.1
Subtotal, outlays	6.8	18.2	32.1	45.5	57.1	66.9
Revenues[b]	0	18.2	13.3	11.7	12.6	14.3
Total, Increases	6.8	36.3	45.4	57.2	69.6	81.2
Total Changes	6.8	-18.6	-27.4	-68.1	-116.7	-131.2
Deficit Under the President's Budget as Estimated by CBO	308.3	268.1	257.0	222.0	204.9	228.5

SOURCES: Congressional Budget Office; Joint Committee on Taxation.

NOTE: The budget estimates reflect the proposals incorporated in the President's budgetary message of February 17, 1993. In early April, the President will present a formal budget containing detailed and revised budget proposals and updated budget estimates.

a. Assumes compliance with the discretionary spending limits in the Budget Enforcement Act through 1995; discretionary outlays are assumed to grow at the same pace as inflation after 1995.

b. Increases in revenues are shown with a negative sign because they reduce the deficit. Estimates of the Administration's revenue proposals were prepared by the Joint Committee on Taxation.

billion in net deficit reduction from the CBO baseline, representing $652 billion in gross reductions, partly offset by $297 billion in increases. In comparison, the 1990 budget summit agreement provided for $482 billion in net deficit reduction over five years.

Differences Between CBO and Administration Estimates

CBO's estimate of the deficit is lower than the Administration's estimate in 1993, 1997, and 1998, but higher in 1994, 1995, and 1996 (see Table I-2). These differences take into account differences in estimates of the budget baseline and the Administration's policy proposals. CBO's estimate of the baseline deficit is lower than that of the Administration in most years, but CBO also projects somewhat smaller savings from the Administration's proposals. Because the Administration's budget estimates are based on CBO's economic assumptions, all of the differences between the Administration and CBO reflect different methods of estimation.

CBO's baseline estimates differ from those of the Administration in two key respects. First, CBO projects higher tax collections after 1994 than the Administration. Differing interpretations of recent trends in corporate income tax collections explain more than half of this difference. Second, both the amount and timing of spending for deposit insurance remain in doubt. During the 1993-1998 period, CBO projects higher outlays for deposit insurance of $6 billion. CBO is more pessimistic than the Administration about the anticipated outlays for savings and loans but less gloomy about the prospects for the Bank Insurance Fund.

For discretionary spending proposals, CBO has generally incorporated the Administration's requested changes in budget authority, even where a proposal is not clearly specified, but has independently estimated the resulting changes in outlays. For mandatory spending, such as Medicaid or Medicare, CBO has used its own estimates of the specific policy changes proposed by the Administration. In three cases--reforming Federal Housing Administration insurance, reforming power marketing administrations, and changing debt-management policies--the Administration has not yet outlined a specific proposal, and CBO's estimate therefore includes no savings for these items.

Differences in estimates of the Administration's policy proposals are concentrated in five areas. First, the Joint Committee on Taxation's estimates of the Administration's revenue proposals, which are shown in the accompanying tables, are about $5 billion a year less than the Administration's estimates. Lower estimates of the amounts generated by the proposed rate increases for

TABLE I-2. DIFFERENCES BETWEEN CBO AND ADMINISTRATION ESTIMATES OF THE ADMINISTRATION'S PROPOSED BUDGET (By fiscal year, in billions of dollars)

	1993	1994	1995	1996	1997	1998
Administration's Estimate of the Deficit	331.4	262.4	241.6	205.3	206.4	241.4
CBO Reestimates of the Administration's Baseline						
Revenues[a]	4.9	b	-6.2	-5.7	-16.0	-27.7
Deposit insurance	-13.9	-3.4	13.6	12.9	-1.5	-1.5
Other outlays	-8.5	-1.8	-1.6	-3.5	-1.5	b
Subtotal	-17.4	-5.2	5.8	3.8	-19.0	-29.2
CBO Reestimates of the Administration's Proposals						
Revenues[a]	-3.6	8.8	4.3	5.7	6.6	5.7
Debt management	0.2	1.6	2.7	3.3	3.9	4.9
Medicare	0	0.6	0.9	0.4	1.3	1.8
Pay offsets	0	0.6	1.0	1.4	1.7	2.0
Debt service	-0.2	-0.1	0.4	0.9	1.6	2.3
Other outlays	-2.0	-0.7	0.2	1.3	2.5	-0.5
Subtotal	-5.6	10.9	9.5	12.9	17.5	16.2
Total Reestimates	-23.1	5.7	15.4	16.7	-1.5	-12.9
Deficit Under the President's Budget as Estimated by CBO	308.3	268.1	257.0	222.0	204.9	228.5

SOURCES: Congressional Budget Office; Joint Committee on Taxation; Office of Management and Budget.

NOTE: The budget estimates reflect the proposals incorporated in the President's budgetary message of February 17, 1993. In early April, the President will present a formal budget containing detailed and revised budget proposals and updated budget estimates.

a. Increases in revenues are shown with a negative sign because they reduce the deficit. Estimates of the Administration's revenue proposals were prepared by the Joint Committee on Taxation.

b. Less than $50 million.

high-income individuals and the compliance and enforcement efforts represent most of this amount.

Second, the Administration's estimates assume savings that grow to almost $5 billion in 1998 from changes in debt-management policies. Because the Administration has not detailed its specific changes in debt-management policies, CBO's estimate does not include budgetary savings from this source. Achieving savings of the magnitude the Administration assumes would require shifting most or all borrowing in long-term bonds and much borrowing in medium-term notes to short-term securities.

Third, CBO's estimates of the savings from the proposed reductions in reimbursement of providers in the Medicare program are below those of the Administration. The differences vary by year but approach $2 billion in 1998. This difference in estimates is largely accounted for by the Administration's inadvertent use of different economic assumptions in estimating the effects of these proposals.

Fourth, the Administration's estimates omit the effect of the proposed reductions in federal civilian and military pay on the level of Defense Department contributions to the federal employee retirement programs. Because the agency's contributions are a set percentage of payroll, a reduction in pay will also shrink the amount of the agency's contributions, which are recorded in the budget as undistributed offsetting receipts. By neglecting to include this loss in receipts, the Administration underestimates the deficit by amounts growing to $2 billion by 1998.

Fifth, because CBO's estimate of the savings generated by the Administration's proposals is lower than that reported in *A Vision of Change for America*, CBO's estimate of the resulting reduction in the cost of servicing the federal debt is also lower. By 1998, this difference reaches $2.3 billion.

Other reestimates to outlays are smaller, both individually and in total. CBO estimates that outlays from the stimulus package would be $2.1 billion lower in 1993 than the Administration assumes but higher by an equal amount over the 1994-1998 period. CBO attaches higher savings to the Administration's proposals to replace guaranteed student loans with direct loans, extend customs fees, and auction rights to use the electromagnetic spectrum. CBO has lower savings estimates, however, for the Administration's proposed reforms in uranium enrichment, hardrock mining, farm price supports, Medicaid, and the federal buildings fund.

Alternative Baseline Concepts

The budgetary savings generated by the Administration's proposals can be measured using several alternative budget baselines (see Table I-3). CBO's estimates use as their starting point the CBO baseline, which assumes compliance with the discretionary spending caps established by the Budget Enforcement Act of 1990. One alternative is the uncapped baseline, which assumes that discretionary spending in the 1994-1998 period grows at just the rate of inflation. The Administration's February 17, 1993, document employs still a third baseline concept, in which nondefense discretionary spending keeps pace with inflation, but defense discretionary spending is held to the levels proposed in the Bush Administration's January 1992 budget request (with various adjustments).

The existence of competing baselines and competing estimates creates considerable confusion. The Administration, for example, states that its policies will reduce the 1997 deficit by $140 billion--the difference between the Administration's baseline of $346 billion and its budget estimate of $206 billion. Using the same baseline concept as the Administration but its own estimating methods, CBO would show a reduction of $122 billion--from $327 billion to $205 billion. Compared with the CBO baseline deficit of $322 billion, however, the Administration's reductions total only $117 billion in 1997. For the 1993-1998 period, CBO would estimate savings of $400 billion using the Administration's baseline concept and $355 billion using the CBO baseline. The differences in the figures arise because some of the Administration's discretionary savings are needed simply to comply with the BEA's spending caps.

THE ADMINISTRATION'S PROPOSALS

Three-quarters of the $355 billion in cumulative deficit reduction contained in the Administration's program would stem from increases in revenues and only one-quarter from cuts in outlays. Extension of expiring tax increases and spending cuts would generate $60 billion of the reduction in the deficit. Continuing various tax credits and other revenue-losing provisions, however, would cost $22 billion. The Administration would increase domestic discretionary spending but reduce defense and mandatory spending. The spending increases would exceed the cuts through 1995, but the spending reductions would dominate in later years.

By 1998, the proposed increases in taxes and reductions in spending are more evenly balanced. The ratio of revenues to gross domestic product (GDP)

TABLE I-3. CBO AND OMB ESTIMATES OF BASELINE DEFICITS
(By fiscal year, in billions of dollars)

	1993	1994	1995	1996	1997	1998
CBO Estimates						
Uncapped Baseline Deficit	301.6	301.5	312.1	318.5	351.0	390.8
Reductions						
Bush Administration's defense proposals[a]	0.2	-5.2	-9.8	-16.3	-21.1	-26.0
Debt-service savings	b	-0.1	-0.6	-1.4	-2.7	-4.3
Subtotal	0.2	-5.4	-10.4	-17.7	-23.7	-30.3
Administration Baseline Deficit	301.8	296.1	301.8	300.8	327.3	360.6
Further Reductions Required to Meet Discretionary Caps						
Discretionary spending	-0.2	-9.2	-16.4	-8.9	-3.2	1.7
Debt-service savings	b	-0.3	-1.0	-1.9	-2.4	-2.6
Subtotal	-0.2	-9.4	-17.4	-10.7	-5.6	-0.9
Capped Baseline Deficit[c]	301.6	286.7	284.4	290.0	321.7	359.7
OMB Estimates						
Uncapped Baseline Deficit	319.2	306.7	306.0	313.6	368.8	418.6
Reductions						
Bush Administration's defense proposals[a]	0	-5.3	-9.5	-15.2	-20.0	-24.8
Debt-service savings	0	-0.2	-0.6	-1.4	-2.6	-4.1
Subtotal	0	-5.4	-10.1	-16.6	-22.5	-28.9
Administration Baseline Deficit	319.2	301.3	295.9	297.0	346.3	389.7

SOURCES: Congressional Budget Office; Office of Management and Budget.

a. Includes adjustments to the Bush Administration's request as estimated by the Clinton Administration.

b. Less than $50 million.

c. Assumes compliance with the discretionary spending limits in the Budget Enforcement Act through 1995; discretionary outlays are assumed to grow at the same pace as inflation after 1995.

would rise from 18.5 percent in 1993 to 19.7 percent in 1998--close to the postwar record of 20.2 percent reached in 1981. Over the same period, spending would decline from 23.5 percent to 22.6 percent of GDP (see Table I-4).

Revenues

The Administration has proposed some 30 revenue-raising items, as well as a smaller number of tax reductions designed to stimulate investment and reward work. The major revenue raisers are an increase in income tax rates for high-income individuals and corporations, elimination of the limit on earnings subject to the payroll tax for Hospital Insurance, inclusion in adjusted gross income of 85 percent (instead of 50 percent) of Social Security benefits above the current income thresholds, and establishment of a broad-based energy tax. The investment proposals include a temporary incremental investment credit, a permanent investment credit for small businesses, extension of the research and experimentation credit and other expiring preferences, and expansion of the earned income credit.

Discretionary Spending

The Budget Enforcement Act established separate dollar limits on defense, international, and domestic discretionary spending for fiscal years 1991, 1992, and 1993. A single overall limit applies to discretionary spending in 1994 and 1995. The Administration has proposed extending the discretionary spending limits through 1998, but it has not yet suggested any specific levels.

In CBO's estimation, the Administration's budget is within or near the current limits on discretionary budget authority for 1994 and 1995, but exceeds the limits on outlays. In 1994, total discretionary outlays exceed the cap by $9.7 billion (see Table I-5). Of this amount, $6.4 billion represents the 1994 outlays from the 1993 stimulus package, which the Administration proposes to treat as an emergency requirement. Under the terms of the BEA, the discretionary spending limits are increased to make extra room for emergency appropriations. Even excluding the outlays from the stimulus package, the Administration's request exceeds the 1994 outlay cap by $3.3 billion.

The Administration's proposals exceed the cap on discretionary outlays by an even larger amount in 1995. Leaving out $3.2 billion in outlays from the stimulus package, discretionary outlays breach their limit by $11.6 billion.

TABLE I-4. CBO ESTIMATES OF THE ADMINISTRATION'S BUDGETARY PROPOSALS (By fiscal year)

	1993	1994	1995	1996	1997	1998
			In Billions of Dollars			
Revenues	1,142	1,242	1,329	1,412	1,485	1,552
Outlays	1,450	1,510	1,586	1,634	1,690	1,781
Deficit	308	268	257	222	205	228
Debt Held by the Public	3,289	3,560	3,821	4,058	4,290	4,549
			As a Percentage of GDP			
Revenues	18.5	19.1	19.4	19.6	19.7	19.7
Outlays	23.5	23.2	23.1	22.7	22.4	22.6
Deficit	5.0	4.1	3.7	3.1	2.7	2.9
Debt Held by the Public	53.3	54.7	55.7	56.3	56.9	57.8
Memorandum: Gross Domestic Product (In billions of dollars)	6,173	6,508	6,855	7,202	7,543	7,873

SOURCE: Congressional Budget Office.

NOTE: The budget estimates reflect the proposals incorporated in the President's budgetary message of February 17, 1993. In early April, the President will present a formal budget containing detailed and revised budget proposals and updated budget estimates.

TABLE I-5. THE ADMINISTRATION'S PROPOSALS FOR DISCRETIONARY SPENDING IN FISCAL YEAR 1994 (In billions of dollars)

Category	CBO Baseline Without Discretionary Caps		President's Budget as Estimated by CBO		Difference	
	Budget Authority	Outlays	Budget Authority	Outlays	Budget Authority	Outlays
Defense	288.0	289.6	264.0	277.8	-24.0	-11.8
International	21.9	21.8	21.9	21.9	-0.1	0.2
Domestic						
General science, space, and technology	17.7	17.5	19.0	18.3	1.3	0.8
Energy	6.1	5.9	5.8	5.7	-0.4	-0.2
Natural resources and environment	22.3	21.9	21.7	22.6	-0.6	0.8
Agriculture	4.5	4.4	4.2	4.3	-0.3	-0.1
Commerce and housing credit	3.6	3.5	3.7	3.7	0.1	0.2
Transportation	14.4	36.5	14.8	39.2	0.4	2.8
Community and regional development	8.0	8.3	8.5	9.5	0.5	1.3
Education, training, employment, and social services	38.2	37.5	42.2	40.0	4.0	2.5
Health	21.3	20.9	22.5	21.6	1.2	0.7
Medicare	3.0	3.0	3.0	3.0	a	a
Income security	32.0	34.8	32.0	35.4	a	0.6
Social Security	0	2.8	0	3.0	0	0.2
Veterans' benefits	17.5	17.4	17.5	17.6	a	0.2
Administration of justice	14.9	15.0	15.2	15.3	0.3	0.3
General government	12.5	12.6	12.7	12.9	0.2	0.3
Allowances	0	0	-3.9	-3.4	-3.9	-3.4
Subtotal, domestic	215.9	242.0	218.9	248.8	3.0	6.9
Total, Discretionary Spending	525.8	553.3	504.8	548.6	-21.1	-4.7
Discretionary Caps[b]	513.2	538.9	513.2	538.9	n.a.	n.a.
Difference	12.7	14.4	-8.4	9.7	n.a.	n.a.

SOURCE: Congressional Budget Office.

NOTE: n.a.. = not applicable.

a. Less than $50 million.

b. End-of-session limits as estimated by CBO.

Within the discretionary spending category, the Administration proposes continued real reductions in defense and real increases in most areas of domestic spending. Defense discretionary budget authority, which totaled $274 billion in 1993, would drop to $264 billion in 1994 and $249 billion by 1997--a cut of 21 percent in real terms. At the same time, domestic discretionary budget authority would grow from its current level of $209 billion to $262 billion--a real increase of 7 percent.

The Administration proposes to increase real discretionary spending in most domestic functions of the budget. By far the largest increases would go to education and related programs--notably, Head Start; elementary, secondary, and postsecondary education; summer youth employment and training; a new national service program for youth; and a new training program for dislocated workers. Compared with the uncapped CBO baseline, the President's program would add $4.0 billion in budget authority (BA) and $2.5 billion in outlays to the education function in 1994, and $13.4 billion in BA and $12.7 billion in outlays in 1998.

Discretionary health programs would also receive substantial increases in funding above the uncapped baseline--$1.2 billion in BA in 1994 and $6.2 billion in 1998. Additional resources would be focused on research relating to AIDS and women, as well as on prevention of substance abuse. The President also proposes large increases in spending for science (for National Science Foundation research and the National Aeronautics and Space Administration), transportation (for highways and mass-transit grants), and income security (for housing assistance; the Special Supplemental Food Program for Women, Infants, and Children; and low-income home energy assistance).

The Administration's proposed reductions in domestic discretionary spending emphasize across-the-board cuts in a wide range of federal programs. The Administration treats many but not all of these cuts as allowances rather than assigning them to specific budget functions. Eliminating pay increases for civilian agencies in 1994 and limiting pay increases during the next three years would reduce discretionary outlays by $1.6 billion in 1994 and $3.5 billion in 1998. Eliminating 100,000 federal jobs would save $0.9 billion in 1994 and $1.6 billion in 1998. An additional $0.6 billion in 1994 and $4.2 billion in 1998 would be saved by further "streamlining" of the federal government. Still other unspecified administrative savings would total $0.5 billion in 1994 and $3.5 billion in 1998.

Unlike the proposed changes in revenues and mandatory spending, the Administration's discretionary proposals cannot all be enacted into law this year, but will depend on future Congressional action. Extending the limits on discretionary spending would constrain the total amount of appropriations, but annual appropriation bills will determine how the total is allocated among individual programs.

Mandatory Spending

The Medicare program accounts for more than half of the proposed cuts in mandatory spending (see Table I-6). Major savings would be achieved bymaintaining the ratio of premium charges to benefit payments for Supplementary Medical Insurance at its 1995 level; extending other expiring provisions, including those that make Medicare the secondary payer for certain beneficiaries and curtail payments for hospital capital expenditures and outpatient departments; and reducing hospital reimbursement rates. The Administration would also cut payments for medical education in hospitals, clinical laboratories, and physicians not in primary care.

In three other programs, savings would also arise largely from extending current savings provisions that are scheduled to expire. These items include eliminating the option for a lump-sum payment in Civil Service retirement, extending the limit on pension benefits paid to certain veterans in nursing homes, and continuing Customs Service merchandise and passenger processing fees. Additional savings would be achieved by reducing farm price support payments, replacing the guaranteed student loan programs with direct federal loans, eliminating personal care as a mandatory benefit and making other reductions in Medicaid, and auctioning future rights to use the electromagnetic spectrum.

Increases in mandatory spending are concentrated in three areas. An extension of emergency unemployment compensation through October 2, 1993, has already cleared the Congress and was signed into law on March 4. The Administration also proposes to increase spending on Food Stamps and to expand the earned income tax credit (EITC) for low-income wage earners; the refundable portion of the EITC appears as an outlay in the budget.

Debt Held by the Public

The Administration's proposals would slow but not halt the growth of federal debt relative to the size of the economy. On its current course, debt held by the public will swell from $3.0 trillion (51 percent of GDP) at the end of 1992 to $4.8 trillion (62 percent of GDP) in 1998. Under the Administration's plan, the debt would reach $4.5 trillion, or 58 percent of GDP, in six years. The Administration's proposal for direct loans to college students would add $54

TABLE I-6. THE ADMINISTRATION'S PROPOSALS FOR MANDATORY SPENDING
(By fiscal year, in billions of dollars)

	1993	1994	1995	1996	1997	1998
Reductions						
Medicare premiums	0	0	0	-1.3	-3.2	-5.1
Extend other expiring Medicare provisions	0	a	a	-2.0	-2.6	-3.0
Reduce hospital reimbursement	0	-1.1	-1.8	-2.1	-2.3	-2.5
Other Medicare savings	0	-1.4	-2.5	-4.2	-5.9	-7.2
Subtotal, Medicare	0	-2.5	-4.3	-9.6	-14.0	-17.9
Farm price supports	0	-0.1	-0.2	-0.8	-1.6	-1.8
Student loans	0	0.1	0.1	-1.1	-2.6	-3.1
Medicaid	0	-0.2	-1.4	-1.8	-2.1	-2.4
Civil Service retirement	0	a	-0.1	-2.2	-3.3	-3.6
Veterans' benefits	0	-0.3	-0.4	-0.4	-0.4	-1.2
Customs user fees	0	0	0	-0.8	-0.8	-0.9
Spectrum auctions	0	-1.7	-1.8	-1.7	-1.0	-1.0
Pay offsets	0	1.0	1.4	1.8	2.3	2.8
Other	0	-0.5	-0.9	-1.3	-1.4	-1.8
Total, Reductions	0	-4.2	-7.5	-17.8	-25.0	-30.8
Increases						
Unemployment compensation	3.3	2.3	0	0	0	0
Food Stamps	0	1.0	2.0	3.0	3.0	3.0
Earned income tax credit	0	0.4	3.8	4.0	4.1	4.3
Other	0	0.1	0.1	a	a	a
Total, Increases	3.3	3.8	5.9	7.0	7.1	7.3
Total Changes	3.3	-0.4	-1.7	-10.8	-17.9	-23.5

SOURCE: Congressional Budget Office.

a. Less than $50 million.

billion to the debt in 1998 but would be matched by a roughly equal increase in interest-earning assets.

CONCLUSIONS

The proposals outlined in *A Vision of Change for America* would make a substantial contribution to reducing the deficit, but they are not sufficient to solve the long-run problem. Both CBO and the Administration estimate that, under the President's policies, the deficit would decline only through 1997 and then resume its rise. By the Administration's own projections, the deficit would reach about $400 billion, or 4 percent of GDP, by 2003.

The Administration pins its hopes for further deficit reduction on its health reform proposals, which are scheduled for release in early May. CBO has frequently pointed out, however, that reforming the health care system is unlikely to curb government spending quickly. In the short run--say, over the next 10 years--it will be exceedingly difficult to realize significant budgetary savings as long as any reform proposal extends coverage to the uninsured, avoids shifting costs to private payers, and maintains many of the desirable aspects of the current system.

A more promising path to still lower deficits would be to make further reductions in programs or to scale back the proposed increases in the President's budget plan, as both the House and Senate Committees on the Budget have done.

CHAPTER II. THE MACROECONOMIC IMPLICATIONS OF THE PRESIDENT'S BUDGET AND A REEXAMINATION OF THE CBO ECONOMIC FORECAST

Enactment of the Administration's budget proposals would affect the pattern of economic growth over the next few years and would ultimately raise the economy's level of output. The Administration's estimates of the economic effect of its proposals, along with other factors, are incorporated in its policy forecast (see Table II-1). Since the Administration used the Congressional Budget Office's (CBO's) economic forecast in preparing its baseline budget, CBO both analyzed the impact of the Administration's program and reexamined its own economic forecast.

HOW WILL THE ADMINISTRATION'S POLICIES AFFECT THE ECONOMY?

The Administration's proposals are likely to have little net effect on the economy in the next few years, but they may raise inflation slightly and have probably already contributed to a decline in long-term interest rates. The portion of the proposals addressed to short-run stimulus is small and some of its effects are spread out over a few years. The longer-term proposals for reducing the federal deficit are scheduled to be phased in smoothly, so that their overall impact in any one year is also limited. The process of deficit reduction inevitably weakens growth for a time, as CBO described in its most recent *Economic and Budget Outlook.* If the recent decline in long-term interest rates persists, however, it will help offset the effects of deficit reduction for the next few years. But even with the assistance of the decline in interest rates, the President's package is not likely to strengthen the economy in relation to the CBO baseline through the mid-1990s. Eventually, the reduction in the deficit and the support given to investment will increase the productive potential of the economy, but these effects will probably not show up in increased output and incomes until well beyond the period covered by the current budget projections.

Clearly, the effect of the program in 1993 and 1994 depends on how soon the Congress takes action. Unemployment compensation has already been extended; this analysis assumes that programs for summer jobs will be enacted soon and that the bulk of the package will be passed by this September. CBO's outlay estimates of the Administration's proposals and the Joint Committee on Taxation's revenue estimates are used throughout.

The budget resolutions passed by the House and the Senate incorporate plans for more deficit restraint than that proposed by the Administration. Those plans would tend to weaken growth in the near term slightly more than the Ad-

TABLE II-1. CONGRESSIONAL BUDGET OFFICE BASELINE, ADMINISTRATION, AND *BLUE CHIP* ECONOMIC PROJECTIONS, CALENDAR YEARS 1992-1998

		Forecast		Projected			
	1992	1993	1994	1995	1996	1997	1998
Real GDP							
(Percentage change, year over year)							
CBO	2.0	2.8	3.0	2.9	2.7	2.4	2.0
Administration	2.1	3.1	3.3	2.9	2.6	2.5	2.5
Blue Chip	2.1	3.2	3.1	2.8	2.6	2.3	2.5
GDP Deflator							
(Percentage change, year over year)							
CBO	2.6	2.4	2.4	2.3	2.3	2.2	2.2
Administration	2.6	2.5	2.9	3.0	3.0	3.0	3.0
Blue Chip	2.6	2.5	3.0	3.4	3.5	3.4	3.3
Consumer Price Index[a]							
(Percentage change, year over year)							
CBO	3.1	3.0	2.7	2.7	2.7	2.7	2.7
Administration	3.0	3.1	3.1	3.3	3.3	3.4	3.4
Blue Chip	3.1	3.1	3.4	3.7	3.8	3.7	3.6
Civilian Unemployment Rate							
(Percent)							
CBO	7.4	7.1	6.6	6.2	6.0	5.8	5.7
Administration	7.4	6.9	6.4	6.1	5.9	5.7	5.5
Blue Chip	7.4	7.0	6.5	6.2	6.1	6.1	6.0
Three-Month Treasury Bill Rate (Percent)							
CBO	3.5	3.1	3.7	4.4	4.7	4.8	4.9
Administration	3.5	3.7	4.3	4.7	4.8	4.9	5.0
Blue Chip	3.5	3.3	4.0	4.7	4.9	4.9	4.7
Ten-Year Treasury Note Rate							
(Percent)							
CBO	7.0	6.7	6.6	6.6	6.5	6.5	6.4
Administration	7.0	6.7	6.6	6.5	6.5	6.4	6.4
Blue Chip[b]	7.0	6.5	6.9	7.1	7.3	7.1	7.0

SOURCES: Congressional Budget Office; Office of Management and Budget; Eggert Economic Enterprises, Inc., *Blue Chip Economic Indicators.*

NOTES: The CBO forecast is based on data available through December 1992 and does not reflect fourth-quarter data for gross domestic product or the consumer price index published in January 1993. The *Blue Chip* forecasts are based on a survey of private forecasters published on March 10, 1993.

The Administration used CBO's economic forecast in its budget calculations. The forecast labeled "Administration" in this table reflects the Administration's own forecast and includes its estimate of its own programs' effects.

a. Consumer price index for all urban consumers (CPI-U).

b. The *Blue Chip* does not project a 10-year note rate. The values shown here are based on the *Blue Chip* projection of the Aaa bond rate, adjusted by CBO to reflect the estimated spread between Aaa bonds and 10-year Treasury notes.

ministration's proposals and add a little more to the potential growth of the economy in the long term. But the additional spending cuts are not large enough to affect the outlook significantly.

Changes in the Federal Deficits

One of the most important measures of the economic impact of the President's proposals is the change in the standardized-employment deficit. This has two aspects: in the short run, the government deficit (adjusted for the effects of the business cycle) is a handy measure of the fiscal stimulus provided by the budget; and in the longer run, reductions in the government deficit indicate how much less of national saving the government is absorbing, leaving more for private investment and reducing the need for financing from abroad.

In relation to CBO's baseline projections, the Administration's program adds little to the standardized-employment deficit (and thus provides a tiny fiscal stimulus) in 1993.[1] In 1994 it would reduce the deficit, which contributes to long-term goals but does nothing to increase short-term growth. The program increases the deficit trivially in 1993--by 0.1 percent of gross domestic product (GDP)--and then reduces it by 0.2 percent of GDP in 1994 (see Table II-2). By this measure, the proposals imply a small fiscal restraint amounting to some 0.2 percent of GDP over the two-year period.[2] The additional restraint would continue through 1998, when the President's proposals would bring the standardized-employment deficit to 2.8 percent of GDP, as compared with 4.4 percent in the CBO baseline.

Such a reduction in government borrowing aims at increasing the productive potential of the economy by shifting resources out of consumption uses--spending by households and government--and into investment uses. This shift in resources would allow private investment to be financed with less reliance on foreign borrowing. But the shift would probably not occur swiftly or painlessly and, taken by itself, would suppress economic activity for a number of years.

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1. The deficit measure most relevant for this calculation is the standardized-employment deficit, which purges the deficit of the effects of the business cycle and removes outlays for deposit insurance, which CBO believes have little concurrent effect on the economy. The outlays for deposit insurance primarily represent an exchange of assets and, therefore, do not directly increase the current income or wealth of the private sector or add to private demand.

2. Both versions of the budget resolution--those passed by the House and the Senate--would change the net fiscal restraint over the next two years by less than 0.1 percent of GDP.

TABLE II-2. THE STANDARDIZED-EMPLOYMENT DEFICIT

	1992	1993	1994	1995	1996	1997	1998
			In Billions of Dollars				
CBO Baseline[a]	201	229	223	231	257	311	352
President's Budget as Estimated by CBO	201	236	204	204	189	194	220
			As a Percentage of Potential GDP				
CBO Baseline[a]	3.3	3.6	3.3	3.3	3.5	4.1	4.4
President's Budget as Estimated by CBO	3.3	3.7	3.1	2.9	2.6	2.5	2.8

SOURCE: Congressional Budget Office.

NOTE: These measures of fiscal policy exclude outlays for deposit insurance and allied contributions for Operation Desert Storm.

a. This measure assumes compliance with the Budget Enforcement Act's discretionary spending limits in 1994 and 1995; after 1995, discretionary spending is assumed to increase at the rate of inflation.

Just how much economic activity would be held down depends in part on how the Federal Reserve responds to the fiscal action. If the Federal Reserve acts aggressively to temper the fall in output by lowering short-term interest rates and increasing money growth before the economy weakens, much of the output loss could be avoided. If, however, the Federal Reserve follows, rather than leads, the economy, output loss will probably be greater.

CBO has assumed that the Federal Reserve will offer a mild offset to the fiscal restriction by maintaining money growth at the rate that would have prevailed in the absence of the deficit reduction. Under this assumption, CBO has estimated that a deficit reduction program about twice as large as the President's proposal--one that would eliminate the deficit over the next five to 10 years--might reduce the short-run growth rate of the economy by about one-half of a percentage point for a period of between three and five years.[3] The uncertainty in this estimate largely reflects economists' imperfect knowledge of the way fiscal policy affects the economy, as well as uncertainty about the Federal Reserve's response. The President's proposal, which reduces the deficit by smaller

3. See Congressional Budget Office, *The Economic and Budget Outlook: Fiscal Years 1994-1998* (January 1993), Chapter 5.

increments, would have correspondingly smaller short-term costs and provide smaller long-term benefits.

These estimates include the normal effect of lower government borrowing on capital markets. Reducing deficits reduces interest rates because it weakens the economy and because the federal government reduces its own demand for credit. The early effect of the announcement of the President's program seems to have been far greater than normal, however. Long-term interest rates fell by about 0.6 percentage points in the first three months of 1993. Although a quick response to the program was always a theoretical possibility, few economists expected so rapid and large a drop in rates.

In addition to the President's program, a number of other factors might have affected the recent behavior of the capital market. Among these factors are a possible market reassessment of expectations of future nonfederal demands for capital and developments in the rest of the world. Economists have long thought that long-term rates were high, given the weakness in the economy and the outlook for inflation. The spread between long- and short-term interest rates was extraordinarily high during 1992, and long-term interest rates also appeared to be high when adjusted for inflation. Many analysts attributed the high rates to fears of a worldwide shortage of capital during the 1990s or to increased uncertainty about the size of future deficits and their effect on interest rates.[4] If those factors were important, the drop in rates this year could be attributed in part to a delayed reassessment of the implications of future demand and supply of capital on interest rates and not solely to a reassessment of future deficits.

It is likely that U.S. capital markets have also been affected by the worsening news about the economies of Europe and Japan.[5] Officials of Germany's Bundesbank now think the situation is sufficiently serious to allow interest rates to fall modestly, and the markets may anticipate another decline. Japan's economy is also experiencing very slow growth. Because world capital markets are tightly linked, the weakness in these economies lowers U.S. interest rates.

The net effect of these factors has been to lower interest rates much faster than the President's program would have been expected to lower them. This will

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4. See Congressional Budget Office, *The Economic and Budget Outlook*.

5. Bad foreign news also helps resolve another puzzle: why hasn't the U.S. dollar depreciated? Theory and past experience suggest the dollar should fall if deficits are expected to fall because the outlook for U.S. interest rates should be reduced. A weaker outlook for foreign economies, however, also presages lower interest rates abroad, and this tends to make the U.S. exchange rate appreciate. The lower expectation for foreign interest rates may have offset the depreciation that the new U.S. budget policy would otherwise produce.

help boost growth in 1993 and, in 1994, offset much of the effects of the fiscal restraint that will occur in that year.

How the Investment Tax Credit Changes the Story

Changes in government borrowing, although they are a useful indicator, do not take into account all the effects of fiscal policy. The President's program includes a measure--the temporary, incremental investment tax credit (ITC)--that is designed in part to increase the leverage of fiscal policy by stimulating private investment spending at relatively low cost to the budget. If successful, the ITC would encourage additional investment. The budgetary cost would be reduced because the credit is designed to apply only to investment above an amount based on investment in previous years (see Chapter III). Thus, this program holds the promise of relatively large increases in private investment spending at low budgetary cost.

According to CBO's estimates, however, the temporary, incremental ITC exerts only a modest additional leverage. Each dollar of tax credit is likely to generate about one and a half dollars in additional private investment during 1993 and 1994. Thus, the additional leverage from the ITC, in relation to the calculations already incorporated in the standardized-employment deficit, amounts to only about $5 billion in 1994. This amount is small in relation to the size of the economy. (The impact is likely to be more concentrated in 1994 because of the administrative complexities of an incremental ITC and a possible delay in writing regulations.)

Looking forward another year, this credit will not be available to new investment in 1995 and later years, though another element of the President's program would maintain a permanent ITC for small business only. The majority of the new investment that the temporary ITC will stimulate in 1994 will probably come from investment that would otherwise have taken place in 1995. Thus, in 1995 the overall fiscal restraint will be magnified by a policy-induced reduction in private investment. The proposal includes provisions to penalize companies that allow their investment to drop too much in 1995, but the effect of these provisions is uncertain.

The Effect on Employment

Estimates of the employment effects will mirror those of the proposals on the level of real GDP. Given the likelihood that the Administration's proposals will make little difference to the overall economy for the next few years, total employment will not be greatly affected. The level of employment will probably be similar to the baseline levels.

The Administration has claimed that its proposals will create an additional 500,000 jobs by the end of 1994. Additional job creation of that magnitude would only be likely if real GDP at that time is about 0.5 percentage points above the baseline. On balance, given the restraint of the deficit reduction, the slight offsetting stimulus from the ITC, and the low interest rates discussed above, the level of GDP is likely to be approximately the same as the baseline at the end of 1994. Therefore, even if the effects of the decline in interest rates are included, it does not seem likely that the Administration's proposals will significantly affect the number of permanent jobs.

The Administration also claims that its proposals will create 700,000 summer jobs. The money proposed for the summer program could actually fund that number of jobs, so the major question is simply whether or not local governments will be able to gear up to spend the money in the time given. If the legislative action occurs late, as it did last year, only a small amount of the appropriation will be spent this year.

The Effect on Inflation

The Administration's policies will not foster higher inflation by stimulating demand, but the proposed energy tax will probably induce slightly higher inflation for a few years. As noted above, the combined effect of the Administration's proposals and the low interest rates are not likely to raise the level of GDP above the CBO baseline. Demand growth, therefore, will not be stimulated so much as to strain the economy's productive capability.

The energy tax, however, by directly raising the price of energy and indirectly increasing costs for goods and services that use energy, will slightly increase the level of prices in general. The energy taxes will stimulate a relatively small increase of about 0.5 percent in the level of prices by 1997. Because the energy taxes would be applied in three annual increases beginning in July 1994, the 0.5 percent change in the price level would be spread out over the 1995-1997 period. The rate of change of the level of prices would be higher in each of those three years by about 0.1 to 0.2 percentage points. After the phase-in is complete, inflation would return to its baseline rate.

The Effect of the Budget on the Level of Potential GDP by 1998

The Administration's proposals would increase the level of the economy's potential output by the end of the projection period. The increase in the potential growth rate stems from the effect of lower federal deficits on national saving and investment. As the federal deficit falls, investment and capital accumulation will be greater than in the CBO baseline and the economy's potential level of output will increase. Using a standard growth model, potential growth would be about 0.1 percentage point greater by 1998 than the 2.0 percent rate incorporated in the baseline.

Factors Other Than Deficit Reduction That May Help Potential. Other aspects of the Administration's proposals, specifically the proposed increases in public infrastructure and education and training, and the private investment caused by the permanent ITC, have been cited as additional economic stimulants. These policies are unlikely to add significantly to the potential growth rate of GDP during this decade, however, even though the programs could have merit. Some of these programs, such as additional funding for Head Start and basic research and development projects, could ultimately increase potential GDP, but will not do so soon. Head Start funding will not have a significant effect on the potential level of output until the children it affects enter the labor force. Basic research expenditures also have a long gestation period before their product applications strengthen the economy.

Other programs, such as those that improve the environment, may increase welfare, but few of the benefits will be included in GDP as it is currently measured. Environmental gains would raise potential GDP only insofar as they increased the productivity of capital or labor in the production of goods and services that are included in GDP. An improvement in the health of workers or a slowing of the rate of deterioration of production facilities would be reflected in potential GDP, but such gains are likely to have a small impact, particularly in this decade.

The permanent ITC and investment in transportation infrastructure, which in theory could stimulate more investment during the 1990s, are too small to affect the level of potential GDP significantly. The proposed increase in spending on public transportation infrastructure would be about $3 billion a year in the 1997-1998 period. The amount is trivial in relation to the amount of spending on public and private investment in the economy--approximately $850 billion. Therefore, it will have no discernable impact on long-run growth. In addition, much of the benefit of better roads is a reduction in commuting time, a benefit that is not measured in GDP.

The permanent ITC is also likely to have a small effect. Since only small businesses qualify for the 5 percent permanent ITC, and since they account for a small percentage of the private capital stock, the ITC will not raise the level of the capital stock significantly.

Will the Income Tax Increase Hurt Potential? The President's proposals include a sharp increase in the taxation of high incomes. The new top bracket of income tax raises two questions: how easy will it be for the rich to avoid the tax by shifting income into tax-favored forms, such as capital gains; and how much will the tax change affect behavior that is economically significant, particularly work effort and saving? Assuming, as Chapter III concludes, that any shifting probably will not have a significant impact on revenues, the question of saving and work effort remains.

Work effort is unlikely to be affected significantly. The thin evidence that is available suggests that changes in income tax rates may be important for work effort among the poor, but less important for the bulk of the labor force.

Saving, however, could be affected. For broad-based tax changes, econometric evidence does not settle the question of whether tax increases reduce or increase private saving, but the rich may be different in this respect.

First, rich people generally save more of their incomes. Therefore, even if they do not change the percentage of their income that they save after taxes, taxing them more heavily will discourage saving more than increasing taxes on a broader segment of the population.

Second, there is some evidence that the savings of the rich are more sensitive to changes in taxes than are the savings of moderate-income and poor people (that is, the rich will tend to maintain their consumption in the face of an increase in income taxes by reducing their saving rate). If so, the Clinton program will imply a slightly smaller long-term improvement in productive capacity because the increase in total national saving will be somewhat smaller.

REEXAMINING THE CBO FORECAST

As noted previously, there is little reason to assume that the Administration's proposals will have a major effect on economic growth or inflation over the next two years. But have any other recent developments overtaken the CBO baseline forecast? Some of the recent economic data, such as the upward revision of the fourth-quarter real GDP growth rate to 4.8 percent, have led a number of forecasters to raise their growth-rate projections for 1993 and 1994, whereas others, noting the deteriorating situation abroad, argue that the outlook has worsened. A reexamination of the forecast in light of recent developments indicates that CBO's long-term interest rate forecast for 1993 appears to be too high, but that the forecasts for real growth and inflation are still reasonable.

The *Blue Chip* consensus estimates, which build in forecasters' assumptions for the final form of the budget and its effect, indicate growth in 1993 and 1994 that is slightly higher than CBO's forecast. *Blue Chip* also indicates slightly lower long-term interest rates this year and significantly higher inflation in 1994 than CBO forecast.

Three Percent Growth for 1993 Is Still a Reasonable Forecast

Although output grew more rapidly in late 1992 than CBO assumed, there are strong reasons for continuing to assume that growth in 1993 will be close to 3 percent. The long-term adjustment problems mentioned in the CBO winter report are still present, corporate restructuring continues, commercial construction will remain weak, demographics will dampen demand for residential construction, and the household debt burden, although it has eased somewhat, is still high.

The weakening of foreign demand is a new development. Forecasts for foreign growth have been revised downward since December and the dollar has been somewhat stronger than CBO anticipated. The consensus forecast for Japan's growth this year is now 1.5 percent, 1 percentage point lower than last November's forecast. The forecast for growth in Germany in 1993 has been similarly reduced--from 0.7 percent growth to a decline of 1.0 percent. In addition, despite the fall of the dollar against the Japanese yen, the trade-weighted value of the dollar was about 3 percent higher during the first quarter than CBO forecast. These developments will make U.S. export growth weaker this year than the CBO baseline assumed.

Slower gains in personal consumption will also constrain growth in the first half of this year. The growth of consumption, which was the strongest category of demand in the last half of 1992, will probably slow in the first half of this year. Consumption outpaced disposable income last year, dropping the personal saving rate in the second half of 1992 below that of the first. It is likely that households will try to maintain current saving rates or even rebuild savings, and such an effort will weaken consumer demand in the first half of this year.

By contrast to developments in foreign demand and consumption, the lower long-term interest rates, if they remain low, will stimulate growth this year. Although budget developments will heavily influence rates in the coming months, it is reasonable to assume that long-term interest rates will remain at least slightly below the CBO baseline. This will stimulate growth more than assumed in the baseline.

On balance, the lower interest rates and the worsening foreign outlook approximately offset each other, resulting in little net effect on GDP growth for the year. The quarterly pattern of growth will probably be different than was previously thought, however. The unexpectedly strong growth in late 1992 will be counterbalanced by slightly weaker than expected growth in the first half of this year as consumers retrench. The overall growth for the year still appears likely to be about 3 percent.

Comparison with the Recent Consensus Forecast

The major difference for the next two years between the CBO baseline forecast and the current *Blue Chip* consensus lies in the forecast for inflation, although the consensus indicates slightly stronger real growth and lower long-term interest rates this year, and higher interest rates in subsequent years (see Table II-1).

The *Blue Chip* forecasters expect significantly higher inflation in 1994 than does CBO. Unless growth is much more rapid than that envisioned by the consensus forecast, CBO does not foresee inflationary pressures developing in 1994. Because growth of the labor force will increase, the unemployment rate is likely to remain relatively high well into 1994 despite a respectable pace of job creation. Wages, therefore, will continue to be moderate in relation to productivity gains through the forecast horizon. Pressures on factories' capacity to produce are also unlikely to rise enough to raise the rate of inflation.

Long-term interest rates will probably be slightly lower this year than the CBO forecast indicated. The *Blue Chip*, however, forecasts an increase in nominal interest rates next year. Most of the difference between the CBO and the consensus forecasts for interest rates in 1994 reflects different inflation assumptions. After adjusting for this difference, long-term interest rates are slightly higher in the CBO baseline than in the *Blue Chip* forecast.

CHAPTER III. THE ADMINISTRATION'S REVENUE PROPOSALS

The President's budget contains a large number of revenue proposals. Some of the proposals extend provisions in the tax law that expired in 1992, or will expire in the next few years, but many of the proposals are new. The President's proposals include increasing income tax rates on high-income individuals and large corporations, extending the Hospital Insurance (HI) portion of the payroll tax to all the wages of the highest wage earners and self-employed individuals, taxing a higher proportion of Social Security benefits, and imposing a new energy tax. The budget also contains proposals that broaden the tax base for some taxpayers.

The President's budget intends to return some of the revenue gains from tax-rate increases and base-broadening measures in the form of tax incentives for a wide variety of activities. These proposals include restoring most of the tax incentives that expired in 1992 and partially reinstating some of the tax preferences that the Congress eliminated or scaled back in the Tax Reform Act of 1986.

AN OVERVIEW OF THE PRESIDENT'S TAX PROPOSALS

The President's revenue proposals have a number of broad themes. First, the proposals as a whole increase revenue to reduce the federal deficit. Second, the proposals raise a large share of the new revenues from high-income taxpayers in order to shift the distribution of the tax burden among income groups. Third, the proposals include a major new tax on energy consumption. Fourth, some proposals either extend expiring tax incentives or introduce new ones. Finally, a number of smaller proposals broaden the tax base, penalize certain activities, and improve compliance.

Increasing Revenues

Based on estimates from the Joint Committee on Taxation (JCT), the President's proposals will increase net receipts by $28 billion in 1994 and $267 billion through 1998 (see Table III-1). Proposals that increase revenues amount to $46 billion in 1994 and $337 billion in the 1994-1998 period. These increases are offset in part by other proposals that reduce revenues by $18 billion in 1994 and $70 billion in 1994 through 1998. In addition, proposed changes in the earned income tax credit (EITC) increase outlays by about $17 billion over the 1994-1998 period.

TABLE III-1. JCT/CBO ESTIMATES OF THE CLINTON ADMINISTRATION'S REVENUE PROPOSALS (By fiscal year, in billions of dollars)

	1994	1995	1996	1997	1998
Stimulus and Investment Proposals					
Investment Credits and AMT Depreciation	-13.4	-7.1	-4.2	-3.8	-4.2
Enterprise Zones	-0.2	-0.7	-1.1	-1.6	-2.1
Expand Earned Income Tax Credit[a]	-0.2	-1.9	-2.0	-2.1	-2.2
Exclude Capital Gains on Original-Issue Small Business Stock	0	-0.1	-0.2	-0.2	-0.2
Extend Preferences	-4.1	-3.3	-4.1	-5.0	-5.8
Other	-0.2	-0.3	0	0.1	0.2
Subtotal	-18.2	-13.3	-11.7	-12.6	-14.3
Revenue-Raising Proposals					
Increase Top Individual Tax Rate to 36%; 26% & 28% AMT; Increase AMT Exemption to $45,000/$33,750; 39.6% Rate on Taxable Income Greater Than $250,000; Extend Phaseout of Personal Exemptions and Limit on Itemized Deductions	25.7	17.0	19.9	24.0	25.8
Remove Cap on HI Taxable Wage Base[b]	2.8	6.0	6.4	6.8	7.2
Include 85% of Social Security Benefits in AGI	2.9	6.1	6.9	7.7	8.5
Increase Income Tax Rate on Large Corporations	8.1	5.4	5.7	5.9	6.1
Establish Broad-Based Energy Tax[b]	1.0	9.4	17.0	22.1	23.5
Extend 2.5 Cents per Gallon Gas Tax[b]	0	0	2.6	2.7	2.7
Cap Possessions Tax Credit (Sec. 936) at 65% of Wages	0.2	0.8	1.9	2.7	2.7
Restrict Deduction for Business Meals and Entertainment to 50%	1.8	3.2	3.3	3.5	3.6
International Tax Provisions	0.4	1.1	1.0	1.0	1.1
Compliance Provisions	0.1	0.2	0.2	0.2	0.2
Change Corporate Estimated Tax Rules	0	0	0	4.3	0.9
Other	2.9	3.2	3.1	3.8	3.9
Subtotal	45.8	52.4	68.1	84.8	86.0
All Proposals					
Total	27.7	39.1	56.4	72.2	71.7

SOURCES: Congressional Budget Office; Joint Committee on Taxation.

NOTE: JCT = Joint Committee on Taxation; AMT = alternative minimum tax; HI = Hospital Insurance; AGI = adjusted gross income.

a. Two-thirds of the effect of expanding the EITC is in the form of refundable tax credits. The refundable portion is not included here; it is included with the outlay proposals.

b. Net of income tax offsets.

Among the revenue-raising proposals, about 60 percent of the increase in revenue in 1994 through 1998 comes from increases in individual and corporate income tax rates, repeal of the wage cap on the health insurance payroll tax, increased taxation of Social Security benefits, and increases in estate and gift tax rates. The increase in income tax rates on high-income individuals by itself accounts for about one-third of the pickup in gross revenues and almost half of the net revenue gain (after accounting for revenue-losing proposals). Another quarter of the gross revenue pickup comes from the new energy tax and extending the 2.5 cent portion of the motor fuels tax that is allocated to general revenues. Proposals to restrict some business and individual deductions, eliminate some tax preferences, and alter some provisions affecting international business would raise an additional 10 percent of the gross revenue.

Investment incentives account for more than three-fourths of the proposed revenue reductions in 1994 through 1998. The proposed temporary and permanent investment tax credits and revised rules for depreciation under the alternative minimum tax (AMT) make up almost half of the revenue reduction; another fifth comes from extending the tax credits for research and experimentation (R&E) and low-income housing. The other major item is the proposed expansion of the EITC, which would increase the deficit by about $24 billion over five years. About two-thirds of the budgetary cost of the expanded EITC is accounted for by the refundable portion, which the Congressional Budget Office (CBO) records as an increase in outlays.

Redistributing the Tax Burden

The President's proposals will shift a greater share of the federal tax burden to high-income taxpayers. CBO estimates that the tax proposals (including the refundable portion of the EITC) will raise total effective federal tax rates (ETRs) on average by about 7 percent for families in the top quintile of the income distribution, about 3 percent for families in the third and fourth quintiles, and about 1 percent for families in the second quintile, and will reduce ETRs by about 4 percent on average for families in the bottom quintile (see Table III-2). The lower ETR in the bottom quintile is a consequence of expanding the EITC.

Within the top quintile, the increase in taxes is relatively largest for families with the highest incomes. Families in the top 1 percent would bear more than 55 percent of the burden of the new taxes. The proposal would raise the ETR for these families by almost 20 percent, from about 28 percent under current law to about 33 percent under the proposal. The new ETR for

TABLE III-2. CHANGES IN EFFECTIVE TAX RATES UNDER THE PRESIDENT'S TAX PROPOSALS, BY INCOME GROUP (In percent)

	Effective Tax Rates		Percentage Change in		Share
	Current Law[a]	Proposal	Effective Tax Rate	After-Tax Income	of Change in Taxes
	Families Ranked by Adjusted Family Income				
Income Quintile					
Lowest	7.0	6.7	-4.3	0.3	-0.9
Second	15.0	15.2	1.1	-0.2	1.4
Third	19.3	19.8	2.7	-0.7	6.6
Fourth	22.1	22.6	2.6	-0.7	10.8
Highest	26.2	28.1	7.1	-2.5	81.3
All	22.8	24.0	5.1	-1.5	100.0
Detail on Highest Quintile					
81 percent to 90 percent	24.6	25.2	2.6	-0.8	8.4
91 percent to 95 percent	25.9	26.5	2.5	-0.9	5.6
96 percent to 99 percent	26.8	27.8	3.6	-1.3	10.8
Top 1 percent	28.0	33.2	18.7	-7.3	56.5
	Families Ranked by Dollar Income				
Income Level					
Less than $10,000	7.5	8.0	6.7	-0.5	0.8
$10,000 to $20,000	11.5	11.8	2.9	-0.4	1.7
$20,000 to $30,000	16.9	17.0	0.4	-0.1	0.5
$30,000 to $40,000	19.8	20.2	2.3	-0.6	3.8
$40,000 to $50,000	21.6	22.2	2.9	-0.8	5.4
$50,000 to $75,000	23.4	24.1	2.7	-0.8	11.6
$75,000 to $100,000	25.2	25.8	2.4	-0.8	6.8
$100,000 to $200,000	26.1	26.8	2.4	-0.9	8.2
$200,000 or more	27.9	32.7	17.6	-6.8	60.3
All	22.8	24.0	5.1	-1.5	100.0

SOURCE: Congressional Budget Office.

NOTES: The estimates assume 1998 tax law and 1994 income levels. They include all tax proposals except the enterprise zone proposal, the proposal on corporate estimated tax payments, and miscellaneous compliance measures.

Pretax family income is the sum of wages, salaries, self-employment income, rents, taxable and nontaxable interest, dividends, realized capital gains, and all cash transfer payments. Income also includes the employer's share of Social Security and federal unemployment insurance payroll taxes, and the corporate income tax. For purposes of ranking by adjusted family income, income for each family is divided by the projected 1994 poverty threshold for a family of that size. Quintiles contain equal numbers of people. Individuals are treated as families of one. Families with zero or negative income are excluded from the lowest income category but are included in the total.

Changes in individual income taxes, premiums, and entitlements are distributed directly to families paying those taxes and premiums, or receiving those benefits. Changes in payroll taxes are distributed to families paying those taxes directly, or indirectly through their employers. Changes in federal excise taxes are distributed to families according to their consumption of the taxed good or service. Changes in corporate income taxes are distributed to families according to their income from capital.

a. Current law reflects the scheduled expiration of the limitation of itemized deductions, the phaseout of personal exemptions, and the 2.5 cent component of the gasoline tax that goes into the general fund.

the top 1 percent would be slightly greater than their ETR in 1980 (about 32 percent), but smaller than their ETR in 1977 (almost 36 percent).

The quintile rankings used in the top panel of Table III-2 array families by adjusted family income (AFI), a measure that adjusts for need based on family size. The results are similar when families are ranked by dollar income, except in the lowest-income groups (see bottom panel of Table III-2). The ETR of the highest-income families increases by the largest absolute amount and the largest percentage. Families with incomes of more than $200,000 would bear 60 percent of the additional tax burden, while families with incomes of more than $100,000 would pay almost 70 percent. The ETR for families with incomes of more than $200,000 would increase by about 18 percent.

The tax proposals affect families at the same income level quite differently, as highlighted by the differences in the measured changes in the ETR for low-income taxpayers between the two panels of Table III-2. As a result, an increase or decrease in the tax burden for a quintile as a whole does not mean the tax burden will change even in the same direction for any family within the quintile. The results by quintile are consistent with a wide range of outcomes for separate families.

For example, because the EITC in its current form goes to wage earners in families with children, its effect is highly uneven within the bottom quintile. The average ETR for families without children in the bottom quintile increases under the proposal; at the same time, the ETR falls substantially for families with children. Because the AFI measure gives larger families a lower ranking than smaller families at the same income level, it shows a tax reduction for the bottom quintile as a whole. In contrast, when families are grouped by unadjusted income levels, families with incomes of less than $20,000 experience an overall tax increase. This effect takes place because those groups contain relatively more single people and families without children, who would benefit less from the expanded EITC than average families in the bottom quintile ranked by adjusted family income.

The energy tax also varies in its impact within quintiles, depending on the proportion of its income that a family spends on gasoline, home heating oil, natural gas, and electricity. The net tax increase for low-income families mainly reflects the effects of the proposed new energy tax, although families in all income groups also bear some of the burden of higher corporate income taxes.

To compensate low-income families for the effects of the proposed energy tax, the President has proposed increases in Food Stamps and the Low Income Home Energy Assistance Program (LIHEAP). The combined effects of the President's tax and transfer proposals reduce the average ETR (adjusted for changes in LIHEAP and Food Stamps) for families with income under $10,000 and increase the average ETR for families with income between $10,000 and $30,000 by less than 0.2 percent (see Table III-3). Families with incomes of more than $100,000 bear more than 70 percent of the combined tax burden of additional taxes and transfer payments (Food Stamps and LIHEAP).

CBO estimates of the distributional effects of the President's proposals differ from those of the Treasury Department because of differences in methodologies. These methodological differences include different ways of measuring income, grouping people into family or taxpayer units, allocating the burden of taxes collected from companies among income groups, and projecting the most recently available income and tax data to future years.

In spite of those technical differences, CBO and Treasury estimates of the distributional impact of the President's proposals are qualitatively similar. Both CBO and Treasury estimates show that the burden of the tax proposals falls mostly on the highest-income families. Both estimates also show that the average tax burden on families in the lowest-income groups either declines or increases very modestly.

Taxing Energy

The President proposes to impose a new tax on consumption of British thermal units (Btus) of energy. The tax rates would be 25.7 cents per million Btus on coal, natural gas, and nuclear and hydroelectric power and 59.9 cents per million Btus on oil. The proposal would phase in these rates over a three-year period beginning on July 1, 1994, and then index the rates to inflation after July 1, 1997.

CBO calculates that the proposal, when fully phased in, would increase the price of gasoline by 7.5 cents per gallon (about 6 percent), home heating oil by 8.3 cents per gallon (about 7 percent), natural gas by 26.5 cents per million cubic feet (about 4 percent), and residential electricity by 0.3 cents per kilowatt hour on average (about 3 percent). These price changes would increase direct annual energy costs by less than $100 for the average household. The total cost of all goods and services, including the costs resulting from higher energy prices paid by businesses, would rise by over $200 per household.

The Administration lists energy conservation, environmental improvement, and improved national security as benefits from taxing consumption of Btus. The tax will promote all of these objectives to some degree, but the gains are likely to be minimal.

TABLE III-3. CHANGES IN EFFECTIVE TAX RATES BY INCOME GROUP: PRESIDENT'S TAX PROPOSALS, FOOD STAMPS, AND LOW INCOME HOME ENERGY ASSISTANCE PROGRAM (In percent)

	Effective Tax Rates		Percentage Change in		Share of Change in Taxes
	Current Law[a]	Proposal	Effective Tax Rate	After-Tax Income	
	Families Ranked by Adjusted Family Income				
Income Quintile					
Lowest	7.0	5.1	-27.0	2.0	-6.2
Second	15.0	15.1	0.6	-0.1	0.8
Third	19.3	19.8	2.7	-0.6	6.8
Fourth	27.1	22.6	2.6	-0.7	11.4
Highest	26.2	28.1	7.1	-2.5	86.5
All	22.8	24.0	4.8	-1.4	100.0
Detail on Highest Quintile					
81 percent to 90 percent	24.6	25.2	2.6	-0.8	9.0
91 percent to 95 percent	25.9	26.5	2.5	-0.9	6.0
96 percent to 99 percent	26.8	27.8	3.6	-1.3	11.5
Top 1 percent	28.0	33.2	18.7	-7.3	60.1
	Families Ranked by Dollar Income				
Income Level					
Less than $10,000	7.5	5.8	-22.8	1.9	-3.0
$10,000 to $20,000	11.5	11.5	0.2	b	0.1
$20,000 to $30,000	16.9	17.0	0.1	b	0.1
$30,000 to $40,000	19.8	20.2	2.2	-0.5	3.9
$40,000 to $50,000	21.6	22.2	2.9	-0.8	5.7
$50,000 to $75,000	23.4	24.1	2.7	-0.8	12.3
$75,000 to $100,000	25.2	25.8	2.4	-0.8	7.2
$100,000 to $200,000	26.1	26.8	2.4	-0.9	8.7
$200,000 or more	27.9	32.7	17.6	-6.8	64.2
All	22.8	24.0	4.8	-1.4	100.0

SOURCE: Congressional Budget Office.

NOTES: The estimates assume 1998 tax law and 1994 income levels. They include all tax proposals except the enterprise zone proposal, the proposal on corporate estimated tax payments, and miscellaneous compliance measures and also include proposed changes in food stamps and low income home energy assistance program.

Pretax family income is the sum of wages, salaries, self-employment income, rents, taxable and nontaxable interest, dividends, realized capital gains, and all cash transfer payments. Income also includes the employer's share of Social Security and federal unemployment insurance payroll taxes, and the corporate income tax. For purposes of ranking by adjusted family income (AFI), income for each family is divided by the projected 1994 poverty threshold for a family of that size. Quintiles contain equal numbers of people. Families with zero or negative income are excluded from the lowest income category but are included in the total.

Changes in individual income taxes, premiums, and entitlements are distributed directly to families paying those taxes and premiums, or receiving those benefits. Changes in payroll taxes are distributed to families paying those taxes directly, or indirectly through their employers. Changes in federal excise taxes are distributed to families according to their consumption of the taxed good or service. Changes in corporate income taxes are distributed to families according to their income from capital.

a. Current law reflects the scheduled expiration of the limitation of itemized deductions, the phase-out of personal exemptions, and the 2.5 cent component of the gasoline tax that goes into the general fund.
b. Decrease of less than 0.05 percent.

Environmental quality is closely associated with energy use. Burning fossil fuels emits pollutants that contribute to respiratory problems caused by smog and damage to forests associated with acid rain. Burning fossil fuels also emits carbon dioxide, which may contribute to global warming.

Taxes that broadly discourage energy use are, however, a blunt tool for reducing pollution. If it were feasible, it would be better to tax the pollution itself instead of the fuel. The President's proposal would reduce emissions of carbon dioxide less than a tax on carbon content or a flat-rate Btu tax, both of which would impose higher tax rates on coal (the largest source of carbon dioxide emissions) to raise the same revenue.

Energy security is almost exclusively a problem related to oil. The United States currently imports slightly less than half of its oil. The benefits of security consist mostly of the avoided macroeconomic losses from rising oil prices that result from political disruption to oil supplies. CBO estimates that the President's Btu tax would reduce oil imports by about 150,000 barrels per day, or by about 2 percent of net imports, in the first year after full application. These lower imports would reduce U.S. vulnerability to a disruption in world oil supplies, but only marginally. Taxes on all oil or on motor fuels that raised the same revenue as the President's Btu tax would reduce imports more, but not enough to reduce vulnerability to disruptions significantly.

The Btu tax could produce competitive problems for some industries that are relatively high users of energy because the indirect energy content of competing imports would escape the tax. The President's proposal exempts energy consumed as a feedstock, but it does not exempt the use of energy as a fuel by internationally competitive industries. Additional exemptions would protect these industries, but would increase administrative and compliance costs and reduce the revenue pickup from the tax.

The impact on households of energy taxes can differ among regions because of regional differences in the pattern of energy consumption. For any household, the effect on the cost of living depends on the increase in direct and indirect energy costs as a percentage of household spending. The President's Btu tax will increase the cost of living on average by about the same for urban households in the Northeast, the Midwest, the South, and the West, but will increase the cost of living by about 15 percent more for rural households than for urban households. Compared with the President's proposal, a tax on all oil or on motor fuels that raises the same revenue would increase the cost of living even more for rural consumers. A tax on all oil would increase the cost of living by about the same amount for urban consumers in all four regions, while a motor fuels tax would increase the cost of living slightly less for urban consumers in the Northeast.

Stimulating Short-Term Recovery

The President's economic stimulus package includes some tax incentives. The most important of these is the 7 percent temporary, incremental investment tax credit (ITC) for purchases of new machinery and equipment after December 3, 1992, and before December 31, 1994. The credit applies to qualifying investment in excess of 70 percent of the base amount before December 31, 1993, and 80 percent of the base amount in 1994. The base amount is equal to average qualifying investment by the firm in either the three or five previous years. In no case, however, can the base amount be less than 50 percent of current-year investment. Recapture rules would limit the advantage from bunching investments in 1993 and 1994, thereby negating some of the short-term stimulus.

The proposal also contains a permanent, nonincremental ITC for small businesses. The credit rate is 7 percent for qualifying investments placed in service between December 3, 1992, and December 31, 1994, and 5 percent after that date. For both the temporary, incremental ITC and the permanent, small-business ITC, the credit rate is reduced for short-lived assets.

The purpose of the temporary, incremental ITC is to stimulate investment but minimize the revenue loss by limiting the subsidy to marginal investments. Incremental credits, however, involve substantial administrative and compliance problems that could limit their effectiveness in stimulating investment. For example, complex rules may be necessary to limit abuse in determining the investment base. The Administration intends to develop special rules for leased equipment. There will also need to be rules for allocating the base among partnerships and between domestic and foreign entities for multinational corporations. Because there is often a long lag in writing regulations for complex statutes, taxpayers may not receive clear guidance on many of these issues in time to affect their decisions.

Promoting Some Forms of Investment and Employment

The President is proposing a number of incentives to encourage demand for certain types of investment and employment and help some types of producers. Many of the President's proposals extend incentives that were in the tax law in previous years and expired in 1992.

Subsidized Activities. The President's tax proposals subsidize selected activities. The investment tax credit encourages investment in qualified machinery and equipment in the United States, as compared with structures, inventory, and all capital located overseas. The extension of the R&E credit and the introduction of new rules for cost allocation encourage businesses to perform research in the United States. The President is also proposing extending tax incentives for investment in low-income housing (low-income housing credit and mortgage revenue bonds) and high-speed rail facilities (high-speed rail bonds), employment of low-wage workers (targeted jobs credit and EITC), and employer spending on education of employees (extending broad tax exemption of employer-provided educational assistance).

Subsidized Producers. Some of the President's proposed tax incentives assist particular groups of producers. The permanent ITC and the capital gains exemption for stock in small business will make it easier for small companies to raise capital. The proposals for enterprise zones reduce the cost of labor and capital for companies that locate production within designated geographic areas. The temporary, incremental ITC favors firms that deferred investments during the recession over firms that continued to invest. All the tax credits favor investments by firms that have enough tax liability to use the credits over firms that have no current-year tax liability or are subject to the AMT.

Promoting Other Objectives

The President's tax proposals also seek to promote other objectives. Some of the proposals, such as the denial of deductions for lobbying expenditures, intend to discourage some business activities. Other proposals reduce or eliminate preferential taxation of some activities, broaden the tax base, and try to improve compliance.

Discouraging Some Business Activities. The President proposes to eliminate deductions for lobbying and for executive compensation in excess of $1 million that is not tied to productivity. These limits impose a higher effective tax rate on the income of certain employees by denying their employers deductions for the cost of paying them. The President also proposes to reduce the percentage of the cost of business meals and entertainment that firms can deduct from 80 percent to 50 percent and to eliminate deductions for club dues. These latter expenditures are also a cost of business. They do, however, often provide tax-free consumption benefits for sole proprietors and employees who would otherwise have to purchase meals and entertainment with after-tax dollars.

Removing Some Tax Preferences. The President's proposals reduce a number of tax preferences. The proposals reduce the amount that employers can contribute to qualified pensions for higher-paid employees without increasing contributions for other employees; require securities dealers to pay tax on their accrued inventory income; eliminate the tax deduction for reimbursed losses of the Federal Savings and Loan Insurance Corporation; eliminate an exception to rules for limiting the foreign tax credit for passive income of oil and gas and shipping companies; and limit the possessions tax credit to 65 percent of wages to employees in the possession. The overall revenue pickup from these base-broadening proposals is a small percentage of the total revenue gain from the President's proposals.

Improving Compliance. The President proposes four new initiatives to improve compliance with existing tax laws. These include requiring that payers file an information return when they pay corporations more than $600 in a year for services; increasing the standard to avoid understatement and preparer penalties for incorrect positions taken on individual income tax returns; codifying proposed Treasury regulations that establish transfer pricing procedures companies can use to avoid Internal Revenue Service (IRS) penalties; and increasing IRS collections and examinations staff by 2,000 positions. The Administration withdrew another proposal that would have required corporations to validate taxpayer identification numbers (TINs) when they made payments to service providers and increased the percentage withheld from payments if the provider did not furnish a TIN.

JCT estimates that the proposals for filing information returns and establishing tougher criteria for avoiding penalties produce much smaller gains in revenue than the Administration estimates. Unlike the Administration, CBO does not estimate any increase in receipts from the proposal to increase the IRS collections and examinations staff because the Administration has not detailed its specific initiative or established how it would increase receipts.

EFFECTS OF HIGHER MARGINAL TAX RATES

The President's proposals depart most dramatically from tax policy over the previous decade by increasing marginal tax rates on high-income individuals and corporations. Between 1980 and 1992, the top marginal tax rate on individuals declined from 70 percent (50 percent on earned income) to 31 percent, while the top marginal rate on corporations declined from 46 percent to 34 percent. The President's proposals partially reverse these changes. Some commentators have expressed concerns that these changes would adversely affect economic incentives and gather in less revenue than the Administration projects.

Marginal Tax Rates and Incentives

The President's proposals, including the effect of extending the HI tax to all covered earnings, increase marginal tax rates on high-income individuals by much more than they increase average ETRs. For taxpayers with taxable incomes of more than $250,000, the proposals increase the effective marginal tax rate on a dollar of pretax wage income from 31 percent under current law (after the expiration of the phaseout of personal exemptions and limit on itemized deductions) to about 43 percent--an increase of about 40 percent. The proposals increase the marginal tax rate on a dollar of interest or dividend income from 31 percent to about 41 percent--a hike of about 32 percent. Higher marginal tax rates provide incentives for taxpayers to convert taxable income to nontaxable forms and may reduce the incentive to work and save.

Because the top effective tax rate on long-term capital gains will remain at 29 percent (including the effect of the limitation on itemized deductions), the proposals reintroduce a substantial tax differential between ordinary income and capital gains. For taxpayers with the highest incomes, the differential between the rates on capital gains and dividends will increase from about 3 to about 12 percentage points. (Before 1986, the differential was 30 percentage points). The higher marginal tax rates, the increase in the relative preference for capital gains, and the proposed new tax incentives represent a partial reversal of the Tax Reform Act of 1986 (TRA), which lowered marginal tax rates and broadened the tax base. This shift could encourage a reemergence of tax shelters that TRA ended and lead to future pressures that could further erode the tax base.

The increase in the top corporate tax rate for large corporations, combined with partial restoration of some tax preferences for business investment, also reverses in part the effects of TRA. Because the preferences reduce the costs of capital only for selected investments by some corporations, the net effect of the changes is to increase the variation in effective tax rates among investments. The combination of higher rates and selective preferences for certain assets and corporations could reduce the average productivity of the capital stock by encouraging firms to invest in assets with a lower pretax return in order to gain tax benefits. The proposed changes could also lower economic efficiency by inducing the private sector to incur additional transactions costs to transfer ownership of assets to companies with lower tax rates and to those that can benefit from the preferences.

Higher Marginal Tax Rates and Revenue

All budget estimates are uncertain. The estimates of revenue from the President's proposals to raise marginal tax rates contain two important uncertainties--the amount of income the proposals will cover (the tax base) and the size of taxpayers' behavioral responses.

The Tax Base. The base to which the higher income tax rates will apply is uncertain because the changes in rates apply to only a small percentage of the taxpaying population. Even before considering behavioral responses, the revenue effect is highly sensitive to the proportion of total income that the top 2 percent of the population will receive between 1994 and 1998. Primarily because of differences in baseline projections, JCT estimates that the President's proposals to raise individual income tax rates on high-income taxpayers will raise $14 billion (about 11 percent) less in the 1993-1998 period than the Administration estimates.

Behavioral Responses. Official government revenue estimates take into account a variety of behavioral responses to tax changes. People respond to tax changes by shifting their patterns of consumption and investment, rearranging their asset portfolios, altering the timing of when they realize income, and making other adjustments that affect tax liability. Revenue estimates include such responses affecting the composition of income, but hold the total level of gross domestic product fixed.

The proposed increases in marginal tax rates could produce a variety of responses. They could lead to reduced work effort and saving by lowering after-tax wages and rates of return that high-income employees, savers, and the self-employed receive. Conversely, individuals may work and save more to maintain their current and future consumption levels in the face of higher taxes. The evidence from most econometric research does not establish that these aggregate responses are significant, or even show a consistent direction of response. But some recent evidence suggests that high-income taxpayers may reduce their saving when tax rates rise.

In addition, many high-income taxpayers can find ways to convert taxable income to nontaxable or more lightly taxed forms of income. Taxpayers could reallocate their investments from taxable bonds and stocks with high dividend yields to tax-exempt bonds, growth stocks, and household capital; convert ordinary income to capital gains; take more of their compensation in the form of tax-free fringe benefits; and increase deductible charitable contributions. Economists have found some of these activities to be sensitive to changes in marginal tax rates, although the magnitudes of responses are uncertain.

Both JCT and the Administration assume that high-income taxpayers reduce their taxable income to some degree in response to higher marginal tax rates. This behavioral response offsets some of the revenue increase from applying higher rates to income projected under current law. Because the magnitude of the behavioral response is unknown, the net revenue pickup from higher marginal tax rates is uncertain. However, behavioral responses would probably offset only a small share of the static revenue gain unless the magnitude of taxpayer responses is larger than most econometric research suggests.

CHAPTER IV. THE ADMINISTRATION'S DEFENSE PROPOSALS

As part of its economic plan, the Clinton Administration has proposed reductions in defense funding over the next five years. Budget authority for national defense (function 050) would fall from $264 billion in 1994 to $254 billion in 1998. Outlays would decline from $277 billion to $253 billion. The Administration has also announced that it intends to pare the active-duty military to 1.4 million people from its current level of 1.8 million. Detailed five-year plans for changes in forces and weapons, however, will not be available until late this year or early next.

Compared with the Bush Administration's budget prepared in January 1993, the Clinton plan would reduce defense budget authority by $46 billion in 1998. About 40 percent of the savings reflects lower inflation assumptions; another 10 percent, reductions in pay raises; and the remainder, program cuts.

Under plausible assumptions, the cuts in defense programs could be accomplished while maintaining a force of 1.4 million. Funding for the development and procurement of weapons, however, may have to be cut disproportionately compared with funding for personnel and day-to-day operations. Other factors--for example, possible underfunding in the Bush Administration's final budget or Congressional refusal to approve all the changes in pay policy--could force the Clinton Administration either to trim its proposed active-duty force below 1.4 million or to increase its budget request.

EXTENT AND SOURCES OF SAVINGS

Compared with CBO's uncapped baseline, which assumes that defense budget authority beyond 1993 equals the 1993 level adjusted for inflation, savings in the new Administration's plan are substantial. By 1998, budget authority would be reduced by $68 billion and outlays by $62 billion (see Table IV-1). Total savings in the 1994-1998 period amount to $240 billion in budget authority and $188 billion in outlays.

Because the uncapped baseline and the Clinton plan use the same economic assumptions, all these savings stem from policy changes. In 1998, about 50 percent of the reduction in budget authority reflects program cuts proposed by the Bush Administration, including a reduction to a base force of 1.6 million active-duty personnel from today's level of about 1.8 million and various changes in certain weapons programs. Another 15 percent of the reduction reflects changes in pay raise assumptions and President Clinton's

TABLE IV-1. THE CLINTON ADMINISTRATION'S PLAN AND CBO'S UNCAPPED BASELINE FOR NATIONAL DEFENSE (By fiscal year, in billions of dollars)

Category	1994	1995	1996	1997	1998	1994-1998
			Budget Authority			
CBO's Uncapped Baseline	288	296	305	313	322	1,523
Changes						
Bush program cuts	-11	-17	-28	-33	-34	-123
Pay assumptions and policies[a]	-4	-6	-7	-9	-10	-37
Clinton program cuts	-9	-10	-16	-23	-23	-81
Total	-24	-33	-51	-65	-68	-240
Clinton Plan	264	263	254	248	254	1,283
			Outlays			
CBO's Uncapped Baseline	289	293	300	307	314	1,504
Changes						
Bush program cuts	-5	-11	-19	-26	-28	-89
Pay assumptions and policies[a]	-4	-6	-7	-9	-10	-35
Clinton program cuts	-3	-5	-9	-23	-23	-64
Total	-12	-21	-35	-58	-62	-188
Clinton Plan	277	272	265	249	253	1,316

SOURCE: Congressional Budget Office.

a. The savings from pay policies include amounts by which the baseline prescribed in the Budget Enforcement Act overstates pay costs compared with current law.

governmentwide pay policies, including a 1994 pay freeze, reduced pay raises beyond 1994, and changes in the locality pay plan for civilian employees. The remaining 35 percent of savings reflects policy changes that the Clinton Administration has not yet specified.

Another comparison--between the Clinton plan and the final budget the Bush Administration released in January 1993--focuses on differences between the two Administrations. Compared with the final Bush budget, the Clinton plan reduces 1998 budget authority and outlays for national defense by $46 billion and $45 billion, respectively (see Table IV-2). About 40 percent of the 1998 cut reflects the Clinton Administration's assumption of lower inflation. Another 10 percent reflects the changes in pay policy noted above. The Clinton Administration expects to realize the remainder of the cut--$23.4 billion, or only half of the total reduction from the Bush budget--by trimming defense forces and weapons programs.

Because much of the savings in the Clinton plan reflect lower inflation, the Bush Administration's final budget and the Clinton Administration's initial request are closer when compared in real terms. After adjusting for inflation, 1998 budget authority under the final Bush budget is about $252 billion compared with $232 billion under the Clinton budget request--a real difference of about 8 percent compared with 16 percent using nominal numbers.

SUPPORTING AN ACTIVE-DUTY FORCE OF 1.4 MILLION

The primary challenge facing military planners is to structure forces to meet the threats to U.S. national security given the size of the defense budget. Because the Congress may debate and act on President Clinton's proposals for the defense budget before the new Administration releases its detailed plans, this chapter uses available information to examine whether the new Administration's funding level is capable of supporting its planned force of 1.4 million active-duty personnel.

Whether that funding level can support such a force will depend on the answers to many questions. For example, how much can be cut from the Department of Defense's (DoD's) overhead? How long will it take to close bases and streamline maintenance and support activities? Bases can take years to close, and correcting environmental hazards that will linger after troops leave may take even longer. At what point do out-year targets for efficiency savings become unrealistic and contribute to the underfunding of programs? What sort of industrial base does the nation need for future

TABLE IV-2. THE CLINTON ADMINISTRATION'S PLAN AND THE BUSH ADMINISTRATION'S FINAL BUDGET FOR NATIONAL DEFENSE (By fiscal year, in billions of dollars)

Category	1994	1995	1996	1997	1998	1994-1998
			Budget Authority			
Bush Budget (January 1993)	280	284	286	291	301	1,441
Changes						
Lower inflation	-6	-9	-12	-15	-18	-60
Pay policies	-2	-3	-4	-5	-5	-18
Program policies	-9	-10	-16	-23	-23	-81
Total	-16	-22	-32	-42	-46	-159
Clinton Plan	264	263	254	248	254	1,283
			Outlays			
Bush Budget (January 1993)	285	287	288	290	297	1,448
Changes						
Lower inflation	-3	-7	-11	-13	-16	-50
Pay policies	-2	-3	-4	-5	-5	-18
Program policies	-3	-5	-9	-23	-23	-64
Total	-8	-14	-24	-41	-45	-131
Clinton Plan	277	272	265	249	253	1,316

SOURCE: Congressional Budget Office.

production of weapons? How should weapons be acquired and modified to give DoD the weapons and industrial capacity it needs? Clearly, the Administration will have to make a trade-off between the risks of underfunding day-to-day costs and those of underfunding weapons programs.

Personnel and Day-to-Day Operations

Reducing the active-duty force from 1.8 million to 1.4 million could affect the defense budget in many ways depending on the speed of the drawdown, how it is achieved, and how large a reserve force is retained. DoD and the Congress have relied on separation payments, early retirement options, and reducing new enlistments to limit the number of people who must leave military service involuntarily. The Congress resisted the efforts of the Bush Administration to reduce reserve forces in proportion to active forces. All these actions affect the potential budgetary savings in the military personnel accounts.

Similar problems occur with appropriations for operation and maintenance (O&M) and family housing. Even though these accounts are sensitive to force levels, they are difficult to cut quickly during a personnel drawdown. Some O&M costs are relatively fixed, and some savings would come only after a protracted process of closing bases. In the short term, certain costs could rise as a result of consolidations and transfers. During the next five years, perhaps only half of these accounts would reflect savings from the reduction in active-duty personnel.

Given these constraints, how much might be saved in the operations portion of the budget? The estimates in Table IV-3 reflect the results of one plausible set of assumptions: a gradual drawdown to 1.4 million personnel by 1997, limited involuntary separations, delayed O&M savings, and reserve cuts equal to those sought by the Bush Administration. Under these assumptions, military personnel costs would be reduced by $21 billion, or 6 percent, in the 1994-1998 period compared with the Bush Administration's final budget; all funds for day-to-day costs would fall by about $37 billion, or about 4 percent to 5 percent.

Weapons Acquisition

Will funds for weapons programs, which have fallen disproportionately in recent years, again have to be cut disproportionately because personnel savings would be slow to materialize? Under the assumptions noted above,

TABLE IV-3. POSSIBLE CHANGES IN FUNDING TO MAINTAIN AN ACTIVE-DUTY FORCE OF 1.4 MILLION UNDER THE CLINTON ADMINISTRATION'S PLAN (By fiscal year, budget authority in billions of dollars)

	1994	1998	1994-1998
Bush Budget (January 1993)	280.0	300.6	1,441.2
Reductions to Meet Program Adjustments			
Personnel and day-to-day costs			
Military personnel	-1.7	-7.0	-21.1
Operation and maintenance	-1.2	-4.4	-15.3
Family housing	-0.1	-0.2	-0.7
Subtotal	-2.9	-11.6	-37.1
Weapons acquisition			
Procurement	-2.7	-6.0	-21.4
RDT&E	-2.3	-3.8	-15.0
Subtotal	-5.0	-9.8	-36.4
Other reductions	-1.1	-1.9	-7.1
Change in Pay Policies	-1.9	-5.0	-18.1
Change in Inflation Assumptions	-5.5	-18.0	-59.8
Total	-16.5	-46.4	-158.5
Clinton Plan	263.5	254.2	1,282.7

SOURCE: Congressional Budget Office.

NOTES: Estimates assume a gradual drawdown to 1.4 million active-duty personnel by 1997, limited involuntary separations, delayed operation and maintenance savings, and the reduction in reserve forces proposed by the Bush Administration.

RDT&E = research, development, test, and evaluation.

funding for weapons acquisition would be cut three times as much in percentage terms as DoD's operations accounts in 1994. In the 1994-1998 period, budget authority for weapons acquisition would fall by about 7 percent to 8 percent below the level in the Bush Administration's final budget; military personnel and O&M funds would fall by only about 4 percent to 5 percent below the levels planned by the previous Administration.

Even moderately disproportionate cuts in the funds that develop and buy weapons could worsen long-term funding shortfalls. By early in the next decade, the new weapons the Bush Administration scheduled for purchase--particularly new fighter and attack aircraft--might cost considerably more than the funds available to pay for them.[1] Disproportionate cuts in investment funds will worsen this problem unless the Clinton Administration significantly reduces the sophistication and unit cost of new weapons.

Even so, substantial cuts in weapons programs may be both necessary and possible between 1994 and 1998. For example, budget authority for procurement and for research, development, test, and evaluation might have to be reduced by about $5 billion in 1994 and by $10 billion in 1998 compared with levels in the final Bush budget, as shown in Table IV-3. A recent CBO study analyzed a wide range of options for accomplishing such large cuts.[2] Press reports suggest that the Clinton Administration is planning to adopt changes similar to some of those noted in that study, including reductions in the Strategic Defense Initiative. The Congress has already considered many of the other options, and the large reductions they represent may be acceptable in light of the diminished threats to U.S. security that accompanied the end of the Cold War. Finally, there are numerous ways to cut procurement spending other than those analyzed in the CBO study.

EFFECTS OF ALTERNATIVE ASSUMPTIONS

Although some plausible assumptions suggest the Defense Department could maintain an active-duty force of 1.4 million people with the Clinton Administration's planned budget, equally reasonable assumptions suggest that might be very difficult.

1. See Congressional Budget Office, "Balance and Affordability of the Fighter and Attack Aircraft Fleets of the Department of Defense," CBO Paper (April 1992).

2. Congressional Budget Office, *Reducing the Deficit: Spending and Revenue Options* (February 1993).

Inflation Assumptions

Almost 40 percent of the reductions in the Clinton Administration's plan are based on CBO's inflation projections, which are considerably lower than those in the final Bush budget. If actual inflation is higher than CBO assumes, then federal revenues would increase and more funds could be available for defense or other activities without increasing the deficit. All these extra funds, however, would not automatically be put into the defense budget under current law. If inflation is significantly higher and the defense budget is not increased, then sustaining a force of 1.4 million active-duty personnel might not be possible.

Policy Decisions

Major policy issues also remain to be decided. For example, the calculations discussed above assume that the number of reserve personnel is reduced to the level in the final Bush budget. Some Members of Congress, however, have argued for no further cuts in reserve forces. Maintaining reserve forces at current levels could require another $2 billion in funding by 1998.

Furthermore, the Congress might not approve all of the proposed changes in pay policy. The lower raises under the Clinton Administration's plan, though not likely to cause problems during a period of sharp personnel cuts, could in the long run harm the ability of the Defense Department to recruit and retain high-quality personnel. By 1998, these pay changes account for net savings of $5 billion.

The new Administration may also request funding for programs that received a lower priority from the Bush Administration. For example, it may propose some new weapons programs, perhaps including purchase of the V-22 aircraft and more transport ships. Such actions would imply deeper cuts elsewhere in the budget.

Potential Underfunding

The Clinton Administration has indicated a concern, one shared by the Chairman of the Senate Committee on Armed Services, that the final Bush budget is too small to pay for its planned forces and weapons. In fact, the Secretary of Defense has formed a special panel to investigate whether the previous Administration was too optimistic about weapons prices and DoD's ability to achieve management efficiencies. The Clinton Administration assumed that this underfunding could add $8 billion to the budget in 1998. Its proposed budget totals, however, do not appear to include added funds to make up for potential underfunding.

If the panel's review of the Bush budget identifies substantial underfunding, the Clinton Administration hopes to eliminate the shortfall through additional measures, including even more management efficiencies. That may be difficult: any current problem of underfunding no doubt partly reflects the long period required to realize such efficiencies.

Nor will it be easy to offset underfunding or other policy changes through additional program cuts that do not reduce active-duty personnel levels. Assume, for example, that underfunding, coupled with other policy changes, requires $10 billion in funding in 1998 that the Administration has not included in its plan and that a force of 1.4 million is still to be maintained. In that case, all of the unanticipated cuts might have to come from funding for weapons programs, which could fall by about 17 percent compared with the final Bush budget.

Such highly disproportionate cuts in weapons programs could exacerbate problems associated with achieving proposed reductions in outlays. Sharp reductions also might be difficult to make because weapons programs have been cut heavily in recent years in real terms, falling at a rate about twice as fast as day-to-day costs during the 1990-1993 period.

In sum, if the Clinton Administration intends to maintain a force of 1.4 million active-duty personnel, its budget probably does not have much room for underfunding or unanticipated policy changes that add to budgetary needs. If they occur to a significant degree, the Administration would probably have to revisit either the commitment to a force of 1.4 million active-duty personnel or the proposed size of the defense budget.

APPENDIX. CBO BASELINE BUDGET PROJECTIONS

Throughout this paper, the Administration's proposals are contrasted with the Congressional Budget Office's (CBO's) baseline estimates of the budget. The baseline shows the path of revenues and spending if current laws and policies remain unchanged. It is not a forecast of budget outcomes, since policymakers will certainly seek many changes in priorities. But the baseline is a handy yardstick for gauging the potential impacts of proposed changes--those advocated in the President's budget as well as competing packages.

THE BASELINE CONCEPT

Baseline projections follow familiar rules. Revenues and entitlement programs (like Social Security and Medicare) continue on their course until the Congress changes the laws that underpin them--laws defining taxable incomes and setting tax rates, benefit formulas and eligibility, and so forth. For these categories, therefore, the baseline represents CBO's best estimate of what will happen under current laws.

Unlike entitlement programs, discretionary programs are funded anew each year through the appropriation process. Discretionary programs encompass nearly all the defense and international affairs budgets plus many domestic programs: space, energy, transportation, environmental protection, health research, and the salaries and expenses of civilian agencies, to name just a few. The Budget Enforcement Act of 1990 (BEA) set caps on these programs for the 1991-1995 period. Through 1993, separate caps apply to the three broad types of discretionary spending: defense, international, and domestic. In 1994 and 1995, a single lid covers all of these activities. CBO's baseline assumes compliance with the caps, which, as explained below, will inexorably force trade-offs among many competing programs. No discretionary spending caps are specified after the BEA expires in 1995. Thus, the baseline projections simply preserve 1995's real spending levels in 1996 through 1998, boosting them solely for inflation of about 3 percent per year.

Three categories of spending remain. The government has pledged to protect depositors in banks and savings and loan institutions, and the baseline for deposit insurance shows the cost of meeting these promises. Offsetting receipts, such as fees and collections, represent CBO's best estimate of amounts collected under current laws and policies. And net interest is not directly controlled by policymakers, but is driven by market interest rates and future deficits.

In January, CBO published its baseline projections in *The Economic and Budget Outlook: Fiscal Years 1994-1998* and described the key factors that drive the federal government's revenues, spending, and deficit. Since then, CBO has revised its baseline projections modestly in the wake of new information (see Table A-1). Lower outlays by the Bank Insurance Fund dominate the revisions, as record profits in the banking industry in 1992 have reduced the number of institutions expected to fail and the amount of spending needed to close or otherwise resolve them. Because much of the revision reflects a diminished appetite for working capital (funds that are needed temporarily pending the sale of banks' assets), lower spending in 1993 and 1994 is largely offset by diminished income from liquidations and, hence, greater net outlays in later years. Other revisions, taken together, affect the deficit by no more than $1 billion a year.

The remaining tables in this appendix update some of the most widely used information in CBO's January report. Because the revisions are so minor, readers wishing a fuller explanation of any of these estimates can rely on that earlier publication. Clearly, much of the current budget debate centers around the sheer size of the federal deficit, and Table A-2 displays several alternative measures of this gap. The most commonly used measure of the deficit is the difference between total revenues and spending. But participants in the budget debate often cite other figures as well--most usefully, the standardized-employment deficit, which recognizes that part of the deficit merely reflects an economy that is operating beneath its potential.

Federal government revenues by source and outlays by broad category (both in dollar terms and in relation to gross domestic product) are presented in Table A-3. Spending on entitlements and other mandatory programs, chiefly for retirement and health care benefits, accounts for over half of federal government outlays; thus, more information about this huge and fast-growing cluster is displayed in Table A-4.

In its baseline projections, CBO assumes that policymakers will continue to abide by the discretionary spending limits set by the BEA. Separate caps apply both to budget authority (the authority to commit funds, the basic currency of the appropriation process) and to outlays (actual spending); the stricter constraint governs. The caps have no unique implications for particular programs but rather force a bruising competition for resources. As Table A-5 suggests, even freezing funding at this year's levels for two more years would leave policymakers slightly above the outlay caps, pushing them to seek further savings.

Finally, the notion that the deficit will simply fade with time and continuing economic growth has largely been punctured. Although CBO has long done its full-fledged baseline estimates for a five-year horizon, it has recently begun presenting a broad-brush picture of the budget outlook for a full decade ahead. In the absence of concerted action by policymakers, the deficit is likely to climb both in dollar terms and, more worrisomely, as a percentage of GDP (see Table A-6). The growth of health care spending (Medicare and Medicaid) and of interest on the government's burgeoning debt are key contributors to this sobering message.

TABLE A-1. REVISIONS TO THE CBO BASELINE (By fiscal year, in billions of dollars)

	1993	1994	1995	1996	1997	1998
January Baseline Deficit	310	291	284	287	319	357
Revisions						
Deposit insurance spending[a]	-10	-5	b	3	2	1
Other	1	b	1	1	1	1
Total	-9	-5	b	3	2	2
March Baseline Deficit	302	287	284	290	322	360

SOURCE: Congressional Budget Office.

a. Adjusted for changes in interest paid by the Bank Insurance Fund to the Treasury. These payments are intrabudgetary and do not affect the deficit.

b. Less than $500 million.

TABLE A-2. THE DEFICIT OUTLOOK UNDER CURRENT POLICIES (By fiscal year)

	Actual 1992	1993	1994	1995	1996	1997	1998
				In Billions of Dollars			
Total Deficit Assuming Discretionary Caps	290	302	287	284	290	322	360
Deficit Excluding Deposit Insurance and Desert Storm Contributions	292	309	282	275	290	334	368
Standardized-Employment Deficit[a]	201	229	223	231	257	311	352
On-Budget Deficit (Excluding Social Security and Postal Service)	340	352	343	352	368	404	448
Memoranda:							
Deposit Insurance	3	-7	4	10	b	-13	-9
Desert Storm Contributions	-5	0	0	0	0	0	0
Off-Budget Surplus							
Social Security	51	53	59	67	76	82	88
Postal Service	-1	-2	-3	b	2	1	b
Total, Off-Budget Surplus	50	51	56	67	78	83	88
				As a Percentage of GDP			
Total Deficit Assuming Discretionary Caps	4.9	4.9	4.4	4.1	4.0	4.3	4.6
Deficit Excluding Deposit Insurance and Desert Storm Contributions	5.0	5.0	4.3	4.0	4.0	4.4	4.7
Standardized-Employment Deficit[a,c]	3.3	3.6	3.3	3.3	3.5	4.1	4.4

SOURCE: Congressional Budget Office.

a. Excludes cyclical deficit as well as deposit insurance and Desert Storm contributions.
b. Less than $500 million.
c. Expressed as a percentage of potential GDP.

TABLE A-3. REVENUES BY SOURCE AND OUTLAYS BY CATEGORY IN THE CBO BASELINE (By fiscal year)

	Actual 1992	1993	1994	1995	1996	1997	1998
	In Billions of Dollars						
Revenues							
Individual income	476	501	531	567	600	629	662
Corporate income	100	110	120	128	135	138	147
Social insurance	414	434	462	489	515	537	559
Other	101	97	101	105	105	109	113
Total	1,092	1,142	1,214	1,290	1,355	1,413	1,480
On-budget	789	824	878	933	980	1,020	1,070
Off-budget	302	317	336	356	376	393	411
Outlays							
Discretionary							
Defense	304	294	a	a	a	a	a
International	19	21	a	a	a	a	a
Domestic	214	232	a	a	a	a	a
Subtotal, discretionary	537	548	539	540	555	570	585
Mandatory	711	771	815	866	913	983	1,050
Deposit insurance	3	-7	4	10	b	-13	-9
Net interest	199	199	211	231	251	271	293
Offsetting receipts	-69	-67	-69	-73	-74	-76	-79
Total	1,382	1,443	1,501	1,574	1,645	1,734	1,840
On-budget	1,129	1,177	1,221	1,285	1,347	1,424	1,517
Off-budget	252	267	280	289	298	310	323
Deficit	290	302	287	284	290	322	360
On-budget deficit	340	352	343	352	368	404	448
Off-budget surplus	50	51	56	67	78	83	88

(Continued)

TABLE A-3. Continued

	Actual 1992	1993	1994	1995	1996	1997	1998
	As a Percentage of GDP						
Revenues							
Individual income	8.1	8.1	8.2	8.3	8.3	8.3	8.4
Corporate income	1.7	1.8	1.8	1.9	1.9	1.8	1.9
Social insurance	7.0	7.0	7.1	7.1	7.2	7.1	7.1
Other	1.7	1.6	1.6	1.5	1.5	1.4	1.4
Total	18.6	18.5	18.7	18.8	18.8	18.7	18.8
On-budget	13.4	13.4	13.5	13.6	13.6	13.5	13.6
Off-budget	5.2	5.1	5.2	5.2	5.2	5.2	5.2
Outlays							
Discretionary							
Defense	5.2	4.8	a	a	a	a	a
International	0.3	0.3	a	a	a	a	a
Domestic	3.6	3.8	a	a	a	a	a
Subtotal, discretionary	9.2	8.9	8.3	7.9	7.7	7.6	7.4
Mandatory	12.1	12.5	12.5	12.6	12.7	13.0	13.3
Deposit insurance	c	-0.1	0.1	0.1	c	-0.2	-0.1
Net interest	3.4	3.2	3.2	3.4	3.5	3.6	3.7
Offsetting receipts	-1.2	-1.1	-1.1	-1.1	-1.0	-1.0	-1.0
Total	23.5	23.4	23.1	23.0	22.8	23.0	23.4
On-budget	19.2	19.1	18.8	18.7	18.7	18.9	19.3
Off-budget	4.3	4.3	4.3	4.2	4.1	4.1	4.1
Deficit	4.9	4.9	4.4	4.1	4.0	4.3	4.6
On-budget deficit	5.8	5.7	5.3	5.1	5.1	5.4	5.7
Off-budget surplus	0.9	0.8	0.9	1.0	1.1	1.1	1.1

SOURCE: Congressional Budget Office.

a. Discretionary caps are set by category through fiscal year 1993 and in the aggregate for 1994 and 1995. The 1996-1998 estimates are simply 1995 spending adjusted for inflation.

b. Less than $500 million.

c. Less than 0.05 percent of GDP.

TABLE A-4. CBO BASELINE PROJECTIONS FOR MANDATORY SPENDING, EXCLUDING DEPOSIT INSURANCE (By fiscal year, in billions of dollars)

	Actual 1992	1993	1994	1995	1996	1997	1998
Means-Tested Programs							
Medicaid	68	80	92	105	118	131	146
Food Stamps[a]	23	24	24	24	24	25	26
Supplemental Security Income	18	20	24	24	24	28	30
Family Support	16	17	18	18	19	19	20
Veterans' Pensions	4	3	3	3	2	2	3
Child Nutrition	6	6	7	7	8	8	9
Earned Income Tax Credit	8	9	10	13	13	14	14
Student Loans[b]	2	2	3	3	3	3	3
Other	3	3	3	3	4	4	4
Total	146	165	183	200	214	235	255
Non-Means-Tested Programs							
Social Security	285	302	319	335	351	368	385
Medicare	129	146	167	188	211	234	258
Subtotal	414	449	486	523	562	602	644
Other Retirement and Disability							
Federal civilian[c]	37	40	42	44	48	51	54
Military	24	26	27	28	29	31	32
Other	5	5	5	5	5	5	5
Subtotal	67	70	74	77	82	87	91
Unemployment Compensation	37	33	26	25	25	25	25
Other Programs							
Veterans' benefits[d]	16	16	18	17	16	18	18
Farm price supports	9	16	10	9	8	9	9
Social services	5	5	6	5	5	5	5
Credit reform liquidating accounts	4	4	2	-2	-8	-6	-7
Other	13	13	12	11	8	9	9
Subtotal	47	54	47	40	30	35	35
Total	565	605	632	666	699	748	795
Total							
All Mandatory Spending	711	771	815	866	913	983	1,050

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; Medicare premium collections are classified as offsetting receipts.

a. Includes nutrition assistance to Puerto Rico.

b. Includes Stafford loans, Supplemental Loans for Students (SLS), and Parent Loans for Undergraduate Students (PLUS).

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.

TABLE A-5. HOW TIGHT ARE THE DISCRETIONARY CAPS? (By fiscal year, in billions of dollars)

	1994		1995	
	Budget Authority	Outlays	Budget Authority	Outlays
Discretionary Caps	513	539	518	540
Amounts Needed to Preserve 1993 Real Resources[a] (Including adjustment for inflation)				
Defense Discretionary	288	290	296	294
International Discretionary	22	22	23	22
Domestic Discretionary	216	242	222	250
Total	526	553	541	566
Amount over or under (-) caps	13	14	24	26
Amount Needed to Preserve 1993 Dollar Resources[a] (Without adjustment for inflation)				
Defense Discretionary	278	283	278	280
International Discretionary	21	21	21	21
Domestic Discretionary	209	238	209	240
Total	509	543	509	541
Amount over or under (-) caps	-4	4	-9	1

SOURCE: Congressional Budget Office.

NOTE: The discretionary spending caps are based on OMB's preliminary estimate of the Budget Enforcement Act (BEA) caps that will appear in OMB's fiscal year 1994 sequestration preview report in April, modified by CBO's estimate of the cap adjustments the BEA requires in subsequent sequestration reports. The caps shown do not include adjustments for legislation that may be enacted to address emergencies.

a. Excludes International Monetary Fund quota funded in 1993 appropriation.

TABLE A-6. THE TEN-YEAR BUDGET OUTLOOK (By fiscal year)

	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003
In Billions of Dollars											
Revenues	1,142	1,214	1,290	1,355	1,413	1,480	1,538	1,598	1,663	1,731	1,802
Outlays											
Discretionary	548	539	540	555	570	585	601	617	634	651	669
Mandatory											
Social Security	302	319	335	351	368	385	403	420	439	459	480
Medicare	146	167	188	211	234	258	286	316	350	389	432
Medicaid	80	92	105	118	131	146	162	179	198	219	240
Civil Service and military retirement	61	64	67	71	75	79	82	85	89	93	97
Other	180	174	171	163	175	182	186	191	196	202	207
Subtotal	771	815	866	913	983	1,050	1,118	1,192	1,273	1,361	1,457
Deposit insurance	-7	4	10	a	-13	-9	-8	-9	-9	-9	-10
Net interest	199	211	231	251	271	293	314	339	368	400	436
Offsetting receipts	-67	-69	-73	-74	-76	-79	-82	-85	-88	-91	-95
Total	1,443	1,501	1,574	1,645	1,734	1,840	1,944	2,055	2,177	2,311	2,457
Deficit	302	287	284	290	322	360	406	456	515	580	655
Debt Held by the Public	3,282	3,572	3,861	4,157	4,484	4,850	5,261	5,723	6,244	6,830	7,490
As a Percentage of GDP											
Revenues	18.5	18.7	18.8	18.8	18.7	18.8	18.8	18.7	18.7	18.7	18.6
Outlays											
Discretionary	8.9	8.3	7.9	7.7	7.6	7.4	7.3	7.2	7.1	7.0	6.9
Mandatory											
Social Security	4.9	4.9	4.9	4.9	4.9	4.9	4.9	4.9	4.9	4.9	5.0
Medicare	2.4	2.6	2.7	2.9	3.1	3.3	3.5	3.7	3.9	4.2	4.5
Medicaid	1.3	1.4	1.5	1.6	1.7	1.9	2.0	2.1	2.2	2.4	2.5
Civil Service and military retirement	1.0	1.0	1.0	1.0	1.0	1.0	1.0	1.0	1.0	1.0	1.0
Other	2.9	2.7	2.5	2.3	2.3	2.3	2.3	2.2	2.2	2.2	2.1
Subtotal	12.5	12.5	12.6	12.7	13.0	13.3	13.7	14.0	14.3	14.7	15.1
Deposit insurance	-0.1	0.1	0.1	b	-0.2	-0.1	-0.1	-0.1	-0.1	-0.1	-0.1
Net interest	3.2	3.2	3.4	3.5	3.6	3.7	3.8	4.0	4.1	4.3	4.5
Offsetting receipts	-1.1	-1.1	-1.1	-1.0	-1.0	-1.0	-1.0	-1.0	-1.0	-1.0	-1.0
Total	23.4	23.1	23.0	22.8	23.0	23.4	23.7	24.1	24.5	24.9	25.4
Deficit	4.9	4.4	4.1	4.0	4.3	4.6	5.0	5.3	5.8	6.3	6.8
Debt Held by the Public	53.2	54.9	56.3	57.7	59.4	61.6	64.2	67.0	70.1	73.6	77.4

SOURCE: Congressional Budget Office.

a. Less than $500 million.

b. Less than 0.05 percent of GDP.