Chapter One

Introduction

Deep concern over the federal deficit continues to drive the budget debate. The Congressional Budget Office (CBO) projects that if current policies remain unchanged, the deficit will begin to grow in 1997 after four years of decline. That growth is expected to be moderate over the next decade. More troubling, however, are long-term budgetary trends that threaten to create unprecedented deficits and debt by the middle of the next century, potentially causing damage to the economy. Taking action now to reduce the deficit in the near term would contribute to long-term budgetary stability and make the additional policy changes required in the future less painful.

This volume includes many options for changes that would help to lower the deficit by reducing spending or increasing revenues. The President and the Congress have expressed their commitment to a balanced budget by 2002, and the options could be used to devise a wide variety of ways to reach that goal.

The Deficit Outlook

After declining significantly from 1993 through 1996, the federal deficit is projected to begin a period of slow but generally steady growth under current policies and expectations about the economy. CBO estimates that the federal deficit, which dropped to $107 billion in 1996 (its lowest nominal level since 1981), will creep up to $124 billion this year. Moreover, without changes in current policies, CBO projects that the deficit will rise to $188 billion in 2002 (the year that the President and the Congress have targeted for a balanced budget) and to $278 billion by 2007 (see Table 1-1).

Given the size of the U.S. economy, the projected deficits are smaller than those of the past 20 years, although they are well above the average for the 1950s and 1960s. As a percentage of gross domestic product (GDP), the deficit under CBO's baseline assumptions will average 1.9 percent over the 1997-2007 period, compared with an average of 3.5 percent over the previous 20 years and 0.6 percent from 1950 through 1969.[1]

However, those favorable trends do not continue. Beginning about 2010, the first wave of the baby-boom generation reaches retirement age, bringing unprecedented pressure on federal spending for the Social Security, Medicare, and Medicaid programs. At about the same time, the number of people working and paying taxes to support those and other programs will grow much more slowly. In short, unless current policies are changed, those trends would drive federal debt before the middle of the next century to levels that the economy could not sustain.[2]

Another key aspect of the problem has to do with the composition of federal outlays. Over the past 30 years or so, the composition of federal outlays has shifted dramatically from discretionary spending, which is appropriated annually, to mandatory spending, which

1. Congressional Budget Office, *The Economic and Budget Outlook: Fiscal Years 1998-2007* (January 1997), p. xiii.

2. Congressional Budget Office, *Long-Term Budgetary Pressures and Policy Options* (forthcoming).

Table 1-1.
CBO Budget Outlook Under Current-Policy Economic Assumptions with Inflation in Discretionary Programs After 1998 (By fiscal year)

	Actual 1996	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007
						In Billions of Dollars						
Revenues	1,453	1,507	1,567	1,634	1,705	1,781	1,860	1,943	2,033	2,127	2,227	2,333
Outlays												
Discretionary	533	547	543	561	578	595	613	631	650	670	691	713
Mandatory												
Social Security	347	364	381	400	420	441	464	487	513	539	568	599
Medicare and Medicaid[a]	283	307	332	362	396	418	458	495	537	593	637	680
Other mandatory and offsetting receipts	156	165	177	197	217	222	235	242	252	267	272	280
Subtotal	786	836	890	959	1,032	1,081	1,156	1,224	1,302	1,399	1,476	1,558
Net interest	241	248	253	261	267	272	279	289	300	312	325	340
Total	1,560	1,632	1,687	1,781	1,877	1,948	2,049	2,145	2,252	2,381	2,492	2,611
Deficit	107	124	120	147	171	167	188	202	219	254	266	278
Debt Held by the Public	3,733	3,869	4,009	4,173	4,358	4,539	4,740	4,954	5,184	5,448	5,723	6,011
						As a Percentage of GDP						
Revenues	19.4	19.3	19.2	19.0	19.0	18.9	18.8	18.8	18.8	18.8	18.8	18.8
Outlays												
Discretionary	7.1	7.0	6.6	6.5	6.4	6.3	6.2	6.1	6.0	5.9	5.8	5.8
Mandatory												
Social Security	4.6	4.6	4.7	4.7	4.7	4.7	4.7	4.7	4.7	4.8	4.8	4.8
Medicare and Medicaid[a]	3.8	3.9	4.1	4.2	4.4	4.4	4.6	4.8	5.0	5.2	5.4	5.5
Other mandatory and offsetting receipts	2.1	2.1	2.2	2.3	2.4	2.4	2.4	2.3	2.3	2.4	2.3	2.3
Subtotal	10.5	10.7	10.9	11.2	11.5	11.5	11.7	11.8	12.0	12.4	12.5	12.6
Net interest	3.2	3.2	3.1	3.0	3.0	2.9	2.8	2.8	2.8	2.8	2.7	2.7
Total	20.8	20.8	20.6	20.8	20.9	20.7	20.8	20.8	20.8	21.0	21.1	21.1
Deficit	1.4	1.6	1.5	1.7	1.9	1.8	1.9	2.0	2.0	2.2	2.2	2.2
Debt Held by the Public	49.9	49.4	49.0	48.7	48.5	48.2	48.0	47.9	47.9	48.1	48.4	48.6

SOURCE: Congressional Budget Office.

a. Excludes Medicare premiums, which are considered offsetting receipts.

typically is governed by permanent laws. In 1965, discretionary spending accounted for about two-thirds of total federal spending, with mandatory spending accounting for the remaining one-third (all spending is classified as either discretionary or mandatory). By 1996, those spending shares had been reversed, with mandatory spending (including net interest) now accounting for about two-thirds of total federal spending.

At the same time, federal spending as a percentage of GDP climbed significantly. Total federal spending averaged around 18 percent of GDP from 1950 to 1970, rose to over 23 percent of GDP in the early 1980s, and fell to about 21 percent of GDP by the 1990s. Since total revenues averaged closer to 18 percent of GDP throughout the 1950-1990 period, the deficit increased. The recent rise in total revenues to 19.4 percent of GDP in 1996 contributed to narrowing the deficit.

Discretionary spending is expected to total about $550 billion in 1997 and covers a wide array of governmental functions and activities. About half of all discretionary spending goes for national defense--a much smaller share than in the past. The rest funds various domestic and international activities, including housing, agriculture, education, environmental protection, law enforcement, space exploration, research and development, international assistance, and general government.

Mandatory spending consists mainly of large entitlement programs--such as Social Security, Medicare, and Medicaid--and of interest payments on the federal debt. (In recent years, the two main health care entitlements--Medicare and Medicaid--have been the biggest source of growth in mandatory spending.) For most mandatory spending programs, the federal government is obligated to spending levels that depend on factors, such as inflation and the use of health services, that are beyond the government's direct control.

Since fiscal year 1991, limits on total discretionary spending and a pay-as-you-go (PAYGO) requirement for mandatory spending and revenue legislation have been in effect, though those budget enforcement procedures expire at the end of fiscal year 1998 (see Box 1-1). The discretionary spending limits have imposed a rough freeze on total discretionary spending since 1992. The PAYGO requirement generally bars new mandatory spending or revenue legislation from increasing the deficit. However, although effective, PAYGO does not address the growth of mandatory spending under existing law. Controlling that growth has proved to be a more formidable challenge.[3]

Despite reconciliation acts and other laws in recent years designed to slow its growth, mandatory spending is projected to continue rising both as a portion of total spending and as a percentage of GDP.[4] Indeed, in 1997, mandatory spending is expected to approach $1.1 trillion.

Although CBO recently lowered its projections for Medicare and Medicaid spending, rapid growth in those two programs is expected to continue and to outpace that of all other entitlements. In fact, both programs will more than double in size over the next 10 years. Medicare balloons from $209 billion in 1997 to $464 billion in 2007, and Medicaid jumps from $99 billion to $216 billion over the same period. By 2003, annual spending for those two programs combined is projected to overtake, for the first time, annual spending for Social Security.

What Is Needed to Balance the Budget by 2002?

As in previous editions of this volume, CBO presents an illustrative deficit reduction path showing the magnitude of the policy changes needed to reach a balanced budget by 2002 (see Table 1-2). To balance the budget by 2002, CBO estimates that the Congress and the President would have to enact policy changes this year that pare deficits by about $450 billion. Deficit reduction policies totaling that amount would also reduce federal debt-service costs (lowering the deficit by about $45 billion over the period) and produce a balanced

3. For a discussion of the issues involved with controlling mandatory spending, see Congressional Budget Office, *Mandatory Spending Control Mechanisms*, CBO Paper (February 1996).

4. Under the Congressional Budget Act of 1974, reconciliation instructions may be included in a budget resolution that directs committees to report legislation changing mandatory spending or revenue laws. The House and Senate Budget Committees typically package the instructed committees' recommendations (without substantive revision) into one or more omnibus reconciliation bills that the Congress then considers under expedited procedures.

Box 1-1.
Procedures for Controlling the Deficit

Over the past decade or so, the Congress and the President have enacted a series of laws setting forth temporary procedures for reining in the deficit. Those procedures are now scheduled to expire at the end of fiscal year 1998. They must be extended this year to be effective for future budget cycles.

In 1985, the Balanced Budget and Emergency Deficit Control Act (known as Gramm-Rudman-Hollings) established a schedule of fixed deficit targets that called for eliminating the deficit by fiscal year 1991. It created a new procedure--known as sequestration--to make uniform spending reductions if the estimated deficit for a fiscal year did not meet the target for that year. Although deficits shrank initially after the 1985 Balanced Budget Act, they failed to meet the statutory targets (in some years by substantial margins).

In the fall of 1990, the Congress and the President amended the 1985 act to establish new procedures for deficit control. The Budget Enforcement Act of 1990 (BEA), enacted as part of a five-year plan for reducing the deficit, established two new requirements: annual limits on total discretionary appropriations and a pay-as-you-go (PAYGO) requirement for mandatory spending and revenue legislation (both of which are enforced by sequestration mechanisms). Originally, the BEA procedures were set to expire at the end of fiscal year 1995. However, they were extended through fiscal year 1998, without substantive change, as part of the Omnibus Budget Reconciliation Act of 1993.

The current discretionary spending limits and PAYGO requirement generally enforce the 1990 and 1993 deficit reduction agreements. Instead of enforcing fixed deficit targets, they ensure that new spending and revenue laws (on a net basis) are consistent with those agreements and do not increase deficits further through 1998.

The BEA procedures appear to have been effective in controlling discretionary spending, although the end of the Cold War eased the way for significant cuts in defense (which accounts for most of the discretionary spending restraint), and in preventing new mandatory spending and revenue legislation from increasing the deficit. However, the BEA had no effect on the growth of spending under existing law for mandatory programs like Medicare and Medicaid. Some policymakers are advocating changes in the BEA procedures, such as new rules that would permit certain trade-offs between the discretionary and PAYGO categories. This year the Congress is also likely to consider broader budget reforms for controlling deficits, including a balanced budget constitutional amendment.

A new device for controlling the deficit, the Line-Item Veto Act, went into effect this year. In general, it grants the President the authority to cancel certain spending and tax benefits that he signs into law. Only a subsequent law is able to overturn a cancellation.

budget "fiscal dividend" (reducing deficits an additional $80 billion or so over the period).

Economists generally agree that balancing the budget and keeping it balanced would have certain economic effects that would reduce deficits further, producing a fiscal dividend to the budget. Balancing the budget would lead to lower interest rates and slightly higher overall growth, which in turn would trim the deficit by cutting federal interest costs and bolstering federal revenues. Using balanced budget economic assumptions in the budget baseline permits policymakers to take that fiscal dividend into account when fashioning their balanced budget plans. It also gives a measure of the actual policy changes that are needed to reach that goal.[5]

Even if policymakers succeed this year in enacting legislation that is estimated to balance the budget by 2002, an unforeseen economic downturn or other events could spark increased deficits in the intervening years and require further action to stay on track for a balanced budget. Although CBO believes that its economic and programmatic assumptions are reasonable

5. For a more detailed discussion of the fiscal dividend from a balanced budget, see Congressional Budget Office, *The Economic and Budget Outlook*, pp. 59-69.

Table 1-2.
Illustrative Balanced Budget Path (By fiscal year, in billions of dollars)

	1997	1998	1999	2000	2001	2002	Total 1997-2002
CBO's Baseline Deficit[a]	124	120	147	171	167	188	n.a.
Fiscal Dividend[b]	c	-1	-4	-13	-25	-34	-77
Projected Deficit with Fiscal Dividend	124	119	143	158	143	154	n.a.
Restore Full Inflation Adjustment for Discretionary Spending	0	15	14	15	7	9	61
Debt service	0	c	1	2	3	3	10
Subtotal	0	16	15	17	10	13	71
Projected Deficit with Fiscal Dividend and Full Inflation for Discretionary Spending	124	135	158	175	152	167	n.a.
Discretionary Spending Freeze[d]	0	-15	-33	-51	-68	-87	-253
Debt service	0	c	-2	-4	-7	-11	-25
Total deficit reduction	0	-16	-35	-55	-75	-98	-278
Projected Deficit with Fiscal Dividend and Discretionary Spending Freeze	124	119	123	121	78	68	n.a.
Additional Policy Savings Needed to Balance the Budget[e]	0	-15	-30	-40	-50	-59	-194
Debt service	0	c	-2	-4	-6	-9	-21
Total deficit reduction	0	-15	-32	-44	-56	-68	-215
Resulting Deficit	124	103	92	77	22	0	n.a.
Total Policy Savings Needed to Balance the Budget	0	-30	-63	-91	-118	-147	-448
Debt service	0	-1	-4	-8	-13	-20	-45
Total deficit reduction	0	-31	-66	-98	-131	-167	-493

SOURCE: Congressional Budget Office.

NOTES: This table represents one of many possible paths that would lead to a balanced budget. The exact path depends on when the deficit reduction begins and what specific policies are adopted. This path is not based on any specific policy assumptions.

n.a. = not applicable.

a. CBO's baseline projections assume no change in current policies, and they project discretionary spending at the statutory cap for 1998, and at that level adjusted for inflation thereafter.

b. The fiscal dividend is the budgetary effect of improved economic performance that CBO estimates would result from balancing the budget by 2002.

c. Less than $500 million.

d. Assumes that discretionary appropriations for 1998 through 2002 are frozen at the 1997 level.

e. Policy savings in addition to a discretionary spending freeze at the 1997 level.

and analytically sound, relatively minor changes can have a significant effect on the federal budget, especially on revenues and mandatory spending.[6]

The path CBO has chosen does not assume any specific set of policies to reduce the deficit, even though the types of policies adopted would certainly matter. For example, deficit reduction that reduced the incentive to work or invest might have less positive economic effects than those assumed here and could lower the fiscal dividend. Conversely, policies that stimulated growth in the economy's potential output would have more favorable effects.

In calculating its illustrative path, as shown in Table 1-2, CBO uses two different projections for total discretionary spending. Under one projection, discretionary spending is adjusted after 1997 for the full effects of estimated inflation (the so-called uncapped baseline). Under the other, discretionary spending is frozen at the 1997 level through 2002.[7]

The President's 1998 budget proposes that total discretionary spending be held below inflation-adjusted levels but be allowed to grow slightly above a 1997 freeze level.[8] In last year's budget resolution, the Congress proposed that total discretionary spending be reduced slightly below a freeze at the 1997 level. The Congress is now in the process of developing its 1998 budget resolution.

A discretionary spending freeze at the 1997 level would save about $250 billion through 2002 (excluding associated debt-service savings). It would reduce the savings needed from other policy changes to about $200 billion, and thus would amount to over half of the total deficit reduction from policy changes that would be needed to balance the budget. However, that share of deficit reduction is disproportionate to the one-third share of total spending for discretionary appropriations. A freeze on discretionary spending through 2002 would also cut its purchasing power in that year by about 14 percent from that available in 1997.

Policymakers must ultimately choose the specific changes needed to balance the budget. But one message is clear: continued restraint in discretionary spending alone will not be enough to balance the budget or to ensure a sustainable fiscal policy over the next three decades. Many people believe that serious efforts to balance the budget by 2002 and beyond need to include structural policy changes that address the growth of mandatory federal spending.

How to Use This Report

Chapters 2 through 4 list specific policy changes that may be made to reduce spending over the five-year period from 1998 through 2002. Chapter 5 discusses broad policy options and integrated approaches for limiting the growth of Medicare and Medicaid. Chapter 6 provides various options for increasing revenues, including options for broadening the tax base that could be part of broader proposals for tax reform.

In Chapters 2, 3, 4, and 6, this volume presents the pros and cons of each option, along with estimates of the effect that it would have on the deficit between fiscal years 1998 and 2002. For each mandatory spending or revenue option, projected savings are computed from baseline levels estimated to occur under current law.[9] For each discretionary spending option, the volume presents two sets of estimates--one shows how much the proposal would save if the 1997 spending level was adjusted for inflation, and the other calculates how much it would save if the 1997 spending level was frozen through 2002. For defense discretionary options, savings also have been computed relative to the President's 1997 defense plan, adjusted for final action in the 1997 appropriation act.

6. Congressional Budget Office, *The Economic and Budget Outlook*, pp. 49-57.

7. The statutory discretionary spending limits for 1998 are below both the inflation-adjusted and freeze levels for discretionary spending for that year. In its overall baseline budget projections, CBO assumes that discretionary spending will be consistent with those limits and will be adjusted for inflation thereafter (see Table 1-1). However, because the limits are not broken down by individual discretionary accounts or programs, CBO calculates projected savings for discretionary spending options in this volume from the inflation-adjusted and unadjusted levels for 1997. Thus, the illustrative path in Table 1-2 is consistent with the way that discretionary savings are calculated in this volume. The President's 1998 budget also measures proposed discretionary savings from an uncapped baseline.

8. Congressional Budget Office, *An Analysis of the President's Budgetary Proposals for Fiscal Year 1998* (forthcoming).

9. CBO uses revenue estimates provided by the Joint Committee on Taxation.

Chapter 5 discusses broad options for curtailing the growth in federal spending for Medicare and Medicaid over the near term that can provide a basis for longer-term restructuring of those programs. Instead of listing specific policy options for Medicare, the chapter develops integrated packages of options that could yield substantial program savings over the next five to 10 years. The Medicaid discussion also takes a broad perspective on how to contain federal costs, focusing on the extent to which different savings options would change the underlying fiscal relationship between the federal government and the states.

The options stem from various sources, including legislative proposals, the President's budget, previous versions of this volume, CBO staff, other government entities, and private groups. The options are intended to reflect a broad range of possibilities but are neither ranked nor are they necessarily comprehensive. Including or excluding a specific option does not represent an endorsement or rejection of that option by CBO. As a nonpartisan Congressional staff agency, CBO does not make policy recommendations.

CBO has estimated the savings for each option using the budget baseline that incorporates the fiscal dividend of reaching a balanced budget by 2002. Although employing economic assumptions under a balanced budget would affect overall projections of interest rates and economic growth, employing them would affect the savings estimates only for those specific options that are most sensitive to interest rate assumptions--in particular, corporate income tax options.

Readers who choose a path of freezing total discretionary spending as a starting point for developing a comprehensive balanced budget plan must be careful to calculate the savings for individual discretionary options from the unadjusted 1997 level listed for each option. Otherwise, discretionary savings should be calculated using the inflation-adjusted estimates.

In March 1997, CBO will publish a report on the long-term budgetary problems that will arise when the baby-boom generation begins to retire. The policy changes that will be needed to deal with those problems include more fundamental reforms that might take longer to carry out. That report will address in a comprehensive fashion major issues and various options for dealing with long-term trends.

Since last year's volume of *Reducing the Deficit* was published, two advisory bodies have made recommendations to the Congress that bear directly on the issue of achieving a sustainable budget policy for the long term. First, in December 1996, the Advisory Commission to Study the Consumer Price Index (also known as the Boskin Commission) reported that the consumer price index (CPI) overstates the cost of living and thus increases federal spending excessively for those programs to which it is linked. Most economists agree that the CPI overstates the cost of living, but they do not by any means agree on how much. Second, the 1994-1996 Advisory Council on Social Security issued its final report in January 1997. It was unable to reach a consensus and instead submitted three broad approaches for financing Social Security into the next century.

Other General Caveats in Using This Volume

Users of *Reducing the Deficit* should note several other caveats. First, although all of the options devoted to deficit reduction would shave federal interest costs, those savings are not included in the calculations accompanying the individual options. Ordinarily, when CBO receives a detailed budgetary plan, it assesses the savings for each option as in this volume and then computes the additional interest savings (shown as debt service in the illustrative paths in Table 1-2). When such budget packages are put together, one can adjust for any interactions among the parts that would raise or lower the savings--such adjustments cannot be made for the individual options discussed in this volume.

Second, all of the options to reduce grants to state and local governments would affect the financial status of those governments, but that effect is not repeated in each discussion. Furthermore, some of the options affecting states and localities may involve federal mandates. The Unfunded Mandates Reform Act of 1995 establishes procedures intended to control such mandates. It also requires CBO to estimate the costs to states and localities of any mandates imposed by new legislation that the Congress is considering. Individual options do not include estimates of any potential mandates. However, they may discuss related issues where appropriate.

Third, although government assets are sold from time to time, such sales generally cannot be counted to determine compliance either with the statutory discretionary spending limits or with pay-as-you-go procedures. For that reason, CBO has not included any options in this volume for which the sale of assets constitutes the only savings. CBO made that choice mainly because the proceeds from such sales cannot be scored under current budget law. Thus, no judgment is implied concerning the desirability of selling government assets. In fact, by privatizing certain federal functions or activities, asset sales may prompt increased efficiency of operations. In recent budgets, the President has recommended changing the budgetary treatment of asset sales so that they may be counted under the Budget Enforcement Act. Although the 1996 and 1997 budget resolutions have directed that such sales be counted in the Congressional budget process, that directive does not affect their budgetary treatment under the statutory enforcement procedures.

Finally, subsequent CBO cost estimates, which generally accompany any bill reported by a Congressional committee, may not exactly match the numbers shown in this report. The reason is that the policy proposals on which the cost estimates are based may not precisely match the specifications used in developing the options in this volume.