CHAPTER

1

Introduction

The Congressional Budget Office (CBO) has regularly issued a compendium of options to help inform federal policymakers about budgetary choices. Policymakers must decide how much to spend, which programs to fund, what level of revenues is needed to sustain those programs, and how those revenues are to be raised. Those decisions are framed by current fiscal and economic conditions: how large is the annual deficit or surplus, what is the budget outlook for the near and the long term, and what new fiscal and budgetary challenges do lawmakers face? Those determinations are also made in light of broad goals for fiscal policy, such as balancing the budget, enhancing economic stability and growth, ensuring sustainable fiscal policies for the long term, or limiting the size of government. Budgetary decisions may serve other purposes or rationales as well, including offsetting the cost of new initiatives, reordering budgetary priorities in a time of change, or making programs more efficient or effective. The budget options in this volume are intended to assist policymakers as they address those and other fiscal and budgetary issues during the course of the 108th Congress.

The Budget Outlook

The near-term budget outlook has changed significantly over the past several years. After a decade of decreasing deficits—capped by a string of record surpluses from 1998 to 2001—the federal budget reversed course in 2002 and returned to a deficit.[1] For the next decade, CBO projects that if current tax and spending policies remained in place, unified budget deficits would peak this year and drop steadily to yield small but growing surpluses later in the 2004-2013 period.[2]

The Uncertainty of Projections

Budget projections are always subject to considerable uncertainty. In particular, CBO's baseline is required to show future spending and revenues under current laws and policies. Those laws and policies will almost certainly change, however. Lawmakers are contemplating major new initiatives to, for example, raise economic growth, provide a prescription drug benefit to the elderly, and address other priorities. None of those possibilities (or their likely budgetary effects) is reflected in CBO's baseline projections because they would involve changes to current laws and policies. Thus, the actual budget totals for the projection period are virtually guaranteed to differ from the estimates in CBO's baseline, perhaps substantially.

In addition, the nation now confronts the possibility of military conflict with Iraq, the ongoing threat of terrorism, and the new demands of homeland security. Moreover, long-term budgetary pressures linked to the aging of the baby-boom generation will begin to emerge near the end of the current 10-year budget horizon.

1. For a discussion of recent budgetary and economic trends, see Congressional Budget Office, *The Budget and Economic Outlook: Fiscal Years 2004-2013* (January 2003).

2. CBO's next set of budget projections will be published in *An Analysis of the President's Budgetary Proposals for Fiscal Year 2004* (forthcoming in March 2003). Unified budget amounts include the off-budget transactions of the Social Security trust funds and the Postal Service.

Budgetary Choices and Fiscal Goals

Since the mid-1980s, lawmakers have made budgetary choices within a statutory framework of fiscal targets. Those targets, and the general structure of CBO's budget options volumes, have been constructed around the goal of reducing and eliminating budget deficits. From 1985 to 1990, the federal government legislated targets for deficits along a fixed trajectory that declined to zero.[3] That regime failed to achieve its stated goal and was supplanted in 1990 by the Budget Enforcement Act (BEA), which established annual limits on discretionary appropriations and a pay-as-you-go requirement for new laws dealing with mandatory spending or revenues.[4] The BEA framework was intended to ensure that new legislation did not cause deficits to rise (or surpluses to fall). It expired on September 30, 2002.

During most of the period that the BEA procedures were in place, the federal government's unified budget balance improved significantly. Deficits declined steadily after 1992, and beginning in 1998, surpluses were recorded each year through 2001. The BEA framework helped to preserve budget discipline, but its effectiveness started to erode as surpluses began to emerge.[5] Nonetheless, large surpluses continued to accumulate because of a surge in tax revenues stemming mainly from robust economic growth. But the recession in 2001 together with the terrorist attacks of September 11—and lawmakers' responses to those events—caused a sharp drop in federal revenues and a spike in spending that contributed to a return to a deficit in 2002.

3. Those targets were set by the Balanced Budget and Emergency Deficit Control Act of 1985, referred to as the Gramm-Rudman-Hollings Act. They were revised and extended by the Balanced Budget and Emergency Deficit Control Reaffirmation Act of 1987.

4. The BEA divided all spending into two categories for purposes of enforcing the discretionary spending limits and the pay-as-you-go requirement. In general, discretionary spending is provided and controlled by appropriation acts, and mandatory (or direct) spending is provided by laws other than appropriation acts.

5. For a discussion of the BEA procedures and their effectiveness, see Congressional Budget Office, *The Budget and Economic Outlook: Fiscal Years 2004-2013*, Appendix A.

The expiration of the BEA framework raises a broader question: what is the appropriate fiscal goal for the nation, in both the near term and the long term? Throughout the 1980s and 1990s, a broad consensus formed around the goal of eliminating deficits. Although balancing the budget each year has been a common fiscal goal, policymakers also have articulated other goals. For example, balancing the budget over the business cycle is a goal that takes into account the tendency of public spending to rise and revenues to fall when the economy is weak and to do the reverse when the economy is strong. Such automatic budgetary responses tend to dampen cyclical fluctuations.

However, even a fiscal policy that balances the budget in the current year or over the business cycle may not be sustainable over the long term. Under current policies, demographic changes and other factors will generate rising spending for entitlement programs such as Social Security and Medicare, especially in years beyond the current 10-year budget horizon. If, as a result, budget deficits increase, they will lead to greater borrowing from the public. If unchecked, that growth in borrowing and the resulting levels of public debt may become explosive. Alternatively, a fiscal policy that fails to balance the budget in the near term may be sustainable if levels of federal debt relative to the size of the economy are constrained over the long term.

Another important fiscal goal could involve making decisions about the appropriate size of government. Maintaining an appropriate-sized government may be motivated by the desire to allow sufficient scope for market incentives and thereby encourage economic growth. Although governments can provide important benefits to their citizenry, some public programs may be inefficient. Moreover, increases in spending eventually require higher revenues, and tax hikes in general distort the economic decisions of individuals and businesses.

This volume does not advocate or adopt a particular fiscal goal or budget target. Instead, it presents a variety of options to help policymakers in their annual tasks of making budgetary choices, setting priorities, and adapting to changed circumstances.

Rationales for Budget Options

The options in this volume could serve a number of rationales. In general, they would cut spending or increase revenues in the interest of reducing deficits, maintaining overall fiscal discipline, dealing with long-term budgetary pressures, or achieving other fiscal policy goals. But certain options could serve additional purposes. For example, they could be used to help reorder budgetary priorities, offset the cost of new initiatives, limit the overall size of the federal government, restructure programs to achieve policy goals at a lower cost, or improve the efficiency and effectiveness of federal programs.

Options to Reduce Spending

Chapter 2 of this volume presents options to decrease spending. Lawmakers may seek such options to meet near-term fiscal goals, make trade-offs among budgetary priorities, or to reorder those priorities. For example, proposals to substantially increase funding for some discretionary programs, such as ones for homeland security and defense, may have to be offset with reductions elsewhere in the budget if lawmakers decide to limit the rate of growth for total discretionary spending.

Options to reduce spending may also help meet policy or programmatic goals that differ from or are broader than the goal of achieving budgetary savings to comply with a particular fiscal target. For example, some of the options in this volume could be used to reduce the size of government, limit its rate of growth, or scale back activities for which the appropriateness of a federal role was questioned. Other alternatives would enable lawmakers to restructure programs to achieve their goals at a lower cost or to eliminate programs that might have outlived their usefulness or achieved the purposes for which they were created. In some cases, options may reflect changed conditions that could lead to different budgetary priorities and a shift in funding from one program to another. For example, some options for defense are based on new threats to national security, which may lead lawmakers to reduce resources for some defense activities and increase them for others.

Options That Affect Revenues

Chapter 3 presents various options for changing federal tax law. The criteria for including revenue options in this volume are the three goals that guide the federal tax structure: efficiency, equity, and simplicity. In most cases, the options would result in higher revenues, but some options would cause tax collections to fall. Efficiency demands that taxes distort behavior as little as possible. That criterion often requires comparable taxation of alternative economic activities, so some revenue options would eliminate tax provisions that favor particular activities over others. For example, eliminating the tax incentives accorded to oil and gas extraction would treat those activities more like other production and cause businesses and investors to allocate resources among industries on the basis of economic returns rather than tax considerations. Other options would offset inefficiencies that might occur in private markets by taxing activities that impose costs on others. Taxing the emission of pollutants such as sulfur dioxide, for example, would encourage firms to reduce their emissions in a cost-effective manner. Another type of option would alter tax provisions whose desirable goals could be achieved more effectively in a different way. For example, substituting a tax credit for the exclusion of interest income on state and local debt would maintain the current level of tax incentives for borrowing by state and local governments while reducing the federal costs.

Distributional considerations may arise as well. A common rule is that taxpayers in similar economic circumstances pay similar taxes—a principle known as horizontal equity. Alternatively, there is the desire to distribute the tax burden among taxpayers with various amounts of income in conformance with the wishes of policymakers—vertical equity. An option that would improve horizontal equity, for example, would make investment income from life insurance and annuities taxable, thus treating those forms of income in the same way as income from other sources such as bank accounts, taxable bonds, and mutual funds. Other options would seek to adjust vertical equity.

Lessening the tax system's complexity would reduce its administrative costs as well as the costs of compliance for taxpayers. Consolidating the child credit and the personal exemption for children, for example, would make it easier for families to complete their tax returns. Similarly, replacing the panoply of tax rates that apply to long-term capital gains with a single tax rate applied to only a percentage of gains would greatly simplify the multipage form that taxpayers must now complete. Such simplification would also increase the transparency of the tax system, thus making it easier for taxpayers to understand how much they are taxed on their income.

Possible modifications to the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA) are presented in terms of efficiency, equity, and simplicity. That law's major tax-cutting provisions are unique in that they phase in over nearly a decade and are scheduled to expire at the end of December 2010, resulting in a reversion of most tax laws to their pre-2001 status. That situation makes planning for the future difficult for taxpayers. Furthermore, most observers expect that the Congress will not allow EGTRRA to expire but will instead modify its provisions before 2011, adding to taxpayers' planning problems. The Congress could simplify the situation by stabilizing the law. One approach would simply extend or make permanent all of the fully phased-in provisions of the law. Alternatively, the Congress could elect to extend the law by modifying specific parts. The final group of revenue options in Chapter 3 comprises various alternatives for such modifications. Those options range from ones that would freeze provisions short of their final levels to others that would make particular parts of the law permanent. Unlike most other revenue options, some options affecting EGTRRA would reduce rather than raise revenues.

Options to Slow the Growth of Social Security and Medicare

In the absence of changes to current policy, the aging of the population and the continued growth of health care costs over the next several decades will bring about major structural shifts in the federal budget, substantially increasing the amount of resources directed toward programs for the elderly. CBO projects that spending on Social Security, Medicare, and Medicaid combined will climb from 8 percent of GDP today to 14 percent in 2030 and 21 percent in 2075, and as a consequence, unsustainable levels of deficits and public debt will emerge.

Chapter 4 discusses broad options for slowing the growth of Social Security and Medicare, the two largest federal entitlement programs. Because the major budgetary pressures facing those programs arise over a longer horizon, potential savings from those options are presented over a 75-year time frame and are measured relative to the size of the economy rather than in dollar amounts.

Using This Volume

The options to cut spending in Chapter 2 are classified according to the appropriate functional categories of the budget—defense (050), international affairs (150), and so on. For each function, an introductory page provides summary information and data since 1990 on overall trends in mandatory and discretionary spending within that function. For each option, the discussion provides some general background, includes arguments for and against the option, identifies whether it affects mandatory or discretionary spending, estimates the annual reduction in spending for 2004 through 2008, and sums up reductions both for that five-year period and for the 10-year period that ends in 2013. Those options are numbered individually and include, where appropriate, references to related options and to relevant CBO publications.

The savings from options affecting mandatory spending were computed from baseline levels estimated to occur under current law. The savings from options affecting nondefense discretionary spending generally were calculated from the continuing appropriation levels (adjusted for inflation) that were in effect at the time the options were prepared. Full-year appropriations for those programs and activities were enacted on February 20, 2003, in the Consolidated Appropriations Resolution for 2003. Except where noted, the estimated reduction in spending measured in relation to the full-year appropriation law did not differ significantly from that calculated under continuing appropriation levels. Savings affecting discretionary spending for defense were measured relative to the Department of Defense's most recent plan as modified by lawmakers in enacting appropriations for 2003. (The defense and military construction appropriation acts for 2003, which cover most defense programs and activities, were enacted last fall.) New or increased fees may be classified as offsets to spending (offsetting receipts or collections) or as new revenues (governmental receipts).[6]

6. In general, if the fee supports a businesslike activity, it is classified as an offset to spending. If it is based on the government's sovereign

Chapter 3 discusses options that affect revenues, following the format used in Chapter 2 for options to reduce spending. The revenue options are numbered individually and include references to related options and to applicable CBO publications. Each option includes some general background information, arguments for and against the option, estimates of the change in revenues for 2004 through 2008, and the cumulative impact on revenues both for that five-year period and for the 10-year period that ends in 2013. The estimates were computed from baseline revenue levels projected under current law.[7]

An "interactive" version of this volume offering enhanced search capabilities is available on CBO's Web site (www.cbo.gov). That version allows users to search the entire volume by word or phrase. For the specific, numbered policy options in Chapter 2, users can search by spending category (mandatory or discretionary), by budget function, and by federal agency. Those searches can be performed singly or in combination and can also be joined with searches by word or phrase.

Exclusions and Limitations

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

Because the options that address spending are also intended to facilitate the case-by-case review of individual programs, they exclude certain types of governmentwide options that would produce savings in many programs or agencies. Such options would, for example, freeze or cut federal spending across the board or eliminate an entire department or major agency.

Some of the options affecting state, local, or tribal governments or the private sector may involve federal mandates. The Unfunded Mandates Reform Act of 1995 establishes procedures that are intended to control such mandates and requires CBO to estimate the costs of mandates imposed by new legislation that the Congress is considering. However, individual options in this volume do not estimate the costs of potential mandates.

In calculating the changes to spending or revenues for the individual options, CBO did not include changes in federal interest costs. Interest costs or savings typically are estimated as part of a comprehensive budget plan, such as the Congressional budget resolution, but such adjustments are not usually made for individual options of the type discussed in this volume.

Subsequent CBO cost estimates (as well as subsequent revenue estimates by the Joint Committee on Taxation) for legislative proposals that resemble options in this volume may not match the estimates shown in this report. The policy proposals on which those later estimates are based may not precisely match the options in this volume. Further, the baseline budget estimates or levels against which such proposals ultimately are measured may have been updated and thus would differ from those used here.

power to tax, it is classified as a revenue. Fees classified as spending offsets may be further categorized as either mandatory or discretionary, depending generally on the type of legislation that provided for the collections.

7. For cost estimates of legislation that would amend the Internal Revenue Code, CBO is required by law to use estimates provided by the Joint Committee on Taxation. The committee estimated the change in revenue collections that would result from all but three of the options in Chapter 3. For those options—13, 14, and 15—CBO prepared the estimates.