again (see Table 2-1). The deficit peaked at $290 billion in 1992 but is expected to equal just $176 billion in 1995. It then heads back up, topping $200 billion in 1996 and $220 billion in 1997 and 1998. What happens after that depends on what is assumed about discretionary spending, the label given to the funds that are controlled by annual appropriation actions. That particular one-third of federal outlays is governed through 1998 by overall caps.

Roughly speaking, the caps on discretionary spending--originally set in 1990 for the 1991-1995 period and in 1993 extended through 1998--have imposed a near freeze on such outlays during that eight-year period. The Congress makes decisions about the 900 or so discretionary spending accounts one year at a time, through the 13 regular appropriation bills and occasional bills that provide supplemental appropriations or rescind existing appropriations. That type of spending thus stands in sharp contrast to mandatory programs (such as Social Security) and interest spending, which simply continue on track under permanent law and do not require annual decisions about funding.

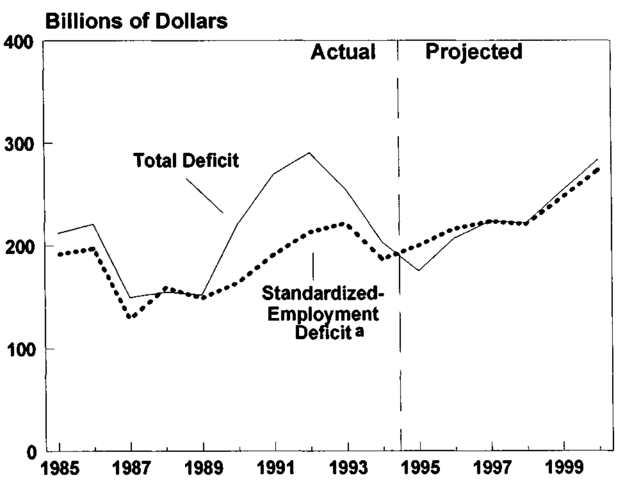
Since 1991, the 13 regular appropriation bills and any supplemental appropriations have had to stay under the caps. But once the caps expire, there is neither an overarching dollar total for discretionary appropriations set in law nor any mechanism to constrain such spending. What then? Traditionally, participants in the budget process have employed constant *real* funding--that is, resources adjusted for inflation--as a benchmark when weighing their decisions about future appropriations. That practice acknowledges that inflation, even at today's relatively low rate, gnaws away at the purchasing power of a fixed dollar total. But some analysts argue that constant *nominal,* or dollar, resources can also serve as a useful benchmark and point out that policymakers have essentially chosen that route from 1991 through 1998.

If discretionary programs are permitted to rise with inflation--that is, by about 3 percent a year--after 1998, CBO estimates that the deficit would climb from $222 billion in that year to $284 billion in 2000, simultaneously inching up in relation to GDP. By contrast, if discretionary outlays stay frozen, the deficit would still climb but less steeply--to $243 billion in 2000--and maintain the same 2.7 percent of GDP as in 1998.

The Standardized-Employment Deficit. Temporary and cyclical factors can obscure fundamental trends in the budget. When these factors are stripped away, the underlying trends in the deficit become more apparent. Although such factors are not very important in CBO's new projections for the 1995-2000 period, they do cast a somewhat different light on the experience of the past few years (see Figure 2-1).

One such transitory factor is spending for deposit insurance. CBO has long stressed that such spending--that is, money spent and recovered in the course of closing or merging insolvent savings and loan institutions and banks--does not spur the economy like other federal outlays. Insured depositors do not become richer when the government honors its commitment to them; rather, the transaction represents a rearrangement of the financial assets and liabilities already present in the economy. Recognizing the limited impact of the expenditures for deposit insurance, credit markets absorbed the Treasury securities is-

Figure 2-1.
The Federal Deficit (By fiscal year)



SOURCE: Congressional Budget Office.

NOTE: The projections assume that discretionary spending rises with inflation after the caps expire in 1998.

a. Excludes deposit insurance and the cyclical deficit. Also excludes contributions from allied nations for Operation Desert Storm in 1991 and 1992.

sued to pay for them with relative equanimity. The real economic loss that is symbolized by deposit insurance outlays occurred when institutions made bad loans and investments, well before the costs appeared in the budget.

As portrayed later in this chapter, outlays for deposit insurance have fluctuated widely in the past few years, soaring as high as $66 billion in 1991 but plunging to net receipts (that is, negative outlays) of $28 billion in 1993. CBO foresees small negative outlays for the 1995-2000 period. The massive losses associated with closing failed institutions have subsided, and the ongoing sales of assets (along with other receipts such as premiums from insured institutions) dominate the totals. But that volatile category of spending, notable for its relative lack of economic effect, should be isolated when analyzing the deficit's trend.

The transitory effects of the business cycle on the budget also affect the deficit and obscure its economic impact. Poor economic performance automatically worsens the deficit--principally because of lower revenues, less dramatically because of extra benefits for unemployment compensation and other programs. Those cyclical effects were very pronounced in the early 1990s when the economy was weak but have faded now that the economy is operating close to capacity.

The standardized-employment deficit is a measure of the imbalance in the budget that would exist if the economy were operating at capacity and tax collections and spending for such purposes as unemployment compensation reflected that robust economy. As explained in Chapter 1, changes in the standardized-employment deficit are used as a measure of the stimulus or drag exerted by fiscal policy. Because of the recession and the high level of outlays for deposit insurance in some years, the record-high total deficits posted in the early 1990s were partly bloated by temporary factors. The subsequent improvement is, therefore, somewhat less dramatic than it may first appear and cannot all be attributed to the deficit reduction measures adopted by policymakers (see Figure 2-1).

Just as outlays for deposit insurance fade into near insignificance in CBO's 1995-2000 projections, so do cyclical factors. An expected slowdown in the economy explains part of the rise in the 1996 deficit. Specifically, CBO estimates that the standardized-employment deficit climbs by just $16 billion in 1996 (from $200 billion to $216 billion), in contrast to the $30 billion jump in the deficit as conventionally measured (from $176 billion to $207 billion). Yet both measures tell the same story about the long-run outlook--namely, that the deficit will settle at just under 3 percent of GDP in the second half of the 1990s.

The On-Budget Deficit and Its Variants

A deficit sometimes cited by policymakers, the press, and the public is the on-budget deficit. Unlike the measures just discussed, this measure has no particular usefulness for macroeconomic analysis; rather, it is rooted in legislation that grants special, off-budget status to particular programs run by the government.

The two Social Security trust funds--Old-Age and Survivors Insurance and Disability Insurance--were granted off-budget status in the Balanced Budget and Emergency Deficit Control Act of 1985. Legislation enacted in 1989 excluded the much smaller net outlays of the Postal Service from on-budget totals.

The fiscal picture looks markedly different if off-budget programs are excluded (see Table 2-1). In isolation, Social Security runs a surplus; its income from the taxes paid by workers and their employers, interest, and a few other sources exceeds its outlays for benefits to the retired and disabled as well as for minor categories of spending. Thus, removing Social Security from the on-budget totals makes the remaining deficit bigger. The Social Security surplus is mostly in the Old-Age and Survivors Insurance (OASI) fund. The Disability Insurance (DI) fund was heading fast toward depletion but was rescued in the waning days of the 103rd Congress by the simple device of reallocating a small portion of the existing payroll tax from OASI to DI. About one-half of the total Social Security surplus stems not from its excess of taxes over benefits but from interest on its holdings of Treasury securities.

Social Security's benefits alone account for more than one-fifth of federal spending, and its payroll taxes for more than one-fourth of government revenues. When they seek to gauge the government's role in the economy and its drain on the credit markets, economists, credit market participants, and policymakers alike look at the total figures and do not ignore this huge program.

Many economists and policymakers, however, deliberately segregate the Social Security program along with Medicare for purposes of long-run analysis. They worry about the future demands that will be placed on the budget by demographic pressures,

Table 2-2.
CBO Projections of Trust Fund Surpluses (By fiscal year, in billions of dollars)

	1995	1996	1997	1998	1999	2000
Social Security[a]	69	73	78	84	90	96
Medicare						
Hospital Insurance	3	-2	-7	-12	-19	-25
Supplementary Medical Insurance	-9	b	1	1	2	2
Subtotal, Medicare	-5	-2	-6	-11	-17	-23
Military Retirement	5	4	4	2	1	b
Civilian Retirement[c]	29	31	32	33	34	36
Unemployment	8	7	5	4	3	3
Highway and Airport	-3	1	2	2	2	2
Other[d]	4	4	4	4	4	4
Total Trust Fund Surplus[e]	107	118	119	119	116	117
Federal Funds Deficit[e]	-283	-326	-343	-341	-369	-401
Total Deficit	-176	-207	-224	-222	-253	-284
Memorandum:						
Net Transfers from Federal Funds to Trust Funds	203	232	252	269	290	314

SOURCE: Congressional Budget Office.

a. Old-Age and Survivors Insurance and Disability Insurance.

b. Less than $500 million.

c. Civil Service Retirement, Foreign Service Retirement, and several smaller funds.

d. Primarily Railroad Retirement, employees' health insurance and life insurance, Hazardous Substance Superfund, and various veterans' insurance trust funds.

e. Assumes that discretionary spending reductions are made in non-trust-fund programs.

especially as the baby-boom generation joins the Social Security and, a few years later, Medicare rolls in droves beginning at the end of the first decade of the next century.

However, even for such analyses, focusing on the on-budget deficit--the deficit excluding Social Security--can lead to faulty conclusions. CBO and others have pointed out that the best way for the nation to prepare for future demographic pressures is to save and invest more now. Greater investment, the main engine of growth, would enlarge the future economic pie and somewhat diminish the relative sacrifices that will be demanded of future workers. Investment, in turn, fundamentally depends on the available pool of saving, whether private (personal and corporate) or government (federal, state, and local). Because government actions to encourage private saving have had, at best, very limited success, the most direct way for the government to foster investment is simply to cut the deficit or even run an overall surplus. As CBO has pointed out, what really matters is that policymakers accomplish this somehow--not whether they record the reduction as part of the Social Security surplus or in the rest of the budget.[1]

The Federal Funds Deficit. The federal funds deficit is the deficit excluding the activities of all trust funds. The two Social Security funds share the trust fund label with many other federal programs. In total, there are more than 150 federal trust funds, though fewer than a dozen account for the vast share of trust fund dollars.

Viewed by themselves, trust funds run surpluses because their earmarked income (chiefly from social insurance taxes and from transfers within the budget, as explained below) exceeds spending for benefits, administration, and other activities. The total trust fund surplus is virtually flat in CBO's projections, climbing slightly from $107 billion this year to about $118 billion a year in 1996 through 2000 (see Table 2-2).

1. See Congressional Budget Office, "Implications of Revising Social Security's Investment Policies," CBO Paper (September 1994), and *The Economic and Budget Outlook: Fiscal Years 1990-1994* (January 1989), Chapter 3.

Nearly all public attention focuses on the Social Security and Medicare trust funds, which run combined surpluses of roughly $70 billion a year, or two-thirds of the total trust fund surplus. Both Social Security and Medicare's Hospital Insurance (HI) fund collect taxes from workers and pay benefits to or on behalf of elderly and disabled recipients. The rising surplus in the Social Security trust funds is offset by a deepening deficit in Medicare's Hospital Insurance fund, which explains why their combined surplus is nearly flat at about $70 billion annually.

A second Medicare program--Supplementary Medical Insurance, or SMI--runs a small surplus or deficit in every year by design. SMI gets roughly one-fourth of its income from enrollee premiums and taps the general fund of the government for the rest of its $60 billion-plus outlays, generally permitting a small surplus. Apart from Social Security and Medicare, total trust fund surpluses run about $40 billion a year and are concentrated in the federal employee retirement and unemployment insurance programs.

In 1995, the total deficit is expected to be $176 billion. It can be divided into a federal funds deficit of $283 billion offset by a trust fund surplus of $107 billion. The line between federal funds and trust funds is not so neat, however, because trust funds receive a large portion of their income from transfers within the budget. Such transfers shift money from the general fund (thereby boosting the federal funds deficit) to trust funds (thus swelling the trust fund surplus). Those intragovernmental transfers total more than $200 billion in 1995. Prominent among them are interest paid to trust funds (about $86 billion in 1995), government contributions to retirement funds on behalf of present and past federal employees ($67 billion), and contributions by the general fund to Medicare, principally SMI ($41 billion). Clearly, each of those transfers was instituted for a purpose--for example, to force agencies to reflect the cost of funding future retirement benefits in weighing their hiring decisions. But it is equally clear that transferring money from one part of the government to another does not change the total deficit or the government's borrowing needs. Without those intragovernmental transfers, the trust funds would have an overall deficit in every year--ranging from about $100 billion in 1995 to almost $200 billion in 2000.

Changes in the Budget Outlook Since August

The budget outlook has worsened only marginally since CBO published its projections last August. Projected deficits are up in every year--by $13 billion in 1995, $31 billion in 1996 and 1997, and slightly smaller amounts thereafter (see Table 2-3). Most of the revision comes from changes in CBO's outlook for the economy.

A Last Look at 1994

Last August, CBO projected a 1994 deficit of $202 billion; two months later, the Treasury Department reported that red ink for that past fiscal year had totaled $203 billion. Although CBO's estimate of the

Table 2-3.
Changes in CBO Deficit Projections Since August 1994 (By fiscal year, in billions of dollars)

	Actual 1994	1995	1996	1997	1998	1999
August 1994 Estimate	202	162	176	193	197	231
Legislative Changes						
Revenues	0	-1	1	1	3	3
Outlays	1	3	1	a	a	a
Deficit	1	2	2	2	3	3
Economic Changes						
Revenues	a	2	9	8	3	a
Outlays						
Net interest	a	8	16	17	15	15
Other outlays	a	a	a	1	2	2
Subtotal	a	8	16	19	17	17
Deficit	a	10	25	27	20	17
Technical Changes						
Revenues	8	6	5	6	9	11
Outlays						
Medicaid and Medicare	a	-7	-6	-8	-11	-15
Other major benefit programs	a	1	1	1	2	2
Deposit insurance	-2	1	3	a	a	1
Net interest	1	a	-1	a	a	1
Other outlays	-6	-1	-3	-2	-2	-3
Subtotal	-7	-5	a	-4	-7	-9
Deficit	1	1	5	2	2	2
Total Changes	2	13	31	31	26	22
Current Estimate	203	176	207	224	222	253

SOURCE: Congressional Budget Office.

NOTES: Reductions in revenues are shown with a positive sign because they increase the deficit.

The deficit projections assume that discretionary spending rises with inflation after the caps expire in 1998.

a. Less than $500 million.

deficit was almost exact, CBO overestimated both revenues and outlays by about equal amounts (see Table 2-3). Revenues were approximately $8 billion less than expected, with most of the shortfall coming in individual income taxes, and CBO overestimated outlays by more than $6 billion. Except for deposit insurance, which came in $2 billion lower than CBO expected, hardly any major program or category differed from CBO's projections by more than a few hundred million dollars.

Revisions to the 1995-1999 Projections

CBO traditionally traces the reason for its revisions to the budget outlook to three sources: newly enacted legislation; changes in the economic outlook; and other, so-called technical factors.

Recent Legislation. Legislation enacted since last August has added $2 billion to $3 billion a year to projected deficits, or $12 billion altogether over the 1995-1999 period. Legislation to implement the Uruguay Round of the General Agreement on Tariffs and Trade (GATT) added less than $3 billion over that period. That legislation significantly reduced collections from tariffs but recouped much of the loss by accelerating tax deadlines, tightening the rules governing underfunded private pension plans, reducing farm subsidies, and cutting the interest rate paid by the government on certain tax refunds to corporations. Other new legislation granted disaster aid to farmers in 1995 and reformed the crop insurance program (a shift that may mitigate the future need for ad hoc emergency aid), relaxed the stringent provisions for payments of Federal Insurance Contributions Act (FICA) taxes on behalf of occasional household workers, and made other, smaller changes to numerous programs.

Discretionary appropriations for fiscal year 1995 conformed precisely to the outlay limits set by law.[2] Because CBO assumed such an outcome in the projections it issued last August, no adjustment--other than to reflect the few emergency appropriations for fiscal year 1995--is called for. While staying within the outlay caps, the appropriators were able to increase budget authority by about 2 percent in dollar terms compared with 1994, equivalent to a reduction of about 1 percent in real terms. Deeper-than-average reductions were imposed on funding in the areas of space and science, energy, agriculture, and general government functions such as the Internal Revenue Service. Programs faring somewhat better were education, training, and social services; subsidized housing; and crime prevention.

Economic Changes. Revisions that stem from changes in the economic outlook largely explain the mild deterioration in the deficit picture. Projected revenues are down, outlays are up, and hence the deficit is bigger. CBO has shaved its projections of wage and salary income, the single biggest component of GDP. Consequently, projected revenues from two sources--individual income taxes and social insurance taxes--are weaker. The outlook for corporate profits remains strong, and CBO has upped its estimate of collections from that source. The net reductions in revenues from the new economic forecast are greatest in 1996 and 1997. That is no coincidence; CBO forecasts that an economic slowdown will begin in late 1995, as the Federal Reserve nudges growth back to a rate that is compatible with low inflation.

Of course, interest rates are the Federal Reserve's main tool for achieving that goal, and the federal government--as a major borrower--is directly affected. Extra interest costs will be $8 billion in 1995 and $15 billion a year or more in 1996 through 1999, compared with the estimates CBO made last August (see Table 2-3). Noninterest outlays will be up modestly, chiefly because of larger cost-of-living adjustments in Social Security and other indexed programs and greater costs for student loans, which are sensitive to interest rates.

Technical Reestimates. Technical revisions are any changes that are not ascribed to legislation or to macroeconomic variables. Such changes have little net effect on CBO's deficit outlook because downward revisions to revenues and outlays, primarily Medicaid, are roughly offsetting.

As noted before, revenues in 1994 fell short of CBO's August projection by about $8 billion. Most

2. See Congressional Budget Office, "Final Sequestration Report for Fiscal Year 1995" (December 9, 1994).

of the technical revision on the revenue front comes from assuming that this weakness will persist. A small revision--less than $300 million a year--stems from the expiration of taxes for the oil spill liability trust fund in December 1994. As required by the Balanced Budget Act, CBO had assumed in its previous baseline that those taxes--like all excise taxes dedicated to trust funds--would be extended, but that did not happen.

On the outlay side, the largest revision by far is in the Medicaid program, which is down by $6 billion in 1995 and by growing amounts thereafter. Fiscal year 1994 witnessed Medicaid growth of just 8 percent--a remarkable slowdown for a program that had doubled in cost in just four years. Anecdotal evidence from the states, which administer the program and charge the federal government for matching payments, suggests that many states are limiting optional coverage and shifting enrollees into health maintenance organizations and other cost-saving arrangements. Disproportionate share payments to hospitals, designed to compensate institutions that care for large numbers of indigent patients, apparently did not grow at all in 1994 as states weighed how to respond to new limitations placed on the provider donation and tax schemes that some states had used to help fund their portion of those payments. In light of those developments, CBO has trimmed its projections of future Medicaid outlays.

A much milder slowdown is apparent in Medicare. That program continues to operate fundamentally on a fee-for-service basis with universal coverage for the eligible population, meaning that some tools wielded by other payers--notably restrictions on coverage and choice--have not been available to it. Although the growth of payments for hospitalizations and physician visits does appear to be decelerating, those reductions are roughly offset by fast-growing costs for care in other settings, particularly for home health care and skilled nursing facilities.

CBO has bumped up its projections of deposit insurance outlays modestly. That change reflects a diminished flow of money from liquidations and a larger-than-anticipated premium cut by the Bank Insurance Fund. Technical revisions to areas other than those mentioned are small.

The Spending Outlook

CBO expects that federal spending will top the $1.5 trillion mark in 1995. For more than a decade, policymakers and budget analysts have divided the spending side of the huge federal budget into several convenient clusters. The categories were formalized in 1990's Budget Enforcement Act.

Discretionary spending denotes programs controlled by annual appropriation bills. For those programs--whether defense, international, or domestic--policymakers decide afresh each year how many dollars will be devoted to continuing existing activities and funding new ones. The baseline projections depict the path of discretionary spending as a whole, assuming that the Congress exactly complies with the caps on discretionary spending dictated by the Balanced Budget Act through 1998. Of course, the appropriators are free to spend less. There are no caps after 1998. Therefore, CBO presents two alternative paths--one in which discretionary spending is frozen in real terms, the other, more stringent one involving a freeze in dollar terms.

All other spending is controlled by existing laws, and the baseline presents CBO's best guess of spending if those laws and policies remain unchanged. *Entitlements and other mandatory spending* consist overwhelmingly of benefit programs, such as Social Security, Medicare, and Medicaid. Spending for those programs is generally controlled by setting eligibility rules, benefit levels, and so forth rather than by voting annually for dollar amounts. *Offsetting receipts*--fees and similar charges that are recorded as negative outlays--likewise are changed only when the Congress revisits the underlying laws. *Deposit insurance spending* reflects the net outlays caused by the government's pledges to protect depositors in insolvent institutions. And growth in *net interest* spending is driven by the government's deficits and by market interest rates.

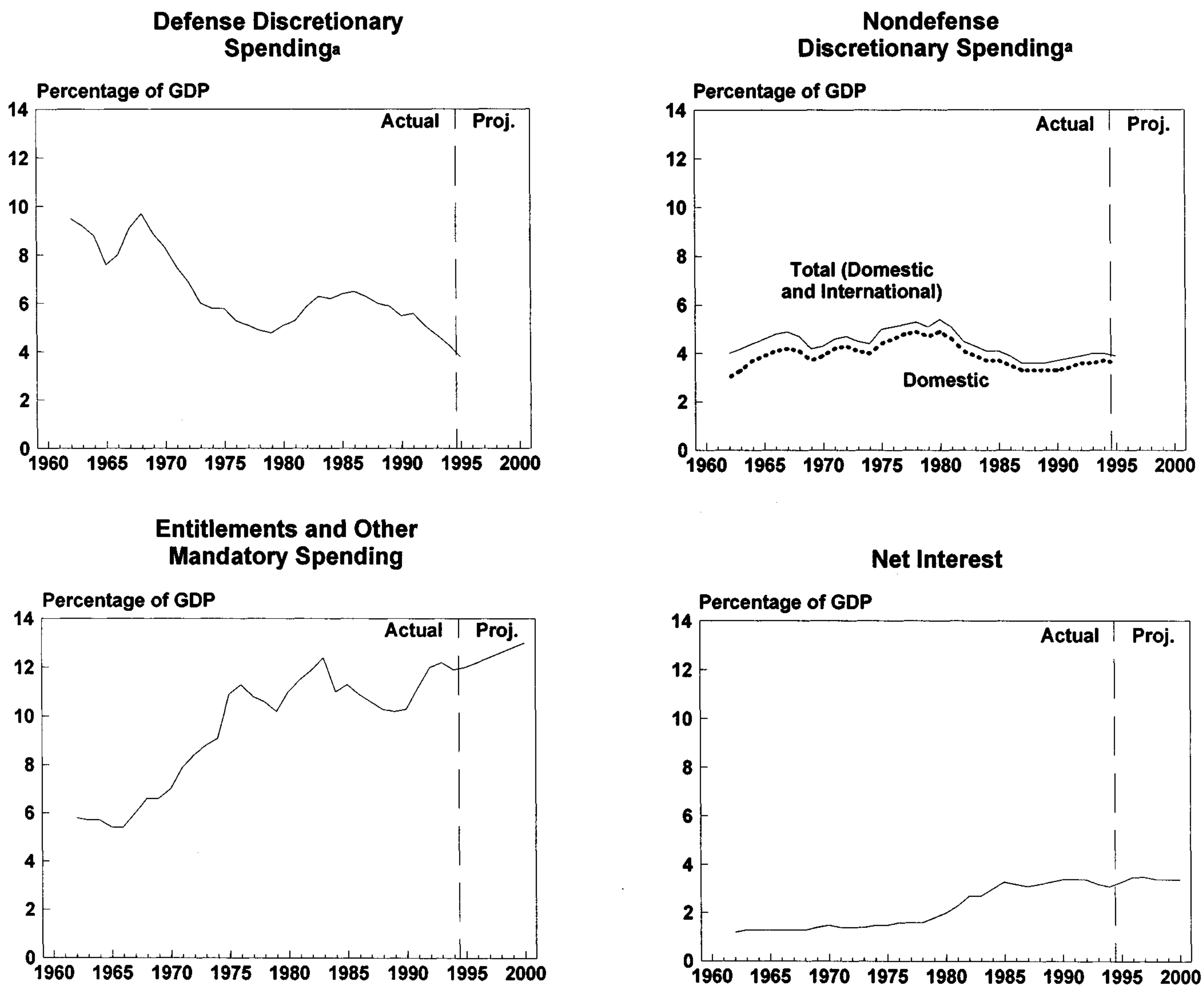
Federal spending now represents about 22 percent of gross domestic product and is expected to stay near that level over the next five years. In the 1960s, federal spending averaged about 19 percent of GDP; for the 1970s and 1980s, the figures were about

21 percent and 23 percent, respectively. Clearly, that percentage has not fluctuated violently. But a pronounced shift has taken place in the composition of federal spending. The government today spends more on entitlement programs and on net interest, and less on discretionary activities, than in the past (see Figure 2-2). More detailed historical data are contained in Appendix E, which lists annual totals for each of these broad categories of spending and for federal revenues.

Discretionary Spending: Defense, International, and Domestic

Each year, the Congress starts with a clean slate in the appropriation process. It votes on budget authority--the authority to commit money--for discretionary activities of the budget, and that authority translates into outlays with a lag. Discretionary programs cover virtually the entire defense and interna-

Figure 2-2.
Outlays by Category as a Share of GDP



SOURCE: Congressional Budget Office.

a. Assumes compliance with discretionary spending caps in the Balanced Budget Act.

tional affairs budgets, but only one-fifth of all domestic spending (the remaining four-fifths of domestic spending is mandatory). In 1995, discretionary spending is expected to total $544 billion, half of it for defense.

Relative to the economy, total discretionary spending is down markedly from typical levels of the 1960s and 1970s. The fortunes of defense and domestic programs have waxed and waned several times over the past few decades. Comparisons with GDP, however, merely express how much a society devotes to public spending in relation to its resources; they tell nothing about the adequacy of such spending, especially as the needs of the nation and the threats faced by it have changed over time.

Defense Discretionary Spending. The share of GDP that is devoted to defense has gradually shrunk in the past three decades, with only two major interruptions: the Vietnam War of the late 1960s and the Reagan-era defense buildup of the early 1980s. Even the costs of Operation Desert Storm appeared as barely a blip against that downward trend. Today, defense outlays are just below 4 percent of GDP. In dollar terms, defense outlays peaked at about $300 billion annually in 1989 through 1991 (not counting estimated spending on Desert Storm in that final year). At $270 billion in 1995, defense outlays are down about 10 percent from those 1989-1991 levels in dollar terms and about one-quarter in real terms. Approximately 40 percent of the dollars devoted to defense go to compensate members of the armed services and civilian employees of the Department of Defense.

Domestic Discretionary Spending. Even as defense spending generally drifted down (in relation to GDP) in the 1960s and 1970s, discretionary spending for domestic programs climbed slowly. It peaked at 4.9 percent of GDP in 1980 before its rise was abruptly reversed. Today, it totals about 3½ percent of GDP, not quite three-fourths of its peak levels in the mid-1970s.

Domestic discretionary spending encompasses a wide variety of federal government activities. Of the $253 billion in expected outlays for 1995, leading claimants are education, training, and social services ($39 billion); income security, chiefly housing subsidies and the administrative costs of running entitlement programs ($39 billion); transportation ($38 billion); the administration of justice and general government activities such as running the Internal Revenue Service (together, $29 billion); natural resources and environment ($21 billion); health research and public health ($22 billion); veterans' benefits, chiefly medical care, other than direct cash payments ($18 billion); and space and science ($17 billion). Approximately one-fourth of domestic discretionary spending goes to pay the compensation of federal employees at nondefense agencies.

So far, domestic discretionary spending has not fared badly under the caps. Although the caps have roughly imposed a freeze on total discretionary outlays since 1991, the steady shrinkage in defense allowed modest increases in domestic programs. Domestic discretionary spending has claimed a steady 3½ percent of GDP since 1991, the first year of the caps, even as defense has shrunk by about a percentage point relative to GDP.

International Discretionary Spending. The smallest of the three major categories of discretionary outlays is international discretionary spending, totaling about $21 billion in 1995. As a share of GDP, this spending has slipped steadily for the past three decades to 0.3 percent of GDP in 1995. This category chiefly includes aid to other countries for humanitarian or security purposes, contributions to international organizations such as the United Nations, and the conduct of foreign affairs.

Discretionary Spending and the Statutory Caps Through 1998. Since 1991, dollar caps set in the Budget Enforcement Act and in the Omnibus Budget Reconciliation Act of 1993 (as amendments to the Balanced Budget Act) have crimped spending for discretionary programs. In 1991 through 1993, separate caps applied to defense, international, and domestic appropriations. Since 1994, a single lid has applied to all three categories, sharpening the competition for resources.

As explained below, the caps will barely allow programs to grow in dollar terms from today's levels over the 1996-1998 period. Because inflation, though subdued, continues at about 3 percent a year, appropriations for discretionary programs will therefore shrink by about 9 percent in real terms.

Separate caps apply to budget authority and outlays. *Budget authority* is the basic currency of the appropriation process; it represents the permission to commit funds. That commitment always precedes actual *outlays* or disbursements--with a short lag for fast-spending activities such as meeting payrolls or providing services directly, and a longer lag for slow-spending activities such as the procurement of weapons or other complex items. Because the caps limit both budget authority and outlays, the more stringent one prevails. In 1992 through 1995, appropriators found the outlay cap tougher to satisfy, and budget authority was therefore billions of dollars under its limit. During the 1996 appropriation cycle, however, that appears unlikely to be the case.

The appropriations debate has thousands of possible outcomes because so many programs are funded out of this single pot. But it is useful to compare the caps with two hypothetical paths for discretionary spending. Both paths take as their starting point the funds actually appropriated in 1995, or a little more than $500 billion in total discretionary budget authority. The first path, a traditional *inflation-adjusted baseline*, preserves real resources at 1995 levels by assuming that future appropriations for each program grow in step with inflation (about 3 percent a year). The second path, an *across-the-board freeze*, restricts each program to the same dollars it received in 1995--forcing it to trim its activities by about 3 percent a year in real terms. Both paths omit any future spending for emergencies such as natural disasters, which cannot be anticipated, but focus instead on the nuts-and-bolts activities of the government.

In both paths, projected levels of budget authority for domestic programs appear slightly erratic from year to year because of fluctuations in the volume of long-term contracts for subsidized housing units that come up for renewal. CBO assumes, for example, that around $10 billion in such contracts will come due in both 1996 and 1997--versus just $3 billion in 1995 and $19 billion in 1998. The Budget Enforcement Act directs CBO to incorporate such renewals, which merely maintain the current stock of subsidized housing units, into its baseline projections. All other domestic program in these illustrations are simply adjusted by inflation (in the first path) or by nothing at all (in the second).

Overall, the caps are barely more generous than a simple freeze on appropriations in 1996 and beyond (see Table 2-4). An across-the-board freeze would bring total discretionary budget authority to about $516 billion and outlays to $542 billion in 1996--within a billion dollars of the limit on budget authority. That approach would seemingly leave the appropriators with $7 billion in allowable outlays to spare. Yet they could use hardly any of that elbow room without breaching the limits on budget authority, unless they drastically shifted money from slow- to fast-spending programs.

What about 1997 and 1998? The freeze on appropriations would essentially continue. Policymakers would have a mere $1 billion to spare, over and above such a freeze, because of the outlay caps (see bottom panel of Table 2-4). That amount is a tiny fraction of the several tens of billions of dollars that they would need to shield all programs from real cuts.

The defense-versus-domestic competition does not promise easy trade-offs. The Clinton Administration will submit its proposed budget for 1996, including its requested funding for defense, in early February. CBO does not know what the President will propose. But a year ago, the Administration requested $256 billion in defense budget authority in 1996. Granting such a request would leave $261 billion for domestic and international budget authority--just enough, as suggested in Table 2-4, to preserve those two categories in real terms if the Congress so chose. But adding to the President's request for defense--as many advocates are now urging--obviously requires taking the dollars from elsewhere.

Discretionary Programs After 1998. The discretionary caps expire after 1998, when such spending will have been roughly frozen for eight years. The outlook for the deficit after 1998 hinges on what happens next.

Of course, the caps on discretionary spending are already playing a vital role in taming the deficit (see Table 2-5). If such programs were merely permitted

Table 2-4.
How Tight Are the Discretionary Caps? (By fiscal year, in billions of dollars)

	1996	1997	1998
Budget Authority			
Discretionary Caps[a]	517	527	531
Amount Needed to Preserve 1995 Real Resources			
Defense	272	282	291
International	21	22	23
Domestic	241	250	268
Total	534	554	582
Amount over or under (-) caps	17	27	50
Amount Needed to Freeze 1995 Dollar Resources			
Defense	263	263	263
International	20	21	21
Domestic	232	234	242
Total	516	517	526
Amount over or under (-) caps	-1	-10	-6
Outlays			
Discretionary Caps[a]	549	548	547
Amount Needed to Preserve 1995 Real Resources			
Defense	270	278	285
International	22	22	22
Domestic	262	274	284
Total	554	574	592
Amount over or under (-) caps	5	26	44
Amount Needed to Freeze 1995 Dollar Resources			
Defense	264	264	262
International	21	21	21
Domestic	257	262	263
Total	542	547	546
Amount over or under (-) caps	-7	-1	-1

SOURCE: Congressional Budget Office.

NOTE: Amounts needed to preserve 1995 real resources include adjustments for inflation of about 3 percent a year. Amounts needed to freeze 1995 dollar resources include no adjustment for inflation. Both paths include the budget authority necessary to renew expiring contracts for subsidized housing. There are no discretionary caps after 1998.

a. The estimated caps are based on those published in CBO's *Sequestration Preview Report for Fiscal Year 1996*, included as Appendix A of this volume, as modified for small adjustments that by law will be made at a later date.

Table 2-5.
Three Scenarios for Discretionary Spending and the Deficit (By fiscal year, in billions of dollars)

	1995	1996	1997	1998	1999	2000
Projections Assuming Full Discretionary Inflation After 1995						
Revenues	1,355	1,418	1,475	1,546	1,618	1,697
Outlays						
Discretionary	544	554	574	592	613	634
Net interest	235	260	272	283	300	320
All other	752	816	881	942	1,012	1,086
Total	1,531	1,630	1,727	1,817	1,925	2,040
Deficit	176	212	251	270	306	342
Deficit as a Percentage of GDP	2.5	2.9	3.2	3.3	3.6	3.8
Baseline Projections With Discretionary Inflation After 1998						
Revenues	1,355	1,418	1,475	1,546	1,618	1,697
Outlays						
Discretionary	544	549	548	547	566	585
Net interest	235	260	270	279	294	310
All other	752	816	881	942	1,012	1,086
Total	1,531	1,625	1,699	1,769	1,872	1,981
Deficit	176	207	224	222	253	284
Deficit as a Percentage of GDP	2.5	2.8	2.9	2.7	3.0	3.1
Baseline Projections Without Discretionary Inflation After 1998						
Revenues	1,355	1,418	1,475	1,546	1,618	1,697
Outlays						
Discretionary	544	549	548	547	547	547
Net interest	235	260	270	279	293	308
All other	752	816	881	942	1,012	1,086
Total	1,531	1,625	1,699	1,769	1,852	1,941
Deficit	176	207	224	222	234	243
Deficit as a Percentage of GDP	2.5	2.8	2.9	2.7	2.7	2.7

SOURCE: Congressional Budget Office.

NOTES: "Discretionary inflation" represents inflation in discretionary spending.

Caps on discretionary spending are set by law through 1998. The first scenario shows what would happen if discretionary outlays were permitted to rise with inflation after 1995, in violation of the caps. The second assumes that discretionary spending complies with the caps through 1998 and grows at the rate of inflation thereafter. The third assumes that discretionary spending complies with the caps through 1998 and is frozen thereafter.

to grow in step with inflation after this year, the deficit would be sharply higher than in CBO's baseline projections--$270 billion (rather than $222 billion) in 1998, and $342 billion in 2000. The deficit would climb relentlessly as a percentage of GDP. The extra costs would appear not just in discretionary spending itself, but also in net interest costs as the Treasury would be forced to borrow more.

CBO's baseline, however, does assume compliance with the statutory caps through 1998. If discretionary spending then keeps up with inflation in 1999 and 2000--the last two years of the standard budget horizon--the deficit would climb from $222 billion in 1998 to $284 billion in 2000, and from 2.7 percent of GDP to 3.1 percent in those same years. Discretionary programs themselves would not absorb a growing share of GDP. Because they would grow no faster than inflation, they would actually shrink in relation to GDP. But they would not shrink enough to offset trends in mandatory spending, interest, and revenues--the subjects of the rest of this chapter--which tug in the opposite direction.

Finally, policymakers could opt to keep discretionary spending frozen at the 1998 level. That would keep the deficit at a flat 2.7 percent of GDP in 1998 through 2000. Clearly, that stability comes at the price of steady reductions in the activities and services funded by those appropriations; in real terms, discretionary outlays would shrink by about 6 percent between 1998 and 2000, and by a total of about 20 percent between 1991 (the first year of the caps) and 2000.

Last year, the Congress settled on one means of constraining the growth of discretionary spending and helping to comply with the caps: reductions in federal civilian employment. Nearly all civilian employees of the government are paid from discretionary funds. The Congress limited the employment of executive branch, non-postal civilians, measured on a full-time-equivalent basis, to 2.1 million in 1994 and to lower levels in each year thereafter--reaching 1.9 million in 1999. Between 1995 and 1999, the shrinkage in employment amounts to 8 percent. The Congress did not spell out reductions by agency or activity. Falling employment will permit reductions in agencies' appropriations. But the resulting year-to-year declines in payroll will be at least partly offset if pay raises are granted to those still employed, as called for under current law.

Entitlements and Mandatory Programs

More than half the $1.5 trillion of federal spending goes for entitlements and mandatory programs. If current policies remain unchanged, mandatory programs are expected to top $1 trillion in 1998--almost twice as much as discretionary spending in that year, the last one governed by the caps (see Table 2-6). Mandatory programs make payments to recipients--usually people, but occasionally businesses, not-for-profit institutions, or state and local governments--who are eligible and apply for funds. Payments are governed by formulas set in law and are not constrained by annual appropriation bills.

The Balanced Budget Act lumps mandatory programs (other than Social Security) together with receipts and subjects them to a pay-as-you-go discipline; that is, liberalizations in those programs are supposed to be funded by cutbacks in other mandatory spending or by increases in taxes or fees. (Similarly, tax cuts must be offset by other tax increases or by savings in mandatory spending.) Social Security has its own set of procedural safeguards, erected to prevent policy actions that would worsen the long-run condition of the trust funds. In its baseline, CBO depicts the likely path of entitlement and mandatory spending if current laws remain unchanged.

Only about one-fourth of entitlement and mandatory spending, or one-eighth of all federal spending, is means-tested--that is, paid to people who must document their need based on low income or limited assets (and often other criteria, such as family status). The remainder, led by the government's big retirement-related programs, has no such requirements and is labeled non-means-tested.

Means-Tested Programs. Medicaid, the joint federal and state program providing medical care to some of the poor, makes up about half of means-tested entitlements. CBO projects that federal outlays for Medicaid will reach $149 billion in 2000, with growth averaging a little over 10 percent a year in the intervening period (see Table 2-7).

Table 2-6.
CBO Projections of Outlays by Category, Assuming Discretionary Inflation After 1998 (By fiscal year)

Spending Category	Actual 1994	1995	1996	1997	1998	1999	2000
	In Billions of Dollars						
Discretionary[a]							
Defense	282	270	270	278	285	295	304
International	20	21	22	22	22	23	24
Domestic	242	253	262	274	284	295	306
Unspecified reductions	0	0	-5	-26	-44	-47	-49
Subtotal	545	544	549	548	547	566	585
Mandatory Spending	789	845	899	962	1,026	1,097	1,173
Deposit Insurance	-7	-16	-9	-5	-5	-3	-3
Offsetting Receipts	-69	-77	-73	-76	-79	-82	-84
Net Interest	203	235	260	270	279	294	310
Total	1,461	1,531	1,625	1,699	1,769	1,872	1,981
On-budget	1,181	1,242	1,323	1,386	1,443	1,530	1,626
Off-budget[b]	279	289	302	313	326	341	355
	As a Percentage of GDP						
Discretionary[a]							
Defense	4.3	3.8	3.7	3.6	3.5	3.4	3.4
International	0.3	0.3	0.3	0.3	0.3	0.3	0.3
Domestic	3.7	3.6	3.6	3.5	3.5	3.4	3.4
Unspecified reductions	0	0	-0.1	-0.3	-0.5	-0.5	-0.5
Subtotal	8.2	7.7	7.4	7.1	6.7	6.6	6.5
Mandatory Spending	11.9	12.0	12.2	12.4	12.6	12.8	13.0
Deposit Insurance	-0.1	-0.2	-0.1	-0.1	-0.1	c	c
Offsetting Receipts	-1.0	-1.1	-1.0	-1.0	-1.0	-1.0	-0.9
Net Interest	3.1	3.3	3.5	3.5	3.4	3.4	3.4
Total	22.0	21.8	22.1	21.9	21.7	21.8	22.0
On-budget	17.8	17.6	18.0	17.9	17.7	17.9	18.0
Off-budget[b]	4.2	4.1	4.1	4.0	4.0	4.0	3.9

SOURCE: Congressional Budget Office.

a. Discretionary spending caps are set in the aggregate through 1998. Projections for individual categories (defense, international, and domestic) show amounts that would be spent if 1995 funding levels were increased by the rate of inflation. Unspecified reductions show the cuts that would then be needed to satisfy the caps. Projections for 1999 and 2000 represent 1998 spending adjusted for inflation.

b. Social Security and the Postal Service.

c. Less than 0.05 percent of gross domestic product.

Table 2-7.
CBO Baseline Projections for Mandatory Spending (By fiscal year, in billions of dollars)

	Actual 1994	1995	1996	1997	1998	1999	2000
Means-Tested Programs							
Medicaid	82	90	100	111	123	136	149
Food Stamps[a]	25	26	27	29	30	32	32
Supplemental Security Income	24	24	24	29	32	35	40
Family Support	17	18	18	19	19	20	20
Veterans' Pensions	3	3	3	3	3	3	3
Child Nutrition	7	8	8	9	9	10	10
Earned Income Tax Credit	11	17	20	23	24	25	26
Student Loans[b]	3	4	3	3	3	3	3
Other	3	3	4	4	5	5	5
Total, Means-Tested Programs	177	194	208	229	248	268	290
Non-Means-Tested Programs							
Social Security	317	334	352	371	390	411	433
Medicare	160	176	196	217	238	262	286
Subtotal	476	510	548	587	628	673	720
Other Retirement and Disability							
Federal civilian[c]	40	42	43	46	48	50	53
Military	27	28	29	31	32	35	37
Other	5	5	5	5	5	5	6
Subtotal	72	75	77	81	85	90	96
Unemployment Compensation	26	22	23	24	26	27	28
Other Programs							
Veterans' benefits[d]	18	17	17	18	19	20	21
Farm price supports	10	10	9	9	8	8	8
Social services	6	6	6	6	6	6	6
Credit reform liquidating accounts	-7	1	e	-2	-3	-6	-6
Other	11	11	11	10	10	11	9
Subtotal	37	45	43	41	39	39	39
Total, Non-Means-Tested Programs	612	651	691	733	778	829	882
Total							
Total Mandatory Spending	789	845	899	962	1,026	1,097	1,173

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 domestic discretionary spending; Medicare premium collections are classified as offsetting receipts.

a. Includes nutrition assistance to Puerto Rico.

b. Formerly known as guaranteed student loans.

c. Includes Civil Service, Foreign Service, Coast Guard, and other retirement programs, and annuitants' health benefits.

d. Includes veterans' compensation, readjustment benefits, life insurance, and housing programs.

e. Less than $500 million.

The growth in Medicaid has subsided from the sky-high rates of the early 1990s. The program jumped by 20 percent to 30 percent a year from 1990 through 1992, but its growth decelerated to 12 percent in 1993 and just 8 percent in 1994. The program's surge was fueled by population pressures, inflation in the medical care sector, liberalizations in Medicaid eligibility contained in legislation (especially coverage of poor children), the recession, court decisions that made the federal government raise its payments to institutions, and the fiscal pressures facing state and local governments that drove many of them to maximize funds from the federal government. One particular component of Medicaid--direct federal payments to hospitals that serve many charity cases, termed disproportionate share hospitals--soared from practically nothing in 1989 to almost $10 billion in 1992 but then failed to grow at all in 1993 and 1994.

Several other means-tested programs have experienced rapid growth, although they do not rival Medicaid in size. Prominent among them are food stamps (up by two-thirds since 1990), which are available to virtually all who qualify on the basis of low income and assets regardless of age or family status; Supplemental Security Income for the aged, blind, and disabled, which has seen its caseload of disabled participants, especially children, and of elderly immigrants climb steeply; and the refundable portion of the earned income tax credit (EITC). A longtime supplement to the earnings of low-income families with children, the EITC was made more generous in OBRA-93 and broadened to cover some childless people. Although the EITC is a provision of the tax code, direct payments to recipients who otherwise owe no taxes--which make up more than 80 percent of the provision's total cost--are treated as outlays since they are equivalent to benefit payments.

One program categorized as means-tested fits somewhat uneasily into that category. That program, student loans, is making or guaranteeing ever-larger volumes of loans (estimated at $13 billion in 1992, $22 billion in 1994, and $33 billion in 2000). And a growing fraction of that volume--projected to climb from 25 percent in 1992 to more than 40 percent in 2000--goes to students or parents who may borrow regardless of income or assets. Since 1992, under the reformed accounting for credit programs mandated by the Budget Enforcement Act, the outlays for new loans that are recorded in the budget have not represented annual cash flows but rather the estimated long-run loss to the government, which takes into account subsidized interest charges, the expected default of some loans, and other expected costs over the loans' lifetime. That is why the student loan program displays costs of about $3 billion a year, despite ever-growing volume. Those costs are primarily associated with students and parents who satisfy the income and asset tests. Although all borrowers have some propensity to default and all enjoy benefits such as caps on interest rates, only that subset of low-income borrowers qualifies for one of the most attractive (and, for the government, costly) features of the program--an interest-free period while the student remains in school.

Non-Means-Tested Programs. Social Security, Medicare, and other retirement and disability programs dominate non-means-tested entitlements. In fact, Social Security surpassed defense in 1993 to become the single biggest program run by the government. Most Social Security beneficiaries, who now number 43 million, also participate in Medicare.

Although Social Security is the larger program, Medicare has grown much faster despite repeated legislative modifications that have reduced spending for the health program significantly below what it would have been in the absence of those efforts. Over the past decade, Medicare grew by an average of 10 percent a year versus Social Security's 6 percent, and similar growth rates are projected for the next five years.

Other retirement and disability programs, at $75 billion in 1995, are less than one-fourth the size of Social Security. They are dominated by benefits for the federal government's civilian and military retirees and Railroad Retirement. Outlays for unemployment compensation peaked at $37 billion in 1992, a recession year, and are now less than two-thirds as large.

Other non-means-tested entitlements encompass a diverse set of programs, mainly veterans' benefits, farm price supports, and certain social service grants to the states. This category totals $45 billion in 1995. It shrinks gradually through 2000, essentially mirroring one of its components: the so-called credit liqui-