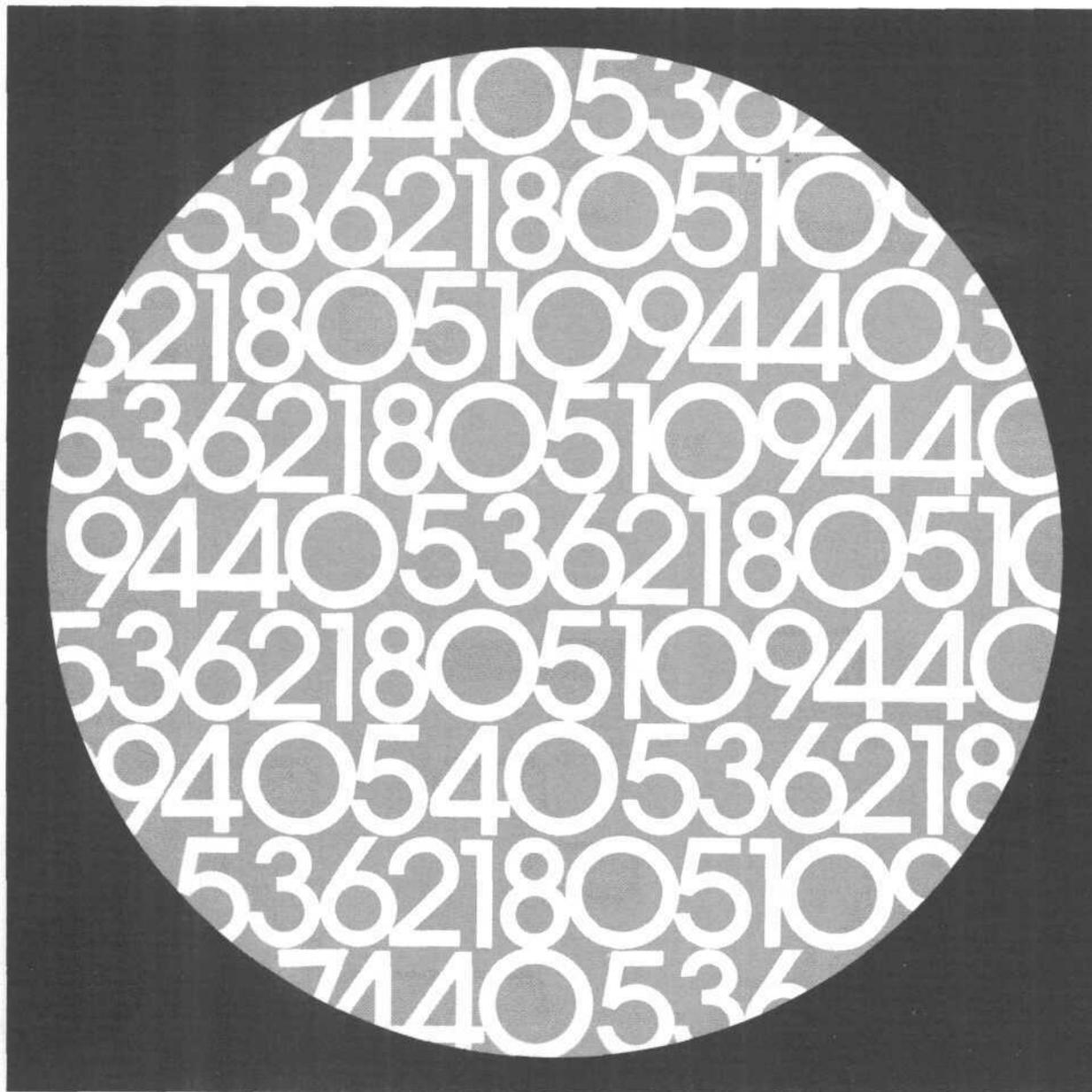


January 1979

# FIVE-YEAR BUDGET PROJECTIONS AND ALTERNATIVE BUDGETARY STRATEGIES FOR FISCAL YEARS 1980-1984

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

As Required by Public Law 93-344



CONGRESS OF THE UNITED STATES



CONGRESSIONAL BUDGET OFFICE

FIVE-YEAR BUDGET PROJECTIONS AND  
ALTERNATIVE BUDGETARY STRATEGIES  
FOR FISCAL YEARS 1980-1984

The Congress of the United States  
Congressional Budget Office

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## NOTES

Unless otherwise indicated, all years referred to are fiscal years.

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

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## PREFACE

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The Congressional Budget Office is required by Section 202(f) of the Congressional Budget Act of 1974 to submit an annual report on budgetary options. This year the report is in two parts: The Fiscal Policy Response to Inflation and Five-Year Budget Projections and Alternative Budgetary Strategies for Fiscal Year 1980-1984.

Five-Year Budget Projections and Alternative Budgetary Strategies for Fiscal Years 1980-1984 presents a set of current policy projections for 1980-1984--an estimate of how the budget would look over the next five years if current policies were continued unchanged. It then discusses illustrative spending and tax options that depart from current policy. Finally, it presents three basic budgetary strategies for setting long-range goals for the budget and the economy.

The Congressional Budget Office is required under Section 308(c) of the Congressional Budget Act to project total new budget authority, outlays, and receipts for each fiscal year between 1980 and 1984. The current policy projections in this report fulfill that requirement. The act also requires the Congressional Budget Office to project tax expenditures for each of the next five fiscal years. A separate report on tax expenditure projections will be issued at a later date.

In keeping with the mandate of the Congressional Budget Office to provide objective, nonpartisan analysis of issues before the Congress, this report contains no recommendations. The programmatic options and illustrative budget strategies do not represent policies advocated by the Congressional Budget Office. They have been chosen simply to indicate the range of possibilities.

All divisions of the Congressional Budget Office contributed to this report. Robert L. Faherty edited the manuscript, and Paula Spitzig coordinated its preparation for publication and typed the many drafts.

Alice M. Rivlin  
Director

January 1979



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## SUMMARY

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As the Congress moves toward decisions on the budget for fiscal year 1980, it needs to look ahead and to balance goals for the economy, the size of government, and the budget deficit. These goals must be weighed against the demands for tax cuts, the provision of more public services, the transfer or redistribution of income, and increased federal assistance to state and local governments.

None of the goals that the Congress might choose to pursue can be achieved quickly. If they are to be achieved at all, decisions on the 1980 budget must be regarded as only one step in an overall budgetary strategy that may take several years to implement fully.

## CURRENT POLICY BUDGET PROJECTIONS

A starting point in considering budgetary alternatives is the current policy budget--an estimate of how the budget would look if current policies were continued unchanged. Under a continuation of current policies, federal outlays and receipts in fiscal year 1980 are estimated to be \$551 billion and \$502 billion, respectively, with a deficit of \$49 billion. If the economy were to grow at an average annual rate of 3.9 percent in fiscal years 1980-1984 (more slowly in 1980, but building by 1982 to an annual rate of 4.5 percent), the unemployment rate would decline to 5.6 percent for fiscal year 1984, current policy outlays would grow to \$755 billion, and receipts would increase to \$849 billion. The growth in outlays is dominated by adjustments for inflation, especially for programs that are indexed to inflation either directly or indirectly under current law. By fiscal year 1984, automatic adjustments--such as the cost-of-living increases for social security, increases in medicare and medicaid attributable to inflation, and pay increases for federal employees--would account for more than 45 percent of the increase over 1979 spending levels. The growth in federal receipts is dominated by the increases in individual income tax revenues that occur as inflation and economic growth move taxpayers into higher tax brackets. Projected increases in social security taxes as a result of the 1972 and 1977 amendments to the Social Security Act also produce significant growth in social insurance revenues.

Current policy outlays, as a percent of the gross national product (GNP), would decline from 21.5 percent in 1979 to 19.4 percent in 1984;

revenues, on the other hand, would increase from 19.7 percent in 1979 to 21.9 percent in 1984. By 1982, the federal government would be taking more out of the economy in tax receipts than it would be putting back in the form of wages, transfer payments, and purchases. The drag on the economy caused by these fiscal policies would probably make it impossible to sustain the 3.9 percent average growth rate assumed in the current policy projections for 1980-1984. Consequently, to achieve an economic growth target of 3.9 percent a year, some fiscal policy changes, in the form of tax cuts or spending increases, would probably be necessary. If these changes were made, the budget deficit would decline in 1981 and 1982 and an approximate balance could be achieved by 1983 (see Summary Table 1). The 1984 surplus would thus be much less dramatic than the raw computation of current policy receipts minus current policy outlays.

SUMMARY TABLE 1. FIVE-YEAR BUDGET PROJECTIONS: BY FISCAL YEAR, IN BILLIONS OF DOLLARS

	1978 Actual	1979 Estimate	Projections				
			1980	1981	1982	1983	1984
Current Policy Receipts	402.0	453.3	502	574	661	749	849
Current Policy Outlays	450.8	493.8	551	604	655	706	755
Fiscal Policy Changes <u>a/</u>	—	—	—	8 to 12	13 to 18	26 to 35	53 to 70
Deficit (-) or Surplus	-48.8	-40.5	-49	-38 to -42	-7 to -12	8 to 17	25 to 42

a/ These changes refer to tax cuts or spending increases.

The budget projection presented here is not the only possible scenario over the next five years. Many policymakers have called for the size of government to be reduced in relation to the economy--an issue that is separable from that of the appropriate economic stimulus. A reduction in federal spending below current policy levels could still be consistent with an economic growth target of 3.9 percent a year and unemployment of 5.6 percent in fiscal year 1984, if the spending reductions were accompanied by corresponding tax cuts. If such a policy were pursued, federal spending as a percent of GNP would decline more rapidly than under current policy. Because of the tax cuts needed to sustain the economic growth target, however, the budget deficit for 1980 would still be about \$50 billion and approximate budget balance would still not be achievable until 1983 or 1984.

## REDUCING THE BUDGET DEFICIT; CONTRACTIONARY SPENDING POLICIES AND WEAKER ECONOMIC GROWTH

Contractionary spending policies are often proposed as a way to reduce the budget deficit and to advance the date when the budget would be balanced. The two goals of a lower deficit and a smaller federal sector probably require settling for lower economic growth. Two possible scenarios are:

- o Spending reductions, starting with a \$15 billion cut in fiscal year 1980, and real economic growth averaging 3.4 percent in 1980-1984; and
- o Larger spending reductions, starting with a \$25 billion cut in fiscal year 1980, and real economic growth averaging 3.1 percent in 1980-1984.

When compared to the current policy spending projection with 3.9 percent real economic growth, contractionary spending policies combined with weaker economic growth targets could result in a lower deficit in 1980, an earlier date for budget balance, and a reduction in the inflation rate. The budget deficit in 1980 could be as low as \$30 billion, with budget balance achievable by 1982, or possibly 1981 (see Summary Table 2). By fiscal year 1984, the inflation rate under the assumption of weaker economic growth could be about 2 percentage points lower than that under the current policy assumptions. These contractionary spending policies, however, would probably result in a 1984 unemployment rate of 6.5 to 7 percent, as compared with the 5.6 percent rate under the stronger growth path.

Assuming that demand in the nonfederal sectors of the **economy--**namely, consumption, investment, state and local expenditures, and net **exports--grows** at a moderately strong pace, there would be no room for tax cuts under the weaker economic growth goals. On the other hand, if weaker economic growth goals were accompanied by weaker nonfederal demand, tax cuts would be needed to reach the growth targets. The date of budget balance would be postponed, probably by a year.

The two contractionary spending policies are intended merely to illustrate the wide range of possibilities for cutting federal spending. The smaller reduction is derived by limiting the growth of the federal budget in response to inflation and by foregoing initiatives anticipated in the Second Concurrent Resolution on the Budget for Fiscal Year 1979 but not yet

SUMMARY TABLE 2. ALTERNATIVE GOALS FOR THE ECONOMY AND THE BUDGET DEFICIT UNDER THE CONTRACTIONARY SPENDING POLICIES

	Current Policy Spending <u>a/</u>	Contractionary Spending	
		\$15 Billion Cut in 1980 <u>b/</u>	\$25 Billion Cut in 1980 <u>b/</u>
Economic Goals (in percents)			
Real growth (average, 1980-1984)	3.9	3.4	3.1
Unemployment rate (1984)	5.6	6.5	6.9
Inflation rate (1984)	6.2	4.5	4.1
Budget Deficit			
1980 (in billions of dollars)	50-55	40	30-35
Year of budget balance	1983-1984	1982	1981

a/ Moderate growth target.

b/ Weaker growth target.

funded by the Congress. Some major options for restricting inflation adjustments are:

- o Capping federal payraises at 5.5 percent in 1980 and limiting them to no more than 7 percent thereafter;
- o Limiting cost-of-living increases for retired federal employees to what would be given under a representative private sector plan;
- o Capping at 5.5 percent the cost-of-living increase for social security that will be effective on July 1, 1979, and limiting further increases to no more than 7 percent;
- o Implementing hospital cost containment; and
- o Approving only two-thirds of the discretionary inflation adjustment for federal programs not indexed under current law.

With these actions, the incomes of the elderly and disabled would not keep pace with inflation--at least in the near term; federal payraises would fall short of comparability with the private sector; some hospital services would be reduced or eliminated; many federal programs--ranging from defense to federal training and jobs programs-- would be smaller because of a reduction in real funding levels.

The initiatives that were anticipated in the second concurrent resolution, but that would be foregone under a contractionary spending policy, include:

- o A 1979 supplemental appropriation for defense, largely for procurement of new equipment and modernization of the defense forces;
- o Funds for new energy programs; and
- o Supplementary fiscal assistance to local governments.

The larger cuts implied by the spending policy that starts with a \$25 billion cut in 1980 represent some of the more specific or targeted reductions the Congress might want to consider. They include:

- o Eliminating all funding for countercyclical public service employment programs;
- o Not renewing general revenue sharing for states in fiscal year 1981, but restricting the program to local governments; and
- o Implementing various changes in social security.

#### DEMANDS FOR NEW AND EXPANDED FEDERAL SPENDING PROGRAMS

At the same time that some policymakers are calling for reductions in spending and in the deficit, others are demanding expansion of federal programs. The most significant possibilities for program expansions appear to be:

- o Real growth in defense spending;
- o National health insurance;
- o Expansion of medicaid, in particular the Early and Periodic Screening, Diagnosis, and Treatment (EPSDT) program;

- o Welfare reform;
- o "Soft" public works programs--that is, a labor-intensive program oriented more toward the renovation and repair of public facilities than toward new construction; and
- o Funding for a 1-billion-barrel strategic petroleum reserve.

The Congress might consider pursuing an expansionary fiscal policy that would accommodate demands for increased programs and would move the economy toward the goal of a 4 percent rate of unemployment by 1983, as specified in the Full Employment and Balanced Growth Act of 1978 (the Humphrey-Hawkins Act). An expansionary fiscal policy of this kind would probably mean significantly higher inflation by fiscal year 1984 and continued large budget deficits (see Summary Table 3).

SUMMARY TABLE 3. ALTERNATIVE GOALS FOR THE ECONOMY AND THE BUDGET DEFICIT UNDER THE EXPANSIONARY SPENDING POLICY

	Current Policy Spending a/	Expan- sionary Spending b/
Economic Goals (in percents)		
Real growth (average, 1980-1984)	3.9	4.7
Unemployment rate (1984)	5.6	4.0
Inflation rate (1984)	6.2	8.7
Budget Deficit		
1980 (in billions of dollars)	50-55	50-55
Year of budget balance	1983-1984	--

a/ Moderate economic growth.

b/ Humphrey-Hawkins unemployment target.

#### DECISIONMAKING FOR 1980 AND BEYOND

Many combinations of programmatic changes and fiscal policy are possible. For example, some policymakers may desire real growth in

defense but at the same time want a reduction in the federal deficit. Such a policy would be possible if the spending increases for defense were offset by some of the targeted **cuts--like** reductions in public service employment and general revenue sharing. Others may desire a current policy spending target, budget balance by 1983, and a health insurance program covering catastrophic illness. This may be possible by using the savings from spending cuts, such as **capping** federal pay or hospital cost containment, to finance catastrophic health insurance.

Regardless of the desired policy, it is important that the Congress begin now to look at economic and programmatic goals not only for fiscal year 1980, but for also for fiscal years 1981, 1982, and even later. Many of the choices for both program expansions and cutbacks that are now available for later years will either not be available at this time next year or, at best, will be severely circumscribed. Many proposals, if enacted in 1979, would have significant effects on the **1981-1984** budgets, but small effects in 1980. Both the Administration and the Congress appear to be moving toward formulating multiyear targets. The strategies and options explored in this report shed light on some of the major alternatives.



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## CHAPTER I. INTRODUCTION AND OVERVIEW

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A useful starting point in assessing alternative budget policies for the 1980s is the budget outlook if current policies were continued unchanged into the future. In this report, the Congressional Budget Office (CBO) projects what federal spending and revenues would be in fiscal years 1980-1984 if current policies persisted. The economic assumptions that underlie these projections are based on CBO's January 1979 analysis of the state of the U.S. economy. <sup>1/</sup> This report also presents estimates of the spending increases or tax cuts likely to be required to maintain consistency between the economic assumptions and the budget projections.

Current policy projections are only the starting point for formulating future policies; the actual shape of the budget over the next five years will be determined by decisions on major budget issues that depart from current policy. These decisions involve the federal government's role in providing public goods and services, redistributing income, and assisting state and local governments, as well as its role in promoting economic growth and price stability. Some of the major budget options likely to be debated during 1979 are discussed in this report in the context of both historical trends and the current policy projections.

The budget estimates, economic assumptions, and budget options should not be construed as recommendations of the Congressional Budget Office. Rather, they are intended to provide a glimpse of the long-run shape and direction of the federal budget.

### ECONOMIC ASSUMPTIONS

Inflation, unemployment, and other levels of economic activity greatly affect federal spending and revenues. For example, higher inflation and unemployment rates automatically lead to increases in federal outlays, especially for social security and unemployment compensation. On the other hand, higher inflation rates lead to greater taxable personal income and, consequently, to greater tax receipts, whereas higher unemployment rates tend to work in the opposite direction. In order to develop budget

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<sup>1/</sup> Congressional Budget Office, The Fiscal Policy Response to Inflation (January 1979).

projections, therefore, explicit assumptions must be made about economic trends over the next several years.

The short-run economic assumptions used for the budget projections in this report include a slowdown in the economy in late 1979 with a recovery beginning in 1980. CBO forecasts that the growth in real gross national product (GNP) will slow from about 6 percent in the fourth quarter of 1978 to approximately no growth in the fourth quarter of 1979. This report takes the midpoint of the CBO range when expressed as a calendar year over calendar year figure. According to this calculation, real economic growth for both 1979 and 1980 will be about 2.5 to 3 percent (see Table 1 and Figure 1). The unemployment rate is assumed to increase to over 6.5 percent by the end of 1980. Inflation is assumed to remain relatively high in 1979 and 1980, with the consumer price index (CPI) increasing at about 8 percent in each year. Interest rates, as reflected by the 91-day Treasury bill rate, are assumed to peak in the second quarter of 1979.

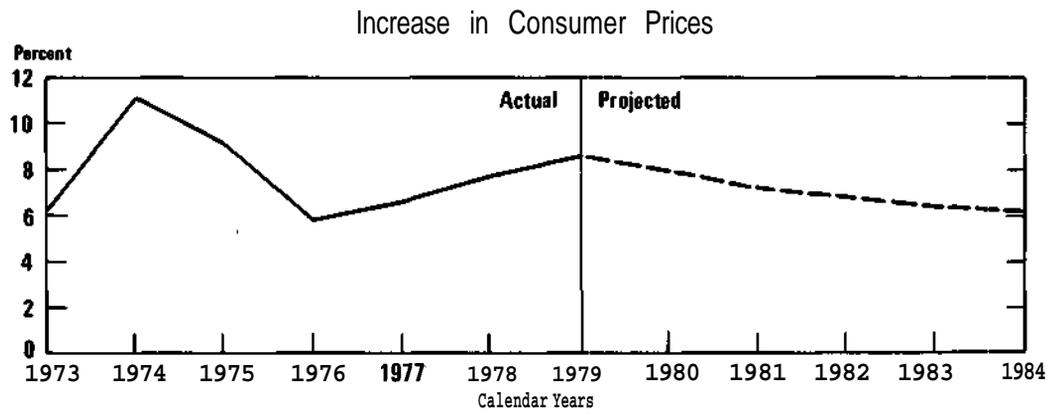
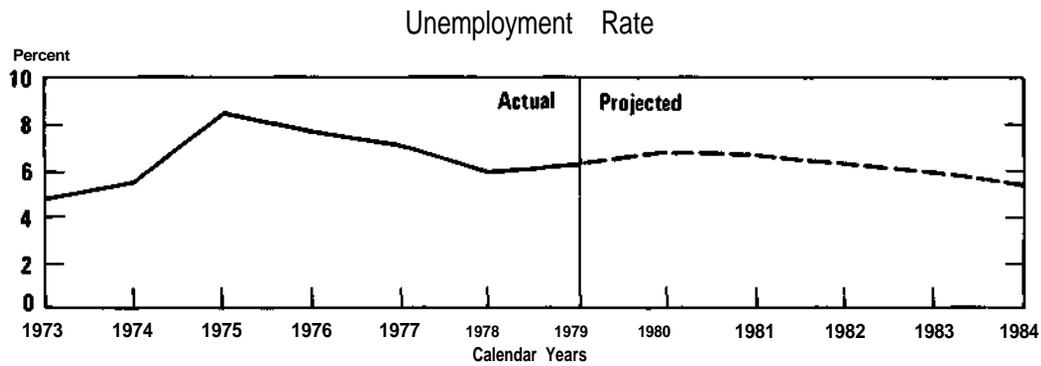
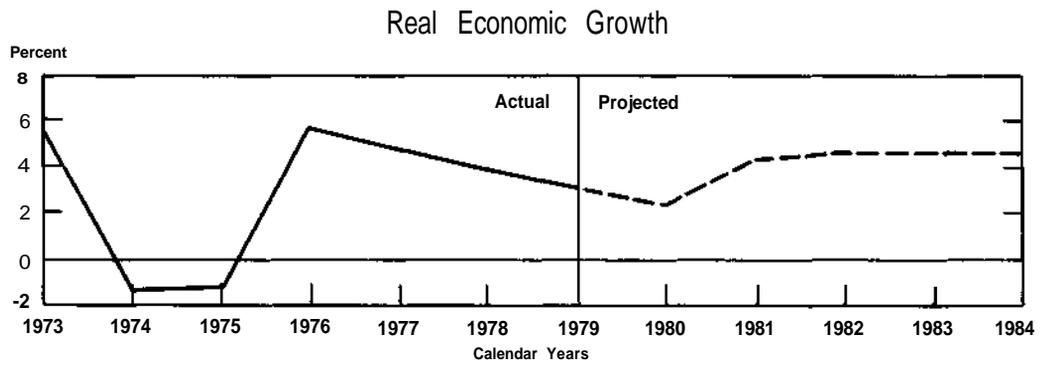
TABLE 1. AGGREGATE ECONOMIC ASSUMPTIONS: BY CALENDAR YEAR

Selected Economic Variables	Actuals		Near-Term Forecast a/		Long-Term Targets			
	1977	1978	1979	1980	1981	1982	1983	1984
Gross National Product (GNP)								
Current dollar GNP (in billions of dollars)	1,887	2,107	2,351	2,395	2,894	3,229	3,595	3,989
Real GNP (in billions of 1972 dollars)	1,333	1,385	1,428	1,463	1,525	1,594	1,667	1,743
Growth rate of real GNP (percent)	4.9	3.9	3.1	2.4	4.3	4.5	4.5	4.5
Unemployment Rate (percent)	7.0	6.0	6.2	6.8	6.6	6.2	5.9	5.5
Consumer Price Index (all urban, percent change)	6.5	7.6	8.4	7.8	7.1	6.7	6.4	6.0
Interest Rate (91-day Treasury bills, percent)	5.3	7.2	9.1	7.6	7.8	7.7	7.5	7.0

a/ Midpoints of the ranges for the economic forecast in Congressional Budget Office, The Fiscal Policy Response to Inflation (January 1979). That forecast is expressed in fourth quarter to fourth quarter numbers, whereas this report uses average calendar year numbers.

The assumptions used for the longer-term projections--that is, for 1981-1984--are only one of many possible economic scenarios. These long-term assumptions are not predictions or forecasts. Rather, they are a

Figure 1.  
Major Economic Assumptions



set of internally consistent long-range economic targets. The assumptions for 1981-1984 reflect an average annual rate of real economic growth of 4.5 percent. This rate of growth is optimistic, but not unprecedented. It is about 1 percent higher than the average rate since World War II, and about 1 percent lower than the rate sustained in the 1961-1966 period. The unemployment rate is assumed to decline slightly from the 1980 level to 5.5 percent by the end of 1984. The inflation rate, which is assumed to be significantly higher throughout the 1981-1984 period than the average since World War II, declines slowly so that by 1984 the rate of increase in the CPI is 6 percent. Finally, interest rates are assumed to decline slowly from current levels. By 1984, the average rate of 91-day Treasury bills is assumed to be 1.7 percentage points higher than the rate in 1977.

### BUDGETARY IMPLICATIONS OF THE ECONOMIC ASSUMPTIONS

CBO's economic forecast implies that, under current tax and spending policies, federal outlays in fiscal year 1979 will be \$493.8 billion and the budget deficit will be \$40.5 billion (see Tables 2 and 3). These estimates exceed the ceilings of \$487.5 billion for outlays and \$38.8 billion for the budget deficit that were set in the Second Concurrent Resolution on the Budget for Fiscal Year 1979. The estimates include Congressional action to date plus initiatives anticipated in the second concurrent resolution but not yet appropriated.

TABLE 2. FIVE-YEAR PROJECTIONS OF OUTLAYS: BY FISCAL YEAR

	1978 Actual	1979 Estimate	Projections				
			1980	1981	1982	1983	1984
Current Policy Outlays (in billions of dollars)	450.8	493.8	551	604	655	706	755
Percent Change	11.9	9.5	11.6	9.6	8.4	7.8	6.9
Percent of GNP	22.1	21.5	21.8	21.5	20.8	20.2	19.4

The budget outlook is more pessimistic in January 1979 than it was at the time of the second resolution because the resolution was based on economic assumptions that are not likely to be realized--largely because of

TABLE 3. FIVE-YEAR PROJECTIONS OF RECEIPTS: BY FISCAL YEAR

	1978 Actual	1979 Estimate	Projections				
			1980	1981	1982	1983	1984
Current Policy Receipts (in billions of dollars)	402.0	453.3	502	574	661	749	849
Percent Change	12.4	12.8	11.2	14.3	15.2	13.3	13.4
Percent of GNP	19.7	19.7	19.9	20.4	21.0	21.4	21.8

increased inflationary momentum and tighter monetary policies. 2/ The new economic forecast has increased outlays throughout the budget. More inflation has increased outlays for social security and other programs explicitly indexed to the CPI, as well as for those programs that keep pace with inflation even though they are not explicitly indexed. Lower economic growth (and higher unemployment) has increased outlays for unemployment insurance and other income security programs, and higher interest rates have increased outlays for interest on the public debt. On the receipts side, the new economic forecast has created little net change. Higher inflation is offset by lower growth.

For the five-year projection of current policy outlays, the average annual rate of increase is 8.9 percent. This results in projected outlays of \$755 billion by fiscal year 1984. Outlays as a percent of GNP decline from 21.5 percent in fiscal year 1979 to 19.4 percent in fiscal year 1984.

The average annual rate of increase for the 1980-1984 projection of current policy receipts is 13.4 percent, reaching a level of \$849 billion in fiscal year 1984. Since this rate of increase is faster than that for the current dollar GNP, receipts as a percent of GNP increase from 19.7 percent in fiscal year 1979 to 21.8 percent by fiscal year 1984. 3/

2/ For further analysis of current economic conditions, see CBO, The Fiscal Policy Response to Inflation.

3/ Since World War II, receipts as a percent of GNP have not achieved a level as high as the 21.8 percent in the 1984 current policy projection. Historically, tax cuts have been enacted. Indeed, as discussed later in this chapter, it is likely that tax cuts would be enacted in the 1980-1984 period to provide sufficient stimulus to achieve the economic growth targets in Table 1.

If current policies were continued, outlays would rise at a slower rate than GNP, and receipts would rise more quickly. The slower rate of increase in outlays occurs because, under the assumption of a continuation of current spending policies, many programs increase at the rate of inflation. The only real growth in current policy outlays results from program activity established under current law. Certain entitlements, such as social security and medicare, grow faster than both the rate of inflation and the rate of increase of GNP because of projected increases in the number of beneficiaries and in the real benefit per recipient.<sup>4/</sup> Other entitlements, however, such as unemployment compensation, increase at a rate even slower than that of inflation because the number of beneficiaries is projected to decline slightly. On the other hand, the faster rate of increase in receipts is almost entirely because of the individual income tax. As GNP and incomes rise, individuals enter higher tax brackets, so that a larger share of their incomes goes to federal income taxes. Also, the scheduled increases in social security taxes contained in the 1972 and 1977 amendments to the Social Security Act cause social insurance receipts to increase faster than GNP.

#### THE PROJECTED DEFICIT

With the rapid rise in federal tax receipts and the not so rapid rise in federal outlays under current policy assumptions, by 1982 the federal government would be taking more out of the economy in tax receipts than it would be putting back in the form of wages, transfer payments, and purchases. Under these circumstances, the federal budget would exert a drag on the economy. This would make it unlikely that the economic assumptions in Table 1 could be achieved and would destroy the consistency between the budget projections and the economic assumptions. For the economic assumptions to be realized, fiscal and monetary policies would, in all likelihood, have to be modified, resulting in budget deficits until at least 1983.

A projection of the deficit that is consistent with the economic assumptions in Table 1 requires explicit assumptions about the changes that would have to be made in fiscal policy: to what extent would tax cuts and spending increases have to be used to counter the fiscal drag exerted by the projected current policy budgets. The more that tax cuts and spending

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<sup>4/</sup> Real benefits per recipient rise in retirement programs such as social security because new beneficiaries receive payments based on a higher real wage history than current beneficiaries.

increases are used to keep the economy on the assumed growth path, the larger the projected deficit.

The magnitude of the fiscal policy changes, and consequently the size of the budget deficit, is governed by several factors. The first is the autonomous strength of the four major components of nonfederal demand: consumption, investment, state and local government purchases, and net exports. Other things being the same, stronger nonfederal demand would mean that smaller tax cuts or spending increases (and consequently smaller budget deficits) would be required to achieve the target growth rates for the economy. Conversely, weaker nonfederal demand would require larger tax cuts or spending increases to achieve the desired growth rate.

The nonfederal demand assumptions for fiscal years 1980-1984 used in this chapter represent a moderate or mildly optimistic scenario (see Table 4). The marginal propensity to consume--that is, what a person spends out of an additional dollar of income--is assumed to average 69 percent. Real investment is assumed to grow at an average of 2 percent in excess of the growth rate of real GNP. The assumed real rate of growth in autonomous state and local government purchases--that is, purchases not induced by federal grants--is about 3 percent. Net exports are assumed to show deficits in fiscal years 1980 and 1981, offset by surpluses in 1982-1984.

TABLE 4. NONFEDERAL DEMAND ASSUMPTIONS: FIVE-YEAR AVERAGES

	Moderate Nonfederal Demand	Stronger Nonfederal Demand	Weaker Nonfederal Demand
Marginal Propensity to Consume (percent)	69.0	69.7	68.3
Growth Rate of Real Investment Minus Growth Rate of Real GNP (percent)	1.9	2.9	0.9
Real Growth Rate of State and Local Expenditures Not Induced by Federal Grants (percent)	<b>2.7</b>	3.5	2.0
Net Exports (in billions of dollars)	2.6	7.7	-6.0

A second factor affecting the projected size of the budget deficit is the direction of monetary policy. Assuming a fixed target for economic growth, an expansionary monetary policy that stimulated nonfederal demand would diminish the need for fiscal policy changes and possibly result in lower deficits.

A third factor is the composition of fiscal policy changes. In general, federal purchases of goods have a larger and more immediate impact per budget dollar on output and employment than transfer payment programs. Specially designed tax changes, such as the investment tax credit, can have powerful effects on output and jobs after a lag of one or two years, while broad-based tax cuts have about the same impact as transfer payments.

The projections of the budget deficits and fiscal policy changes in this report are consistent with the overall economic targets in Table 1 under the nonfederal demand assumptions in Table 4. <sup>5/</sup> The estimated deficit in fiscal year 1979 is \$40.5 billion; this is over \$3 billion larger than the deficit in the second concurrent resolution because of changes in the economic outlook that, in turn, have triggered increased estimates of spending. The projected budget deficit in 1980 is somewhat higher than estimated for 1979, but it declines in 1981 and 1982 to a projected surplus in fiscal year 1983 (see Table 5).

TABLE 5. FIVE-YEAR BUDGET PROJECTIONS: BY FISCAL YEAR, IN BILLIONS OF DOLLARS

	1978 Actual	1979 Estimate	Projections				
			1980	1981	1982	1983	1984
Current Policy Receipts	402.0	453.3	502	574	661	749	849
Current Policy Outlays	450.8	493.8	551	604	655	706	755
Fiscal Policy Changes <sup>a/</sup>	--	--	--	8 to 12	13 to 18	26 to 35	53 to 70
Deficit (-) or Surplus	-48.8	-40.5	-49	-38 to -42	-7 to -12	8 to 17	25 to 42

<sup>a/</sup> These refer to tax cuts or spending increases.

<sup>5/</sup> Monetary policy is assumed to be sufficiently expansionary to allow the nonfederal demand growth.

Ranges are used for the 1981-1984 projections to reflect the fact that the size of the deficit or surplus will vary depending on the type of fiscal action assumed. The larger deficits and larger fiscal policy changes are more likely if increases in income transfer programs or broad-based tax cuts are enacted. Specially targeted tax cuts or spending for federal purchases of goods are more consistent with the smaller deficits and fiscal policy changes.

The Administration has called for a deficit of close to \$30 billion in fiscal year 1980, and for a more rapid decline in the succeeding years than is projected in Table 5. A pattern of that kind is consistent either with a lower target for economic growth, in which case fiscal policy changes could be smaller, or with a stronger nonfederal demand pattern like the alternative shown in Table 4.

The projections of the budget deficit could be somewhat different if the nonfederal demand assumptions were changed. If an investment boom were to develop spontaneously so that the rate of real growth in investment were closer to 3 percent in excess of GNP growth, as shown in Table 4, and if economic activity in the rest of the world were to stimulate exports from the United States, the budget deficits that are consistent with the overall economic growth in Table 1 would decline more rapidly than shown here. The converse is also true, however. If investment were somewhat weaker than assumed, and if lower economic growth in the rest of the world resulted in slower growth in exports, fiscal policy changes designed to sustain U.S. economic growth would result in constant or even increasing deficits over the next five years.

#### MULTIYEAR TARGETS

The Congressional Budget Office has recommended that, as part of the process of formulating annual budget resolutions, the Congress should set multiyear budget targets. At present, budget resolutions are adopted by the Congress for one year at a time, and these decisions are severely restricted by decisions made in prior years. For example, over 70 percent of the 1980 budget will be based on previous decisions. The Congress has wide discretion over spending that will occur in later years--fiscal year 1982, for instance--but under the present scheme it will adopt no 1982 targets until 1981, by which time its choices will be narrowly circumscribed. In the absence of multiyear budget targets, the short-term consequences of legislative actions tend to overwhelm the longer range considerations. Frequently, shutting down a program costs more in the year ahead than keeping it going unchanged; the savings often do not show up until later years. On the other hand, many new programs start slowly but have significant outyear impacts.

Both the President and the Congress appear to be moving in the direction of **multiyear** targets. The President's budget for fiscal year 1980 has policy targets through fiscal year 1982. In the Congress, the Senate Budget Committee actively considered and voted on multiyear targets in their consideration of the 1979 budget, although the **outyear** targets were not voted on by the full Senate.

Five-year projections, such as those found in this report, shed light on how the Congress might proceed with formulating such targets. First, projections of current policy spending and receipts provide a baseline on which to build plans for future spending and receipts. Second, the process of projecting the deficit produces a rough estimate of how much room is available for **fiscal** policy changes, either on the spending side of the budget or on the tax side, if the budget totals are to be consistent with the long-term economic targets.

Setting multiyear targets raises several key questions. What are the goals for the economy and the deficit? What is the appropriate level for spending and receipts in relation to the economy? What new spending or tax initiatives should be phased in, and which programs should be phased out?

Trade-offs are required in setting goals for real economic growth and budget deficits. For example, although stimulative fiscal policy is a potential tool in a long-term plan to reduce the unemployment rate **significantly**, such a policy runs the risk of increasing the budget **deficit**. A goal of 4 percent unemployment by 1983, as specified by the Humphrey-Hawkins Act, would in all likelihood require fiscal stimulus that would result in rising deficits. Trade-offs must also be made among economic goals. If only standard monetary and fiscal policies are used, a program to hold down or reduce inflation would probably preclude reducing the unemployment rate to 4 percent by 1983. <sup>6/</sup> The economic assumptions used in this chapter, and the deficits calculated to be consistent with them, are one of many alternative sets of assumptions that could be used for multiyear budgeting. Goals for economic growth, inflation, and the deficit will be explored further in Chapter IV. Whatever targets are chosen, however, it is important that they be feasible and internally consistent, if multiyear budgeting is to be of value.

Goals for the size of government or, in particular, for the amount of federal spending and receipts in relation to the economy are in many ways separable from goals for the economy. For example, Chapter IV of this

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<sup>6/</sup> See CBO, The Fiscal Policy Response to Inflation.

report contains three basic budgetary strategies for setting targets for federal spending. Each of these strategies suggests a different size for the federal sector in relation to the economy. The first strategy sets the spending target equal to the current policy projection, so that total spending increases at a rate slightly faster than inflation. Federal spending would then be about 19.5 percent of GNP by 1984. The second strategy restricts spending and reduces the size of government. Depending on how deep the cuts were, federal spending under this strategy would be 19 percent of GNP or lower. Finally, the third strategy expands the role of government. It contains increases for many existing programs and also contains some new programs, such as health insurance covering catastrophic illness. Under this strategy, federal spending would average 21 percent of GNP during the five-year period.

After a discussion of the current policy projections in Chapter II, new spending and tax initiatives will be reviewed in light of these projections in Chapter III. Although the aggregate economic goals and goals for the size of government place overall constraints on the number and size of new spending initiatives, other factors need to be taken into account in determining which, if any, of these initiatives should be enacted. These include program needs and costs, as well as the priorities of the federal government for providing public services, redistributing income, and supporting state and local governments. On the tax side, proposals are evaluated on the basis of several factors. One factor is the need for fiscal stimulus. Other considerations include the equity and income redistribution aspects of proposals to index individual income taxes to inflation, the inflationary effects and social security financing aspects of proposed changes in social security taxes, and the national energy policy aspects and inflationary effects of energy tax proposals.



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## CHAPTER II. CURRENT POLICY PROJECTIONS OF THE BUDGET

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In discussing the fiscal year 1980 federal budget, the Congress will consider the appropriate fiscal policy and the size of the budget; it will also address the question of the appropriate long-run composition of the budget to reflect national needs and priorities. Before the Congress takes up these problems, however, it is important to review the composition of the federal budget under the assumption of a continuation of current policies.

If current policies were to continue unchanged, federal spending would increase to \$551 billion in fiscal year 1980 and would reach \$755 billion by fiscal year 1984; federal receipts would be \$502 billion in fiscal year 1980 and would grow to \$849 billion by fiscal year 1984. The most important factor in the long-run growth of current policy spending is the automatic response of the budget to inflation. The engine driving the rapid rise in receipts is the individual income tax. The fiscal drag exerted by the growth in federal revenues makes tax reductions of some kind likely over the next five years. <sup>1/</sup>

This chapter opens with a discussion of the major components of the projected increases in federal spending under current policies. Following that is a presentation of historical changes in spending patterns since 1958. The final section focuses on the composition of the projected increases in federal revenues and historical changes in receipts.

### PROJECTIONS OF SPENDING UNDER CURRENT POLICIES

The projections of current policy spending rely on assumptions about the economy and about the meaning of current policy for various federal spending programs. The economic assumptions used here are those presented in Chapter I. The guiding principle in interpreting current policy over the next five years is to maintain current programs in a manner

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<sup>1/</sup> The discussion in this chapter is confined to the unified budget. Certain activities of the federal government are not, however, **reflected** in the unified budget. Outlays for so-called off-budget agencies exceeded \$10 billion in fiscal year 1978. In addition, the credit activities of the federal government include loan guarantees, some of which are counted as neither budget authority nor outlays. In fiscal year 1978, federal government loan guarantees outstanding totaled \$193 billion.

consistent with the Second Concurrent Resolution on the Budget for Fiscal Year 1979. 2/

### Fiscal Year 1979 Reestimates of Spending

The ceiling for outlays in the second concurrent resolution is \$487.5 billion. It is likely, however, that outlays will be close to \$494 billion and will breach the ceiling (see Table 6). Most of the difference between the current estimate and the ceiling can be attributed to a change in net interest. During the latter part of 1978, interest rates rose to much higher levels than those anticipated in the 1979 second concurrent resolution. CBO's economic forecast for 1979 also contains higher interest rates than those assumed in the resolution. For example, the average interest rate on 91-day Treasury bills in fiscal year 1979 is 2 percentage points higher than the rate assumed for the resolution. Other reestimates in unemployment compensation, federal retirement, and social security are caused by higher forecasted unemployment rates and inflation rates. By the fourth quarter of 1979, the estimated unemployment rate is approximately 1 percentage point higher than that assumed for the second resolution. (Although this difference is relatively small, it occurs within the 6 to 7 percent unemployment range that triggers extended unemployment benefits in many states.) The cost-of-living increase for federal retirees that will take effect in March of 1979 is estimated to be 3.9 percent rather than the 2.6 percent assumed in the resolution. Under the CBO forecast, the social security cost-of-living increase for fiscal year 1979 is 9.0 percent, rather than the 7.1 percent assumed in the resolution; this difference has a greater impact in fiscal year 1980 than in 1979.

A few reestimates have been made that are not directly related to the changing economic outlook--for national defense, the Commodity Credit Corporation, and the Department of Health, Education, and Welfare. These reestimates offset each other, however.

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2/ More detail on the assumptions used for these projections can be found in Appendix A. A detailed discussion of projections methodology, on a program-by-program basis, can be found in Congressional Budget Office, Five-Year Budget Projections: Fiscal Years 1979-1983, Technical Background, Staff Working Paper (January 1978). Any methodological changes since the publication of that report will be treated in the background paper to this volume, Congressional Budget Office, Five-Year Budget Projections: Fiscal Years 1980-1984, Technical Background, Staff Working Paper (forthcoming).

TABLE 6. INCREASES IN OUTLAYS CAUSED BY REESTIMATES FOR FISCAL YEAR 1979: IN BILLIONS OF DOLLARS

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Second Concurrent Resolution	487.5
Net Interest	4.2
Unemployment Insurance	1.2
Federal Civilian and Military Retirement Benefits	0.4
Social Security	0.3
Other	0.3
Second Concurrent Resolution with Revised Economic Forecast	493.8

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Fiscal Year 1980-1984 Projections of Spending

Current policy spending is projected to increase to about \$754 billion by fiscal year 1984. The largest component of the projected growth in outlays is the automatic inflation adjustments, which in 1984 amount to approximately 46 percent of the outlay increases (see Figure 2). By fiscal year 1984, the effect of discretionary inflation adjustments is about half that of the automatic adjustments. Under current policy assumptions, the only real growth in outlays results from the implementation of current laws. <sup>3/</sup> Real growth represents a significant part—over 50 percent—of the increase in fiscal year 1980, but its long-term cumulative effect is not so great—about 32 percent of the increase in 1984. By fiscal year 1984, the major forces driving increased spending are the automatic inflation adjustments.

The projected real growth in expenditures is attributable in large part to social security (see Table 7). This is because of growth in the population eligible for benefits, combined with an increase in the percentage of the eligible population who become recipients. In addition, the average benefit of new retirees rises by more than the rate of inflation each year, reflecting

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<sup>3/</sup> In this context, real growth means increases in outlays over and above the growth that results from inflation. For example, an increase in outlays for social security because of an increase in the number of beneficiaries is treated as real growth.

Figure 2.  
Projected Increases in Federal Outlays under Current Policy,  
Fiscal Years 1980-1984

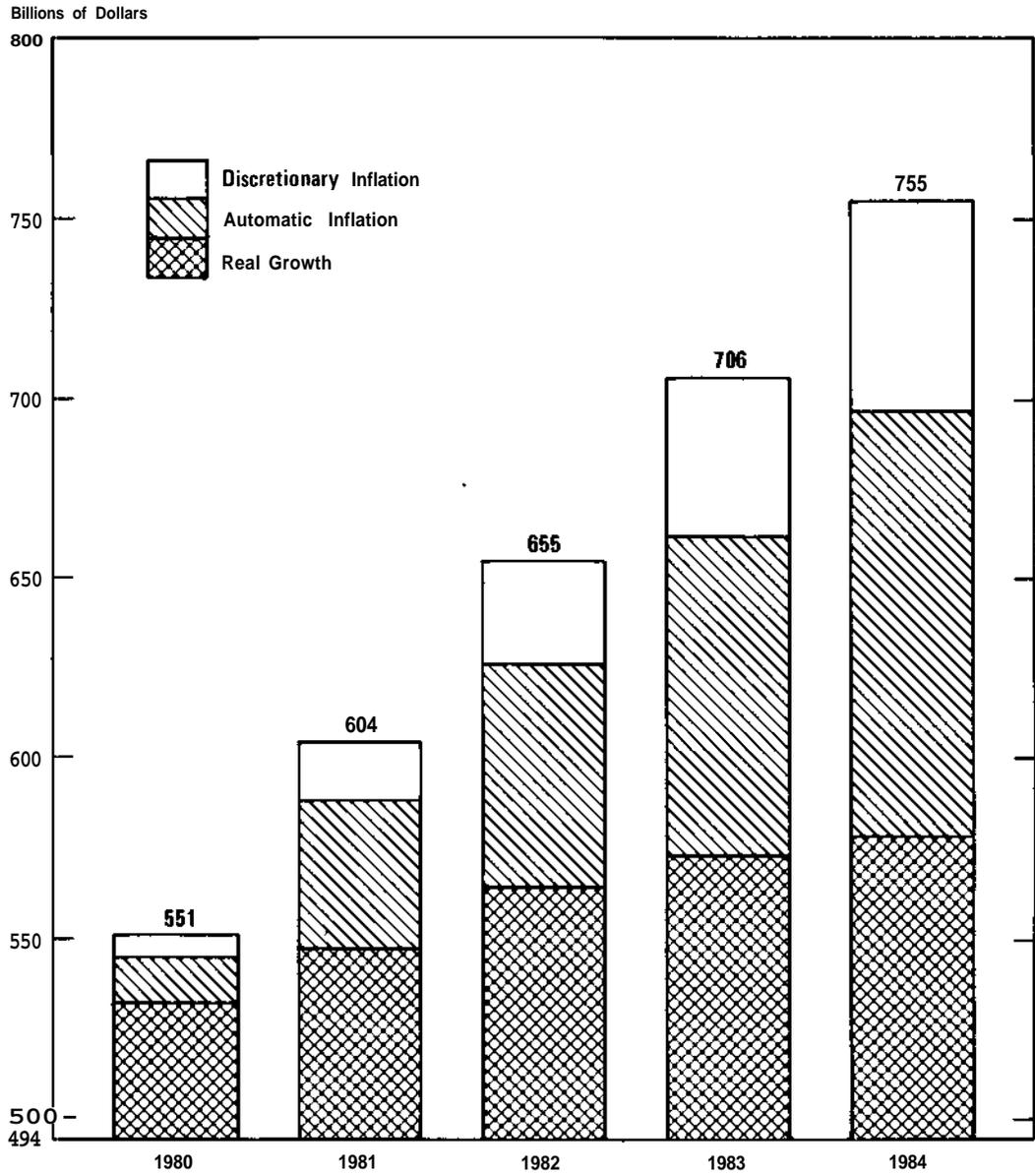


TABLE 7. PROJECTED INCREASES IN FEDERAL OUTLAYS: BY FISCAL YEAR, IN BILLIONS OF DOLLARS

	1980	1981	1982	1983	1984
1979 Estimate	493.8	493.8	493.8	493.8	493.8
Add: Real Growth					
Social security	11.6	17.1	22.4	25.2	28.3
Defense purchases	5.6	10.4	12.5	13.3	13.5
Medicare and medicaid	3.4	6.2	9.0	11.7	14.6
Retired military and civil service retirement	2.0	2.8	3.7	4.6	5.5
Net interest	3.3	6.4	7.9	8.3	7.8
Other	12.0	10.2	14.3	15.6	14.3
Subtotal	531.6	546.9	563.6	572.5	577.8
Add: Automatic Inflation Adjustments					
Social security	2.3	12.1	22.6	33.3	44.6
Medicare and medicaid	4.0	8.6	13.7	19.3	25.6
Retired military and civil service retirement	1.0	3.2	5.3	7.7	10.2
Pay increases for federal employees	4.5	9.8	15.8	22.3	28.7
Other	1.8	7.0	5.1	7.3	9.6
Subtotal	545.2	587.6	626 A	662.4	696.5
Add: Discretionary Inflation Adjustments					
Maintain 1979 level of defense purchases	2.1	5.8	10.6	16.2	22.5
Maintain 1979 level of nondefense purchases	1.4	4.7	8.6	13.5	17.9
Maintain 1979 level of grants	1.3	3.9	6.7	10.0	13.3
Maintain 1979 level of veterans' benefits and other benefits for individuals	1.0	1.9	3.0	3.9	4.8
TOTAL	551	604	655	706	755

higher real wage histories. From fiscal year 1979 to fiscal year 1984, the total number of social security beneficiaries is expected to grow by approximately 5 million and real benefits per recipient are expected to rise by 5 percent for retired workers and by 10.9 percent for disabled workers. The next largest real growth area is national defense, which increases by about \$14 billion in fiscal year 1984. This projected outlay growth is the result of recent trends in national defense budget authority. Since fiscal year 1975, budget authority for defense has been increasing in real terms. Because of the lag between appropriations and outlays, these previous real increases in budget authority continue to result in real increases in outlays through most of the projection period. The projected growth in interest on the public debt is caused largely by the increase in the public debt outstanding. Although the projected budget deficits decline over the five-year period, these deficits continue to increase the amount of the public debt.

The cost-of-living increases for social security dominate the automatic inflation adjustments. The inflation adjustments for medicare and medicaid are also significant, largely because of projected price increases in the medical sector. Payraises for federal employees increase federal outlays by \$28.7 billion in fiscal year 1984, assuming there is no catch-up from the 5.5 percent cap on the payraise for fiscal year 1978. <sup>4/</sup> If a catch-up payraise were approved in fiscal year 1979, the assumed payraise would be 2.9 percentage points higher and outlays would be about \$0.7 billion greater by fiscal year 1984.

The discretionary inflation increases are those that would be required to maintain the same real level of resources in the remainder of the budget as assumed for the second concurrent resolution. The increases for veterans' benefits reflect the effect of cost-of-living adjustments for those programs not directly indexed under current law--namely, veterans' compensation, G.I. bill benefits, and medical care.

#### The Composition of Federal Spending--An Historical Perspective

The composition of federal spending has changed considerably over the last two decades. The budget for fiscal year 1979, for example, contains a much greater emphasis on benefit payments to individuals and grants to

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<sup>4/</sup> According to the annual system for adjusting the pay of federal employees, the October 1978 increase was scheduled to be 8.4 to attain "comparability" with salaries in the private sector. The President, however, limited the payraise to 5.5 percent.

state and local governments than the budget for fiscal year 1958. A useful way to examine the changes that have occurred in the composition of the federal budget is in terms of the percentage of the budget that has been allocated to national defense, benefit payments to individuals, grants, and other federal operations (see Figure 3). 5/

National defense spending was well over half of federal expenditures in fiscal year 1958; in fiscal year 1978, it was about one-fourth. Benefit payments, on the other hand, have climbed from less than one-fourth of federal spending to about 40 percent. A large part of the change in both categories occurred between 1967 and 1974, when national defense spending remained essentially level in nominal terms because of the end of the Vietnam War, whereas benefit payments more than doubled as some new benefit payments programs were initiated and others were vastly expanded. Social security benefits, for example, were increased by 20 percent across the board in 1972. The percent of the federal budget allocated for aid to state and local governments (other than for benefit payments) has also increased steadily. The relative share of the budget for these grants-in-aid has more than doubled since 1959.

The percentage distribution of the budget would not change significantly over the projection period if current policies were to remain intact. Grants would decrease slightly because of the assumed phaseout or expiration of certain antirecession programs. The percentage for national defense would stop declining and would even increase slightly as the increased defense appropriations for fiscal years 1975 through 1978 were actually spent. The percentage for benefit payments would increase slightly because of real growth in some existing programs caused by demographic factors. The decisions that the Congress makes in 1979 will determine in great measure whether past trends in the composition of the budget are continued or reversed, or whether the current policy composition will be maintained for at least another few years.

#### PROJECTIONS OF REVENUES UNDER CURRENT POLICIES

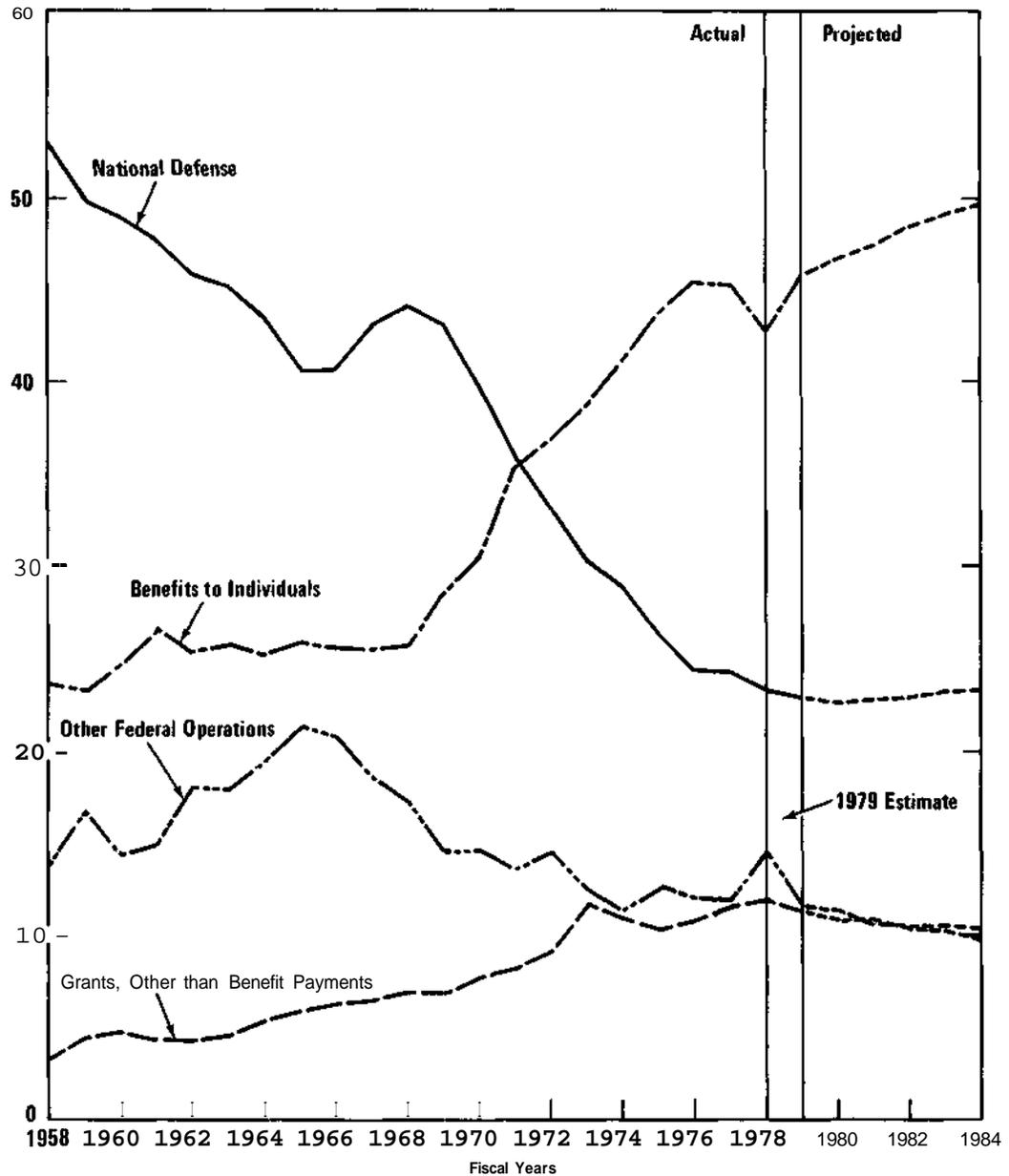
The current policy projections of federal revenues, like those of spending, rely on assumptions about the economy and about the meaning of current policy for federal revenues. Assumptions about economic aggregates, such as GNP and the unemployment rate, are presented in Chapter I;

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5/ Another classification of federal spending is by the major functions of the budget. For the five-year projections of federal spending by function, see Appendix B.

Figure 3.  
The Composition of Federal Spending

Percent of Total Spending



the interpretation of current policy for revenues is based on an extension of current laws. <sup>6/</sup> Consequently, the projections contain the effects of the tax legislation passed near the end of the 95th Congress and the scheduled increases in the taxable wage base and tax rates contained in the 1972 and 1977 amendments to the Social Security Act.

Fiscal Year 1979 Reestimates of Revenues

The revenue floor for fiscal year 1979 established by the 1979 second concurrent resolution is \$448.7 billion. The current estimate of receipts is \$453.3 billion, which is \$4.6 billion higher than the revenue floor in the resolution. Some \$3.3 billion of this difference results from new estimates based on recent collections data that show receipts increasing faster than anticipated (see Table 8).

TABLE 8. INCREASES IN REVENUES CAUSED BY REESTIMATES FOR FISCAL YEAR 1979: IN BILLIONS OF DOLLARS

Corporate Income Taxes	1.9
Social Insurance Taxes	0.4
Customs Duties	0.7
Other	0.3

Fiscal Year 1980-1984 Projections of Revenues

By fiscal year 1984, current policy receipts are projected to rise to \$849 billion, which would represent an unprecedented 21.8 percent of GNP. In all likelihood, the rapid rise in receipts under current law would be reduced by tax cuts that would be needed to achieve the economic targets. The largest component of the increase in current policy receipts is indi-

<sup>6/</sup> More detail on the assumptions and methodologies used for the projections can be found in Appendix A and in the technical background paper to this report.

vidual income taxes, which account for about 55 percent of the total increase in 1984 (see Figure 4). Another 25 percent of the increase is attributable to social insurance taxes.

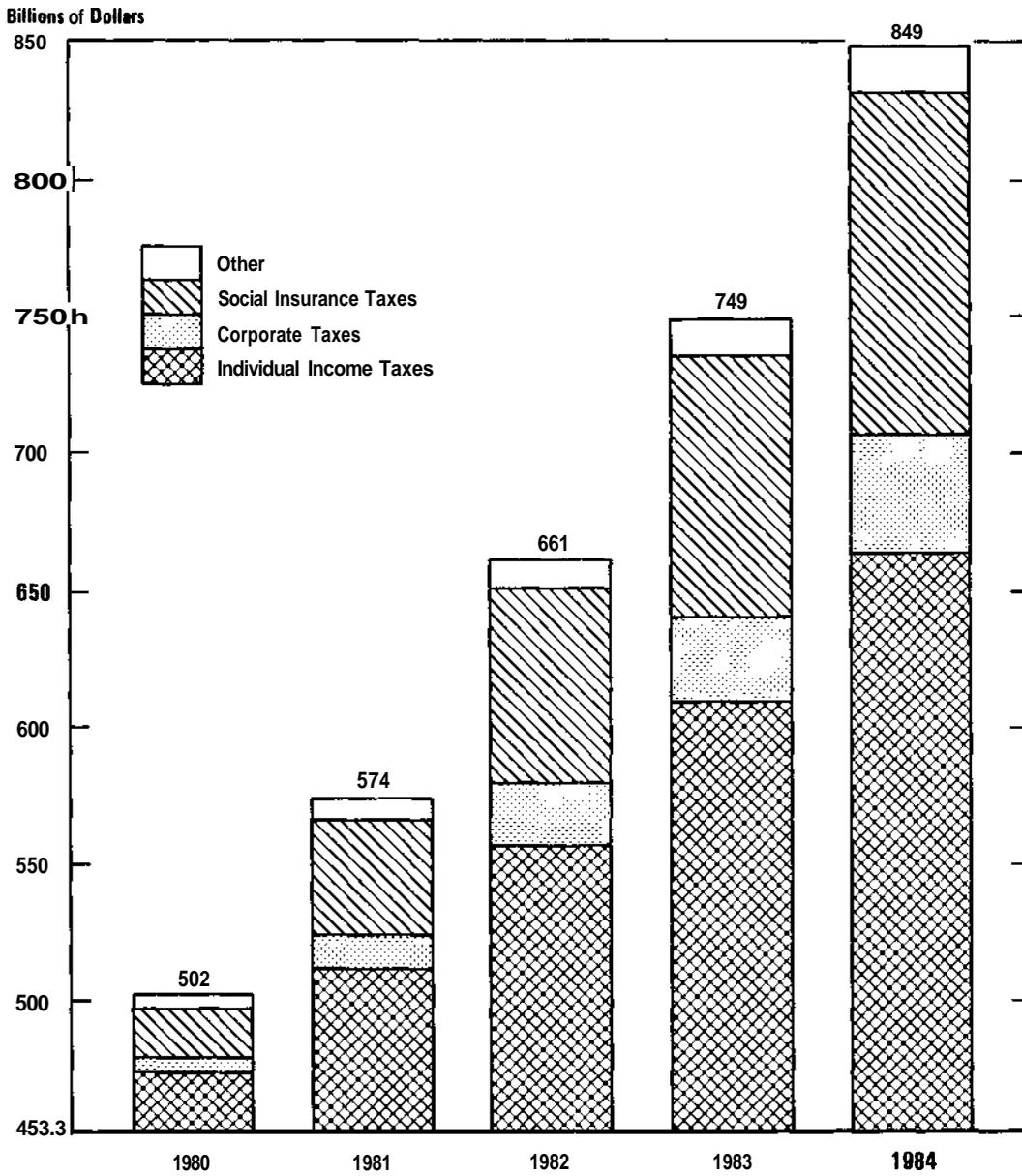
Individual tax collections, which are the largest single source of federal revenues, would grow under current law from \$202.7 billion in fiscal year 1979 to an estimated \$415 billion by fiscal year 1984 (see Table 9). This increase, which averages 15.4 percent a year while incomes rise by only 11.2 percent a year, shows the effect of both inflation and real growth on a graduated tax structure. <sup>7/</sup>

TABLE 9. CURRENT POLICY PROJECTIONS OF REVENUES BY SOURCE: BY FISCAL YEAR, IN BILLIONS OF DOLLARS

	1979 Estimate	Projections				
		1980	1981	1982	1983	1984
Individual Income Taxes	202.7	226	264	310	361	415
Corporate Income Taxes	67.7	73	80	89	100	112
Social Insurance Taxes	142.7	161	187	215	238	268
Excise Taxes	18.8	19	19	19	19	20
Estate and Gift Taxes	5.8	6	7	8	8	9
Customs Duties	7.5	9	10	11	12	14
Miscellaneous Revenues	8.1	8	9	9	10	10
TOTAL	453.3	502	574	661	749	849
Percent of Projected GNP	19.7	19.9	20.4	21.0	21.4	21.8

<sup>7/</sup> The projections of individual income taxes assume an elasticity of revenues with respect to taxable personal income of 1.45. That is, each 1.0 percent of growth in taxable personal income is assumed to raise individual income tax collections by 1.45 percent. (The term "taxable personal income," as used in this report, includes wages and salaries, proprietor's income, dividends, rental income, and personal interest income.)

Figure 4.  
 Projected Increases in Federal Revenues Under Current Policy,  
 Fiscal Years 1980-1984



Corporate tax collections are projected to rise from about \$68 billion in 1979 to \$112 billion by 1984, an increase of about 11 percent a year. Social insurance receipts are projected to rise from \$143 billion in 1979 to \$268 billion by 1984. This increase, averaging 13.4 percent a year, reflects legislated increases in social security taxes--the major portion of social insurance receipts. Social security taxes alone are expected to rise by 14.5 percent annually. Even though social security tax rates are not progressive, these receipts rise faster than the 11.4 percent annual growth of wages and salaries because of increases in the wage base and tax rates enacted in 1972 and 1977. Wage base increases contained in the 1977 legislation cause a larger share of total wages and salaries to be taxed in 1979-1984, making the social security tax an elastic source of revenue over this period.

Receipts from other sources (excise taxes, estate and gift taxes, customs duties, and miscellaneous revenues) are projected to grow at an average rate of 6 percent annually. Customs duties have been rising at more than 6 percent annually, while some excise taxes are declining because of rate reductions.

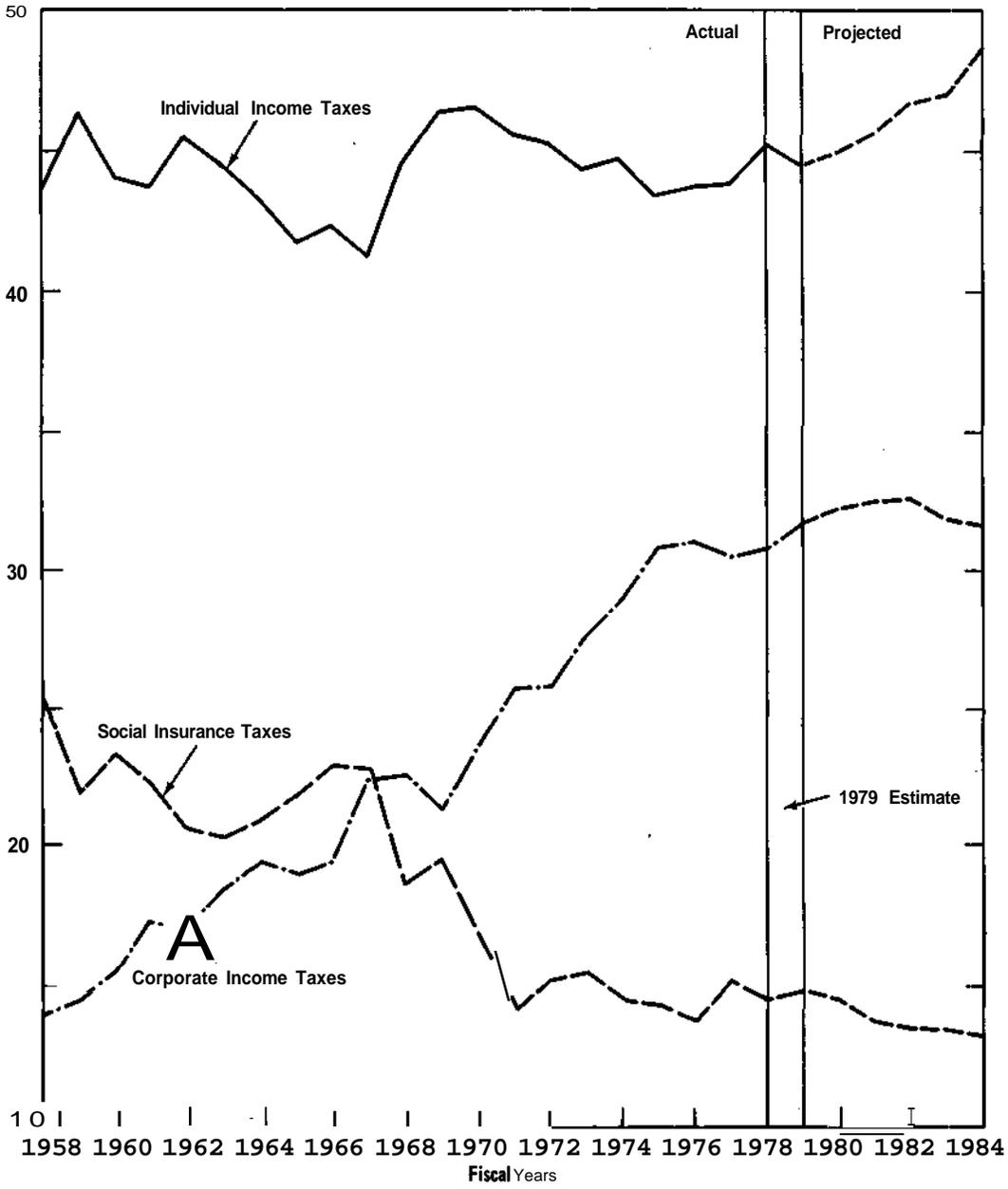
#### The Composition of Federal Revenues-- An Historical Perspective

The degree to which the federal government relies on various sources of revenue has shifted markedly since 1958 (see Figure 5). The relative share of individual income taxes as a revenue source has remained roughly constant at 41 to 47 percent over the past 20 years. Because of increases in both the tax rates and the taxable earnings bases, the share of social insurance taxes (primarily for social security and unemployment insurance) has increased from 14.1 percent in 1958 to about 30.8 percent. Corporate income taxes as a revenue source have declined significantly from 25.2 percent in 1958 to about 14.7 percent in 1978. This shift has resulted from several factors, including changes in the investment tax credit, accelerated depreciation, reductions in the corporate tax rate, and a decrease in corporate profits as a percent of GNP.

If current tax laws were to remain unchanged through 1984, the relative shares of individual income taxes, social insurance taxes, and corporate income taxes would change somewhat because of the graduated rate structure of the individual income tax and the legislated increases in social insurance taxes. The shares for individual income taxes and social insurance taxes would increase slightly, while the share for corporate income taxes would decline from slightly less than 15 percent to just over 13 percent.

Figure 5.  
The Composition of Federal Revenues

Percent of Total Revenues





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## CHAPTER III. SPENDING AND TAX OPTIONS

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The major budgetary issues facing the Congress in its considerations of the budgets for 1980 and beyond will concern proposed departures from current policy. This chapter examines several budget options for the future in light of historical trends and the current policy projections. Each of these options has unique program characteristics that will affect the outcome of future budgetary decisions. In a broader sense, however, decisions on these options, when taken together, will shape the future role of the federal government in the direct provision of public goods and services, the redistribution of income, and the support of state and local governments.

The options presented in this chapter illustrate some of the possible changes from current policy projections. These potential changes were selected from the many budgetary alternatives that have been suggested over the past few years. The discussion is not intended to present the pros and cons of each option, nor to imply a value judgment on the merits of various options not included in the discussion. Rather, the goal is to show the potential impact on the federal budget of major issues likely to be debated over the next few years.

### FEDERAL SPENDING

The budget for fiscal year 1979 emphasizes income redistribution and aid to state and local governments far more than the budget of 20 years ago. This new emphasis reflects a change in policy priorities over the past two decades. Certain budget options for the next five years could, however, change that emphasis. This section presents some of the budget options for national defense, benefit payments to individuals, grants to state and local governments, and other federal operations. These four spending categories are related primarily to one or another of the roles of the federal government:

- o National defense spending, to the provision of public goods and services;
- o Benefit payments to individuals, to income redistribution;
- o Grants to state and local governments, to support of state and local governments; and

- o Other federal operations, to the provision of public goods and services.

Thus, any shift in spending from one category to another also indicates *a shift* in priorities regarding the role of the federal government.

### National Defense

Spending for national defense as a percent of GNP has been declining steadily over the past decade, from about 9.5 percent in 1968 to 5.3 percent in 1978 (see Figure 6). <sup>1/</sup> The current policy projections show that national defense outlays as a percent of GNP would hold at about 4.9 percent in 1979-1981, and then drop to 4.5 percent by 1984. The near-term projections reflect the fact that real growth in appropriations over the past few years will produce real growth in outlays comparable to that in GNP through 1981.

### Possible increases

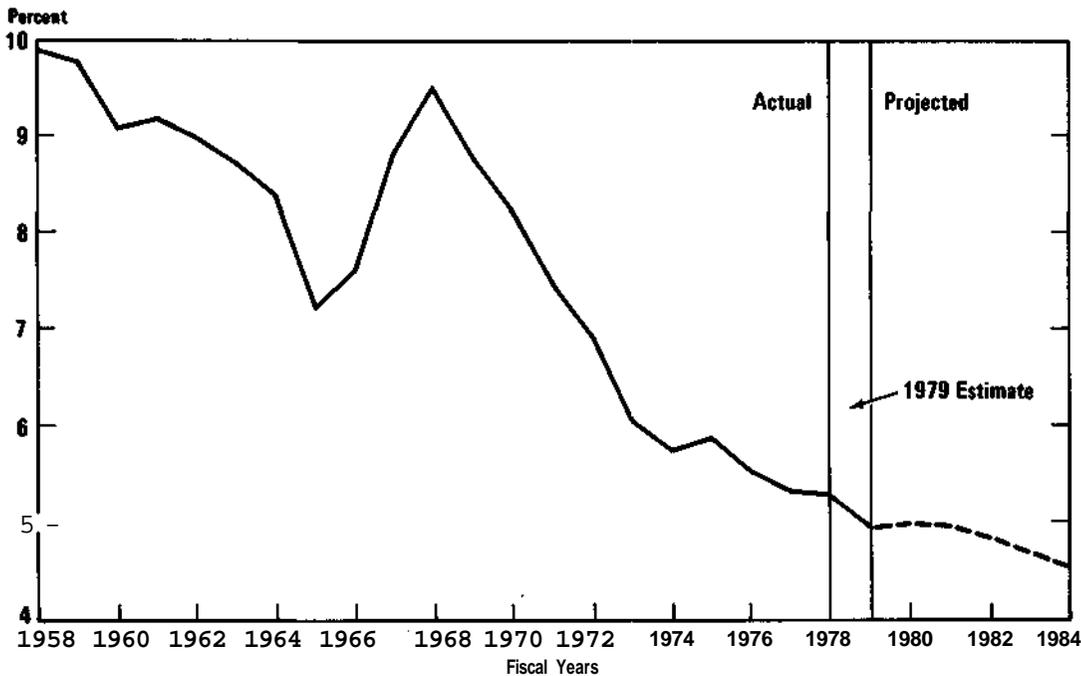
The programmatic options in defense are numerous, and many new programs and weapons have, in fact, been proposed. For example, among the significant budget items likely to be debated this year are a new intercontinental ballistic missile for the Air Force (MX) and an additional aircraft carrier for the Navy. It is beyond the scope of this report to analyze all these proposals. But the major budgetary issue in defense spending is not one or two individual programs; rather, it is the total amount of money to be allocated to defense over the next several years.

Much of the discussion of the total defense allocation has centered around Administration statements to the NATO ministers in 1977 about real growth in defense spending. The United States pledged to increase defense spending "in the region of 3 percent" as part of an agreement by the other NATO governments to do likewise. This pledge, however, has been interpreted in many different ways. The most common interpretations are that the Administration made a commitment to 3 percent real growth in total defense outlays, that it made a commitment to 3 percent real growth in total budget authority for the Department of Defense, or that it made a

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<sup>1/</sup> For this report, spending for national defense is defined as outlays in the national defense budget function (050), and includes the military activities of the Department of Defense, retired pay for the military, atomic energy defense activities, and certain defense-related activities of civilian agencies.

Figure 6.  
National Defense Spending as a Percent of GNP



commitment to 3 percent real growth in budget authority for purchases related to NATO defense.

If the pledge is interpreted to mean an increase in total defense outlays, that commitment would not be difficult to meet in fiscal year 1980. Projections of budget authority under current policies, plus obligational authority already on the books, virtually guarantees such an increase in defense outlays.

In contrast, if the pledge is interpreted to mean real growth in total defense budget authority or budget authority in purchases related to NATO defense, outlays would have to rise significantly above the current policy baseline beginning in fiscal year 1980. Much of this increase would occur in the later years because of the lag between appropriations and outlays. As a result, defense spending as a percent of GNP would remain relatively constant throughout the five-year period, rather than declining in fiscal years 1982-1984.

Where would these increased monies be spent? The funds earmarked for operations in the current policy projections are likely to be sufficient to

support the operations of the current defense forces--that is, to maintain current force readiness--over the next three to five years. 2/ The structure of the defense force, however, is changing. In order to support the increased force structure that is implicit in appropriations already made for new weapon systems, an additional \$1.4 billion in outlays would be required for operations by fiscal year 1984. About 70 percent of these additional outlays would be to support an increase in naval forces.

In view of the Administration's apparent commitment not to increase the Defense Department's civilian or military personnel, it is doubtful that additional operating funds beyond the \$1.4 billion already mentioned would be spent on increasing the operating tempo of defense forces--that is, the flying hours for planes and the steaming hours for ships. Implicit in an increased operating tempo is an increase in civilian personnel to provide logistical support.

If the operating tempo of the defense forces is not increased, the additional funds, if appropriated, are likely to be used primarily for force modernization--that is, investment in purchases of major weapons (for example, ships, aircraft, and missiles), in research and development, and in some military construction. The effect on outlays of providing additional funds for across-the-board increases in investment is relatively small in fiscal year 1980, but it builds rapidly in the outyears (see Table 10).

In debating the issue of 3 percent real growth for defense, the Congress would probably focus not only on the question "3 percent of what," but also on the question "for how long?" Decisions to continue appropriating the additional funds for force modernization implied by Table 10 would likely depend on actions by the principal opponents of the United States (especially the Soviet Union), as well as on actions by U.S. allies (especially the NATO countries).

#### Possible cuts

Where cuts in the defense budget might be absorbed depends on whether military and civilian personnel strengths are changed. If current military personnel strength is maintained, the cuts would have to be absorbed either in the funds for force readiness, or in those for force modernization, or in both. Where cuts might be made in the funds for force

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2/ This result is based on an analysis done using the Defense Resource Model. For details on this model, see Congressional Budget Office, Real Growth and Decline in Defense Operating Costs; Fiscal Year 1978, Staff Working Paper (July 1977).

TABLE 10. POSSIBLE INCREASES IN OUTLAYS ABOVE CURRENT POLICY PROJECTIONS ATTRIBUTABLE TO REAL GROWTH IN DEFENSE SPENDING: BY FISCAL YEAR, IN BILLIONS OF DOLLARS

	1980	1981	1982	1983	1984
3 Percent Increase in Total Defense Outlays	0.0	0.0	0.5	5.5	12.9
3 Percent Increase in Budget Authority for Department of Defense	0.8	3.1	6.7	11.5	17.7
3 Percent Increase in Defense Purchases Related to NATO	0.3	1.1	2.4	4.1	6.2

modernization is difficult to predict; they would not necessarily come from the most visible and debated items, such as the MX missile.

Besides a simple cut in the total allocation, various other across-the-board cuts might be considered. It is beyond the scope of this report to analyze how such cuts might affect specific programs. It is possible, however, to indicate whether the reductions would tend to affect force modernization or force readiness.

Force modernization. One approach to an across-the-board cut would be to fund less than is necessary to cover the anticipated costs of inflation in defense programs. Some have contended that less than full adjustment for inflation throughout the federal budget may be necessary if the goal of decreasing the rate of inflation in the economy is to be achieved. Moreover, it has been argued that less than full adjustment for inflation will encourage greater efficiency in the use of defense resources. The Senate Budget Committee frequently assumed only partial funding of the inflation adjustments in formulating recommended multiyear targets during its markup of the First and Second Concurrent Resolutions on the Budget for Fiscal Year 1979; in many cases, the committee recommended a two-thirds adjustment for inflation.

If only two-thirds of the discretionary inflation adjustment were funded, the cut would mean less money for military procurement, research

and development, and construction. Outlays for force modernization would be about \$4 billion less than current policy projections by fiscal year 1984 (see Table 11).

TABLE 11. POSSIBLE CUTS IN NATIONAL DEFENSE OUTLAYS BELOW CURRENT POLICY PROJECTIONS: BY FISCAL YEAR, IN BILLIONS OF DOLLARS

Reductions	1980	1981	1982	1983	1984
<b>Force Modernization Reductions</b>					
Hold inflation adjustment to two-thirds of cost for procurement, research and development, and construction	-0.2	-0.3	-1.1	-2.1	-3.9
Forego initiatives anticipated in second concurrent resolution but not yet enacted	-0.8	-1.2	-1.5	-1.8	-2.0
<b>Force Readiness Reductions</b>					
Hold inflation adjustment to two-thirds of cost for defense operations	-0.5	-1.1	-1.8	-2.6	-3.5
Limit federal payraises to 5.5 percent in 1980 and 7.0 percent thereafter	-0.9	-1.3	-2.0	-2.6	-3.0
Payraise absorption (20 percent)	-0.6	-0.7	-0.8	-0.8	-0.8
<b>Military Retirement Reductions</b>					
Restrict retired pay increases for military to once a year	-0.5	-0.5	-0.5	-0.5	-0.5
Restrict retired pay increases for military to once a year and to comparability with private sector	-0.6	-0.9	-1.2	-1.4	-1.7

A more limited cut would be to deny funding for the supplemental defense appropriation that the Administration is proposing in January 1979. The second concurrent resolution contains room for this bill because funds

for a new aircraft carrier were deleted from the 1979 defense appropriations bill after a veto battle between the President and the Congress. <sup>3/</sup> Consequently, Congressional action to date on fiscal year 1979 budget authority for national defense is below the second resolution ceiling by about \$1.5 billion. This budget authority is in the programmatic base for the current policy projections, and similar budget authority is embedded in the projections for the outyears. If this budget authority is not granted, the reduction in defense outlays would be \$0.8 billion in fiscal year 1980 and would reach \$2.0 billion in fiscal year 1984. Since it was assumed that these monies would be used primarily for procurement, the principal effect of this cut would be to lower the rate of force modernization.

Force readiness. The inflation adjustment is of critical importance in the accounts that pay for materials to operate current forces. If only two-thirds of the adjustment for discretionary inflation were made in defense operations, projected annual outlays for these accounts would be \$3.5 billion lower than current policy by fiscal year 1984. To the extent that efficiencies did not offset this reduction, the cut could affect force readiness throughout the projection period by providing insufficient funds for purchases of fuel, spare parts, and other goods needed to maintain the operating tempo of current defense forces.

Approximately 45 percent of the outlays for national defense are for pay and benefits for civilian and military employees. One possibility for reductions might thus be in employee compensation. The current policy projections shown in Table 7 contain funds for federal payraises in 1980-1984 consistent with the Federal Pay Comparability Act of 1970. In fiscal years 1976 and 1979, however, federal payraises were capped at 5.0 percent and 5.5 percent, respectively. If federal pay were capped at 5.5 percent in fiscal year 1980, as the Administration proposes, and if future payraises were limited to a maximum of 7 percent--consistent with the Administration's anti-inflation goals--the savings would be \$3 billion by fiscal year 1984. Except for fiscal year 1980, these ceilings on pay increases would not result in a decline in real wages (given the rates of inflation assumed in this report), although the raises would fall short of the amount needed to achieve comparability. The reduction would probably have little effect, in terms of retention and recruitment of personnel, on the

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<sup>3/</sup> When the second concurrent resolution was originally formulated, it was anticipated that the defense appropriations bill would contain funds for a carrier. The President vetoed the defense authorization and subsequently the funds for a carrier were deleted. As a result, the defense appropriations bill was lower than originally anticipated.

defense civilian work force and the officer force of the military, but it would probably imply a continuation or even a worsening of recruitment and retention problems for enlisted personnel in the Army and the Navy, and consequently could hamper force readiness.

A further across-the-board cut in personnel costs could be attempted by forcing the Department of Defense to absorb part of any payraise that is granted. Historically, the Executive Branch and the Congress have forced federal agencies to absorb part of the cost of annual federal payraises. This has been used as a way of forcing efficiencies. Although the amount absorbed has varied considerably, the average has been about 20 percent of the cost of the payraises. If 20 percent absorption were assumed in fiscal years 1980-1984 for both civilian and military payraises, the savings for defense would be approximately \$0.8 billion a year. In the past, the absorption has been implemented primarily by decreasing the amount spent for purchases related to force readiness, rather than by reducing spending for personnel.

Military retirement. A final set of cuts would involve the treatment of retired pay for those already on the retiree rolls (or who will enter those rolls by 1984). National defense spending for fiscal year 1979 includes over \$10 billion for retired pay of uniformed military. Outlays for this purpose will rise to over \$16 billion by fiscal year 1984. At present, retired military can receive two **cost-of-living** increases each year, in April and October, based on the change in the CPI. If these increases were given only once a year, as with social security benefit payments, the net savings to the federal government would be approximately \$500 million a year.

A second change would be to alter not only the timing but also the amount of the increases. Recent evidence indicates that private sector pension plans (which are seldom indexed), when combined with social security benefits, compensate individuals partially for increases in the cost of living. 4/ If a representative system that combined private pension and social security were used, the federal retiree would receive cost-of-living adjustments covering about 70 percent of the increase in the CPI. If social security increases were capped at 5.5 percent for 1979 and at 7 percent **thereafter**, the federal retiree would receive about 50 percent of the increase in the CPI in 1980 and 70 percent thereafter. The savings from this option would total \$1.7 billion by 1984. 5/

4/ Congressional Budget Office, Options for Federal Civil Service Retirement; An Analysis of Costs and Benefit Provisions, Budget Issue Paper (December 1978).

5/ Savings from applying these cuts to civilian defense and nondefense employees are discussed in the following section on benefit payments to individuals.

One problem with changing the military retirement program is that it constitutes one of the important tools that the Department of Defense has to recruit and retain the numbers and quality of personnel needed for the armed forces. A change in the retirement program would affect the department's ability to meet these goals. Perhaps more important, there may be superior approaches to reducing the long-run cost of military retired pay than simply applying across-the-board cuts. In fact, in 1979 the Administration is likely to propose a major restructuring of the military retirement system. The proposed changes could increase benefits for those who leave the military with fewer than 20 years of service, while decreasing benefits for retirees with 20 or more years of service. These changes could eventually result in substantial cost savings, but they are likely to increase outlays during the next few years. The Administration's proposal is not yet sufficiently definite to permit precise estimates of effects on costs and analysis of potential effects on recruitment and retention.

The restructuring of military retired pay illustrates a general problem with seeking efficiency cuts in the defense budget--that is, seeking to reduce the costs of defense without also diminishing defense capabilities. Such cuts are unlikely to yield cost savings in the short-run; in fact, financing the transition may add to short-run costs. Examples other than restructuring military retired pay include streamlining the U.S military bases (by closing unneeded installations and reducing the work force at others) and reforming the wage board pay system for blue-collar federal workers.

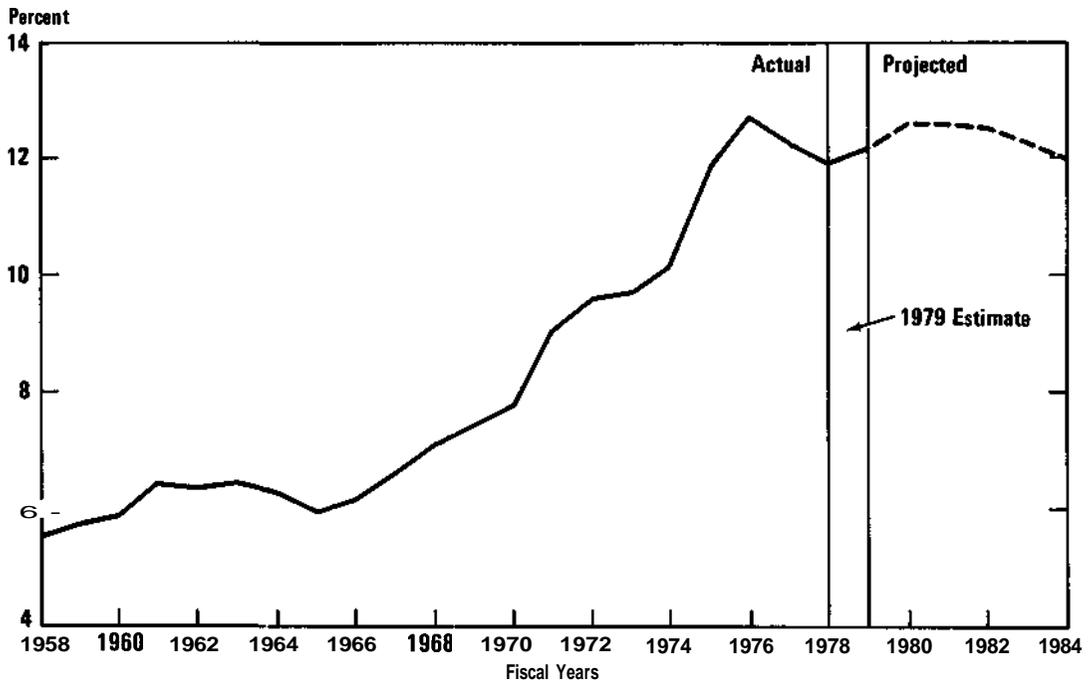
### Benefit Payments to Individuals

A major function of the federal government that has evolved over the past 20 years is the redistribution or transfer of income through benefit payments to individuals. Among the programs that provide benefit payments to individuals are social security, medicare, medicaid, certain welfare programs, higher education Basic Educational Opportunity Grants (BEOG), veterans' compensation and pensions, and the earned income credit. Some benefit payments, like medicaid and Aid to Families with Dependent Children (AFDC), are made through state and local governments; others, like social security and veterans' compensation and pensions, are direct federal payments.

Programs that provide benefit payments to individuals, either directly or indirectly through federal grants to state and local governments, have grown from less than 25 percent of the budget to more than 40 percent. One way to measure the magnitude of the role of the federal government in redistributing income is to compare benefit payments to

individuals with personal income. Over the past 20 years, benefit payments to individuals as a percent of personal income have more than doubled (see Figure 7). The growth is concentrated over the past decade, when these payments grew from 7 percent of personal income to almost 12 percent. This decade was marked by the introduction or expansion of programs, such as medicare, medicaid, food stamps, and the earned income credit. In the social security program, which accounts for nearly half of the benefit payments, the average retirement benefit, even after adjusting for changes in inflation, increased by about .55 percent. In 1977-1978, however, benefits to individuals as a percent of personal income declined slightly, mainly as a result of the economic recovery, since some of the programs, such as unemployment compensation, depend greatly on the state of the economy. Under current policy assumptions, benefit payments in the 1980-1984 period grow at approximately the same rate as personal income.

Figure 7.  
Benefit Payments as a Percent of Personal Income



Possible increases

National health insurance. The issue of national health insurance may significantly alter the five-year budget outlook. Any national health

insurance plan would substantially increase projected benefit payments—if not in fiscal year 1980, certainly over the next five years.

A wide variety of alternative national health insurance plans have been proposed, ranging from insurance against catastrophic expenditures, to mixed public and private insurance systems covering the working population through employer-provided insurance, and to universal health insurance entirely funded and administered by the federal government. Most of these alternatives have ramifications that would extend beyond the federal government into the private economy. Although it is beyond the scope of this report to present even a cursory analysis of the various proposals, one alternative is examined briefly to illustrate their potential impact on the budget.

Catastrophic health insurance is advocated by some as a low-cost option that minimizes federal intervention in the health care sector while meeting one of the fundamental objectives of any national health insurance plan--protection against unusually high medical expenses. Moreover, it is sometimes seen as a first step toward a comprehensive national health insurance program.

One possible version of catastrophic health insurance would pay all hospital, physician, and pharmaceutical expenses above \$5,000 for persons under 65. For those 65 and over, the plan would supplement the hospital insurance under medicare, paying the coinsurance required during long hospitalizations and paying for all nonpsychiatric hospital care in excess of medicare's limits. To encourage private participation in this system, employers would be required to offer similar benefits in order to continue to exclude from taxable wages contributions for health insurance for employees. Such a program, beginning in fiscal year 1981, would add roughly \$9 billion to the federal budget by fiscal year 1984 (see Table 12). More than 5.5 million persons with exceptionally high medical expenses--about 2.5 percent of the population--would receive benefits under the program.

Expansions of medicaid. During the 95th Congress, several proposals to expand the Early and Periodic Screening, Diagnosis, and Treatment (EPSDT) program of medicaid were discussed. The various plans all aim to increase the use of health services by children of poor families. Eligibility would be extended to children under age 6 of all families with incomes below a particular ceiling, including those not receiving welfare. The plans would also increase the number of services that must be covered by the states, extend for certain children the list of optional services for which matching federal funds are available, and enlarge the share of EPSDT program costs borne by the federal government.

TABLE 12. POSSIBLE INCREASES IN OUTLAYS FOR BENEFIT PAYMENTS ABOVE CURRENT POLICY PROJECTIONS: BY FISCAL YEAR, IN BILLIONS OF DOLLARS

	1980	1981	1982	1983	1984
Catastrophic Health Insurance	--	5-6	6-7	7-8	8-9
Medicaid--EPSDT <u>a/</u>	0-0.5	0-0.5	0-0.5	0-1.0	0-1.0
AFDC Changes <u>b/</u>	0-0.5	1-2	2-3	3-4	4-6
Veterans' Education					
Extend eligibility period	1.0	1.0	0.9	0.8	0.6
Tuition subsidy	0.2-0.4	0.2-0.4	0.2-0.4	0.2-0.3	0.1-0.3
Rate increase <u>c/</u>	0.3	0.4	0.3	0.2	0.2

a/ The Early and Periodic Screening, Diagnosis, and Treatment program. It is assumed that the second concurrent resolution includes over \$0.1 billion for EPSDT and other medicaid increases in fiscal year 1979. The amounts shown here are above the projected growth of this figure, which itself is expected to approach \$1 billion by fiscal year 1984.

b/ Aid to Families with Dependent Children.

c/ Accounts for the cost-of-living increase between fiscal years 1978 and 1979 that would be made up in fiscal year 1980.

Funds for some of these provisions are already assumed in the second concurrent resolution and in the current policy projections for 1980-1984. The most expansive of the plans, however, would make an additional 2.8 million children eligible for medicaid benefits and could further increase federal spending by as much as \$1 billion in fiscal year 1984. The net effect on aggregate state spending of any of these plans would be small. A few states, however, would spend much more than they do currently, and a few others much less.

Changing the welfare system. A number of proposals to modify the welfare system were introduced in the last session of the Congress, including the Administration's Program for Better Jobs and Income (PBJI).

PBJI would have increased federal spending by about \$19 billion in fiscal year 1984, while reducing state and local spending by approximately \$4 billion. In view of the tightness of the budget over the next few years, it is unlikely that an expensive, comprehensive welfare reform proposal like PBJI will be reintroduced or enacted. Less ambitious proposals may, however, be considered by the Congress in 1979.

One near-term budget option would be to establish a national minimum payment under the AFDC program--for example, a benefit that in combination with food stamps would be between 65 and 75 percent of the poverty level--and to extend the AFDC for unemployed fathers program to all states. These changes would cost the federal government between \$4 billion and \$6 billion in fiscal year 1984, and they would reduce state and local expenditures by \$2.0 to \$3.4 billion. Approximately 375,000 additional families would receive benefits under such proposals. 6/

Further possible changes in the welfare area are related to public service employment. One proposal, which is discussed later in the section on grants to state and local governments, would provide an additional 300,000 public service jobs by fiscal year 1984 to unemployed welfare recipients at a net federal cost of \$3 to \$4 billion.

Veterans' education. Several proposals have been made to extend the eligibility period for the veterans' G.I. Bill from 10 to 12 years. These include a blanket extension to all veterans; an extension only for those who served between August 5, 1964, and December 31, 1970; and an extension only for those in training. An extension only for veterans who served between 1964 and 1970 would cost about \$1 billion in fiscal year 1980 (see Table 12).

Because veterans in some areas have access to relatively inexpensive educational institutions while others do not, it has been proposed that those in high-tuition areas receive a subsidy to compensate, at least partially, for the greater amount they have to pay. Some plans would allow veterans to accelerate their entitlement--that is, use up more than one month's entitlement in a single month of training. Other plans would pay a portion of the higher than average tuition costs. Depending on the plan adopted, tuition subsidies could cost from \$200 to \$400 million in fiscal year 1980.

6/ If a national minimum benefit payment were set at the poverty level, increased federal costs would be \$17.7 billion by fiscal year 1984. State and local costs, however, would be lower by \$6.9 billion. Over 1.1 million additional families would receive benefits under this proposal.

Finally, a rate increase for veterans' training will likely be enacted for fiscal year 1980, since no increase has been provided for fiscal year 1979. (The Congress has usually passed G.I. Bill rate increases every one or two years.) The current policy projections hold the level of resources for 1979 constant in real terms--which implies a rate increase to cover the inflation between 1979 and 1980. It is possible, however, that the rate increase that will be enacted will attempt to cover the inflation between 1978, the year of the last rate increase, and 1980. If so, the increment to current policy outlays would be about \$0.3 billion for fiscal year 1980.

#### Possible cuts

Under current policy, benefit payments increase in absolute terms faster than any other part of the budget. The options for reductions from current policy projections fall into three categories:

- o Limiting cost-of-living increases and automatic adjustments for inflation;
- o Cutting selected existing programs; and
- o Foregoing new programs or program expansions anticipated in the 1979 second concurrent resolution.

Limiting automatic inflation adjustments. Large reductions in projected benefit payments could be achieved by providing less than the full cost-of-living increase guaranteed under current law. These limitations would make more credible the federal government's efforts to curb wage increases of the working population. Social security and federal retirement recipients have obtained large real increases in federal benefits over the past decade. Moreover, the elderly are not so disproportionately poor in relation to the total population as they used to be. In 1970, for example, 25 percent of those 65 years and over were below the poverty threshold, as compared with 13 percent of the total population. By 1977, these figures were 14 percent and 12 percent, respectively.

Arguments against such a limitation stress that the automatic cost-of-living adjustment was intended to maintain a fixed real benefit after retirement that would not be subject to further ad hoc increases or decreases. No ad hoc increases in real social security benefits have occurred since 1975, when the program first went on the automatic system, although such increases had occurred in the preceding five years. A reduction in the cost-of-living adjustment now could set a precedent for increases that exceed the cost-of-living in the future.

Another objection to a limitation is that many elderly and disabled social security recipients become more dependent on social security during periods of inflation, because their other sources of income do not keep pace with increases in the cost of living. Most private pensions and state and local government pensions are fixed in dollar terms, and therefore they decline in real value during inflation. Property income is another important source of income for the elderly, accounting for 20 to 25 percent of the income of persons 70 years and over. Income from some assets may well rise even faster than inflation, but assets in the form of savings accounts yield an income that often does not keep pace with inflation because of ceilings on interest rates. Finally, with a limitation on benefits, groups such as widows over 70 years of age, who depend on social security for about half their income, would suffer a decline in real purchasing power that would be difficult to make up.

The largest cuts in current policy outlays resulting from a limit on automatic inflation adjustments would be in social security benefits. One possible limit would be a 5.5 percent ceiling on the July 1, 1979, increase and a 7 percent ceiling on the increases in 1980 and 1981. With these limits, the reduction in social security benefits would be \$3.7 billion in 1980 and \$5.3 billion in 1981 (see Table 13). (Under the economic assumptions shown in Chapter I, the increases estimated for 1982-1984 under current law are less than 7 percent.)

A limit on cost-of-living increases would also produce substantial reductions in civil service retirement benefits. If cost-of-living increases were granted once a year instead of twice a year, as under current law, the savings would be approximately \$0.6 billion annually. Restricting the cost-of-living increases to amounts comparable to those under private sector pension plans would save an additional \$1.8 billion by 1984.

Somewhat different than the proposals to limit or cap automatic CPI increases are proposals to cut hospital costs through government regulation. These proposals would be expected to reduce federal outlays, because the federal government now pays for 39 percent of community hospital expenditures in the country--largely through its funding of the medicare and medicaid programs.

Total expenditures in community hospitals have been growing rapidly. Since 1970, they have increased at an average annual rate of 15 percent, which is about 4 percentage points faster than the average rate of increase for consumer services expenditures. This rapid increase has occurred despite the fact that federal price controls were in effect for two and one-half years during this period. Some of the factors contributing to this

TABLE 13. POTENTIAL CUTS IN OUTLAYS FOR BENEFIT PAYMENTS  
BELOW CURRENT POLICY PROJECTIONS: BY FISCAL  
YEAR, IN BILLIONS OF DOLLARS

	1980	1981	1982	1983	1984
Alter Inflation Adjustments for					
Existing Programs					
Social security	-3.7	-5.3	-6.2	-6.7	-7.1
Civil service retirement					
Once-a-year raise	-0.5	-0.6	-0.6	-0.6	-0.7
Comparability with private sector	-0.7	-1.2	-1.6	-2.0	-2.3
Hospital cost containment	-0.5	-1.4	-2.8	-5.1	-7.4
Other	-1.0	-1.3	-1.6	-1.9	-2.3
Cut Selected Existing Programs					
Social security	-0.3	-0.9	-1.8	-2.6	-3.8
Student assistance	--	--	-0.2	-0.5	-0.8
Child nutrition	-1.4	-1.6	-1.7	-1.9	-2.1
Forego Initiatives Assumed in					
1979 Second Concurrent Resolution					
EPSDT	-0.3	-0.6	-0.7	-0.9	-1.0
Student Assistance	-0.1	-0.2	-0.2	-0.2	-0.2
Other	-0.1	-0.1	-0.1	-0.1	-0.1

rapid increase are the same as those that would cause spending on any other good or service to rise--inflation, the growth in population, and increases in income that lead to the purchase of more and better services. Other factors, however, are unique to the health care area. The federal infusion of dollars has enabled many elderly and low-income people to use more hospital services than would otherwise have been the case; this, of course, was a basic reason for the increased federal expenditure. But the increase in federal funding, combined with the growth in private insurance, is believed to have led to an over-use of hospital services, spurring unnecessary hospital admissions and increasing the amount of resources utilized per admission. It is difficult to determine how much of the total increase in hospital expenditures is attributable to such waste.

One proposal to limit the rate of increase in total hospital expenditures would place a cap on increases in community hospital revenues of about 10 percent a year, following a phase-in year. This would save approximately \$17 billion in federal funds for medicare and medicaid over five years (see Table 13). Another approach would be to reward low-cost hospitals and to penalize high-cost hospitals. Such a proposal is contained in Section 2 of the Talmadge bill reported by the Senate Finance Committee in the 95th Congress. The five-year savings to the federal government from the Talmadge bill would be less than \$1 billion, in part because the limits would apply only to some costs. The response of individual hospitals to the incentives in the bill would alter the savings, and thus the magnitude of the cut in federal spending cannot be reliably estimated. A third proposal is for the federal government to take no immediate action, while the hospital industry pursues its own voluntary program. The hospital industry has announced a goal to reduce the annual rate of increase to 11.6 percent by the end of 1979. If that goal were met, some \$21 billion in federal funds would be saved over five years.

In addition to producing savings for the federal government, a reduction in hospital expenditures would lead to savings for the public and for state and local governments. Five-year nonfederal savings would be about \$33 billion under the mandatory revenue caps and about \$39 billion under a successful voluntary effort. Because the Talmadge bill covers only federal programs, savings by others under this proposal would depend on actions taken by hospitals in response to incentives in the proposal.

No estimate has been made of the effect on resource use of revenue controls such as those in hospital cost containment proposals. It may be that the proposed ceilings are not high enough to allow for inflation in the prices of goods and services purchased by hospitals and for desired increases in the amount and quality of services. Furthermore, since the revenue cap regulates rates of increase across the board, it would affect efficient and inefficient hospitals alike, even though efficient hospitals may be operating with little waste to trim.

Cutting selected existing programs. Efforts to retard the rate of growth of social security benefit payments--which will be increasing not only because of inflation adjustments, but also because of programmatic and demographic factors--are likely to include a number of proposals for targeted cuts. Most of the proposals are for reducing projected benefits to new beneficiaries.

One proposal, which was recommended by a consultant panel to the Congress, was considered during the debate on the 1977 amendments to the Social Security Act. Under this proposal, the benefit formula and the

average wages upon which benefits are based would be indexed to prices; under current law, they are indexed to wages. If wages rise at a faster rate than prices (as they usually have in the past), the average benefit paid to future retirees would not rise as fast under the **price-indexing** proposal as under current law, thereby resulting in savings. If price indexing were substituted for wage indexing for persons retiring in 1979 and beyond, savings would be insignificant in 1980 and 1981. By **1984**, however, under the economic assumptions in Chapter I, savings would rise to about \$1 billion. Estimates of the long-term savings of such a change in the benefit structure indicate that it would be possible to fund social security benefits over the next 75 years with a combined Old Age and Survivors Insurance and Disability Insurance (**OASDI**) tax on employers and employees of 9.9 percent of taxable payroll, as compared with 13.6 percent under current law. The issues involved in changing the benefit formula are complex, and they raise fundamental questions about the level of benefits society should provide for the retired population, about the pace at which these benefits should change as the incomes of retiring workers rise over time, and about the interaction of savings, pensions, social security benefits, and earnings.

Other proposals for cutting social security benefits would not change the general level of benefits but would reduce benefits for particular groups. For example, benefits for workers with dependents have expanded over the years in an effort to meet certain welfare objectives. But social security benefits are not based on financial need, and thus it has been suggested that a substantial proportion of the recipients of these welfare-oriented benefits are not the people for whom the provisions were intended. In addition, it has been argued that the growth of public assistance, supplemental security income (SSI), food stamps, and other aid programs based on need remove some of the reasons for putting; these special benefits in the social security program.

One possible target for cuts in social security payments are the benefits to disabled workers. Under the current law, some families with a disabled worker receive social security benefits that greatly exceed the **worker's** earnings during his or her working years. Since social security benefits are not taxed, and since the worker incurs work-related expenses that the disabled retiree does not have, the differential between benefits and disposable earnings is even larger.

The proposal has been made to limit the total amount of benefits paid to a disabled worker and his family to 80 percent of the **worker's** average indexed monthly earnings before retirement. Another version of the proposal would place the limit at 150 percent of the **worker's** individual benefit (as opposed to his family benefit) if that amount were smaller. The

recipients of disability benefits differ greatly in the amount of income they receive from sources other than social security. It is estimated, however, that the average non-social security income for the families of male beneficiaries of disability insurance will reach about **\$8,400** in 1979, and about \$12,600 for the families of female beneficiaries. The average annual social security benefit for these families will add \$6,800 for male beneficiaries and \$5,200 for female beneficiaries. A limit on replacement rates--that is, the ratio of a **beneficiary's** benefit to his earnings at the time of **disability**--would reduce the family benefit of those affected by about 25 percent. The extent to which this reduction would be offset by increased earnings of other family members is not known. For those with low incomes, benefits from public assistance, food stamps, and other programs would likely rise to **offset** the reduction, at least partially.

Since the proposal would apply only to new awards and not to current beneficiaries, savings would be small at first (about \$100 million in 1980), but they are estimated to rise to about \$600 million annually in **1984**, depending on which version of the proposal is adopted.

A second possible target would be to reduce or eliminate the social security benefits to students 18 through 21 years of age who are children of retired, deceased, or disabled workers. Currently about one-eighth of all full-time undergraduate students receive such benefits, which are estimated to average about \$2,100 per student in fiscal year 1979. Although these social security benefits are not based on **students'** financial need, most recipients are from families with a somewhat lower income than the average student. The median adjusted gross income of families with social security student **beneficiaries** is estimated to be about **three-quarters** of the median income for all families with children in college.

Various proposals have been made to limit the student benefit. One proposal would phase out social security benefits for students by making 18-year-olds ineligible starting at the end of 1979, 19-year-olds ineligible at the end of 1980, 20-year-olds ineligible at the end of 1981, and so forth. Savings from such a proposal are estimated to be \$230 million in fiscal year 1980, rising to about \$1.7 billion in **1984**.

Reducing or eliminating these student benefits could lead to increased costs in other federal student aid programs based on needs because some students who would have received social security benefits would become eligible for other types of aid. It is estimated that eliminating the social security student benefit would increase the costs of the Basic Educational Opportunity Grants program by less than 1 percent, or by \$40 million in 1984.

A third possible target would be to eliminate the minimum benefit payment to retired, disabled, and surviving beneficiaries. The 1977 amendments to the Social Security Act reduced the minimum benefit by freezing it at the 1979 level of \$122 a month for all new awards. Some have proposed, however, that the minimum benefit be completely eliminated. The minimum typically applies to workers with only a few years of covered earnings. Since these workers have not had enough years of covered earnings to meet the requirements of the benefit formula, many years of zero earnings must be included in calculating their average wage bases, which are used to determine benefits. Although the social security benefit formula now provides high replacement rates for workers with low average wage bases, the level of benefit could be very low without the minimum.

About three-quarters of retired workers receiving the minimum are women. About half of these women, however, receive a supplement to their minimum benefit since they are eligible for a spouse benefit or for a widow benefit that exceeds their minimum benefit. This group would not experience any change in their social security benefits if the minimum were eliminated, since the spouse or widow component of their benefit would simply rise to make up the difference. Moreover, about 6 percent of those receiving the minimum are workers with a government pension who have worked only a few years under social security. This group typically has an above average retirement income. The remaining persons receiving the minimum are women and men who, for reasons of poor health, family responsibilities, or other factors, have worked a limited number of years in social security. In general, persons receiving the minimum appear to have relatively low incomes, with an estimated 50 percent higher incidence of poverty than the average person 65 years of age and older. A reduction in the social security benefit for those with low incomes, however, is likely to be at least partly compensated by an increase in SSI, food stamps, and other benefits.

Savings to social security from eliminating the minimum (taking into account the increase in spouse and widow benefits) are estimated to be less than \$100 million in fiscal year 1980, rising to \$400 million in 1984. As noted above, this savings would be offset to some extent by increases in public assistance benefits elsewhere in the budget.

The current policy projections for student assistance contain a constant level of real resources (budget authority) for all programs. This assumes that the parameters of the Basic Educational Opportunity Grants program, which accounts for about two-thirds of the funding for student assistance, would be periodically expanded. If that program were to remain unchanged, however, the current policy projections would overestimate the

likely costs of the program in fiscal years 1982-1984. As it is currently constituted, the program should eventually decrease in size for two reasons. First, the eligible pool of students will diminish because of shifts in enrollments, an absolute decline in total enrollments, and an increase in the share of enrollment accounted for by part-time students. Second, fewer students will remain eligible because the program is based on needs; in general, family incomes are projected to increase more rapidly than college costs over the next few years, so financial need is projected to decline in the long run. If the current parameters for the basic grants program are maintained, the costs of the program will be \$0.8 billion lower by 1984 (see Table 13). Retaining the BEOG program in its current form, however, would alter not only the size of the program, but also its focus. In fiscal year 1979, the program was expanded to include approximately 1.4 million additional middle-income students. If the program's current parameters are maintained, these same students will gradually no longer be eligible because their families' improved financial condition will raise them above the program's definition of financial need. Therefore, the program would again become focused primarily on lower-income families.

The school lunch and other child nutrition programs currently provide benefits in the form of cash and food to subsidize lunches and breakfasts in schools to all children regardless of income, meals in summer camps and other summer programs, and meals served in residential child care institutes, day care projects, and juvenile detention institutions. School lunches and breakfasts are fully subsidized for children from families whose incomes are below 125 percent of the poverty level. The subsidy declines for children from higher-income families.

In the past, various proposals have been made to change the child nutrition programs. These included limiting the full subsidy to children from families with incomes below 100 percent of the poverty level with a declining subsidy up to 125 percent of the poverty level, eliminating the subsidies to summer camps, and eliminating the subsidies to child care and day care institutions. These reductions would save \$1.4 billion in fiscal year 1980, with the savings rising slightly in later years; they would reduce the number of children served by 8.1 million.

Forego initiatives assumed in the 1979 second concurrent resolution. The final category of possible cuts in the current policy projections includes program expansions anticipated in the second concurrent resolution for fiscal year 1979 that would be foregone. These include:

- o An expansion of the Early and Periodic Screening, Diagnosis and Treatment program in medicaid;

- o A further expansion in student assistance beyond the program already enacted; and
- o Other program expansions.

The characteristics of proposals to expand EPSDT have already been discussed. The anticipated supplemental appropriation for student assistance may not be necessary now that an authorization setting the parameters of the BEOG program for 1979 has been enacted. Additional program expansions anticipated in the resolution include a number of relatively small expansions for AFDC and civil service retirement.

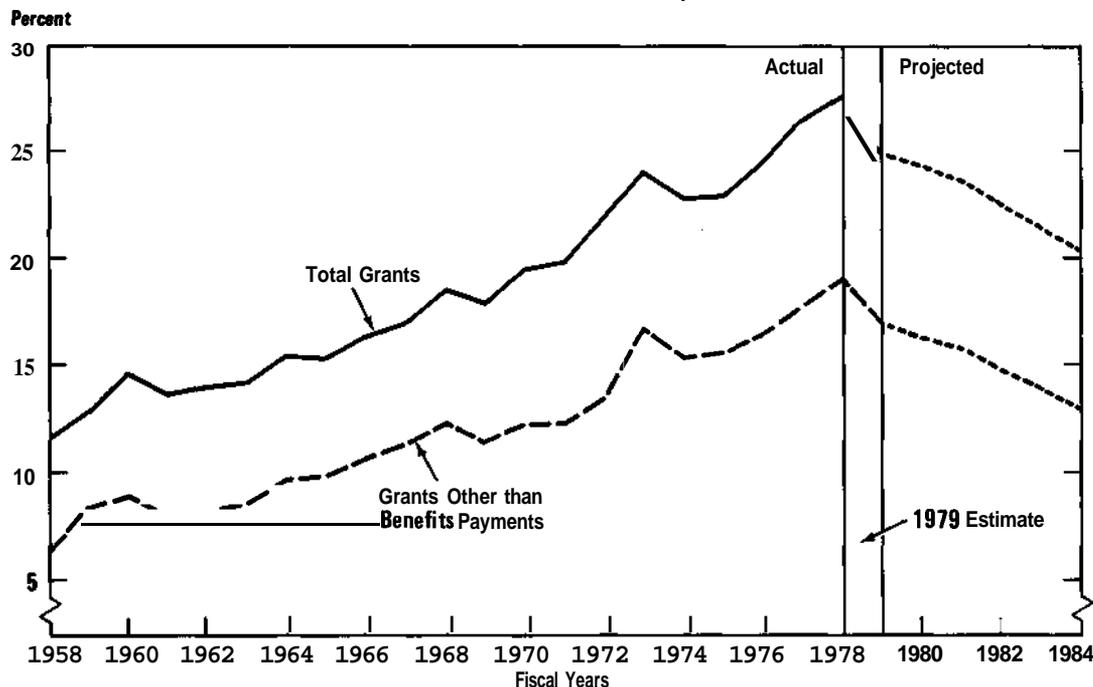
### Grants to State and Local Governments

In fiscal year 1978, grants to state and local governments comprised 17.4 percent of the federal budget. Of this total, roughly one-third was for programs that provided benefits to individuals--principally medicaid and AFDC. These programs were discussed in the previous section on benefit payments to individuals. The other two-thirds was for programs with a wide range of purposes: for example, assisting with the development of capital facilities (the federal-aid highways program and Environmental Protection Agency construction grants), supporting the delivery of services (aid to elementary and secondary education), or combating unemployment (the public service employment and countercyclical public works programs). Most grant programs are narrowly focused; they are designed to achieve specific objectives by funding programs administered at the state or local levels subject to federal guidelines. Some, most notably general revenue sharing, are somewhat different in that state and local governments are given greater discretion regarding the use of the funds.

The past 20 years have seen a dramatic rise in federal support of state and local governments. The proportion of state and local expenditures financed by federal grants increased from 11.7 percent in 1958 to over 26 percent in 1978 (see Figure 8). Much of the growth, particularly in recent years, has been in programs providing direct federal aid to local governments. Grants for benefit payments did not grow as fast as other grants during the period.

Under current policies, the importance of federal support for state and local governments is expected to decline over the 1979-1984 period. To a large extent, this is caused by the phasedown or expiration of antirecession programs such as public service employment, Antirecession Fiscal Assistance (ARFA), and local public works.

Figure 8.  
Grants as a Percent of State and Local Expenditures



The grants category is likely to be the source of many proposed spending increases over the next few years. If taxpayer movements, such as the one that spawned Proposition 13 in California, spread to other states, there may be an increased demand for federal assistance so that state and local government services can be maintained. The continued problems of older central cities also promise to be a source of continuing demand for increased federal aid. On the other hand, there have been proposals for cutbacks that could reduce federal aid below the current policy levels. These proposals are based on the rationale that the budgets for some state and local governments have shown operating surpluses, while the federal budget has been running large deficits. Some proposals to reduce federal aid assume that the surpluses will be run down, not that the services will be eliminated.

#### Possible increases

The Administration's urban policy, submitted in early 1978, included several proposals that could have an impact on future budgets. Among these

were supplementary fiscal assistance, labor-intensive public works, and the National Development Bank.

Supplementary fiscal assistance. Supplementary fiscal assistance would continue the flow of aid to distressed local governments that was terminated at the end of fiscal year 1978, when the ARFA program expired. The ARFA program was intended to provide funds to local governments facing fiscal difficulties because of high unemployment and the 1974-1975 recession. A bill that would have extended the ARFA program was passed by the Senate during the 95th Congress, but it was not voted on by the House. The bill would have made general purpose grants to state and local governments when national unemployment exceeds 6 percent, and would have provided supplementary fiscal assistance to the most hard-pressed local governments when the national unemployment rate drops to between 5 and 6 percent. The distribution of funds under this bill would have been more targeted than under the old program. If the bill were to become law effective in fiscal year 1980, it could increase outlays over current policy levels by \$0.4 billion in 1980, by \$1.3 billion in 1981, and by lesser amounts in succeeding years as the economy improves (see Table 14). 7/ If the trigger in the ARFA program were raised above 6 percent, outlays would be substantially lower.

"Soft" public works. The labor-intensive public works program proposed by the Administration in 1978 called for \$3 billion in budget authority over three years. The program was intended to provide jobs for the long-term unemployed and to aid local governments by financing the renovation and repair of public facilities. Although similar in many respects to the Antirecession Local Public Works program, the new program would not be oriented to new construction. If a "soft" public works program like the Administration's original proposal were enacted sometime in fiscal year 1979, it would have its greatest impact on the federal budget in fiscal years 1981-1983, adding \$0.8 billion, \$1.0 billion, and \$0.7 billion to current policy outlays in each of those years, respectively. 8/

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7/ The second concurrent resolution includes \$550 million for supplementary fiscal assistance in 1979, and the current policy projections include another \$550 million in 1980.

8/ The House has interpreted the 1979 second concurrent resolution as containing \$750 million in budget authority for such a program. The Senate, however, has interpreted this budget authority as being for disaster loans. The current policy projections treat the \$750 million as a one-time allowance for miscellaneous requirements.

TABLE 14. POSSIBLE INCREASES IN OUTLAYS FOR GRANTS TO STATE AND LOCAL GOVERNMENTS ABOVE CURRENT POLICY PROJECTIONS: BY FISCAL YEAR, IN BILLIONS OF DOLLARS

	1980	1981	1982	1983	1984
Supplementary Fiscal Assistance/ ARFA Extension <u>a/</u>	0.4	1.3	1.0	0.6	0.5
"Soft" Public Works	0.3	0.8	1.0	0.7	0.2
National Development Bank <u>b/</u>	0.1	0.7	1.0	1.2	1.3
Taxable Municipal Bonds (net cost)	0.1	0.4	1.2	1.8	2.4
Jobs Programs for Unemployed Welfare Recipients	0-0.5	1-2	2-3	2-3	3-4
Federal-Aid Highways	--	--	--	0.5	0.8

a/ Antirecession Fiscal Assistance program.

b/ All outlays attributable to the bank proposal are included, even though some should not be classified as grants to state and local governments.

National Development Bank. Under the Administration's proposal, a new financial institution would be established to attract private investment in economically distressed areas, hence providing jobs to the unemployed and adding to the tax base of distressed governments. To achieve this objective, a National Development Bank would guarantee loans to private businesses, subsidize interest rates, provide grants covering part of the costs of the business investment, and establish a secondary market for business loans. If the Congress establishes the bank in the form proposed by the Administration, budget outlays could rise over current policy levels by \$0.2 billion in 1980, by \$0.7 billion in 1981, and greater amounts in future years. Although these outlays would, for the most part, go directly to private businesses, public local development authorities would be closely involved in all aspects of the bank's operations.

Taxable municipal bonds. In 1977 and 1978, the Administration proposed legislation that would subsidize the borrowing costs of state and local governments if they issue taxable bonds instead of tax-exempt ones. The **effect** would be to replace the indirect subsidy currently provided through the tax exemption of interest earned on municipal securities with a direct subsidy. There are two **reasons** for doing this. First, the option to offer a taxable municipal bond should make it easier for state and local governments to finance their activities, since tax-exempt organizations such as pension funds or foundations, which generally do not now invest in tax-exempt securities because of their low interest rates, might be interested in taxable securities. Second, all state and local governments might find their cost of borrowing reduced if some state and local governments switched from nontaxable bonds to taxable bonds. The supply of tax-exempt bonds would be reduced, thus lowering the interest rate at which these bonds would have to be **offered**. Any subsidies paid by the federal government to state and local governments to cover the higher interest cost associated with taxable bonds would be partially **offset** by revenue gains attributable to the taxes that would be paid on interest earned by holders of the securities. Even so, it is estimated that the net cost of a taxable municipal bond option similar to recent proposals would reach **\$2.4 billion** by fiscal year **1984**.

Jobs program. As discussed earlier, a possible option in the area of welfare involves providing public service jobs to unemployed welfare recipients. A jobs program of this kind would build up to 300,000 jobs by fiscal year **1984**. If this program was adopted as an add-on to the existing public service employment program, it would increase outlays by \$3 to \$4 billion in 1984. If the program was substituted for the current program, there would be no net change in outlays.

Federal-aid highways. Near the end of the 95th Congress, a surface transportation bill was enacted, which set the budget authority for the federal-aid highways program through fiscal year 1982. The new law provides for significant increases in 1979, 1980, and 1981; in 1982, however, it has a drop of \$1.2 billion for some programs. No explicit reason is given for the cut. It is likely that, as 1982 draws near, pressure will mount for a new bill with appreciably larger numbers for 1982 and beyond. The lag between budget authority and outlays in the highway programs is such that changes in the law would not appreciably affect the outlay totals until 1984, when the increase could be as much as \$0.8 billion. The additional funds would most likely be used for repair and rehabilitation of the Interstate Highway System, as well as for its timely completion, and for the bridge rehabilitation and replacement program. Opponents of future increases are likely to argue that the viability of the Highway Trust Fund is already being called into question because of the new **law--under** which budget authority exceeds estimated receipts for the next few **years--and** that further increases would only exacerbate the problem.

## Possible cuts

A wide range of cuts in federal grants to state and local governments have been proposed. Some of these reductions would affect particular programs—such as the general revenue sharing program and the Comprehensive Employment and Training Act (CETA) program--whereas others would be more across the board in nature.

General revenue sharing. The general revenue sharing program expires in fiscal year 1981, but the Administration is expected to submit a proposal to reauthorize it sometime in 1979. The current policy projections assume extension of the program, with an adjustment for inflation, in fiscal years 1982-1984. Among the alternatives that have been discussed are eliminating the program, eliminating the state part of the program, or maintaining the program but only providing for a constant level of outlays with no adjustment for inflation. The rationale put forward for eliminating the state part of the program is that local governments are in greater need of assistance than are states, many of which have run budget surpluses in recent years. (Also, the loss to states of general revenue sharing might be offset by the fiscal relief accorded by the passage of welfare reform.) Eliminating the state part of the program would save more than \$2 billion a year (see Table 15).

The current law authorizing the general revenue sharing program set a constant level of grants between 1977 and 1980. Because of inflation, the support provided to state and local governments has declined in real terms. The current policy projections for 1981-1984 contain adjustments for inflation and consequently would maintain the real level of support provided by the program over that period. <sup>9/</sup> If adjustments were not made for inflation, there would be a saving under current policy projections of \$0.5 billion in 1981, rising to \$2.2 billion in 1984.

Eliminate Title VI of CETA. The Congress passed a revised Comprehensive Employment and Training Act in 1978. The new law authorizes funding for training and for public service jobs for the structurally and cyclically unemployed. The number of slots funded by Title VI of the act--the countercyclical employment program--is directly related by statutory formula to the unemployment rate and the number of unemployed

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<sup>9/</sup> As a general rule, for discretionary programs, current policy projections hold the real level of resources constant. If the level of resources has already been set for some of the future years, the rule is to hold the real level constant, starting in the first year after expiration.

TABLE 15. POSSIBLE CUTS IN OUTLAYS FOR GRANTS BELOW CURRENT POLICY PROJECTIONS: BY FISCAL YEAR, IN BILLIONS OF DOLLARS

	1980	1981	1982	1983	1984
Eliminate General Revenue Sharing to States	—	-2.4	-2.6	-2.8	-3.0
Hold General Revenue Sharing Constant in Nominal Terms	--	-0.5	-1.0	-1.6	-2.2
Eliminate Title VI of CETA	-4.3	-5.8	-5.4	-5.1	-4.5
Reduce Funding for CETA Countercyclical Jobs (Title VI)	-2.2	-4.1	-3.4	-5.1	-4.5
Forego Initiatives Assumed in 1979					
Second Concurrent Resolution					
Supplementary fiscal assistance	-0.6	--	--	--	--
Mass transit	-0.1	-0.2	-0.2	-0.2	-0.1
Elementary and secondary education	-0.2	-0.3	-0.3	-0.3	-0.3
Other	-0.5	-0.6	-0.7	-0.7	-0.8
Limit Discretionary Inflation Increases					
Transportation	--	-0.1	-0.1	-0.2	-0.3
Community development	--	--	-0.1	-0.2	-0.3
Employment and training	-0.3	-0.6	-0.9	-1.2	-1.5
Other	-0.1	-0.6	-1.1	-1.7	-2.3

individuals. The new law has not been fully implemented in fiscal year 1979 because the Congress has not yet passed an appropriation; CETA is currently operating under a continuing resolution for fiscal year 1979.

Some criticism has been leveled at CETA public service employment; the reasons cited have been problems in management and targeting as well as a failure to provide productive jobs or meaningful training opportunities. One budget option would be to eliminate the countercyclical public service employment program under CETA in fiscal year 1980, thus eliminating

458,000 public service employment jobs in that same year. This would result in savings of \$4.3 billion under current policy projections in fiscal year 1980.

Eliminating the countercyclical public service employment program could result in decreased employment opportunities for eligible individuals who are from families living at or below the Bureau of Labor Statistics' lower living standard or who are receiving welfare assistance. There has been controversy, however, over the extent to which the program has actually provided opportunities for those who would not otherwise have found employment. It has been estimated that the total unemployment rate would increase by as much as 0.2 percentage points if the Title VI program were eliminated. The actual increase would depend on how much job substitution occurred and what fiscal policies were set by state and local governments--matters that have also been controversial.

Reduce Funding for Title VI of CETA. Totally eliminating Title VI jobs as of September 30, 1979, would result in major layoffs. A more gradual phaseout, however, in which most jobs were eliminated through attrition, could avoid much of the economic distress that would result from such an abrupt policy change. Therefore, another budget option would be a lesser reduction in the number of slots funded under countercyclical public service employment. If the number of slots were cut by 50 percent to 229,000, potential savings would be \$2.2 billion below current policy projections. To the extent CETA prime sponsors could keep wage costs below the mandated average, more than 229,000 slots could be funded while maintaining the \$2.2 billion savings.

Forego initiatives. If the Congress were to forego supplementary fiscal assistance, increased operating subsidies for existing mass transit systems, funding for new elementary and secondary education grants for districts with high concentrations of lower-income children, and an increase in the ceiling for social services grants, it could reduce outlays by \$1.4 billion in fiscal year 1980. Funds for all these programs were allowed in the second concurrent resolution for 1979, and they are included in the current policy projections.

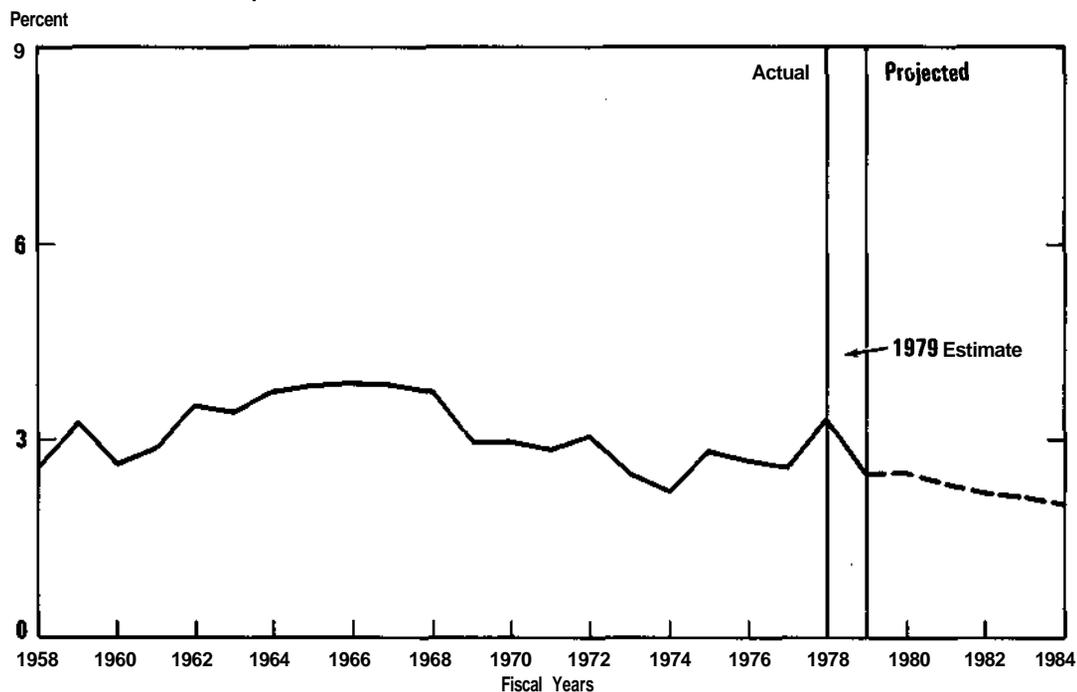
Limit increases. Across-the-board cuts in federal grant programs are also a budget option. One such possibility would be to limit discretionary inflation adjustments for these programs to two-thirds of the rate of inflation. Although the effects of such a cut would be felt throughout the budget, the largest impact would be in transportation, community development, education, employment and training, and revenue sharing. In transportation, the subsidy level for the operations of mass transit systems would be lower in real terms. The reduction for community development would be primarily for the block grant program. Since that program provides general

purpose grants to local governments, the effects of the cut would be somewhat diffuse. For employment and training programs, the result of a cut would be a decrease in training and employment slots; the scope of the decrease would depend on average wage costs within the CETA program, the extent of job substitution, and fiscal policy responses of state and local governments to a loss of federal funds.

### Other Federal Operations

A final category of spending--labeled "other federal operations"--includes various federal programs, most of which provide public goods and services, such as space exploration, energy research and development, and the maintenance of national parks. Farm price supports are also included in this category. As with national defense, the resources used by the federal government in providing the goods and services in this category can be approximated by taking outlays for other federal operations as a percent of GNP. Since fiscal year 1958, other federal operations as a percent of GNP has hovered around 3 percent (see Figure 9). If current policies are continued, and if programs are not expanded in real terms, spending as a percent of GNP will decline slightly.

Figure 9.  
Other Federal Operations as a Percent of GNP



### Possible increases

Other federal operations includes many activities of the federal government that are relatively small in size, but when combined add up to over \$60 billion a year. Among the largest program areas are energy, farm price supports, space exploration, and some transportation programs. Civilian agency pay--that is, pay for federal employees in agencies other than the Department of Defense--is also included in this category.

Strategic petroleum reserve. In the energy area, the current policy projections assume spending in fiscal years 1980-1984 for a 500-million-barrel strategic petroleum reserve. The reason for such a reserve is that it would provide partial protection for the U.S. economy against the disruptive effects of production restrictions similar to the Arab oil embargo that occurred from October 1973 to March 1974. Recent analysis by the Congressional Budget Office indicates that, if a year-long embargo occurred in 1982, a 500-million-barrel reserve—as compared with a 250-million-barrel reserve--could avert a loss in GNP in 1982 of \$200 billion or more, depending on the extent of the restrictions. <sup>10/</sup> Reserves larger than 500 million barrels would increase the protection. The currently authorized goal is for a 1-billion-barrel reserve, but funds have been appropriated only for a 500-million-barrel reserve. If funds are appropriated for the larger reserve, outlays would be increased significantly in fiscal years 1983 and 1984. By fiscal year 1984, the larger reserve could add \$2.2 billion to spending. Total program costs would increase by about \$9.3 billion. Because the pace of spending for this program has been relatively slow, appropriations for a 1-billion-barrel reserve would have little effect on 1980 outlays. The final determination of how desirable a larger reserve would be will depend on an analysis of the increase in costs versus the increase in benefits in the event of production restrictions, together with an assessment of the likelihood of future restrictions.

Energy activities. The 1979 second concurrent resolution anticipated additional funding for energy activities beyond that already appropriated. Fifteen programs, ranging from coal research to operating expenses for magnetic fusion, were under active consideration for funding. The resolution, however, reflects funding for only some of these authorizations, and thus the current policy projections would not accommodate all of them. If these new programs were fully funded, spending would increase above

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<sup>10/</sup> The Economic Impact of Oil Import Reductions, prepared by the Congressional Budget Office for the Senate Committee on Energy and Natural Resources, 95 Cong. 2 sess. (1978).

projections by \$0.2 billion in fiscal year 1980 and by \$0.4 billion in fiscal years 1983 and 1984 (see Table 16).

TABLE 16. POSSIBLE INCREASES IN OUTLAYS FOR OTHER FEDERAL OPERATIONS ABOVE CURRENT POLICY PROJECTIONS: BY FISCAL YEAR, IN BILLIONS OF DOLLARS

	1980	1981	1982	1983	1984
1-Billion-Barrel Strategic Petroleum Reserve	--	--	--	0.3	2.2
Funding for New Energy Activities	0.2	0.3	0.3	0.4	0.4
Solar Satellite Research and Development	—	0.1	0.1	0.1	0.1
Fifth Space Shuttle Orbiter	—	0.1	0.2	0.2	0.2
Dairy Price Supports	0.1	0.2	0.2	0.2	0.2
Airport Noise Reduction	0.4	0.4	0.5	0.6	0.7
Census Programs	0.1	0.1	0.1	0.1	0.1

Solar satellite research and development. In fiscal year 1979, the House of Representatives authorized \$15 million for a demonstration program for solar satellite research and development. The long-range purpose of the program would be to build satellites with solar panels that would convert solar energy into microwaves. These would, in turn, be transmitted back to earth and converted to electricity. According to preliminary estimates, this program could cost as much as \$100 million a year in fiscal years 1981-1984.

Space shuttle orbiter. The Congress has yet to reach a final decision on whether to fund a fifth space shuttle orbiter. Funds for some items with long lead times were included in the 1979 appropriation to avoid potential

delays and cost increases if a decision is made to go ahead with full procurement. The fifth orbiter is not likely to be an issue in 1980. If final approval were given in 1981, the estimated increase in outlays in 1982-1984 would be about \$200 million a year.

Dairy price supports. Estimates for farm price supports in future years are highly uncertain. Changes in assumptions about administrative actions, yields, exports, domestic use, or producers' behavior can increase or decrease outlays by several billion dollars in any year. One potential increase above the current policy spending projection involves dairy price supports. Legislation setting the minimum support level at 80 percent of parity expires at the start of fiscal year 1980, at which time the minimum level becomes 75 percent, unless modified by the Administration or the Congress. If the actual level were to remain at 80 percent of parity throughout the projection period rather than 75 percent, outlays would increase above projections by about \$0.1 billion in fiscal year 1980 and by about \$0.2 billion thereafter.

Miscellaneous increases. Federal outlays for the retrofit of aircraft to reduce airport noise and for the decennial census and the newly approved mid-decade census may also rise above current policy projections. Although the projections for periodic censuses contain funds for the mid-decade census, the costs may be considerably above those included in the projections, because of uncertainty surrounding the nature of this new census.

#### Possible cuts

Because other federal operations includes pay to federal employees in the nondefense agencies, some of the across-the-board reductions discussed in the national defense function apply here as well. These options include capping future federal payraises, forcing agencies to absorb 20 percent of the cost of federal payraises, and decreasing the number of federal employees by 3 percent a year. The 20 percent absorption would reduce outlays below current policy projections by \$0.3 billion in 1980-1981 and by \$0.4 billion in 1982-1984. A 5.5 percent cap on payraises plus the 20 percent absorption would lower outlays by \$0.6 billion in 1980, increasing to \$2.6 billion in 1984 (see Table 17).

The cap on federal payraises would result in a real decline in wages for federal workers in 1980, and would provide for payraises that fall short of comparability with the private sector in 1981 and 1982. Caps on payraises when combined with limits on retirement benefits may, in the long run, make recruitment and retention of personnel more difficult if the federal service fails to remain competitive with private sector employment.

TABLE 17. POSSIBLE CUTS IN OUTLAYS FOR OTHER FEDERAL OPERATIONS BELOW CURRENT POLICY PROJECTIONS: BY FISCAL YEAR, IN BILLIONS OF DOLLARS

	1980	1981	1982	1983	1984
Civilian Agency Payraise Absorption of 20 Percent	-0.3	-0.3	-0.4	-0	-0.4
Cap of 5.5 Percent on Payraises Plus 20 Percent Absorption	-0.6	-1.0	-1.6	-2.1	-2.6
Limit Discretionary Inflation Adjustment	-0.6	-1.6	-2.8	-4.1	-5.5
Forego Initiatives Anticipated in Second Concurrent Resolution					
Energy	-0.3	-0.6	-0.8	-0.9	-1.0
Natural resources	-0.4	-0.5	-0.5	-0.5	-0.6
Other	-0.2	-0.6	-0.4	-0.5	-0.4

The 20 percent payraise absorption most likely would be financed by cuts in purchases and probably would have little effect on the level of services.

Another across-the-board reduction would be to limit discretionary inflation increases for other federal operations to two-thirds of the cost. This limit would affect many programs throughout the budget. The categories of spending affected the most would be international affairs (economic aid and the Export-Import Bank), space exploration and space flight, energy supply, natural resources (water resources), education and employment (student loans), health (research), and veterans' medical care. The cuts would imply some real decline in programs. Because of the lag between appropriations and outlays, the reductions would not have significant effects on outlays or on the level of services provided by various federal programs until 1981 or 1982. By fiscal year 1984, however, outlays would be reduced from the current policy projection by over \$5 billion.

The second concurrent resolution contained funds for new programs or program increases--particularly for energy and natural resources--that have yet to be enacted. The anticipated requirements for energy are

primarily for the various energy supply projects that were under active consideration at the end of the 95th Congress. The bulk of the natural resources funds are for water resource projects, including many of the projects vetoed by the President near the end of the 95th Congress.

## FEDERAL REVENUES

In fiscal year 1979, federal revenues are estimated to be 19.7 percent of GNP. If current laws were to remain in **effect**, this percentage would rise to 21.9 percent by fiscal year **1984**, the highest percentage since World War II. Over the past 20 years, revenues have exceeded 20 percent of GNP only twice: in fiscal years 1969 and 1970, following the passage of the 10 percent income tax surcharge in the Revenue and Expenditure Control Act of 1968 (see Figure 10).

As discussed in Chapter I, some changes to the current policy baseline, in the form of tax cuts or spending increases, are likely if the economic targets are to be achieved. On the revenue side, two of the major options are cuts in individual income taxes and in social security taxes. Changes in business taxation and the President's "real wage insurance" proposal could also **affect** revenues **significantly**. Other tax options that are related primarily to policy goals other than overall economic **growth--such as employment tax credits, tuition tax credits, and energy taxes--are** likely to have smaller effects on revenue.

### Individual Income Taxes

As was pointed out in Chapter II, because of the graduated tax structure, individual income taxes rise faster than taxable personal income. 11/ Historically, the Congress has enacted frequent tax reductions that offset the effects of this increase and that stimulated growth in the economy (see Figure 11). Tax cuts were enacted in **1964**, 1969, 1971, 1975, 1976, 1977, and 1978. It is likely that major tax policy initiatives over the next five years will include proposals to cut individual income taxes.

The projected increase in individual income taxes under current policies stems chiefly from the interaction of inflation and the graduated

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11/ The term "taxable personal income," as used in this report, includes wages and salaries, **proprietor's** income, dividends, rental income, and personal interest income.

Figure 10.  
Federal Revenues as a Percent of GNP

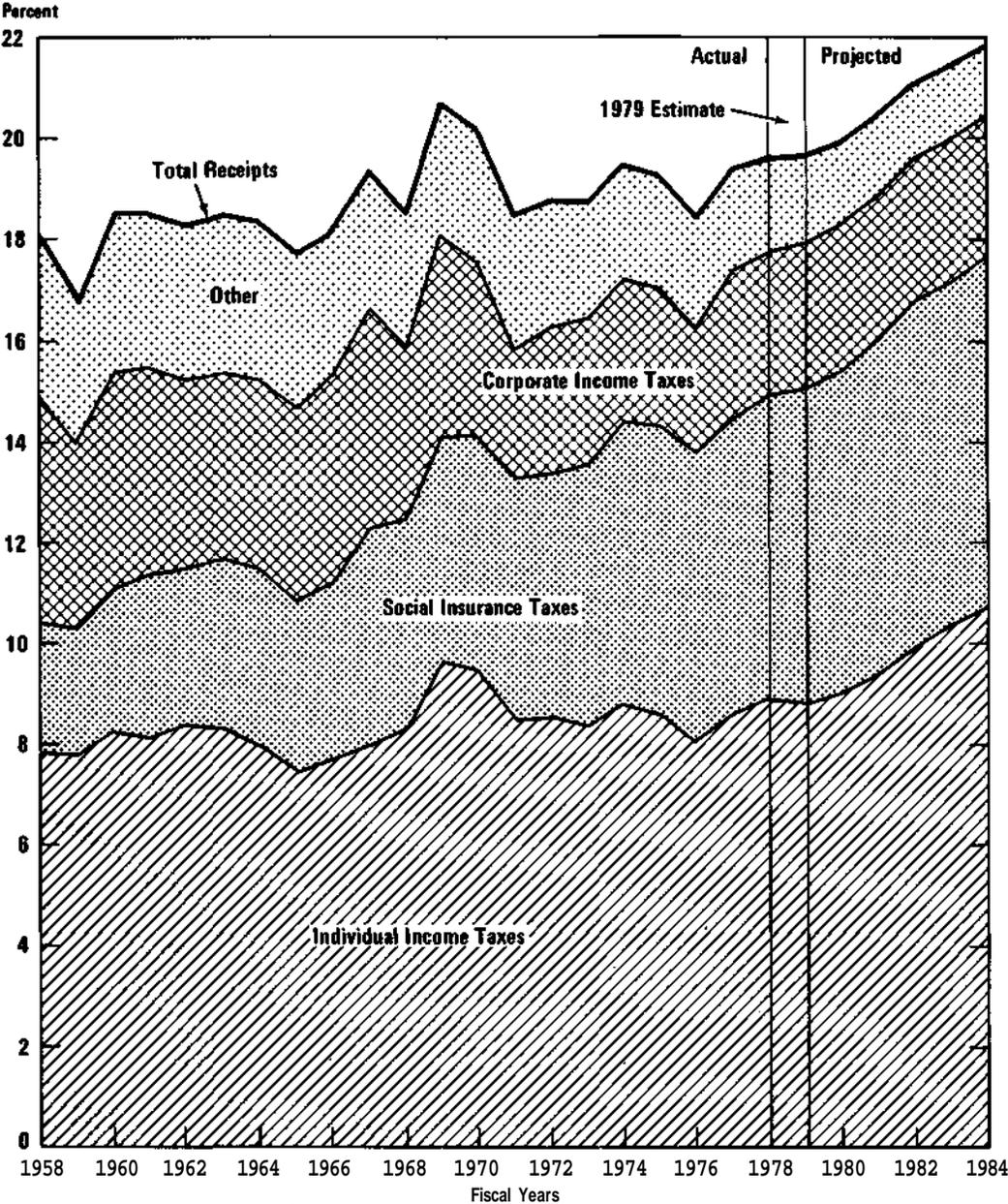
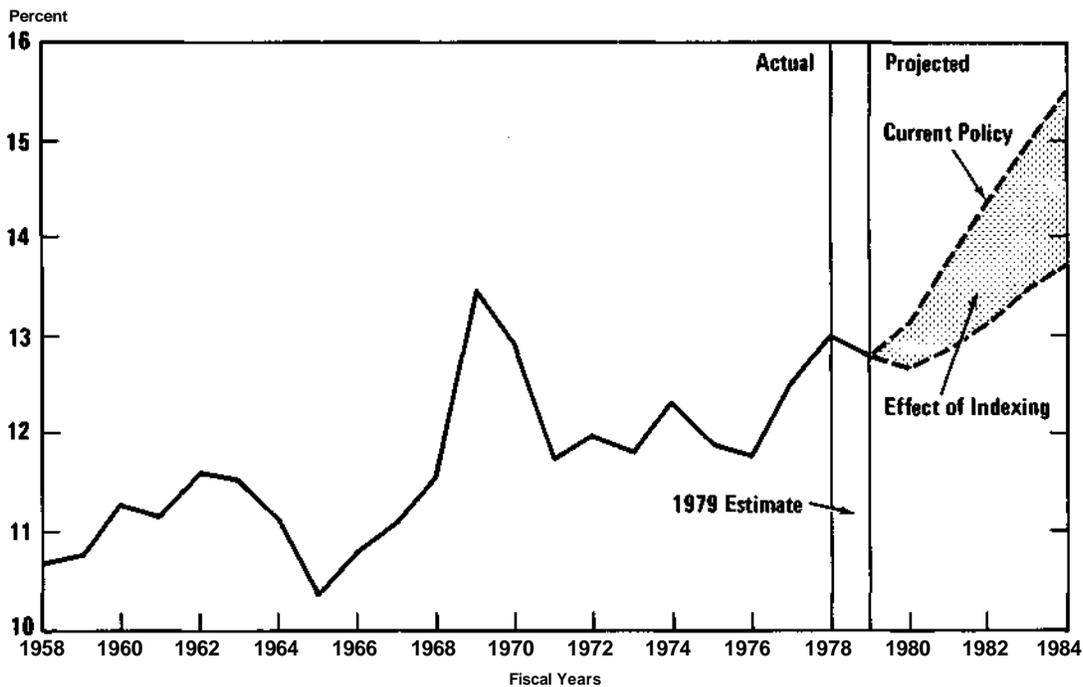


Figure 11.  
Individual Income Taxes as a Percent of Taxable Personal Income



tax structure. Without a legislated cut in taxes, disposable after-tax personal income would actually decrease over the next five years for individuals whose wages just keep pace with inflation. A frequent proposal for dealing with this problem is to index the individual income tax for inflation. This would reduce revenues below current policy levels by an amount equal to the extra gain in revenues attributable solely to the disproportionate response of the graduated tax structure to inflation. Such indexing would reduce revenues by \$8 billion in fiscal year 1980 and by \$47 billion in 1984 (see Table 18).

Even if individual income taxes were indexed to inflation, however, projected individual income tax revenues would still take a larger percentage of personal income in 1984 than in 1980 because of real growth in personal incomes. This real growth, which pushes taxpayers into higher tax brackets just as inflation does, would increase taxes as a percent of personal income from about 12.7 percent in 1980 to about 13.7 percent in 1984 (see Figure 11). To offset this increase and to hold taxes as a percent of personal income constant over the five-year period would require additional

TABLE 18. POSSIBLE CUTS IN INDIVIDUAL INCOME TAXES BELOW CURRENT POLICY PROJECTIONS: BY FISCAL YEAR, IN BILLIONS OF DOLLARS

	1980	1981	1982	1983	1984
Indexing to Inflation	-8	-17	-26	-36	-47
Further Reductions to Hold Average Tax Burden Constant		1	7	15	24

reductions in revenues beyond those for indexing to inflation. These additional revenue cuts would amount to \$1 billion in 1981, rising to \$24 billion in 1984 (see Table 18).

Tax cuts to offset the increase in revenues resulting from inflation could, of course, be made by periodic ad hoc reductions like those enacted over the last 15 years rather than by automatic indexing. Across-the-board rate reductions, such as those proposed in the Roth-Kemp bill in the 95th Congress (but of smaller magnitude), are also possible. <sup>12/</sup>

#### Social Security Taxes

The 1972 and 1977 amendments to the Social Security Act established a schedule for increases both in the wage base on which taxes are computed and in the tax rates. Under the economic assumptions in Chapter I, the wage base would increase from \$17,700 in 1978 to \$37,000 by 1984. The tax rates for both employers and employees rise from 6.13 percent in 1979 to 6.7 percent in the 1982-1984 period. These scheduled changes cause social insurance revenues to increase rapidly during the projection period. Social insurance taxes as a percent of wages and salaries are projected to rise from 11.9 percent in fiscal year 1979 to 13.0 percent in 1984.

<sup>12/</sup> For a detailed analysis of the Roth-Kemp bill, see Congressional Budget Office, An Analysis of the Roth-Kemp Tax Proposal, Background Paper (October 1978).

The first increases legislated by the 1977 amendments went into effect on **January 1, 1979**. The average worker found his annual payroll taxes increased by less than \$15. Workers earning more than the 1978 maximum of \$17,700 could have their taxes increased by as much as \$260 in 1979. The additional revenues resulting from the 1977 amendments are estimated to be \$11 billion in fiscal year 1980 and would reach \$29 billion by fiscal year 1984 (see Table 19).

TABLE 19. EFFECTS ON REVENUES OF A CANCELLATION OR DELAY IN 1980-1982 SOCIAL SECURITY TAX INCREASES: BY FISCAL YEAR

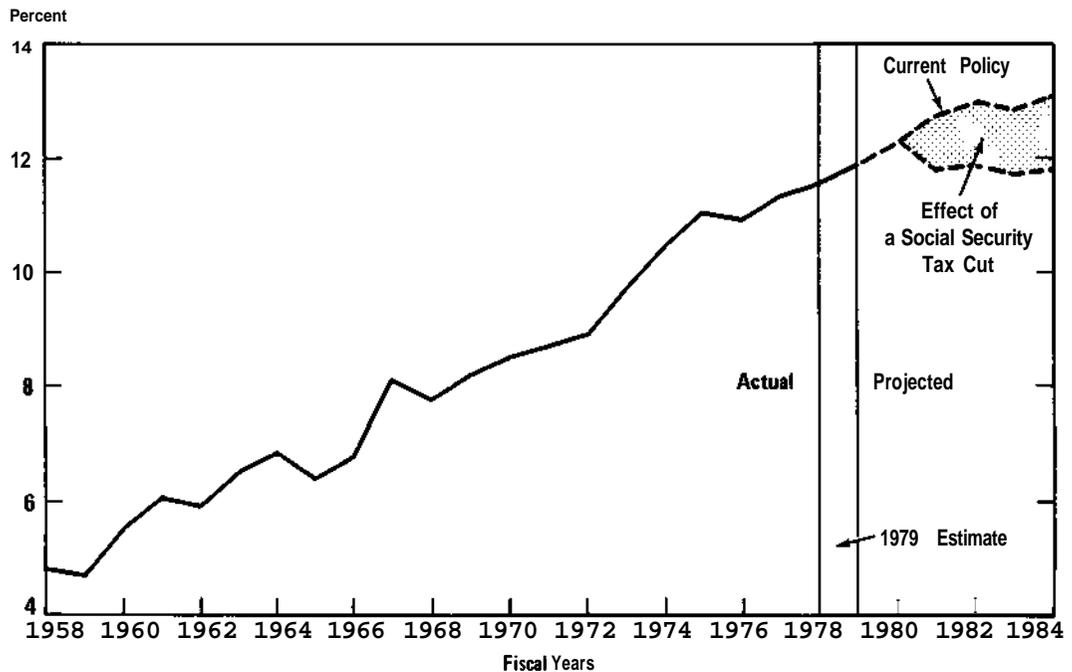
	1980	1981	1982	1983	1984
Revenue Increases Contained in 1977 Amendments	11	17	25	28	29
Reduction from Revenue Increases Contained in 1977 Amendments Caused by Freezing Rate in 1981 and Allowing Gradual Increase in the Taxable Maximum	—	-14	-19	-22	-25
Revenue Increases Following Rollback	11	3	6	6	4

The scheduled increases in social security taxes are meant to provide sufficient revenues to fund expected outlays in the Old Age and Survivors Insurance (OASI) and Disability Insurance (DI) programs over the next 40 years. Since the passage of the 1977 amendments, however, concern has grown over the effects of the tax increase on individuals and the economy. The scheduled increases in payroll taxes could reduce employment and consumer demand. Another concern is that the payroll tax increases may aggravate inflation at a time when prices are already increasing at too rapid a rate.

During the 95th Congress, several proposals were introduced that would have cut social security taxes by rolling back all or part of the increases contained in the 1977 amendments or by changing the method of

financing for the OASI, DI, and hospital insurance programs. This report is not intended to examine these alternatives. It may be useful, however, to show the effects on revenues of one possible reduction in social security taxes. If the social security payroll tax rate was frozen at 6.13 percent starting in fiscal year 1981 while the taxable maximum was allowed to increase with inflation, the resulting tax cut would be equivalent to a rollback of about three-quarters of the increase approved in 1977 (see Table 19). Such a rollback would reduce social insurance revenues as a percent of wages and salaries from 11.9 percent in fiscal year 1979 to 11.8 percent in fiscal year 1984 (see Figure 12).

Figure 12.  
Social Insurance Taxes as a Percent of Wages and Salaries



In order to maintain the soundness of the social security system, any such reduction in social security taxes would probably have to be accompanied by reductions in benefits or by some alternative method of financing. Several alternatives have been suggested, including contributions from general revenues (which would require smaller income tax cuts or possibly even income tax increases) or some new source of revenue, such as a value-added tax.

A rollback in social security taxes would have somewhat different **aggregate** economic effects than a reduction in individual income taxes. Income tax and social security tax cuts of equal size for employees would each provide about the same degree of overall economic stimulus. If the part of social security taxes paid by employers were also cut, however, a large part of the cut would probably be passed on to consumers in the form of lower prices. CBO has estimated that a \$10 billion decrease in payroll taxes, divided equally between employers and employees, could lead to a 0.35 percent reduction in the price level after about one year. Based on this analysis, a social security tax rollback of the size shown in Table 19 could reduce the level of the CPI by about 0.5 percent in 1981, and by 0.3 percent in 1984. The effect on economic growth of a cut in social security taxes on employers and employees would be about the same as an income tax cut of the same size.

### Corporate Income Taxes

Current policy projections for corporate income taxes do not rise as rapidly as those for individual income taxes and social insurance taxes. Corporate income taxes as a percent of corporate profits are projected to decline by fiscal year 1984, largely because of the reduction in the corporate rates enacted in the Revenue Act of 1978. Although inflation has less impact on the corporate tax than it does on the individual income tax, there is concern that current tax allowances for depreciation on business machinery and equipment may be too low during periods of rapidly rising prices. Proposals to allow more generous allowances for depreciation are therefore likely to be considered in the 96th Congress. These proposals could result in significant tax reductions.

### Other Tax Policy Issues

The use of taxes or tax credits to further policy goals other than those related to aggregate economic growth has been increasing in recent years. The 1978 tax and energy bills alone contained new or increased tax credits designed to encourage the hiring of the hard-core unemployed, rehabilitation of older commercial and industrial buildings, home insulation, the purchase of solar energy equipment, child care, pollution control, political contributions, oil drilling, and van pooling. Bills providing tax credits for tuition passed both the House and the Senate in 1978, but they were not finally enacted. As more attention is focused on restricting direct federal spending, there may be more proposals to use the tax system to provide incentives to stimulate specific kinds of economic and social activities. The revenue losses that result from these tax incentives must be

taken into account in the budget, however, just as the costs of direct spending programs must be.

The revenue losses from such tax expenditure proposals can be substantial. For example, the tuition tax credit proposals passed by the House and the Senate in 1978 would have resulted in revenue losses ranging from \$0.5 to \$1.1 billion in fiscal year 1980, to as much as \$1.4 billion in 1984 (see Table 20). Even larger losses would have resulted from more generous tax credit options considered earlier in the year. Some of the latter options also would have affected outlays, since the credit was refundable to individuals whose credit exceeded their liability for tax.

TABLE 20. EFFECTS ON REVENUES OF 1978 TUITION TAX CREDIT PROPOSALS: BY FISCAL YEAR, IN BILLIONS OF DOLLARS

	1980		1981		1982		1983		1984	
Range for House and Senate Bills and Conference Report	-0.5 to -1.1		-1.0 to -1.4		-0.8 to -1.4		0 to -1.5		0 to -1.4	
Larger Tax Credit Options	-0.5	-1.1	-1.2	-2.6	-1.	-4.1	-2.2	-4.9	-2.5	5

Tax expenditures often tend to distribute proportionately more benefits to wealthy taxpayers than to the poor or middle-income taxpayers. For example, in the final version of the tuition tax credit bill presented to the 95th Congress, only 13 percent of the benefits would have gone to families or individuals with incomes below \$15,000, whereas 54 percent of the benefits would have gone to families or individuals with incomes above \$25,000.

#### Real wage insurance

President Carter's "real wage insurance" proposal is likely to be one of the first tax proposals to come before the 96th Congress. Under the President's plan, groups of workers who agree to hold their average wage increases below 7 percent would receive a tax credit or rebate if the overall rate of inflation exceeds 7 percent. According to Administration estimates, which are currently being reviewed by CBO, the cost would be about \$5 billion in lost revenues for each percentage point of inflation over 7 percent.

## Energy taxes

In April 1977, the Administration proposed a crude oil equalization tax designed to raise the price on domestic crude oil--which is currently subject to price controls--to approximately the world price. Over time, consumers were expected to respond to this increased price by conserving petroleum or substituting alternative energy sources that would decrease oil imports. To maintain consumer real income, the entire tax was to be rebated, partly on a per capita basis and partly to individuals who consume fuel oil for home heating. Although the Administration's proposal was passed by the House, it was not enacted into law during the 95th Congress.

The existing mandatory price controls on domestic crude oil are scheduled to expire on June 1, 1979, but the President retains discretionary authority to maintain controls until the expiration date of September 30, 1981. During this 16-month period, the President can modify the system, but any change resulting in full decontrol before 1981 has to be submitted to the Congress for review, with either house having the power of veto. Since the Administration is still committed to reducing oil imports by increasing the price of domestic oil, a new proposal is expected during the 96th Congress. This could involve a system of phased decontrol (which would require Congressional acquiescence, but not explicit approval) or some combination of decontrol and a tax on crude oil. Tax options to accompany decontrol run the spectrum from another crude oil equalization tax, to an excess or windfall profits tax, or a severance tax on crude oil. All of these options would require Congressional action. They would all increase the price of domestic oil paid by consumers to the world price, but they would return the revenues to oil producers, consumers, or both, through taxpayer rebates, "plowback" credits for investment in oil production, or similar devices. The distribution of revenues between producers, consumers, and government is one of the critical questions in the debate. The other major question is whether the potential energy savings, import reductions, and production increases that might result from the higher prices are worth the rise in inflation the increases would cause. The net effect on the budget of the tax would probably be negligible if the tax was rebated.



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## CHAPTER IV. ALTERNATIVE BUDGETARY STRATEGIES

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Any formulation of aggregate **multiyear** budget targets must somehow balance goals for the economy, the size of government, and the budget deficit. These goals must also be weighed against the demands for tax cuts, the provision of public goods and services by the federal government, the redistribution of income, and federal assistance to state and local governments. The budgetary strategies in this chapter are derived by:

- o Setting targets for spending, or for the size of government; and
- o Deciding on the trade-off between economic growth and budget deficits.

For example, under a contractionary budget policy, spending cuts could be used to lower the deficit while simultaneously slowing economic growth, or the spending cuts could be offset by tax cuts so that economic growth is not changed.

This chapter examines alternative budgetary strategies, using as a starting point three types of basic spending policies: a continuation of current policy, contractionary spending policies, and an expansionary spending policy. The presentation contains many point estimates and precise economic targets for future years merely to clarify the relationships between the alternatives. The tables should therefore be viewed as illustrations, rather than as CBO predictions, of where the economy and the budget will be **five years from now**.

### SPENDING STRATEGY 1--A CONTINUATION OF CURRENT POLICY

If a multiyear target for spending were set at current policy levels, federal spending would increase in absolute terms from about **\$495** billion in fiscal year 1979 to about **\$750** billion by fiscal year **1984**, but it would decrease from about 21.5 percent of the GNP to about **19.4** percent. Adopting this spending strategy would not preclude changing the emphasis or the mix of federal programs. For example, national defense could be expanded if other federal **activities--such** as the redistribution of income, aid to state and local governments, or other federal **operations--were** reduced. If 3 percent real growth in defense outlays was desired, no cuts from current policy would be needed in fiscal years 1980 or 1981. Starting

in 1982, however, the projected spending for the rest of the budget (about \$500 billion by that time) would have to be reduced. This could be done by across-the-board reductions, such as caps on federal payraises and changes in **cost-of-living** formulas for some federal benefit programs, or by targeted cuts, such as reductions in general revenue sharing and cuts in public service employment. Since most of the proposed spending increases have a small impact on outlays in fiscal year 1980, the offsetting reductions required by this strategy would probably not have to begin immediately.

With spending set at current policy levels, the economic growth targets discussed in Chapter I--namely, real growth averaging 3.9 percent in 1980-1984 and an unemployment rate of 5.6 percent by 1984--could probably be achieved only if tax cuts were enacted. The tax cuts consistent with this scenario for spending and economic growth would be approximately equal in magnitude to the effects of indexing the individual income tax to inflation and partially rolling back social security taxes. The budget deficit would decrease from about \$50 billion in fiscal year 1980 to a small surplus by 1983 (see Table 21).

TABLE 21. GOALS FOR THE ECONOMY AND THE BUDGET DEFICIT UNDER A CURRENT POLICY SPENDING STRATEGY

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Economic Goals (in percents)		
Real growth (average, 1980-1984)		3.9
Unemployment rate (1984)		5.6
Inflation rate (1984)		6.2
Budget Deficit		
1980 (in billions of dollars)		50
Year of budget balance		1983

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SPENDING STRATEGY 2--CONTRACTIONARY SPENDING POLICIES, CUTS BELOW CURRENT POLICY

Continuation of current policies is not the only possible scenario for spending over the next five years. Many policymakers have called for contractionary spending policies that would result in a more rapid decline in federal spending as a percent of GNP. The reductions could be across-the-board, targeted at **specific** programs, or some combination of both.

By fiscal year 1984, the largest component of the increase in current policy spending is the automatic adjustments to inflation. Discretionary inflation increases also have a significant effect on outlays. The tie between federal outlays for programs and past price movements--either by formal indexing as specified by law or by de facto indexing--gives a momentum to inflation similar to that imparted by cost-of-living escalators in the private sector. One method of implementing a contractionary budget policy would be to "decouple," to some degree, the response of federal outlays to inflation. This implies some of the budget options discussed in Chapter III, including:

- o Capping federal payraises at 5.5 percent in 1980 and limiting them to no more than 7 percent thereafter;
- o Limiting cost-of-living increases for retired federal employees to what would be given under a representative private sector retirement plan;
- o Capping at 5.5 percent the cost-of-living increase for social security that will be effective on July 1, 1979, and limiting further increases to no more than 7 percent;
- o Implementing hospital cost containment; and
- o Approving only two-thirds of the discretionary inflation adjustment for federal programs that are not indexed under current law.

A policy to decouple the response of federal outlays to inflation would result in real decline in the programs involved. Under such a policy, the incomes of the elderly and disabled would not keep pace with inflation, at least in 1980-1982. The pay increases for federal workers would fall short of comparability with the private sector in 1980 and 1981, and this could affect recruitment and retention of personnel. The effects of the discretionary inflation cuts would not be felt very much in fiscal year 1980 because of the lag between appropriations and outlays. Eventually, the cuts would probably somewhat diminish defense readiness and slow the pace of force modernization. The cuts would probably also slightly reduce the number of participants in both public service employment and federally sponsored training programs. Less money would be available for health research, space exploration, mass transit, and development of alternative energy sources. In fact, decoupling the response of the budget to inflation would result in some cuts in most federal programs. On the other hand, decoupling would reduce outlays by about \$11 billion in fiscal year 1980, and the savings would grow to \$49 billion by fiscal year 1984 (see Table 22).

TABLE 22. POTENTIAL CUTS IN OUTLAYS BELOW CURRENT POLICY PROJECTIONS UNDER SPENDING STRATEGY II: BY FISCAL YEAR, IN BILLIONS OF DOLLARS

	1980	1981	1982	1983	1984
Decouple the Response of Federal Outlays to Inflation	11	20	30	39	49
Forego Initiatives Assumed in 1979 Second Concurrent Resolution	4	5	5	6	7
Further Cuts	-10	-13	-13	-14	-15

Contractionary policies resulting in more severe cuts in 1980 are clearly possible; for example, federal payraises and other **cost-of-living** increases could be foregone completely. Although these policies would lower 1980 outlays, they are probably not desirable in the long run, since they would create much greater pressures for make-up or catch-up adjustments in later years.

Contractionary **spending** policies could also include cuts that are more targeted. One initial possibility is to forego action on programs anticipated in the second concurrent resolution for 1979 but not yet funded. This would lower current policy outlays by \$3 to \$4 billion in fiscal year 1980, with the savings growing to about \$7 billion by 1984 (see Table 22). Foregoing the funding of these programs would slow the pace of defense modernization, since investment in new weapons would probably be funded in the anticipated 1979 defense supplemental appropriation. Energy supply programs authorized under the national energy cut would not be funded. A program for supplementary fiscal assistance to state and local governments (or extension of the Antirecession Fiscal Assistance program) would be foregone. No expansion of Early and Periodic Screening, Diagnosis, and Treatment under medicaid would be approved.

The possibilities for further targeted cuts, by reducing or eliminating existing programs that have already been funded in fiscal year 1979, are numerous; some of these were discussed in Chapter III. For example, the countercyclical public service jobs program could be reduced or even

eliminated. General purpose revenue sharing could be limited to local governments only. The formulas for the basic grants program under student assistance for higher education could be left **unchanged**--a strategy that would reduce the number of eligible students and eventually change the emphasis of the program back to the support of low-income students only, as family incomes rise. Various changes to social security, such as limiting benefits paid to a disabled worker and his family to 80 percent of the **worker's** average indexed monthly earnings before retirement, would result in relatively small savings in 1980, but the savings would grow significantly by fiscal year **1984**.

Contractionary budget policies might include a mix of some of the targeted cuts and the across-the-board cuts implied by decoupling the response to inflation. Suppose, for example, that spending targets consistent with decreasing the response of the budget to inflation were desired, but that 3 percent real growth in defense outlays was also sought. This could probably be achieved by decoupling in the nondefense areas, **foregoing** most of the nondefense initiatives assumed in the second concurrent resolution, and limiting general revenue sharing and countercyclical public service employment starting in 1982.

For illustrative purposes, two contractionary spending policies are shown in Table 23. One would provide for across-the-board cuts related to inflation adjustments and would forego the initiatives assumed in the second resolution. The savings under this option are about \$15 billion in fiscal year 1980, and they grow to about \$55 billion by **1984**. Spending as a percent of GNP would decline from 21.5 percent in 1979 to between 18 and 19 percent by **1984**, depending on whether the cuts are somewhat offset by tax cuts in order to sustain a high level of economic growth. A second, more severe contractionary policy cuts existing programs even further. The policy provides for various targeted cuts, such as eliminating countercyclical public service employment.

Contractionary spending policies could still be consistent with an economic growth target of 3.9 percent a year and an unemployment rate of 5.6 percent for fiscal year 1984, if the outlay reductions were converted to tax cuts. Among the possible tax cuts would be indexation of individual income taxes to inflation, cuts to keep individual income taxes as a percent of personal income at a constant level, and a partial rollback of the social security payroll tax. Under contractionary spending policies and real economic growth of **3.9 percent**, federal spending as a percent of GNP would decline more rapidly than under current policy, but the tax cuts needed to sustain economic growth would lead to a 1980 budget deficit of about \$50 billion and budget balance would still not be achievable until 1983 or 1984 (see Table 24).

TABLE 23. REDUCTIONS FROM CURRENT POLICY UNDER TWO CONTRACTIONARY SPENDING POLICIES: BY FISCAL YEAR

	1980	1981	1982	1983	1984
Reduce Inflation Adjustments and Forego Initiatives in 1979 Second Concurrent Resolution					
Reduction in billions of dollars	-15	-25	-35	-45	-55
Outlays as a percent of GNP	21	21	20	19-20	18-19
Reduce Inflation Adjustments, Forego Initiatives, Reduce Federal Employment, and Cut or Eliminate Selected Programs					
Reduction in billions of dollars	-25	-38	-48	-59	-70
Outlays as a percent of GNP	21	20-21	19-20	19-20	18-19

Reductions in federal spending are often proposed as a way of lowering the **deficit** and advancing the date **when** the budget would be balanced. The two goals of a smaller federal sector and a lower deficit probably require settling for lower economic growth.

Contractionary spending policies, when combined with weaker economic growth targets, could result in a lower deficit in 1980, an earlier date for budget balance, and a reduction in the inflation rate. The budget deficit in 1980 could be as low as \$30 billion, with budget balance being achievable by 1982, or possibly 1981 (see Table 24). The inflation rate under the assumption of weaker economic growth could drop to close to 4 percent by fiscal year 1984. These policies, however, would probably result in a 1984 unemployment rate of 6.5 to 7 percent, as compared with 5.6 percent under the stronger growth path.

If the growth in demand in the nonfederal sectors of the economy were assumed to be moderately strong for each of the alternatives, there would be no room for tax cuts under the weaker economic growth goals. On the other hand, if weaker economic growth goals were accompanied by weaker nonfederal demand, some tax cuts would be needed to reach the

TABLE 24. ALTERNATIVE GOALS FOR THE ECONOMY AND THE BUDGET DEFICIT UNDER THE CONTRACTIONARY SPENDING POLICIES

	Moderate Growth Target <u>a/</u>	Lower Growth Targets	
		\$15 Billion Cut in 1980	\$25 Billion Cut in 1980
Economic Goals (in percents)			
Real growth (average, 1980-1984)	3.9	3.4	3.1
Unemployment rate (1984)	5.6	6.5	6.9
Inflation rate (1984)	6.2	4.5	4.1
Budget Deficit			
1980 (in billions of dollars)	50-55	40	30-35
Year of budget balance	1983-1984	1982	1981

a/ It is assumed that spending cuts are offset by tax reductions, so that economic growth is unaffected.

growth targets. The date of budget balance could be postponed, probably by a year.

The options in Table 24 illustrate that the desired size of the federal sector and the appropriate economic stimulus from the budget are separable issues. It is possible to reduce the size of government by cutting spending without having a restrictive effect on overall economic activity, if such a spending reduction is accompanied by tax cuts.

### SPENDING STRATEGY 3--AN EXPANSIONARY SPENDING POLICY

The demands for program expansions are numerous. Spending increases have been proposed for almost every federal program, and new programs have been proposed as well. One possible spending strategy is to expand the role of government so that federal spending as a percent of GNP

would average between 21 and 22 percent over the next five years. The major components of such an expansion could include:

- o 3 percent growth in defense budget authority;
- o Catastrophic health insurance;
- o Expanded medicaid for Early and Periodic Screening, Diagnosis, and Testing;
- o Welfare reform composed of AFDC changes and a jobs program for welfare recipients;
- o A "soft" public works program; and
- o A 1-billion-barrel strategic petroleum reserve.

This expansionary spending strategy would not necessarily add significantly to current policy outlays in 1980. By fiscal year 1984, however, the spending increases would be about \$60 billion over current policy (see Table 25).

TABLE 25. ALTERNATIVE GOALS FOR THE ECONOMY AND THE BUDGET DEFICIT, UNDER AN EXPANSIONARY SPENDING STRATEGY

	Moderate Growth Target	Higher Growth Target
<b>Economic Goals (in percents)</b>		
Real growth (average, 1980-1984)	3.9	4.7
Unemployment rate (1984)	5.6	4.0
Inflation rate (1984)	6.2	8.7
<b>Budget Deficit</b>		
1980 (in billions of dollars)	50-55	50-55
Year of budget balance	1983-1984	—

An expansionary spending policy could be pursued within the context of the economic growth targets specified in Chapter I, in which case unemployment would decline to about 5.6 percent by 1984 and the budget would be balanced by 1983. There would, however, be no room for tax cuts under this policy, since the fiscal policy changes needed to achieve the economic targets would have been taken on the spending side. On the other hand, a higher economic growth target could be set, with unemployment declining to 4 percent by 1983, as specified in the Full Employment and Balanced Growth Act of 1978 (Humphrey-Hawkins Act). As seen in Table 25, the drawback in pursuing this higher growth path is that it would probably lead to significantly higher inflation rates--a rate of 8.7 percent in fiscal year 1984--and could increase the budget deficit to about \$60 billion by 1984.



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APPENDIXES

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APPENDIX A. SPECIAL ASSUMPTIONS FOR CURRENT POLICY PROJECTIONS

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The current policy projections are based on economic assumptions and an interpretation of the meaning of current policies. The basic economic assumptions used for the projections are contained in Chapter I. In order to make projections, however, certain specialized assumptions are necessary. These are delineated in this appendix. The extension of current policies generally means the extension of those programs assumed in the Second Concurrent Resolution on the Budget for Fiscal Year 1979. Since appropriations have already been made for most federal government programs for fiscal year 1979, the base for the projections was Congressional action to date (through the end of the 95th Congress), plus initiatives or supplementals that were assumed in the second concurrent resolution but have yet to be acted upon by the Congress.

SPENDING ASSUMPTIONS

Costs for many ongoing federal programs are related to specialized economic assumptions not shown in Chapter I. For example, **cost-of-living** increases for social security and supplemental security income are based on the rate of increase in the **CPI**, as measured by the percent change from the first quarter of one calendar year to the first quarter of the next. Table **A-1** contains some of the major specialized assumptions used for the projections of spending. The final set of assumptions in the table, the index of federal purchases, was not used to project any accounts, since the Congressional Budget Office uses specialized indexes and weights for almost every one of the several hundred accounts in the budget that contain federal purchases. This index in effect represents an implicit deflator for the projections of spending for these accounts.

The major methodological assumptions underlying the spending projections are the following:

- o The costs of a few federal programs (notably, general revenue sharing and the federal-aid highways program) are specified by existing law. Also, some programs, such as social services grants, have statutory ceilings on outlays. For these programs, the projections are based on current laws.
- o Some federal **programs--such** as social security, medicare, unemployment insurance, and interest on the public **debt--are**

TABLE A-1. ECONOMIC ASSUMPTIONS USED FOR PROJECTIONS OF SPENDING: PERCENT CHANGE

	1980	1981	1982	1983	1984
CPI (first quarter over first quarter)	8.1	7.3	6.8	6.5	6.2
CPI for Food (third quarter over third quarter)	7.8	7.2	6.8	6.4	6.2
CPI for Medical Services (second quarter over second quarter)	10.4	9.9	9.3	8.7	8.2
Index of Compensation per Manhour (fiscal year over fiscal year)	9.0	8.9	8.9	8.4	8.3
Federal Payraise	7.6	7.4	7.9	7.7	7.0
Defense Purchases (fiscal year over fiscal year)	7.7	7.5	7.3	7.2	7.5
Nondefense Purchases (fiscal year over fiscal year)	8.3	7.4	7.2	7.1	7.0

open-ended; that is, their costs are determined primarily by population changes or economic factors and are not reviewed annually by the Congress through the appropriations process. Other federal programs--such as medicaid, public assistance, and veterans' pensions--are also open-ended in the same sense, even though their funds are appropriated annually. Projections for these programs are based on specific economic assumptions and anticipated population changes.

- o Although the statutory authority for many federal programs will expire during the five-year projections period, authorizations are assumed to be renewed routinely, except for programs that are clearly of a one-time nature, such as temporary study commissions. In general, for federal programs with authorizations that expire during the projections period, the projections extrapo-

late into fiscal years 1980-1984 the same level of resources assumed for the second concurrent resolution. In most cases, provision of the same level of real resources was interpreted to mean the same level of real budget authority. Outlays for these discretionary programs were estimated by applying spendout rates to the budget authority levels. 1/ With few exceptions, the projections do not include funding for specific needs or projects, such as the Trident submarine. Rather, they hold constant the resources, such as procurement funds, that are devoted to general needs, like national security. No attempt was made in this analysis to determine what specific projects could be funded under these assumptions. 2/

- o The major exceptions to the preceding rule are programs that are assumed to be of a temporary nature and are projected to be phased out over the projections period. For example, part of the temporary employment assistance program, which provides funds for public service jobs at state and local government levels, is assumed to phase down as the unemployment rate falls, consistent with the recently enacted authorization for Comprehensive Employment and Training Assistance (Public Law 95-524).
- o The projections assume no increase in military or civilian federal employment. 3/ Federal pay scales are assumed to be adjusted annually in accordance with the Federal Pay Comparability Act of

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1/ For programs that do not receive new budget authority every year, the "same level of resources" was interpreted to be the same level of obligations. Outlays were estimated by applying spendout rates to the obligation levels.

2/ In the past, CBO has estimated alternative defense force structures that fit within current policy constraints, using the Defense Resource Model. A discussion of the model can be found in Congressional Budget Office, Real Growth and Decline in Defense Operating Costs; Fiscal Year 1978, Staff Working Paper (July 1977).

3/ Projections for personnel costs are consistent with the Leach Amendment, which limits civil service personnel to the September 30, 1977, level of 2,191,000. The total can rise with the annual growth of the U.S. population (for which growth was 1.6 percent, or 35,000 people, in fiscal year 1978).

1970, except that the projections do not include a catch-up payraise in fiscal year 1980 for the 5.5 percent pay cap in fiscal year 1979. The costs for pay increases each year are initially estimated under the category "allowances for payraises" and are then distributed among federal programs the following year, as is customary in the presentation in the federal budget.

- o Existing laws provide for direct, automatic **cost-of-living** adjustments for most federal programs providing direct benefit payments to individuals. Until recently, veterans' benefits were a major exception. With the passage of Public Law 95-588, however, part of veterans' pensions were directly indexed to the **CPI**. Veterans' compensation, G.I. Bill benefits, and medical care are still not indexed. Outlays for a few programs, such as medicare and medicaid, are indirectly indexed for inflation, since the federal government pays part of the costs. Finally, the benefit levels for some programs, such as public assistance and unemployment insurance, are set by state and local governments under federal guidelines. It is assumed that the benefits under these programs will also keep pace with inflation. Together, benefit payment programs that in some way respond automatically to inflation constitute nearly one-half of the federal budget.
- o As discussed above, for most federal programs with authorizations due to expire during the **1980-1984** period, the projections contain a constant real funding level. For these programs, however, the funding level is discretionary; that is, outlays depend on the amount the Congress chooses to authorize and appropriate. Although there is no statutory requirement that appropriations for such programs receive adjustments for inflation, maintenance of current policies has been interpreted to mean that all programs receive some kind of inflation adjustment. Therefore, in order to assess the cost of inflation to the government, estimates were also made of federal spending without the discretionary inflation adjustments, and finally with neither the discretionary nor the automatic **adjustments** included.

#### REVENUE ASSUMPTIONS

The revenue projections are sensitive to specialized assumptions about the economy not shown in Chapter I. For example, social security taxes are estimated using assumptions about wages and salaries, proprietor's income, and the size of the labor force, in addition to the CPI and the unemployment rate. Corporate income tax projections are based on

assumptions concerning corporate profits. Individual income taxes are estimated using assumptions about various components of personal income. Table A-2 contains some of the more important specialized assumptions used for making the revenue projections.

TABLE A-2. ECONOMIC ASSUMPTIONS USED FOR PROJECTIONS OF REVENUES: BY CALENDAR YEAR

	1979	1980	1981	1982	1983	1984
<b>Wages and Salaries</b> (in billions of dollars)	1,229.1	1,344.2	1,510.8	1,707.8	1,903.9	2,114.0
<b>Proprietor's Income</b> (in billions of dollars)						
Farm	29.7	32.3	33.9	35.6	37.5	39.5
Nonfarm	94.0	100.9	108.3	115.8	123.9	132.4
<b>Other Taxable Personal Income <sup>a/</sup></b> (in billions of dollars)	263.2	291.6	326.6	370.7	418.3	470.7
<b>Civilian Labor Force</b> (in millions)	102.9	105.3	107.4	108.9	110.3	111.6
<b>Employment</b> (in millions)	96.5	98.2	100.3	102.1	103.8	105.5
<b>Corporate Profits</b> (in billions of dollars)	205.1	232.4	258.8	289.4	322.6	357.3

<sup>a/</sup> Includes dividends, rental income, and personal interest income.

The current policy projections of revenues include the effects of the provisions of the Revenue Act of 1978, the Energy Tax Act of 1978, and miscellaneous tax bills passed during the second session of the 95th Congress. They also include the effects of scheduled increases in social security taxes that result from the 1977 amendments to the Social Security Act. Table A-3 shows the effect on projected revenues of the major legislated changes enacted during the 95th Congress.

Tax receipts depend primarily on nominal incomes, which reflect both real economic growth and inflation. Because of the graduated tax structure, individual income taxes have a more than proportional response to increases in nominal income. The estimates of individual income tax collections made

TABLE A-3. EFFECT OF SELECTED CHANGES APPROVED BY THE 95TH CONGRESS ON PROJECTED REVENUES: BY FISCAL YEAR, IN BILLIONS OF DOLLARS

Legislation	1979	1980	1981	1982	1983	1984
Revenue Act of 1978	-19	-37	-44	-52	-58	-65
Energy Tax Act of 1978	-1	-1	-1	-1	-1	-1
Social Security Act Amendments of 1977	3	11	17	25	28	28

in this report are based on a revenue elasticity of 1.45 with respect to taxable personal income; that is, each 1.0 percent of growth in taxable personal income yields growth in individual income tax collections of 1.45 percent. The specific methods used in projecting revenues are discussed in the forthcoming technical background paper to this volume.

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APPENDIX B.      CURRENT POLICY PROJECTIONS OF FEDERAL  
SPENDING BY FUNCTION

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In this report, federal spending is categorized into national defense, benefit payments to individuals, grants to state and local governments, and other federal operations. Another important classification of federal spending is by the major functions of the budget. The functional classification is a means of presenting budget authority and outlays in terms of the principal purposes that federal programs are intended to serve, regardless of the methods used to carry out the activities. The Congressional Budget Act of 1974 requires the Congress to include estimates of budget authority and outlays for each function in its annual budget resolutions.

The relationship between the spending categories used in this report and the functional classification is as follows:

- o The national defense category is the same for both classifications.
- o The bulk of the benefit payments to individuals are found in functions 550, 600, and 700.
- o Grants to state and local governments (other than grants for payments to individuals) are concentrated largely in functions 300, 400, 450, 500, and 850.

Tables B-1 and B-2 contain current policy projections of budget authority and outlays by function.

**TABLE B-1. BUDGET AUTHORITY PROJECTIONS BY FUNCTION: BY FISCAL YEAR, IN BILLIONS OF DOLLARS**

Function	1979 Estimate	Current Policy Projections				
		1980	1981	1982	1983	1984
National Defense (050)	127.2	137	148	159	172	185
International Affairs (150)	12.6	13	15	16	17	18
General Science, Space, and Technology (250)	5.2	6	6	6	7	8
Energy (270)	8.5	6	6	10	11	10
Natural Resources and Environment (300)	13.3	14	15	16	17	19
Agriculture (350)	9.2	5	5	5	5	5
Commerce and Housing Credit (370)	5.5	6	6	6	7	7
Transportation (400)	19.5	21	22	21	23	24
Community and Regional Development (450)	8.6	9	10	11	11	12
Education, Training, Employ- ment, and Social Services (500)	32.7	37	40	42	44	46
Health (550)	52.9	59	71	81	90	101
Income Security (600)	<b>193.4</b>	222	246	274	299	330
Veterans' Benefits and Services (700)	20.4	22	23	24	26	27
Administration of Justice (750)	4.3	5	5	5	6	6
General Government (800)	4.2	4	5	5	5	6
General Purpose Fiscal Assistance (850)	8.8	9	9	10	10	11
Interest (900)	52.5	57	61	63	64	64
Allowances (920)	0.8	1	2	2	2	2
Undistributed Offsetting Receipts (950)	-18.4	-19	-20	-22	-23	-25
<b>TOTAL</b>	<b>561.3</b>	<b>615</b>	<b>673</b>	<b>736</b>	<b>793</b>	<b>857</b>

TABLE B-2. OUTLAY PROJECTIONS BY FUNCTION: BY FISCAL YEAR,  
IN BILLIONS OF DOLLARS

Function	1979 Estimate	Current Policy Projections				
		1980	1981	1982	1983	1984
National Defense (050)	113.3	125	139	151	163	175
International Affairs (150)	7.2	8	9	9	10	11
General Science, Space, and Technology (250)	5.0	5	6	6	7	7
Energy (270)	7.7	8	7	9	11	11
Natural Resources and Environment (300)	11.4	13	14	15	16	17
Agriculture (350)	6.5	5	6	5	5	6
Commerce and Housing Credit (370)	2.8	4	4	4	4	4
Transportation (400)	17.3	19	20	21	22	23
Community and Regional Development (450)	9.2	9	10	10	10	11
Education, Training, Employ- ment, and Social Services (500)	30.2	35	38	40	42	44
Health (550)	49.3	58	66	75	84	94
Income Security (600)	161.6	184	203	223	241	260
Veterans' Benefits and Services (700)	20.1	22	23	24	26	27
Administration of Justice (750)	4.3	5	5	5	6	6
General Government (800)	4.2	4	5	5	6	6
General Purpose Fiscal Assistance (850)	8.8	9	9	10	10	11
Interest (900)	52.5	57	61	63	64	64
Allowances (920)	0.8	1	2	2	2	2
Undistributed Offsetting Receipts (950)	-18.4	-19	-20	-22	-23	-25
<b>TOTAL</b>	<b>493.8</b>	<b>551</b>	<b>604</b>	<b>655</b>	<b>706</b>	<b>755</b>

