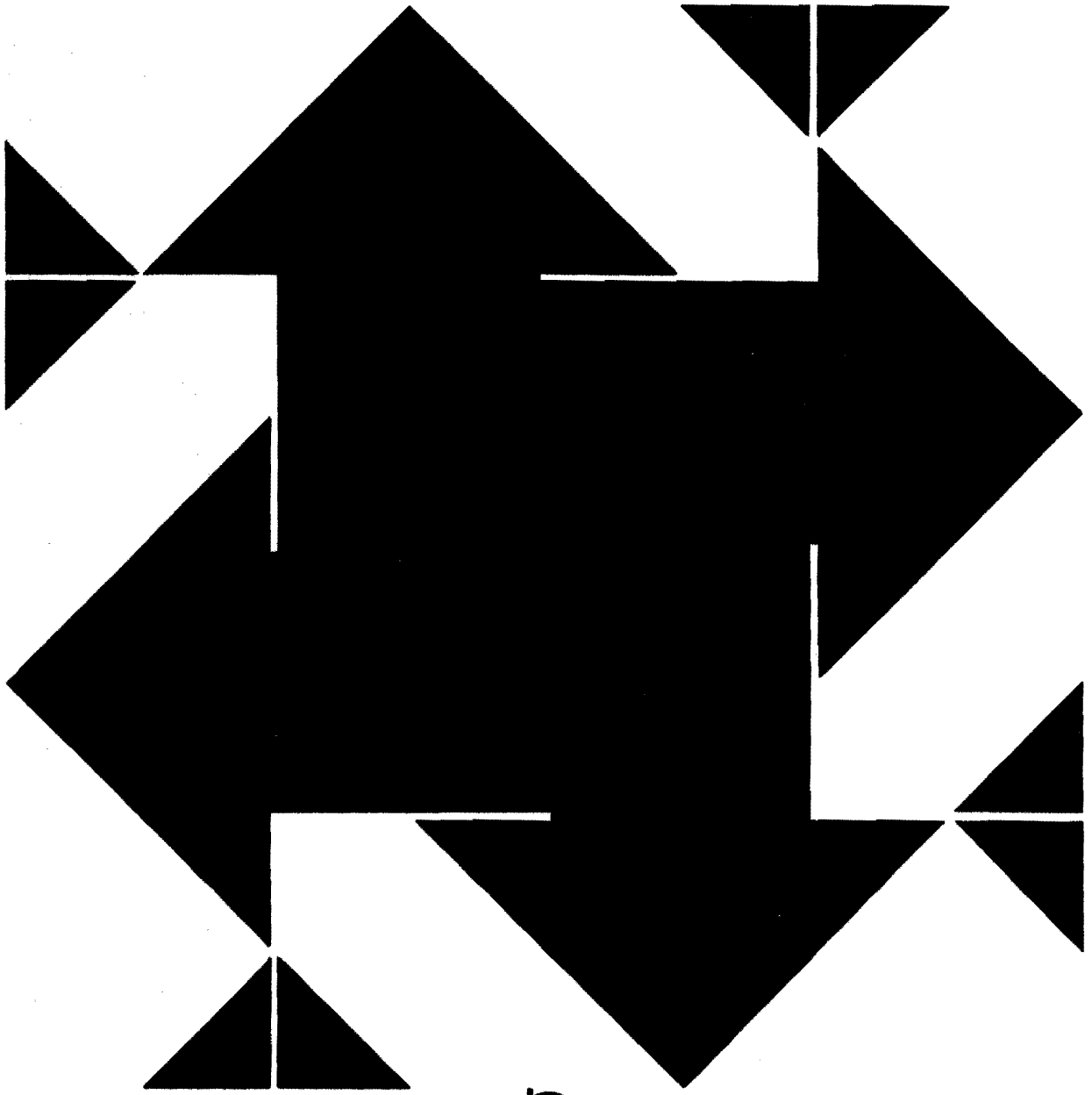
February 1977

BUDGET OPTIONS FOR FISCAL YEAR 1978

A Report to the Senate and House Committees on the Budget

As required by Public Law 93-344



CONGRESS OF THE UNITED STATES

CONGRESSIONAL BUDGET OFFICE

CHAPTER 8

p. 122 line 5: "less than" should follow "from".

CHAPTER 9

p. 126 Table 25: heading of second column from left should be: "Mean Annual Earnings of Full-Time, Full-Year Workers (Dollars)".

p. 128 (last sent. in last paragraph): "educational" should be "education".

p. 132 3rd line from the bottom: "result in" should be "fund".

CHAPTER 10

p. 154 First sent. in 2nd para.: "$168 to $200 billion" should be "$108 to $138 billion".

CHAPTER 12

p. 181 Table 33:

Column 1 +16.7 should be +16.1

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NOTES

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

The federal budget uses a fiscal year. For 1976 and before, fiscal years ran from July 1 through June 30 and were referred to by the years in which they ended. The Congressional Budget Act of 1974 changed the fiscal year to begin on October 1 and end on September 30. The interim between the old and new fiscal years, July 1 through September 30, 1976 is called the transition quarter; fiscal year 1977 began on October 1, 1976.

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

Dollars are expressed in current terms unless otherwise indicated.

PREFACE

This report is one of a number of documents that has been prepared by the Congressional Budget Office (CBO) for the Committees on the Budget pursuant to Section 202(f) of the Congressional Budget Act of 1974 (P.L. 93-344). A more complete analysis of the current state of the economy, the economic outlook and alternative policies to stimulate the economy are contained in the CBO report, The Disappointing Recovery (January 11, 1977). In addition, a series of Budget Issues Papers has been prepared that treat in detail many of the program options discussed in Part II of this report. A CBO Staff Working Paper, Overview of the 1978 Budget, contains an analysis of President Ford's budget proposals for fiscal year 1978. A separate report on fiscal year 1978 tax expenditures will be issued at a later date.

In keeping with the mandate of the Congressional Budget Office to provide objective, nonpartisan analysis of budget issues, this report contains no recommendations. The budget options presented in this report do not represent policies advocated by the Congressional Budget Office. They are simply alternatives chosen to illustrate the broad range of options available to the Congress.

All divisions of the Congressional Budget Office contributed to the preparation of this report. Special thanks, however, should go to Janet L. Fain for her perseverance, skill, and good humor throughout the preparation and production of this report and to Shirley Hornbuckle for assistance and cooperation in typing a major portion of the final report. Barbara M. Bishop, Jill Bury, Betty J. Ingram and Patty Minton also helped with the typing. Editorial assistance was provided by Patricia Johnston, Tricia Knapick, Michael Olmert, and Johanna Zacharias.

Alice M. Rivlin
Director

February 1977

TABLE OF CONTENTS

TABLES

Tables, continued Page

FIGURES

SUMMARY

The Congress is currently debating two sets of budget decisions. First, it must decide whether to amend the budget for the current fiscal year -- fiscal year 1977 which began on October 1, 1976 -- to provide more stimulus to the economy. When decisions on the fiscal year 1977 budget were made in September 1976, the economy was expected to continue its recovery from the recession at a pace sufficient to bring the unemployment rate down to about 7 percent by the end of 1976 and about 6 percent by late 1977. The recovery, however, has been disappointing and unemployment is now expected to remain above 7 percent even by the end of 1977 unless the Congress takes action to stimulate the economy through tax cuts, spending increases, or a combination of the two.

Second, by mid-May the Congress must set spending and revenue targets for fiscal year 1978 which begins on October 1, 1977. It is difficult to make major changes in the federal budget in any one year, but relatively small changes in spending or revenues made in fiscal year 1978 are likely to have large effects on the budgets of future years. Therefore, in making these decisions, the Congress should consider its long-run budget and economic goals.

CONFLICTING GOALS: THE NEXT FIVE YEARS

Longer-run goals include balancing the budget and keeping the economy on a healthy growth path with low inflation. Moreover, while there is substantial support for improving government services -- for example, through welfare reform, expanded federally financed health insurance, or strengthening defense capabilities -- there is also widespread feeling that the share of national output flowing through the federal budget should be held to its current level or even lowered.

Is it feasible over the next five years simultaneously to balance the budget, maintain a healthy overall economic growth rate, finance new federal initiatives and keep the federal share of GNP from growing?

The answer depends on what we mean by a "healthy" growth rate and on the performance of the nonfederal (private, state, local and export) sectors of the economy.

If "healthy" is defined as a growth rate high enough to result in a 4.1 percent 1982 unemployment rate (called the "baseline" growth path in this report), then it will take an unusually strong performance in the nonfederal sectors -- compared to past experience -- also to achieve a federal budget that is in balance or in surplus by fiscal year 1982. With a less strong performance by the nonfederal sectors, the baseline growth rate can be achieved only with the stimulus of federal deficits. With a weak performance by the nonfederal sectors, the baseline growth path probably cannot be achieved at all.

But if "healthy" means a growth rate leading to a 5.5 percent 1982 unemployment rate (called the "less vigorous" growth path in this report), the fiscal year 1982 budget can be in balance if the nonfederal sectors of the economy perform at more normal levels; but if that performance is weak, there is little hope of balancing the budget.

These results hold whether the federal spending is held to the current policy level between now and fiscal year 1982, or whether spending is cut $50 billion or increased $50 to $100 billion over the current policy level. With lower levels of expenditures, however, larger deficits brought about by very large tax cuts will be needed to keep the economy on a given growth path.

Holding federal spending to current policy levels (i.e., funding current programs with allowance for inflation and demographic change) would allow the federal share of GNP to decline from its present level of 22.5 percent to between 19.4 and 20.6 percent depending on how fast the economy grows. As much as $50 billion could be added to this level of federal spending by fiscal year 1982 without increasing the federal share even if overall economic growth is on the "less vigorous" path.

This report examines the fiscal impact of some illustrative new federal initiatives under varying assumptions about growth targets and the strength of the nonfederal sectors. It concludes that substantial increases in

spending (such as welfare reform, catastrophic health insurance, and provisions for long-term care, plus increases in defense spending) could be added to the current policy level of federal spending by fiscal year 1982 without difficulty, provided they were phased in slowly. The stronger the nonfederal sectors of the economy, however, the more difficult it will be to add new federal programs without cutting old ones or raising taxes; as resources become more fully utilized, the choices of whether to employ them in the federal or the nonfederal sectors become more difficult.

In setting budget targets for fiscal year 1978 and considering related legislation, the Congress will be addressing some basic decisions in about a dozen areas -- decisions that can have important budgetary consequences over the next several years. These areas are discussed in Part II of the report and very briefly summarized below.

NATIONAL DEFENSE

Measured in dollars of constant purchasing power, outlays for national defense declined steadily from their Vietnam peak in the late 1960s through fiscal year 1975, but have risen since then. Defense outlays are about $101 billion in fiscal year 1977 -- just under a quarter of the budget -- and would reach about $114 billion in fiscal year 1978 on a current policy basis. Decisions about the fiscal year 1978 budget for national defense will have important implications not only for next year, but for the level and pattern of defense spending in the longer run.

General Purpose Forces

Decisions about spending for general purpose forces include:

- Whether and at what pace to continue the major procurement and modernization underway for the Army and the tactical air forces.

- How to balance the Navy shipbuilding program between aircraft carriers and their escorts versus other forces, such as attack submarines and frigates more specialized in countering the Soviet submarine threat.

These decisions, in turn, depend heavily on assessments of the risk of war in Europe and the nature, timing and duration of such a war should it occur. Since other threats to U.S. security could probably be countered with smaller forces than those needed to deal with a Soviet attack on Western Europe, the European scenario dominates debate over the size of general purpose forces.

The ability to maintain a coherent early defense against a Warsaw Pact attack is the first priority of the current defense strategy of the United States, although forces are also needed to sustain a longer conflict if initial defenses fail. Although recent Department of Defense (DoD) reports have stressed the importance of the initial battle in Europe, much of the present DoD force expansion and modernization program appears to be aimed at improving capability to fight a longer war. Expansion of the Army from 13 to 16 active divisions, conversion of Army divisions to armored or mechanized divisions (based in the United States), expansion of the U.S. Air Force to 26 tactical air wings, and an increase in the size of the Navy are all moves that would enhance capability for sustaining a long war but do little to improve ability to withstand an initial attack. Other DoD proposals, such as base hardening (including shelters for aircraft), airlift enhancement and some types of procurement, would improve chances of warding off an attack for which there would be little warning time.

The Congress may want to consider options that reflect alternative views of the risk of surprise attack versus the risk of sustained war. For example:

- Adding to funds for improvement of initial fighting capability (prepositioning more Army stocks, procuring more all-weather aircraft) could add about $3.7 billion to the baseline DoD program over the fiscal year 1978 to 1982 period.

- Reducing force expansion (building fewer ships, especially carriers, and holding up the expansion of airwings and divisions) would save about $18.7 billion over the same period.

- Doing both -- reducing force expansion while enhancing capacity to withstand surprise attack -- would save about $15.0 billion over this period.

Strategic Nuclear Forces

In addition, the Congress must decide whether and at what pace to modernize strategic forces with B-1 bombers, Trident submarines and missiles, cruise missiles, and a new land-based intercontinental ballistic missile. The strategic balance has shifted in recent years from clear superiority for the United States to a more equal balance between the United States and the Soviet Union. In the face of this situation, a range of U.S. postures is possible, each with particular implications for the budget. Two such options discussed in the report are:

- o A finite-deterrence posture involving a highly survivable smaller force for assured destruction. Reliance would be primarily on sea-launched ballistic missiles. The Trident program would be continued, but the B-1 bomber and the M-X missile would not be procured. Compared with the present DoD program, about $16.4 billion would be saved over fiscal years 1978 to 1982.

- o An essential-equivalance posture would insure that U.S. forces were not perceived as inferior to Soviet forces in any dimension. The Trident program would be accelerated, and both the B-1 bomber and a large number of M-X missiles would be procured. It would add about $5.2 billion to programs now planned by DoD.

Defense Manpower

A third major issue is how to control the growth of defense manpower and retirement costs while remaining able to recruit and retain high quality personnel. Spending for manpower, including retirees, will amount to about $56 billion in fiscal year 1978 and could increase rapidly in the future if DoD continues to seek large numbers of high quality recruits from a declining population of young males in a more prosperous economy. Unless defense manpower policies are changed, potential cost increases could threaten the future of the all-volunteer force.

Possible cost-saving changes in personnel management include improving training efficiency in the Army, reducing

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turnover, and other policy changes that would prevent a rise in the cost of recruiting the all-volunteer force. Reform of the retirement system and moving to a salary system for military compensation could also save substantial sums in the long run, as would adoption of the Rockefeller Commission's recommendations with respect to compensation for civilian employees.

Taken together, the manpower changes considered here would save about $2 billion a year by fiscal year 1982 and more in the longer run.

ENERGY

The national energy problem caused by the increasing gap between demand and domestic production calls for a series of decisions by the Congress: budgetary decisions relating to research, development, demonstration, and commercialization of alternative new technologies, both nuclear and nonnuclear; and nonbudgetary decisions having to do with regulation, pricing, and other controls. These decisions are disparate, but can be tied together into alternative national energy policies by balancing four competing goals: efficient use of resources; low-cost energy for consumers; protection from interruption in supply; and preservation of the environment. The choices are made more difficult by the realization that energy policy can hinder the achievement of full employment and reduced inflation. In addition, making these choices has been constrained by a debate about the extent and type of federal participation in the energy area.

Overall energy policy options may be illustrated by the following examples, chosen to represent policies stressing different goals.

- o A continuation of present policies would be characterized by gradual decontrol of petroleum prices to minimize the adverse impact on consumers and the economy of rapid price increases, heavy emphasis on nuclear research and development projects, and moderate controls and standards for conservation and environmental protection. Ten years from now, this would result in a middle course compared to other options, with respect to both total consumption and dependence on interruptible imports. Federal

energy expenditures in 1982 would be about $6.2 billion, compared to $4.1 billion in fiscal year 1977.

- A free market policy could stress quick decontrol of prices, shifting federal support for research and development to those areas such as solar energy and coal where private support is likely to be inadequate, and shifting as much of the long-run development task as possible to the private sector. This would be efficient from a narrow economic standpoint and would reduce dependence on imports through price incentives to domestic producers, although it would not change total consumption much relative to present policy. The cost would be high prices to consumers and the disruption of present ways of doing business. Federal expenditures would be very slightly below current policy levels.

- Low imports, achieved through domestic price decontrol combined with import fees, augmented federal support for research and development and commercialization through devices such as production subsidies for new fuels, and stockpiling. Such policies might reduce total energy consumption by about 5 percent and imports by two-thirds by fiscal year 1986. It would cost a cumulative $30 billion over present policy in the ten years, and would tend to redistribute income from energy consumers to producers.

- Low cost to consumers could be achieved by very slow price decontrol which would encourage consumption but not production. Some hedges against interruption of the continued heavy imports could be built in by stockpiling and conservation, and heavy research and development effort focused on new energy sources for the longer run. Energy use by 1986 would be up by about 5 percent compared to present policy, and imports would roughly double. The added federal cost over the next ten years would be almost $50 billion.

- An emphasis on preservation of the environment would stress concentration of research and development on sources thought to be relatively less polluting, and a strengthening of environmental standards. Price controls would also be phased out. This approach

would reduce both domestic demand and production, but imports would be slightly higher than under present policy. The added federal costs would be about $20 billion over the next decade.

AGRICULTURE

The costs of government farm price support programs have fallen dramatically in the last few years; outlays for fiscal year 1977, estimated at $1.8 billion, are well below those of the 1960s and the early 1970s, largely because shortfalls in world production and diminishing stocks have pushed the market prices of basic commodities well above support levels. Nevertheless, the situation of American agriculture has not fundamentally changed. It still has the capacity to produce more than domestic and foreign markets will accommodate at acceptable prices when worldwide growing conditions are favorable. The threat of surpluses and depressed farm incomes remains real, especially in view of rapid increases in the cost of farm production. At the same time, consumers have a strong interest in avoiding the escalation of food prices which has been and might be again a major contributor to domestic inflation.

With major agriculture legislation expiring this year, the 95th Congress will be called on to make decisions that could have multibillion dollar impacts on future budgets. One question the Congress must address is whether to continue the heavy reliance on market mechanisms for setting commodity prices, using direct payments to provide some measure of income stability for farmers. This approach avoids the acquisition of large publicly held stocks that can be costly to the taxpayer; however, this approach permits large fluctuations in price which might be mitigated by the existence of such stocks. Market-oriented policies have been criticized for addressing inadequately the interests of livestock producers, consumers, and the less developed nations.

Another option is a return to past policies in which the government established market prices and purchased any surpluses that occurred. This approach has been criticized for interfering with efficient production and farm exports, and for increasing the cost of achieving income and price support goals. A mixed approach that combines a market-oriented policy with a reserve program under government control is a third option: here the reserves could be used to dampen price fluctuations.

In either case, future federal budget costs will depend heavily on the level at which prices (and incomes) are supported. The major issue is whether to continue the current policy, which allows substantial administrative discretion in setting support levels, or to tie support levels to production costs legislatively. The budgetary effects of linking target prices and loan rates to the costs of production could be substantial, perhaps amounting to increases of over $5 billion a year by 1982.

Another major issue, albeit of less budgetary importance, is the extent to which the government should pay for protecting farmers against natural disasters.

HOUSING

This year, in addition to new proposals, the Congress must make decisions about the several major housing programs expiring at the end of fiscal year 1977. These include: the subsidized Government National Mortgage Association (GNMA) Tandem program, the Section 235 homeownership program and the Community Development Block Grant program (part of which supports housing activities). In addition, decisions about the funding levels and mix among the Section 8 new construction program, the Section 8 existing housing program, and public-housing subsidy programs will affect the future thrust of the federal housing assistance effort.

Current federal housing programs vary in terms of: the type of housing that is assisted, the income groups that receive the assistance, whether the program is primarily aimed at assisting lower-income groups or is structured to stimulate construction, and the budget cost per assisted housing unit. Because of this program variation, it is possible to change the mix and funding levels of current housing programs so as to emphasize alternative goals of federal housing policy. The following options illustrate how this would be done:

- Current policy. If today's programs are maintained at current levels, $17.9 billion in budget authority and $4.9 billion in outlays would be required in fiscal year 1978; by fiscal year 1982, the housing budget would grow to $22.9 billion in budget authority and $7.2 billion in outlays. Most of the growth in budget authority and outlays would provide increased housing assistance for low- and moderate-income families.

- Increased housing assistance for low- and moderate-income families. To accomplish this goal, additional fiscal year 1978 budget authority could be directed at the Section 8 programs for existing and newly constructed housing, the public housing program, and the revised Section 235 program.

- Increased stimulus to the housing construction industry. Although there are substantial time lags between program funding and construction activities, the logical candidates for added funding to achieve this objective would be the GNMA Tandem multifamily program, the Section 8 new construction and public housing programs, and the Section 235 program.

- Increased homeownership affordability. The prime candidates for providing aid in this area are the Section 235 and GNMA Tandem subsidy programs. In addition, the proposals that call for deferred and graduated payment mortgages could also be used to increase homeownership affordability.

URBAN MASS TRANSPORTATION

The major federal mass transportation program is directed by the Urban Mass Transportation Administration (UMTA). The first session of the 95th Congress is likely to consider new authorizing legislation for UMTA. The need for new budget authority for UMTA is controversial, for while it had an unreserved balance of $8.7 billion in October 1976, the agency considers that it has promised all of this money to specific projects or purposes in future years. If the Congress wishes to honor these promises, any major new transit systems approved in fiscal year 1978 would eventually require additional budget authority, although the repercussions on fiscal year 1978 outlays would be small.

This debate will offer the Congress a chance to review alternative strategies for meeting urban transportation needs. Three possible emphases are: massive capital assistance designed for new facilities; grants to defray the cost of operating deficits; and aid to low-capital projects that improve existing systems through operational, regulatory, and pricing actions.

UMTA received $11.8 billion in new budget authority in 1973 and 1974 that was to last through 1980. About $4 billion is being used for formula grants to urbanized areas, mostly to offset transit deficits. About $7 billion was set aside for capital grants, of which about 30 percent is being spent for buses and the remaining 70 percent split about evenly between construction of new rail transit systems and improvements or extensions of old ones.

One alternative to continuing present policies would be to expand the UMTA program through major additions to both capital and formula grants. This would lead to completed rail systems in 18 to 23 urban areas by the mid-1980s; at present, there are only eight. Critics of this course point to the apparent inability of such systems to solve the major urban transportation problems, their projected operating deficits, and their great initial capital expense.

Another option would be to have no new rail starts but to expand the program that funds low-capital projects. Such programs would emphasize improving the efficiency of the existing transportation system. Only the four rail systems that have received letters of commitment from UMTA and that are in a construction or detailed engineering phase would be completed.

Finally, UMTA's current direction could be shifted by expanding the formula grant program. Such an option would provide increased funds that could be used to relieve the burden on farebox revenues and on state and local taxes to support transit. This approach would give local authorities greater freedom to decide the appropriate mix between capital projects and operating support. The local authorities' discretion in the use of formula grants gives this option some of the characteristics of a transit block program.

FISCAL PROBLEMS OF BIG CITIES

The major federal programs aimed at urban problems include:

- Community Development Block Grants.

- o General Revenue Sharing and Antirecession Assistance.
- o Comprehesive Employment and Training Act (CETA) training and public service jobs grants.
- o Accelerated public works.
- o Various housing programs.
- o Urban mass transit programs.
- o Law Enforcement Assistance Administration programs.
- o Title I of the Elementary and Secondary Education Act grants for compensatory education programs.
- o Environmental Protection Agency waste-water treatment grants.

The current session of Congress is likely to make decisions on the Community Development Block Grants, CETA, antirecession financial assistance, and public works programs, as well as on several housing programs.

Explicitly or implicitly, Congressional decisions are likely to determine not only the levels and specific provisions of urban programs, but also whether these programs should be directed primarily at the economic plight of city people and institutions or the fiscal plight of city governments.

If the stress were on fiscal aid, the Congress could increase Community Development Block Grants; CETA public employment programs; or antirecession fiscal assistance. Formulas for existing aid could be shifted toward large cities.

Stress on improving the viability of city economies could lead to enlargement of public works programs; tax or other incentives for expansion of private industry in declining cities; special financing institutions, such as urban development banks; or shifting of federal employment and purchases toward declining cities.

In addition, more general policies such as welfare reform and environmental efforts could affect cities strongly.

Tax, regulatory, energy and related policies could be reexamined for their specific impacts on large cities.

STRUCTURAL EMPLOYMENT

When the overall economy is weak and even when it is much stronger, unemployment, underemployment, and associated employment problems have disproportionate effects on people who do not fit well into the structure of jobs the economy makes available. Few skills, lack of training, discrimination, or geographic location are the causes of most structural employment problems, and they are concentrated among teenagers, nonwhites, the less educated, and residents of depressed areas.

The four current programmatic approaches to ameliorate these problems are: on-the-job training; classroom training; work experience (temporary employment to help those unaccustomed to holding a job), and public service employment. Federal spending in these areas is authorized by Community Service Employment for Older Americans which provides part-time work experience for senior citizens; the Work Incentive Program (WIN), which provides training and job placement for welfare recipients; and the various titles of the Comprehensive Employment and Training Act (CETA), which provide public service employment and training for various groups, including disadvantaged youth. Fiscal year 1976 outlays for all of these programs were approximately $5.1 million.

The Congress will have to decide on a level of funding for each of these programs in fiscal year 1978, particularly in the light of proposals for economic stimulus which combine the need for immediate jobs with the longer term effort to reduce structural employment problems. In addition, CETA expires at the end of fiscal year 1977, and reauthorization must be considered. Finally, various new initiatives, particularly to stimulate private jobs and training for the structurally disadvantaged, have been suggested.

Among the major fiscal year 1978 options open to the Congress are:

- Continuation of current policy, at an estimated cost of $7.7 billion, for 510,000 years of service in job programs and 240,000 years of service in training.

- Augmenting public service employment, largely as part of the immediate economic stimulus package. An additional $2.5 billion would fund 300,000 more jobs.

- Augmenting training programs. One billion dollars would fund 220,000 years of service. Evaluation of existing training programs shows some modest income gains for trainees, although income differentials between trainees and similar people who have not received training may fade after a few years.

- Specialized youth programs. Two billion dollars could fund either 165,000 jobs in an urban setting or 100,000 jobs in a rural setting (rural public service jobs generally require residential facilities for the jobholders) plus 250,000 training slots in either type of setting.

In addition, suggestions have been made for increasing employment in the private sector through tax credits or wage subsidies. These suggestions have not been tested enough to evaluate their effectiveness, but it seems likely that such programs targeted on groups in need will be more cost-effective than general subsidies.

HEALTH

The shape of the federal health policy in the next few years depends on how the Congress answers two interrelated questions:

- What can be done to hold down increases in costs, especially for care financed by the federal government, without impairing quality?

- What can be done to improve access to medical care for those who still have difficulty obtaining it and paying for it?

The 95th Congress, during its first session, will have an opportunity to deal with these questions through three types of decisions. First, the authorizations for health planning and resource development programs, for the National Cancer Institute, for the National Heart and Lung Institute, and for community mental health and community health centers

expire in 1977. Because the health planning legislation includes provisions that control the number of facilities and support state efforts to set hospital rates, the re-authorization process could have a significant impact on future health expenditures.

Second, the Congress will have to decide on proposals that hold down the rate of increase of medicare and medicaid expenditures. Such proposals have significant budgetary impact since these two programs, which account for 83 percent of federal health spending, have grown at a rate of 140 percent over the last five years.

Third, the Congress may also make a preliminary decision on national health insurance. More than a dozen national health insurance bills were introduced in the 94th Congress, and the new Administration has pledged to develop a national health insurance proposal within the next few years.

Assuming that the Congress decides to follow current policy, existing federal health program expenditures are estimated at $45.2 billion in fiscal year 1978 and $75 billion in fiscal year 1982. Most of this increase is projected for health care financing programs (medicare and medicaid). Significant cost savings in these programs can be achieved either by increasing the rate of cost-sharing borne by recipients as proposed by the Ford Administration or by mechanisms that control hospital reimbursement rates.

Increased access to health care could be achieved by plans that would extend insurance coverage to all poor families (federalized medicaid), by extending federal financing to cover the costs of long-term care or catastrophic illness, or by adoption of some form of national health insurance. The cost and impact of federalizing medicaid would, of course, vary with eligibility levels, the nature of the benefit package, and with whether states are required to maintain their current levels of contribution. A program fully financed by the federal government might add about $44 billion to the current policy spending level by fiscal year 1982.

Similarly, the cost of increased support for long-term care would depend on whether the effort is structured around

a block grant for nursing homes and community services, or is an entitlement that would support congregate housing and home health care. A major effort to cover the costs of long-term care might cost $16 billion to $22 billion in addition to current policy spending by fiscal year 1982. Catastrophic health care plans can be designed to meet costs resulting from either long-term care, expenses incurred by low-income families, or the rare but extremely high cost treatments that exceed the limits of normal health insurance. A limited program covering only high cost treatments might cost about $20 billion more than the current policy spending level by fiscal year 1982. Finally, the cost of a national health insurance program would vary widely depending on whether it is financed through premiums or totally supported by the tax system. A tax-financed plan would cost from $108 billion to $138 billion by fiscal year 1982, replacing virtually all private spending for health care.

SOCIAL SECURITY

Social security benefits are funded essentially by the current flow of payroll taxes. The two trust funds, Old Age and Survivors Insurance (OASI) and Disability Insurance (DI), serve mainly as accounts into which earmarked taxes are deposited and from which benefits are paid, with reserves serving primarily to cushion temporary excesses of outlays over revenues. At present, the social security system faces two types of financing problems.

First, there is the short-run problem primarily caused by the recession. Slow growth in wages and employment has caused revenues to grow more slowly than expected. At the same time, rapid inflation has increased benefits to higher levels than expected. An unexpected increase in the number of disability insurance recipients has also contributed to greater outlays on the part of that program. As a result, under currently legislated tax rates, the combined OASI and DI trust fund reserves may be reduced to a level many observers would consider inadequate by the early 1980s. The DI trust fund is likely to be depleted before then and will demand early attention.

Second, the system faces longer-run problems. Demographic patterns will create a substantial increase in the

ratio of retired to working age population about 40 years from now, thus requiring heavier contributions from workers to support retirement benefits equivalent to current ones. Moreover, another long-term problem -- one that is more easily remedied -- arises from the method established by the 1972 Social Security Amendments to adjust the benefit structure automatically for inflation. Under this method, the way in which benefits replace the pre-retirement earnings of retirees makes it overcompensate for the rate of inflation. If the inflation and wage growth now projected for the future should occur, future benefits would grow explosively and, for many retirees, would exceed their final salary. This flaw is often referred to as "overindexing," and proposals to correct this aspect of the benefit structure are often called "decoupling" proposals.

Remedies for the Short Term

The short-run financial condition of the social security system depends on the course of the economy. If economic recovery is slow (for example, if unemployment falls to 5 percent in 1982 and then levels off), social security outlays might continue to exceed revenues and the OASI trust fund reserves could decline from 55 percent of the year's outlays in 1976 to 7 percent in 1985. A more rapid economic recovery -- one in which unemployment falls to 4.5 percent in 1981 and then levels off) would result in a smaller decline in the OASI balances -- to 32 percent of outlays by 1985, in which case no remedial action would be needed. The status of the DI trust fund, however, is more critical. Reserves are expected to be depleted by 1980, even under optimistic assumptions about the economy.

Some action must be taken to maintain a cash balance in the DI trust fund during the next few years and to stabilize the OASI trust fund for the next several years. One option is to increase payroll taxes over the next three years as proposed by the Ford Administration. The Ford Administration estimated that its proposal would result in combined OASDI reserves equal to 40 percent of outlays by 1982. Critics of the proposal point out that the payroll tax is regressive and that a further increase would tend to restrict economic growth at the time when unemployment is still high. Other options include postponing the payroll

tax rate increase until economic conditions improve, increasing the taxable earnings base, general revenue funding for the social security system, and a shift of hospital insurance tax receipts to OASDI. The last of these would then require general revenue funding for the hospital portion of medicare benefits.

The longer-run financial situation of the social security system is critically dependent on a number of factors including future fertility rates, rates of inflation, and the rate of growth of real wages. If the current benefit structure is maintained while the fertility rate remains low, prices continue to go up at current rates, and real wages grow slowly, social security benefits could amount to one-third or more of taxable payroll by the year 2030. About half of such an increase in benefits as a percent of payroll would be the result of the overindexing of benefits for inflation in the 1972 Social Security Amendments. The several options under discussion for remedying this problem have drastically different effects on the long-run cost of social security benefits.

Whatever approach is chosen, the decoupling procedure must be started soon if large future costs are to be avoided. Hence, it seems prudent for the Congress to address both the long-run and the short-run social security problems within the next few years.

WELFARE REFORM

The federally assisted welfare system is not a system at all, but a collection of overlapping and ill-coordinated programs to aid those in need. Cash assistance is provided to low-income families with children by Aid to Families with Dependent Children (AFDC), to needy aged, blind and disabled persons through Supplemental Security Income (SSI), and to needy veterans through pensions. The food stamp, medicaid, child nutrition and housing assistance programs provide in-kind benefits based on need.

These welfare programs -- particularly AFDC, medicaid, and food stamps -- have been criticized for their rapid growth, administrative complexity, wide differences among states, and perverse incentives which discourage work and may affect family structure. Further, benefits have been

called inadequate to support recipients decently. Much of the needy population -- often those in husband-and-wife families, single persons, childless couples, and the working poor -- is not covered at all by a federally supported cash assistance program.

Although the Congress will have to make decisions on particular programs -- food stamp reauthorization and control of fraud and abuse in the medicare and medicaid programs -- it will probably not legislate any major reform this year. A major reform proposal, however, will be submitted by the Administration, and it is likely that debate will begin during this session.

Under current policy, the benefit costs to local, state, and the federal governments of the programs listed above would be $53.2 billion in fiscal year 1978 and $75.2 billion in fiscal year 1982, with about half the increase accounted for by medicaid.

Possible changes in welfare include the following incremental (program-by-program) alternatives:

- Program tightening to limit eligibility could save about $1 billion a year in federal benefit costs. Other provisions, such as tightening of work requirements, preventing fraud and abuse, and simplifying administrative procedures, could result in additional savings.

- National standards could be substituted for the 50 state AFDC, standards and a uniform minimum federal benefit could be provided. A federal minimum in which the combined AFDC and food stamp benefits equal 100 percent of the poverty line could add $12 billion to fiscal year 1978 federal benefit costs, falling to half that amount by fiscal year 1982. These increases in federal AFDC benefit costs do not include corresponding changes in medicaid and food stamp benefits.

- Similar national standards for medicaid could cost the federal government $17 billion in additional benefits in fiscal year 1978 and $24 billion in 1982.

Proposals for more comprehensive welfare reform include:

- Combining a number of the incremental reforms including national standards for AFDC and a simplified food stamp program could increase federal fiscal year 1978 and $13 billion in fiscal year 1982. This increase does not include corresponding changes in medicaid benefit costs.

- A comprehensive cash assistance program, frequently referred to as a negative income tax, would substitute for a number of welfare program cash payments with a minimum benefit to families with no income. Benefits would be reduced as earnings increased in such a way that family income (earnings plus welfare benefits) would grow. This would provide an incentive to work. Such a program no income. Benefits would be reduced as earnings increase in such a way that family income (earnings plus welfare benefits) would grow. This would provide an incentive to work. Such a program substituted for AFDC and food stamps could raise federal benefit costs by $9 billion in fiscal year 1978 and by $15 billion in fiscal year 1982.

- A third approach to comprehensive reform are the multitrack plans. These stress low benefits and high work incentives for employable recipients, and higher benefits for nonemployable persons. Employability would be defined to exclude mothers of small children, disabled individuals, as well as aged and other individuals not expected to work. Such programs stress training or jobs as an integral part of the reform. Multitrack proposals have yet to be costed.

FOOD STAMPS

The Food Stamp program subsidizes purchases of food by low-income households. Any eligible household--after meeting an income test, an asset test, and a work requirement--can buy fixed amounts of food stamps from the government, which can be used like money to buy food.

The current program has raised the food and nonfood consumption of low-income households, reduced the number of households whose total resources fall below the official poverty threshold, and evened out some of the regional variation in public assistance. It now aids about 17 million people at a cost of about $5.5 billion in fiscal year 1977.

In recent years, critics of the program have complained about its rapidly increasing cost and about the fact that some people with incomes above the poverty level receive benefits. Others have criticized the program's administrative complexity and its inadequate integration with other welfare programs. Because the authorization for the program expires at the end of fiscal year 1977, the 95th Congress has the opportunity to assess these and other criticisms and to modify the existing program accordingly.

A continuation of current policy would probably not mean continued rapid increases in the program's cost and number of participants. The increases experienced over the last six years were caused by factors that need not be repeated:

- In 1969 and 1970 administrative and legislative adjustments lowered the purchase requirement, set uniform national income eligibility limits, and raised the basic allotment.

- The 1973 amendments mandated that the program be extended to the entire nation and to outlying U.S. territories. At the same time, jurisdictions that had maintained commodity distribution programs were required to replace them with the food stamp program.

- Worldwide food inflation, beginning in 1972, greatly expanded the program's costs.

- Finally, the 1974-1975 recession increased the number of eligible households.

Assuming a gradual economic recovery, food-price inflation at a rate experienced in the 1960s, and no major legislative changes, the cost of the current program would

80-294 O - 77 - 3

be about $5.4 billion in fiscal year 1978 and $5.9 billion in 1982. The 1978 figure represents a $150 million decrease in cost and a one million decrease in participants from the program levels of fiscal year 1977.

Legislative proposals embodying three general types of changes from current policy have been introduced in the Congress. Some would continue the existing program but make marginal changes designed to simplify the program's administrative complexity, make the nonpoor ineligible, and establish uniform benefit reduction rates. Such incremental changes might cut program costs slightly or increase them by as much as $0.5 billion a year by fiscal year 1982, depending on the nature of the changes.

Another approach would shift the program's emphasis more in the direction of food consumption by limiting participation to households below the poverty line and increasing the purchase requirement to a level that was more equivalent to the household's expenditures on food in the absence of the program. This would cut fiscal year 1982 program costs by about $0.8 billion.

Still another approach would shift the program's emphasis more in the direction of income supplementation by removing the requirement that households purchase food stamps, or by allowing recipients to completely cash out their stamps. Such an approach would add $2 billion to $3 billion to annual program costs by fiscal year 1982 and substantially increase the number of beneficiaries.

PART I. FEDERAL BUDGET-MAKING: DECISIONS FOR THE SHORT AND LONG RUN

CHAPTER 1. BUDGET-MAKING: SHORT-RUN DECISIONS IN THE LONGER-RUN CONTEXT

Between January and mid-May, 1977, the 95th Congress must make two related sets of budget decisions:

- It must consider whether to amend the budget resolution for fiscal year 1977, which began on October 1, 1976, to provide more stimulus to the economy.

- It must set spending and revenue targets for fiscal year 1978, which will begin on October 1, 1977.

Both sets of decisions will have lasting effects on the activities of the federal government and on the economy as a whole. Hence, it is important for the Congress to consider not only the immediate situation; their deliberations must also take into account the future size of the federal sector of the economy, the relative importance of various federal programs, the way the federal government redistributes resources among individuals, the future health of the economy, and the chances of balancing the federal budget in the next few years.

AMENDING THE BUDGET FOR FISCAL YEAR 1977

In September 1976, the Congress passed the Second Concurrent Resolution on the Budget for Fiscal Year 1977 providing for:

Budget authority of $451.55 billion.
Outlays of $413.1 billion.
Revenues of $362.5 billion.
Deficit of $50.6 billion.

Under ordinary circumstances these figures would not be subject to further review, but unforeseen developments in the economy justify reopening the question of whether they are appropriate.

In the judgment of the Congress, the budget contained in the September resolution was appropriate to the needs of the economy which then appeared to be recovering from a deep recession at a fairly healthy rate. Projections at the time indicated that the unemployment rate would fall to about 7 percent by the end of 1976 and to about 6 percent by the end of 1977. In their reports on the second resolution, both the Senate and House Committees on the Budget noted that additional economic stimulus should be considered in early 1977 if the recovery did not follow the projections; this proved to be the case. Without further federal action, the unemployment rate now seems likely to be above 7 percent even at the end of 1977. The Congress must therefore consider whether a tax cut or a spending increase, or some combination of the two, is needed to restore the economy to the rate of recovery anticipated when the September decisions were made.

SETTING TARGETS FOR FISCAL YEAR 1978

The Congress must also begin work on the First Concurrent Resolution on the Budget for Fiscal Year 1978. This resolution, to be passed by May 15, 1977, will specify a revenue target and budget authority, as well as spending targets by major functional categories, such as defense, health, and agriculture. In setting these targets, the Congress must deal not only with the question of how much the federal budget should stimulate or restrain the economy, but also with other basic questions. In addition, decisions on the fiscal year 1978 budget will be complicated by the fact that this year the Congress received two sets of executive branch budget proposals -- one from the outgoing Ford Administration and one from the incoming Carter Administration.

THE IMPORTANCE OF LOOKING AHEAD

Two facts about the federal budget make it imperative that the Congress consider the future effects of fiscal year 1977 and 1978 decisions:

- In the course of just one year it is neither possible nor desirable to change the budget dramatically.

- Small changes made in any given year can have major consequences in future years.

The Inertia of the Budget

A significant portion of each year's spending (about 15 percent of fiscal year 1977 outlays) reflects legal commitments from prior years; for example, payments now due on an aircraft carrier ordered several years ago. An even larger portion (about 58 percent of fiscal year 1977 spending) is mandated by existing laws. Social security payments must be made, the interest on the federal debt must be met, and the states must be reimbursed for expenses incurred in the Aid to Families with Dependent Children (AFDC), unemployment compensation, and other entitlement programs.

Since the Congress has the power to change the laws, the problem is not primarily legal. But people are expecting these payments and many would suffer hardships if they did not get them. Indeed, many payments not actually mandated by law, such as research grants to universities or education grants to school districts, are also expected and cannot be cut back suddenly without considerable disruption and political outcry. Likewise, rapid increases in the budget may be equally infeasible. Major new programs require advance planning if serious waste and inefficiency are to be avoided.

The fact that major budget changes are difficult to make in any one year -- sometimes called the "uncontrollability" of the federal budget -- can hardly be regarded as undesirable. Few citizens would want to live in a country where government commitments were not honored, where policy fluctuated wildly from year to year, and where the aged or handicapped and other recipients of federal benefits never knew for certain whether they would continue to receive their checks. Nevertheless, the limited extent to which change is possible in one year demands planning ahead.

Future Impact of Present Change

While changes in the budget in any one year are usually marginal, such changes may imply a major reordering of future priorities. Thus, a new weapons system or a major

river development may have costs that are small in the first year, but that grow to many billions of dollars in future years. Elimination of a tax preference, on the other hand, may make little difference in the first year but produce substantial future tax revenues. The same caveats apply to what may be seen as small changes in the fiscal year 1977 and 1978 programs.

PLAN OF THE REPORT

This report illuminates some of the budget choices the Congress will have to make in the coming months; it identifies the major options and describes what they mean in the short and long run. The remainder of this section discusses, first, the four types of decisions involved in making any budget -- decisions about the overall size of federal spending, priorities among federal programs, the impact of the budget on the distribution of resources among individuals, and the impact of the budget on the economy as a whole. Chapter 1 then turns to a brief description of the current state of the economy, the prospects for the next two years, and the broad fiscal policy alternatives that should be considered if the economy is to maintain a healthy rate of economic recovery without risking more inflation.

Chapter 2 identifies some longer-run objectives of budget policy, such as continued economic recovery, new federal programs, restraining the size of the federal sector, and balancing the budget. It examines the conflicts among these goals and the circumstances under which it would be possible over the next five years to attain these goals at the same time.

Part II discusses some of the major programmatic decisions that the Congress is likely to consider in connection with the fiscal year 1978 budget and identifies in more detail the longer-run consequences of each.

This report does not analyze the Ford Administration's fiscal year 1978 budget; such an examination is contained in the CBO Staff Working Paper, Overview of the 1978 Budget: An Analysis of President Ford's Proposals (January 1977). CBO will also prepare an analysis of President Carter's budget proposals.

FOUR DIMENSIONS OF THE FEDERAL BUDGET

The complex process of making decisions on the federal budget determines, in large measure, the answer to four key questions:

- What share of national output should be devoted to federal programs?
- How should federal resources be allocated among different activities?
- How should the federal government affect the distribution of resources among individuals and businesses?
- How much should the federal government stimulate or restrain the economy?

These questions are rarely addressed explicitly. Nevertheless, every final budget voted by the Congress implies answers to all of these questions, and the answers to each can change dramatically from year to year.

What Share of National Output Should Be Devoted to Federal Programs?

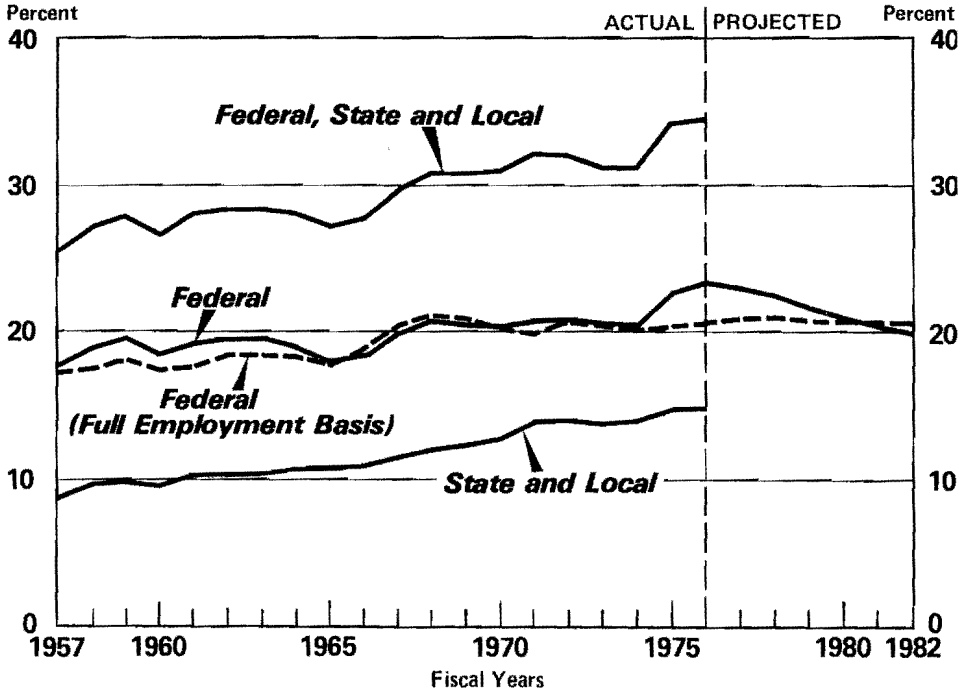
Federal spending as a percent of gross national product (GNP) is a useful measure of federal influence on the economy. The fact that more than one dollar in five flows through the federal treasury, however, does not mean that the federal government controls an equivalent proportion of national production. Much federal spending, for example, is in the form of transfers to individuals, such as social security benefits. The people who get these transfers, not federal officials, decide how their money is to be spent for goods and services. Direct purchases of goods and services by the federal government -- dams, aircraft carriers, and the pay for federal employees -- are quite limited, accounting for only 8.3 percent of national output in 1976. By contrast, the federal government, through rules and regulations telling individuals and businesses what they can and cannot do with their resources, has a pervasive impact far beyond the confines of the federal budget.

In the past two decades, federal spending as a percent of gross national product has risen -- from 17.6 percent in fiscal year 1957 to 23.0 percent in fiscal year 1977 (see Figure 1, in which the calculations are made on a National Income and Product Account basis). Much of this increase has occurred since 1974 and is attributable to the current recession, which not only lowered the growth of the gross national product, but also boosted federal spending for programs such as unemployment compensation. If both the budget and the economy are examined in a way that adjusts for these cyclical fluctuations in economic growth and federal spending, the relative size of the federal sector has risen less dramatically, from 17.2 to 20.5 percent of the full-employment GNP over the past two decades.

At the same time, however, the state and local government share, even adjusted for the grants received from the federal government, has been rising much more rapidly. Hence, the share of national output spent by all levels of government has risen from 25.4 percent in fiscal year 1957 to 33.6 percent in 1977.

Figure 1

Federal, State and Local Government Expenditures as a Percent of GNP



State and local spending increases, partly associated with past increases in the school-age population, have tapered off recently and are not expected to rise rapidly in the next few years. What happens to the federal share will depend on Congressional budgetary decisions.

A continuation of the federal programs currently on the books would not result in federal spending rising as a percent of GNP. CBO recently projected the cost of federal programs over the next five years on a current policy basis, a method that allows for expected increases in the population eligible for benefit programs such as social security and veterans' pensions and for increases needed to offset inflation. 1/ On this basis, federal outlays as a percent of GNP would fall from its present level of 22.5 percent to 19.4 percent by fiscal year 1982, assuming a health economic recovery is somehow maintained (see Table 1). If the recovery is slow, the drop in federal outlays as a percent of GNP would be less dramatic. Thus any increase would reflect Congressional decisions to add new programs or to increase spending on current programs by more than is required to compensate for inflation and increases in the numbers of persons eligible for benefits (see Table 1).

How Should Federal Resources Be Allocated Among Types of Activities?

Decisions on the fiscal year 1978 and later budgets, of course, will reflect Congressional decisions about the relative importance of the major activities -- defense, health, housing, revenue sharing, highways, aid to veterans, and so forth. But within these broad areas, further decisions must be made concerning relative emphasis. For example, within the area of defense should more or less emphasis be placed on modernizing the Navy, building a new strategic bomber, or augmenting manpower?

1/ Five-Year Budget Projections: Fiscal Years 1978-1982, CBO Report, December 1976.

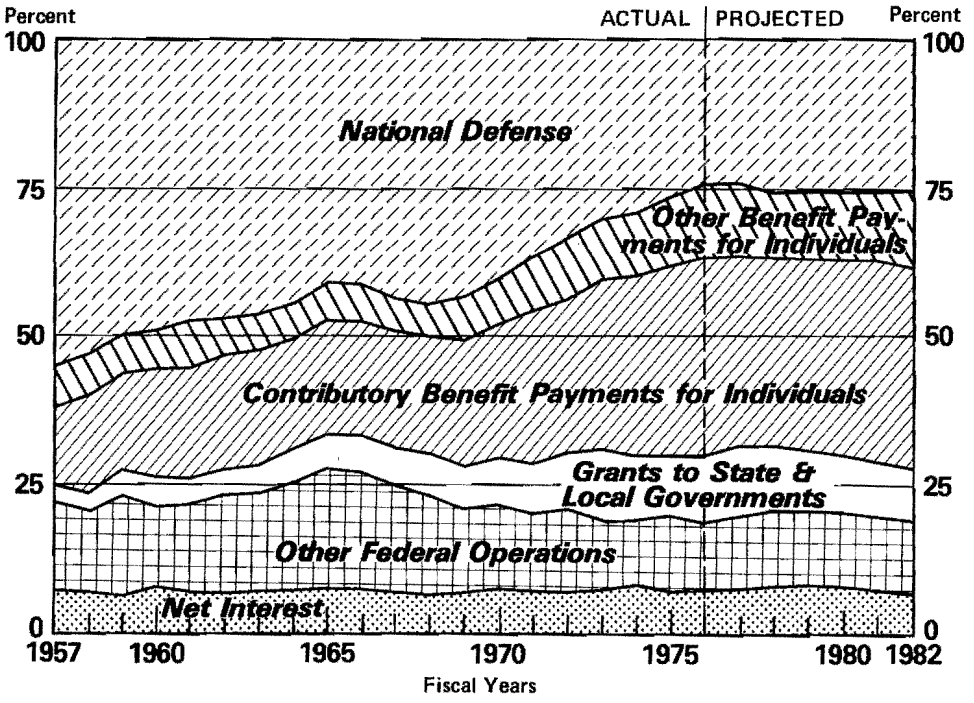
TABLE 1. MAJOR COMPONENTS OF BUDGET OUTLAY PROJECTIONS, FISCAL YEARS 1976 TO 1982

Major Component	1976 (Actual)	1977 (Estimate)	Projections 1978	1979	1980	1981	1982
	Billions of Dollars						
National Defense	90.0	100.7	113.6	120.8	130.8	139.1	147.4
Contributory Benefit Payments For Individuals	123.4	134.6	143.9	156.7	171.2	188.0	197.5
Other Benefit Payments For Individuals	44.3	49.2	52.0	55.8	59.5	63.5	77.9
Grants to State and Local Governments	40.4	48.0	48.8	47.5	48.2	50.3	53.2
Net Interest	26.8	30.4	35.8	38.6	39.5	39.5	39.4
Other Federal Operations	40.8	50.2	56.6	60.8	64.6	67.4	70.3
Total	365.7	413.1	450.7	480.1	513.9	547.8	585.7
	Percent of Total Outlays						
National Defense	24.6	24.4	25.2	25.2	25.4	25.4	25.2
Contributory Benefit Payments For Individuals	33.7	32.6	31.9	32.6	33.3	34.3	33.7
Other Benefit Payments For Individuals	12.1	11.9	11.5	11.6	11.6	11.6	13.3
Grants to State and Local Governments	11.1	11.6	10.8	9.9	9.4	9.2	9.1
Net Interest	7.3	7.4	7.9	8.0	7.7	7.2	6.7
Other Federal Operations	11.2	12.1	12.6	12.7	12.6	12.3	12.0
Total	100.0	100.0	100.0	100.0	100.0	100.0	100.0
Total Outlays as a Percent of GNP	22.6	22.5	22.2	21.4	20.7	20.0	19.4

In recent years the allocation of federal spending among major activities has changed dramatically. Two decades ago, defense and international affairs accounted for more than half of the budget; today these functions amount to just under a quarter of all funds spent by the federal government (see Figure 2). Much of the growth has been in federal programs that give cash or in-kind benefits to individuals. Contributory benefit payment programs, such as social security and medicare, grew from 13.3 percent of total outlays in fiscal year 1957 to 32.6 percent in 1977. Noncontributory benefit payment programs, such as Aid to Families with Dependent Children and food stamps, increased from 7.0 to 11.9 percent over this period. Federal grants to local governments have also shown rapid growth, from 2.7 percent in 1957 to 11.6 percent in 1977.

Figure 2

Composition of Federal Spending as a Percent of Federal Outlays



Continuation of these relative changes is not inevitable. CBO projections of the budget indicate that, with allowance for likely economic and demographic changes, only small shifts in the relative importance of major federal functions will occur over the next five years if current policies are continued (see Table 1). Payments to individuals would rise slightly as a percent of the budget, although not faster than the economy as a whole.

Even over the next 25 years, payments to individuals will not rise faster than the economy as a whole unless the Congress changes current policies. Continuation of present benefit programs -- with allowances for changes in the eligible population and for increasing benefits as fast as prices, or even as fast as wages -- implies that the proportion of GNP devoted to these programs will stay constant at about 9 to 10 percent. 2/ If Congress enacts new benefits, adds new categories of beneficiaries, or increases payments faster than wages, these proportions will rise; but such actions would call for new legislation. They are not the inevitable consequence of past decisons.

Priority decisions are also made, although often less consciously, on the revenue side of the budget. The federal government has sought to encourage certain types of activity and to reward certain categories of persons by reducing their tax liability. Such "tax expenditures," as these reductions from normal tax liabilities are called, often differ little from programs that spend federal resources directly. For example, the tax-exempt status of municipal bond interest saves state and local governments money by lowering their borrowing costs; the same result could be achieved by providing these governments with a direct grant to cover part of their interest payments.

2/ See Growth of Government Spending for Income Assistance: A Matter of Choice, prepared by CBO for the Senate Budget Committee (Washington, D.C.: U.S. Government Printing Office, 1975).

How Should the Federal Governement Affect the Distribution of Resources Among Individuals and Businesses?

Decisions made both on the spending and taxing sides of the federal budget affect the distribution of income among individuals and businesses -- among large and small businesses, among industries, among geographic areas, and among individuals of various ages, occupations, and income levels.

On balance, direct federal taxes do not greatly alter the distribution of income among individuals in various income groups (see the last two columns of Table 2). The progressive impact of the personal income tax, which falls more heavily on upper-income groups, is largely offset by the regressive impact of the social security payroll tax which falls heavily on low- and middle-income wage earners.

TABLE 2. PERCENTAGE DISTRIBUTION OF INCOME TO FAMILIES a/ CLASSIFIED BY PRE-TAX/PRE-TRANSFER INCOME QUINTILES FOR FISCAL YEAR 1976

Quintile	Pre-tax Pre-transfer Income	Social Insurance Added	Cash Transfers Added	In-Kind Transfers Added b/	Post-tax/ Post-transfer Income
Lowest	0.3	3.6	4.5	6.1	7.2
Second	7.2	9.4	9.6	10.1	11.5
Third	16.3	16.3	16.2	16.0	16.6
Fourth	26.0	24.5	24.2	23.6	23.4
Highest	50.2	46.2	45.6	44.2	41.3
Total c/	100.0	100.0	100.0	100.0	100.0

SOURCE: Congressional Budget Office Background Paper, No. 17, Poverty Status of Families Under Alternative Definitions of Poverty, January 1977.

a/ Includes single individuals as one-person families.

b/ Includes medicaid, medicare, as well as food stamps, housing assistance, and child nutrition benefits.

c/ Details may not add to totals because of rounding.

On the spending side, however, federal transfer programs directly improve the relative position of lower income groups, especially when in-kind transfers, such as food stamps or medicare payments, are counted as income. While the poorest fifth of all families had only 0.3 percent of all income before taxes and transfers, after receipt of income transfers this group's share was 6.1 percent of the total.

Over the past two decades the proportion of total federal revenues derived from the individual income tax has remained constant at approximately 45 percent (see Figure 3), while the proportion derived from payroll taxes has risen and the share from the corporate income tax has declined. Looking to the future, however, the income tax share is likely to rise if current tax policy is continued -- primarily because inflation and economic growth combine to push taxpayers into higher tax brackets (see Table 3). In the past, the Congress has periodically cut income taxes to offset these automatic revenue increases.

Figure 3

Receipts by Source as a Percent of Total Receipts

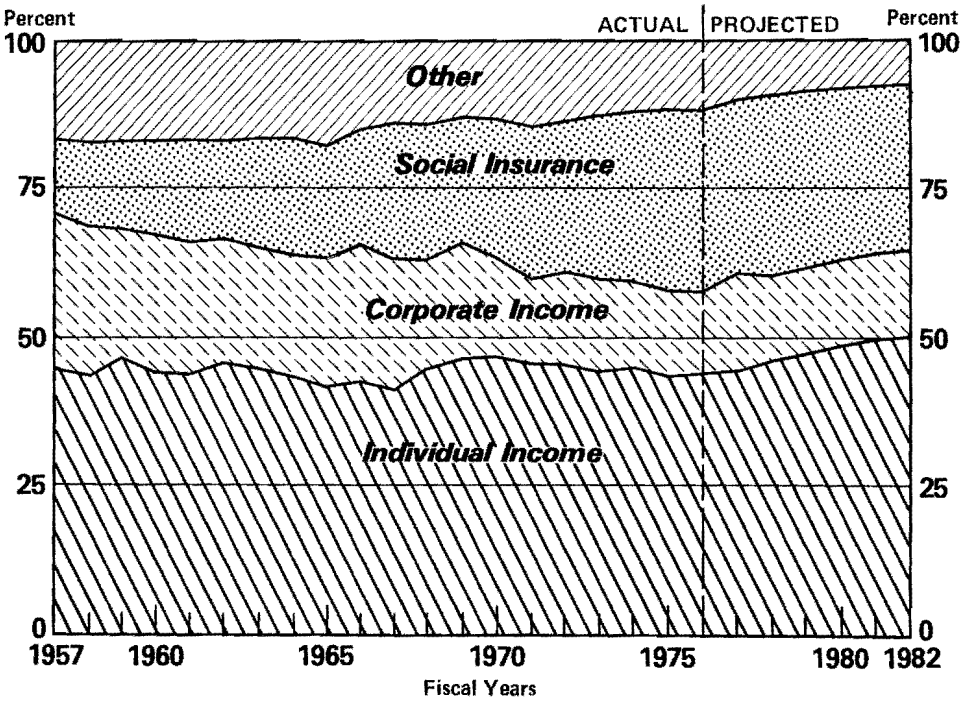


TABLE 3. PROJECTIONS OF FEDERAL BUDGET RECEIPTS BY SOURCE, FISCAL YEARS 1976 TO 1982

Source	1976 (Actual)	1977 (Estimate)	Projections 1978	1979	1980	1981	1982
	Billions of Dollars						
Individual Income Taxes	130.8	161.7	188	219	255	295	341
Corporate Income Taxes	41.4	58.5	58	67	77	85	92
Social Insurance Taxes and Contributions	92.7	107.1	124	139	152	170	188
Other Taxes and Receipts	34.3	35.2	37	39	41	43	46
Total	299.2	362.5	407	464	526	594	668
	Percent of Total Receipts						
Individual Income Taxes	43.9	44.6	46.2	47.2	48.5	49.7	51.1
Corporate Income Tax	13.8	16.1	14.2	14.4	14.6	14.3	13.8
Social Insurance Taxes and Contributions	30.9	29.5	30.5	30.0	28.9	28.6	28.1
Other Taxes and Receipts	11.4	9.7	9.1	8.4	7.8	7.4	6.9
Total	100.0	100.0	100.0	100.0	100.0	100.0	100.0

To What Extent Should the Federal Government Stimulate or Restrain the Economy?

As a general rule, when the federal government pays out more money than it takes in, it adds to demand for goods and services; when it takes in more money than it pays out, it restrains demand. Tax cuts or added spending that increase the budget deficit or reduce the surplus stimulate the economy and reduce unemployment, but at the cost of increased inflationary pressures. Tax increases or expenditure reductions that increase the budget surplus or reduce the deficit have the opposite effects. The magnitude of these effects depends critically on the overall state of the economy. When the economy is operating far below its potential with substantial numbers of idle plants and workers, increases in the budget deficit are thought to increase output and employment while adding little to inflation in the short run. On the other hand, when the economy is running at full capacity, increased federal spending that is not offset by higher taxes will just boost prices, without significantly changing either output or employment.

80-294 O - 77- 4

The stimulative and inflationary impacts of various types of spending and taxing may differ. For example, added federal outlays that place demands on sectors of the economy that are operating at or near capacity (e.g., health care) are likely to have more of an inflationary impact than are outlays that place demands. sectors with large quantities of underutilized resources (e.g., construction). In the latter situation the result is more likely to be increased economic activity rather than inflation. Tax cuts aimed at people who tend to save large fractions of their incomes are less likely to boost the economy through increased consumer demand than are cuts directed at persons who spend all of their incomes.

To a certain extent the budget reacts automatically to stabilize the economy -- cushioning the depressant effects of a recession and dampening the inflationary impacts of a boom. When the growth of the economy slackens and unemployment begins to rise, the budget deficit increases automatically because spending increases for such entitlement programs as unemployment compensation, food stamps, and welfare. At the same time, tax revenues decline, or grow more slowly, because of lower corporate profits and personal incomes. When the economy begins to expand rapidly, the opposite chain of events occurs -- spending that is related to unemployment drops while revenues expand, thus reducing the size of the deficit or expanding the size of the surplus. Because of the progressive nature of the personal income tax, revenues tend to respond more than proportionately to changes in the economy.

The budget also can reflect discretionary policies aimed at stabilizing the economy. The Tax Reduction Act of 1975 and programs such as emergency public works, expanded public service employment, and countercyclical revenue sharing represent discretionary budget actions of the 94th Congress that were designed to stimulate the economy. The temporary tax surcharge enacted in 1968 was aimed at slowing down an overheated economy.

In the past two decades, the federal budget has been in deficit in all but three years (see Table 4). The deficits of the past three years have been especially large and have added substantially to the national debt;

TABLE 4. THE FEDERAL SURPLUS OR DEFICIT AND DEBT, FISCAL YEARS 1957 TO 1977

Fiscal Year	Billions of Dollars			Federal Debt as a Percent of GNP
	Surplus (+) or Deficit (-)	Surplus (+) or Deficit (-) at Full Employment a/	Federal Debt	
1957	+ 3.2	+ 6.6	272.4	63.0
1958	- 2.9	+ 8.9	279.7	63.3
1959	-12.9	- 2.7	287.8	61.8
1960	+ 0.3	+10.2	290.9	58.5
1961	- 3.4	+13.1	292.9	57.6
1962	- 7.1	+ 6.6	303.3	55.5
1963	- 4.8	+ 7.4	310.8	53.9
1964	- 5.9	+ 4.4	316.8	51.4
1965	- 1.6	+ 3.4	323.2	49.2
1966	- 3.8	- 4.0	329.5	45.7
1967	- 8.7	- 9.0	341.3	44.1
1968	-25.2	-28.1	369.8	44.6
1969	+ 3.2	+ 0.8	367.1	40.6
1970	- 2.8	+ 1.9	382.6	39.8
1971	-23.0	- 7.1	409.5	40.2
1972	-23.4	- 8.0	437.3	39.9
1973	-14.8	-12.2	468.4	37.9
1974	- 4.7	+ 2.2	486.2	35.7
1975	-45.1	- 4.6	544.1	37.5
1976	-66.5	-11.6	631.9	39.3
1977 b/	-50.6	-18.0	700.0	37.1

SOURCE: Unless otherwise noted, all figures are from the Budget of the United States Government for Fiscal Year 1978.

a/ Fiscal year 1977 estimates are derived from the fiscal year 1977 Second Concurrent Resolution. GNP for fiscal year 1977 is a CBO estimate.

b/ Federal outlays and GNP at full employment are CBO estimates.

they have also reversed the long decline in the size of that debt relative to the economy. For the most part, these recent deficits have resulted from the automatic stabilizers built into the federal budget, rather than from discretionary action taken by the Congress or the Executive Branch.

The effects of the automatic stabilizers can be isolated by examining the budget on a full-employment basis -- that is, on the basis of what spending and revenues would be if the economy were operating at full employment. On this basis the budget was in surplus for 11 of the past 20 years (see Table 4).

Of course, the fiscal policy encompassed in the budget is not the only instrument that the federal government can use to influence the pace of economic activity. International economic policy may be used to stimulate foreign trade, and Presidential exhortations or wage and price controls can be used to attempt to hold prices down. More important, however, is the role played by the Federal Reserve System, which controls monetary policy -- the supply of money and bank credit available to the economy. By manipulating the growth of commercial bank reserves and reserve requirements, the Federal Reserve System influences the money supply, interest rates, business spending on capital goods, and household spending on houses and consumer durables. If the growth of the money supply is restricted, interest rates will tend to rise and spending on such items will be curtailed; a rapid expansion of money supply will lead initially to easier credit and increased spending on the types of goods that are purchased with borrowed money. These effects on demand gradually diminish, and ultimately most of the impact of monetary policy is not on real output but rather on the rate of inflation. Because the Federal Reserve System is partially independent of the President and the Congress, the nation's monetary policy does not automatically support or accomodate the nation's fiscal policy.

1977 BUDGET: IS MORE STIMULUS NEEDED?

The recession that occurred between late 1973 and early 1975 was the longest and deepest recession the economy has experienced since the 1930s. As tax receipts fell below high employment levels and recession-related expenditures rose, the federal budget deficit widened automatically, cushioning the recession's adverse effects on the nation. In early 1975, in an effort to speed recovery, the Congress voted a substantial tax cut. Automatic stabilizers, the tax cut, and some antirecession increases in spending brought the deficit for fiscal year 1976 to a record $66.5 billion.

By the time the Congress turned to decisions on the fiscal year 1977 budget, however, the economy was recovering and continued growth at a rapid rate seemed likely. A somewhat smaller deficit of $51 billion was voted for

fiscal year 1977, and there seemed a good chance that rising output and employment would bring the federal budget even closer to balance by fiscal year 1978. Unfortunately, the nonfederal sectors of the economy have not responded to the recovery as strongly as implied by the earlier forecast. Business investment in plant and equipment has been sluggish, and recent evidence indicates this pattern is likely to continue at least through mid-1977. A slower-than-expected recovery in Western Europe and Japan has contributed to weakness in demand for U.S. exports. The prolonged strike at the Ford Motor Company in late 1976 reduced production and income below levels they would have otherwise achieved. Finally, the much-discussed spending shortfall by the federal sector itself also tended to slow the rate of economic growth.

Considering the slowdown in the economic recovery, a maintenance of the fiscal policy inherent in the Second Concurrent Resolution on the Budget for Fiscal Year 1977 would result in a 3.5 to 5.0 percent growth in real GNP from the fourth quarter of calendar year 1976 to the fourth quarter of calendar year 1977 (see Table 5). 3/. This is projected to result in an unemployment rate of between 7.1 and 7.8 percent by the end of 1977. If current policies are continued, 1978 growth in real GNP is expected to be between 3.0 and 5.5 percent, with an unemployment rate between 6.6 and 7.6 percent by late 1978.

The federal deficit is projected to be larger than that specified in the second concurrent resolution primarily because lower incomes and profits lead to smaller tax receipts. In addition, however, slower growth will increase some federal outlays, such as those for food stamps and similar entitlement programs. Lower than expected interest rates, on the other hand, have led to downward revisions in projected federal interest payments. Together, these influences are expected to produce a fiscal 1977 deficit -- again, if current policies are continued -- of $54 to $58 billion.

3/ For a more complete discussion of the economic outlook and various fiscal stimulus options, see The Disappointing Recovery, CBO Report, January 1977.

TABLE 5. ECONOMIC PROJECTIONS BASED ON CURRENT POLICY, CALENDAR YEARS 1977 TO 1978 a/

Economic Variables	Levels			Rates of Change (percent)	
	1976	1977	1978	1976 to 1977	1977 to 1978
GNP (billions of current dollars)	1745 to 1755	1890 to 1950	2040 to 2170	8.0 to 11.0	7.0 to 11.5
GNP (billions of 1972 dollars)	1282 to 1287	1325 to 1350	1370 to 1420	3.5 to 5.0	3.0 to 5.5
General Price Index (GNP deflator, 1972 = 100)	136 to 137	142 to 145	148 to 154	4.5 to 6.0	4.0 to 6.0
Consumer Price Index (1967 = 100)	173 to 174	181 to 184	188 to 195	4.3 to 5.8	3.8 to 5.8
Unemployment Rate (percentage points)	7.9	7.1 to 7.8	6.6 to 7.6	--	--

a/ Fourth quarter estimates.

Since the recovery has not proceeded as projected, the Congress may wish to consider some changes in fiscal policy that could move the economy closer to the output and employment goals underlying the second budget resolution. A few of the many policy combinations that would accomplish this are summarized in Table 6. One combination consists of an $8 billion personal tax rebate, a $5 billion (annual rate) continuing personal tax reduction, and a $2.5 billion (annual rate) continuing corporate tax reduction. Such a policy is estimated to add 0.7 percent to economic growth during 1977, but only 0.1 percent in 1978. The eventual impact of this policy on inflation is 0.1 to 0.2 percentage points.

A second policy combination would add to the first combination a $5 billion (annual rate) continuing increase in countercyclical revenue sharing and public service employment and a $6 billion authorization for accelerated public works, with spending taking place slowly over several years. This policy combination is similar in broad outline to proposals by the Carter Administration. It adds an estimated 1 percent to real GNP growth during 1977 and 0.4 percent in 1978.

A third policy combination would double the tax options of the first combination and add to them the spending increases of the second policy combination. This relatively large stimulus package would increase real GNP growth by an estimated 1.7 percent in calender year 1977 and 0.5 percent in 1978. Its estimated effects are shown in the third column of Table 6.

It should be realized, however, that the choice among the options for stimulating the economy does not turn solely on an evaluation of the need for stimulus and the relative effectiveness of available instruments. The effect of the choice on the future size and mix of federal spending programs and on the distribution of resources among individuals and business must also be considered.

A permanent cut in taxes is more consistent with a long-run strategy of reducing the size of federal budget relative to the economy than is a temporary tax cut or an increase in spending. A tax cut, whether permanent or

TABLE 6. ILLUSTRATIVE COMBINATIONS OF EXPANSIONARY FISCAL OPTIONS

Selected Impacts a/	Combination 1	Combination 2	Combination 3
1977 Impact			
Direct Budget Cost, Fiscal Year (billions of dollars)	+ 10	+ 12	+ 22
Net Budget Cost, Fiscal Year (billions of dollars)	+ 9	+ 10	+ 19
Employment, 4th Quarter (thousands)	+310	+610	+920
Unemployment Rate, 4th Quarter (percentage points)	-0.25	-0.45	-0.70
1978 Impact			
Direct Budget Cost, Fiscal Year (billions of dollars)	+ 8	+ 16	+ 23
Net Budget Cost, Fiscal Year (billions of dollars)	+ 4	+ 7	+ 10
Employment, 4th Quarter (thousands)	+355	+ 905	+1,260
Unemployment Rate, 4th Quarter (percentage points)	-0.25	-0.65	-0.90
1980 Impact, Inflation Rate (Rate of change of consumer prices from 1979:4 to 1980:4, percentage points)	+0.1 to 0.2	+0.3 to 0.5	+0.4 to 0.7

a/ All impacts are differences from a baseline path.

temporary, can favor either business or consumers and can be designed to make the tax structure either more or less progressive.

While making decisions on the fiscal policy appropriate to the immediate needs of the economy, however, the Congress must also keep in mind the impact of current decisions on longer-run goals. Can the budget be balanced as the economy returns to full employment? Can new initiatives be accommodated without increasing the federal share of total national output? The next chapter considers these longer-run dilemmas.

CHAPTER 2 RECONCILING CONFLICTING BUDGET GOALS: THE NEXT FIVE YEARS

In fiscal years 1977 and 1978, the federal budget is almost certain to be in substantial deficit. The Congress will be debating how large a deficit is consistent with a healthy recovery, not how to balance the budget. In the longer run, however, most people regard a balanced budget as desirable. Both President Carter and former President Ford have strongly supported the goal of a balanced budget.

At the same time almost everyone believes that federal budget policy should promote sustained economic growth leading to low unemployment and only moderate inflation. In addition, many people favor major new federal programs to meet various public needs -- financing health care, improving housing, developing new energy sources, cleaning up the environment, or strengthening the nation's defense. But many people, including some of those who favor new programs, also feel strongly that federal activities already play too large a role in the economy; they would favor holding federal spending as a proportion of gross national product to its present level or lowering it.

Are these goals compatible? Is it possible to balance the federal budget over the next few years and still have a growing economy and a declining unemployment rate? Would a balanced budget leave room for new federal programs?

To a large extent, the answers to these questions depend on the strength of demand in the nonfederal sectors of the economy. If consumer demand is high and private investment is vigorous, a healthy rate of economic growth can be maintained with minimal stimulus from the federal budget. On the other hand, if consumer demand is weak and private investment is sluggish, more federal stimulus will be necessary to keep the economy growing. Prospects for a balanced budget will then be diminished.

The compatibility of a balanced budget with healthy economic growth, moreover, depends heavily on what growth rate is desired. If the private economy is weak, for example, more federal stimulus will be needed to reach

a high overall economic growth rate than to reach a lower one.

While it is not possible to forecast the strength of the private economy with any degree of certainty more than a year or so in advance, historical experience can indicate plausible ranges of nonfederal activity over the next five years. This chapter considers the consequences of three assumed levels -- strong, moderate, and weak -- of nonfederal demand. It also addresses two economic growth paths that might be considered desirable goals -- a high or "baseline" growth path and a less vigorous path. It attempts to answer such questions as: Under what assumptions about the nonfederal economy will it be possible to balance the federal budget and reach a specified growth path? How much room will there be for new programs if the balanced budget and economic growth targets are to be attained?

ASSUMPTIONS ABOUT THE NONFEDERAL SECTORS

Consumer spending, private investment, state and local spending, and net exports are, of course, influenced by fiscal policy, but they are also affected by the strength of consumer and investor confidence, technological development, inflationary expectations, and such unpredictable events as crop failures and oil embargoes. In addition, monetary policy plays an important role in influencing the strength of nonfederal demand, especially demand for investment goods. Similarly, net exports depend heavily on the strength of foreign demand, inflation abroad, and other international developments.

To give a picture of the plausible range of nonfederal activity, CBO has examined the past behavior of such variables as the savings rate and the rate of total investment growth, state and local purchases, and net exports. Based on this examination, future patterns of nonfederal demand were designated strong, moderate, or weak. 1/ These designations in turn were used to show how strong, moderate, or

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1/ A forthcoming CBO Technical Staff Paper, Closing the Fiscal Policy Loop: A Long-Run Analysis, contains a detailed explanation of the methodology that underlies this section.

weak demand by nonfederal sectors would constrain policymakers in their attempts to achieve various goals for the level of federal expenditures, changes in the tax laws, the size of the federal deficit, and the rate of economic growth. 2/

ECONOMIC GROWTH GOALS

Two economic growth paths for the economy -- the federal plus the nonfederal sectors -- were chosen to bring out the impact of varying economic growth goals on budget decisions. The higher or baseline economic path is consistent with the long-range economic assumptions used by both Committees on the Budget for the Second Concurrent Resolution on the 1977 Budget (see Table 7). This path would involve a real economic growth rate averaging 5.1 percent over the next five years and an unemployment rate falling to 4.1 percent by the end of fiscal year 1982. It would imply an annual rate of inflation (Consumer Price Index) that is below 5.0 percent initially but rises to above 5.5 percent by the end of the five-year period. The second or less vigorous path involves a slower economic expansion. The annual rate of economic growth would average almost one percent lower than in the baseline path. The unemployment rate at the end of the five-year period would be 5.5 percent, but the pace of inflation would moderate to 4.6 percent by 1982.

CURRENT POLICY EXPENDITURES

The first budget strategy examined is that of holding expenditures at the current policy level for the next five years and using tax changes to achieve the target rates

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2/ These assumed nonfederal demand patterns were chosen solely to illustrate the impact that variations in nonfederal behavior can have on federal budget policy. They do not constitute a prediction. This report does not consider what federal policy actions are likely to stimulate or inhibit nonfederal demand.

TABLE 7. ECONOMIC ASSUMPTIONS, FISCAL YEARS 1977 TO 1982

Economic Variables	1977	1978	1979	1980	1981	1982
Baseline Assumptions						
Gross National Product (GNP)						
Current Dollar GNP (Billions of Dollars)	1835.6	2034.2	2247.2	2484.8	2740.5	3026.0
Real GNP (Billions of 1972 Dollars)	1318.4	1392.2	1468.8	1548.2	1622.9	1696.5
Growth Rate of Real GNP (Percent)	5.5	5.6	5.5	5.4	4.8	4.5
Unemployment Rate	7.0	6.1	5.5	4.9	4.5	4.2
Consumer Price Index (Annual Percent Change)	5.06	4.8	4.7	4.9	5.2	5.7
Less Vigorous Economic Expansion						
Gross National Product (GNP)						
Current Dollar GNP (Billions of Dollars)	1835.6	2029.2	2211.6	2406.0	2617.1	2848.0
Real GNP (Billions of 1972 Dollars)	1318.4	1388.8	1446.6	1504.5	1564.6	1627.2
Growth Rate of Real GNP (Percent)	5.5	5.3	4.2	4.0	4.0	4.0
Unemployment Rate	7.0	6.1	5.9	5.8	5.7	5.5
Consumer Price Index (Annual Percent Change)	5.0	4.8	4.6	4.6	4.6	4.6

of growth. 3/ This means that all government programs currently on the books (except those that are explicitly temporary) would be continued and the expenditures for them would be adjusted for inflation and the impact of demographic changes. For example, social security expenditures would be adjusted not only for increases in the cost of living, but also for increases in the number of persons eligible for social security. If current policy expenditures were maintained, federal spending would rise at a slower rate than would the gross national product (GNP) under either of the growth paths considered here. Federal expenditures as a fraction of GNP would decline from the present 22.5 percent to a level between 19.5 and 20.6 percent in fiscal year 1982, depending on which GNP path were used for comparison.

If current policy expenditures were maintained, a balanced budget in fiscal year 1982 could be attained only if the nonfederal sector were strong (see Table 8). Even in this case, maintaining the higher economic growth rate would require substantial tax cuts late in the period to offset the normal revenue increases that result from rising incomes and a progressive personal tax structure. If such tax cuts were not made, the federal budget would exert a restraining influence on the economy and economic growth would suffer.

If demand by the nonfederal sectors proved only moderately strong, an increasing federal deficit involving still larger cuts in taxes would be necessary to achieve the baseline GNP path. If the nonfederal sectors were weak, still larger deficits would be required; indeed, it seems unlikely that the baseline economic path could be achieved at all if nonfederal sector demand were weak.

If, however, the economic goals were less ambitious -- if the nation were willing to settle for the less vigorous economic path over the next five years -- it would be easier to balance the budget with a declining ratio of federal spending to GNP. With only moderately strong demand by the nonfederal sectors of the economy, continued

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3/ For a description of current policy expenditures and revenues see, Five-Year Budget Projections: Fiscal Years 1978-1982, CBO, December 1976.

TABLE 8. CURRENT POLICY EXPENDITURES, FISCAL YEARS 1978 TO 1982, IN BILLIONS OF DOLLARS

Fiscal Year	Federal Expenditures (Unified)	Ratio of Expenditures to GNP (Percent)	Strong Nonfederal Demand: Budget Surplus (+) or Deficit (-)	Strong Nonfederal Demand: Required Tax Increases (+) or Decreases (-)	Moderate Nonfederal Demand: Budget Surplus (+) or Deficit (-)	Moderate Nonfederal Demand: Required Tax Increases (+) or Decreases (-) a/	Weak Nonfederal Demand: Budget Surplus (+) or Deficit (-)	Weak Nonfederal Demand: Required Tax Increases (+) or Decreases (-)
BASELINE GNP PATH								
1978	451.0	22.1	- 15.8	+ 28.1 a/	- 49.8	- 5.8	b/	b/
1979	480.0	21.3	- 13.2	+ 2.7 a/	- 57.6	- 41.6	b/	b/
1980	514.0	20.6	- 20.6	- 32.6 a/	- 77.2	- 89.2	b/	b/
1981	548.0	19.9	- 11.3	- 57.3 a/	- 81.6	-127.6	b/	b/
1982	586.0	19.3	+ 1.0	- 80.9 a/	- 86.1	-168.1	b/	b/
LESS VIGOROUS GNP PATH								
1978	451.0	22.2	c/	c/	- 45.3	+ 0.5	- 79.9	- 34.0
1979	483.0	21.8	c/	c/	- 29.0	+ 0.0	- 73.2	- 44.1
1980	519.0	21.5	c/	c/	- 24.3	- 10.4	- 79.6	- 65.7
1981	552.0	21.0	c/	c/	- 13.6	- 23.3	- 81.4	- 91.1
1982	587.0	20.6	c/	c/	- 5.6	- 39.2	- 88.0	-121.6

a/ Figures in this column are differences from current policy tax collections.

b/ The deficits and tax cuts in this column are too large to be regarded as plausible and are, therefore, omitted from the table.

c/ A tax policy that generates substantial surpluses would be required to keep the economy from growing at a faster rate.

current policy expenditures combined with modest tax cuts would bring the budget close to balance by fiscal year 1982. Indeed, if the nonfederal sectors were strong, the federal budget could run a substantial surplus without endangering the attainment of this less vigorous economic path. Only if the nonfederal sectors were weak would it be necessary to run a large and increasing federal deficit even to attain the less vigorous path.

$50 BILLION LOWER FEDERAL SPENDING BY FISCAL 1982 4/

A second budget strategy would involve spending cuts of $50 billion below CBO's current policy estimates by fiscal year 1982. This is somewhat below the long-term expenditure path implied by the recently submitted Ford Administration budget. Such a path would imply a reduction in the ratio of federal spending to the gross national product from 22.5 percent to between 17.7 and 18.8 percent by 1982 depending upon which GNP path is used.

As may be seen in Table 9, no matter what is assumed about the strength of nonfederal demand, the lower expenditures implied by this budget strategy would have to be accompanied by even larger tax cuts than those required by current policy expenditures to keep the economy growing even at the less vigorous rate. Indeed, near balance in the federal budget could be achieved by the end of the period only if nonfederal demand were strong or if a growth path below the less vigorous one used here were accepted. Moderate nonfederal demand would require large and growing deficits to achieve the baseline GNP path. Smaller and shrinking deficits would, however, be consistent with moderate nonfederal demand and attainment of less vigorous economic growth.

4/ In this and the following section, it is assumed that changes in expenditures from a current policy path are divided among purchases of goods and services, transfer to persons and grants-in-aid in the same ratios as these categories bear to one another in the current policy projection.

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TABLE 9. $50 BILLION LOWER FEDERAL EXPENDITURES BY FISCAL YEAR 1982, IN BILLIONS OF DOLLARS

Fiscal Year	Federal Expenditures (Unified)	Ratio of Expenditures to GNP (Percent)	Strong Nonfederal Demand: Budget Surplus (+) or Deficit (-)	Strong Nonfederal Demand: Required Tax Increases (+) or Decreases (-)	Moderate Nonfederal Demand: Budget Surplus (+) or Deficit (-)	Moderate Nonfederal Demand: Required Tax Increases (+) or Decreases (-) a/	Weak Nonfederal Demand: Budget Surplus (+) or Deficit (-)	Weak Nonfederal Demand: Required Tax Increases (+) or Decreases (-)
BASELINE GNP PATH								
1978	441.0	21.6	- 20.4	+ 13.5 a/	- 54.5	- 20.5	b/	b/
1979	460.0	20.4	- 21.0	- 25.0 a/	- 65.6	- 69.6	b/	b/
1980	484.0	19.4	- 30.6	- 72.6 a/	- 87.4	-129.4	b/	b/
1981	508.0	18.5	- 22.3	-108.3 a/	- 92.9	-178.9	b/	b/
1982	536.0	17.7	- 10.5	-142.5 a/	- 97.9	-229.9	b/	b/
LESS VIGOROUS GNP PATH								
1978	441.0	21.7	c/	c/	- 49.9	- 14.0	- 84.6	- 48.7
1979	463.0	20.9	c/	c/	- 36.7	- 27.6	- 81.0	- 71.9
1980	489.0	20.3	c/	c/	- 34.2	- 50.3	- 89.7	-105.8
1981	512.0	19.5	c/	c/	- 24.7	- 74.4	- 92.6	-142.3
1982	537.0	18.8	c/	c/	- 17.2	-100.8	- 99.9	-183.5

a/ Figures in this column are differences from current policy tax collections.

b/ The deficits and tax cuts in this column are too large to be regarded as plausible and are, therefore, omitted from the table.

c/ A tax policy that generates substantial surpluses would be required to keep the economy from growing at a faster rate.

$50 OR $100 BILLION IN NEW FEDERAL PROGRAMS BY FISCAL 1982

Current policy spending allows for normal growth in the programs already enacted, but not for new programs -- unless these are substituted for existing programs. In the past, of course, the federal government has periodically taken on increasing responsibilities, and at present there is support for further expanding those responsibilities. To illustrate the consequences of such increases, this section analyzes two expenditure strategies which raise federal spending $50 billion and $100 billion, respectively, above current policy levels by fiscal year 1982. The lower of these two paths assumes that successive increments of $10 billion are added to current policy spending each year through fiscal year 1982, representing an average growth in federal expenditures of 9.0 percent a year; this is comparable to the average rate of increase experienced from fiscal year 1960 through 1976. This rate of increase would imply approximate constancy in the ratio of federal spending to GNP; that ratio would be 21.0 percent to 22.3 percent of GNP by 1982, depending on which GNP path is used.

The higher path assumes an increase of $20 billion over current policy spending levels in each year, or an average growth rate of federal spending of 10.7 percent per year between fiscal years 1977 and 1982. This is roughly the same as the average rate of increase between 1970 and 1976, but above the corresponding figure for earlier periods. It would imply a rise in the ratio of federal spending to GNP from its current 22.5 percent to between 22.7 percent and 24.1 percent, depending on which GNP path is used.

As shown in Tables 10 and 11, the basic story remains the same, even when expenditures are growing faster than current policy: attaining the higher baseline growth path while balancing the budget is possible only if nonfederal demand is strong. If nonfederal demand is only moderate, it will be necessary either to settle for the less vigorous GNP growth path or to run a federal deficit. With higher spending, however, the deficit need not be as large as under current policy to achieve a particular growth path. The cuts below current policy taxes shown in Tables 10 and 11 are considerably smaller than those shown in Table 8. Moreover, as may be seen in Table 11, if private demand is strong and the higher federal expenditure level is

TABLE 10. $50 BILLION ADDITIONAL FEDERAL EXPENDITURES BY FISCAL YEAR 1982, IN BILLIONS OF DOLLARS

BASELINE GNP PATH

Fiscal Year	Federal Expenditures (Unified)	Ratio of Expenditures to GNP (Percent)	Strong Nonfederal Demand: Budget Surplus (+) or Deficit (-)	Strong Nonfederal Demand: Required Tax Increases (+) or Decreases (-)	Moderate Nonfederal Demand: Budget Surplus (+) or Deficit (-)	Moderate Nonfederal Demand: Required Tax Increases (+) or Decreases (-) a/	Weak Nonfederal Demand: Budget Surplus (+) or Deficit (-)	Weak Nonfederal Demand: Required Tax Increases (+) or Decreases (-)
1978	461.0	22.6	- 11.2	+ 42.7 a/	- 45.2	+ 8.7	b/	b/
1979	500.0	22.2	- 5.4	+ 30.5 a/	- 49.7	- 13.7	b/	b/
1980	544.0	21.8	- 10.6	+ 7.3 a/	- 67.0	- 49.0	b/	b/
1981	588.0	21.4	- 0.2	- 6.2 a/	- 70.3	- 76.3	b/	b/
1982	636.0	21.0	+ 12.5	- 19.4 a/	- 74.2	-106.2	b/	b/

LESS VIGOROUS GNP PATH

1978	461.0	22.7	c/	c/	- 40.7	+ 15.1	- 75.2	- 19.3
1979	503.0	22.7	c/	c/	- 21.2	+ 27.8	- 65.3	- 16.2
1980	549.0	22.8	c/	c/	- 14.5	+ 29.3	- 69.5	- 25.6
1981	592.0	22.6	c/	c/	- 2.6	+ 27.6	- 70.1	- 39.8
1982	637.0	22.3	c/	c/	+ 5.9	+ 22.3	- 76.1	- 59.7

a/ Figures in this column are differences from current policy tax collections.

b/ The deficits and tax cuts in this column are too large to be regarded as plausible and are, therefore, omitted from the table.

c/ A tax policy that generates substantial surpluses would be required to keep the economy from growing at a faster rate.

TABLE 11. $100 BILLION ADDITIONAL FEDERAL EXPENDITURES BY FISCAL YEAR 1982, IN BILLIONS OF DOLLARS

BASELINE GNP PATH

Fiscal Year	Federal Expenditures (Unified)	Ratio of Expenditures to GNP (Percent)	Strong Nonfederal Demand: Budget Surplus (+) or Deficit (-)	Strong Nonfederal Demand: Required Tax Increases (+) or Decreases (-)	Moderate Nonfederal Demand: Budget Surplus (+) or Deficit (-)	Moderate Nonfederal Demand: Required Tax Increases (+) or Decreases (-) a/	Weak Nonfederal Demand: Budget Surplus (+) or Deficit (-)	Weak Nonfederal Demand: Required Tax Increases (+) or Decreases (-)
1978	471.0	23.1	- 6.7	+ 57.2 a/	- 40.5	+ 23.4	b/	b/
1979	520.0	23.1	+ 2.3	+ 58.3 a/	- 41.8	+ 14.1	b/	b/
1980	574.0	23.1	- 0.6	+ 47.3 a/	- 56.8	- 8.8	b/	b/
1981	628.0	22.9	+ 10.7	+ 44.7 a/	- 59.0	- 25.0	b/	b/
1982	686.0	22.6	+ 24.1	+ 42.1 a/	- 62.4	- 44.4	b/	b/
LESS VIGOROUS GNP PATH								
1978	471.0	23.2	c/	c/	- 36.1	+ 29.7	- 70.5	- 4.6
1979	523.0	23.6	c/	c/	- 13.5	+ 55.5	- 57.4	+ 11.6
1980	579.0	24.0	c/	c/	- 4.6	+ 69.2	- 59.5	+ 14.3
1981	632.0	24.1	c/	c/	+ 8.3	+ 78.6	- 58.8	+ 11.4
1982	687.0	24.1	c/	c/	+ 17.5	+ 83.9	- 64.2	+ 2.1

a/ Figures in this column are differences from current policy tax collections.

b/ The deficits and tax cuts in this column are too large to be regarded as plausible and are, therefore, omitted from the table.

c/ A tax policy that generates substantial surpluses would be required to keep the economy from growing at a faster rate.

desired, taxes must actually be raised to keep the economy from growing faster than the baseline rate. Failure to implement such tax increases in this situation would lead to intense inflationary pressures as rapidly expanding federal programs competed with the nonfederal sectors for the fully employed resources of the economy.

GENERAL IMPLICATIONS

The key point for Congressional decision-making that arises from the preceding analysis is that, no matter what the strength of nonfederal demand, the federal government faces a wide range of budget possibilities over the next five years. However, because not all combinations of desired economic and budgetary goals can be achieved, tradeoffs must be made.

The greater the vigor of the nonfederal sectors:

- The easier the achievement of a high GNP with less federal action.
- The smaller the deficit or the greater the surplus for any federal expenditure strategy.
- The less the federal flexibility for increasing expenditures or decreasing taxes.

The higher the desired level of federal expenditures:

- The easier the achievement of high GNP through federal action.
- The smaller the deficit or the greater the surplus needed to attain a specified economic goal.
- The smaller the opportunity to cut taxes.

The higher the GNP goal (and the lower the unemployment goal):

- The greater the deficit or the smaller the surplus for any desired level of federal expenditures.

- The greater the federal flexibility for increasing expenditures or decreasing taxes.

- The greater the danger of continuing or accelerating inflation.

NEW SPENDING INITIATIVES

To place the previous discussion in a programmatic context, it is useful to examine the budget implications of some of the specific spending initiatives now under consideration. How do the costs of various combinations of programs relate to the alternative long-term fiscal scenarios presented earlier?

Estimates can be made of the amount of expenditure increase or tax reduction (compared with current policy) that would be needed in fiscal year 1982 under alternative assumptions about growth goals and the strength of non-federal demand (see Part A of Table 12). These can be compared with the projected costs in fiscal year 1982 of some spending options discussed in greater detail in Part II of this report (see Part B of Table 12).

Under most circumstances it appears possible to accommodate many of the spending options open to the Congress without serious risk of having to raise taxes above current policy levels. 5/ The major exception is a federally funded comprehensive national health insurance plan. Although the large-scale sectoral shifts implicit in such a program mean that the $108 billion annual cost of the program is not directly comparable to the "fiscal room" shown in Part A of Table 12, one point seems clear. It is that, under all but one of the hypothetical sets of economic conditions, a large-scale, tax-financed health program would

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5/ It should be noted that comparison of fiscal year 1982 program costs with the "fiscal room" shown in Part A of Table 12 ignores program specific considerations. While such comparisons are useful as a rough guide for long-term planning purposes, they should be interpreted with caution.

TABLE 12A. RANGE OF REQUIRED DEPARTURES FROM CURRENT POLICY TAXES OR EXPENDITURES IN FISCAL YEAR 1982, BILLIONS OF DOLLARS

Economic Conditions	Tax Decrease (-) Assuming Current Policy Expenditures a/	Expenditures Increase (+) Current Policy Taxes b/
Baseline GNP Growth Path		
Strong Nonfederal Demand	- 81	+ 61
Moderate Nonfederal Demand	-168	+132
Less Vigorous GNP Growth Path		
Moderate Nonfederal Demand	- 39	+ 30
Weak Nonfederal Demand	-122	+ 98

TABLE 12B. PROJECTED COSTS OF SELECTED NEW PROGRAMS IN FISCAL YEAR 1982, BILLIONS OF DOLLARS c/

Program	Cost
Welfare Reform	
National Standards (AFDC)	6.3
Comprehensive Cash System (Income Security for Americans)	15.3
Health Care	
Federalized Medicaid (Federally Financed)	44.1
Catastrophic Insurance	19.0 to 20.0
Tax Financed National Health Insurance	108.0 to 138.0
Energy	
Low Consumer Cost Emphasis	7.8
Low Import Emphasis	3.1
Agriculture	
Deficiency Payments (Wheat, Feedgrains, and Cotton) with Target Prices and Loan Rates Set in Relation to the Cost of Production	5.4

a/ Figures based on Table 8.

b/ For the details of the methodology used to calculate these numbers see the forthcoming CBO Technical Staff Paper, Closing the Fiscal Policy Loop: A Long-Run Analysis.

c/ These are cost changes from the current policy spending levels except in the case of Energy where the change is measured from the present policy spending level. The National Defense options discussed in Part II of this report do not lend themselves to a comparison of this type.

occupy most of the room available for new spending initiatives and would most likely require compensating reductions in other federal programs or tax increases above current policy levels. 6/

Various combinations of other programs, such as welfare reform plus catastrophic health insurance or long-term care plus increased defense spending, could use most if not all the room available in the budget, particularly if the less vigorous growth goal were supported by a moderate or stronger nonfederal economy. On the other hand, if the gap between growth aspirations and nonfederal demand strength is large, this combination plus others could be accommodated on fiscal policy grounds with room left over for tax cuts. Added spending, of course, reduces the scope for cutting taxes below current policy levels.

CONCLUSION

In almost all cases, some room will be available by fiscal year 1982 for federal spending or tax cuts beyond current policy. How much will be available depends crucially on the GNP growth goals and the support provided for such goals by the nonfederal sectors of the economy. A modest goal and strong nonfederal demand would leave little room for additional demand generated by higher federal spending or lower taxes.

The space available for federal programs thus varies. Very substantial commitments to future spending might fill the space or even overfill it, requiring future cutbacks in public or private spending. More modest commitments, however, will leave some flexibility to future Congresses. The question thus is: How much commitment now as against how much flexibility later?

6/ Added expenditures in the early years of a large-scale health program could be significantly above the increments to current policy assumed in Table 11. It would thus be necessary, on fiscal policy grounds, to reduce other programs, raise taxes above levels implied by Table 11, or implement the plan more slowly in the early years for each combination of GNP growth and nonfederal demand strength.

PART II. FEDERAL BUDGET CHOICES FOR FISCAL YEARS 1978 to 1982

Expenditures for national defense constitute slightly less than a quarter of the fiscal year 1977 federal budget -- $100.6 billion of a total budget of $413.1 billion. 1/ The current policy level of outlays for the national defense function in fiscal year 1978 is $113.6 billion (see Table 13). Measured in dollars of constant purchasing power, outlays for defense declined steadily from their Vietnam peak in the late 1960s through fiscal year 1975; real outlays grew slightly in fiscal year 1976 and will probably grow by 4 to 5 percent in fiscal year 1977.

CONGRESSIONAL DECISIONS

The Congress will face a number of major defense issues this year including:

- Whether and at what pace to continue the major procurement and modernization underway for the Army and the tactical air forces.
- How to balance the Navy shipbuilding program between aircraft carriers and their escorts or other forces, such as attack submarines and frigates more specialized in countering the Soviet submarine threat.
- Whether and at what pace to modernize the strategic bomber force with B-1 bombers, cruise missiles, a new land-based intercontinental ballistic missile, airborne warning and control aircraft, and new interceptors for continental air defense.

1/ For a more detailed discussion of the issues covered here, see the CBO Budget Issue Papers, Planning U.S. General Purpose Forces: Overview (January 1977), The Navy (December 1976), Army Procurement Issues (December 1976), The Tactical Air Forces (January 1977), Theater Nuclear Forces (January 1977), and The Costs of Defense Manpower: Issues for 1977 (January 1977).

TABLE 13. NATIONAL DEFENSE OUTLAYS IN BILLIONS OF DOLLARS, FISCAL YEARS

	1976 (Actual)	1977 (Estimated)	1978 (Current Policy)
Department of Defense			
Military and Civilian Pay	38.2	40.7	43.7
Retired Pay	7.3	8.3	9.0
Purchases	42.5	49.9	48.1
Military Assistance			
Foreign Military Sales Trust Fund	-0.6	-0.2	0.2
Other	1.1	0.7	0.6
Defense-related ERDA Programs	1.6	1.8	2.0
Other Defense-related Programs	0.1	-0.6	a/
Total	90.0	100.6	113.6

a/ Less than $50 million.

- How to control the growth of manpower and retirement costs while remaining able to recruit and retain high quality personnel.

Decisions on these matters will have important long-run consequences for the size of the defense budget and the capability of U.S. forces. Because major defense procurement programs usually extend over several years and because equipment that is procured must later be maintained and operated, the full budgetary impact of decisions to expand and modernize forces this year will not be felt for five to eight years, or even longer.

The discussion of these defense issues is divided into three parts: general purpose forces, strategic nuclear forces, and manpower and retirement.

THE GENERAL PURPOSE FORCES

The general purpose forces comprise the ground and tactical air forces, all of the Navy except the ballistic missile submarine fleet and its support ships, and the mobility forces that provide air- and sea-lift. The general purpose forces contain most of the manpower and are responsible for most of the cost of the U.S. defense establishment. 2/ Table 14 shows their size and composition.

TABLE 14. U.S. GENERAL PURPOSE FORCES, JULY 1, 1976

ACTIVE		RESERVE	
Ground Forces:		Ground Forces:	
Army (Divisions)	16	Army (Divisions)	8
USMC (Divisions)	3	USMC (Divisions)	1
Naval Forces:		Naval Forces:	
Aircraft Carriers	13	Destroyers	30
Major Surface Warships	159	Mine Warfare Ships	22
Nuclear Attack Submarines	63	Amphibious Ships	3
Amphibious Ships	62	Patrol Combatants	5
Auxiliaries	104		
Other	21		
Total Ships	422	Total Ships	60
Tactical Air Forces: a/		Tactical Air Forces: a/	
USAF:		USAF:	
Attack/Fighter Aircraft	2,300	Attack/Fighter Aircraft	900
USN:		USN/USMC:	
Attack/Fighter Aircraft	1,200	Attack/Fighter Aircraft	300
USMC:			
Attack/Fighter Aircraft	500		
Total Attack/ Fighter Aircraft	4,000	Total Attack/ Fighter Aircraft	1,200

a/ Numbers of aircraft are approximate.

2/ The general purpose forces account for about 36 percent and the strategic for about 8 percent of the defense budget, according to the most widely used Department of Defense accounting scheme. With more complete allocation of the various overhead functions, such as logistics and training, these proportions are about 59 and 16 percent, respectively.

The principal contingency against which the U.S. general purpose forces are planned is a worldwide war between the Soviet Union and its allies and the United States and its allies. In this contingency, the center of conflict is in Europe, but it is assumed also that there would be combat or a threat of combat in Northeast Asia. This hypothetical case is regarded as a suitable tool for force planning because Europe and Japan are important to U.S. interests; because there is a concrete military threat deployed in Eastern Europe; and because of the belief that, if our forces are adequate for this contingency, they will also be adequate for other contingencies.

Should the war described in the planning scenario actually occur, it would cause enormous casualties and widespread destruction. The balance of forces between NATO and the Warsaw Pact is such that neither can be sure of a successful military outcome. The United States is probably unwilling to buy general purpose forces large enough to guarantee U.S. victories in such a situation. Moreover, an attempt to do so might simply provoke an offsetting Soviet buildup. Thus, the outcome of a major war with the Soviet Union would be uncertain. Since neither side would have an overwhelming predominance of force, generalship, circumstances, morale, and luck would likely be decisive. Either side can undertake programs that might shift the odds, but there is no way for one, in the near term, to acquire an overwhelming advantage.

Such assessments of the military balance, however, do not by themselves determine whether we want to spend more or less on the general purpose forces. Prudent balancing of costs and risks would have to consider the likelihood that some conflict might actually erupt and whether or not the Soviets have any interest in disrupting the status quo. There is, in addition, the question of the appropriate division of effort between ourselves and our allies. Can other countries pick up burdens the United States decides not to carry? If they did, or if they did not, and the overall capability of the United States and its allies declined, how would world politics change and how would U.S. interests be affected?

Even within the current definition of our interests, a number of overall choices remain. What level of risk will the United States accept and what size and type of

general purpose force is consistent with that risk? How should the United States balance the competing demands for capability to fight a brief war or a protracted war? How should the United States balance the demand for an ability to respond quickly to a sudden war with an interest in having the largest and most effective forces possible after some period of mobilization? The options below illustrate the impact of such choices on the defense budget.

General Purpose Forces Options

The ability to maintain a coherent early defense without giving up too much ground in the face of a Warsaw Pact attack in Europe is the fundamental requirement of our current defense strategy. Only if that can be done can other forces be brought to bear to produce a favorable outcome. Thus, priority in defense planning should go to ensuring that NATO forces have a good chance of preventing a deep penetration of Western Europe. Then forces are needed to sustain the war for as long as necessary. However, because the United States can never be entirely sure it could stop any attack, it is possible to concentrate too heavily on forces for the early battles, and provide too few for later phases of the war. The options presented below show alternative ways to strike the balance between initial and long-term capability.

The Department of Defense (DoD) Baseline. Although recent DoD Reports have stressed the importance of the initial battle in Europe, much of the present Department of Defense force expansion and modernization program is aimed at improving the capability to fight a longer war. Expansion of the Army from 13 to 16 active divisions may not contribute to an early NATO defense; it may even reduce it. 3/ Conversion of Army infantry divisions to armored or

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3/ This is primarily because the smaller force could mobilize faster and would be less dependent on affiliated reserve units. For a more detailed treatment of this point, see U.S. Army Force Design: Alternatives for Fiscal Years 1977-1981, CBO Staff Working Paper, July 16, 1976.

80-294 O - 77 - 6

mechanized infantry divisions would not bolster initial capability because the equipment for the new divisions most likely would be moved to Europe by sea, and thus would arrive well after the early phases of the war. The expansion of the U.S. Air Force to 26 tactical air wings is primarily aimed at improving sustaining capability. Strategic mobility improvements proposed by DoD, such as the airlift enhancement program, however, should improve NATO's early capability.

The baseline program shown in Table 15 includes a general expansion toward a fleet of 600 ships, including procurement of further nuclear aircraft carriers and escort vessels equipped with the AEGIS air defense system. 4/ The ability of carrier-based aircraft to contribute significantly to the early phase of a land war in Europe is uncertain. Similarly, it is not clear that additional resources devoted to containing the Soviet submarine and aircraft threats to the Atlantic shipping lanes would significantly increase the rate of delivery of reinforcements and supplies in the first months of a war. The present size and structure of the Navy, particularly the balance between aircraft carriers and their escorts, and more specialized antisubmarine vessels, must be justified by reference to contingencies other than an abrupt, brief NATO/Warsaw Pact conflict.

Some programs in the DoD baseline would, however, improve rapid reaction and initial fighting capability. These include:

- o Base hardening, including shelters for aircraft.
- o Airlift enhancement.
- o Armored combat vehicles (XM-1 tank and MICV personnel carrier).

4/ Nuclear-powered aircraft carriers were included in the five-year defense program underlying the fiscal year 1977 budget request, but have been dropped in the Ford Administration's fiscal year 1978 request in favor of smaller vessels.

- o The Cobra/TOW helicopter and infantry antitank guided missile programs.

- o Reconnaissance and battle management improvements such as airborne warning and control systems (AWACS).

Added Initial Fighting Capability. If NATO is seen to be vulnerable to a sudden and intense attack from the Warsaw Pact, there are many possible solutions. One, which would be direct and which would have an immediate and measurable impact, would be for the United States to deploy more forces to Europe. Another would be to subsidize our European allies to upgrade the equipment and readiness of their NATO forces. Both of these measures would clearly raise defense budgets and would be contrary to the U.S. foreign policy trend that encourages our allies to shoulder more of their own defense burden. Neither seems likely to be seriously considered except in response to a much more threatening situation in Europe. While these programs will not be discussed in the options considered here, they should not be ruled out as possible future responses.

We can improve our response to an initial Warsaw Pact attack by improving the forces that can get into the early battle and by improving the capability to move forces rapidly from their peacetime locations to the battle field.

An option that would add initial fighting capability to the present baseline modernization and improvement programs would:

- o Increase prepositioned (POMCUS) stocks for Army forces.

- o Procure additional all-weather tactical aircraft and further adapt present aircraft, especially the A-10, to all-weather missions.

- o Accelerate procurement of antitank guided missiles and Cobra/TOW attack helicopters.

These steps, added to the current program of expansion to 16 divisions and 26 wings, and procurement of another aircraft carrier, would increase the national defense budget authority by about $3.7 billion from 1978 to 1982.

Reduced Force Expansion with Rapid Reaction Improvements. For some time, the military services have been producing forces designed to fight a long war. And this capability may be enough to provide longer-term backup to the forces that will react to any Warsaw Pact aggression. For example, present and programmed antisubmarine warfare (ASW) forces can defeat the Soviet submarine force over a period of months and are adequately supported in this sea control role by present Navy aircraft carrier force levels. However, because of the Navy's emphasis in its force planning on the use of carriers to attack enemy targets ashore (power projection), the United States may now have a larger carrier force than is required for sea control alone. But the power projection mission may not be germane to war in Europe. It may be very expensive to acquire the capability to attack Soviet land-based forces directly from the sea, and such a capability may have little effect upon the outcome of the campaign in Central Europe, either in the shorter or longer term.

Thus, in this option, programmed Navy force improvements relatively specialized in the power projection mission would be eliminated to free resources for increased rapid reaction capability.

Similarly, the Army's expansion to 16 divisions would be curtailed, both to save the resources involved in outfitting the additional three divisions and to ensure that those Army divisions that do join the battle in Europe have adequate combat support. In this option, expansion of the Air Force would be limited to 24 wings, with 2 wings of F-15s deleted from the plan. In addition, USMC and Navy tactical air wings would be equipped and trained so that they could operate from land bases in Europe.

If the improvements that relate to rapid reaction mentioned in the previous option are programmed into the present force, along with the restraints mentioned above, national defense budget authority could be some $15 billion below the DoD baseline program over the next five years.

Reduced Force Expansion. Other needs for national resources may be found to be more pressing than the need for a substantial increase in U.S. military capability in Europe. The overall deterrent capability of NATO backed by U.S. strategic forces may be seen as adequate, and it can

be argued that U.S. force improvements in Europe do not appreciably improve NATO capabilities as a whole unless our allies follow suit with commensurate improvements. This view would hold that our allies, with the possible exception of the Federal Republic of Germany, have never taken the conventional NATO war scenario seriously enough to have acquired the forces and war reserves to support it adequately. There is thus little incentive for the United States to do so.

An option that would reflect willingness to continue with forces very similar to our present forces, without the expansion and upgrading included in the previous options,

TABLE 15. BUDGET OPTIONS FOR GENERAL PURPOSE FORCES, IN BILLIONS OF DOLLARS, FISCAL YEARS

Option	1977	1978	1979	1980	1981	1982
CBO Current Policy Projection	112.1	120.0	126.7	134.9	143.6	153.2
DoD Baseline Program a/	112.1	122.4	131.9	141.6	151.5	160.2
Changes from Baseline Program						
Added Initial Fighting Capability		+0.4	+1.1	+1.3	+0.9	+0.0
Added Initial Capability and Reduced Force Expansion		-1.9	-2.6	-2.3	-4.7	-3.5
Reduced Force Expansion		-2.3	-3.7	-3.6	-5.6	-3.5

a/ The basis for this projection is described in CBO Budget Issue Paper, Planning U.S. General Purpose Forces: Overview, January 1977.

would imply defense costs over the next five years that would be below the DoD baseline by some $18.7 billion. Small additional costs might be incurred to improve the theater nuclear forces, given their increased importance in this option.

THE STRATEGIC NUCLEAR FORCES

The offensive strategic nuclear forces of the United States include Minuteman and Titan intercontinental ballistic missiles (ICBMs), Polaris and Poseidon submarine-launched ballistic missiles (SLBMs), and B-52 and FB-111 bombers. Strategic defensive forces include air defense interceptors and the radar and communications networks designed to provide warning of a ballistic missile attack. The United States has no active antiballistic missile (ABM) system.

The growth of Soviet strategic nuclear forces in the last decade has necessitated a reassessment of the role of the U.S. nuclear forces. As the balance now stands, neither the United States nor the Soviet Union can defend itself from a strategic nuclear attack or prevent an attack by launching an all-out attack on the other's strategic nuclear forces. Thus, neither side can use strategic bombardment without suffering retaliation that could include destruction of much of the nation's industry and the deaths of tens of millions of people.

Some have argued that the use of strategic forces need not inevitably escalate to that kind of catastrophe, and that strategic nuclear forces may be needed to make controlled, limited strikes as well as to devastate the opponent.

Whether the strategic forces are designed for mutually assured destruction, or for carrying out limited nuclear options or both, the criteria of adequacy are elusive. For example, one might decide that the forces were adequate if, after absorbing a well-designed first strike, they could destroy half of the opponent's industry and one-quarter of its population. But then, what if some set of assumptions and calculations about a hypothetical attack showed that U.S. forces could only destroy 40 percent of the industry and 20 percent of the population in response?

Would this signal a need for major upgrading of U.S. strategic forces? Further, the country to be deterred from striking first does not, presumably, have access to the calculations done by the other. Both sides likely make such calculations using quite conservative assumptions about the effectiveness of each other's forces. The situation may arise in which each side has severe anxiety about the adequacy of its own forces as a deterrent to the other, and neither side is willing to forego its efforts to redress the balance.

The criteria of adequacy for limited nuclear options are even more difficult, ambiguous, and uncertain than those related to deterrence. This is because many assumptions have to be made about the scenario in which the option would take place, the effect on the enemy, his response, third-party perceptions and responses, and so on.

Thus deciding whether the United States has enough strategic nuclear forces to support its objectives is inherently very difficult. Referring to simpler and more accessible measures, such as numbers of launchers, or warheads, or megatons, is no more useful, since the bewildering array of yields, accuracies, vehicles, target systems, and other variables on both sides defies meaningful comparison.

Whatever the measure of the strategic balance, the story is now far different from that of a decade ago. For example, the United States now has fewer strategic offensive launchers than the Soviet Union (see Table 16). Numbers of launchers do not tell the whole story. U.S. deployment of multiple independently targetable warheads (MIRVs) on 550 Minuteman III ICBMs and on more than 400 Poseidon SLBMs has greatly increased the number of warheads that can be delivered against the USSR. The Soviet Union lagged behind the United States in MIRV deployment, but it is now catching up. But the Soviet warheads generally tend to be more powerful than their U.S. counterparts. This trend has elicited concern.

The shift of the strategic balance towards the Soviet Union has created a dilemma for U.S. defense planners. In 1966 the United States had a clear margin of superiority and this dominated any uncertainty over the calculations or the

TABLE 16. U.S. AND SOVIET STRATEGIC LAUNCHERS, 1966 AND 1976

Type	1966 a/		1976 b/	
	U.S.	USSR	U.S.	USSR
ICBMs	934	340	1054	1500
SLBMs	512	130	656	850
Intercontinental Bombers	680	155	421	180

a/ Statement of Secretary of Defense Robert S. McNamara on the fiscal year 1968 Defense Budget.

b/ Report of Secretary of Defense Donald H. Rumsfeld to the Congress on the fiscal year 1977 Budget.

criteria. Now, however, the balance is more even. The objective of U.S. defense planners must be to ensure that no credible set of exchange calculations could convince the Soviet Union that it has a first-strike capability or that some limited strike could produce a great advantage while still keeping U.S. cities hostage against a retaliatory strike. At the same time, it seems reasonable to avoid acquiring or planning to acquire U.S. strategic forces that could do the same thing to the USSR.

A range of strategic postures is consistent with the fundamental objective of deterrence. All of the following options lie within that range, but each arises from a different policy emphasis and each implies the procurement of different forces:

- Finite-Deterrence Posture. Highly survivable, smaller force for assured destruction, with some hedges against Soviet technological breakthroughs, and very limited capability for selective employment.

- Second-Strike Counterforce Posture. Highly survivable assured destruction force with the additional capability to attack Soviet strategic forces remaining after a Soviet attack on the United States. Counterforce capability would be considerable, but not sufficient to threaten a disarming first strike.

- Limited-Options Posture. Capable of conducting selective nuclear attacks over an extended period for political or military purposes, while absorbing similar attacks, modest counterforce capability, backup assured destruction capability.

- Essential-Equivalence Posture. Equality or better in most or all key indicators of strategic force size and capability, such as deliverable warheads, equivalent megatonnage, etc., with substantial counterforce capability.

Since U.S. strategic force size and composition change only slowly over the years in response to the changing emphasis of national budgets, the force options outlined here simply indicate general directions for change, and should not be taken as final force designs. However, it is possible to talk generally about the kinds and numbers of systems associated with each. None of the options would violate the ABM Treaty, the SALT I offensive weapons accord, or the Vladivostok agreements.

For purposes of comparison, the present Department of Defense plan for strategic forces includes procurement of the B-1 bomber, with an eventual force goal of 241 aircraft; procurement every two years of three Trident submarines armed with Trident I missiles; development of the Trident II missile; development and deployment of a new ICBM called M-X, which will be capable of firing from mobile launchers; and development of air- and sea-launched cruise missiles. The following paragraphs sketch modifications to that DoD plan.

The finite-deterrence force would place primary dependence for assured destruction on SLBMs, but would hedge against Soviet ASW breakthroughs by retaining the Minuteman III force and the B-52 force until they were clearly obsolete.

The finite-deterrence force would represent considerably less investment in strategic forces than is now being programmed by DoD. It would continue the Trident program as planned by DoD, would not buy the B-1, and would defer procurement of a follow-on manned bomber until the 1990s. Further, it would not procure the M-X, nor a ship-launched cruise missile, and it would defer production of a new ICBM until at least the 1990s.

Choosing the finite-deterrence force would be consistent with the view that present Soviet strategic programs are mainly the response of conservative military planners to past U.S. programs. This force is also consistent with the view that strategic supremacy does not provide important political advantages. A finite-deterrence force would still be capable of inflicting severe damage on the Soviets following a first strike.

Compared with present Defense Department programs, choosing the finite-deterrence force goal would imply savings of about $16.4 billion over the fiscal year 1978 to 1982 period.

A force with a second-strike counterforce capability would require most of the force improvements currently programmed. The Trident submarine program would continue at its planned rate, ultimately replacing the Polaris/Poseidon force. The B-1 bomber would be continued with a goal of 241 operational aircraft to provide a means of delivering large numbers of warheads with high accuracy. Air-launched cruise missiles would be procured for use on the B-52 and the B-1, but ship-launched cruise missiles would not be procured. To aid the bombers in their mission and to hedge against a Soviet breakthrough in ASW, the M-X missile program would also be continued.

A second-strike counterforce capability would be a response to the possibility of a strategic conflict that began with an attempt by the Soviets to destroy U.S. land-based nuclear forces while retaining sufficient forces to threaten U.S. cities. Without a survivable force capable of destroying the remaining Soviet missiles, the United States would have to choose between capitulation and attacking Soviet cities. With such a force, the United States could attack the withheld Soviet weapons, leaving both sides dependent on their sea-based deterrent forces. A

rough balance would once again exist, and some of the population centers of both nations might remain undamaged. It is argued that U.S. bombers and surviving missiles could provide the needed counterforce capability while submarines could provide an assured retaliatory force.

The costs of this force would be essentially the same as the currently programmed force over fiscal years 1978 to 1982 (see Table 17).

TABLE 17. BUDGET OPTIONS FOR STRATEGIC NUCLEAR FORCES, IN BILLIONS OF DOLLARS, FISCAL YEARS

Option	1978	1979	1980	1981	1982
Changes from DoD Baseline Program					
Finite-Deterrence Force	-2.8	-2.7	-3.6	-4.0	-4.1
Second Strike Counterforce a/	--	--	--	--	--
Limited-Options Force	-1.8	-2.3	-2.5	-2.6	-2.3
Essential-Equivalence Force	+0.3	+1.0	+0.5	+2.5	+0.9

a/ Less than $50 million.

The limited-options posture would place primary emphasis on the controlled and selective use of nuclear weapons for coercive purposes. It would feature the capability to make small-scale nuclear strikes against the USSR (and to sustain limited strikes in return) over an extended period, while preserving the threat of an assured destruction attack to deter the Soviet Union from unlimited attacks.

To provide an assured destruction capability, a Trident submarine force similar in size to that needed in the

finite-deterrent force (20 submarines) would be required Sea-launched strategic cruise missiles would be developed to provide greater flexibility in launch areas, flight paths, and targets for limited strikes. No B-1 bombers would be procured but a force of stand-off bombers armed with cruise missiles would be developed to replace the B-52s as they are retired. The single-warhead Minuteman II would be retained as the principal weapon to carry out limited strikes. It would be equipped with the NS-20 guidance and command data buffer system. When Minuteman II reaches the end of its service life, it would be replaced in upgraded silos by a new single-warhead missile for which research and development (R&D) would begin in fiscal year 1978. The yield and accuracy combination on this replacement would result in a very high probability of destroying a hardened target with a single missile. The M-X missile program would continue with an ultimate force goal of 200.

Choosing the limited-options force would be consistent with the view that nuclear war need not always escalate into global nuclear war and that limited nuclear strikes can have important military or political effects. To be reasonably sure that the Soviets could not convince themselves that their forces could win a war with the United States and its allies, deterrence would require strengthening across the entire spectrum of forces. For strategic forces, this would mean proceeding toward the limited-options force described above.

The limited-options force would be less costly than that now planned by DoD. It would require $11.5 billion less for strategic force funding from fiscal years 1978 to 1982.

The goal of an essential-equivalence force would be not only a credible war fighting posture but also the assurance that U.S. strategic forces could not be perceived to be inferior to Soviet forces. This force would include 30 Trident submarines, 241 B-1 bombers, the sea- and air-launched cruise missiles, and command and control improvements. Four hundred Minuteman IIs would be retained and the Minuteman III force would be replaced by 600 M-X missiles, 200 of which would be mobile. Strategic force R&D would be accelerated, particularly antiballistic missile projects. The follow-on interceptor would be procured. Resources allocated to civil defense would be greatly expanded.

Choosing the essential-equivalence force would be consistent with the view that war with the Soviet Union would almost certainly lead to global nuclear exchanges. In this situation, the appearance of superiority in strategic forces by the USSR could provide significant leverage in international affairs. Further, because other nations would also perceive Soviet nuclear superiority, they might be unwilling to resist Soviet pressure for long. The production of nuclear forces equal or superior to Soviet forces in most of the conventional measures of force size and capability would be needed to make credible the U.S. commitment to defend itself and its allies from Soviet aggression. Although this option might not be compatible with SALT, the view of Soviet intentions from some quarters would probably regard SALT as simply a device for achieving Soviet nuclear dominance.

The cost of the essential-equivalence force would be considerably higher than that now programmed by DoD -- some $5.2 billion higher from fiscal year 1978 to 1982.

DEFENSE MANPOWER

As the nation's largest employer, the Department of Defense in fiscal year 1977 will pay $53 billion to more than four million active, reserve, and retired military personnel, and to one million civilian employees. Under current policy, payroll costs will grow to around $56 billion in 1978, excluding several billion in the costs of maintaining and supporting defense personnel.

Defense payrolls have risen sharply in recent years, not only because of rapid inflation and the end of the draft, but also because of costly manpower policies. If these policies are continued -- especially if the Department of Defense continues to seek large numbers of high quality recruits from a declining population of young males -- manpower costs will continue to grow rapidly. Growth could be particularly rapid if the economy should expand rapidly and the number of jobs available to young men should increase substantially. Unless defense manpower policies are changed, potential cost increases could threaten the future of the all-volunteer force.

Because manpower costs are such a large part of the defense budget, relatively small changes in pay scales, in personnel turnover and rotation, and in the numbers required for support can have a large impact on costs. This section discusses, in turn, personnel training and management, policies affecting recruiting of the all-volunteer force, and the compensation of defense employees.

Military Personnel Management

The Department of Defense does not hire personnel trained for its unique missions. Instead, the Department recruits and trains personnel in a closed system. Nearly 20 percent of all uniformed personnel are engaged in training and recruiting activities that cost $7 billion in fiscal year 1977. Since 1974, the Defense Department has reduced the proportion of military personnel in overhead positions. There are three areas where further overhead reductions might be achieved without cutting numbers of forces: training, turnover, and recruiting.

Training Efficiency. In fiscal year 1977, basic military and advanced skill training for newly enlisted recruits will cost nearly $3 billion. These entry-level training costs could be cut significantly through more efficient use of trainee time and staff.

The minimum length of entry-level training for most recruits is set by law; the Congress recently reduced the minimum from four to three months. With improvements in entry-level training techniques, some integration of training phases, and better management of training time, the services could shorten entry-level training and take advantage of the change in the law. Savings averaging 20 percent are feasible in Army entry-level training time, as are smaller cuts in Navy and Air Force training. Together, these reductions would save more than $200 million per year.

The Army spends 50 to 130 percent more per week to train a recruit than the other services. Reductions in Army training staff and support, in addition to those associated with shorter training cycles, to bring the Army more in line with the other services, would save $50 million per year.

Reduced Military Turnover. Between fiscal years 1978 and 1982, the rate of turnover among military personnel will be 23 percent, rather than the 15 percent that was predicted in advance of the shift to all-volunteer forces. High turnover rates lead to higher recruiting and training costs but to smaller numbers of expensive senior personnel and to reduced retirement costs.

The present high turnover rate results from large losses among first-term personnel and from controls placed by the services on reenlistments. Procedures adopted in fiscal year 1974 to expedite discharges of marginal performers increased the percentage of recruits who failed to complete their first terms of enlistment from 25 to 37 percent. The Defense Department has established, but not enforced, goals for reducing first-term discharges that would still permit high discharge rates for persons in training. Meeting these goals would cut costs by $85 million in fiscal year 1978; a return to the even lower pre-1974 loss rates would save $170 million in fiscal year 1978. Loss rates before the 1974 policy changes could be considered relatively high because they were associated with the sharp cuts in forces at the end of the Vietnam conflict.

Higher reenlistment rates also can reduce turnover and costs by reducing the complement of untrained personnel and increasing productivity levels among military personnel. An increase of 20,000 per year in reenlistments, including civilians with prior military service, is feasible and would produce net savings of $110 million in fiscal year 1978 and $600 million over the next five years, largely through reductions in untrained personnel. To benefit fully from higher reenlistment rates, however, changes must be made in the military retirement system.

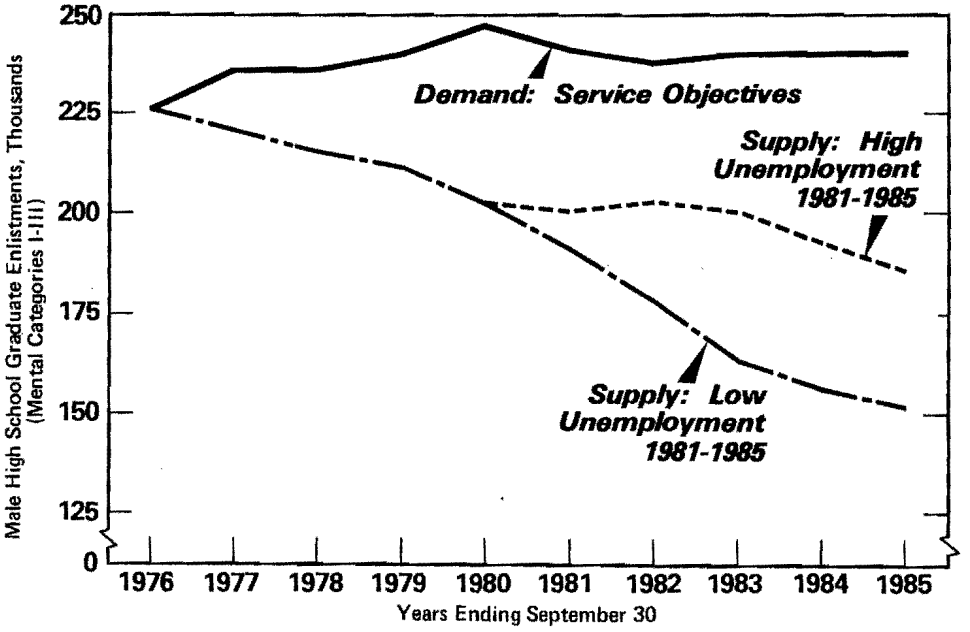
Military Recruiting

The services are seeking recruits who meet higher education and mental aptitude standards. This policy increases the demand for the very type of recruit who already is in short supply and who will be even more scarce in the 1980s because of declining birth rates in the 1960s. Projected increases in civilian job opportunities and rising civilian pay scales will make it more difficult for the services to compete for recruits.

Under a variety of assumptions about the future course of the economy, the supply of high quality recruits will fall short of the demand (see Figure 4). If the pace of economic growth is slow (high unemployment), demand will exceed supply of recruits in fiscal year 1985 by about 53,000; if the economic recovery is more rapid and the unemployment rate falls faster (low unemployment), demand in fiscal year 1985 will exceed recruit supply by over 85,000. Were the armed forces to try to make up for these shortages with across-the-board pay increases, about $8 billion (in 1977 dollars) would be added to 1985 manpower costs. Even if pay inducements were limited to bonuses for recruits, costs would go up by more than $2 billion in 1985. The need for sizable cost increases may lead to an abandonment of the all-volunteer force and hasten a return to the draft.

Figure 4

Projected Demand and Supply for Prime Recruiting Candidates, 1976-1985 Total Department of Defense a/



a/ For the details of the economic assumptions underlying the high and low unemployment projections, see *The Costs of Defense Manpower: Issues for 1977,* appendix, CBO, Budget Issue Paper, January 1977.

Changes in manpower policies would allow the Defense Department to overcome projected shortages without large increases in cost, and without a return to conscription. One approach would be to maintain high recruit quality but reduce the number of recruits. If the services increased the proportion of women from 6 to 10 percent, replaced some military personnel in jobs that can be performed by civilians, but, most important, adopted the changes in turnover, training, and reenlistment that are discussed above, the demand for recruits in fiscal year 1985 could be reduced by over 85,000. These actions would erase the shortages of recruits, even if the unemployment rates in the 1980s were low; would avoid large cost increases; and would save about $150 million per year in manpower costs (in 1977 dollars).

Another approach is to accept reduced recruit quality but continue to be selective about the caliber of personnel on active duty. The services disqualify about 42 percent of all potential recruits on physical or mental grounds. This is higher than the rejection rate among allied nations and far higher than the rate in the Soviet Union. Relaxing physical standards slightly could reduce the fiscal year 1985 shortage of recruits by about 8,000.

In future years, the services plan to increase the percentage of recruits who have high school diplomas. High school graduates typically have lower discharge rates than other recruits and are superior in other ways as well. But these benefits must be weighed against the feasibility and costs of concentrating recruiting efforts on a diminishing supply of candidates. A return to quality levels of fiscal year 1974 would reduce the fiscal year 1985 shortage by 31,000. By accepting a higher proportion of applicants with low test scores, particularly high school graduates in this category, shortages could be reduced by an additional 16,000. Turnover would remain high because programs to eliminate marginal performers would be maintained. However, this second set of options, along with some increases in recruiting and advertising, would also reduce the fiscal year 1985 shortfall by over 85,000. Because of more rapid turnover and higher recruiting costs, these options could increase costs by about $300 million per year after 1980 (in 1977 dollars).

80-294 O - 77 - 7

Military Compensation

Over the past ten years, several study groups have concluded that the present military compensation system does not provide incentives that allow the Defense Department to recruit and retain the personnel it needs at minimum cost. The major problem includes high costs, a complex system of benefits that does not provide uniformed personnel with a clear picture of their total pay, and a pay and allowance pattern that does not always help the Defense Department compete in the labor market for the personnel it needs.

Retirement Reform. Retirement reform can help cut costs and can help to achieve a more effective pattern of incentives. Several study groups have noted that the Defense Department needs more trained personnel with five to ten years of experience, fewer personnel with 10 to 20 years, and more personnel with 20 years or more. The current nondisability retirement system does not encourage such a pattern. It provides immediate annuities after 20 years of service, but virtually no benefits for less than 20 years of service. As a result, the retirement system provides little incentive to reenlist a first time because benefits are distant (first reenlistment usually occurs after three or four years of service). Because the services feel obliged to let personnel who sign up for a first reenlistment remain on duty until they qualify for a pension, the current retirement system causes the services to refuse some first reenlistments to hold down the number who will qualify for full benefits.

An alternative retirement system would provide -- or vest -- some benefits after as few as five years of service. This should increase incentives to reenlist and make the services more willing to encourage first reenlistees and then to discharge some with pension benefits, after ten or twelve years. A reformed retirement system probably would reduce benefits to personnel who retire with 20 years of service and thereby increase the number who stay on after 20 years.

Retirement reforms affect costs as well as retention patterns. Most reforms increase costs by up to $150 million a year for the first few years, chiefly because of early vesting and transition provisions, but the long-range savings are large. A proposal submitted to the Congress

last year would save $700 million a year (in today's dollars) by the year 2000. The proposal of a governmental interagency committee would save $2 billion a year by the year 2000. Other relatively minor changes to the retirement law could improve equity and consistency in military retirement and cut costs.

Salary System. Military personnel receive several types of pay. Some are in-kind rather than cash, and some benefits are exempt from federal income and social security taxes. Several studies have recommended replacing the complex military pay system with a single, fully taxable military salary. Such a salary system would make total pay more apparent and easier to compare with compensation for other work. This might aid in recruiting and reenlistment programs and, conceivably, could reduce pressures for future pay raises. A salary system would also provide equal pay to single and married personnel when they have equal rank, experience, and responsibilities. Single personnel now receive less pay. A military salary system also would display all manpower costs in the Defense Department budget; some now are hidden as foregone tax revenues.

There are drawbacks to a salary system. For example, determining fair charges for the food and housing that the Defense Department now provides would pose a significant administrative problem. Some groups of military personnel, particularly married servicemen, might object because their salaries would grow at a slower rate for a few years than salaries for single personnel. At the same time, relatively faster growth of single persons' pay may slow or reverse the growth in the fraction of the military force that is married. A decline in the proportion of married personnel could eventually reduce the costs of transfers, medical care, and other fringe benefits.

In the first year or so, a salary system would almost certainly increase costs because of transition provisions designed to prevent any pay cuts. Beyond the first few years, the system could be designed to leave unchanged most costs to the government, with the roughly $2 billion in higher costs to the Department of Defense offset by higher tax revenues from military salaries. Under an illustrative alternative developed by CBO, all but social security costs are left unchanged.

Civil Service Compensation

Thirty percent of defense manpower costs relate to civilians. The Department of Defense thus has a major stake in proposed changes in federal civilian compensation.

The pay of all General Schedule (white-collar) employees is determined by one national survey of professional, administrative, technical, and clerical employees in the private sector. The President's Commission on Federal Compensation (Rockefeller Commission) proposed that clerical and technical employees be separated from executive and managerial employees and that clerical/technical pay be determined on a regional basis. These two changes together should save all federal agencies about $100 million per year and the Defense Department about $40 million.

Larger savings would result from adopting the Rockefeller Commission proposals concerning Wage Board (blue-collar) employees. Current law ensures that blue-collar workers are paid on an average 9 percent more than their private-sector counterparts in comparable jobs; some workers can receive 35 percent more. Higher federal wages result from the way comparable pay must be determined and from the fact that wages for some workers in rural areas are based in part on urban salaries. The Rockefeller Commission proposals would eventually reduce defense costs by $510 million per year in today's dollars. Transition provisions reduce first-year savings to $110 million and savings over the next five years to about $2 billion. Although changes in both General Schedule and Wage Board pay would reduce costs, they are likely to be controversial. For example, they are opposed by public employee unions because they would restrain pay increases and change definitions of comparability.

Even without changes in federal pay schedules, the mix of General Schedule pay grades affects costs. The average grade of the Defense Department's General Schedule employees has increased about 6 percent since fiscal year 1964. The classification system used to establish General Schedule grades may have fostered some over-grading, though shifts in the composition of the white-collar force toward more technical occupations may also account for a significant portion.

If the Congress judges that some or all of past growth in average grade is unjustified, then grades can be reduced and so can costs. A relatively modest reduction, for example a return to the fiscal year 1975 grade distribution, would save $200 million over the next five years. A more drastic reduction, such as a return to the fiscal year 1964 distribution, would save much larger amounts.

Conclusion

Since defense manpower costs have risen so sharply in the last five years, the analysis and options focus on ways to cut the rate of growth without cutting the size of the forces. One obvious way to cut costs would be to reestablish the draft, although truly large savings would require reductions in pay for new personnel. Re-establishment of the draft would, in effect, transfer costs out of the defense budget and onto a particular segment of the population -- draft-age, physically and mentally fit males.

The costs associated with various current and proposed policies are detailed in Table 18. The current DoD manpower program, inflated by future pay raises, will grow further if DoD tries to meet recruiting objectives under current policies. Increases could range from $1.7 billion to $4.9 billion by 1982, although these increases could be avoided by changes in policies toward personnel turnover, reduction in quality, and better use of available manpower. Further savings from the current program can be achieved under the options already discussed.

TABLE 18. MANPOWER BUDGET OPTIONS, IN BILLIONS OF DOLLARS, FISCAL YEARS

Option	1978	1979	1980	1981	1982
DoD Baseline Program	55.8	58.8	61.9	65.5	69.6
Possible Increases under Current Recruiting Policies	+.2	+.3	+ .8 to +1.9	+1.1 to +3.0	+1.7 to +4.9
Changes from DoD Baseline Program					
Training Efficiencies	-.3	-.3	-.3	-.3	-.3
Reduced Turnover	-.3	-.3	-.3	-.3	-.3
Retirement Reform	+.1	--	--	-.1	-.2
Salary System (Net Savings)	+.1	-.3	-.4	-.4	-.5
Blue-Collar Pay Reform	-.1	-.3	-.4	-.6	-.7
White-Collar Change	-.1	-.1	-.1	-.1	-.1
DoD Baseline Program Less Changes	55.2	57.5	60.4	63.7	67.4

CHAPTER 4 ENERGY

THE ISSUES

The energy problem facing the United States is easy to characterize: the low-cost, abundant, and secure supply of energy that fueled the nation's economic growth and life-style is simply no longer available. Domestic oil and gas production peaked in the early 1970s. 1/ Since then, oil imports have risen rapidly to fill a widening gap between rising demand and declining domestic production. A growing dependence on imports has increased the nation's vulnerability to foreign embargoes and production cutbacks.

Energy prices, which declined in real terms through the 1960s, have risen rapidly in the 1970s as our more accessible and economical oil reserves were depleted and as the power to set prices shifted to an increasingly cohesive foreign cartel. While recent legislation has slowed the domestic transition to the new regime of higher world prices and curtailed supplies, average energy prices for Americans have doubled in the last three years.

Officials responsible for developing an energy policy have been faced with choices among frequently competing goals, such as low consumer costs, security of supply, environmental protection, and economic efficiency. Among these, the choice has been made more difficult by the realization that energy policy can hinder the achievement of full employment and reduced inflation. In addition, making these choices has been further constrained by a debate about the extent and type of federal participation in the energy sector.

1/ For a more detailed discussion of the issues covered here see CBO Budget Issue Papers, Energy Policy Alternatives, February 1977 and Energy Research, Development, Demonstration, and Commercialization, January 1977.

In the face of this dilemma, the emphasis has been placed on the development of the more abundant domestic resources, such as coal, and on promising new technologies. Yet, environmental and other considerations have slowed coal production; the future of nuclear power is clouded; and other technologies are far away from the future of widespread use.

CONGRESSIONAL DECISIONS

While the 94th Congress took some actions to deal with these problems, the 95th Congress is certain to face further legislative decisions covering energy. Some of these major energy-related decisions are not primarily budgetary but could have a profound effect on the economy. These decisions include:

- Whether and how to deregulate natural gas prices.
- Additional controls on strip mining, and a variety of other environmental and regulatory issues which could affect coal use and production.
- Gas production in Alaska and transportation to the lower 48 states.
- Changes in automobile emission standards (amendments to the Clean Air Act).
- The rate at which to allow domestic oil prices to rise under the provisions of the Energy Policy and Conservation Act of 1975.

Other energy-related decisions before the 95th Congress could have important budgetary impacts. These decisions include:

- The size and scope of energy conservation programs.
- The level and mix of funding for energy research, development, and demonstration -- including the relative emphasis to be accorded nuclear power, solar energy, and other programs.
- How and at what rate to provide uranium enrichment services.

- Whether to provide loan guarantees, price supports, and direct subsidies for commercialization of new and emerging energy technologies such as synthetic fuels.

- The ultimate size and growth rate of the petroleum stockpile established by the Energy Policy and Conservation Act of 1975.

- The treatment of the nuclear fuel cycle and the question of nuclear proliferation, including regulation, research, reprocessing of spent fuels, and ultimate disposal of nuclear wastes.

GOALS OF ENERGY POLICY

Past Congressional action suggests four broad objectives of the nation's energy policy: first, the efficient economic use of alternative energy resources; second, low-cost energy for consumers; third, protection from interruptions in the supply; and fourth, protection of the environment. Two general considerations -- to conserve scarce domestic resources and to limit the budgetary impact -- have also influenced the shape of the nation's energy policy. Finally, measures to achieve any of these energy goals must be evaluated on the basis of their impacts on employment and price stability.

Many of the conflicts among these goals are obvious. Low-cost energy encourages use, which in turn generates pollution. Protecting the environment through strong regulations on air quality, strip mining, and nuclear waste raises the cost of energy. Protecting the nation from supply interruptions means the creation of domestic reserves or alternative sources of supply, both of which would raise energy costs. The efficient use of alternative energy sources, which would require modifying the regulations that currently hold down the price of natural gas and domestic oil, might raise both inflation and unemployment. Although the contradictions in some of these conflicting goals can be lessened somewhat, trade-offs exist and choices eventually must be made.

ENERGY POLICY OPTIONS

The nation's energy policy consists of hundreds of decisions, made in quite diverse areas. Moreover, these decisions can be carried out by countless instruments that influence the supply of or demand for energy. Because of their impact on the economy and their reliance on technologies and production facilities that are slow to develop, shifts in energy policy must be gradual and thus may take many years to have effect. In addition, the budgetary impacts of energy policy tend to be small compared with the tremendous private resources in this sector of the economy. However, the economic impact of federal energy policy is grossly understated by its budgetary significance. This is because federal policy operates largely through regulatory mechanisms that have low budgetary costs, because federal resources influence much larger private ones, and because federal research and development in large part shape the future structure of energy in the United States.

Some of the basic policy options facing the Congress are: continue today's policies or shift toward policies that would place greater emphasis on one of the four objectives -- economic efficiency, low costs, reduced reliance on foreign supplies, or protection of the environment. Of course, there are numerous policy packages that shift the emphasis away from current policy; those described below should be regarded as only illustrative of different approaches.

Continuation of Present Policies 2/

One option is to continue the present policy, which is mainly an attempt to minimize the economic impact of the recent rise in world energy prices. The Energy Policy and Conservation Act of 1975 (EPCA) calls for the gradual decontrol of oil prices over 39 months (ending in 1979). This is expected to raise petroleum prices by no more than

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2/ The present policy term differs from the current policy designation used in Five-Year Budget Projections: Fiscal Years 1978-1982, (CBO Report, December 1976), in that a more disaggregate method is used here to project future program costs.

10 percent in any one year. The Federal Power Commission's (FPC) most recent opinion sets the ceiling prices of natural gas sold in interstate commerce at $1.44 per thousand cubic feet; ceiling prices will be permitted to rise by 4 cents per year.

If present policies were pursued without change, the nation's research and development activities would continue to stress many projects, with heavy emphasis on nuclear development. While the current programs of the Energy Research and Development Administration (ERDA) would be completed, there would be no major new ones.

As called for in the EPCA, petroleum storage under present policy will consist of the building up of the 500-million-barrel reserve over the next six years at a cost of about $8 billion. Because sales of oil from the Naval Petroleum Reserve will be used to offset these costs, net budgetary costs should be well below $2 billion. When filled, this reserve will contain an amount equal to about three months of imports under present policies.

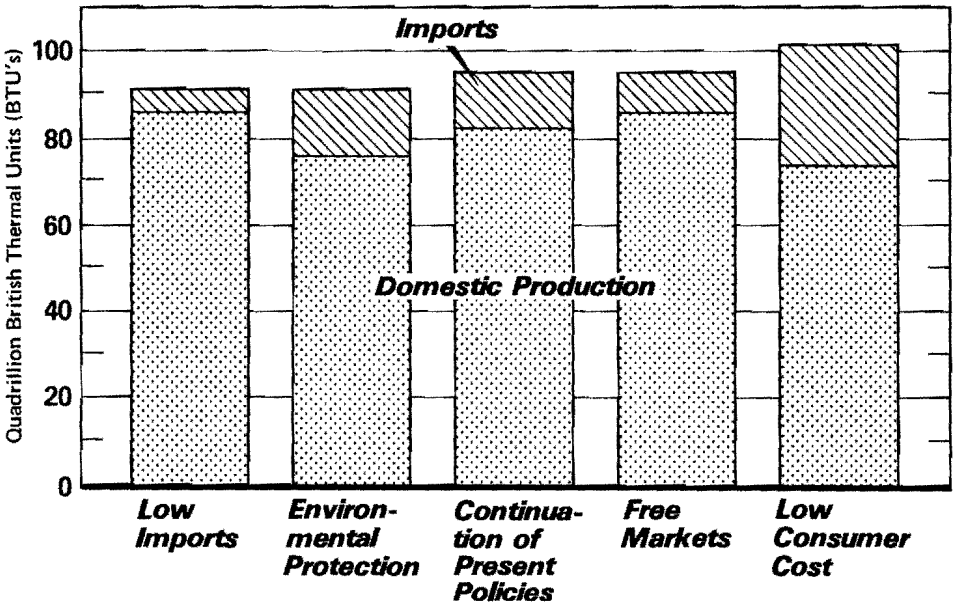
The principal federal environmental standards under present policy are those set by the Clean Air Act of 1970, and the Water Pollution Control Act of 1972. These and other pieces of legislation set standards for auto emissions and commercial and industrial establishments. It is estimated that the achievement of the goals set by these pieces of legislation will involve an expenditure of almost $500 billion by private industry and government during the 1975 to 1984 period. 3/ The major energy conservation provisions of present policy, set down by the EPCA and the Energy Conservation Act of 1976, call for standards on automobile mileage, buildings, and appliances, among others.

Also under present policies, energy consumption is expected to grow by less than 3 percent a year over the next decade (see Figure 5). Dependence on imports, as a percent of total consumption, is expected to increase slightly. Federal energy expenditures (budget subfunction 305) will amount to $6.2 billion by 1982 (see Table 19).

3/ Environmental Quality, The Seventh Annual Report of the Council on Environmental Quality, September 1976, p. 167.

Figure 5

Projected Energy Consumption in 1986 for Alternative Energy Policy Packages



Note: One-half million barrels of oil per day yields approximately one quadrillion BTU per year.

These funds support research and development programs; general operating programs, including the Federal Energy Administration (FEA); uranium enrichment services; such regulatory agencies as the Federal Power Commission (FPC) and the Nuclear Regulatory Commission; and the petroleum storage programs. The reorganization of the federal government's energy agencies is unlikely to affect total budgetary costs significantly.

Free Markets

Government regulations and interference in energy markets have distorted prices and fostered the inefficient

TABLE 19. BUDGET AUTHORITY FOR ALTERNATIVE ENERGY POLICIES, IN BILLIONS OF DOLLARS, a/ FISCAL YEARS

Option	1977	1978	1982	1978-1986 b/
Continuation of Present Policies	4.9	6.3	6.2	6.6
Change from Present Policies				
Free Markets	--	-0.7	-0.1	-0.2
Low Imports	--	0.8	3.1	3.2
Low Consumer Cost	--	-1.0	7.8	4.8
Environmental	--	0.3	2.0	2.0

a/ Includes budget subfunction 305.

b/ Because budget authority varies significantly from year to year, depending upon such factors as the speed of the fill of the petroleum storage, this column provides annual averages over the 1978 to 1986 period.

use of energy. In particular, holding prices of oil and natural gas below market levels encourages use of these fuels and may retard the development of alternative sources. One way of shifting away from this situation would be to lay greater stress on free markets. A policy package that moved in this direction might involve:

- A phase-out of oil price controls over a period shorter than the planned 39 months.
- Immediate decontrol of the price of all new natural gas.
- A shift of the focus of federal research and development toward areas where private funding is inadequate (e.g., solar and coal).

- o A reduced effort in areas where the private sector is better equipped to operate such as in demonstration and commercialization projects.

- o Construction and operation of new uranium enrichment facilities by private owners.

- o A relaxation of current energy conservation measures.

- o A reexamination of government tax and other policies that create imperfections in energy markets.

With this policy package total energy consumption would differ little from the level implied by present policy. Reliance on foreign sources of energy, however, would be reduced and domestic production encouraged by greater competition in the energy industry.

While there are many arguments in favor of shifting policy in this direction, it is always possible that energy supplies will not increase significantly with higher prices and that the degree of competition possible in energy markets is limited.

Low Imports

Reducing the nation's dependence on foreign energy sources could be given greater emphasis. An energy policy package directed at this objective might include the accelerated phaseout of oil price controls and the decontrol of the price of new gas, as discussed in the previous option. This would increase energy prices and have an especially adverse impact on low-income persons. Import fees might be imposed to raise the price of foreign oil and to encourage greater production and reliance on domestic resources. A second element would be an augmented research, development, demonstration, and commercialization program. If ERDA fully funded its current program and added to it the demonstration of all projects in its national plan, $3 billion would be added to annual ERDA outlays by 1982. Heavy production subsidies -- such as price supports for synthetic fuels -- would also play a part. To achieve a production level of one million barrels a day would involve

government costs of between $100 and $400 million per year.

If federal policy were to stress a reduced emphasis on foreign energy resources, the petroleum stockpile could be reduced from currently planned levels. This is because a new embargo would have a reduced impact on domestic energy consumption. The savings involved could be more that $4 billion over the period 1977 to 1982. Environmental standards would have to be relaxed and energy conservation standards strengthened under this option. Specifically, emission standards for automobiles and electric power plants might be eased, while mileage standards for cars and the efficiency standards for new appliances and buildings might be strengthened.

Overall, a policy package of this sort could be expected to reduce total energy consumption by about 5 percent from current policy levels and reduce imports by two-thirds by 1986.

The budget costs of this option would be almost $30 billion above those of present policy from 1977 to 1986. The price of energy, however, would be slightly higher than the levels anticipated under current policy. While this would be a prime stimulus to production, it also would imply a redistribution of resources from energy users to producers. This option would also affect regional economics, with the production areas such as Wyoming, West Virginia, and the Gulf states gaining and the energy-poor Northeast losing.

Low Consumer Cost

Federal policy could also be shifted more toward the goal of assuring low-cost energy. A policy with this objective would call for a slower phaseout of oil price controls -- possibly over five years -- and the continued regulation of new gas prices, possibly at prices below $1 per thousand cubic feet. While such policies would keep prices down, they would also continue existing inefficiencies and would not stimulate domestic production. An emphasis on cheap energy would, in addition, call for full funding of ERDA's research and development effort and

pursuit of the other measures included in the "low import" policy package. To ensure low prices to consumers even during periods of international turmoil, the size of the proposed petroleum stockpile could be doubled to one billion barrels at an additional cost of more than $8 billion over the next five years. If energy conservation standards were strengthened, demand could be reduced to keep it near the reduced supply that would result from the low regulated prices. Such prices would provide domestic producers with little incentive to expand output.

By 1986, under this policy package energy prices would be somewhat below those assumed in the present policy scenario, energy use would be about 5 percent larger, and imports would double.

Environmental Protection Emphasis

A strategy that focused on protecting the environment from the effects of the production, transportation, and use of energy would stress higher prices to reduce consumption and would encourage development of cleaner sources of energy. The emphasis in the area of government-sponsored research and development would shift to nonfission energy sources. The solar, coal, fusion, and geothermal projects of ERDA could be given maximum funding. Probably no more than an additional $11 billion could be absorbed productively by these efforts over the next five years. Because of the uncertainties surrounding the environmental impacts of nuclear power, reliance on this energy source might be scaled back. The ultimate decision would depend upon a thorough analysis of the relative health and environmental risks associated with coal and nuclear power. Environmental standards in general would also be strengthened. For example, the emission standards for both automobiles and electric power plants would be raised. Similarly, more stringent efforts could be made to promote energy conservation.

This approach would reduce both domestic demand and production of energy. Imports, however, would be slightly higher than those projected under present policies. Federal budget costs would be greater than those of the present policy scenario.

CONCLUSION

Energy markets are continuing to change very rapidly. For this reason it is important that federal policy preserve a degree of flexibility if it is to avoid creating further instabilities. Unfortunately, the need for flexibility means that more than one solution to a given problem may have to be pursued -- and that will be expensive.

While the budgetary costs of various federal energy policies are important, government regulations, especially on pricing and imports, are likely to exert much greater effects on energy production and use. Federal energy policy is also likely to have a profound impact on the economy. Rapid increases in energy prices, or curtailment of energy use, will slow economic growth. Furthermore, energy policy will have distributional ramifications. If prices rise, those persons, regions, and industries that are relatively heavy energy users will be hurt. All this, plus the inherent conflicts in the nation's energy goals, must be confronted by the Congress.

80-294 O - 77 - 8

CHAPTER 5 AGRICULTURE

THE ISSUES

The well-being of the country's farmers and a well-capitalized agricultural sector that produces enough food -- and at reasonable prices -- have long been a national interest. 1/ Inevitably, these needs have brought about a substantial federal presence in agriculture. Over the past 40 years the capacity of U.S. farms has exceeded demand. Most government programs aimed at agriculture have thus focused on supporting farm prices, and on avoiding, managing, or disposing of the surpluses that result from supporting prices. During much of the 1960s and the early 1970s these programs were relatively expensive, running between $3 and $4 billion a year.

The costs of government price support programs have fallen dramatically in the past few years; the outlays for fiscal years 1976 and 1977 of $1.01 billion and $1.82 billion are well below those of the 1960s and early 1970s. The causes of this drop have little to do with changes in U.S. agricultural policy. Rather, the reduced costs can be traced to shortfalls in world production and diminishing stocks, which drove market prices of basic commodities substantially above government support levels, thus leaving most provisions of the current law inoperative.

The record high grain and soybean prices of 1973-1975 that produced the drop in program costs also sharply increased farm incomes. Total net farm income, which varied between $11.0 and $14.0 billion from 1961 to 1971, jumped to $18.2 billion in 1972 and $33.3 billion in 1973. Even

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1/ For a more detailed discussion of the issues covered here, see U.S. Food and Agricultural Policy in the World Economy, CBO Report, April 1976 and Food and Agriculture Policy Options, CBO Budget Issue Paper, February 1977.

though farm income has declined since 1973, the estimated level of $24 billion for 1976 is appreciably higher than the income levels of the past decade.

While aggregate farm income and prices remain relatively high and the costs of government programs have come down, several new concerns have arisen. The first of these is the increased dependence on export markets. In the decade before 1972, U.S. agriculture exports amounted to between 12 and 15 percent of production annually (between $5.0 and $7.0 billion). Since 1973, exports have averaged 23 percent of production or $21.6 billion a year. Grain and soybeans account for most of the increased exports, making U.S. farm earnings very sensitive to world grain and oilseed production and prices. While these export earnings have provided part of the foreign exchange needed to pay for the escalating cost of oil imports, U.S. farm incomes are now precariously subject to the vagaries of foreign demand. This is because the prospects for large U.S. grain exports at relatively high prices depend largely on factors beyond U.S. government control -- worldwide weather conditions, the trade policies of foreign governments, and the efforts of importing nations to boost their own food production.

A second issue of recent concern is the uneven distribution of income gains. For example, while many grain farmers enjoyed soaring incomes, livestock producers were hurt by rising feed costs. This prompted a large-scale liquidation of beef and dairy cattle, which in turn depressed livestock prices. From mid-1973 to the end of 1974, the capital losses realized by beef producers totaled almost $2 billion. Moreover, the income gains of the past few years have not been uniform to producers of all sizes. For the most part, income gains have been concentrated among the larger producers -- those with gross annual sales above $100,000 and net incomes above $40,000.

A third concern is the rapid rise in production costs, particularly increased land value. High grain prices and soaring farm incomes have caused farm real estate to double in value since 1970. While established land owners have experienced significant capital gains, the increase in land value has become a part of the production costs for recent purchasers and renters of farm land. Energy costs have also

had an impact on agriculture production costs. Petroleum is not only vital for tractors, and other farm machinery, and for grain drying, it is also essential to nitrogen fertilizers, pesticides, and other farm chemicals.

The contribution of rising food prices to inflation represents a fourth concern. Nearly 40 percent of the increase in the consumer price index (CPI) between 1971 and 1974 was attributable to food. While much of the increase in food prices stemmed from increased marketing and processing costs, rising farm prices contributed more than half. Higher food prices can have a substantial impact on the economy through the CPI; wages are pushed up by escalator clauses and higher negotiated-wage settlements; likewise, federal spending must be increased for programs such as food stamps and social security, whose benefits are indexed to the cost of living.

THE OUTLOOK

U.S. agriculture is still adjusting to the economic shocks of the past four years. Crop production was good in 1976 and with normal weather and expected yields, should be even better in 1977. Worldwide grain stocks increased for the first time in three years in 1975-1976 and are being further built up in 1976-1977. Foreign demand for U.S. grain is therefore expected to level off, causing exports to stabilize or fall slightly. Although this combination -- increased production, larger stocks, and weaker exports -- is expected to cause grain prices to fall, it should lead to a recovery in the livestock sector. Total net farm income is not expected to increase over the next two or three years, and real net farm income (adjusted for inflation) is likely to decline.

This outlook suggests that the fundamental position of U.S. agriculture has changed little from the 1950s and 1960s. The United States continues to have the capacity to produce more than domestic and foreign markets will accommodate at acceptable prices when worldwide growing conditions are favorable. The threat of surplus stocks and depressed farm prices and incomes remains very real.

CONGRESSIONAL DECISIONS

The nation's agricultural legislation -- the Agriculture and Consumer Protection Act of 1973, the Rice Production Act of 1975, and the Agricultural Trade Development and Assistance Act of 1954 (Public Law 83-480) -- expires at the end of crop year 1977. Related programs, including the Food Stamp Act of 1964 and parts of the Commodity Distribution and School Lunch programs, will also expire at the end of fiscal year 1977. From the standpoint of potential budget costs and general economic influence, the decisions made with respect to these programs will be among the most important ones taken by the 95th Congress. For the most part the budget impacts of these decisions will not be felt until fiscal year 1979.

In making these decisions the Congress will face different pressures. The farm community, concerned over the current market outlook, sees the key issues as the threats of falling farm prices and incomes eroded by inflation. In addition, many farmers are concerned about current and potential federal intervention in their farming operations. Consumers, on the other hand, worry more about high retail food prices and how farm policy can be used to avoid repetition of the rapid food price inflation of the 1973 to 1975 period. Foreign nations also have an interest in the outcome of the Congressional debate. A nation's views of the issues depend upon whether it is a major competitor with U.S. exports, a major commercial customer, or a potential aid recipient.

POLICY OPTIONS

- How and at what level should farm prices be supported?
- Should this support include protection against natural disasters?
- Should consumers be protected from the effects of very high farm prices just as producers are now protected from very low prices?
- How open should U.S. agricultural markets be to other nations?

Decisions on these four issues will involve conflicting interests and goals. They could have far-reaching effects on the commitment of resources to farming, the allocation of resources within farming, the relative well-being of grain farmers and livestock producers, the success of U.S. farm exports, the level and stability of food prices, the availability of food aid, and the cost to the general taxpayer of operating the commodity programs. 2/

While decisions on these issues will affect the budgetary impact of any new agricultural legislation, future costs will also depend on worldwide growing conditions. Because of this, agricultural prices are difficult to forecast with any degree of accuracy, and cost estimates for various options (presented in Table 20) are similarly uncertain.

Farm Price Supports, Mechanisms, and Levels

Federal programs to support and stabilize farm prices and incomes have shifted their emphasis since the 1930s. The early programs that intervened directly in the operations of commodity markets have given way to ones with more emphasis on direct payments to producers. This shift, together with the worldwide production shortages in the 1970s, reduced, at least temporarily, outlays for commodity programs, eliminated most government stocks, and diminished the need for production allotments and quotas, acreage diversion, and surplus disposal -- all policies designed to limit supplies.

One option is to continue the heavy reliance on market mechanisms of current commodity programs. Under these policies (with loan rates kept substantially below market prices) freely set market prices are used to provide production signals to farmers and to distribute the resulting supply among users and between current consumption and storage stocks. Direct payments are used to provide some measure of income stability for farmers. Because they do

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2/ The following discussion deals with the major commodity programs -- wheat, feedgrains and cotton. Rice, dairy, and peanut programs are discussed in the CBO Budget Issue Paper, Food and Agriculture Policy Options.

not require the large, publicly held stocks that could assure a reasonable degree of price stability, market-oriented policies have been criticized for addressing inadequately the interests of livestock producers, consumers, and the less-developed nations.

TABLE 20. AGRICULTURE BUDGET OPTIONS, OUTLAYS IN MILLIONS OF DOLLARS, FISCAL YEARS

Option	1977	1978	1982
Deficiency Payments (Wheat, Feedgrains, and Cotton)			
Current Policy	0	0	700
Target Prices and Loan Rates Set in Relation to Cost of Production, Including Current Land Value	NA	2,900	6,100
Disaster Payments and Crop Insurance			
Current Policy	362	362	362
Disaster Payments Covering 90 Percent of Variable Costs	NA	250	250
Crop Insurance Only (Discontinue Disaster Payments)			
Expanded Crop Insurance, 25 Percent Premium Subsidy	NA	97	97
Grain Reserve (20 Million Metric Tons)			
Annual Operating Cost (Excluding Profits or Losses from Grain Sales and Purchases)	NA	NA	350

Another option is a return to past policies in which the government established market prices and purchased any surpluses, which it then held. This approach has been criticized for interfering with efficient production and farm exports, and increasing the cost of achieving income (and price) support goals. The government stocks that have resulted, however, from such policies can provide both price stability for the consumer and a source for the food needed by some less-developed countries. A mixed approach that combines a market-oriented policy with a reserve program under government control is a third option: Here the reserves could be used to dampen price fluctuations.

Though the debate over the mechanisms for stabilizing prices and incomes will be important, future federal budget costs will depend more on the level at which prices (and incomes) are supported. The major issue is whether to continue current policy, which allows substantial administrative discretion in setting support levels, or to tie support levels to production costs legislatively. The budgetary effects of linking target prices and loan rates to the costs of production could be substantial. For example, in fiscal year 1979, deficiency payments for wheat, feedgrains, and cotton would be $3.6 billion if target prices were set equal to 100 percent of production costs (excluding management costs but including current land values). Under current policy the budget cost would be $0.4 billion. If loan rates were held at current policy levels, rather than raised along with target prices, deficiency payments would be about 30 percent higher. Loan outlays would be lower but not fully offsetting, however, with less potential for export subsidies.

Protection Against Natural Disasters

Catastrophes such as flood, drought, wind, and hail can cause serious crop damage. The major issue is the extent to which the government should pay for protecting farmers against natural disasters. Producers of wheat, feedgrains, cotton, and rice are now protected against such hazards by two types of federal programs: the disaster payments provisions of the 1973 Agriculture Act and the 1975 Rice Production Act, and the Federal Crop Insurance Corporation (FCIC). The disaster payments program provides insurance free to eligible producers, but these payments fluctuate and

are generally quite costly to the government -- $557 million in fiscal year 1975, $288 million in 1976, and $374 million in 1977. The program has been criticized because it does not provide adequate coverage for producers with extremely large crop losses; yet it makes payments for some losses that could easily be absorbed by the producers. Furthermore, unlike other kinds of insurance, hazards involving managerial judgment are covered; this aspect is open to abuse. For example, a cotton farmer who decides it is too wet to plant cotton may receive a prevented-planting payment, even though he later plants another crop such as soybeans.

The federal outlays for the FCIC program are only the administrative costs, which have been minimal; premiums are used to cover indemnities. The major problem with this program is that the FCIC acts very much like a private insurer: No insurance is available where experience says that a sound insurance program would be too risky -- which means roughly half of the nation's counties.

Two options seem most realistic: improvement of the current disaster payments provisions, including some changes to reduce their cost; or, replacement of disaster payments with an expanded FCIC, to provide coverage throughout the nation. If the disaster payments program were designed to cover 90 percent of a producer's variable production costs, the first option would reduce outlays from fiscal year 1978 to 1982 by about $100 million a year. Nationwide, FCIC, with some subsidized premiums and discontinued disaster payments, would reduce outlays by about $250 million annually over the fiscal year 1978 to 1982 period.

Protecting Consumers from High Farm Prices

One outcome of the commodity programs of the 1950s and 1960s was that overall food prices were quite stable. Recent times have shown that greater price fluctuations are possible under current programs when government stocks are diminished and when cropland is more fully exploited. Thus, a serious question arises: Should policies be adopted that would assure more stable prices and provide both domestic and foreign consumers with protection against sharp price increases? A domestic grain reserve, under direct government ownership or control, is an option that could do this.

The costs of a domestic grain reserve would depend on its size and the level of price stability sought. Historically, grain stocks of about 60 million metric tons have kept price fluctuations within 20 percent of average prices. Given current expectations about private stocks, a government-controlled grain reserve of perhaps 20 million metric tons could achieve this level of price stability. Such a stock would involve an acquisition cost of roughly $2 billion and annual storage and interest costs of over $300 million. However, receipts from sales could provide some -- perhaps a substantial -- offset; grain held three years would have to be sold at 150 percent of its acquisition price for receipts to offset costs. It would be more difficult to offset costs in this manner, the larger the stock. If private carryover stocks remained at current levels, this size government reserve would provide protection against the consequences of highly unstable prices. One problem, however, is that those who currently hold private carryover stocks could be encouraged to diminish the size of their stocks. If this occurred, the price-dampening effect of the government reserve would be lessened.

Continuing an Open Agriculture Market

While not primarily a budget issue, the question of how free U.S. agricultural trade policy should be has important budget dimensions. Insulating domestic markets from international adjustments can be expensive, 3/ and it may lower the income of crop producers and grain exporters, as well as foreign exchange earnings.

Against this must be matched some of the risks of open agricultural markets, including the likelihood of greater price fluctuations, serious adjustment problems for livestock growers, higher food prices, and the possible curtailment (or higher budget cost) of food aid. However, the range of policies to deal with these risks falls far short of the restrictive policies of many foreign govern-

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3/ Estimates indicate that Soviet efforts to run a relatively closed agricultural economy cost roughly $28 billion in 1975.

ments. 4/ One option is the domestic grain reserve, just discussed. Another option is an international grain reserve to help diminish the burden of adjustment that major grain-exporting countries, principally the United States, now shoulder. For the United States, bilateral agreements have some effect in reducing instability. Although an open world trade holds substantial promise for significantly dampening instability, the prospects for real progress along these lines do not appear to be good.

4/ For a thorough treatment of these options, see U.S. Food and Agricultural Policy in the World Economy, CBO Report, April 1976.

CHAPTER 6 HOUSING

THE ISSUES

Federal housing policy currently focuses on three problems: the inadequate housing of some people with low or moderate incomes, the low rate of housing starts, and the high cost of housing. 1/

Despite steady improvement in the quality of the housing stock, many low- and moderate-income households occupy physically inadequate housing; and many of these households and others spend a disproportionate share of their incomes for a place to live. While many other attributes also help to determine housing adequacy, approximately three million such households live in homes that are overcrowded or that lack some plumbing facilities. In 1974, the number of low- and moderate-income households paying rents that exceeded one-quarter of their income was 7.8 million -- up from 6.9 million in 1969.

Housing construction is an important sector of the economy. Even in the depressed year of 1975, it accounted for 27 percent of all private investment. While housing construction has recovered substantially from the depressed levels of 1975, the low level of starts of multifamily dwellings and the 14 to 16 percent unemployment rate among construction workers are still problems.

Concern over affordability stems from the feeling that costs of decent housing, particularly for homebuyers, are rising faster than income. In fact, during the past five

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1/ For a more detailed discussion, see Housing Finance: Federal Programs and Issues, CBO Staff Working Paper, September 1976; Homeownership: The Changing Relationship of Cost and Incomes, and Possible Federal Roles, CBO Budget Issue Paper, January 1977; and the forthcoming CBO Budget Issue Paper on housing assistance for low- and moderate-income families.

years overall housing costs have risen no faster than the consumer price index or median family incomes. Those households who were homeowners or renters throughout the period saw their costs increase one-third less than general prices. But the costs for people buying a home for the first time rose about one and one-half to two times faster than general prices or incomes.

CURRENT HOUSING POLICIES

Federal housing activities can be grouped into four major categories: housing assistance (part of budget subfunction 604), mortgage credit operations (budget subfunction 401 and off-budget), community development (budget subfunction 451), and tax expenditures. The assistance programs are primarily subsidy programs aimed at making decent housing affordable to low- and moderate-income people. Mortgage credit and thrift insurance activity, much of which is off-budget, serve to increase the amount -- and decrease the cost -- of mortgage lending through direct federal lending, federal insurance on private loans, and providing funds for private lenders, largely by buying mortgages in the secondary market. Together these activities should encourage housing construction and make homeownership easier. They primarily benefit middle- and upper-income families. Some community development funds are used to improve the condition of existing housing. The principal housing-related tax expenditures encourage homeownership by permitting the deduction of mortgage interest and property taxes from a homeowner's taxable income. This primarily benefits middle- and upper-income households. Tax expenditures also encourage the construction of rental housing by permitting accelerated depreciation on new rental buildings.

Federal expenditures on these activities are small compared with the huge sum of private money that goes for housing. In fiscal year 1977 the direct outlays for housing (both on- and off-budget) are estimated at $6.3 billion and the loss of tax revenues is estimated at $12.2 billion (see Table 21). The estimated value of housing consumption was $158 billion in fiscal year 1976. But by other measures, federal involvement is substantial. During 1975 nearly one-fourth of all housing starts were assisted by federal

TABLE 21. THE HOUSING BUDGET, ESTIMATES FOR FISCAL YEAR 1977, IN BILLIONS OF DOLLARS a/

Budget Subfunction	Budget Authority	Outlays
Housing Assistance (part of subfunction 604)	15.5	3.0
Mortgage Credit and Thrift Insurance (401)	3.2	-0.7
Housing Part of Community and Regional Development (451) b/	0.4	0.3
Total On-Budget	19.1	2.6
Off-Budget Housing-related Programs	8.1	3.7
Tax Expenditures for Housing (foregone revenues)	NA	12.2

a/ On-budget estimates from the Second Concurrent Resolution for Fiscal Year 1977; off-budget estimates and tax expenditures from the Budget of the United States Government: Fiscal Year 1978.

b/ Includes that share of the Community Development Block Grant program expected to be used for housing programs.

subsidy or insurance programs. Most families live in housing assisted by some form of federal program or tax expenditure.

In addition, some federal activities not specifically directed at housing nevertheless have very important impacts on housing. Changes in monetary policy influence the cost and availability of mortgage credit, and thus affect the level of housing construction and the affordability of housing. When monetary policy is used to reduce inflationary pressures, it slows housing activity. This force works at cross purposes with housing credit programs designed to offset housing cycles; it also conflicts with the goal of maintaining high and stable levels of housing construction. Federal regulations that limit the interest paid on deposits and restrict the types of loans made by lending institutions affect mortgage credit as well. Whether the regulations taken together improve or hurt the mortgage credit supply is uncertain. Income assistance programs (including welfare and food stamps) have a great effect on the ability of lower-income people to afford decent housing. Housing expenditures from income assistance programs probably significantly exceed the amounts of direct federal housing subsidies.

CONGRESSIONAL DECISIONS

Four major housing-related questions may confront the 95th Congress:

- Through what mix of programs should housing assistance be provided for more low- and moderate-income families? Through programs that subsidize existing housing? Or through programs that build and subsidize new housing? Or through general income assistance? Should subsidized housing be publicly or privately owned?

- Should stimulants be applied to the construction industry, which would thereby strengthen overall economic recovery?

- Should the existing ways of making homeownership affordable be extended and expanded, or should new ways be developed?

- Should large-scale housing rehabilitation programs be started?

These issues will come up as a number of today's housing programs expire, as funding decisions are made on continuing programs, and as new initiatives are debated. The principal on-budget program directed specifically at stimulating construction -- the subsidized GNMA 2/ "Tandem" program -- expires at the end of fiscal year 1977. Through this program the government makes commitments to purchase mortgages that private lenders make at below-market interest rates; GNMA is now purchasing only FHA-insured mortgages on multifamily housing. The Section 235 program, which stimulates construction as well as homeownership, provides interest subsidies to moderate-income purchasers of new homes; this legislation also expires at the end of the current fiscal year. In addition, the authorization for the Community Development Block Grant program expires at the end of fiscal year 1977. Roughly 11 percent ($200 million) of the money distributed to local governments under this program has been used for housing-related activities. The Section 8 and public-housing subsidy programs, 3/ which have been directed toward newly constructed buildings, will require decisions about funding levels and about the allocation between new and existing housing. Decisions must also be made on funding for rural housing loans. And new proposals to promote homeownership and housing rehabilitation will surely be presented to the Congress this year.

BUDGET OPTIONS

Housing programs typically have long lead times and long-term funding commitments. As a result, federal spending on housing in fiscal year 1978 will be determined largely by past commitments. Decisions made this year to change the emphasis of federal policy to better address

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2/ Government National Mortgage Association, a federally owned corporation.

3/ Authorized by the Housing and Community Development Act of 1974.

one or another problem may affect the budget authority for fiscal year 1978; but the effects on spending will be felt largely in the future.

Current Policy

If today's housing programs are continued at current levels (adjusted for inflation), $17.9 billion in budget authority and $4.9 billion in outlays would be required in fiscal year 1978; by fiscal year 1982, the housing budget would grow to $22.9 billion in budget authority and $7.2 billion in outlays (see Table 22). Most of this growth represents increases in the number of subsidized housing units under the Section 8 programs and the public housing program. An estimated 3.8 million households would be assisted by the end of fiscal year 1982, 70 percent more than the 2.2 million now assisted. Under the current policy option, the GMNA Tandem programs (subfunction 401) would not be reauthorized.

TABLE 22. CURRENT POLICY BUDGET FOR HOUSING IN BILLIONS OF DOLLARS, FISCAL YEARS

		1978	1979	1980	1981	1982
Mortgage Credit and Thrift Insurance a/ (subfunction 401)	BA b/	1.1	0.9	1.0	1.2	1.4
	0 c/	0.4	-0.1	-0.1	-0.2	-0.2
Housing Part of Community d/ and Regional Development (part of 451)	BA	0.4	0.5	0.5	0.5	0.6
	0	0.4	0.4	0.4	0.5	0.5
Housing Assistance (part of 604)	BA	16.4	17.3	18.5	19.7	21.0
	0	4.0	4.8	5.6	6.2	6.9
Total e/	BA	17.9	18.7	20.0	21.4	22.9
	0	4.9	5.1	5.9	6.5	7.2

a/ Assumes no reauthorization of GNMA Tandem Emergency Programs.

b/ Budget authority.

c/ Outlays.

d/ Includes only the 11 percent of Community Development Block Grants now being used for housing, plus Section 312 rehabilitation loans.

e/ Figures may not add to totals due to rounding.

Increased Housing Assistance for Low- and Moderate-Income Families

An estimated 2.2 million households lived in subsidized housing at the end of fiscal year 1976; some 1 million additional households can be aided by budget authority already provided through fiscal year 1977. To increase the number of households aided, additional budget authority for housing assistance programs is required in fiscal year 1978. Four existing programs could be used: (1) the Section 8 existing housing program, which subsidizes rent in rental units that are already built and that are chosen by low- or moderate-income participants; (2) the Section 8 new construction program which subsidizes rents in new rental units; (3) the public housing program, which subsidizes costs of new, publicly owned housing rented to low-income tenants; and (4) the revised Section 235 program, which reduces mortgage payments for middle-income buyers of new homes. 4/

Each of these programs has a different target group and a different cost per household. Only the public housing program assists primarily poor people (median tenant income was about $3,400 in 1975). The Section 235 program assists middle-income households, those with incomes of approximately $13,000. The Section 8 programs can assist both low-and moderate-income households, those with incomes up to about $11,000. Programs that assist the poor are more costly. For families with the same incomes, programs that subsidize newly contructed housing are roughly twice as expensive as those that assist families in existing housing units; however, subsidies for new housing may also stimulate housing construction and employment. In some areas the supply of existing housing may be so inadequate that new construction is needed to provide housing and to hold down

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4/ There are three other programs that have not been funded in recent years: The Section 236 program which provides mortgage interest subsidies for moderate-income rental housing, the rent supplement program for low-income renters, and the Section 23 program under which public housing authorities lease private housing for low-income families.

rent increases. The additional budget authority and outlays required to assist 10,000 additional households through each of these mechanisms are presented in Table 23.

There are several alternative mechanisms to help low- and moderate-income people to afford adequate housing. These include: block grants for housing, which would distribute funds to state or local governments and let them determine the particular housing assistance mechanism; 5/ extensive housing rehabilitation programs, which would subsidize the upgrading of housing; and income assistance programs, which help low-income households obtain adequate housing simply by raising their incomes.

Increased Housing Construction Stimulants

Total housing starts have risen substantially from the low levels of 1975 and are expected to continue at high levels. Nevertheless, while single-family construction is near record levels, construction of multifamily units remains below the levels of 1968 to 1973.

But can current programs stimulate construction quickly? The answer is open to question. The lag between program activation and the start of construction is frequently more than a year in the GNMA Tandem programs for government-insured multifamily housing. Furthermore, little is known about how many units that may receive GNMA assistance under an expanded program would have been built even without the program. Time lags are probably even greater for new construction under the Section 8 and public housing programs, but the substitution effects may be less pronounced because new low-income units are seldom built without subsidies. The Section 235 program may be able to do little to stimulate single-family construction, which already is very high. Increasing the programs listed in Table 23 by 10,000 units does not mean that this number

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5/ The Ford Administration's fiscal year 1978 budget proposed distributing budget authority among local areas and allowing them to choose among the various Section 8 programs.

will be added to the total level of construction activity; again, the substitution effect will likely take its toll.

Increased Homeownership Affordability

The Section 235 and GNMA Tandem subsidy programs for buyers of new homes, both of which will be up for reauthorization this year, could be used to address the affordability problem. Section 235 serves moderate- to middle-income people (typically those with about 90 percent of median family income). GNMA's shallower subsidies have not been available for single-family houses during the past year but could be redirected to such homes through administrative actions. Because there are no income limits for the GNMA program, people with incomes well above the median have generally benefitted from this program, the main objective of which has been to stimulate construction. None of the current programs is specifically for first-time homebuyers, those who have suffered the most in recent years. Nor do these programs serve lower-income people. The focus on expensive new homes also limits the size and breadth of the group the programs can serve.

Existing programs, of course, could be retargeted and new ones could be proposed to aid first-time buyers. Several of the proposals for new forms of mortgages could improve homeownership affordability. For example, proposals introduced in the 94th Congress that called for deferred and graduated payment mortgages (S. 3193 and S. 3692) were intended to achieve this objective. These options would let buyers pay lower mortgage costs now and higher costs later when their incomes have risen (from inflation or job and productivity advances). Such programs could be limited to first-time buyers. Neither type of mortgage need involve substantial permanent outlays by the federal government -- deferred payment mortgages use federal loans to be repaid later and graduated payment mortgages can use only federal insurance (see Table 23). Subsidy funds could then be used for deeper subsidies -- homeownership or renting -- for lower-income people or for other purposes.

TABLE 23. HOUSING BUDGET OPTIONS, BUDGET AUTHORITY AND OUTLAYS, IN MILLIONS OF DOLLARS, FISCAL YEARS 1978 TO 1982 a/

Type of Housing Program	Income Group Assisted	Objective	Budget Authority (BA) and Outlays (O)									
			1978		1979		1980		1981		1982	
			BA	O	BA	O	BA	O	BA	O	BA	O
Section 8 - Existing Housing	Low- and Moderate-Income Renters	Assistance	370	3	0	13	0	16	0	16	0	17
Section 8 - New Construction	Low- and Moderate-Income Renters	Assistance Stimulant	916 b/	0	0	0	0	0	0	17	0	36
Public Housing Construction	Low-Income Renters	Assistance Stimulant	1,104	0	0	0	0	7	5 c/	22	5 c/	33
Section 235 Revised New Construction	Middle-Income Homebuyers	Assistance Stimulant	300	0	0	5	0	10	0	10	0	9
GNMA Tandem d/ Multifamily	All Renters	Stimulant	244	0	0	0	0	21	0	12	0	0
GNMA Tandem d/ Single-Family	All Homebuyers	Stimulant	406	4	0	38	0	4	0	0	0	0
Deferred Payment e/ Mortgages	Middle-Income Homebuyers	Assistance Stimulant	176	f/	0	3	0	6	0	6	0	6
312 Rehabiliation Loans	Homeowners	Assistance	83	61	0	19	0	-5	0	-6	0	-6

a/ Estimated budget impacts of assisting an additional 10,000 households using 1978 authorizations. Budget authority for the Section 8, public housing, and Section 235 programs is much larger than the outlays shown because it represents the total commitment for annual subsidies under long-term (15- to 40-year) contracts.

b/ BA shown is for private developer projects; $1,832 million BA would be required for projects financed by state or local government housing agencies.

c/ BA shown is for public housing operating subsidies.

d/ BA equals full amount of mortgage. The much smaller outlays assume resale in year of mortgage purchase and 7.5 percent interest mortgages.

e/ Assumes 2 percent interest reduction through deferral, $35,000 mortgage. BA shown assumes interest reduction payments for full thirty year life of mortgage. Federal outlays would be repaid in later years. A graduated payment mortgage maintenance program would have zero direct outlays if insurance premiums covered defaults.

f/ Less than $1 million.

Rehabilitation

Rehabilitation programs for declining but basically sound lower-income neighborhoods are often discussed. Less attention has been given to the more difficult and expensive problems of rehabilitating housing in neighborhoods that are badly deteriorated.

Three federal programs now assist rehabilitation efforts: local governments can use the Community Development Block Grants for this purpose; the Section 312 program provides a small sum ($40 million in 1976) for low-interest rehabilitation loans; and a small amount of Section 8 subsidies has been committed to rehabilitation. If federal policy is to place greater emphasis on rehabilitation, the scope of the block grant and Section 312 programs can be changed when these programs come up for reauthorization this year. Another model is the federally sponsored Urban Reinvestment Task Force, which has encouraged private and public cooperation in rehabilitating some neighborhoods. This effort has been limited to rather small projects and has relied only marginally on federal money. Funding for items such as investment in public improvements, underwriting of higher-risk loans, and low-cost financing for housing repairs probably would be needed to foster the rehabilitation efforts in declining neighborhoods.

THE ISSUES

The cost, quality, and adequacy of public transportation are constant sources of complaints from nearly all city dwellers. Since the early 1960s, the Congress has authorized a number of programs to encourage or improve mass transit; these programs have focused increasingly on service adequacy, energy use, pollution control, congestion, and the structure of urban regions. 1/

The major federal mass transportation program is directed by the Urban Mass Transportation Administration (UMTA), which received some $11.8 billion in new budget authority in 1973 and 1974; this sum was to last through 1980. Nearly two-thirds of the money -- about $7.1 billion -- has been budgeted for capital grants. UMTA exercises considerable discretion over the distribution and use of the capital grants. About 30 percent of the capital funds is used for buses; the remaining 70 percent is split between construction of new rail transit systems and improvements in old rail networks.

Another $4 billion of UMTA's budget authority was provided by law for grants distributed by formula among urbanized areas. Local governments can use these grants either to help defray transit operating deficits or to fund capital projects; some 94 percent of these funds has been used to offset deficits. A much smaller portion of UMTA's budget authority -- roughly $0.7 billion -- has been allocated for administration, research, demonstration, planning, and training.

The Federal Highway Administration (FHWA) has two major programs that also can be used for mass transit.

1/ For more detailed treatment of the issues covered here, see the forthcoming CBO Budget Issue Paper on urban mass transportation.

At local option, federal-aid urban system money can be used for capital programs although such use has been minimal up to now. Also, Interstate highway money earmarked for so-called nonessential urban segments of these highways can be used for transit facilities and non-Interstate highways. These Interstate transfers require a separate appropriation from general revenues, however, and do not deplete the Highway Trust Fund. In fiscal year 1977, an estimated $575 million of Interstate transfers will be used for transit grants, almost all of this money will be used for the construction of subway systems or commuter railroads.

CONGRESSIONAL DECISIONS

The first session of the 95th Congress is likely to consider new authorizing legislation for UMTA. Such action is unlikely to affect outlays for fiscal year 1978 except to the extent that funds for operating deficits are expanded. The need for budget authority is controversial. While UMTA's capital grant program had an unreserved balance of $4.8 billion in October 1976, the agency considers that it has informally promised all of this money to specific new rail systems, and bus and rail replacement projects. If so, major new programs launched in fiscal year 1978 would eventually require additional budget authority, although the repercussions on fiscal year 1978 budget outlays would be small. The apparent lack of uncommitted funds prompted both the Ford Administration and Congressional supporters of mass transit to indicate their intention to submit new legislation.

The debate over new authorizations for UMTA programs and funding will offer the Congress the chance to review the status and prospects of alternative strategies for meeting urban transportation needs. At present there are three major strategies for solving the urban transportation problem. One relies on massive capital assistance, especially for the construction of new facilities; another is designed to help defray operating deficits; a third stresses small capital projects that improve existing systems through operational, regulatory, and pricing mechanisms. Of course, these alternatives are not mutually exclusive. To date, federal programs have emphasized the first two, and they are likely to continue to be a mix of them all.

Capital Assistance

The current emphasis, as has been noted, is clearly on capital assistance for new rail systems, modernization and extension of existing rail systems, and bus purchases. The effectiveness of spending on modernization and buses is not altogether clear. Furthermore, there is certainly a question about whether new rail systems can significantly alleviate urban transportation problems, at least in the short run. Such systems are extremely expensive: San Francisco's BART cost $1.6 billion to build; Washington, D.C.'s 98-mile Metro will probably cost more than $5 billion.

BART and several extensions elsewhere have had little impact on car traffic and congestion. In San Francisco some people gave up driving in favor of public transportation, but within a year of BART's completion in 1973, traffic flows returned almost to their previous level. BART and the other modernized and extended rail systems have also had large and increasing operating deficits, thus saddling state and local governments with yet another burden. Furthermore, heavy rail systems appear to conserve little energy, in part because construction consumes so much, and also because riders are attracted from fuel-efficient buses. New systems encourage additional trips.

Of course, these results are drawn from the experience of a very few cities. Given the differences in urban structure and transportation problems that exist among cities, it would be unfair to assume that these short-term failings will recur everywhere a new system is built. Furthermore, new rail systems may eventually have a significant impact upon urban transportation by reshaping the structures of urban areas themselves and by fostering regulatory and pricing policies that seem infeasible so long as people have no alternative to their cars. However, capital programs, large or small, if they are to be effective, probably must be used in conjunction with regulatory or pricing mechanisms aimed at reducing automobile use.

Operating Grants

Little information on the effects of federal operating aid on urban transportation is available, both because

the program is new and because its effects are hard to trace. While there is a great demand for operating assistance, there is concern that these grants reduce local incentives for efficient operations. In addition, it is feared that operating assistance may be spent largely on higher pay for transit workers and lower fares for riders rather than for improved or expanded service. The solution could be a linking of grants to performance and service criteria.

Low-Capital Projects

Projects that require small amounts of capital appear to be among the more effective transportation programs. Included in this category are operational, regulatory, and pricing changes. Their focus is on streamlining the use of existing roadways through such means as contraflow and reserved bus lanes, coordinated traffic signals, and ramp metering. Although these measures can produce important local improvements in speed and capacity, many organizational and jurisdictional problems must be overcome first.

Regulatory solutions generally restrict certain transportation activities and encourage others. For example, cars may be excluded from downtown areas to ease bus and pedestrian movement. Curb lanes can be reserved exclusively for buses. Special lanes on commuter highways can be designated for use by car pools and buses. Downtown parking can be restricted to ease traffic and encourage public transit and car pools. Commercial deliveries can be prohibited during rush hours. And work hours can be staggered. Most such regulations have been local not national, although they have been encouraged by UMTA's Transit System Management (TSM) program. Generally, these efforts have been successful but difficult to get underway.

By changing the expense of using different modes of transportation, pricing solutions attempt to alter the public's transport preferences. While there is little evidence about their effectiveness, a great many pricing solutions have been proposed and adopted in some places. They include:

- Raising fares at rush hour. This can shift the costs more onto peak-period users, encourage greater use when systems are underutilized, and discourage nonessential trips during rush hour, but this could hurt low-income transit users.

- o Charging tolls on commuter roads during rush hour. This would encourage reliance on mass transit, cut congestion, and make the car commuter bear more of the social costs of the congestion and pollution he creates.

- o Raising downtown parking charges to encourage transit use and car pools, and reduce the space used for parking.

There are now no federal programs exclusively designed to encourage the adoption of pricing solutions. In fact, there are some legal impediments -- such as the toll prohibition on federal-aid highways. 2/

BUDGET OPTIONS

The range of options for the level and type of federal assistance is wide. The federal government could continue to exercise a great deal of control over the distribution and use of mass transit assistance. Under this approach, the federal government could continue to emphasize rail systems, reallocate funding away from discretionary grants and towards more formula grants, or shift to policies that encourage operating, pricing, and regulatory solutions. Or, this approach could be scrapped in favor of a federal transportation block grant. This would permit state and local governments a great deal of discretion in deciding how to solve local transportation problems.

The decisions about funding and general approach are interrelated. For example, if federal policy is to encourage the construction of new rail systems, a considerable amount of new budget authority for the capital grant program will be required if more than just a few cities are to be helped. Furthermore, local mass transit authorities will want some commitment from the federal government about help in covering the operating deficits of these new systems.

2/ Section 301 of Title 23, United States Code, prohibits tolls with a few minor exceptions.

Continue Present Policy 3/

If UMTA programs were continued, at roughly the same level and with the same focus as in recent years, the discretionary capital grant program would generate about $1.25 billion in obligations a year. At this level, existing UMTA budget authority would be used up in fiscal year 1980; at that time new budget authority is assumed to be added to increase the capital grant program to $1.4 billion a year (see Table 24). The formula grant program would grow from $775 million in fiscal year 1978 to about $1 billion in 1982. Transit grants through Interstate highway transfers depend upon the decisions made by state and local governments but are assumed to continue at the rate of $575 million a year called for in the 1977 Department of Transportation Appropriations Act.

Under this option, construction of rail projects underway in Atlanta, Baltimore, Buffalo, and Miami could continue at the anticipated pace. While commitments to additional new systems could be made, no actual spending would be possible until the early 1980s. Given the long lead time needed for planning and engineering, this should cause only minor delays in UMTA's program. If transit industry projections are correct, the growth scheduled for the formula grants will keep pace with the increases in the operating expenses and deficits of the nation's transit systems, and will continue to defray between 20 to 25 percent of these deficits.

Continuing the UMTA capital grant program, with its current mix of funding, can be questioned. Most important,

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3/ This differs only slightly from the definition of current policy presented in Five-Year Budget Projections: Fiscal Years 1978-1982, CBO Report, December 1976. The primary difference is that, when major new budget authority is added in fiscal year 1980, the capital grant program is increased by $150 million and continued growth is assumed in the formula grant program for 1981 and 1982.

the wisdom of allocating 35 percent of the funds to new rail systems is debatable because of the great expense of such systems, their projected operating deficits, and their apparent inability to solve the major urban transportation problems.

TABLE 24. BUDGET OPTIONS FOR THE URBAN MASS TRANSPORTATION ADMINISTRATION, IN MILLIONS OF DOLLARS, FISCAL YEARS

Option	1977	1978	1979	1980	1981	1982
Present Policy						
Budget Authority	455	430	430	910	2,930	2,980
Outlays	1,890	2,160	2,570	2,700	2,950	2,980
Total Program Level a/	2,653	2,755	2,830	3,055	3,105	3,155
Changes from Present Policy						
Expanded Program						
Budget Authority	--	--	410	3,070	1,750	2,100
Outlays	--	240	410	680	970	1,310
Reduced Rail, Expanded Low Capital						
Budget Authority	--	100	125	-210	-490	-265
Outlays	--	10	40	50	60	--
Expanded Formula Grants						
Budget Authority	--	--	--	980	-850	-130
Outlays	--	120	110	250	320	280

a/ Total program level is measured by UMTA's administrative reservations.

Expanded UMTA Program

A proposal being discussed among transit officials calls for a major expansion in both capital and formula grants, while basically maintaining the same program structure. Such an augmented program assumes capital grants to be $1.9 billion in fiscal year 1978 and to grow to $3.1 billion in fiscal year 1982 -- more than double the $1.4 billion under present policy. One-fifth of capital grants would be earmarked for buses, with the remainder available for rail and other fixed-guideway facilities.

In addition to an expanded rail modernization effort, this option would provide funds to complete new starts committed or under construction in Atlanta, Baltimore, Buffalo, Miami, and Detroit. Five to ten more systems of moderate size similar to those underway in Atlanta and Miami could be started. Eighteen to 23 urban areas would have completed rail systems by the mid-1980s; at present, there are only eight.

Formula grants would be increased to $1 billion in fiscal year 1978 and grow to $1.4 billion in fiscal year 1982. This should cover about one-third of the nationwide transit operating deficit for current systems; it does not reflect the likely deficits of new systems. If this budget option is intended to defray a substantial portion of large-city deficits, the allocation formula would have to be changed to reflect the size of the deficit, preferably coupled with some incentive to control cost.

With an expanded UMTA program more cities would have rail systems, but the problems that would occur under present policies would likely be exacerbated. Simple expansion of the UMTA program would probably reduce the pressure for more effective assistance programs. The risk of future deficits would certainly be increased if rail systems proliferated in lower-density urban areas, especially without effective controls on zoning and auto use.

No New Rail Starts; Expanded Low-Capital Program

The UMTA program could be continued without providing funds for new rail system starts. Rail systems that have received letters of commitment (which are not legally

binding) from UMTA and that are in a construction or detailed engineering phase would be completed. The list of such cities includes Atlanta, Baltimore, Buffalo, and Miami, but not Detroit, where considerable planning remains to be done. The Washington, D.C., Metro would continue to be funded using Interstate transfer funds. Cities that have received encouragement but no formal commitment from UMTA, (e.g., Honolulu and Los Angeles) would be excluded. Existing programs for bus replacement, rail modernization, and operating assistance could be continued.

Under this option, capital spending differs little from that of present policy in fiscal years 1977 and 1978. As construction of new systems is completed in the early 1980s, however, the level of new obligations will drop by roughly one-third or about $500 million a year.

As indicated earlier, low capital projects that focus on increasing the productivity of transportation systems, seem to be very cost-effective. The Congress thus might couple an expansion of support for such projects with a reduction of support for new rail systems. While UMTA currently encourages such Transportation System Management (TSM) projects, no separate funding is earmarked specifically for such projects. This option assumes such a program will be added to the UMTA authority beginning in fiscal year 1978 at a level of $100 million and growing to $200 million by 1982. The program would fund projects such as vehicle priority schemes, contraflow lanes, synchronized traffic signals, and peak period automobile restrictions.

Expanded Formula Grants

The UMTA program could be restructured by shifting funds to an expanded formula-grant program. While the existing grant program is authorized to expand from $650 million in fiscal year 1977 to $900 million in 1980, many view this expansion as inadequate in the face of growing deficits. In 1975 the nationwide operating loss of transit systems was about $1.5 billion, while fiscal year 1975 formula grants were authorized at only $300 million. New York City's formula grant funds covered only 8 percent of its bus and subway deficit.

60-294 O - 77 - 10

This grant program could in fact be increased while keeping the total UMTA program level unchanged. The size of the discretionary capital grant program could be reduced to whatever would be needed to complete existing rail starts (Atlanta, Baltimore, Buffalo, and Miami), and the rail modernization effort could expand slightly. By 1982 the formula grants would be 70 percent above the level assumed in present policy. The increased formula grants could be used not only for operating assistance but also for capital projects, such as bus replacement, which follow a regular, predictable cycle and therefore do not need discretionary grants.

Increasing the formula grant program could relieve the burden on farebox revenues and on state and local taxes to support transit. That is, fares and state and local taxes could thus be lower than they would be otherwise. This would represent an income transfer to transit users in particular and to urban residents in general. Ridership might even be encouraged by low fares, although most studies suggest that such a subsidy would not increase the number of riders significantly.

The current operating subsidy provides little incentive for transit management to attack the underlying causes of their system's financial problems. If the formula-grant program were expanded, incentives should be considered for improving transit service and controlling costs. For example, operating aid could be tied to growth in ridership, increased transit-vehicle miles, improved service to various transit-dependent groups, meeting specific maintenance standards, and higher downtown parking fees for private cars, to name but a few. This approach could change some fundamental aspects of the transit situation, rather than simply treat the symptom, which is the deficit. From the standpoint of recipient governments, larger formula grants would provide local officials with more flexibility to determine their own programs and the officials could formulate plans on the basis of predictable funds.

CONCLUSION

Federal policy concerning mass transit should not be developed in isolation. It needs to be closely coordinated with urban highway policies. The relationships between

mass transit policy and energy and environmental policy also bear constant watching. It must be remembered that urban transportation has the long-run potential for altering residential and employment patterns. Transit commitments for both today and tomorrow thus deserve a long look on the part of the Congress.

CHAPTER 8 FISCAL PROBLEMS OF BIG CITIES

THE ISSUES

For the past two decades the nation has grappled with the problems facing its big cities. At first, federal programs focused mainly on rebuilding the physically deteriorated central parts of cities; the most significant of these efforts was the large-scale urban renewal program. During the 1960s, the thrust shifted from places to people. New federal programs concentrated mainly on the poor and minority populations; these efforts were designed to assist the urban poor directly and to extend financial aid to local governments and nonprofit organizations that provided special services for the poor. Many of these programs came under criticism for their administrative complexity and ineffectiveness, and for the fiscal strain they placed on cities.

In the early 1970s the emphasis of federal policy shifted again, this time to the fiscal problems of city governments. General Revenue Sharing, was among the initiatives designed to ease the fiscal strain on local governments; it gave the cities more control over the use of federal aid. But the near bankruptcy of New York City reinforced the concern over big cities' finances and generated interest in new and expanded city-oriented federal programs.

The roots of the problems faced by cities are complex. The social and economic problems that characterize some cities as urban places are distinct from the fiscal problems that beset city governments, although the two sets of problems are often related. Many cities are suffering from contracting economies, losses of jobs and population, high rates of unemployment and little growth in resident incomes. In some cases this reflects the current depressed state of the national economy; in others, however, intrinsic structural problems may be the cause. Changes in technology, the composition of the local labor markets, government policy, and consumer preferences combine to make some cities that

were once desirable locations for business enterprises relatively less attractive today. These factors have encouraged the migration of businesses from the city to the suburbs, and from one region of the country to another.

As economic opportunities have left the cities, so too have people. Because workers can commute to jobs, however, population movements within metropolitan areas may be independent of the locations of businesses. People move because they want better housing and recreation; lower taxes, pollution, and crime; or more public services. These are more often found in the suburbs. But once people relocate, they increase the market for goods and services, and create incentives for further movements by businesses.

Central cities have been losers and suburban areas gainers in the decentralization process. Between 1970 and 1974 central cities decreased in population by nearly 2 percent while suburban areas grew by more than 8 percent. People who left the city had higher incomes than those who moved in.

Cities in the northeast and northcentral regions were more likely to experience economic contraction than cities in other parts of the country. Part of the explanation for their decline lies with factors that are affecting all of the northeast and northcentral regions. High energy costs, for example, increased the cost of doing business or living in suburban areas as well as central cities. Other factors impinge only on the cities. For example, cities that had their greatest growth during the first wave of industrialization are vulnerable to decline because their plants, housing, and public infrastructures are ill-suited to the demands of modern industry and life-styles. Newer communities in the same region do not share these problems.

Besides being places, cities are political entities. And their governments can and do have fiscal problems. While fiscal distress is an elusive, difficult-to-measure concept, a city may be said to have a fiscal problem if it must continually increase its tax rate merely to maintain its present public services. Fiscal difficulties do not necessarily imply that a city is near bankruptcy. Many cities faced with weak tax bases have cut services or raised taxes -- or both -- in order to balance their budgets.

A weak local economy is often responsible for a government's fiscal problems since the tax base is dependent upon local economic activity. Such fiscal problems may be temporary (caused by the recent recession and inflation) or chronic (related to the area's contracting economy). Unfortunately, the need for services rarely decreases at the same rate as a city's tax base because some costs are fixed and others are difficult to cut back. Furthermore, as a city's economy and population decline, the proportion of the population most dependent on public services is likely to increase.

Sometimes, a government's fiscal problems may be independent of changes in its economic base. Fiscal problems may follow from the way government is organized at the state and local levels. In some areas, the underlying economic base may be sound but the jurisdiction's boundaries and powers may preclude effective taxation of income generated by the area's economic activity. State policies that place especially heavy service responsibilities on a city may be the cause of difficulty in some areas. Furthermore, state aid for local governments may not accurately reflect the higher costs, added service burdens, and inadequate tax base of the large city. Finally, of course, mismanagement, corruption, or inefficiency have been known to force governments into fiscal difficulties.

FEDERAL ACTIVITIES AFFECTING CITIES

Many activities of the federal government have an impact on cities; but often these impacts are indirect and unintended. For example, tax policy, which has favored new construction over rehabilitation, homeownership over rental housing, and capital-intensive production technologies over labor-intensive ones, has encouraged development outside cities. Federal policies designed to increase homeownership and improve highway transportation have fostered suburbia at the expense of the city. Some regulatory policies, such as rate-setting at both the Civil Aeronautics Board (CAB) and Interstate Commerce Commission (ICC), have favored smaller towns and have encouraged the decentralization of economic activity. These unintended consequences of federal policy may have a greater impact on cities than programs designed specifically to help the cities.

Among the larger federal activities specifically aimed at dealing with urban problems are:

- The Community Development Block Grant program which distributes funds primarily to jurisdictions in metropolitan areas for use in activities that strengthen the viability of urban communities.

- The Urban Mass Transportation Administration's (UMTA) programs which provide local governments with capital grants for the purchase of new buses, rail cars, and rail systems, and with operating grants to help offset deficits.

- The Comprehensive Employment and Training Act (CETA) which provides grants for manpower training and public service employment activities.

- The Law Enforcement Assistance Agency's (LEAA) programs which fund innovative and modernization projects in the areas of police protection, courts, and corrections.

- The General Revenue Sharing and Antirecession Assistance programs which provide financial support for the maintenance and expansion of general public services.

- The Accelerated Public Works program which provides funds for small capital works projects that can be completed quickly in areas with high rates of unemployment.

- Title I Education Grants, which support compensatory educational services for disadvantaged children.

- The Environmental Protection Administration's (EPA) grants which finance the construction of waste-water treatment facilities.

- The various housing (Section 8 and public housing), health (medicaid), and welfare (Aid to Families with Dependent Children and food stamps) programs which assist low-income families.

Of course, the problems addressed by these programs are not restricted to metropolitan areas. As a result, governments other than those of large cities benefit from these programs.

CONGRESSIONAL DECISIONS

The basic question facing the 95th Congress is whether it is both desirable and feasible for the federal government to attempt to restore the economic vitality of declining big cities. On the one hand, it can be argued that their decline is part of the natural balancing process of the economy. That is to say, expansion is concentrated in areas that offer businesses low production costs and individuals a desired life-style. The underlying market forces may be so strong that federal efforts to reverse these trends stand little chance of success. Furthermore, successful intervention may introduce inefficiencies that could slow the rate of national economic growth. On the other hand, it can be argued that the federal government has a responsibility to act because past and present federal policies have contributed substantially to economic decentralization and central-city decline. Furthermore, continued decline may soon present unacceptable costs. One need think only of the increased dependency of people left in areas with limited economic opportunities and the neglected and underutilized physical resources.

While an increased federal effort on behalf of declining cities might be justified by either position, the type of activity supported might differ. If a reversal of economic trends does not appear reasonable, then the federal government might simply help declining cities and their residents adjust to the changing conditions. Training and mobility assistance would permit citizens to pursue economic opportunities elsewhere. The painful effects of decline on those yet remaining might be met through expanded income assistance programs and grants to help local governments maintain public services despite their shrinking tax bases. If the Congress wants to reverse or delay current trends, then resources might be directed toward bolstering local economies. Business operation or expansion could be subsidized directly, through loans or tax credits, or

indirectly through additional investment in public infrastructure or government services. But current programs offer little guidance about the amount of money necessary for a long-term reversal of economic decline in big cities.

Whatever strategy is adopted, an increased federal effort requires decisions on:

- Whether the assistance should be directed primarily at local governments or private individuals and corporations.
- Whether existing programs can be used or new ones will be required.
- What types of cities should be helped and how the relative need of various areas can best be measured.
- How much the states should be required to reform their state aid or service responsibilities to assist the federal effort.

A number of important city-oriented pieces of legislation expire at the end of fiscal year 1977, thus presenting the 95th Congress with an opportunity to deal with these issues. Among these pieces of legislation are the Community Development Program, the Antirecession Financial Assistance Program, CETA, and several subsidized housing programs. New initiatives, such as urban tax incentives and urban financing banks, are likely to be proposed. Also, the New York City Seasonal Financing Act of 1975 may have to be revised to take account of a recent court ruling that ordered the city to pay $1 billion on notes on which it suspended payment in 1975.

BUDGET OPTIONS

There is no simple way to determine what is an appropriate amount for the federal government to devote to relieving the problems of cities. Very little is known about the effectiveness of existing, let alone proposed, programs designed to aid cities. As a result, only broad policy approaches, rather than specific proposals with detailed budget costs, are presented here.

Augmented Assistance to Governments

There are a number of ways that the federal government might choose to increase the assistance provided to big city governments. The Community Development Block Grant program could be expanded and targeted more towards declining cities. The program now distributes some $3.25 billion a year, roughly 40 percent of which goes to cities of over 250,000 persons.

If the existing distribution formula is maintained and the "hold harmless" 1/ provisions are phased out as called for in the current law, some large declining cities will experience a reduction in their community development block grants. This situation could be avoided by altering the formula. Some have suggested that if factors such as a city's population loss, age of the housing stock, changes in the city's tax base, or changes in private sector jobs were included in the formula, block grant moneys would be targeted more toward those cities experiencing the worst fiscal problems. An alternative would be to set aside a sum to be distributed at the discretion of the Secretary of HUD to particularly hard-pressed cities.

The appropriation for antirecession fiscal assistance, which provides grants to state and local governments to maintain vital services, will be spent before the end of fiscal year 1977. This will occur because the amount distributed in each quarter is determined by the national unemployment rate, and unemployment has been considerably higher than was anticipated when the appropriation was passed. Under the latest projections of the unemployment rate, $250 million more would have to be authorized and appropriated for the remainder of the fiscal year to fund the program at the level called for under the formula.

If this temporary program is reauthorized for fiscal year 1978, changes could be made to increase the level of

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1/ The "hold harmless" provision ensures that communities do not receive less than they received in the past from the assistance programs that were discontinued when the Community Development Block Grant program was established.

funding and skew the distribution more in the direction of the larger, more troubled cities. The program now provides resources that amount to roughly 8 percent of the estimated revenue loss of recipient governments resulting from full employment; this percentage could be raised somewhat.

The program now allocates money according to unemployment over 4.5 percent (so-called excess unemployment) and revenue-sharing entitlements. The distribution of resources could be further shifted by considering excess unemployment as unemployment over some rate higher than 4.5 percent.

The public service employment programs provided under CETA are up for reauthorization for fiscal year 1978 and for supplemental funding for fiscal year 1977. Increased funding for these programs or increased targeting of CETA money toward large cities are both possibilities.

The money from these or other programs would provide resources that could be used to increase public services or reduce tax burdens. While this would certainly help big cities adjust to their deteriorating circumstances, it is not clear that such assistance could, in and of itself, lead to a revitalization of economic life in these cities.

Aiding the Economies of Cities

The number of federal policies intended directly to affect the economic bases of local areas is severely limited. The Economic Development Administration (EDA) has primary responsibility for a series of programs providing business development loans and guarantees and public facility grants. While urban areas have not been the primary beneficiaries of these programs in the past, this situation is expected to change as a result of modifications in the law and statements of Congressional intent made during last year's reauthorization. These programs received appropriations of $360 million in fiscal year 1977, an amount well below their authorized level. While these efforts could be expanded, little is known about their effectiveness, particularly in urban areas.

Title I of the Public Works Employment Act of 1976 assists the capital budgets of local governments by funding small, quickly started capital projects in areas of high unemployment. It could aid local economies if used to rebuild the urban public infrastructure upon which the private sector depends. While $2 billion was appropriated for this program, applications for projects costing roughly $24 billion were received by the Commerce Department. Some observers have suggested that the administrative distribution process has pushed the benefits of this program away from central cities and toward smaller municipalities and rural areas. Additional funds could be authorized for this program and earmarked specifically for declining cities.

Several proposals have been put forward that call for special federal incentives for expansion of private industry in declining cities. One of these is to provide an added investment tax credit of two or three percentage points for firms that expand their investment in declining cities. The credit might even be made refundable to make the incentive attractive to firms with profits so low that they have small tax liabilities at present.

Another proposal is to have the federal government encourage special financing institutions, such as urban development banks. While these ideas have been put forth only in the most general terms, most entail loans to businesses at below-market interest rates in targeted areas as well as the support of municipal capital development. Some proposals involve the federal government's guaranteeing the loans to private developers wanting to expand or start new businesses in declining cities, while others call for a federal subscription of capital to the new institutions.

The private economic sectors of declining large cities could also be boosted through federal purchasing and employment policies. Attempts could be made to locate new federal installations and jobs in such cities. This, however, may be difficult to do. Federal employment has not expanded in recent years; and since federal employment is often related to providing services, new jobs are likely to be located where the population growth is. As for federal purchasing of goods and services, preference could be shown to businesses located in depressed or declining areas

(similar to preferences for small or minority-owned businesses). A preference for areas with labor surpluses is already specified in Defense Manpower Policy No. 4, but a prohibition against the payment of price differentials included in the Defense Appropriations Act makes the administration of the preference difficult.

Adjustment Assistance

In the New York City Seasonal Financing Act the federal government provides temporary assistance to the city so that it can adjust to changed fiscal circumstances. Similar assistance could be offered to a wider range of cities that wish to restructure their debts and adjust their spending patterns in the face of decline in their economic bases. The New York City legislation should involve no subsidies and no net outlays since the loans are made and paid back within a year. But it does involve a significant degree of state and federal supervision and monitoring of the city's financial behavior. If the federal government were to extend such emergency assistance to more cities, the scope of federal involvement with each recipient could be significant.

CONCLUSION

Of course, the range of activities that affect the financial health of cities goes well beyond the few mentioned here. Welfare reform options, mass transit policies, and environmental programs could have major impacts. The policies that are alleged to be geographically discriminatory could be reviewed and altered. Tax and regulatory policies might be changed to eliminate any bias against declining areas or regions. Energy decisions should likewise be carefully considered to determine their regional impacts. In every instance where a redirection of policy is considered, however, the advantage to declining areas should be weighed against the possible added cost to the federal government and the expected impact on areas now thought to be healthy.

CHAPTER 9 STRUCTURAL EMPLOYMENT

THE ISSUES

Whether the overall economy is strong or weak, unemployment, underemployment, low earnings, and labor force discouragement will affect certain groups disproportionately. These problems -- called structural problems -- are concentrated among teenagers, nonwhites, the less educated, and residents of economically depressed areas (see Table 25). 1/

The reasons for this concentration of hardships vary. Lack of skills and work experience are thought to be responsible for the situation facing many youth. The tremendous influx of teenagers and women into the labor force has also increased the competition for entry level jobs. Nonwhites suffer discrimination, which restricts not only their access to jobs but also their opportunity to obtain the education and training needed to advance. People living in decaying urban centers and other chronically depressed areas usually face an inadequate demand for labor. Hardest hit, of course, are people with a combination of several of these disadvantages. Few are worse off, say, than a black youth who is poorly educated, who has little or no job experience, and who lives in an inner city ghetto that offers few chances for work.

CURRENT PROGRAMS

Many federal programs and policies indirectly or directly affect these structural problems. For example, the job opportunities of the hardest hit groups probably are increased significantly by fiscal and monetary policies that boost economic growth and employment.

1/ For a more detailed treatment of the issues covered here, see Public Employment and Training Assistance: Alternative Federal Approaches, CBO Budget Issue Paper, February 1977.

TABLE 25. SELECTED CHARACTERISTICS OF GROUPS WITH A HIGH INCIDENCE OF STRUCTURAL UNEMPLOYMENT FOR 1975

Group	Median Annual Earnings of Full-Time Workers (Dollars)	Percent of Civilian Labor Force		
		Unemployed	Under-employed a/	Discouraged Workers b/
U.S. Total	12,654	8.5	4.0	1.2
Teenagers	5,277	19.9	7.7	2.0
Youth c/	7,943	13.6	5.2	1.2
Nonwhites	9,080	13.9	5.5	2.9
Nonwhite Teenagers	NA d/	36.9	9.3	NA
Central City Residents	NA	9.6	NA	NA
Persons with Less than High School Education	9,097	NA	NA	NA

SOURCE: U.S. Bureau of Labor Statistics.

a/ Part-time workers for economic reasons.

b/ Discouraged workers are persons who report that they want to work, but are not looking for jobs because they believe they cannot find any.

c/ Age 20 to 24.

d/ Data not available.

Direct federal efforts to deal with structural employment problems date from the early 1960s. They attempted to increase the number of jobs available to particular groups and to augment the skills and training of these persons so that they could better compete in the labor market. The Area Redevelopment Act of 1961 (ARA) and its successor, the Economic Development Act of 1965, were designed to boost the economies and job opportunities of specific geographic areas that were in a decline. The Manpower Development and Training Act of 1962 (MDTA) was intended at first to upgrade the skills of experienced workers pushed out of their jobs by automation; it later stressed skills for the untrained. The Vocational Education Act of 1963 supported training for young persons about to enter the labor market. The Civil Rights and Economic Opportunity Acts of 1964 began the emphasis on enhancing minority groups' access to jobs and/or improving skills. The Public Employment Program (PEP), which was authorized by the Emergency Employment Act of 1971, provided public service jobs for the unemployed and underemployed. While the original emphasis of the Public Employment Program was on structural employment problems, the 1971 recession caused the program's focus to shift more toward the problems of general unemployment.

Four major federal programs are now directed toward structural employment problems. The largest is the Comprehensive Employment and Training Act of 1973 (CETA), which consolidated many of the programs of the 1960s into a block grant distributed through a formula to states and to 445 units of local government. For the most part, these recipients design and operate employment and training programs under the following five titles of CETA:

- Title I provides job opportunities, training, education, and other services to enable people to get and keep the best jobs they can.

- Title II provides the unemployed and underemployed with transitional employment in public service jobs in regions with substantial unemployment. Training is also given to enable persons to move into jobs or training not supported by this title.

80-294 O - 77 - 11

- Title III provides the services covered in Titles I and II for population segments such as youth, migrant and seasonal farm workers, native Americans, and others.

- Title IV provides intensive residential and nonresidential programs of education, vocational training, work experience, and other activities.

- Title VI provides transitional employment for the unemployed and underemployed and public project jobs for low-income, long-term unemployed, welfare recipients and persons whose unemployment compensation benefits have been exhausted. 2/

The Work Incentive Program (WIN), authorized under the 1967 Amendment to the Social Security Act, originally provided job training, but recently has emphasized job placement for recipients of welfare benefits. Most healthy recipients of Aid to Families with Dependent Children (AFDC) who do not have to care for a child under the age of six or a handicapped dependent must register for the WIN program. As an incentive for employers to hire welfare recipients, firms are permitted a tax credit of up to 20 percent of the first year's wages paid to each WIN participant or welfare recipient during the first year on their payrolls.

The Community Service Employment for Older Americans program, authorized by Title IX of the Older Americans Comprehensive Service Amendment of 1973, provides unemployed low-income people over the age of 54 with part-time community service employment. (See Table 26 for characteristics of participants in the above programs.)

Finally, the Vocational Education Act of 1963 provides grants to states for in-school vocational education. This program represents only 12 percent of all vocational education spending. There is some question as to whether it stimulates spending for vocational educational as is intended.

2/ Title V established the National Commission for Manpower Policy.

TABLE 26. CHARACTERISTICS OF NEW PARTICIPANTS IN SELECTED EMPLOYMENT AND TRAINING PROGRAMS, FISCAL YEAR 1976

Program	New Participants	PERCENT					
		Low-Income Persons	Minority Group Members	Under 22 Years Old	Less than High School Education	Cash Assistance Recipients	Unemployment Compensation Recipients
CETA - Title I	1,587,900	76	57	57	54	26	6
CETA - Title II	249,600	47	44	22	26	19	13
CETA - Title III							
Migrants and Farm Workers	24,200	100	54	48	88	7	1
Native Americans	17,500	89	99	45	53	13	NA
Summer Youth	888,000	100	55	100	94	38	NA
CETA - Title IV (Job Corps)	44,000	100	73	100	100	41	NA
CETA - Titles VI and II a/	499,900	44	36	22	26	13	14
Community Service Employment for Older Americans	6,000	100	27	NA	50	NA	0
Work Incentive Program	19,600	100	44	17	60	100	NA
Total	3,336,700	76	53	61	59	27	6

a/ An emergency supplemental appropriation merged Titles II and VI of CETA for the purpose of extending Title VI positions beyond the expiration date of December 31, 1975.

EVALUATION

The four major types of activities sponsored by these programs are:

- On-the-job training, which provides training for regular job vacancies, generally by payment to public or private employers for the added cost of hiring and training.
- Classroom training, which provides occupational or prevocational skill training.
- Work experience, which offers temporary, usually part-time, employment for such groups as youth or older workers.
- Public service employment, which provides work in the public sector either for transition to an unsubsidized job or for countercyclical purposes.

These basic activities are supplemented by others, such as allowances, day care, recruitment, assessment, and placement. Of course, all these programs differ in terms of benefits and beneficiaries, cost, and effectiveness (see Tables 26 and 27).

Training

The major programs directly aimed at increasing skills are the Title I and Title IV (Job Corps) programs of CETA, which enrolled 564,000 and 45,000 people, respectively, in fiscal year 1976. 3/ The latter program focuses exclusively on disadvantaged young persons who have not completed high school (see Table 26). Most of the Job Corps participants are minority group members and nearly half come from welfare recipient families. Most of those receiving classroom or on-the-job training under Title I come from disadvantaged homes, are nonwhite, have not graduated from high school, and are young.

3/ In fiscal year 1976 there were about 1.3 million participants in Title I. Only 44 percent were in training; most of the rest participated in work-experience programs.

TABLE 27. SUMMARY OF SELECTED EMPLOYMENT AND TRAINING PROGRAM DATA, FISCAL YEAR 1976

Program	Outlays (Millions of Dollars)	Years of Service	Cost per Year of Service	Cost per Participant a/
CETA - Title I Training and Work Experience	1,698	448,300	3,786	1,256
Title II Jobs	544	75,300	7,226	2,175
Title III - Summer Youth Employment Work Experience	459	250,700	2,380	595
Title IV - Job Corps Training	181	20,200	9,231	4,156
Title VI Jobs	1,872	226,600	8,262	3,906
Community Service Employment for Older Americans	47	12,700	3,387	6,943
WIN	307	30,600	10,300	3,287

SOURCE: Unpublished U.S. Department of Labor data.

a/ Most CETA programs do not take a full year.

The average cost per participant in the training component of Title I was about $1,400, while that of the Job Corps was about $4,200 (see Table 27). The Job Corps emphasis on severely disadvantaged youth and use of residential treatment facilities explains most of the cost difference. The effectiveness of these training programs is difficult to measure. It appears, however, that the earnings of participants are raised by roughly $400 one year after the program; but five years later very little additional income results from these programs. While not readily calculable, other gains should be noted. These include the possibility of reduced expenditures for other programs, such as welfare, unemployment compensation, and food stamps; and, from the beneficiaries' standpoint, the increased self-esteem that comes with being an active member of the labor force.

Direct Employment

Titles II and VI of CETA provided 90 percent of the 290,000 public service employment (PSE) jobs funded in fiscal year 1976. On an annual basis, the cost per PSE job was about $8,300. Since these programs are primarily antirecession programs, they have been targeted toward all unemployed or underemployed persons. As a result, those holding PSE jobs tend to be older, better educated, and from higher-income groups than those receiving training (see Table 26). Because the Title VI reauthorization (Public Law 94-444) targeted the new PSE jobs on the long-term unemployed, AFDC recipients, and unemployment compensation exhaustees, this may not hold in the future. Furthermore, it called for the creation of specific public projects rather than additional regular local government jobs.

The actual number of additional jobs created by PSE is uncertain because local governments may use federal funds to pay for some employees they would have hired anyway without the federal program. The rate of such "fiscal substitution" has been estimated to be as much as 60 percent in public service employment after one year, and it may approach 90 percent in ensuing years. If these estimates are accurate, a $1.0 billion outlay on public service employment would result in only about 50,000 additional jobs in the first year. During periods of economic slack, when many state and local governments are cutting back employment, fiscal

substitution should be substantially less. It may also be true that fiscal substitution would be less if public project jobs were targeted toward those who would not be likely to be hired, such as the disadvantaged, minorities, the chronically unemployed, and young people. Such was the purpose of the restrictions placed on the Title VI program.

There were also more than 500,000 part-time jobs funded by work experience activities -- mostly within CETA Title I and the Summer Youth Program (Title III). These jobs are part-time and often are assigned to new entrants or reentrants to the labor force. The average annual cost per job was only about $3,300 for Title I and $2,400 for summer youth (about $600 per summer). That is to say, nearly 300,000 year-round Title I jobs or about 1.7 million three-month summer jobs can be funded for $1 billion. Because of the low wages and provisions in the legislation, these jobs are often filled by youths and disadvantaged workers. Fiscal substitution may be less of a problem here because local governments cannot hire regular employees at such low wages.

CONGRESSIONAL DECISIONS

Because of the lull in the economic recovery, the 95th Congress will be faced with demands to stimulate the economy and employment, both for the remainder of fiscal year 1977 and for 1978. But three questions will have to be resolved first:

- In the programs designed to stimulate employment directly, how much of an emphasis should be given to those groups that suffer from structural problems?
- How much emphasis should be given to skill development and training programs compared with work experience and public service employment?
- How much should these programs rely on the private sector and how much on the government?

Decisions on the CETA program alone will require the Congress to deal with these questions. The fiscal year 1977 funding for temporary employment assistance (Title VI of CETA) is roughly $2 billion below the levels mentioned by the Budget Committees in their reports on the Second Con-

current Resolution on the Budget for 1977. 4/ The public service jobs provided through Title VI of CETA have funding through fiscal year 1977 derived from $1.0 billion in budget authority from prior years and $1.4 billion provided in a continuing resolution. If the full amount contemplated by the Budget Committees were to be used, additional jobs or training could be provided in fiscal year 1977.

The debate over the reauthorization of the CETA program, which expires at the end of fiscal year 1977, will give the Congress another chance to focus on structural employment problems. Two of the issues listed above -- the degree of targeting on the seriously disadvantaged and the balance between public service jobs, work experience, and training -- must be dealt with during this reauthorization.

Several new initiatives are also possible. The problems of youth employment are likely to generate a renewed interest in some type of year-round youth employment and training program. 5/

The Congress is likely to receive proposals for stimulating private firms to increase employment. These include proposals to extend the tax credit now available to firms that hire welfare recipients to cover other disadvantaged groups or workers in depressed areas, to offer partial wage subsidies to firms that hire certain people, and to give federal payments to firms that expand on-the-job training for the disadvantaged.

BUDGET OPTIONS

Unlike many other budget decisions, those having to do with structural employment policies do not restrict

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4/ See House Report No. 94-1457, pp. 40 and 74, and Senate Report No. 94-1204, p. 38.

5/ Among the proposals introduced in the 94th Congress were the Youth Community Service Act (S. 3869), the Comprehensive Youth Employment Act (H.R. 13021), the Youth Counseling and Employment Act (H.R. 13008), the Youth Employment Act (H.R. 12795), and the Young Adult Conservation Corps Act (H.R. 10138).

future budget flexibility. Over three or four years, new approaches can be tried and old ones modified, and funding can be changed. A continuation of current policy, as well as four illustrative budget options that emphasize public service jobs, youth employment programs, training activities, and private sector programs, are presented below.

Current Policy

A continuation of current policies would imply outlays in fiscal year 1978 of some $7.7 billion 6/ (see Table 28). Under this approach, 510,000 public service jobs, 470,000 work experience opportunities, and 360,000 training slots would be funded for a full year. Because some of the programs do not last a full year, and because of turnover, the number of persons participating would be greater: 1.1 million in PSE jobs, 1.9 million in work-experience jobs, and 900,000 in training. If the characteristics of participants remained unchanged, roughly three-quarters of the 4 million new participants would come from disadvantaged families. Some 1.6 million youths (600,000 service years) would be reached. If the substitution rate for PSE were 50 percent, the unemployment rate would be reduced by no more than a few tenths of a percentage point. This effect may be larger if fiscal substitution is reduced by the new public project jobs under Title VI.

Augmented Public Service Employment

Because of the disappointing economic recovery, many have argued for significantly increasing public service employment and work experience jobs. The inflationary impact of this can be moderated if the program is directed at providing jobs for those suffering from structural employment problems. At current PSE wage levels, an additional 300,000 jobs would cost $2.5 billion in fiscal year 1978; if the wage level dropped to the level of the minimum wage, 200,000 positions would be supported by $1 billion.

6/ The current policy base assumes an appropriation level of $6.5 billion in fiscal year 1977, as called for in the Second Concurrent Resolution on the Budget.

TABLE 28. STRUCTURAL EMPLOYMENT BUDGET OPTIONS, FISCAL YEARS

	Outlays (Millions of Dollars)		Years of Service (Thousands)			
			1977		1978	
	1977	1978	Jobs	Training	Jobs	Training
Current Policy	7,007	7,666	460	360	510	360
Changes from Current Policy						
Augmented PSE	--	2,490	--	--	300	--
Augmented Training	--	1,000	--	--	0	220
Youth Programs						
CETA Type	--	2,000	--	--	165	250
Rural Type	--	2,000	--	--	100	250

Presumably, income assistance outlays would then fall and tax receipts would increase as a result. The net cost of funding 300,000 jobs would thus be closer to $1.3 billion.

There is some question as to how many PSE jobs state and local governments can or want to provide. In fiscal year 1976 state and local officials showed some reluctance to gear up large PSE programs. This may be in part because they did not want to face the problems associated with turning out PSE workers when federal funds were used up; in a few cases, useful tasks for these workers may have been difficult to organize. Governments also may not have wanted to face the public discontent that could result if public service levels are cut back as the PSE program is phased down. If 300,000 PSE jobs were added to the current

policy level of 530,000, this would represent 7 percent of the 12 million employees of state and local governments. Significant further expansion may be difficult.

Of course, added PSE could take the form of federal jobs or jobs in the private sector. This was the approach taken in the Senate-passed Emergency Rail Transportation Improvement and Employment Act of 1975 (S. 1730), which called for the creation of jobs to rebuild the nation's rail beds.

Augmented Training

Rather than focusing on added public sector employment opportunities to deal with structural employment problems, greater emphasis could be placed on training. One argument for increasing training now is that when job prospects are generally grim, the job and income opportunities foregone by trainees are relatively small. Such training could thus increase the employability of large numbers of persons with structural employment problems. It could, however, lead to discouragement if few jobs are available for those completing the training. An added $1 billion earmarked for the CETA Title I training programs could provide training for 630,000 persons; a similar amount provided through the Job Corps would assist only 220,000 persons.

Youth Programs

The extremely high rate of youth unemployment and the special problems faced by this group have generated interest in expanding youth employment, training, and work experience programs. Such efforts could stress jobs, skill development, expanded educational opportunities, or counseling and placement activities.

During fiscal year 1976 some 58,000 public service jobs and more than 550,000 work-experience and training positions were held by persons under 22. Many of the work-experience programs for young persons are available only during the summer. An Urban Youth Corps to rebuild decaying parts of cities and an expansion of the Youth Conservation Corps, which employs youths in national parks and forests, are among the many possible ways to expand opportunities for young workers. A rural program might cost as much as $4,000

more per service year because of the need for residential facilities to house the workers and the more extensive use of materials. For $1 billion, an urban program could provide 165,000 jobs while a rural one could provide only 100,000 jobs. Alternatively, additional training slots could be designated for youth. About 250,000 training slots could be created per $1 billion.

Private Sector Incentives

Direct subsidies could be used to encourage private sector employment of those persons experiencing structural employment problems. 7/ For unskilled workers, the subsidy could reduce the gap between what the employer is willing (or required by minimum wage laws) to pay and what the employees need. If subsidized employees received on-the-job training, their value could gradually increase until they were capable of competing for unsubsidized jobs.

The incentive could be offered as tax credit or wage subsidy to employers who hired specific types of individuals, or as a voucher to the workers. A wage subsidy could take the form of a reduction in the social security or unemployment compensation tax paid by the employer. The subsidy could be restricted to specific groups of workers, such as teenagers, the long-term unemployed, or people without high school diplomas. The incentives could also be restricted to firms in areas of high unemployment -- inner cities or depressed rural communities.

Very little is known about the potential effectiveness of wage subsidies. For example, it is not known exactly how much of a subsidy or tax credit is needed to provide a reasonable incentive -- either to employers or to prospective employees. The program could also create incentives to hire new workers who will merely displace existing

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7/ See the forthcoming CBO study on employment wage subsidies and tax credits. More than a dozen tax credit proposals were introduced in the 94th Congress.

workers. Estimates of the number of new jobs that would be created by tax credit and wage subsidy programs differ greatly. 8/

The most effective subsidies appear to be those that are targeted on specific workers. By nature, however, these are complicated to administer. Their complexity raises the total cost per new job created, and it may lead to lowered participation. The experience of the WIN tax credit demonstrates these points. 9/

Many federal activities have significant effects on the unemployed and those suffering from structural unemployment. Income assistance programs, particularly the unemployment compensation system, are also as important to these groups as are incentives or development in depressed areas and programs that promote vocational and higher education opportunities.

8/ See Kenneth R. Biederman, "Alternative Tax Subsidies for the Training and Employment of the Unemployed," in The Economics of Federal Subsidy, A Compendium of Papers, Part IV: Higher Education and Manpower Studies, Congressional Joint Economic Committee, 92nd Congress, 2nd Session, August 28, 1972; Gary C. Fethke and Samuel H. Williamson, Employment Tax Credits as a Fiscal Policy Tool, Congressional Joint Economic Committee, 94th Congress, 2nd Session, July 21, 1976; and Warren Farb and Douglas Bendt, An Analysis of a Corproate Job Tax Credit, Congressional Research Service, Library of Congress, March 11, 1976.

9/ See the report prepared for the Department of Labor, Interim Report on the Study to Assess WIN and Welfare Tax Credits (Minneapolis, Minn.: Impact, Inc., February 15, 1976.)

CHAPTER 10 HEALTH CARE

THE ISSUES

In the past decade national health expenditures, both public and private, have grown from $42 to $135 billion or from 5.9 to 8.4 percent of the GNP. 1/ The increase reflects both inflation -- medical care prices in the last decade have risen about a third faster than the Consumer Price Index (CPI) -- and significant increases in the use of health services, especially by the poor. Much of this increased use has been made possible by federal medicare and medicaid programs, which together will cost $32 billion in fiscal year 1977. Because so much health spending is now financed by the federal government, any future inflation in medical costs will have a substantial impact not only on the private costs of care but on the federal budget as well.

Despite massive increases in spending and trends toward more equal access to services, health care is still denied to some, either because they are poor or because they live in inner-city or rural areas where doctors are scarce. Approximately 40 million people with incomes under $10,000 have inadequate health insurance protection and are ineligible for medicaid.

While some people go without medical care, there is mounting evidence of inefficient use of existing resources. Some physicians provide services that could be handled by less-skilled health personnel; services that could be dealt with on a more economical outpatient or informal basis are provided in a hospital or nursing home. Furthermore, there have been indications of widespread provider and recipient fraud in two of the government's major health programs -- medicaid and medicare.

1/ For a more detailed treatment of the issues covered here, see Catastrophic Health Insurance, CBO Budget Issue Paper, January 1977, and a forthcoming CBO Budget Issue Paper on long-term care for the elderly and handicapped.

Federal health policy for the next few years depends heavily on two questions:

- What can be done to hold down increases in costs, especially for care financed by the federal government, without impairing quality?

- What can be done to improve access to medical care for those who still have difficulty obtaining it and paying for it?

These questions are related, since providing more health financing will only add to demand and exacerbate inflation unless ways are found to control costs. Hence, controlling costs in existing federal programs is sometimes seen as a prerequisite to broadening federal insurance protection. On the other hand, since it is difficult to devise ways of holding down costs in medicare and medicaid alone without adding to the burdens of the poor and the aged or providing them with second-class care, it is sometimes argued that medical care costs can only be controlled if the federal government pays an even larger share of the total -- and thus buys more leverage in the system.

CURRENT PROGRAMS

The federal government's complex array of health programs falls into four categories:

- Financing programs that help the poor and the aged pay for medical care.

- Tax expenditures designed to ease the burden of paying for care.

- Direct care programs for some special populations.

- Programs designed to increase the supply of medical resources.

Financing

Medicare for the aged and disabled, and medicaid for the poor, are the major federal health care financing programs. Together, they will cost an estimated $32.0

billion in fiscal year 1977, almost 83 percent of the federal health budget (excluding veterans' health programs). States, which administer medicaid, are expected to spend another $8.4 billion on that program. An estimated 23.6 million aged and 2.4 million disabled persons will be covered by medicare, while 24.4 million poor persons will receive benefits under the medicaid program.

Despite these large expenditures, serious coverage problems remain for both the aged and the poor. Because of medicare cost-sharing requirements and the exclusion of certain types of services -- particularly long-term care -- medicare pays only about 42 percent of the health expenditures of the aged. Approximately one-fifth of the aged receive medicaid benefits to supplement medicare. However, many low-income aged persons and other families with incomes below the poverty level are not eligible for benefits. In 1975, an estimated 8 to 10 million persons with incomes below the poverty level were excluded from the medicaid program.

Problems of provider and beneficiary fraud and program mismanagement in both medicare and medicaid have become a serious concern in recent years. It appears likely that legislation dealing with fraud and program management will be a high priority in this session of the Congress.

Tax Expenditures

The federal government also subsidizes medical care through the tax system. This is done by excluding from a person's taxable income the health insurance premiums paid on his behalf by his employer and by allowing large medical expenses as itemized deductions. In fiscal year 1977 an estimated $7.8 billion in federal tax revenue will be foregone as a result of these tax expenditures. The benefit of these expenditures, however, is not distributed evenly. While taxpayers with incomes in excess of $15,000 accounted for less than 30 percent of all tax returns in 1976, they received about 59 percent of the benefits of these tax expenditures.

Direct Care

Programs that provide services or comprehensive care to specific populations account for about 6 percent of the

80-294 O - 77 - 12

federal health budget, or $2.2 billion. The direct care programs operated by the federal government include the Indian Health Service, the National Health Service Corps, and the Public Health Service Hospitals. In addition, the Veterans Administration's health care system will spend an estimated $4.4 billion on direct care in fiscal year 1977.

Other federal programs provide local or state agencies with grants to establish community and migrant health centers, maternal and infant care programs, and children's and youth projects in low-income areas or in areas lacking in health resources. Comprehensive care programs serve an estimated 3.7 million persons. In addition, 1.4 million persons will receive hospital care through the Veterans Administration. Direct delivery systems can provide comprehensive care at lower costs per person than can financing programs, and they seem to be more effective at reaching persons in inner-city and isolated rural areas.

Resource Supply

Less than $1 billion of the $38.9 billion in federal health expenditures projected for fiscal year 1977 is devoted to such resource supply programs as health planning and manpower training assistance. Historically, resource development has been directed at increasing the number of hospitals, physicians, and other personnel on the assumption that this would not only improve access but lower the rate of increase of medical prices and expenditures. More recently, however, it appears that increasing the supply of health resources has little effect on prices or access. In fact, it may spur total expenditures by increasing the per capita consumption of physician services and physician-generated hospital services.

This problem -- one of excess capacity stimulating its own demand -- has been recognized by the Health Planning and Resource Development Act (Public Law 93-641), which makes federal planning assistance contingent upon state programs to control the supply of new health facilities. The importance of further action along these lines is underscored by projections that suggest that over the next quarter century the number of physicians per person in the nation will rise by 50 percent. If the amount of health care delivered

continues to be determined by the supply of health resources, substantially higher per capita health expenditures could result.

CONGRESSIONAL DECISIONS

Several program authorizations expire in 1977: those for health planning and resource development programs, for the National Cancer Institute, for the National Heart and Lung Institute, and for community mental health and community health centers. A number of smaller programs will also expire. The fiscal year 1977 budgets for the two biomedical institutes were $1.0 billion. While the dollar expenditures for the nonbiomedical programs due to expire are small, some of these programs, such as the health facilities planning legislation, could significantly change total health expenditures. This is because the health facilities planning legislation includes provisions that control the number of facilities and supports state efforts to set hospital rates.

Far more direct budgetary importance attaches to current proposals to contain the rate of increase of medicare and medicaid expenditures. The 140 percent cost increase in these programs over the last five years has been caused largely by higher cost per unit of service rather than by either larger numbers of beneficiaries or higher rates of use. Many critics have concluded that the rapid increase in government health care spending is in itself a major cause of the cost increases. One reason may be that medicare and medicaid reimburse hospitals on a retrospective cost basis, which creates no incentives for efficiency or cost-consciousness.

In addition to considering methods of containing the cost of existing programs, the Congress may also make a preliminary decision on whether national health insurance is desirable. More than two dozen national health insurance bills were introduced in the 94th Congress; the new Administration has pledged to develop a national health insurance proposal within the next few years.

POLICY OPTIONS

Current Policy

If existing health programs are continued, federal health expenditures will be $45.2 billion in fiscal year 1978 and will grow to $75 billion by fiscal year 1982 (see Table 29). 2/ In addition, health-related tax expenditures will reduce federal revenues by $7 billion in fiscal

TABLE 29. HEALTH CARE BUDGET OPTIONS, OUTLAYS IN BILLIONS OF DOLLARS, FISCAL YEARS a/

Option	1977	1978	1982
Current Policy	38.9	45.2	73.9
Changes From Current Policy			
Reimbursement Controls		- 0.7	- 5.9
Federalized Medicaid			
Federal/State Financed		17.1	24.3
Federal Financed		29.0	44.1
Long-Term Care			
Block Grant		1.0	2.0 to 4.0
Major Effort		6.0	16.2 to 22.2
Catastrophic Insurance Plan to Cover Unusual High Expenses		10.0 to 11.0	19.0 to 20.0
National Health Insurance			
Tax Financed		84.0 to 86.0	108.0 to 138.0
Premium Financed		18.0 to 21.0	14.0 to 27.0

a/ Includes function 550 but excludes Veterans Administration and Department of Defense health expenditures.

2/ Exclusive of Veterans Administration and Department of Defense programs.

year 1978 and by $15.1 billion in 1982. Although health planning, professional standards review organizations (PSROs), and recent health manpower legislation may marginally improve access and decrease costs over the next five years, it is doubtful that current trends in health care inflation or expenditure will greatly change.

Controlling the Costs of Current Programs

Proposals to reduce federal health costs usually focus on methods of controlling hospital charges, which account for 58 percent of federal medicaid and medicare costs. One approach is to increase cost-sharing by recipients. The Ford Administration's 1977 and 1978 budgets called for imposing 10 percent co-insurance for the first 60 days of hospitalization in the medicare program. Under the present statute, medicare completely covers the cost of the first 60 days of hospitalization after the recipient pays the deductible which is a fixed amount equal to the average cost of one hospital day. The Administration estimated that the co-insurance plan would save the federal government $1.8 billion in fiscal year 1978. The savings could reach $3.2 billion by 1982.

One possible benefit of this approach would be a greater effort on the part of both physicians and patients to decrease the number of admissions and shorten hospital stays, which could cut costs considerably. The cost-sharing approach, however, would place a larger share of the burden on some people who could not afford it.

Controlling hospital reimbursement rate increases is another approach frequently mentioned for limiting price rises. The permissible annual increase of hospital reimbursement rates could be held at a fixed percent (say, 10 or 12 percent) or could be tied to an index of general inflationary pressures (say, 3 percent more than the rise in the Consumer Price Index). Some flexibility would probably be required in such ceilings to allow hospitals to make needed capital purchases and major improvements.

The amount of savings that can be expected from such reimbursement schemes depends not only on the set rate, but also on whether that rate applies to all patients, to the

public programs only, or to just certain public programs. 3/ If the rate of increase could be reduced by 3 percent per year from the expected pace, the medicaid and medicare programs would save approximately $700 million in fiscal year 1978 and $5.85 billion by 1982. A limit of 7 percent on the annual increases in medicare reimbursement alone, as was proposed in the Ford Administration's 1977 and 1978 budgets, would reduce medicare costs by $1.46 billion in fiscal year 1978 (see Table 30).

TABLE 30. MEDICARE COST SAVINGS FROM ALTERNATIVE PROSPECTIVE REIMBURSEMENT CEILINGS, FISCAL YEARS 1978 AND 1982, IN BILLIONS OF DOLLARS

Ceiling	1978	1982
7 percent	$1.46	$11.24
10 percent	1.00	8.07
12 percent	0.70	5.71
CPI plus 3 percent	1.33	10.14
CPI plus 5 percent	1.03	7.99
CPI plus 8 percent	0.57	4.45

A third approach is to limit some components that make up hospital costs. Three measures are frequently suggested:

- Limiting reimbursement to some set fraction of the average daily operating charges of similar hospitals in a region. For example, if the average routine cost were $100 per day, and the reimbursement ceiling were set at 20 percent above that, there would be no reimbursement for routine costs above $120 per day. Those hospitals with costs below

3/ While medicare reimbursements are set by the federal government, medicaid reimbursements are established by the states and under current statute are less amenable to federal policy.

the average could be given an incentive payment for their efficiencies. Senator Herman Talmadge of Georgia introduced a proposal similar to this in the 94th Congress (S. 3205).

- Limiting reimbursement for cost increases that come from nonlabor factors, such as the use of more technologically advanced equipment and more laboratory tests per patient. These intensity factors are projected to increase by approximately 10 percent during 1977 and to contribute more than 5 percentage points to the expected 16.6 percent increase in hospital costs. Limits could also be placed on costs related to increases in staff-to-patient ratios, which have been rising recently by 2 percent a year.

- Placing in an escrow account the portion of current hospital reimbursements that result from depreciation. These funds could later be used by hospitals for capital projects which have been approved by state health planning agencies. Such a proposal was incorporated in the Ford Administration's 1978 budget request and was estimated to save $440 million in 1978.

The savings that could result from applying some of these measures only to the medicare program are provided in Table 31. These measures could be imposed individually or collectively, but the savings from a combination of measures would not equal the sum of the savings of the individual measures. This is because hospitals would respond to different measures in a similar way. For example, efforts to hold down routine costs as well as limit cost increases attributable to higher staff-to-patient ratios result in a decrease in staffing; controls placed on the use of reimbursments for depreciation and limited reimbursments for cost increases related to nonlabor factors would both act to curb capital expenditures.

Controls applied only to reimbursements under public programs could create incentives for institutions to discriminate against public program beneficiaries, thus

TABLE 31. MEDICARE SAVINGS FROM LIMITING INCREASES IN SELECTED HOSPITAL COST COMPONENTS, FISCAL YEARS 1978 AND 1982, IN BILLIONS OF DOLLARS

	1978	1982
Limit on Routine Cost Reimbursement		
105 Percent Level	0.59	1.08
110 Percent Level	0.44	0.80
120 Percent Level	0.21	0.38
Limit Intensity Factors to 2 Percent per Year	0.58	4.50
Hold Intensity Factors to 60 Percent of Present Trend and No Increase Allowed in Staff per Patient	0.40	4.11
Hold Intensity Factors to 80 Percent and Limit Increases in the Staff per Patient Ratio to 1 Percent per Year	0.27	2.28

worsening the access problems. If public and private insurance programs maintained different reimbursement standards for a long time, medicare and medicaid beneficiaries might be given a lower standard of care than private patients. In addition, some of the costs not reimbursed by medicare and medicaid might be shifted to private patients. If this occurred, the net reduction in federal budget cost would be larger than the reduction in overall spending for health.

If reimbursement controls are applied to individual hospitals regardless of community needs and services, the controls may not curb the duplication of expensive treatment centers and surplus hospital beds. These problems might be better addressed by such measures as guidelines or limits on

the number of beds according to community size. Alternatively, reimbursement programs could be linked more closely to planning and facility regulation so that rates would reflect the community's desires.

Increasing Access to Health Care

An estimated 25 million people (about 12 percent of the population) have neither private nor public coverage. For the most part, these persons are in families with incomes below the national median. They are the self-employed, the unemployed, the chronically ill, students, and employees of small, low-wage businesses. Some 8 million of such uninsured persons may be able to obtain services from a source such as the Veterans Administration; but this still leaves 17 million who must bear the full financial burden of their health care. An additional 19.4 million people from families with incomes below the national median have very poor private coverage -- that is, insurance in which out-of-pocket expenditures can create a severe hardship.

Several proposals have been made for a limited expansion in current federal financing or delivery programs to meet the most critical access problems. These include plans to extend insurance coverage to all poor families (federalized medicaid) and plans to extend federal financing for long-term care and catastrophic illnesses. These limited expansion programs are sometimes thought of as steps in the direction of comprehensive national health insurance.

Federalized Medicaid

A federalized medicaid program with uniform nationwide eligibility and benefit standards could accomplish the first objective and, via the spend-down provision, provide the entire population with minimum protection from catastrophic expenditures. 4/ Such a program was proposed in the 94th

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4/ Spend-down eligibility under medicaid means that a family becomes eligible for medicaid benefits when its expenditures for medical services reduce its income to the level at which a family is normally entitled to join the program.

Congress as part of the Catastrophic Health Program and Medical Assistance Reform Act (S. 2470). The numbers of persons aided and the cost would depend upon the choice of eligibility levels and the benefit package. If a program similar to the most generous state plans now underway were chosen, an estimated 35 million persons would receive benefits; about one-third of these would be people who at present are uninsured.

The added cost of such a program would be $17 billion in fiscal year 1978 and $24 billion in fiscal year 1982. If states were required to maintain their current levels of contributions, new federal costs would amount to $7.2 billion in fiscal year 1978.

Long-Term Care

Federal, state, and local governments spent $5.1 billion in 1975 on long-term medical and social services for chronically disabled, mostly elderly, persons. While these expenditures are large and have risen threefold in the past five years, an estimated 0.8 to 1.4 million of the aged and disabled who need such long-term care do not receive it. They are kept from getting care not only by lack of finances but also because of the fragmented organization of long-term care.

One option for increasing federal aid in this area is through a consolidated long-term care block grant for nursing home and community services. Such a grant would funnel all long-term care funds through a single local agency which would be responsible for arranging for care in the community. The emphasis is on an improved organization of services, not necessarily on increased financing. While pressures to increase funding to meet demand would undoubtedly exist, federal expenditures could be controlled by the authorization and appropriation processes. If a grant equal to present long-term care spending plus roughly $1 billion were created, from 120,000 to 150,000 more people in need of long-term care services could get them.

Alternatively, a long-term care entitlement program that would include congregate housing and home health care would meet the potential demand for long-term care, but at a substantial cost. If such a program were phased in to

permit the supply of housing and other services to grow, the incremental federal cost would be between $16 billion and $22 billion by 1982. Similar bills were introduced in the 94th Congress (S. 2702 and H.R. 2268).

Catastrophic Health Insurance

Catastrophic health costs are those that are either extremely large or are high relative to a family's resources. Such expenses usually arise from one of three causes: long-term care; moderate expenses incurred by low-income families; and the rare, extremely high-cost treatments that exceed the limits of an otherwise adequate insurance policy. There have been a number of recent proposals to protect all Americans against catastrophic expenditures. These include the Long-Ribicoff Bill (S. 2470) introduced in the 94th Congress, the Ford Administration's 1978 budget proposal for catastrophic benefits, and tax credit plans such as that proposed by Senator Brock (S. 1528) in the 94th Congress.

The cost of a catastrophic insurance plan depends upon the problem it tries to address. The long-term care and federalized medicaid proposals discussed earlier would provide protection against the first two sources of catastrophic expenditures. A plan for just the third problem -- unusually high expenses -- might involve payment of hospital care after the 150th day and nonhospital medical expenses that exceed $2,000 for the nonmedicare population. If such a plan were fully financed by the federal government, it would cost between $10 and $11 billion in fiscal year 1978.

A plan that met all health expenses over a certain percent of family income, say 15 percent, would cost about $16 billion in fiscal year 1978. Because such a plan would encourage a decrease in basic insurance coverage, it could decrease national health expenditures by $0.5 billion.

A catastrophic protection plan that covered long-term care, all expenses for low-income families, and unusually high expenditures would cost between $70 and $75 billion in fiscal year 1978. Such a plan would be similar to many of the national health insurance proposals and should be compared to other comprehensive alternatives.

Comprehensive National Health Insurance

While it is not realistic to envision passage of a national health insurance bill in time to affect the fiscal year 1978 budget, it is important to consider the possible impact of such a program if adopted in the next several years. A comprehensive national health insurance program could be wholly tax-financed and publicly administered; tax-financed but privately administered; or a voluntary or compulsory, mixed public and private system that covered the working population through employment-based insurance. 5/ The federal budgetary impact of national health insurance depends on four factors: whether the plan is financed primarily through taxes or premiums, how broad a range of benefits is provided, how much of the costs beneficiaries would have to share, and the plan's cost control features.

A totally tax-financed plan with no cost-sharing for covered services could add from $168 to $200 billion to federal health expenditures by fiscal year 1982; in contrast, a compulsory employment-based, premium-financed plan with cost-sharing might increase federal spending by as little as $15 to $20 billion in 1982. The range of these cost estimates reflects the varying assumptions about the effectiveness of cost controls. While a tax-financed plan would lower revenues lost through health tax expenditures, a premium-financed plan would raise them. Of course, private spending on health care would fall under all these plans but probably not as much as the rise in government outlays. 6/

Because of the great costs of comprehensive insurance, the Congress may want to consider proposals that would

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5/ For a description of proposals introduced in the 94th Congress, see National Health Insurance Proposals: Provisions of the Bills Introduced in the 94th Congress, Social Security Administration, 1976.

6/ For a discussion of national health insurance costs, see A Comparison of the Costs of Major National Health Insurance Proposals, U.S. Department of Health, Education and Welfare, September 1976.

slowly introduce national health insurance. Among the plans that have been suggested for phasing in benefits are a catastrophic insurance plan, federalized medicaid, or a program for maternal and child health services (popularly known as kiddiecare).

CONCLUSION

In addition to options for phasing in national health insurance, the 95th Congress is likely to concentrate on cost control. The proportion of public and private expenditures now devoted to health is already great. And the impact of increased health spending on inflation is likely to make cost controls the key criterion in evaluating any national health insurance proposal.

Control of health prices through insurance reimbursement is more difficult when there are multiple sources of funding. Purchasing power is now divided between public and private third-party reimbursement and consumer out-of-pocket spending. This reduces and fragments the leverage that can be exerted on provider charges. A single program covering the entire population could offer the greatest potential for controlling health costs. It could do this by establishing hospital budgets and professional fee schedules in advance. If that potential were not fully realized, however, a tax-financed public plan could be far more inflationary than the present mixed system.

THE ISSUES

Last year, the social security system paid out about $76 billion in cash benefits to 33 million retired or disabled workers and their dependents. 1/ To support this system, most wage and salary workers and the self-employed contribute through payroll taxes to two trust funds: old-age and survivors insurance (OASI) and disability insurance (DI). Contributors to the system count on social security benefits to be an important part of their incomes when they retire. The question has been raised, will those expectations continue to be fulfilled?

Several recent government reports have presented a pessimistic financial outlook for social security. These reports cite funding deficits and detail the shaky status of the trust funds over the next decade. During the first half of the next century, the reports suggest sharp increases in payroll taxes will be needed to meet the payments called for under the current benefit structure.

Of course, there is no danger that the system will not continue to make payments to present and future retirees. For, unlike a private insurance program, social security benefits are supported by tax receipts. These can always be raised by the government. The real issues involve the method of taxation, the mechanics of funding, and the planning of long-term benefit and tax commitments.

Social security benefits are funded essentially by the current flow of payroll taxes. The OASI and DI trust funds serve mainly as accounts into which earmarked taxes are deposited and from which benefits are paid. The reserves held in the funds serve primarily to cushion temporary excesses of outlays over revenues.

1/ For a more detailed treatment of the issues covered here, see the forthcoming CBO Budget Issue Paper on the social security system.

Because social security is funded essentially on a pay-as-you-go basis, short-run problems can arise if changes in the economy or other factors cause tax receipts to fall behind benefit payments. The recession, which slowed the growth in wages and employment just after a period of substantial benefit increases, has caused social security revenues to grow more slowly than benefit payments for the past few years. An unexpected increase in the number of disability insurance (DI) recipients has led to greater outlays in that part of the program. As a result, it is not out of the question that, by the early 1980s, the combined OASI and DI trust fund reserves will be reduced to a level many observers would consider inadequate. The DI trust fund is probably going to be depleted before then and therefore will demand early attention.

A pay-as-you-go system can also have long-run problems, especially if the size of the retired population grows faster than that of the working population. In fact, such a demographic shift is expected to create a problem in about 40 years. Another long-term problem -- but one that is more easily remedied -- arises from the method established by the 1972 Social Security Amendments to adjust the benefit structure automatically for inflation. Under this method, the extent to which benefits replace the preretirement earnings of retirees is determined capriciously by the rate of inflation and the growth in real wages. If the inflation and wage growth now projected for the future should occur, future benefits would grow explosively. This flaw is referred to as overindexing; and the benefit structure is classified as a coupled system because a single method is used to adjust the benefits of present retirees and future retirees for inflation. Proposals to remove this aspect of the benefit structure are called decoupling proposals. 2/

DECISIONS BEFORE THE CONGRESS

Because the schedules of benefits and taxes are statutory, changes in benefit and revenue policies must be

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2/ The term "decoupling" has been used to cover all procedures that eliminate overindexing, even those, such as the Hsiao proposal, that rely on a single method for adjusting for inflation.

enacted by the Congress. In the 95th Congress, issues related to both short- and long-run problems are likely to arise.

The questions for the short run are whether additional revenues will be needed over the next decade. If so, how much? How soon? And how should they be raised? The answer to the last question involves the difficult issue of whether to give up exclusive reliance on earmarked payroll taxes and use general revenue financing as well. Underlying this issue is the philosophical rationale of the social security system. The program has always been influenced by two partially conflicting goals: to provide a mandatory retirement insurance program with benefits tied to past tax contributions, and to redistribute income, giving relatively larger amounts to those whose needs would not be met by a benefit that was strictly proportional to past contributions. Many Americans feel that preservation of the insurance elements of the program requires funding through a payroll tax. This does not, however, preclude borrowing from general revenues.

As for the long-run problem, the specific issue likely to face the Congress is that of choosing a method for decoupling. Different methods have different implications for the growth of future benefits and for the distribution of benefits. Therefore, the choice of a method depends partly on the practical issues of how much of the gross national product we are willing to allocate to social security benefits in the future and how we want those resources allocated.

Other issues may, of course, come up in the next few years concerning various aspects of the highly complex tax and benefit structure of social security. For example, the issue of spouse benefits and the fairness of how one-earner and two-earner families are treated has begun to receive increasing attention.

FINANCING ISSUES FOR THE SHORT TERM

At present, OASDI benefits are funded from a tax of 9.9 percent levied on the first $16,500 of wages (the maximum taxable earnings in 1977); these payments are shared equally by employer and employee. Self-employed people pay a tax of 7 percent. An additional tax of 1.8 percent for wage

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and salary workers (0.9 percent for the self-employed) goes for medicare hospital insurance.

Over the past five years social security outlays have been growing at a faster rate than revenues; outlays actually exceeded revenues in fiscal years 1975 and 1976. As a result, the balances in the combined OASDI trust funds have fallen from an amount equal to one year's outlays in 1970 to 57 percent of a year's outlays at the start of 1976.

The decline resulted, to a large extent, from the economic slowdown of the past few years. Since 1973, payroll tax receipts have grown more slowly than anticipated because of the slow growth in real wage rates (that is, wages adjusted for inflation) and because of the high unemployment since 1974. Outlays increased rapidly in 1972 as a result of a 20 percent across-the-board increase in benefits. Several legislated benefit increases raised outlays in the next three years. Since 1975, benefits have been tied, or indexed, to increases in the consumer price index, which have been very high. In addition, the number of beneficiaries increased somewhat more than expected as workers, faced with poor job opportunities and rising social security benefits, retired earlier than they might have had the economy been stronger.

The number of disability insurance beneficiaries has continued to grow at a rapid rate. Although the recent growth in the DI program was partly caused by the depressed economy, economic factors do not appear to be responsible for all of the growth. Other factors, such as the liberalization of the definition of disability and the addition and increasing value of medicare benefits, are believed to be important.

The Next Decade

The short-run financial status of social security depends upon the future course of the economy, which cannot be predicted with any certainty beyond the next few years. If economic recovery is slow (that is, if unemployment does not fall to 5 percent until 1982 and then levels off), social security outlays would continue to exceed revenues and the OASI trust fund would decline from 55 percent of

a year's outlays in 1976 to 7 percent by 1985. 3/ A more optimistic forecast of the economy, one in which unemployment falls to 4.5 percent in 1981 and then levels off, produces a smaller decline in the OASI balances -- to 32 percent of outlays by 1985. The status of the DI trust fund is less equivocal. Outlays rise so much faster than revenues that the funds are depleted in 1979 under the more pessimistic economic assumptions and in 1980 under the optimistic assumptions.

Options for the Short Run

Some action must be taken to keep the DI trust fund from collapsing during the next few years and to stabilize the OASI trust fund within the next decade. One option, of course, is to increase payroll taxes. The Ford Administration's budget for fiscal year 1978 proposed a three-step increase in the combined employer-employee OASDI tax rate, adding 0.2 percentage point in January 1978, another 0.6 percentage point in 1979, and another 0.3 percentage point in 1980. The Administration estimated that these increases would result in combined OASDI trust funds equal to 40 percent of outlays by 1982.

A major objection to raising taxes in 1978 is that it would restrict economic growth at a time when unemployment is still likely to be high (that is, above six percent). In the short run a tax increase would put some upward pressure on the overall price level; after a period of time it could reduce the employment opportunities of low-wage

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3/ The projections of social security revenues and outlays are made using a statistical model developed by Lawrence Thompson and Paul Van de Water. Using this model and an extrapolation of the "central" five-year assumptions used by the social security trustees in their 1976 report (unemployment plateaus at 5 percent instead of 4.6 percent after 1981) leads to a depletion of the OASI funds in 1985. Under the same set of assumptions, the model used by the trustees projects depletion before 1985.

earners. 4/ Because the payroll tax falls most heavily on families with incomes from $8,000 to $25,000 a year, this solution is also considered to be relatively regressive. It should be noted that any increase in the payroll tax would be in addition to the 0.4 and 0.5 percent increases that are already scheduled for the hospital insurance component of the payroll tax in 1978 and 1981.

One alternative to an immediate tax rate increase is to take temporary measures to ensure the payment of social security commitments that would permit the postponement of a rate increase until economic conditions improved (or allow time for the consideration of other options). More permanent alternatives to a payroll tax rate increase would include an increase in the taxable wage base, a shift to substantial general revenue funding or a shift of the hospital insurance tax to the OASI and DI programs. 5/

Postpone a Payroll Tax Rate Increase Until Economic Conditions Improve. One option would be to increase the percent of the total payroll tax going to the DI trust funds and at the same time reduce the percent going to the OASI

4/ The portion of the social security tax levied on employers serves, in effect, as an increment to the minimum wage. When payroll taxes are increased, employers gradually shift at least part of the tax increase to workers in the form of lower wage increases. However, when workers are at the minimum wage, employers cannot require employees to absorb the tax in the form of lower wages, so the payroll tax increase would act as an increase in the minimum wage. Workers whose skills could not command the cost of employment (the minimum wage plus the payroll tax and the cost of any fringe benefits) would be likely to suffer a decline in employment prospects.

5/ Of course, changes in the retirement or disability programs that resulted in a lower rate of growth of benefit payments would lessen the need for additional revenues.

funds. Such an expedient would avoid an increase in the total payroll tax during the present period of high unemployment. Shifting revenues from OASI to DI, of course, would accelerate the decline of the OASI trust fund balances. Depending upon the economic forecast, the combined OASDI trust funds would have reserves of from 14 to 28 percent of a year's outlays at the start of 1982.

Are these safe margins? When should taxes be raised? And by how much? The answers to these questions depend in part on the role expected of the trust funds. If social security is to be funded fully by the payroll tax, one criterion for determining the size of the trust fund reserves is that they be large enough to withstand a serious recession without demanding a payroll tax hike during the period of high unemployment. One study concludes that, by this criterion, a reserve that represented 60 percent of a year's outlays at the onset of a severe recession would be sufficient. 6/ However, payroll taxes would have to be raised once unemployment fell to acceptable levels if reserves were to be built up to the 60 percent level again.

Smaller reserves could be maintained in the trust funds if loans from general revenues were routinely used to finance fund deficits that resulted from recessions.

Increase the Taxable Earnings Base. Payroll tax revenues can also be increased by raising the maximum earnings subject to the tax. At present, the taxable maximum is $16,500, and this ceiling increases automatically each year at a pace that is related to the past rate of increase of average covered wages. However, because few workers are at high earnings levels, it would require a substantial increase in the ceiling to obtain the same amount of revenue that could be derived from a small tax rate increase. Indeed, it is estimated that removing the ceiling altogether would produce the equivalent of a 1.5 percentage point increase in the OASDI tax rate.

6/ See The Social Security Trust Funds as Contingency Reserves by P.N. Van de Water and L.H. Thompson, Technical Analysis Paper No. 9, Office of Income Security Policy, Department of Health, Education and Welfare, July 1976.

Although raising the ceiling is sometimes preferred to a tax rate increase because it is more progressive, this remedy has been criticized because it results in higher future program costs. Since benefits are based on taxable earnings, an increase in the earnings base would result in higher benefits in the future for high wage earners, thereby adding to the long-run costs of the system.

General Revenue Funding on a Permanent Basis. The decision to use general revenue funding for social security as opposed to a continued reliance on the payroll tax depends on fundamental choices about the overall function of social security. Those who view social security simply as a transfer payment from current workers to current beneficiaries regard the payroll tax as part of the total tax system. Viewed in this way, many would consider the OASDI tax as undesirable since it tends to decrease the overall progressiveness of the tax system. Viewed as a transfer program it may also be difficult to justify earnings-related benefits and other aspects of the benefit structure.

Those who view social security primarily as an insurance system regard the payroll tax as a mandatory contribution towards an earned retirement benefit. Although the link between benefits and contributions is weak, many feel that the link is important to public support of the program; some would also make the link stronger. Another argument cited for funding through the payroll tax is that it leads to restraint since increases in benefits must usually be accompanied by increases in the earmarked payroll tax.

It has been suggested that the burden of the payroll tax on low-income families is better dealt with through direct tax relief rather than by revising the means of financing social security. In this regard the Earned Income Credit, passed by the Congress in 1975, has been viewed by some as an offset to the payroll tax since it provides relief from federal income tax payments (or direct cash payments) to low-income families with dependent children.

Of course, the general revenues that could be used to support social security must come from some place -- from an increase in the federal deficit, an increase in income or other taxes, or a reduction in other government spending.

The extent to which general revenue funding restricts economic expansion and is less regressive than a payroll tax increase depends upon how it is ultimately financed. For example, if the federal deficit were simply enlarged, general revenue funding would not restrict the economy. If general revenue funding of social security benefits ultimately resulted in a reduction in low-income housing assistance or compensatory education benefits, the outcome would be quite regressive. This is because the payroll tax falls most heavily on families with incomes from $8,000 to $25,000 a year, and these housing and education benefits are concentrated on families with incomes below $8,000. 7/

Shift the Hosptial Insurance Tax to OASDI. Another proposal for funding that has been discussed is to shift all or a portion of the hospital insurance (HI) payroll tax to the OASDI programs on a permanent basis. It has been suggested, that since medicare benefits are based on hospital expenses incurred, and not on prior earnings, some of the arguments against using general revenue funding for OASDI do not apply for the HI program. However, medicare is now a $22 billion program and is growing rapidly. Future funding of medicare out of general revenues could, therefore, imply substantial increases in the federal income tax.

LONG-RUN ISSUES

The long-run financial situation of the social security system depends critically on a number of factors, including future fertility rates, rates of inflation, and the rates of growth of real wages (adjusted for inflation). If the current benefit structure is maintained and fertility rates stabilize at an average of 2.1 children per woman (that is,

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7/ Payroll taxes are a smaller burden on families below the $8,000 level because they have less income from earnings and proportionately more from nontaxable transfers. The tax remains fairly proportional in middle- or high-income ranges because the number of earners per family increases in this range. For example, a family with an income of $20,000 is less likely to have one earner at this level and is more likely to have two earners both below the taxable maximum.

the rate that would keep population at a stationary level), and prices (CPI) and real wages rise by 4 and 2 percent a year, respectively, social security expenditures would increase to 22 percent of taxable payroll by the year 2030. If tax receipts were set to match these, this would imply a tax burden more than double the current level of 9.9 percent. If the fertility rate stabilized at 1.7, and prices (CPI) and real wages grew at 5 and 1.25 percent a year, respectively, benefits would amount to as much as 37 percent of taxable payroll by the year 2030.

One factor underlying these sharp increases in benefits is a projected increase in the ratio of retired to working populations expected to start about 30 years from now. This increase is the result of the swing that has occurred in the birth rate -- from the prolonged baby boom that began after World War II and lasted to the mid-1960s to the very low birth rates of the 1970s. While the fertility rate may rise above its current low of roughly 1.8, it is not expected to rise much above the 2.1 level over the long term.

Another factor, which accounts for about half of the increase in benefits as a percent of payroll in the long-range projections (assuming a 4 percent inflation rate), is the result of the aspect of the 1972 Social Security Amendments that produced the overindexing or overadjustment of benefits for inflation.

Overindexing

Under the current system, a retiree's benefit is determined through a procedure that applies a rate schedule to the average monthly earnings (AME) on which he paid payroll taxes during his working life. 8/ As of July 1976, the schedule provided a monthly benefit for a worker retiring at age 65 equal to 138 percent of the first $110 of AME, plus 50 percent of the next $290, plus 47 percent of the next $150, and so on through five additional brackets.

8/ For most workers the 20 highest years of earnings are averaged; the law provides that this period is to increase each year until a total of 35 years of earnings are included in the average.

Because this benefit formula replaces a smaller fraction of the AME as the AME rises, it results in a progressive benefit structure. 9/

The 1972 Social Security Amendments established an automatic adjustment of the benefit rate schedule for inflation. If the consumer price index (CPI) increases by 3 percent or more since the last annual adjustment, the rates in the benefit schedule are raised by the percent increase in the CPI since the last adjustment. Thus, if the CPI were to rise by 10 percent next year, the schedule given above would provide 152 percent instead of 138 percent of the first $110 of AME, and so on [138 + (.10 x 138) = 152].

For those who are already retired and therefore have fixed wage histories (AME), this adjustment mechanism keeps the real value of the social security benefit constant. However, for those who are still working, the provision results in the unintended overindexing of future benefits because their wages typically will increase by the rate of inflation plus a productivity factor of 1 or 2 percent. Thus, without the indexing of the rate schedule, the benefits of future retirees would rise because inflation pushes up the worker's wages. 10/ The automatic indexing of the rate schedule then represents a second adjustment for inflation.

The effect of this overindexing is cumulative. The replacement rate -- the ratio of a new retiree's benefit to his earnings in the year before retirement -- may increase

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9/ A recipient's benefit is adjusted upward by 50 percent if a dependent spouse is involved. A recipient's benefit is reduced if the wage earner retires before age 65.

10/ To ensure that wage increases are reflected in higher benefits, the maximum wage covered by social security is automatically increased by the rate of increase in average wages.

dramatically under conditions of persistent inflation. 11/ In fact, with persistently high rates of inflation, some retirees could receive benefits that exceed their preretirement wages; that is, their replacement rates could exceed 100 percent.

Options for Decoupling

Because of the serious fiscal consequences of the present overindexed system, there has been considerable interest in adopting a new procedure for adjusting the benefits of existing and future retirees for inflation and for economic growth. Implicit in any such mechanism are value judgments about the distribution of resources between current and future generations of workers and retirees, and between those working and those retired at any point in time. Judgments regarding the amount of benefits received by different generations are commonly measured by the average replacement rate (the ratio of benefits to earnings in the year before retirement). Under the present system, the replacement rate fluctuates rather capriciously depending upon the inflation rate and the rate of growth of real wages. Most would agree that, as the economy grows and the standard of living rises, the average real benefit of a retiree should also grow. Just how fast it grows determines, in large part, the burden that will be placed on future taxpayers.

There are many ways to correct this overindexing of the current system. The Social Security Benefit Indexing Act (H.R. 14430), proposed by the Ford Administration in 1976, represents one approach. The Hsiao proposal (H.R. 12334),

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11/ With low rates of inflation the overindexing provision can produce declining replacement rates. For example, if the rate of inflation averaged 0.5 percent a year, the replacement rate for a worker earning the median wage would actually decline from 43 percent in 1976 to 30 percent by 2045. However, the very low rates of inflation that produce declining replacement rates are considered unlikely. Note that the replacement rate has been defined in other ways, for example, benefits as a percent of AME.

named after the director of a panel established to advise the Congress on social security, represents another. Each provides a different answer to the question of how fast future benefits should grow relative to future average earnings.

In general, the Ford Administration's proposal provides increases in the benefits of new retirees that keep pace with the increases in the standard of living of the working population and increases in the benefits of those already retired that keep pace with inflation. Because the number of retirees will be growing faster than the number of workers, this approach implies that an increasing share of future GNP will have to be devoted to social security.

The Ford Administration's proposal uses an indexing technique that keeps the replacement rate roughly constant for workers at the same relative point in the earnings distribution. 12/ For example, the average worker retiring in the year 2050 would enjoy the same replacement rate as the average individual retiring in 1977 even though the former worker will be very much richer in real terms. For this reason this approach is sometimes described as one that maintains constant replacement rates. However, the terminology may be confusing, because although the proposal keeps the average replacement rate constant as the average worker grows richer, it does this by increasing the replacement rates of workers whose wages do not rise as rapidly as the average.

A numerical example can clarify this approach. The average new beneficiary in 1976 had annual preretirement wages of about $8,600 and received a social security benefit of about $3,600. This retiree's replacement rate was therefore 42 percent ($3,600 ÷ $8,600). If real wages grew by 2 percent a year, the average worker retiring in the year 2050 would have a preretirement wage of $37,200 in terms of today's purchasing power. Because the Ford Administration's proposal would keep the average replacement rate constant,

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12/ The replacement rates would remain constant only in an oversimplified world in which a worker had earnings that placed him at the same relative point on the earnings distribution in every year of his life.

this average worker would receive an annual benefit of $16,400 (.44 x $37,200). 13/

However, although the Ford Administration's proposal maintains constant replacement rates for workers at a particular point on the earnings scale, it implies a rising replacement rate for workers whose earnings grow less rapidly than the average. The new retiree whose preretirement wages had only kept pace with inflation (i.e., had real earnings in 2050 of only $8,600) would receive a benefit of $8,600 in terms of today's purchasing power. The replacement rate would be 100 percent. And this would mean the worker would not have to reduce his standard of living upon retirement as is now the case for retirees solely dependent upon social security. Of course, such a worker would be poorer relative to the average worker in 2050 because economic growth would have raised the average worker's earning to $37,200 in real terms.

By contrast the Hsiao proposal calls for the real benefits of the average worker to rise but not as rapidly as the standard of living of the working population. Under this approach the same real earnings would always result in the same real benefits; thus the worker retiring with real earnings of $8,600 in 2050, would get about what he gets today ($3,800 in constant dollars). However, the Hsiao proposal allows the progressiveness inherent in the current benefit formula to prevail over time. As the average real wage rises in the future, the average replacement rate would fall. The average worker retiring in the year 2050 would, of course, receive more in benefits than the average worker today, but only because his real life-time earnings would be higher. His annual benefit would rise to $8,600 and the implied replacement rate would be 23 percent ($8,600 ÷ $37,200).

13/ While the intention was to keep the average replacement rate constant, a technical problem with the method causes it to increase slightly. Note that after 1978 the across-the-board increase in benefits that occurred in 1972 caused the average replacement rate to increase to 42 percent from 32 percent, which was the average for the prior decade.

Because it provides higher benefits than the Hsiao proposal, the Ford Administration's proposal would entail higher future expenditures. Under the assumptions of a 4 percent rate of inflation, a 1.75 percent growth in real wages, and a fertility rate of 1.9, the Ford Administration's proposal would result in expenditures equal to 18.9 percent of taxable payroll by the year 2030. This compares with 26.0 percent under the present benefit structure and 12.5 percent under the Hsiao proposal (the current level is 10.8 percent). Thus, both the Ford Administration's approach and a continuation of current policy mean that social security will be a much larger share of the nation's future resources than would be the case under the Hsiao approach.

There are, of course, different philosophies underlying each proposal. Implicit in the Ford Administration's proposal is the view that the purchasing power of social security benefits should keep pace with the purchasing power of a worker's preretirement earnings. That is, in a relative sense, future generations will be as dependent for post-retirement support on the social security system as are current generations.

The philosophy underlying the Hsiao proposal assumes that workers with a life-time history of high earnings will be relatively less dependent on social security benefits upon retirement because they are more likely to have private pensions and savings. As the average income of workers rises, pensions and other private savings are also likely to increase in relative importance, and therefore replacement rates can fall. Moreover, by keeping payroll taxes low, private savings would be encouraged. If society should desire to transfer more economic resources to the retired population, there would always be the option of raising the benefit levels later on.

The Cost of Waiting

Whatever approach is chosen, the decoupling procedure must be started soon if large future costs are to be avoided. While actions affecting replacement rates now will not affect total costs for many years, the costs of delay are substantial. It has been estimated, for example, that the cost of delaying decoupling from 1978 to 1988 under the Ford

Administration and Hsiao proposals could amount to 0.4 and 1.7 percent of taxable payroll, respectively, by the year 2000.

CHAPTER 12 WELFARE REFORM

THE ISSUES

The growth, structure, equity, and effects of federally supported welfare programs have recently stirred considerable debate, and not without cause. During the past decade, both the number of welfare recipients and program costs have risen tremendously. The Aid to Families with Dependent Children (AFDC) rolls, for example, have more than doubled, and that program's cost has gone up fivefold. 1/

The uncoordinated and overlapping programs for the poor have created an administrative maze for welfare workers and recipients alike. Federal and state (and sometimes local) governments split the responsibility for some programs. Different federal and state agencies are charged with running related programs. Benefits, regulations, and eligibility conditions vary from program to program, and from state to state as well. Much of the needy population -- often those in husband-and-wife families, single persons, childless couples, and the working poor -- are not covered by a federally supported cash assistance program. While the effects of the current welfare system are only partly known, the system seems to have certain undesirable features. Work incentives are undermined by the exclusion from eligibility of many people with jobs. Benefit levels that can exceed the earnings of people who work full time for low wages, and the large reductions in benefits that result from additional earned income also discourage working. Migration may be encouraged by the variation among state programs; marital instability may be fostered by the frequent exclusion of intact families. And, further aggrevating these problems, many of the programs' investigative procedures are demeaning and tend to undermine self-esteem and self-sufficiency.

1/ For a more detailed treatment of the issues covered here, see the forthcoming CBO Budget Issue Paper on welfare reform options and Poverty Status of Families under Alternative Definitions of Income, CBO Background Paper No. 17, January 13, 1977.

CONGRESSIONAL DECISIONS

Most of the major welfare programs are permanently authorized, and therefore the Congress does not have to evaluate their merits in the course of a periodic reauthorization procedure. Many are also entitlement programs, whose appropriation levels are generally not matters of Congressional debate but, rather, are determined simply by the numbers of persons receiving the benefits. Several reauthorizations will come up this year, however, and the Carter Administration plans to submit a welfare reform proposal by the end of 1977.

In the past, the welfare proposals before the Congress have ranged from incremental reforms that would only slightly modify current programs to a comprehensive overhaul that would substitute a single new program for several existing ones. Somewhere in the middle of this spectrum are proposals that would build on the existing system, but only after making major modifications in some current programs.

If passed by the Congress, some incremental reforms could affect the budget in fiscal year 1978. The more comprehensive types of changes, however, would take a number of years to plan and get underway. The full costs of such proposals would not be felt, therefore, until the early 1980s.

THE CURRENT SYSTEM

The welfare system is an inexact term that refers to those programs designed to improve the condition of lower-income persons. These programs are means-tested -- that is, eligibility is determined in part by a family's resources. While some welfare programs provide cash assistance, others, such as food stamps and medicaid, are in-kind programs that provide assistance in the form of goods and services. The major federally assisted welfare programs are:

- The AFDC program provides cash assistance to low-income, female-headed families with dependent children and to families in which the father is

disabled. In roughly half the states, eligibility is also extended to some families with unemployed fathers. Within broad federal guidelines, eligibility and benefit standards are set by the states, and the program costs are shared by federal, state, and in some cases, local governments.

- The food stamp program (which is discussed in greater detail elsewhere in this report) provides needy households with monthly allocations of coupons redeemable for food. While its administrative costs are shared with the states, the federal government picks up the entire cost of the bonus stamps.

- Supplemental Security Income (SSI) provides cash assistance to needy aged, blind, and disabled persons. While the basic SSI benefit is paid by the federal government, many states have supplemented the basic benefit with state funds.

- Medicaid provides needy people with the means to obtain medical care. Within broad guidelines the states determine eligibility criteria and the services provided. Costs are shared by federal, state, and, in some cases, local governments.

- Veterans' pensions are provided to disabled and aged war veterans and their dependents or survivors if their incomes are below certain levels.

- Child nutrition programs provide food assistance to needy and non-needy children.

- Housing assistance programs subsidize the rents and mortgage payments of low-income households.

There are, of course, a number of other income-support programs -- such as social security, medicare, and unemployment compensation -- which are not means-tested but that provide substantial assistance to low-income persons.

Together, the various types of income-support programs -- both the means-tested and the social insurance programs -- raise the level of resources of low-income families markedly. In 1976, over one-quarter of all families had resources, exclusive of government assistance, below

80-294 O - 77 - 14

the official poverty line. After adding in social insurance, cash assistance, and in-kind transfers (including medicare and medicaid), and after payment of taxes, only 6.9 percent of all families had resources below the poverty line (see Table 32).

TABLE 32. FAMILIES a/ BELOW THE POVERTY LEVEL UNDER ALTERNATIVE INCOME DEFINITIONS, FISCAL YEAR 1976

Families Below Poverty Level	Pre-Tax/ Pre-Transfer Income	Pre-Tax/ Post-Social Insurance Income	Pre-Tax/ Post-Money Transfer Income	Pre-Tax/ Post-In-Kind Transfer Income		Post-Tax/ Post-Total Transfer Income
				I b/	II	
Thousands	20,237	11,179	9,073	7,406	5,336	5,449
Percent	25.5	14.1	11.4	9.3	6.7	6.9

a/ Unrelated individuals are included as one-person families.

b/ Excludes medicare and medicaid benefits.

OBJECTIVES AND ISSUES IN WELFARE REFORM

The general objective of a welfare reform system is the provision of adequate support for those in need through a structure that promotes both fairness and efficiency and at the same time encourages individuals to work and ultimately remove themselves from welfare. Actual achievement of these goals, however, is slowed by the structure and administration of welfare programs and by the amount of tax dollars governments are willing to make available.

In any welfare system, these individual goals, by their very nature, are competing and must be weighed one against

the other in meeting the overall welfare objectives. In balancing these competing objectives, decision-makers deal implicitly and oftentimes explicitly with several major issues. For both program and system design, these issues include considerations such as the adequacy of benefits versus work-incentive structures, the population eligible for assistance, responsiveness, the number of programs, the form of assistance (i.e., cash or in-kind), and fiscal and administrative responsibility.

The issue of adequacy versus work incentives stems in part from the tradeoff between these two goals within limited program costs. Given a limited budget, high benefit guarantees for those with no income can only be realized if benefits are reduced significantly for those with some income. If benefits are reduced substantially when a recipient earns money, the person has little incentive to work. On the other hand, lower benefit guarantees could provide more in the way of work incentives through a more gradual reduction of benefits for those with earned income. But a low guarantee might be considered inadequate for those with no income.

Current welfare programs are generally limited to categories of the low-income population considered more deserving, such as dependent children, the aged, the blind, and the disabled. Not until the advent of the food stamp program was there a major program that guaranteed universal coverage for all segments of the low-income population.

Fairness would require equal treatment of those in need, but persons interested in reform are divided in their support of programs that call for categorization of the low-income population rather than universal coverage. Proponents of categorization want to identify and assist those low-income families with heads who cannot or should not be expected to work. Fearful of its impact on work incentives, they are reluctant to provide direct cash assistance to families with able-bodied adults who are unemployed but capable of earning a living or who are employed in low-paying jobs. Proponents of universal coverage point to the needs of the working poor and to segments of the low-income population who may derive a higher income from the combined benefits of several welfare programs. They are concerned about the incentives in the current program structure that foster family splitting to

meet categorical eligibility requirements. Universal coverage would encourage family cohesion and provide for fairer treatment.

Responsiveness to the individual needs of each low-income family is another issue in welfare system design. Any program that standardizes eligibility and benefits according to factors such as income, assets, and family size as measures of need falls short of this goal. A perfectly responsive system would require a case-by-case determination of family needs, but such a system could be costly and difficult to administer and inequities could result from caseworker discretion.

The number of programs designed to meet special needs and to serve categories of the poor is also a reform issue. Some of the poor now receive direct cash assistance, as well as in-kind forms of support to meet particular consumption needs (i.e., food, health, and housing). The direct provision of such goods and services is thought by some to be the most effective way to ensure that these basic consumption needs are met. As a result, in such a multiple program system, welfare families may receive benefits from several separately administered programs, each with its own set of objectives. The negative incentives, inequities, and excessive administrative costs caused by a multiple program system have led some to favor a consolidation of several of these programs into a single cash payment.

The form of assistance (cash or in-kind) relates directly to the issues associated with number of programs. If one objective of the transfer system is to meet the consumption needs of the poor, direct provision of those goods and services might be the best way to achieve this objective. Simply providing enough cash does not ensure that the poor spend it for basic needs. Furthermore, in recent years, society appears willing to support larger program outlays as long as there is some assurance as to how the poor spend their dollars.

Unfortunately, even with in-kind assistance, there is no guarantee that the consumption goals will be fully realized. Whether the in-kind transfer really increases consumption of a particular good or service or simply supplements income by releasing available cash resources for other purposes depends upon the type of in-kind transfer.

Some critics have even argued that programs such as food stamps are demeaning and inefficient and should be replaced with direct cash assistance.

Finally, the fiscal and administrative responsibility for income support touches upon a range of issues. Some consider state and local governments to be better capable of evaluating the needs of their poor; yet many states are fiscally incapable of funding such large programs. Today, welfare programs represent a mixture of federal, state, and local roles, probably an inherently inefficient mix.

Recently, there has been increasing pressure for federal fiscal relief for state and local governments. And the welfare of the poor has become a national concern. Fiscal relief, however, has implications for both the control over the expenditure of federal tax dollars and the appropriate roles for different levels of government. Welfare policy from a national perspective might require different structures than policies pursued at lower levels of government. Localized need determination may have to be sacrificed for a structure with uniform treatment of the poor throughout the nation.

BUDGET OPTIONS

In addition to continuation of the current policy, four alternative approaches are presented here to illustrate the range of proposals for reforming the welfare system. One of them involves incremental reforms of individual programs within the existing welfare complex. The other three are more thoroughgoing: first, concurrent reforms in a number of welfare programs, which constitute a comprehensive reform package; second, an alternative that substitutes a single comprehensive and restructured cash-benefit program for several of the current cash and in-kind programs; and, last, an approach that uses as a basis some existing welfare and nonwelfare income support programs to build a new, multitrack welfare system.

Within each approach many program details, such as eligibility criteria and benefit levels, can be altered to vary coverage and costs. The costs of welfare programs

also depend on the state of the economy. Slow economic growth and high rates of unemployment push costs up. The costs also depend on how the poor respond to the program incentives. While a number of welfare experiments have been conducted, there is still a great deal of uncertainty about how the low-income population and private industry would react to a new system. 2/

Current Policy

If the current welfare system were continued unchanged, the total benefit cost (federal, state, and local) of the seven basic programs would be $53.2 billion in fiscal year 1978 and $75.2 billion in 1982 (see Table 33). Without these programs 22.8 and 20.3 percent of all families would have resources below the official poverty level in 1978 and 1982, respectively; with these transfers the fraction below this threshold would drop to 4.7 and 3.4 percent, respectively. 3/

2/ For example, in regard to the negative income tax, Albert Rees and Harold W. Watts, ("An Overview of the Labor Supply Response" in Joseph A. Pechman and P. Michael Timpane, (editors), Work Incentives and Income Guarantees: Results from the Negative Income Tax Experiment [The Brookings Institution: Washington, D.C. 1975]) found a reduction in hours worked ranging from 8 to 16 percent for white households, a slight reduction for black households, and a 2 to 6 percent reduction for Spanish-speaking households. These results were based on a low-payment guarantee with a 50 percent benefit reduction rate on earnings.

3/ These estimates depend on the state of the economy, which was assumed to follow the recovery path projected by the CBO in July 1976, and upon the assumption that program standards will keep pace with inflation. Unless noted otherwise, the incidence of poverty is calculated on a post-tax, post-transfer (including medicare and medicaid) basis.

Incremental Changes to Current Programs

Many people argue that, whatever the shortcomings of existing welfare programs, they can only be changed piece by piece. They therefore advocate various sorts of incremental changes. Such changes, however, could either reduce or increase costs.

TABLE 33. BUDGET OPTIONS FOR WELFARE BENEFIT OUTLAYS, FISCAL YEARS 1978 AND 1982, IN BILLIONS OF DOLLARS

Option	1978			1982		
	Federal	State & Local	Total	Federal	State & Local	Total
Current Policy a/	37.2	16.0	53.2	51.5	23.7	75.2
Change from Current Policy						
Program Tightening (AFDC) b/	- 0.8	- 0.6	- 1.4	- 1.0	- 0.8	- 1.8
National Standards (AFDC) b/	+12.2	- 4.9	+ 7.3	+ 6.3	- 6.7	+ 9.5
National Standards (medicaid)	+16.7	- 9.7	+ 6.9	+24.1	+14.9	+ 9.2
Incremental Reform Package c/	+10.3	- 4.9	+ 5.4	+13.1	- 6.6	+ 6.6
Income Security for Americans	+ 9.1	- 0.7	+ 8.4	+15.3	- 6.9	+ 8.4

a/ Includes benefit payments but not the administrative costs for AFDC, food stamps, SSI, medicaid, veterans' pensions, and housing assistance.

b/ Does not include increased or decreased medicaid and food stamp costs associated with this option.

c/ Does not include approximately $1 billion in additional medicaid costs which result from growth in the AFDC population.

Program Tightening. Several bills were introduced in the 94th Congress that would tighten and simplify program administration and restrict eligibility to target benefits more on the poor in both the AFDC and the food stamp programs. Food stamp changes are discussed later in this report. The National Welfare Reform Act of 1975 (H.R. 5133, S. 1719), which was not reported out of committee in the last Congress, dealt specifically with AFDC reform.

Among its major cost cutting features, the bill would limit eligibility by prohibiting AFDC for strikers and

for children over age 17, by limiting gross income eligibility to 150 percent of family needs, by reducing and standardizing work expense deductions, by tightening work requirements, by requiring non-needy persons in the household to make contributions for the support of AFDC families with whom they are living, and by limiting program fraud and abuse. In fiscal year 1978 such a system could eliminate an estimated 730,000 families a year from the 4.5 million families on the welfare rolls, but only about 12 percent of these families would be in poverty without the AFDC benefit payment. However, since additional food stamps would partially fill this gap, some of these families would still be lifted out of poverty by the food stamp program. Overall, this form of program tightening would reduce benefit costs in the AFDC program by $1.4 billion in fiscal year 1978 and $1.8 billion in 1982. 4/ Such a measure would have a negligible impact on the incidence of poverty among families in both fiscal years 1978 and 1982. As a result of program interaction, medicaid costs would fall because of the reduction in AFDC eligibility but food stamp costs would rise to partially offset the loss of AFDC income.

National Standards. Specific incremental reforms designed to increase benefits and program equity are possible in the AFDC, medicaid, and food stamp programs. The food stamp alternatives are discussed elsewhere in this report.

AFDC. Some observers have expressed a desire to federalize the AFDC program in a way similar to what was done in 1972 when the SSI program replaced the federal/state categorical programs for the aged, blind, and disabled (OAA, AB, and APTD). Such a reform would treat similar people in different states more equally and would provide some measure of fiscal relief to state and local governments.

4/ The estimate does not include the feature that would require non-needy persons residing in AFDC families to make a contribution to the state welfare agency equal to the state's payment standard for a single person.

Federalizing the AFDC program would involve national standards for many of the program characteristics that vary from state to state, such as benefit levels, the treatment of work expenses, incapacitated fathers, stepfathers, and unemployed fathers.

If federal minimums were set so the combination of the federal minimum plus food stamp bonus coupons equaled the poverty level, total AFDC benefit costs would be $7.2 billion over the current policy level in fiscal year 1978. The federal share would rise by $12.2 billion and state costs fall by $5.9 billion. The additional costs are the product of both the liberalization of benefits in some states and the expansion of the eligible population -- primarily to more families with unemployed adults. Caseloads would increase by 1.2 million families annually and an additional 1.2 million of those with resources below the poverty line before receipt of this cash assistance would be moved out of poverty by the AFDC program. If states were required to supplement the federal minimum for persons currently receiving welfare so that such cases did not experience reduced benefits, fiscal relief would be given to those states in which the current federal contribution per case is below the federal guarantee of the new program. State benefit costs in fiscal year 1978 could drop by roughly $4.9 billion. Food stamp costs would fall but medicaid costs would rise.

Medicaid. Federalization of medicaid -- that is, eliminating the existing interstate variations in benefits and eligibility and providing full federal financing -- is one possible way of better meeting the medical needs of the low-income population. 5/ A plan similar in some features to the medical assistance portion of one national health insurance proposal (S. 2470) would provide a limited, but uniform, array of medical services, with some patient cost-sharing, and eligibility based on income and medical expenditures. Medical services covered under such a program would include institutional, physician, and home health services; preventive care; and mental health services. Patient cost-sharing would be at a rate of $3 per visit per family for the first 10 outpatient physician visits each year. The income eligibility level net of health costs

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5/ See Chapter 10, Health, for further discussion.

would be set at roughly the poverty line; some families with incomes above the poverty level would qualify for assistance by virtue of their health expenditures.

If this reform option were implemented in fiscal year 1978, total medicaid benefit costs would increase by $6.9 billion over the current policy level. As a result of full federalization, federal benefit costs would rise by $16.1 billion. This growth reflects both an expansion in eligibility to population categories, such as single persons, childless couples, and intact families with able-bodied family heads between the ages of 18 and 64, and the provision of a uniformly generous package of medical services. With states and localities now paying, on the average, 45 percent of program benefit costs, federalization would imply $9.2 billion in fiscal relief for such governments.

Comprehensive Restructuring

The illustrative comprehensive reform packages described below range from simultaneous incremental reforms in several different programs to comprehensive cash assistance (akin to a negative income tax) and other approaches that separate the needy population into employables and unemployables and which significantly alter the structures of current programs. 6/ In this latter strategy, public and private job creation may, in some cases, be an important element in the reform. Job programs, of course, affect the cost and impact of all welfare proposals and can be integrated with welfare programs in a variety of ways. 7/

6/ The term employable is used in this section to mean persons who are regarded to be capable of working outside of the home.

7/ An approach not examined here is that which ties benefits to work effort. Benefits are linked to either hourly wages or earnings under this approach in an attempt to help the working poor. The existing earned-income tax credit is an example of a work-conditioned program.

Incremental Reform Package. One option is simultaneous incremental reforms in several existing programs. A combination of national standards in AFDC with a uniform minimum benefit, a simplified food stamp program similar to that described in the chapter that deals with food stamp options, and a continuation of the current medicaid program would result in benefit costs for these programs rising by $5.4 billion over the current policy levels in fiscal year 1978. When compared with the current policy level, an additional 198,000 families would be raised above the poverty line by such an incremental reform package.

Comprehensive Cash Assistance. The replacement of several or all cash and in-kind transfer programs with a single cash benefit is another way of reforming the welfare system. Such a consolidation would simplify program administration and reduce costs by eliminating administrative duplication. Comprehensive cash assistance proposals of this sort are often referred to as negative income taxes (NIT) because they can be integrated with the existing tax system and administered by the Internal Revenue Service and because they tax away benefits as the recipient's other income increases. The basic elements of an NIT, which are also common to programs, such as food stamps, AFDC, and SSI, are: (1) a basic benefit guarantee for a family with no other income; (2) a formula for reducing the guarantee as other income rises (called a marginal tax or benefit reduction rate); and (3) a level of income at which the transfer payment is zero (the break-even level). Sophisticated variations in the program elements are possible. For example, the basic income guarantee can be modified according to the size and composition of the family; benefit reduction formulas can be varied, depending upon the type of pre-transfer income (e.g., social security versus earned income); and transfers can consist of cash or federal income tax credits and cash.

As an approach to welfare reform the negative income tax provides benefits to all those with incomes below certain thresholds, regardless of other characteristics such as age, sex, or employability. Because some of those eligible for payments will be employable, but not working because they do not want to work, a key portion of the negative income tax is the creation of economic incentives to work. This is accomplished by ensuring that those

who work will get more money than those who do not by allowing the retention of a portion, but a decreasing portion, of welfare payments as family earnings increase.

Advocates of the NIT approach have argued that it is more equitable than other approaches because it does not provide vastly different benefits to different categories of people with similar incomes, that it would improve social and economic incentives and rewards, that it could be easily administered by the IRS, and that it would give the needy more freedom to make their own budget decisions.

There have been many NIT proposals over the past decade, including the Family Assistance Plan proposed by President Nixon in 1970. One of the most advanced of the current proposals is the Income Security for Americans (ISA) plan originally developed by the Joint Economic Committee (H.R. 14031, S. 3000). 8/

ISA would replace the AFDC and food stamp programs with a system of tax credits for all families and cash allowances for the very poor, all under IRS administration. While the SSI program would be retained, it is assumed that medicaid would be replaced by some form of national health insurance. A version of ISA, which accounts for changes in tax laws since the development of the original ISA plan, would include the replacement of the current $750 personal exemption with a refundable tax credit of $225 per person. The existing $35 tax credit per exemption would be retained, but in a refundable form. Any person whose tax liability would not exhaust the tax credits would receive the difference as a cash payment from the government. Taxpayers with positive tax liabilities would also have their taxes reduced by the credit if they faced less than a 30 percent marginal tax rate; 9/ for the rest, tax liabilities would increase.

8/ Another comprehensive NIT proposal is the Income Supplement Program (ISP) developed by HEW in 1974. It is described in more detail in the forthcoming CBO Budget Issue Paper on welfare reform.

9/ Because ($750 x .30) + $35 = $225 + $35.

In addition to the refundable tax credit, low-income families would receive an allowance for basic living expenses (ABLE), which would vary according to a family's size, income, and type. For a family of four with no other income, the combination of tax credits (4 x [$225 + $35]) and ABLE ($3,400) would provide an income guarantee of $4,440 per year in fiscal year 1978. The various sources of non-ABLE income would partially offset the basic allowance according to benefit reduction formulas that would vary by income source. For a family of four with earned income only, the ABLE payment would go to zero when family earnings reached $6,800 and the family would face a positive tax liability at an income of $8,880. States would be required to supplement these payments for existing welfare recipients so that they did not lose benefits.

ISA would have a net impact on the federal budget of $9.1 billion in fiscal year 1978 and $15.3 billion in 1982, and a net budget cost of $8.4 billion in each of the two years. 10/ While the ABLE payments would be $1.5 billion less than levels needed to maintain current policy in the programs which ABLE would replace, the tax credits would reduce fiscal year 1978 revenues an estimated $9.9 billion. Not all of the tax relief would go to the poor. In fiscal year 1978, $5.3 billion would go to families whose pre-tax/pre-welfare incomes would be less than $5,000; $3.0 billion would go to those with pre-tax/pre-welfare incomes between $5,000 and $10,000; and the rest, $4.5 billion, would lower the tax burdens of those with pre-tax/pre-transfer incomes between $10,000 and $25,000. This distribution of tax relief was intended to offset partially the inflation induced increases in the tax liabilities of middle- and low-income families. The group with pre-tax/pre-welfare incomes in excess of $25,000 would have its tax liability increased by $3.0 billion. Under ISA the incidence of poverty among families would be reduced from 4.7 to 4.0 percent in 1978.

Multitrack Approaches. A second major approach to comprehensive welfare reform is the multitrack approach, which responds to what many feel is the administrative and

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10/ Excludes any changes in administrative costs.

political oversimplification of negative income tax proposals. Typically, the multitrack approach attempts to build on existing programs, including the current welfare and unemployment compensation systems and perhaps the tax system. This approach categorizes people according to employability and applies different tracks to each group. Generally those who are categorized as nonemployable are provided with relatively high benefits but face high benefit-reduction rates. Employables are offered a relatively low benefit but face a lower benefit-reduction rate. This is meant to provide a strong work incentive; benefits in this track may also be work-conditioned (i.e., one must be willing to work or lose the benefits). Some recent plans of this type have stressed guaranteed jobs, the creation of public and private jobs, and an emphasis on training and employment of those who are employable.

In its survey of alternative approaches to welfare reform the Joint Economic Committee published a categorical job guarantee (CJG) plan. An updated version of this plan would provide jobs for those who can work and are considered employable. It would give income support to those who cannot or are not expected to work. Every low-income family with at least one employable person would be guaranteed one full-time job; other families would not be eligible. Families of different sizes and types (e.g., single-parent, multiple-parent) would receive different wage guarantees for these jobs. A single parent could work half-time with only a 25 percent wage reduction; or a single parent with a child under six could stay at home and would still receive a relatively generous welfare payment. The federal government would guarantee a job by either creating public service employment or by finding jobs in the private sector with wages that matched the federal guarantee.

The categorical job guarantee plan would eliminate AFDC for those who are considered employable, retain the current food stamp program, and replace medicaid with job-related health insurance for those who are employable. Compared with current programs, the cost of this proposal could be rather high. This is because the benefits are higher than they are in the programs that are replaced; benefits are extended to persons generally not eligible for some of the major welfare programs -- namely, low-income single persons,

childless couples, and intact families; for the families eligible for a job, benefits are not income-conditioned. The exact cost of a job guarantee program has not been estimated.

CHAPTER 13 FOOD STAMPS

THE ISSUES

During the early 1960s the inability of many low-income Americans to obtain a nutritionally adequate diet became an issue of national concern. The major response to this was the food stamp program which began in 1965 as a small, geographically limited experiment costing less than $100 million. Over the following decade it has grown into a nationwide program serving more than 17 million persons at a cost of some $5.5 billion in fiscal year 1977. 1/

In recent years, critics have raised some tough questions about the program. Taxpayers and officials alike complain about the soaring costs and numbers of beneficiaries in the program. It is said to be hampered by irregularities, abuse, and mismanagement. Some are also critical because the program benefits a number of people with incomes above the poverty level. Further complaints are heard about the program's administrative complexity and its inadequate integration with other welfare programs. With the legislative authority for the program expiring at the end of fiscal year 1977, the Congress has an opportunity to assess the existing program and to consider changing it.

The food stamp options that face the Congress vary greatly both in their purposes and effects. Proposals run the gamut from tightening the current program and focusing it even more sharply on food consumption to loosening the system and giving the recipients greater control over the use of the transferred resources. In terms of cost, these approaches could significantly reduce or increase federal outlays. Because the food stamp program is a major element in the complex of programs that provides

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1/ For a more detailed discussion of the issues covered here see The Food Program: Income or Food Supplementation?, CBO Budget Issue Paper, January 1977.

80-294 O - 77 - 15

assistance to low-income Americans -- a complex that includes Aid to Families with Dependent Children (AFDC), Supplemental Security Income (SSI), medicaid, veterans pensions, social security, and more -- it should not be changed without consideration of how those changes mesh with existing or planned federal, state, and local efforts to assist low-income families.

THE CURRENT PROGRAM

The food stamp program subsidizes purchases of food by low-income households. Any eligible household -- after meeting an income test, an assets test, and a work requirement -- can buy fixed amounts of food stamps from the government, stamps which can be used like money to buy food. The value of the stamps participants are required to purchase (the allotment) differs according to household size. The amount a household must pay for the stamps (the purchase requirement) depends upon the household's size and its income adjusted for a number of deductions. The difference between the allotment and the purchase requirement is the transfer of in-kind benefits, known as the bonus value of the stamps. The bonus value is paid by the federal government; the program's administrative costs are shared evenly by the federal and state -- and occasionally local -- governments that administer the program.

The food stamp program has raised the food and nonfood consumption of low-income households, reduced the number of households whose total resources fall below the official poverty threshold, and evened out some of the regional variation in public assistance.

In September 1975, the average food stamp household received $79 a month in bonus food stamps -- that is, $948 a year. This represented an average transfer of about 25 cents per person, per meal. While the food stamp program provides the wherewithal to raise food consumption, not all its benefits appear as increased food expenditures. Without the program, many current food stamp recipients would spend more on food than they are required to pay for their allotment of food stamps; thus the program frees income for other uses. For every $1 of bonus value received in 1973, an average of 43 cents was freed for nonfood purchases.

The program's value in improving nutrition, however, is not clear. Increased food expenditure and nutritional improvement are not synonymous; there is little evidence that relates the level of nutrition among low-income households to the benefits from the food stamp program.

What is clear, however, is that the main beneficiaries of the program are low-income households. In September 1975, the average food stamp household had a gross cash income of about $298 ($3,576 a year) which was 23 percent of the average family income at that time. In September 1975, 78 percent of the recipient households had incomes below the poverty threshold; roughly 86 percent of all of the benefits went to such households. Only 10 percent of the recipient households had incomes more than 25 percent above the poverty line; these households received less than 5 percent of the total benefits. But because of the complex system for determining income -- one that permits the deduction of a fraction of earnings, child-care costs, and medical bills -- some households with gross incomes of $10,000 or even $12,000 may be eligible.

Even though the food stamp program is the only federal public welfare program that is generally available to the working poor, most of its benefits go to those households that receive some other form of public assistance. In 1975 more than 42 percent of the participating households received income from the AFDC program; 17 percent had incomes from the SSI program. Only 22 percent had any income from work. Some 57 percent of the food stamp benefits went to households receiving some other form of public assistance; only 19 percent went to the working poor.

While the food stamp program was never designed specifically to lift participating households out of poverty, it can. If the food stamp bonus value is considered as income, one-quarter of the participating households now classified as poor would be lifted out of poverty by the program. 2/

2/ The bonus value of food stamps is not now counted as income in the government's calculations of the number of households with incomes below the poverty threshold.

By no means do all eligible households participate in the program. Only 55 percent -- 5.9 million of an estimated 10.7 million eligible households -- participate. That 55 percent, however, claims 63 percent of the total potential benefits because those participating tend to have lower incomes than nonparticipating eligibles. If all those eligible did participate, the cost of the program would rise from the current $5.5 billion to $8.7 billion.

The food stamp program also helps narrow some of the regional disparities among state cash assistance benefits. This occurs because AFDC, general assistance, and SSI benefits are all counted as income in determining the amount a welfare household must pay for its food stamp allotment. While the differential in average monthly AFDC benefits between New England and the southern states is $165, the regional differential in AFDC plus food stamp benefits is $115.

BUDGET OPTIONS

The major options are: continue the existing program, make marginal changes that would simplify the program's administrative complexity, remove the nonpoor from eligibility, and establish uniform benefit reduction rates. Other options are to shift the program's emphasis either more in the direction of food consumption or more toward income supplementation. Each of these broad approaches has a different budgetary impact, and each affects low-income people differently.

Current Policy

The current program will not, as some fear, result in a continuation of the rapid increase in costs and numbers of participants. Most of the events that caused past growth are unlikely to happen again. For example, in the 1969 to 1971 period, administrative and legislative adjustments were made that lowered the purchase requirement, set uniform national income eligibility limits, and raised the basic allotment. These changes increased both the eligible population and average benefits. In 1973, amendments were passed that mandated that the food stamp program be extended nationwide and to the outlying U.S. territories;

jurisdiction that had maintained commodity distribution were required to replace that program with the food stamp program. The worldwide food inflation that started in 1972 also greatly expanded the program. This has happened because both allotments and income eligibility standards are increased every six months in accordance with the increase in the price of certain foods. Finally, the recession of 1974-1975 left many people unemployed and lowered some family incomes, thus increasing the number of eligible households.

The sensitivity of the food stamp program to legislative and economic changes means that the recent trends are not inevitable. Over the past year, improvements in unemployment and the slowing of food-price inflation have lowered both program costs and participation. If there is a gradual recovery in the economy, an increase of food prices roughly parallel to the rate of food-price inflation of the late 1960s, and no major legislative changes, the food stamp program should cost the federal government roughly $5.4 billion in fiscal year 1978 and benefit an average of 16.5 million people. This is a decrease of about $150 million in cost and 1 million in participants from the fiscal year 1977 estimates. By 1982, continuation of the current program would imply costs of $5.9 billion and 15.0 million participants (see Table 34).

Of course, continuing the current program would do nothing to simplify the program's administration or to remove households with incomes above the poverty level. The current mix of food consumption and income supplementation would remain unchanged.

Incremental Reforms

The Ford Administration proposal of February 1976, a bill passed by the Senate, and one reported by the House Agriculture Committee during the 94th Congress are examples of incremental reform. 3/ These bills would have modified certain elements of the food stamp program: the definition of income, income eligibility, the types and amounts of

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3/ S. 3136 and H.R. 13613.

TABLE 34. FEDERAL FOOD STAMP PROGRAM BUDGET OPTIONS ESTIMATED COSTS AND PARTICIPANTS, FISCAL YEARS

Option	Budget Costs (Billions of Dollars)		Participants (Millions of Persons)	
	1978	1982	1978	1982
Current Policy	5.4	5.9	16.5	15.0
Incremental Reforms				
Ford Administration Regulations	4.9	5.7	13.5	12.0
Senate-passed Bill (S. 3136)	6.0	6.5	15.5	14.0
House Agriculture Committee-reported Bill (H.R. 13613)	5.3	6.0	15.9	14.8
Food Consumption Emphasis				
Buckley-Michel (S. 1993)	4.6	5.1	12.3	10.8
Income Support Emphasis				
Elimination Purchase Requirement Dole-McGovern (S. 2451)	6.5	7.7	18.2	18.0
Complete Cash-out	7.6	8.6	27.0	24.5

deductions, and the purchase requirements. All these proposals would replace the current system of itemized deductions with a standard deduction. The monthly standard deduction proposed -- $100 in the Senate bill and in President Ford's proposal -- was higher than the average deduction claimed by participating households. This change would concentrate more of the benefits on the poorest households, which now have few deductions; it would also simplify the program's administration.

Another incremental reform would set the food stamp purchase requirement at a fixed percent of household income (after deductions). That portion of income needed to purchase food stamps now varies by household size and income level. A third element common to many of the incremental reform proposals is an income eligibility standard that would exclude those above the poverty level. The bills passed by the Senate and reported by the House Committee would also have removed students and workers on strike from eligibility.

The particular impacts of the bill passed by the Senate and the one reported by the House Agriculture Committee are detailed in Table 35 at the end of this chapter. Together they would have increased the program's ability to reduce poverty, redistributed food stamp benefits from the northeastern part of the country to the southern and midwestern states, and excluded a million recipients whose incomes (other than food stamps) exceeded the poverty threshold. While the Senate-passed bill would have increased federal costs by about $600 million both in fiscal year 1978 and fiscal year 1982, the bill approved by the House Agriculture Committee would have slightly reduced federal outlays in the short run but would have caused additional federal outlays of about $100 million by fiscal year 1982. The House bill also would have increased state costs by about $100 million.

The Ford Administration's proposal contained similar changes: it would reduce federal cost by approximately $500 million in fiscal year 1978 and $800 million in fiscal year 1982. Its major cost reduction would come from a change in the accounting period over which income is measured. The system now estimates a household's expected income for the next month; under the Ford Administration's proposal, the income received during the past three

months would be counted. This change would exclude 3 million of the 17 million recipients. It would concentrate benefits on longer-term needy households and reduce the program's response to the food needs of families that suddenly find their incomes lowered. It would also probably increase the program's administrative complexity.

Food Consumption Emphasis

The two basic methods of bringing about more food consumption by households under the food stamp program are:

- First, limit participation to households below the poverty line.
- Second, increase the purchase requirement to a level that is more nearly equivalent to the household's expenditures on food in the absence of the program.

One such proposal (S. 1993) would have increased the purchase requirement from the current level of roughly 19 percent of gross income to about 30 percent. This proposal also would have included in the definition of a household's income such other benefits as special assistance payments in the school lunch and child nutrition programs, benefits received in the special supplemental food program for Women, Infants and Children (WIC), and benefits from the program for feeding the elderly. Proposals of this sort would reduce federal costs considerably, largely because they would significantly reduce the number of participating households (see Table 34).

Income Support Emphasis

The program could be shifted more in the direction of income support by removing the requirement that households purchase food stamps. If this were done, eligible households would receive only their bonus value in food stamps. This would reduce the amount of stamps in circulation by approximately 40 percent. Some minor savings would result because fewer stamps would have to be printed, handled, or stored.

While such proposals would shift the program's emphasis, their effects would not be uniform across all households. The program would still push food consumption onto those households qualifying for the largest bonuses; households with small bonuses would have greater choices in their consumption.

If the purchase requirement were removed, one of the impediments to participation would also disappear. And 2 to 3 million eligible nonparticipants might then join the program: that is an increase of between 10 and 20 percent over present levels. Of course, increased participation would be accompanied by increased costs.

Senate Bill 2451, introduced in the 94th Congress, would have created a program without a purchase requirement. This proposal would have increased program costs by $1.1 billion in fiscal year 1978 and $1.8 billion in fiscal year 1982. Compared with the existing program, more benefits would have been concentrated on smaller households and those with elderly members.

The income supplementation emphasis could be made complete by cashing-out food stamps -- that is, by replacing the bonus food stamps with an equivalent amount of cash. The House Agriculture Committee bill included a cash-out of bonus stamps for certain elderly, blind, and disabled persons. Although the cash-out proposal is not normally regarded as a food stamp option, it should be considered in the broader discussion of comprehensive welfare restructuring proposals. This option represents one extreme on a continuum from an in-kind welfare program designed to increase the consumption of nutritious food to an unrestricted cash assistance program that provides maximum recipient choice about how the transfer is spent.

Households receiving cash, as opposed to stamps, would use a portion of it to buy food. The limited evidence does not suggest that households receiving cash have any better or worse diets than those receiving food stamps. If recipients value food stamps at less than their bonus value -- which is the actual cost of these transfers to the government -- the benefits in an all-cash system could be less than those of the stamp system, and the recipients would still consider themselves better off. If the food stamp program were cashed-out, administrative problems

TABLE 35. POLICY CRITERIA FOR EVALUATING MAJOR FOOD STAMP PROGRAM ALTERNATIVES

Legislative Alternatives and Estimated Federal Budget Costs	Average Benefits	Food/Income Tradeoff	Distribution of Benefits	Work Incentives	Administrative Simplicity
1. 1978: a/ $5.4 billion 1982: $5.9 billion	Basic guarantee set at level based on consumption pattern of low-income households in 1965-1966, meeting the Recommended Dietary Allowance for a four-person household consisting of a couple aged 20-54, with two children aged 6-8 and 9-11. Guarantee adjusted semi-annually based on food price changes. Guarantees family of four, regardless of sex-age composition, with zero income following benefits: 1978 1982 Monthly $172 $207 Annually $2,064 $2,480 Meal/Person $47 $57	Estimated that on the average approximately $.57 of $1 federal transfer spent on food. Average food stamp household increased food expenditures $40.00 per month (1973), over what normally would have been spent. No evidence of improved nutritional standards through participation. Current proportion of total income spent on stamps, estimated 19.4%.	Estimated 50% of eligible population in any given month participate. Participation highest among lowest income groups, and households receiving other public assistance benefits. Approx. 87% benefits distributed to 78% of participating households below poverty; 22% of benefits to working poor households. Estimated 26% participating poor households removed from poverty.	Low tax rate on earnings (approx. 30%), and low basic guarantee, results in good work incentive by itself. In conjunction with other programs, however, potential work incentives problems. Estimated that 37% of households receiving AFDC income face marginal tax of approx. 75%. Food stamp benefit notch $288 family of four at net break-even income.	Administratively complex, involves coordination of over 3,000 welfare certification offices; issuance of authorization to purchase (ATP) cards by over 14,250 government agencies, post offices, and banks; acceptance of coupons by 270,000 retail and wholesale outlets; redemption by banks, Federal Reserve and special account in Treasury. Complexities of deductible and asset determination result in overissuance and underissuance of proper benefits.
2. Program Refinements S. 3136, Senate passed Reform Act April 8, 1976, 94th Congress, 2nd session 1978: $6.0 billion 1982: $6.5 billion	Maintains current guarantee levels, but increases average transfer to eligible current recipients approximately 19%.	Relative to current program reduces slightly proportion of income required to purchase stamps to 16.3%. Results in decline in food consumption per $1 federal transfer.	Maintains high gross income eligibility standards. Redistributes benefits away from larger size households to smaller more elderly; increases benefits to working poor. Estimated 36% poor households removed from poverty.	Standard deduction lowers implicit tax rate, increases work incentive. Provides special deduction for taxes and special deduction for households with earned income, increased expenditures for work registration. Food stamp benefit notch $618 for family of four at break-even net income.	Simplifies eligibility determination through standardizing deductions, uniform purchase requirement. Maintains current administrative and distribution system.
3. Program Refinements H.R. 13613, House Committee on Agriculture, September 1, 1976. 94th Congress, 2nd session 1978: $5.3 billion 1982: $6.0 billion	Maintains current guarantee levels, but increases average transfer to eligible current recipients by 19%.	Maintains approximately current program food consumption impact, reduces direct food consumption impact for elderly, blind, and disabled.	Increased participation among elderly, blind, and disabled; 91% of benefits go to persons below poverty. Redistributes benefits away from smaller size households to larger size, reduces benefits to working poor. Estimated 25% poor households removed from poverty.	Relative to current program no significant change in work incentives. Provides low implicit tax rate, allowance for taxes, plus $30 for earned income, child care deductions. Food stamp benefit notch $480 at break-even net income.	Increases administrative complexities, requires eligibility determination for blind and disabled, requires increased agency coordination. Continues determination verification mandatory deductions, child care expenditures.

a/ Fiscal years.

TABLE 35. (continued)

Legislative Alternatives and Estimated Budget Costs	Average Benefits	Food/Income Tradeoff	Distribution of Benefits	Work Incentives	Administrative Simplicity
4. Program Refinements Administration regulations enjoined June 18, 1976. 1978: $4.9 billion 1982: $5.7 billion	Maintains current guarantee levels, increases average transfer to households remaining eligible after 90 day retrospective accounting period by approx. 7%.	Maintains approximate current program food consumption impact, approx. 20% of gross income would be used to purchase stamps.	Reduces potential participation of working households, due to 90 day accounting system. Redirects benefits to elderly and smaller households. Estimated 29% of participating poor households removed from poverty.	Standard deduction results in low implicit tax rate. No reduction for taxes or work expenditures.	Simplifies administration, through fixed deduction levels and flat purchase requirement; complicates administration with 90 day accounting system and monthly reporting system.
5. Nutrition Specific S. 1993, Buckley H.R. 8145, Michel as introduced in 94th Congress 1978: $4.9 billion 1982: $5.7 billion	Increases basic benefits to low-cost food plan, approx. 30% higher than current program. Standard family of four remained unchanged for pricing higher food. Average transfer to eligible current recipients increases approximately 24%.	Increases proportion of transfer dollars spent on food by participants. Approximately 30% of gross cash income would be used to purchase stamps.	Concentrates 98% of benefits to households below poverty, increases proportion of benefits going to elderly households and public assistance households, reduces benefits going to working poor households.	Decreases work incentives through non-allowance of work related expenditures, higher average tax rate minor impact on work incentive. Food Stamp benefit notch approximately $940 per family of four at net break-even income.	Simplifies administration through elimination of deductibles. Complicates administration through revised asset tests and monthly reporting system.
6. Elimination-Purchase Requirement S. 2451, Dole-McGovern, H.R. 10467, Heinz H.R. 10441, Hall as introduced in 94th Congress 1978: $6.5 billion 1982: $7.7 billion	Maintains current guarantee levels, increases average transfer to eligible, current recipients by approx. 15%.	Reduces proportion of transfer dollar spent on food; reduces implicit purchase requirement to 17% of gross income. Increases food expenditures for needy households not participating because of purchase requirement.	Increases participation primarily among higher income groups. Expands eligible population. For current recipients redistributes benefits to lower income, smaller more elderly households.	Maintains current work incentives, eliminates benefit notch, allowing normal phase-out and special deductions for work related expenditures.	Simplifies program administration, reduces approximately 40% coupons in circulation. Simplifies administration through uniform deduction and benefit reduction rates.
7. Cash-Out Food Stamp 1978: $7.6 billion 1982: $8.6 billion	Assumes current program guarantee level, and current accounting system. Provides opportunity for households to secure adequate diet; does not guarantee adequate diet.	Increases food expenditures per $1 transfer reduced to 20-30 cents. Marginal propensity to consume from cash less than from coupons.	Increases participation, in higher income groups. Redistribution of total benefits shifts toward higher income groups.	Assuming 30% marginal tax rate, current deduction for work-related expenditures, relative to current program no change in work incentives.	Simplifies program administration; reduces issuance, purchasing and redemption process; provides for easier program integration.

would be reduced because the program could be consolidated with other cash assistance programs.

If the basic guarantee and benefits remained the same under a cashed-out system, and if the current accounting system remained unchanged, the cost of the new system would exceed that of the current program by $2.2 billion in fiscal year 1978 and by $2.7 billion in 1982. The increased costs would be attributed to a nearly doubled rate of participation; those who choose not to participate in the food stamp program may come forward for cash. But most of the new recipients would get lower average benefits than those already in the program.

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